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Foreign investment in India and its taxation

- Vijay Sambamurthi & Daksha Baxi***

Introduction

Over the past decade, India has migrated from a closed economy and is slowly maturing into a liberalized one. Although the Central government has changed five times since 1996, each government voted to power at the Centre has supported and hastened the liberalization process - an encouraging sign to foreign investors. Recently, several reforms have been introduced in relation to the foreign investment regulatory regime. Furthermore, the Insurance Regulatory Development Authority Act has been enacted, which is a landmark in the history of privatization of key sectors of the economy. The introduction of these changes has resulted in an increase in foreign investment into India. The following table gives the inflow of foreign direct investment into India for each year commencing 1993.

Year	Inflow of FDI (millions in USD)*
1993	397.10
1994	730.90
1995	856.45
1996	2308.66
1997	3650
1998	2964.45
1999	3748.45
2000**	1312.90

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*   Foreign exchange conversion rate used : $1 = Rs. 45
* * for the first four months of year 2000
Source : Ministry of Commerce and Industry

This article examines, in general, the foreign investment regulatory regime in India and the taxation regime corresponding to each investment route of foreign investment.

Foreign investment in India

The rather draconian Foreign Exchange Regulation Act, 1973 ("**FERA**"), which hitherto governed foreign investment into India, has now been repealed and replaced by the less stringent Foreign Exchange Management Act, 1999 ("**FEMA**"), which came into effect from June 1, 2000.

According to the FEMA, the Reserve Bank of India ("**RBI**") has the power to issue Regulations and the Central Government has the power to make Rules governing the matters covered by the FEMA, including foreign investment into India. Accordingly, the RBI has issued several Regulations, including the Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2000 (the "**Regulations**") setting down the norms for foreign investment into India.

As per the amended foreign investment regime now in place in India, foreign investors can invest in India through any of the different routes set forth below:

1. Foreign Direct Investment ("**FDI**")
2. Investment in export trading companies
3. Investment by Non-resident Indians ("**NRI**") and Overseas Corporate Bodies (owned to the extent of at least 60% by NRIs)
4. Offshore fund investment
5. Issue of American Depositary Receipts/Global Depositary Receipts by Indian Companies.

FDI route

Automatic Route

The Regulations contain the Foreign Direct Investment Scheme, which set down the criteria for eligibility for the automatic route. No prior permission of the RBI is required for investments by foreign investors under the automatic route as long as all the following conditions are satisfied:

1. The investment should not be in areas where foreign investment is prohibited such as broadcasting, real estate, *etc.*; See **Annexure I** hereto.

2. The investment, if made in certain sectors, should be within the sectoral equity caps prescribed for those sectors; See **Annexure II** hereto.

3. The investment should be by way of issue of fresh equity and not by way of transfer of shares from existing shareholders to such foreign investor;

4. The foreign investor concerned should not already have a previous tie-up or venture in India in the same or allied area of business in which the proposed investment is to be made;

5. The investment should not be in an activity/area which requires an industrial licence.

6. The foreign investment, if made in companies in Small Scale Industries, shall not exceed 24 % of the equity of such companies.

While there is no need for prior approval of the RBI under the automatic route, within 30 days of the receipt of the consideration from the foreign investor, the Indian company is required to file a report with the RBI giving certain details and within 30 days from the date of the issue of shares to the foreign investor, another declaration in the prescribed form[1] is required to be filed with the RBI. To reiterate, the procedure detailed in this paragraph is only with respect to FDI which satisfies all requirements of eligibility for automatic approval as set out above and does not apply to the transfer of shares from an existing shareholder to non-residents.

Non-automatic approval

Special approval of the Foreign Investment Promotion Board ("**FIPB**") or the Cabinet Committee on Foreign Investment ("**CCFI**") is required for foreign investment which does not qualify for the automatic approval route. Such approval is granted on a case-by-case basis. This process usually takes about 30 days. The FIPB is under the domain of the Ministry of Commerce and Industry and it has the power to accept or reject proposals for investments up to INR 6 billion. The FIPB sends its recommendations to the Minister of Commerce and Industry for final approval. The approval of the Government of India to an application made to the FIPB is communicated to the applicant by the Secretariat of Industrial Assistance ("**SIA**"), which is also a body under the Ministry of Commerce and

[1] Form FC – GPR

Industry, the primary function of which is to provide entrepreneurial assistance to investors.

While the Ministry of Commerce and Industry will decide each proposal on its merits, it will primarily look at the quantum of investment, employment generation, new technology, export commitment and other possible benefits to India as the main criteria for deciding foreign investment applications. During February 1998, the RBI issued a notification[2] stating that once the foreign investor has obtained the approval of the FIPB it would not be required to approach the RBI before the Indian companies issue shares in its favor. However, within 30 days of the issue of shares, the company issuing the shares would be required to file a declaration in the prescribed form[3] with the RBI. This process may be followed only in respect of fresh issue of shares by an Indian company and does not apply to transfer of shares form residents to non-residents.

All mega projects involving more than INR 6 billion of overseas investment will have to be submitted to the CCFI, other than those eligible for automatic approval. Once the CCFI approves the proposal, the final approval would be issued by the Ministry of Commerce and Industry.

Projects involving the public sector or activities in sensitive areas will also need the approval of the Cabinet Committee on Economic Affairs ("**CCEA**").

Investment in export trading companies

Automatic approval is available for foreign investment up to 51% (equity) in the case of new trading companies primarily engaged in export activities. However, the dividends from such investments will be allowed to be repatriated only after such companies register themselves with the Ministry of Commerce and Industry (office of the Director General of Foreign Trade) as registered exporters or importers.

To be eligible for certification by the Ministry of Commerce and Industry, the average net foreign exchange earned relating to eligible exports during the preceding three licensing years, in INR, must be:[4]

- INR 120 million for Export Houses;
- INR 620 million for Trading Houses;

[2] Notification No. F.E.R.A. 182/98 RB dated February 10, 1998, issued by the RBI.
[3] Form ISD.
[4] *Source*: Chapter XII, 137. Export Performance Level (For 1999-2000), Export and Import Policy, Ministry of Commerce, Government of India.

- INR 3.12 billion for Star Trading Houses; and
- INR 9.37 billion for Super Star Trading Houses.

In the alternative, the net foreign exchange earned relating to eligible exports during the preceding licensing year, in INR, must be:

- INR 180 million for Export Houses;
- INR 900 million for Trading Houses;
- INR 4.50 billion for Star Trading Houses; and
- INR 13.50 billion for Super Star Trading Houses.

Investment by Non-resident Indians ("NRI") and overseas corporate bodies (owned to the extent of at least 60% by NRIs)

There are two investment options available to NRIs and OCBs, which are explained below:

1. *FDI Investment on a non-repatriation basis*

With a view to attracting foreign investment from Non-resident Indians ("**NRIs**") and Overseas Corporate Bodies ("**OCBs**") owned to the extent of 60% or more by NRIs, the RBI is providing them with special incentives. NRIs and OCBs are allowed to invest in shares or convertible debentures issued by Indian companies either by public issue or by private placement, on a non-repatriation basis without any limit, subject to the following conditions[5]:

- NRI / OCB investment in shares or convertible debentures under this scheme may not be made in certain Indian companies such as companies that are engaged in agricultural / plantation activities or real estate business or construction of farm houses or dealing in Transferable Development Rights.

- The consideration for the purchase of the shares or convertible debentures should be made from inward remittance through normal banking channels from abroad or out of funds held in NRE / FCNR /NRO / NRSR / NRNR[6] accounts maintained with an authorized bank in India.

[5] Schedule 4 to the Foreign Exchange Management (Issue or Transfer of Security by a Person Resident Outside India) Regulations, 2000.

[6] These are dollar accounts of non-resident in Indian banks.

- The sale proceeds or maturity proceeds of the shares or convertible debentures purchased by NRIs/ OCBs under this route may not be repatriated outside India and shall be credited only to NRSR or NRO account.

2. *Portfolio investment scheme*[7].

NRIs and OCBs are allowed to purchase the shares or debentures of an Indian listed company directly from the secondary market under the portfolio investment scheme, either on a repatriation or on a non-repatriation basis provided that the aggregate of the NRI and OCB investment does not exceed 10% of the total paid-up share capital of the Indian company. However, this aggregate ceiling may be raised to 24 % if a special resolution to that effect is passed by the shareholders of the Indian company concerned[8]. This is further subject to the condition that the holding of each NRI/OCB should not exceed 5% of the paid-up capital of the company[9]. The investment under the portfolio scheme by NRIs and OCBs is further subject to the following conditions :

- The NRI /OCB designates a branch of an authorized bank for routing the transactions relating to purchase and sale of shares/convertible debentures under this scheme, and routes all such transactions only through such branch;

- The NRI / OCB takes delivery of the shares purchased and gives delivery of the shares sold;

- Payment for the purchase of shares/convertible debentures is made by inward remittance in foreign exchange through normal banking channels or out of funds held in India in NRE / FCNR accounts if the shares are purchased on repatriation basis and by inward remittance or out of funds held in NRE /FCNR / NRO /NRNR/NRSR account of the NRI / OCB if the shares are purchased on a non-repatriation basis .

Although the investment/principal amount of deposits/loans made/held by NRI/OCBs on non-repatriation basis under these schemes continue to be non-repatriable, the RBI[10] permits full repatriation of net income/interest *etc.* earned (*i.e.* after payment of tax) on such investments/deposits/loans.

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[7] Schedule 3 to the Foreign Exchange Management (Issue or Transfer of Security by a Person Resident Outside India) Regulations, 2000.

[8] Proviso to Paragraph 1 (iv) of Schedule 3 to the Foreign Exchange Management (Issue or Transfer of Security by a Person Resident Outside India) Regulations, 2000.

[9] Paragraph 1 (1(ii) and 1(iii) of Schedule 3 to the Foreign Exchange Management (Issue or Transfer of Security by a Person Resident Outside India) Regulations, 2000.

[10] Ref: AD/MA-15/96 dated September 12, 1996.

3. FDI by NRIs and OCBs

Apart from the above two routes, NRIs and OCBs can also make investments through the FDI route explained above if they satisfy all the conditions prescribed therein.

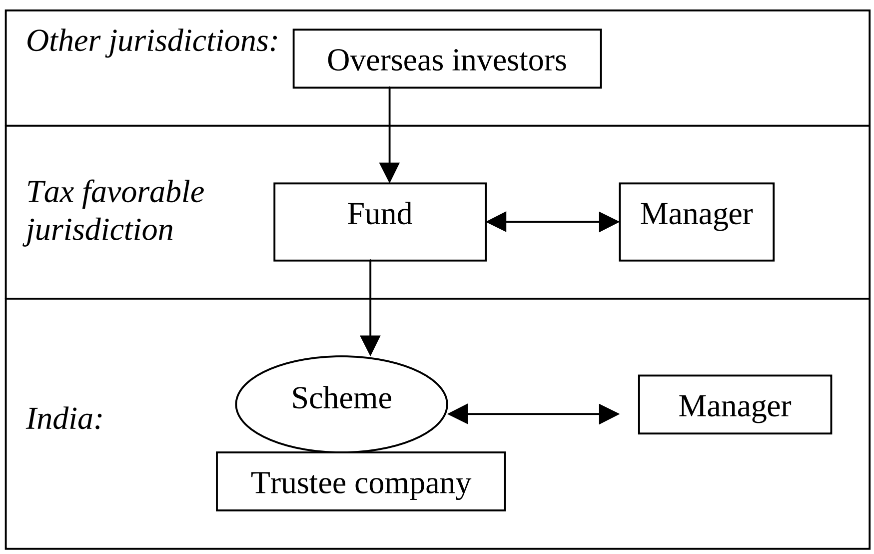
Offshore Fund Investment

The main routes available for offshore funds investing in Indian companies are:

- investment in the scheme set up by an Indian mutual fund;
- investment as a Foreign Institutional Investor ("**FII**")[11]; and
- venture capital investment route[12].

1. Investment in a Scheme set up by an Indian Mutual Fund

A typical structuring chart of an investment by an offshore fund in a scheme of an Indian mutual fund is depicted below:



[11] It is also possible for an offshore fund to register as an FII and invest directly in Indian portfolio companies. This investment route is discussed later in this chapter.

[12] This investment route is discussed later in this chapter.

Under this route, an Indian mutual fund sets up a scheme (a kind of trust) all the units of which are purchased by the offshore fund. The scheme invests in Indian securities in accordance with the investment objectives of the offshore fund and earns interest, dividends, and capital gains which are distributed to the offshore fund which in turn would distribute the same to its investors. Very often, such income is not distributed but is reinvested. Upon the sale or redemption of the units, the offshore fund earns capital gains. It is generally advisable to locate the offshore fund in a tax-favorable jurisdiction, like Mauritius, so as to take advantage of certain concessional tax benefits and to provide tax neutrality to global investors.

2. Foreign institutional investors

Portfolio Investment

Foreign Institutional Investors ("**FIIs**") are regulated by the Securities and Exchange Board of India (Foreign Institutional Investors) Regulations, 1995 (the "**FII Regulations**"), issued by the SEBI in November 1995. Entities seeking FII status are required to apply for registration to the SEBI and also obtain the permission of the RBI for permission to invest in Indian securities. However, the applications for carrying on activities as a FII are given a single-window clearance and therefore, there is no requirement for two separate applications to the SEBI and RBI. The said approval will be valid for an initial period of five years, on the expiry of which it may be renewed for a further period of five years[13].

Once registered with the SEBI, FIIs can invest in shares and convertible debentures of companies which are listed or unlisted or to be listed in India and dated government securities. They can also invest in the schemes floated by domestic mutual funds and derivatives traded on a recognized stock exchange. Such investments are permitted on repatriable basis, without any lock-in period. In addition, any registered FII willing to make 100% investments in debt securities will be permitted to do so, subject to specific approval from the SEBI as a separate category of FIIs or sub-accounts[14].

The aggregate holding of all FIIs (not including foreign investment by an FII under the FDI route set forth above) cannot exceed 24% of the issued share capital of any Indian company. This 24% limit may be increased to 40%, provided that the shareholders of the Indian company pass a special resolution to this effect. Furthermore, the holding of a

[13] Regulation 8 of the SEBI (Foreign Institutional Investors) Regulations, 1995.
[14] "Subaccounts" include those institutions, established or incorporated outside India and those funds, or portfolios, established outside India, whether incorporated or not, on whose behalf investments are proposed to be made in India by an FII.

single FII in any Indian company cannot exceed 10% of such company's total issued share capital[15].

FDI Route for FIIs

FIIs may also, apart from the portfolio investment route, invest into Indian companies through the FDI route and would be subject to all the regulations relating to FDI as explained above.

3. Venture capital investment route

An active segment for foreign investors is "private equity funds". There are currently no regulatory guidelines for foreign venture capital funds. However, the SEBI is likely to introduce regulations governing foreign venture capital funds. Therefore, they invest in Indian companies under the FDI regime and sometimes also under the FII route. They could also invest through domestic venture capital funds in India. The domestic venture capital vehicle may be organized in the form of a trust or a company. However, the foreign investor would have to obtain the prior approval of the FIPB to invest in Indian venture capital funds.

In India, venture capital funds (organized in the form of a trust or a company) are governed primarily by government guidelines for VCFs and the accompanying tax regime if the tax benefits available to VCFs are to be availed of, and the Securities and Exchange Board of India Venture Capital Regulations, 1996. [16].

Issue of American Depositary Receipts/Global Depositary Receipts

Indian companies can attract foreign investment pursuant to the American Depositary Receipt ("**ADR**")/Global Depositary Receipt ("**GDR**") and Foreign Currency Convertible Bonds ("**FCCBs**") issue route. Currently, subject to the satisfaction of certain conditions, Indian companies pursuing an ADR/GDR issue are not required to obtain the prior approvals of either the Ministry of Finance or the RBI under the Issue of Foreign Currency Convertible Bonds and Ordinary Shares (Through Depository Receipt Mechanism) Scheme, 1993 (the "**Scheme**"), subsequent to the amendment to the Scheme on January 19, 2000. However this relaxation does not extend to Indian companies issuing FCCBs. The foreign investment in an Indian company made through the ADR/GDR route is considered as FDI for the purposes of the Foreign Exchange Management (Transfer or

[15] Regulation 15(5) of the SEBI (Foreign Institutional Investors) Regulations, 1995.
[16] The SEBI is proposing to review the SEBI Venture Capital Regulations, 1996, which are expected to be announced in the near future.

Issue of Security by a Person Resident Outside India) Regulations, 2000 and hence if the Indian issuing company falls within the list of industries in which foreign investment is prohibited, or if the foreign investment pursuant to the ADR/GDR issue exceeds the percentage limit stipulated in the Regulations, the Indian company will be required to obtain the prior approval of the FIPB. Once the approval of the FIPB, if so required, has been obtained, the issuing company would be permitted to issue its underlying shares through the ADR/GDR route. Subsequent to the issue of the ADRs/GDRs, the Indian company is required to comply with certain post-closing disclosure requirements and make filings with the RBI and the Ministry of Finance in the prescribed form.

Currently, there is no two-way fungibility. This means that once the ADRs/GDRs have been redeemed into the underlying shares, they cannot be reconverted into ADRs/GDRs.

General Taxation

The Income Tax Act, 1961 ("**ITA**") is amended every year by the Finance Act. The Finance Act, 2000 has made substantial changes to the existing provisions of the ITA.

Domestic companies continue to be taxed at the rate of 38.5% (including a 10% surcharge) and the foreign companies at the rate of 48%. No surcharge is payable by foreign companies. Surcharge on income tax is payable by individuals, both resident and non-resident, at the following slab rates :

Annual income less than Rs.60,000 : No surcharge

Annual income in the range of Rs.60,001 – Rs.150,000 : 10 %

Annual income above Rs.150,000 : 15 %

For partnership firms effective tax rate continues to be 38.5%[17].

Minimum Alternative Tax

The new provisions have reduced Minimum Alternate Tax ("**MAT**")[18] applicable to domestic companies and branches of foreign companies from 10.5% to 7.5% (plus surcharge of 10% bringing the effective tax rate to 8.25%) on the book profits[19].

[17] All these tax rates are set out in Schedule I to the Finance Act, 2000.
[18] See Section 115JB of the ITA.
[19] Book profits for the purpose of MAT means profits as shown in financial statements presented to the shareholders

Distribution Tax

The distribution tax payable by the domestic companies under section 115-O of the Income Tax Act, 1961 on dividends has been increased from 10% to 20% (plus a surcharge of 10%, bringing the effective tax rate to 22 %). However, the dividends in the hands of shareholders continue to remain tax exempt. Tax payable by Mutual funds or Unit Trust of India (UTI) on distribution of income has been increased from 10% to 20%. This would be further subject to a surcharge of 10%. However, the open-ended equity oriented funds will continue to get the benefit of exemption from such tax for the next two years.

Venture Capital Investments

The provisions relating to Venture Capitalists (**VCs**)[20] have been overhauled. Now, the Securities and Exchange Board of India (**SEBI**), has been made a single point nodal agency for regulating offshore and domestic VCs. A VC can be set up either as a trust (**VCF**) or as a company (**VCC**) in India. The VCs registered with SEBI would now enjoy a complete '*pass through*' status for tax purposes. This means that there will be no tax on the VCs on any income earned from investments in unlisted securities. Also there would be no tax payable by the VCs upon distribution of income to the investors. The income distributed by the funds will be taxed in the hands of the investors at applicable rates, depending upon the nature of income.

Employees Stock Option Plans (ESOPs)

The two-point tax incidence on ESOPs has been finally removed. The employees of a company granting options will not be taxed on the perquisite value (being the difference between the market value and offer price of the employer company's shares) at the time of exercise of stock options on the date of exercise. The ESOP would now be taxed only at the time of sale of the shares acquired under ESOP as capital gains. The difference between the sale price and the offer price would be taxed as capital gains (long term or short term depending on the period of holding of the shares). Further, if the employee gifts the shares obtained upon exercise of options at any time, it will trigger capital gains tax implication.

Export Incentives:

Till the last year, 50 % to 100% of the remuneration received in foreign exchange and profits from exports of goods, software, projects, film software, royalties were exempt from

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[20] See Sections 10 (23FB) and 115U of the ITA.

taxation[21]. This exemption is now being withdrawn in a phased manner over 5 years. 20% of export profits would be subjected to tax at normal corporate tax rates in the year 2000-2001, 40% in the year 2001-2002, and so on till full 100% would be brought to tax in the year 2004-2005.

Units set up in Free Trade Zones (FTZs) and Technology Parks and hundred per cent Export-oriented undertakings (EOUs)[22]:

Units set up in FTZs or Hardware and Software Technology parks and 100% EOUs enjoyed a tax holiday for ten years from the year in which the units started commercial production. Now a sunset clause for this tax holiday has been introduced whereby this exemption will end in the year 2009. Thus, the units set up till March 2000 will have concessions for 10 years, those set up in 2000-2001 for nine years and so on. 25% of the profits and gains derived from domestic sales shall be deemed to be profits and gains derived from export of such articles or things or computer software which shall fall within the purview of these provisions. Further, a new provision has been introduced to provide that from the year in which there is a change in the beneficial ownership of the undertaking, the benefit of this tax holiday will be lost. In case of companies, if there is a change in the ownership of more than 49% share capital in any year subsequent to the year in which the unit was set up, the beneficial ownership of the undertaking would be presumed to have changed and accordingly the tax benefit would no longer be available to that company in respect of such an undertaking.

Advance Rulings:

Prior to the Finance Act, 2000, only non-residents were allowed to apply for advance rulings. Now Indian residents can seek advance ruling if they are undertaking transactions with non-residents[23]. Further, besides a question of law or fact, certain residents can now seek an advance ruling on computation of total income pending before any income tax authority or appellate authority.

Conclusion

With more and more sectors being opened up and with the sectoral equity caps being enhanced, the Indian market continues to progress stolidly towards a globalized economy. The commitment to achieve capital account convertibility on the rupee as expressed in the FEMA is also a very positive sign. The recent spate of reforms brought in and given effect

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[21] This exemption is under Section 80 HHC of the ITA.
[22] See new Sections 10A and 10B of the ITA.
[23] See Section 245Q of the ITA.

to by the FEMA have been received with enthusiasm from the international investment community. However, there are still expectations of liberalization in other sectors where foreign investment is still either prohibited or regulated strictly, like for example, real estate, broadcasting, agricultural and plantation business etc. As the wheel of the globalized economy keeps turning, one could reasonably expect these sectors to be liberalized as well in the future.

Though the Indian Government has consistently been showing its commitment to the process of liberalization and has also taken steps to cut down a lot of the much-dreaded red tape, the approval processes need to become more expedient and investor-friendly. There are still several cases where the FIPB delays the grant of its approval beyond reasonable time frames, which might lead to frustration for the investors. Hopefully, the Government will succeed in eliminating such cases of regulatory delays and provide a healthy investment climate coupled with an expeditious bureaucracy that encourages more inflow of foreign investment into India.