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PRESENTATION ON INDIA – LEGAL AND TAX ASPECTS
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India was economically very insulated from the rest of the world in 1991. Then with Mr. P.V. Narasimha Rao as Prime Minister and Dr. Manmohan Singh as Finance Minister the economy began to open up. Industrial licensing which was earlier very important began to be reduced substantially, and foreign investment was allowed to be received, Indians began to be allowed to invest outside India and the tax rates have come down substantially.

There are still some areas of over-regulation which are a legacy of the past and which continue and there are also certain new areas of activity where there is substantial regulation.

One important law is the Foreign Exchange Management Act, 1999 which is administered primarily by the Reserve Bank of India. The Act is brief, but there are a large number of Regulations and Notifications which amplify and interpret the Act. All foreign investments must be made within the scope of FEMA and of the FDI (Foreign Direct Investment) Policy.

The Income-tax Act provides for the taxation of Indian entities and also of non-Indian entities and gives certain exemptions in respect of certain categories of income. India also has signed Double Tax Avoidance Agreements with a number of countries including countries in Europe. In addition, there are other taxes and duties, e.g. Customs Duty on import of goods, Excise Duty on manufactured goods, VAT on sales, Service Tax on services, Works Contract tax on contracts such as those for construction, Stamp Duty on documents etc.

The Constitution of India was promulgated with effect from 26th January 1950, which is called Republic Day. Under the Constitution, the powers and functions have been divided between the Central Government and the State Governments and the 7th Schedule to the Constitution of India has three lists, the Union List, the State List and the Concurrent List, which set out the items upon which the Central Government and State Government may legislate.

Let us examine step by step the process of investment into India.

When a Company wishes to have a presence in India, some options are to open a Liaison Office, to open a Branch Office or to invest in a Company in India, either as a Joint Venture or as a wholly owned subsidiary.

Liaison Office

A Liaison Office may be set up in India purely as a cost centre which is carrying on liaison activities. All funds have to come in from overseas and no amount of money can be earned in India at all.

In order to set up a Liaison Office, the overseas Company has to apply to the Reserve Bank of India and explain the reasons for which a Liaison Office is considered necessary or desirable. The RBI will consider the application and then, if it falls within the scope of the regulations, the RBI will grant approval. The LO can then be set up. It can take premises on lease for a period of upto five years, it can appoint personnel, it would open a Bank account and it could buy movables such as equipment, motor cars etc. as required. The funds have to come in from overseas for the expenditure of the LO. The accounts have to be audited and a copy of the Audit Report has to be submitted to the RBI every year. The Company should also register with the Registrar of Companies as a foreign Company and would have to file documents and an Annual Return with the Registrar of Companies. It would also have to register under local laws such as the Shops and Establishment Act of the place where it is situated etc. The LO itself will not have to pay income-tax because it does not earn income. However, it will have to register with the Income-tax Department as a tax deducter, because income-tax does have to be deducted at source on payments of salaries, professional fees, rent etc. and Tax Deduction Returns have to be filed regularly. The approval for a Liaison Office is normally given for three years at a time and then application can be made to renew. The LO may empty Indian citizens or even non-Indian citizens. Non-Indian citizens need an appropriate visa to be able to work in India.

A Liaison Office is useful in order to understand the market or in the case of an organization which has customers in India but no manufacturing facility here or which has suppliers in India and in cases where quality of goods needs to be checked regularly etc. before export.

Branch Office

A foreign Company may also set up a Branch Office in India. This again needs prior approval of the RBI. The activities have to be specified. A Branch Office is usually permitted only for activities such as consultancy and for large organizations which are necessarily international in nature such as for airlines, shipping companies etc. A Branch Office would have to get an income-tax Permanent Account Number (PAN) and a Tax Deduction Account Number (TAN). It would also need to register with the Registrar of Companies as a foreign Company and under local laws.

The income-tax presently on a Branch Office is at the rate of 40% plus a surcharge of 2½% thereon plus 3% education cess on the total, i.e. 40% + 1% + 1.23% = 42.23%. The profit after tax can be remitted out of India when required.

Investment in a Company

Investments in a Company are governed by the FDI (Foreign Direct Investment) Policy. The Policy has been liberalized substantially over the last three years, and broadly is as under.

Many activities fall under the "automatic" route. There are some sectors of specific activities and investments which fall under the automatic route but are subject to certain conditions. There are other sectors where there is a ceiling on the percentage that a foreign Company may hold in an Indian Company and there are certain areas of activity in which foreign investment is not permitted at all. These are illustrated hereunder.

Automatic Route

If a foreign Company wishes to invest into the shipping sector or consultancy organization or in most kinds of manufacturing activities, this falls within the automatic route. The overseas Company could invest into an Indian Company i.e. the Indian Company will issue fresh shares. The overseas Company could also incorporate a new Indian Company to become a 100% holder. The overseas Company may also buy existing shares from a person who is already a holder of the share. In the case of a fresh investment under the automatic route, the steps are simply these - that once the Indian Company agrees to accept the investment of the overseas Company, the OC remits money to IC, IC obtains a Foreign Inward Remittance Certificate (FIRC) from the Bank and submits the FIRC to the RBI within 30 days of the receipt of the funds. Then when IC actually passes a resolution and allots the shares to OC, IC has to submit a Return of Allotments to the Registrar of Companies within 30 days and also must within that period of 30 days submit Form FC-GPR to the RBI. This is therefore a post-facto declaration and not a prior approval.

In the case where FC buys existing share from an Indian Shareholder, then FC must have an agreement with the Indian Shareholder and remit funds from overseas to the Indian Shareholder. The Shareholder would then inform IC and would need to get a confirmation from the Bank that the sale price has been received in foreign exchange. Once the Bank gives the confirmation, IC can pass a resolution recognizing the transfer from the Indian holder to FC.

Sectors in which there are regulations

There are certain sectors which fall under the automatic route, but which nevertheless have regulations. India discouraged foreign Companies from engaging in the real estate sector in the past. It was only with Press Note No.2 of 2005 that the Policy for investment by an overseas entity into the real estate sector became attractive.

1. The policy on real estate investment therefore is that an OC can acquire even 100% of an Indian Company's shares.
2. If OC gets 100% of IC's share, then the minimum investment that has to be brought in by OC is US$ 10 million.
3. If OC holds less than 100% of IC's shares, i.e. if it is a Joint Venture, then OC has to bring in a minimum of US$ 5 million.
4. This minimum amount of US$ 10 million or US$ 5 million, as the case may be, has to be brought in within six months of the date of the first investment by OC.
5. There is a lock-in period and OC cannot transfer its shares for a minimum period of three years.
6. The projects undertaken by IC have to be such that there is a minimum construction of 50,000 sq.mtrs. in each project or in case of development of serviced plots, the land area has to be a minimum of 25 acres.
7. IC cannot carry on the business merely of buying and selling Land. Sectors in which there are ceilings on holdings

For example, if OC wishes to invest in an Indian Company doing insurance business, then it is permitted to hold only upto 26% under the Automotive Route but is subject to Licensing by the Insurance Regulatory and Development Authority. Investment in excess of this percentage is subject to approval by the FIPB (Foreign Investment Promotion Board), which is located in New Delhi. The steps then would be that an application has to be made to the FIPB, explaining the proposed investment. If FIPB approves, then OC may invest into IC. Thereafter, a declaration will have to be made to the RBI which actually administers the investment after the approval in principle has been granted by the FIPB.

Areas in which no foreign investment is permitted

Foreign investment is not permitted in the fields of agriculture,

atomic energy etc. A copy of the Policy is attached herewith.

Foreign Institutional Investors

The investments mentioned above are classified as Foreign Direct Investment as the money comes directly into the Indian Company. If however, an overseas entity wishes to buy shares on a Stock Exchange, then this can only be done through the FII (Foreign Institutional Investor) route. It is only an established FII that would get permission to be an investor but the FII can have sub-accounts. Approval for an FII is to be obtained from SEBI (Securities and Exchange Board of India).

GDRs and ADRs

Indian Companies are permitted to issue Global Depository Receipts and American Depository Receipts.

Overseas Direct Investment

Indian Companies are permitted to invest in Companies outside India. Under the automatic route the investment can be unto 4 times the net worth of the Indian Company, and the investment should be in the same core sector. More than that can be remitted out with the permission of the RBI.

Taxation

India had very high Income-tax rates, Estate Duty and annual Wealth-tax etc. Estate duty has been removed since a number of years and the income-tax rates are now as under:-
For individuals, a maximum of 30.9%, for Companies a flat 33.99%. For foreign Companies, the rate is 42.23%.

At present the law is that if a Company wishes to declare a dividend, it must pay a Dividend Distribution Tax which is 16.995% of the dividend declared. The recipient of the dividend then does not have to pay any income-tax. In the event of any entity making a Long Term Capital Gain, the normal rate of tax on such gain is 20% + surcharge + education cess, which in the case of an individual goes upto 20.60% and in the case of a Company, it would be 22.66%.

Likewise, a business in an SEZ (Special Economic Zone) also gets certain tax benefits.

Section 115A provides for concessional rate of tax on royalties.

India also has Double Tax Avoidance Agreements with many countries including Belgium. There are certain exemptions given under the treaties, and Indian law is very clear that it is a taxpayer's choice to opt either for the regular law or treaty, whichever gives the maximum benefit.

Transfer Pricing

If an entity in India has transactions with an associated enterprise outside India, then an Audit Report has to be furnished in respect of all such transactions and these have to be justified to ensure that they are on arms length basis. If they are not on arms length basis, then the Income-tax Department has the right to make additions and to bring to tax what the Department feels is the correct income.

The definition of "associated enterprise" is very wide and one has to be very careful.

Tax deduction at source is required for all payments to non-residents and in many circumstances.

Advance Rulings

A foreign enterprise can apply for and get an Advance Ruling on tax issues.

Conclusion

Indian has a comprehensive legal system, but at present the Courts are overburdened and litigation takes many years. The Government has recently however announced that it intends to set up 5,000 additional Courts and tribunals to bring the litigation period down.