

CROSS BORDER TRANSACTIONS AND INVESTMENTS



Committee on International Taxation
The Institute of Chartered Accountants of India
(Set up by an Act of Parliament)
New Delhi

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Foreword

The Interim Budget Speech of the Hon'ble Finance Minister for the Financial Year 2019-20 had a clear mention that due to a stable and predictable regulatory regime, growing economy and strong fundamentals, India has attracted massive amount of Foreign Direct Investment (FDI) during the last 5 years - as much as \$239 billion. This period has also witnessed a rapid liberalisation of the FDI policy, allowing most of the FDI to come through the automatic route.

India is now one of the front runners among the developing countries for attracting FDI. Its strong and stable growth and commitment to institutional reforms has made it one of the most attractive destinations for FDI. Cross border flow of capital, human resource and technology has increased manifold over the period of time, which in turn, has led to various tax challenges across the globe.

Having regard to the same, the Committee on International Taxation of the Institute of Chartered Accountants of India (ICAI) has taken efforts to come out with this new publication on 'Cross border Investments and Transactions'.

I would like to express my gratitude to CA. Nihar N. Jambusaria, Chairman and CA. Pramod Jain, Vice-Chairman, Committee on International Taxation of ICAI for the initiative taken to come out with this new publication.

I am sure that this publication would be of great use for our members practising in the area of International Taxation.

Best Wishes

Place: New Delhi
Date : 20.06.2019

CA. Prafulla P. Chhajed
President, ICAI

Preface

The laws governing cross border transactions and investments have become a subject of wide comprehension, sufficient to justify a work under the title. Keeping in mind the dynamic tax and regulatory environment in India, this publication has been prepared to provide an insight into the tax and regulatory considerations having an impact on cross border transactions.

Considering the significance of the subject, the Committee on International Taxation considered bringing out this publication. This Publication consists of chapters dealing with various aspects such as inbound and outbound investment, exports, imports, critical transfer pricing and cross border mergers with an aim to aid professionals in identifying the key issues involved in cross border transactions and investments.

I am sincerely thankful to CA. Prafulla P. Chhajed, President, ICAI and CA. Atul K. Gupta, Vice-President, ICAI for being guiding force behind all initiatives being taken by the Committee.

I am appreciative of the time and efforts put in by CA. Amrish Shah, who authored this publication. He was actively supported by CA. Mehul Modi, CA. Jatin Kanabar, CA. Rohinton Sidhwa, CA. Shuchi Ray, Mr. Anoop Kalavath, CA. Amit Pahwa, CA. Kaushik Saranjame, Mr. Sameer Maniar, CA. Mansi Mehta, CA. Manish Jain, CA. Amit Dattani Mr. Abdullah Faikh, CA. Paras Modi, CA. Vipul Verma, CA Urvi Jagirdar, CA. Maitri Vikam, CA. Manoj Kumar, CA. Sonal Maheshwari, Mr. Yash Mehta, Mr. Jesal Bakhai and Mr. Ankan Maiti. Without their focussed efforts this publication would not have seen the light of the day.

I am thankful to CA. Sanjiv K. Chaudhary, Past Central Council member for undertaking the task of review of the said publication. I also appreciate the efforts of CA. Mrugen Trivedi, CA. Palav Shah, CA. Naziya Siddiqui, Mr. Mahendra Iyer, CA. Anuradha Rathod, CA. Alpesh Shete, CA. Shailendra Dhole, CA. Ashish Choudhari and Mr. Sunil Chawan for actively assisting CA. Sanjiv K. Chaudhary in the review of this publication.

I am also grateful for the unstinted support provided by Vice-Chairman CA. Pramod K. Jain and other members (including co-opted members) and special invitees of the Committee on International Taxation; CA. Tarun Jamnadas Ghia; CA. Nandkishore Hegde ; CA. Chandrashekhar Vasant Chitale; CA. Aniket Sunil Talati; CA. Dayaniwas Sharma; CA. G. Sekar;

CA. Pramod Kumar Boob; CA. Satish Kumar Gupta; CA. Hans Raj Chugh ;Shri Sunil Kanoria; Shri Chandra Wadhwa ;Dr. Ravi Gupta ; CA.T.P.Ostwal; CA. Padam Chand Khincha; CA. Yogesh Thar; CA. Ameya Kunte and CA. Vijay Gupta.

Last, but not the least, I appreciate the efforts made by CA. Mukta Kathuria Verma, Secretary, Committee on International Taxation and CA. Dhiraj Shrivastav, Project Associate for co-ordinating the project and for rendering secretarial assistance.

Place: New Delhi

Date: 18.06.2019

CA. Nihar N. Jambusaria

Chairman,

Committee on International Taxation, ICAI

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Chapter 1

Cross Border Transactions and Investments – An Introduction

1. Introduction

Foreign Direct investment plays an important role in the development of countries, especially for developing countries like India, where development and growth requires a high amount of capital investment. Foreign capital is seen as a way of filling in the gap between domestic savings and investment. One of the key factors for attracting foreign capital is the tax and regulatory environment, which has a direct bearing on the investment climate in the country.

Prior to 1991, India was a closed economy. The erstwhile Foreign Exchange (Regulation) Act, 1973 which governed foreign exchange transactions was a restrictive legislation which hindered the growth and modernization of Indian industries and was more so an approval regime for various foreign exchange transactions. It emphasized on “exchange control” rather than “exchange management”.

With a long-term perspective to boost the Indian economy by achieving higher growth rates and enhancing the international competitiveness of the Indian manufacturers, reforms were made to remove rigidity in various segments of Indian economy. These reforms opened up the country to foreign investment and came to be known as New Economic Policy i.e. Liberalisation, Privatisation and Globalisation Policy (“LPG Policy”). Following this, in 1999, the Foreign Exchange Management Act (“FEMA”) was introduced to replace the Foreign Exchange (Regulation) Act, 1973. FEMA placed emphasis on exchange management instead of exchange control.

Investment climate in India has improved considerably since the opening up of the economy in 1991. Today, India is in the league of the top-100 countries in the World Bank’s rankings on ease of doing business recording a jump of 23 positions against its rank of 100 in 2017¹. It is currently placed at

¹ PIB Press Release dated 31 October 2018

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77th rank out of in 190 countries in the World Bank's rankings on ease of doing business. This is largely attributed to ease in FDI norms across sectors of the economy. The Reserve Bank of India ("RBI") has rationalized Foreign exchange norms from time to time while maintaining a mechanism for effective monitoring of foreign exchange transactions carried out for facilitating cross-border flow of funds.

The Finance Minister of India in his Interim Budget Speech for the FY 2019-20 has mentioned that due to a stable and predictable regulatory regime, growing economy and strong fundamentals, India has attracted massive amount of Foreign Direct Investment (FDI) during the last 5 years - as much as \$239 billion. The previous two decades have witnessed a rapid liberalisation of the FDI policy, allowing most of the FDI to come through the automatic route. The largest chunk of current FDI inflows in India are through the automatic route.

India is now one of the front runners among the developing countries for attracting FDI. Its strong and stable growth and commitment to institutional reforms has made it one of the most attractive destinations for FDI. The FDI inflows in India stood at INR 2,888.89 billion in the financial year 2017-18. Mauritius and Singapore have been the largest source of FDI, standing at 34% and 18% of the total FDI inflows in India².

In line with global development, the Indian Government has also modified its approach and regulations that affect cross-border transactions:

2. Abolition of the Foreign Investment and Promotion Board (FIPB)

High inflow of funds through the automatic route became a critical factor for FIPB to be phased out. The FIPB was abolished in June 2017. In the post FIPB regime, major responsibilities of the FIPB such as granting government approval for foreign investment under the extant FDI Policy and FDI Regulations were entrusted to the concerned Administrative Ministries / Departments by laying down a Standard Operating Procedure (SOP) with detailed guidelines to guide the Administrative Ministries / Departments for processing of FDI proposals. The SOP and the guidelines have been instrumental in ensuring consistency of treatment and uniformity of approach across sectors.

² Data gathered from the website of the Department of Industrial Policy and Promotion (DIPP)

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The Department for Promotion of Industry and Internal Trade (“DPIIT”) (Erstwhile “Department of Industrial Policy & Promotion” or “DIPP”) has been given the responsibility to grant approval on behalf of the government for issue of equity shares under the FDI policy under the approval route for import of capital goods / those relating to issue of equity shares for pre-incorporation expenses, for certain categories of FDI proposals viz., those relating to Non Resident Indians (NRI)/ Export Oriented Unit's (EOU's) requiring government approval after obtaining necessary input from other Ministries as may be required.

3. FEMA - Cross Border Merger Regulations

In March 2018, the RBI has notified the Foreign Exchange Management (Cross Border Merger) Regulations, 2018. The notification of Cross Border Merger Regulations is as a significant move as it would provide the much needed impetus to spur FDI in the country. These regulations involve reformulation of the pre-existing laws and enactment of certain new key provisions.

These Regulations have broadly been demarcated under two heads namely, inbound and outbound mergers, specifying the regulatory regime for such mergers. Whilst the inclusion of the deemed prior approval of RBI on fulfilment of conditions of the Regulations will expedite the process for all cross border mergers and has strengthened the government initiative of ease of doing business in India, there is a need to modify the tax laws in line with the cross border merger changes for the same to be operational on the ground.

4. OECD’s BEPS project and implementation of the MLI framework

Base erosion and profit shifting (BEPS) refers to corporate tax planning strategies used by multinationals to "shift" “profits” from higher-tax jurisdictions to lower-tax jurisdictions, thus "eroding" the "tax base" of the higher-tax jurisdictions. The aim of the OECD’s BEPS project was to harmonize taxation of profits across countries so that governments can collect their due taxes. The project culminated with the creation of the Multilateral Instrument (MLI) framework, which is an overarching instrument that modifies bilateral tax treaties signed between various countries in a manner that is compliant with the aims of the BEPS project. Once the MLI becomes effective with respect to India’s tax treaties, possibly from April

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2020, the bilateral tax treaties between India and various countries will stand modified to the extent prescribed in the MLI depending on the permissible elections made by India as well its treaty partners on the exact manner of application of the MLI. This would have an impact on the tax consequences of cross border transactions. However, United States of America has generally kept itself away from the OECD BEPS project.

5. Tightening of the inbound investment route from certain favourable jurisdictions

For decades, inbound investment into India largely was routed by multinationals (headquartered in US, Europe etc) through countries such as Mauritius, Singapore, Cyprus, Netherlands, largely on account of the favourable tax treaties that these countries have signed with India that gave a capital gains tax exemption in India to the investor upon exiting the Indian investment. For almost the last two decades, the Indian tax authorities had been scrutinizing the exemption claims made by investors under such treaty provisions to assess whether such claims are valid or amount to “treaty shopping” which it regarded as tax avoidance. Some headway was made in 2005 when the India-Singapore tax treaty was amended to include certain codified substance requirements for the Singapore investor in order to avail such exemptions in India. The Mauritius and Cyprus routes remained unaltered. Only a decade after that in April 2017 the exemption was taken away for future investments for these countries, with the past investments being grandfathered. Recently, media reports have suggested that certain tax treaties such as Netherlands that still give a capital gains tax exemption in certain situations may now be on the Government’s radar. As of today, due to these changes, the entire landscape of planning an inbound investment into India has undergone a sea change.

6. Place of Effective Management (POEM)

Under the POEM provisions, foreign subsidiaries of the parent as regarded “residents” of the parent’s country of residence, if these foreign subsidiaries are effectively controlled and managed from the parent’s country of residence. India moved to the POEM concept in financial year 2016-17 to determine the tax residence of foreign companies. The POEM test is essentially based on various parameters to determine who are the real decision makers in respect of the key decisions of the company, where are they based and where are these key decisions made. As a result, outbound

investment structures of Indian companies are now viewed in a completely different perspective and has thrown up new challenges in planning outbound investment transactions of the Indian corporates.

7. Indirect transfer of shares

In 2012, post the landmark Vodafone judgement of the Supreme Court, India amended its domestic tax law to levy tax on transfer of shares of a foreign company that holds significant amount of Indian investments. Recently in 2018, the OECD has also come out with a report on how countries could introduce / tighten indirect transfer provisions through their tax treaties. As of now, the OECD has have refrained from extending it to all assets and restricted it to shares of companies holding immovable property in the source country. Again, this may become relevant on in planning outbound investment transactions of the Indian corporates.

Chapter 2

Brief Overview of FEMA

This section covers:

- *Evolution of foreign exchange law in India*
- *Definitions under FEMA*
- *Regulatory Framework under FEMA*

To keep pace with the liberalized business environment and to facilitate economic activities, a rule based law relating to foreign exchange was introduced. The new law viz., the Foreign Exchange Management Act, 1999 (FEMA / the Act) was enacted and made effective from 1 June 2000 which replaced the law of yesteryears, i.e. Foreign Exchange Regulation Act, 1973 (FERA).

With the liberalization of the Indian economy in 1991, foreign investment in various sectors was permitted gradually. FEMA considers offences related to forex as civil offences and regulates forex matters consistent with the emerging framework of the World Trade Organisation (WTO).

Broadly, the objectives of FEMA are:

- (i) To facilitate external trade and payments; and
- (ii) To promote the orderly development and maintenance of forex market in India.

FEMA is applicable to the whole of India and also to all branches, offices and agencies outside India which are owned or controlled by a person resident in India; and to any contravention committed outside India by any person to whom the Act applies.

The Indian rupee is not yet fully convertible on the capital account which implies that capital account transactions such as investments, loans etc. between persons resident in India and persons resident outside India, are restricted by regulations framed by the RBI in this regard.

Power to make Rules and Regulations under FEMA vests with the Central Government and the Reserve Bank of India (RBI) respectively.

FEMA permits only an “authorised person” to deal in forex or foreign security. Such an authorised person, under the Act, means an authorised dealer, money changer, off-shore banking unit or any other person authorised to deal in forex or foreign security by the RBI.

Unless permitted by the Act, Rules or Regulations framed thereunder or with general or special permission by RBI, a person shall not:-

- (i) Deal in or transfer any forex or foreign security to any person not being an authorized person;
- (ii) Make any payment to or for the credit of any person resident outside India in any manner;
- (iii) Receive otherwise than through an authorized person, any payment by order or on behalf of any person resident outside India in any manner;
or
- (iv) Enter into any financial transaction in India as consideration for or in association with acquisition or creation or transfer of a right to acquire, any asset outside India by any person.

For the purpose of this clause, financial transaction means any payment to, or for the credit of any person, or receiving any payment for, by order or on behalf of any person, or drawing, issuing or negotiating any bill of exchange or promissory note, or transferring any security or acknowledging any debt.

Further, except as provided under the Act, no person resident in India can acquire, hold, own, possess or transfer any forex, foreign security or any immovable property situated outside India.

1. Definitions

Let us look at some of the important definitions under FEMA:

1.1 Capital Account Transaction

Capital account transaction means a transaction which alters the assets or liabilities, including contingent liabilities, outside India of persons resident in India or assets or liabilities in India of persons resident outside India, and includes transactions referred to in section 6(3) of the Act.

1.2 Current Account Transaction

Current account transaction means a transaction other than a capital account transaction and without prejudice to the generality of the foregoing such transaction, includes:

- (i) Payments due in connection with foreign trade, other current business, services, and short-term banking and credit facilities in the ordinary course of business;
- (ii) Payments due as interest on loans and as net income from investments;
- (iii) Remittances for living expenses of parents, spouse and children residing abroad; and
- (iv) Expenses in connection with foreign travel, education and medical care of parents, spouse and children.

1.3 Export

Export, with its grammatical variations and cognate expressions, means:

- (i) The taking out of India to a place outside India any goods;
- (ii) Provision of services from India to any person outside India

1.4 Foreign Exchange

Foreign exchange means foreign currency and includes:

- (i) Deposits, credits and balances payable in any foreign currency;
- (ii) Drafts, travellers' cheques, letters of credit or bills of exchange, expressed or drawn in Indian currency but payable in any foreign currency;
- (iii) Drafts, travellers' cheques, letters of credit or bills of exchange drawn by banks, institutions or persons outside India, but payable in Indian currency.

1.5 Foreign Security

Foreign security means any security, in the form of shares, stocks, bonds, debentures or any other instrument denominated or expressed in foreign currency and includes securities expressed in foreign currency, but where

redemption or any form of return such as interest or dividends is payable in Indian currency.

1.6 Import

Import, with its grammatical variations and cognate expressions, means bringing into India any goods or services.

1.7 Person Resident in India

Person resident in India means:

- (i) A person residing in India for more than one hundred and eighty-two days during the course of the preceding financial year but does not include:
 - A. A person who has gone out of India or who stays outside India, in either case:
 - (a) for or on taking up employment outside India, or
 - (b) for carrying on outside India a business or vocation outside India, or
 - (c) for any other purpose, in such circumstances as would indicate his intention to stay outside India for an uncertain period;
 - B. A person who has come to or stays in India, in either case, otherwise than:
 - (a) for or on taking up employment in India, or
 - (b) for carrying on in India a business or vocation in India, or
 - (c) for any other purpose, in such circumstances as would indicate his intention to stay in India for an uncertain period;
- (ii) Any person or body corporate registered or incorporated in India,
- (iii) An office, branch or agency in India owned or controlled by a person resident outside India,
- (iv) An office, branch or agency outside India owned or controlled by a person resident in India.

1.8 Person Resident outside India

Person resident outside India means a person who is not resident in India.

1.9 Transfer

Transfer includes sale, purchase, exchange, mortgage, pledge, gift, loan or any other form of transfer of right, title, possession or lien.

Transactions under FEMA are broadly categorized as current account transactions and capital account transactions. Let us examine the nuances of both.

1.10 Current Account Transactions

Current account transactions follow the 'negative list' principle and are generally freely permitted.

Section 5 of the Act authorises a person to sell or draw forex to or from an authorised person if such sale or drawal is a current account transaction as defined under the Act.

The central government has framed the Foreign Exchange Management (Current Account Transactions) Rules, 2000 (FEMCAT Rules) dealing with various aspects of current account transactions.

Schedule I of the FEMCAT Rules lists down the prohibited transactions such as remittance out of lottery winnings, remittance for banned/prescribed magazines, football pools, sweepstakes, etc.

Schedule II of the FEMCAT Rules lists down the transactions which require prior approval of the central government of India such as remittance for cultural tours, remittance of prize money / sponsorship of sports activity abroad by a person other than International / National / state level sports bodies, if the amount involved exceeds US\$ 100,000, etc.

Schedule III to the FEMCAT Rules lists down permissible current account transactions such as private visits to any country (except Nepal and Bhutan), going abroad for employment, travel for business, etc. upto a permissible limit of USD 250,000 per financial year except for certain specified cases where additional remittances can be made. Further, certain categories of remittances by person other than individuals mentioned therein require prior approval of the RBI for remittances exceeding specified amounts towards donations, consultancy services, reimbursement of pre-incorporation expenses, etc.

1.11 Capital Account Transactions

Capital Account Transactions such as loans, investments, setting-up offices in India, acquisition of immovable property etc. are regulated under FEMA.

Section 6 of the Act empowers the RBI to specify, in consultation with the central government, any class or classes of capital account transactions which are permissible and the limit up to which forex drawal shall be admissible for such transactions.

Accordingly, the RBI has framed the Foreign Exchange Management (Permissible Capital Account Transactions) Regulations, 2000, which govern Capital Account Transactions under FEMA. Schedule I to these Regulations specifies permissible Capital Account Transactions for a person resident in India whereas Schedule II specifies permissible Capital Account Transactions for a person resident outside India.

The RBI has been empowered to issue Regulations for the purpose of regulating the following Capital Account Transactions:

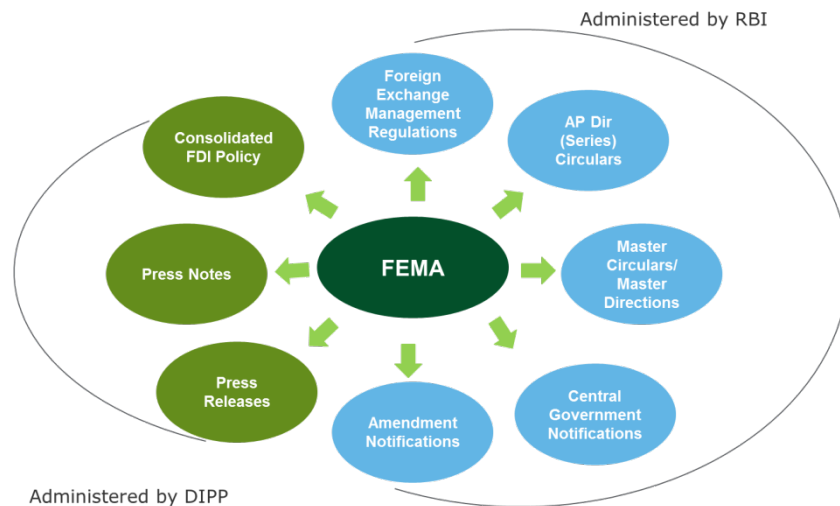
- (a) Transfer or issue of any security or foreign security by a person resident in India;
- (b) Transfer or issue of any security by a person resident outside India;
- (c) Transfer or issue of any security or foreign security by any branch, office or agency in India of a person resident outside India;
- (d) Any borrowing or lending in forex in whatever form or by whatever name called;
- (e) Any borrowing or lending in rupees in whatever form or by whatever name called between a person resident in India and a person resident outside India;
- (f) Deposits between persons resident in India and persons resident outside India;
- (g) Export, import or holding of currency or currency notes;
- (h) transfer of immovable property outside India, other than a lease not exceeding five years, by a person resident in India;
- (i) acquisition or transfer of immovable property in India, other than a lease not exceeding five years, by a person resident outside India;

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- (j) giving of a guarantee or surety in respect of any debt, obligation or other liability incurred:
 - (i) by a person resident in India and owed to a person resident outside India; or
 - (ii) by a person resident outside India.

2. Broad regulatory framework under FEMA

The Regulatory framework under FEMA is jointly administered by the RBI and the Government of India through Department of Industrial Policy and Promotion (DIPP).



2.1 Foreign Exchange Management Regulations

These are issued by the RBI under section 47 of FEMA after following due process including approval by Parliament.

2.2 AP DIR (Series) Circulars

These are in the nature of general or specific directions issued by RBI to the Authorized Persons under section 10(4) and 11(1) of FEMA.

2.3 Master Directions

These are a compilation of FEMA Regulations issued by RBI on a particular topic (Eg: Foreign investment in India, Direct Investment outside India) as amended by the AP DIR (Series) Circulars.

In case of any conflict between the FEMA Regulations and the Master Directions, the FEMA Regulations will prevail, as they are the primary source of law on the basis of which the corresponding Master Direction is compiled.

2.4 Central Government Notifications

These are issued by the central government under various sections of FEMA.

2.5 Amendment Notifications

Any amendments to the existing Regulations are notified by the RBI through the amendment notifications.

2.6 Consolidated Foreign Direct Investment (FDI) Policy

The government has put in place a policy framework on FDI, which is embodied in the Circular on Consolidated FDI Policy, updated every year, to capture and keep pace with the regulatory changes. The Consolidated FDI Policy is issued by the Department of Industrial Policy and Promotion (DIPP), Ministry of Commerce & Industry, Government of India.

2.7 Press Notes / Press Releases

Amendments to the FDI Policy are notified by the DIPP through Press Notes / Press Releases.

Source References:

- Foreign Exchange Management Act, 1999
- Foreign Exchange Management (Current Account Transactions) Rules, 2000 (FEMCAT Rules)
- Foreign Exchange Management (Permissible Capital Account Transactions) Regulations, 2000

Chapter 3

FEMA Guidelines on Inbound Investments

This section covers:

- *Regulatory framework for foreign investment in India*
- *Key Definitions under FDI Policy and FDI Regulations*
- *Eligible investors*
- *Schedules governing various types of foreign investment in India*
- *Eligible investee entities*
- *Entry routes for foreign investment in India*
- *Sectoral caps and entry conditions*
- *Downstream investment*
- *Types of instruments*
- *Pricing Guidelines*
- *Reporting under FDI*
- *Other provisions under FDI such as conversion of ECB into equity etc.*
- *Entry options for foreign investors*
- *Overview of Companies Act, 2013 for foreign investment*
- *Importance of inbound investment structure*

Foreign investment in India is governed by the Foreign Exchange Management (Transfer or Issue of Security by a Person Resident outside India) Regulations, 2017 ('FDI Regulations 2017' or 'the Regulations'), read with the Consolidated FDI Policy issued by the DIPP, Ministry of Commerce, Government of India. These Regulations provide for permissible investments, sectoral limits for foreign investment, pricing, reporting, transfers, etc.

As on the date of this publication, the FDI Policy of 2017 is in force, which will in due course, be amended to bring the same in line with the FDI Regulations, 2017 which were notified on 7 November 2017.

FEMA Guidelines on Inbound Investments

The FDI Policy 2017 reflects the changes made to the erstwhile FDI Policy after the abolition of the Foreign Investment Promotion Board (FIPB) and specifies the competent authorities for grant of approval for FDI in sectors/activities requiring government approval and the process to be followed.

In addition, the FDI Policy 2017 consolidates other key changes made since the erstwhile FDI Policy, such as liberalisation of FDI in certain key sectors.

1. Definitions

Let us look at some of the important definitions under the FDI Policy, 2017 and the FDI Regulations, 2017:

1.1 Capital Instruments

Capital Instruments means equity shares (including partly paid-up shares), debentures (fully, compulsorily and mandatorily convertible), preference shares (fully, compulsorily and mandatorily convertible) and share warrants issued by an Indian company.

Share warrants are defined to mean those issued by an Indian company in accordance with the Regulations issued by the Securities and Exchange Board of India (SEBI). Capital instruments can contain an optionality clause subject to a minimum lock-in period of one year or as prescribed for the specific sector, whichever is higher, but without any option or right to exit at an assured price.

1.2 Control

Control shall include the right to appoint a majority of the directors or to control the management or policy decisions including by virtue of their shareholding or management rights or shareholders agreements or voting agreements. For the purposes of Limited Liability Partnership (LLP), 'control' will mean right to appoint majority of the designated partners, where such designated partners, with specific exclusion to others, have control over all the policies of the LLP.

1.3 Convertible Note

Convertible Note means an instrument issued by a 'start-up company' evidencing receipt of money initially as debt, which is repayable at the option of the holder, or which is convertible into such number of equity shares of such start-up company, within a period not exceeding five years from the

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date of issue of the convertible note, upon occurrence of specified events as per the other terms and conditions agreed to and indicated in the instrument.

1.4 Foreign Direct Investment (FDI)

FDI means investment through capital instruments by a non-resident in an unlisted Indian company or in 10 per cent or more of the post issue paid-up equity capital on a fully diluted basis (i.e. total shares that would be outstanding if all possible sources of conversion are exercised) of a listed Indian company.

1.5 FDI linked performance conditions

It means the sector specific conditions stipulated in Regulation 16 of FDI Regulations 2017 for companies receiving foreign investment;

1.6 Foreign Portfolio Investment (FPI)

FPI means any investment made by a non-resident through capital instruments where such investment is less than 10 per cent of the post issue paid-up share capital on a fully diluted basis of a listed company or less than 10 per cent of the paid up value of each series of capital instruments of a listed company.

For computation of 10 per cent limits, investment by the investor group (i.e. the same set of beneficial owners) will be considered. To make investments under the FPI route, FPI license from Securities and Exchange Board of India (SEBI) under the SEBI (FPI) Regulations, 2014 will be required to be obtained.

It has been clarified that that a person resident outside India i.e. a non-resident may hold foreign investment either as FDI or FPI in any particular Indian company and not under both routes.

In case if FPI holding increases to 10 per cent or more of the total paid up equity capital on a fully diluted basis, such investments shall be re-classified as FDI subject to the conditions to be specified by SEBI and RBI in this regard and make requisite compliances.

In case of existing FDI (i.e. investments made before enactment of FDI Regulations 2017) falls below 10 per cent of the post issue paid-up equity capital on a fully diluted basis of an Indian company, it would be still be classified as FDI.

1.7 Group Company

Group company means two or more enterprises which, directly or indirectly, are in a position to:

- (i) Exercise 26 per cent or more of voting rights in other enterprise; or
- (ii) Appoint more than 50 per cent of members of board of directors in the other enterprise.

1.8 Investment on repatriable basis

It means investment, the sale / maturity proceeds of which, net of taxes, are eligible to be repatriated out of India and the expression 'investment on non-repatriable basis' shall be construed accordingly.

1.9 Non-Resident Indian (NRI)

NRI means an individual resident outside India who is a citizen of India or is an Overseas Citizen of India (OCI) cardholder within the meaning of section 7 (A) of the Citizenship Act, 1955. 'Persons of Indian Origin' cardholders registered as such under Notification No. 26011/4/98 F.I. dated 19.8.2002 issued by the central government are deemed to be 'Overseas Citizen of India' cardholders'.

1.10. Start-up company

Start-up company means a private company incorporated under the Companies Act, 2013 and recognised as such in accordance with notification number G.S.R. 180(E) dated 17 February 2016 issued by the DIPP and complies with the conditions laid down by it.

2. Aspects of Foreign Investments in India

The various aspects of foreign investment in India are as follows:

- Eligible investors
- Eligible investee entities
- Entry routes for investment
- Caps on investments
- Prohibited sectors
- Entry conditions on investment

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- Downstream investment
- Sector-Specific Policy for Total Foreign Investment
- Types of instruments
- Pricing guidelines
- Reporting requirements
- Other provisions

While foreign investment in India can be through various routes, viz., FDI, FPI, FVCI etc. this publication focuses primarily on FDI.

2.1 Eligible investors

A non-resident can invest in India, subject to the FDI policy except in those sectors/activities which are prohibited. However, a citizen of Bangladesh or an entity incorporated in Bangladesh can invest only under the government route. Further, a citizen of Pakistan or an entity incorporated in Pakistan can invest, only under the government route, in sectors/activities other than defence, space and atomic energy and sectors/activities prohibited for foreign investment.

A NRI or an OCI may on repatriation basis, purchase or sell capital instruments of Indian companies of a listed Indian company in the manner and subject to conditions specified in Schedule 3.

A NRI or an OCI may on non-repatriation basis, purchase or sell capital instruments of an Indian company or purchase or sell units or contribute to the capital of a LLP or a firm or proprietary concern, in the manner and subject to the terms and conditions specified in Schedule 4.

A company, trust and partnership firm incorporated outside India and owned and controlled by NRIs can invest in India with the special dispensation as available to NRIs under the FDI Policy.

A non-resident, other than a citizen of Bangladesh or Pakistan or an entity incorporated in Bangladesh or Pakistan, may invest, either by way of capital contribution or by way of acquisition/ transfer of profit shares of an LLP, in the manner and subject to the terms and conditions as specified in Schedule 6.

Foreign portfolio investors (FPIs) can invest in Indian companies under the portfolio investment scheme, wherein the individual holding of FPIs shall not

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exceed 10 per cent of the capital of the company, and the aggregate FPI investment shall not exceed 24 per cent of the capital of the company. This aggregate limit of 24 per cent can be increased to the sectoral cap/statutory ceiling, as applicable, by the Indian company concerned, through a resolution by its Board of Directors followed by a special resolution to that effect by its General Body and subject to prior intimation to RBI.

A SEBI registered Foreign Venture Capital Investor (FVCI) may purchase:

Securities issued by an Indian company engaged in any sector mentioned in Schedule 7 of the FDI Regulations 2017 and are not listed on a recognised stock exchange at the time of issue of the said securities,

Securities issued by a start-ups irrespective of the sector in which it is engaged.

Units of a domestic Venture Capital Fund (VCF) registered under the SEBI (Venture Capital Fund) Regulations, 1996 or a Category- I Alternative Investment Fund (Cat-I AIF) registered under the SEBI (Alternative Investment Fund) Regulations, 2012 or units of a scheme or of a fund set up by a VCF or by a Cat-I AIF.

If the investments are in capital instruments, then it shall be subject to the extant FDI Regulations and extant FDI policy including sectoral caps, etc.

A Non- Resident Indian may subscribe to the National Pension System governed and administered by the Pension Fund Regulatory and Development Authority (PFRDA), provided such subscriptions are made through normal banking channels and the person is eligible to invest as per the provisions of the PFRDA Act. The annuity / accumulated saving will be repatriable.

Various schedules governing the types of foreign investment in India under the FEMA Regulations 2017 are as follows:-

Schedule	Types / Particulars
1	Foreign Direct Investment Scheme
2	Purchase / Sale of capital instruments of a listed Indian company on a recognised stock exchange in India by FPIs
3	Purchase / Sale of capital Instruments of a listed Indian company on a recognised stock exchange in India by an NRI or an OCI on repatriation basis

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4	Purchase / Sale of Capital Instruments or convertible notes of an Indian company or units or contribution to the capital of an LLP or investment in a firm or a proprietary concern by an NRI or an OCI on non-repatriation basis
5	Purchase / Sale of securities other than capital instruments by a person resident outside India
6	Investment in LLP
7	Investment in FVCI
8	Investment by a person resident outside India in an Investment Vehicle
9	Investment in Depository receipts by a person resident outside India
10	Issue of Indian Depository Receipts (IDRs)

2.2 Eligible investee entities

- Indian Company: Indian companies can issue capital under FDI Scheme.
- Partnership Firm / Proprietary Concern: NRIs / PIOs resident outside India can invest in the capital of a firm or a proprietary concern in India subject to prescribed conditions.
- Trusts: FDI is not permitted in Trusts other than in 'VCF' registered and regulated by SEBI and subject to conditions in 'Investment vehicle'.
- Limited Liability Partnerships (LLPs): FDI in LLPs is permitted subject to the following conditions:-
 - (i) FDI is permitted under the automatic route in LLPs operating in sectors / activities where 100 per cent FDI is allowed through the automatic route and there are no FDI-linked performance conditions.
 - (ii) An Indian company or an LLP, having foreign investment, is also permitted to make downstream investment in another company or LLP in sectors in which 100 per cent FDI is allowed under the automatic route and there are no FDI-linked performance conditions.

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- (iii) Conversion of an LLP having foreign investment and operating in sectors / activities where 100 per cent FDI is allowed through the automatic route and there are no FDI-linked performance conditions, into a company is permitted under automatic route. Similarly, conversion of a company having foreign investment and operating in sectors/activities where 100 per cent FDI is allowed through the automatic route and there are no FDI-linked performance conditions, into an LLP is permitted under automatic route.
- (iv) FDI in LLP is subject to the compliance of the conditions of LLP Act, 2008.
- Investment Vehicle: An entity being 'investment vehicle' registered and regulated under relevant regulations framed by SEBI or any other authority designated for the purpose including Real Estate Investment Trusts (REITs) governed by the SEBI (REITs) Regulations, 2014, Infrastructure Investment Trusts (InvIts) governed by the SEBI (InvIts) Regulations, 2014, Alternative Investment Funds (AIFs) governed by the SEBI (AIFs) Regulations, 2012 and notified under Schedule 8 of the FDI Regulations 2017 is permitted to receive foreign investment from a person resident outside India (other than an individual who is citizen of or any other entity which is registered / incorporated in Pakistan or Bangladesh), including an FPI or an NRI, subject to prescribed conditions.
- Start-up Companies: Start-ups can issue equity or equity linked instruments or debt instruments to FVCI against receipt of foreign remittance, as per FDI Regulations 2017. Also, in keeping with the Government of India's "Start-up India" initiative, the RBI has opened a new avenue for investments into start-ups in India, i.e. convertible notes. Start-ups can issue convertible notes to person resident outside India subject to prescribed conditions.

2.3 Entry Routes for investment

Foreign investment in India can be either under the automatic route or under the government route:

2.3.1 Automatic route refers to the entry route through which investment in India by a person resident outside India does not require prior approval of RBI or the government. Only *post-facto* intimation to RBI is required under automatic route. The remittance in India under automatic route should be

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made through normal banking channels and is subject to compliance with pricing guidelines as mentioned hereinafter.

2.3.2 Government route means that investment in the capital of resident entities by non-resident entities can be made only with the prior approval of government (competent administrative ministry / department for grant of approval).

Foreign investment in sectors / activities under government approval route will be subject to government approval where:

- (i) An Indian company is being established with foreign investment and is not owned by a resident entity or
- (ii) An Indian company is being established with foreign investment and is not controlled by a resident entity or
- (iii) The control of an existing Indian company, currently owned or controlled by resident Indian citizens and Indian companies, which are owned or controlled by resident Indian citizens, will be / is being transferred / passed on to a non-resident entity as a consequence of transfer of shares and / or fresh issue of shares to non-resident entities through amalgamation, merger/demerger, acquisition etc. or
- (iv) The ownership of an existing Indian company, currently owned or controlled by resident Indian citizens and Indian companies, which are owned or controlled by resident Indian citizens, will be / is being transferred / passed on to a non-resident entity as a consequence of transfer of shares and / or fresh issue of shares to non-resident entities through amalgamation, merger/demerger, acquisition etc.
- (v) It is clarified that foreign investment shall include all types of foreign investments, direct and indirect, regardless of the respective schedule of the FDI Regulations 2017 under which the investment is made. FCCBs and DRs having underlying of instruments being in the nature of debt shall not be treated as foreign investment.
- (vi) Investment by NRIs under schedule 4 of the FDI Regulations 2017 will be deemed to be domestic investment at par with the investment made by residents and is non-repatriable.
- (vii) A company, trust and partnership firm incorporated outside India and owned and controlled by non-resident Indians will be eligible for investments under schedule 4 of the FDI Regulations 2017 and such

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investment will also be deemed domestic investment at par with the investment made by residents and is non-repatriable.

2.4 Caps on investments

Investments can be made by non-residents in the capital of a resident entity only to the extent of the percentage of the total capital as specified in the FDI policy.

An illustrative list of sectors which are under automatic route along with the respective sectoral caps is given below:

Cap	Sector/ Activity
Up to 49%	<ul style="list-style-type: none">• Telecommunication services• Private Sector Banks• Infrastructure Company in the Securities Market viz. Stock exchange, Commodity derivative exchange, depositories and clearing corporations• Power exchanges• Scheduled air transport services• Defence• Insurance• Pension
Up to 74%	<ul style="list-style-type: none">• Brownfield pharmaceuticals
Up to 100%	<ul style="list-style-type: none">• Manufacturing• Mining (other than of titanium bearing minerals and ores)• Greenfield / existing Airport projects in Civil Aviation Sector• Greenfield pharmaceuticals• Wholesale / cash & carry trading and B2B e-commerce• Asset Reconstruction Companies• Credit Information Companies• Setting up of industrial parks and Construction Development Projects

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Cap	Sector/ Activity
	<ul style="list-style-type: none"> • Petroleum & Natural Gas exploration • Plantation of tea, coffee, rubber, cardamom, palm oil tree and olive oil tree • Non-scheduled air transport services • Broadcasting carriage services i.e. Teleports, Cable Networks, Direct to Home broadcasting, Mobile TV and Head-end-in-the Sky Broadcasting Services (HITS) • Duty free shops • Single Brand Product Retailing • Other Financial Services (regulated by financial sector regulators viz., RBI, SEBI, IRDA, PFRDA, NHB or any other notified financial sector regulator)

An illustrative list of sectors requiring prior government approval along with the respective sectoral caps is given below:

Cap	Sector/ Activity
Up to 26%	<ul style="list-style-type: none"> • Publishing of newspaper and periodicals dealing with news and current affairs and Indian edition of foreign magazines dealing with news and current affairs
Up to 49%	<ul style="list-style-type: none"> • Private Security Agencies • Terrestrial Broadcasting FM (FM Radio), subject to such terms and conditions, as specified from time to time, by Ministry of Information and Broadcasting • Up-Linking of 'News & Current Affairs' TV Channels
Up to 51%	<ul style="list-style-type: none"> • Multi Brand Retail Trading
Investment > 49% and up to 74%	<ul style="list-style-type: none"> • Private Sector Banks
Investment > 49% and up to 100%	<ul style="list-style-type: none"> • Telecommunication services • Defence (wherever it is likely to result in access to modern technology or for other reasons to be recorded.)

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Cap	Sector/ Activity
Investment > 74% and up to 100%	<ul style="list-style-type: none">• Brownfield pharmaceuticals
Up to 100%	<ul style="list-style-type: none">• Mining and separation of titanium bearing minerals and ores• Satellite – establishment and operation

2.5 Prohibited sectors

Investment by a person resident outside India is prohibited in the following sectors:

- (1) Lottery Business including government/ private lottery, online lotteries.
- (2) Gambling and betting including casinos.
- (3) Chit funds (except for investment made by NRIs and OCIs on a non-repatriation basis).
- (4) Nidhi Company.
- (5) Trading in Transferable Development Rights (TDRs).
- (6) Real estate business or construction of farm houses.

Note: "Real estate business" shall not include development of townships, construction of residential /commercial premises, roads or bridges and Real Estate Investment Trusts (REITs) registered and regulated under the SEBI (REITs) Regulations 2014.

- (7) Manufacturing of cigars, cheroots, cigarillos and cigarettes, of tobacco or of tobacco substitutes.
- (8) Activities/ sectors not open to private sector investment viz., (i) Atomic energy and (ii) Railway operations (other than those specifically permitted).

Foreign technology collaboration in any form including licensing for franchise, trademark, brand name, management contract is also prohibited for lottery business and gambling and betting activities.

2.6 Entry conditions on investment

Investments by non-residents can be permitted in the capital of a resident entity in certain sectors / activity with entry conditions. Such conditions may

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include norms for minimum capitalization, lock-in period, etc. The entry conditions in various sectors / activities are provided in Chapter 5 of the FDI Policy and Regulation 16 of the FDI Regulations 2017.

2.7 Downstream investment

Downstream Investment means indirect foreign investment, by an eligible Indian entity, into another Indian company/LLP, by way of subscription or acquisition.

'Indirect foreign investment' means downstream investment received by an Indian entity from:

- (i) another Indian entity (IE) which has received foreign investment and (i) the IE is not owned and not controlled by resident Indian citizens and/or Indian Companies/LLPs which are ultimately owned and controlled by resident Indian citizens or (ii) is owned or controlled by persons resident outside India; or
- (ii) an investment vehicle whose sponsor or manager or investment manager (i) is not owned and not controlled by resident Indian citizens and/or Indian Companies/LLPs which are ultimately owned and controlled by resident Indian citizens or (ii) is owned or controlled by persons resident outside India

Downstream investment by an LLP not owned and not controlled by resident Indian citizens or owned or controlled by persons resident outside India is allowed in an Indian company operating in sectors where foreign investment up to 100 percent is permitted under automatic route and there are no FDI linked performance conditions.

Indian entity which has received indirect foreign investment shall comply with the entry route, sectoral caps, pricing guidelines and other attendant conditions as applicable for foreign investment.

Guidelines for calculating total foreign investment in Indian companies:

- (a) Any equity holding by a person resident outside India resulting from conversion of any debt instrument under any arrangement shall be considered as a part of total foreign investment;
- (b) Foreign Currency Convertible Bonds (FCCBs) and Depository Receipts (DRs) having underlying instruments in the nature of debt, shall not be considered for computation of total foreign investment;

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- (c) The methodology for calculating total foreign investment would apply at every stage of investment in Indian companies and thus in each and every Indian company;
- (d) For the purpose of downstream investment, the portfolio investment held as on March 31 of the previous financial year in the Indian company making the downstream investment shall be considered for computing its total foreign investment;
- (e) The indirect foreign investment received by a wholly owned subsidiary of an Indian company will be limited to the total foreign investment received by the company making the downstream investment;

Downstream investment made into Indian companies will be subject to the following conditions:

- (a) Approval of the Board of Directors as also a Shareholders' Agreement, if any;
- (b) Indian entity making the downstream investment shall bring in requisite funds from abroad and not use funds borrowed in the domestic markets. Downstream investments can be made through internal accruals.
- (c) Capital instrument of an Indian company having indirect foreign investment may be transferred to:
 - (i) A person resident outside India, subject to adherence to reporting requirements.
 - (ii) A person resident in India subject to adherence to pricing guidelines.
 - (iii) An Indian company which has received foreign investment and is not owned and not controlled by resident Indian citizens or owned or controlled by persons resident outside India.
- (d) The first level Indian company making downstream investment shall be responsible for ensuring compliance with the provisions of the FDI Regulations 2017 for the downstream investment made by it at second level and so on and so forth. Such first level company shall obtain a certificate to this effect from its statutory auditor on an annual basis. Such compliance of the regulations shall be mentioned in the Directors' Report in the Annual Report of the Indian company. Qualified reports issued by the statutory auditor shall be immediately brought to the notice of the regional office of the RBI.

2.8 Sector-Specific Policy for Total Foreign Investment

1. The FDI Policy / FDI Regulations 2017 specify sectoral cap for foreign investment in respective sectors / activities. The total foreign investment in that particular shall not exceed the sectoral / statutory cap.
2. Foreign investment in the sectors / activities is subject to applicable laws/ regulations, security and other conditionalities.
3. In sectors / activities not specifically listed in the FDI Regulations 2017 or not in the prohibited list mentioned above, foreign investment is permitted up to 100 per cent under the automatic route, subject to applicable laws/ regulations, security and other conditionalities. However, foreign investment in financial services other than those specified would require prior Government approval.
4. Wherever there is a requirement of minimum capitalization, it shall include premium received along with the face value of the capital instrument, only when it is received by the company upon issue of such instruments to the person resident outside India. Amount paid by the transferee during post-issue transfer beyond the issue price of the capital instrument, cannot be taken into account while calculating minimum capitalization requirement.
5. Foreign investment into an Indian company, engaged only in the activity of investing in the capital of other Indian company/ies, will require prior approval of the government. A Core Investment Company (CIC) will have to additionally follow the RBI's regulatory framework for CICs.
6. For undertaking activities which are under automatic route and without FDI linked performance conditions, an Indian company which does not have any operations and also has not made any downstream investment, may receive investment in its capital instruments from persons resident outside India under automatic route. However, approval of the government will be required for such companies for undertaking activities which are under government route. As and when such a company commences business or makes downstream investment, it will have to comply with the relevant sectoral conditions on entry route, conditionalities and caps.
7. The onus of compliance with the sectoral / statutory caps on foreign

investment and attendant conditions, if any, shall be on the company receiving foreign investment.

2.9 Types of instruments

Indian companies can issue equity shares, fully, compulsorily and mandatorily convertible debentures and fully, compulsorily and mandatorily convertible preference shares subject to pricing guidelines/valuation norms prescribed under FEMA Regulations. The price/conversion formula of convertible capital instruments should be determined upfront at the time of issue of the instruments. The price at the time of conversion should not in any case be lower than the fair value worked out, at the time of issuance of such instruments, in accordance with the extant FEMA regulations [as per any internationally accepted pricing methodology on arm's length basis for the unlisted companies and valuation in terms of SEBI (ICDR) Regulations, for the listed companies].

Optionality clauses are allowed in equity shares, fully, compulsorily and mandatorily convertible debentures and fully, compulsorily and mandatorily convertible preference shares under FDI scheme, subject to the following conditions:

- (a) There is a minimum lock-in period of one year which shall be effective from the date of allotment of such capital instruments.
- (b) After the lock-in period and subject to FDI Policy provisions, if any, the non-resident investor exercising option/right shall be eligible to exit without any assured return, as per pricing/valuation guidelines issued by RBI from time to time.

Other types of Preference shares/Debentures i.e. non-convertible, optionally convertible or partially convertible for issue of which funds have been received on or after 1 May 2007 are considered as debt. Accordingly all norms applicable for External Commercial Borrowings (ECBs) relating to eligible borrowers, recognized lenders, amount and maturity, end-use stipulations, etc. shall apply. Since these instruments would be denominated in rupees, the rupee interest rate will be based on the swap equivalent of London Interbank Offered Rate (LIBOR) plus the spread as permissible for ECBs of corresponding maturity. It is pertinent to note that Foreign Exchange Management (Borrowing and Lending) Regulations, 2018, provides that certain hybrid instruments, such as optionally convertible debentures, presently covered under ECB, would be governed by specific hybrid instruments' Regulations to be notified by the Government of India.

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The inward remittance received by the Indian company vide issuance of DRs and FCCBs are treated as FDI.

Acquisition of Warrants and Partly Paid Shares: An Indian company may issue warrants and partly paid shares to a person resident outside India subject to following terms and conditions:

For partly paid shares, twenty five percent of the total consideration amount (including share premium, if any), has to be received upfront and the balance consideration towards fully-paid equity shares should be received within a period of twelve months from the date of issue of partly-paid shares.

The time period of 12 months for receipt of the balance consideration need not be insisted upon where the issue size exceeds rupees five hundred crore and the issuer complies with Regulation 17 of the SEBI (Issue of Capital and Disclosure Requirements) (ICDR) Regulations, 2009 regarding monitoring agency. Similar exemption is available to an unlisted Indian company, provided it appoints a monitoring agency on the same lines as required in case of a listed Indian company under the SEBI (ICDR) Regulations. Such monitoring agency (AD Category -1 bank) should report to the investee company as prescribed by the SEBI regulations, *ibid*, for the listed companies.

For share warrants, at least twenty five percent of the consideration has to be received upfront and the balance amount within eighteen months of issuance of share warrants.

In case of non-payment of call money on partly paid shares or balance consideration towards share warrants, the forfeiture of the amount paid upfront will be in accordance with the provisions of the Companies Act, 2013 and the Income Tax provisions, as applicable.

The deferment of payment of consideration amount by the foreign investors or shortfall in receipt of consideration amount as per applicable pricing guidelines will not be treated as subscription to partly paid shares and warrants.

Issue of Foreign Currency Convertible Bonds FCCBs and DRs:

- (a) FCCBs/DRs may be issued in accordance with the Scheme for issue of Foreign Currency Convertible Bonds and Ordinary Shares (Through Depository Receipt Mechanism) Scheme, 1993 and DR Scheme 2014 respectively, as per the guidelines issued by the Government of India there under from time to time.

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- (b) DRs are foreign currency denominated instruments issued by a foreign depository in a permissible jurisdiction against a pool of permissible securities issued or transferred to that foreign depository and deposited with a domestic custodian.
- (c) In terms of the FDI Regulations 2017, a person will be eligible to issue or transfer eligible securities to a foreign depository, for the purpose of converting the securities so purchased into depository receipts in terms of Depository Receipts Scheme, 2014 and guidelines issued by the Government of India thereunder from time to time.
- (d) A person can issue DRs, if it is eligible to issue eligible instruments to person resident outside India under the respective schedule of the FDI Regulations 2017.
- (e) The aggregate of eligible securities which may be issued or transferred to foreign depositories, along with eligible securities already held by persons resident outside India, shall not exceed the limit on foreign holding of such eligible securities under the relevant regulations framed under FEMA.
- (f) The pricing of eligible securities to be issued or transferred to a foreign depository for the purpose of issuing depository receipts should not be at a price less than the price applicable to a corresponding mode of issue or transfer of such securities to domestic investors under the relevant regulations framed under FEMA.
- (g) The issue of depository receipts as per DR Scheme 2014 shall be reported to the RBI by the domestic custodian as per the reporting guidelines for DR Scheme 2014.

Two-way Fungibility Scheme: A limited two-way fungibility scheme has been put in place by the Government of India for American Depository Receipts (ADRs) / Global Depository Receipts (GDRs). Under this scheme, a stock broker in India, registered with SEBI, can purchase shares of an Indian company from the market for conversion into ADRs/GDRs based on instructions received from overseas investors. Reissuance of ADRs/GDRs would be permitted to the extent of ADRs/GDRs which have been redeemed into underlying shares and sold in the Indian market.

Sponsored ADR/GDR issue: An Indian company can also sponsor an issue of ADR/GDR. Under this mechanism, the company offers its resident shareholders a choice to submit their shares back to the company so that on

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the basis of such shares, ADRs/GDRs can be issued abroad. The proceeds of the ADR/GDR issue are remitted back to India and distributed among the resident investors who had offered their Rupee denominated shares for conversion. These proceeds can be kept in Resident Foreign Currency (Domestic) accounts in India by the resident shareholders who have tendered such shares for conversion into ADRs/GDRs.

2.10 Transfer of capital instruments of Indian company

A person resident outside India holding capital instruments of an Indian company or units or a person resident in India, may transfer such capital instruments or units so held by him in compliance with the conditions, if any, specified in the respective Schedules of FDI Regulations 2017 and subject to the terms and conditions specified under sub regulation 10 of the Regulations. The transfer provisions are summarised hereunder:

Transferor	Transferee	Mode of transfer	Permissible route
A person resident outside India, not being an NRI or an OCI or an erstwhile overseas corporate body	Any person resident outside India	Sale or gift, including transfer of capital instruments of an Indian company pursuant to liquidation, merger, de-merger and amalgamation of entities/ companies incorporated or registered outside India	Automatic route unless the company is engaged in a sector which requires Government approval
An NRI or an OCI holding capital instruments of an Indian	Any person resident outside India	Sale or gift	Automatic route unless the company is engaged in a sector which

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Transferor	Transferee	Mode of transfer	Permissible route
company or units on repatriation basis			requires Government approval
A person resident outside India	A person resident in India	Sale/ gift or may sell the same on a recognised stock exchange in India in the manner prescribed by SEBI	Automatic route subject to the adherence to pricing guidelines, documentation and reporting requirements as applicable. Where the capital instruments are held by the person resident outside India on a non-repatriable basis, above conditions shall not apply
A person resident in India, or an NRI or an OCI or an eligible investor under Schedule 4 of the Regulations, holding capital instruments of an Indian company or	A person resident outside India	Sale	Automatic route subject to the adherence to entry routes, sectoral cap, pricing guidelines, documentation and reporting requirements as applicable. Where the capital

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Transferor	Transferee	Mode of transfer	Permissible route
units on a non-repatriation basis			instruments are being transferred to an NRI or an OCI or an eligible investor under Schedule 4 of these Regulations acquiring such investment on non-repatriation basis, above conditions shall not apply
A person resident in India, or an NRI or an OCI or an eligible investor under Schedule 4 of the Regulations, holding capital instruments of an Indian company or units on a non-repatriation basis	A person resident outside India	Gift	With prior approval of the RBI and subject to specified conditions
An NRI or an OCI or an eligible investor under Schedule 4 of the	An NRI or an OCI or an eligible investor under Schedule 4 of the	Gift	Automatic route

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Transferor	Transferee	Mode of transfer	Permissible route
Regulations holding capital instruments of an Indian company or units on a non-repatriation basis	Regulations who would hold such capital instrument on a non-repatriation basis		

2.11 Pricing Guidelines

The pricing guidelines stipulated in the FDI Regulations 2017 for issue / transfer of capital instruments are summarized below:

Issue of capital instruments	Type of Company / issue	Pricing guideline
	Listed Indian Company	Price worked out in accordance with the relevant SEBI guidelines
	Company going through a delisting Process	As per the SEBI (Delisting of Equity Shares) Regulations, 2009
	Unlisted Indian Company	Valuation of capital instruments done as per any internationally accepted pricing methodology for valuation on an arm's length basis duly certified by a Chartered Accountant or a SEBI registered Merchant Banker or a practicing Cost Accountant

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	Shares issued to Non-Resident pursuant to subscription to MOA in compliance with Companies Act, 2013	At face value and no valuation required
	In case of issue of convertible capital instruments, the price at the time of conversion should not in any case be lower than the fair value worked out as mentioned above, at the time of issuance of such instruments.	
Transfer of capital instruments from a Resident to a Non-Resident	Price not less than the:	
	Listed Indian Company	Price worked out in accordance with the relevant SEBI guidelines / price at which a preferential allotment of shares can be made under the SEBI Guidelines, as applicable
	Company going through a delisting Process	Price worked out as per the SEBI (Delisting of Equity Shares) Regulations, 2009
	Unlisted Indian Company	Valuation of capital instruments done as per any internationally accepted pricing methodology for valuation on an arm's length basis duly certified by a Chartered Accountant or a SEBI registered Merchant Banker or a practicing Cost Accountant
	The guiding principle would be that the person resident outside India is not guaranteed any assured exit price at the time of making such investment/ agreement and shall exit at the price prevailing at the time of exit.	

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Transfer of capital instruments from a Non-Resident to a Resident	Price not more than the:	
	Listed Indian Company	Price worked out in accordance with the relevant SEBI guidelines / price at which a preferential allotment of shares can be made under the SEBI Guidelines, as applicable
	Company going through a delisting Process	As per the SEBI (Delisting of Equity Shares) Regulations, 2009
	Unlisted Indian Company	Price the valuation of capital instruments done as per any internationally accepted pricing methodology for valuation on an arm's length basis duly certified by a Chartered Accountant or a SEBI registered Merchant Banker or a practicing Cost Accountant
Transfer of capital instruments from a Non-Resident to another Non-Resident	There are no pricing guidelines prescribed under FEMA for transfer of capital instruments by a non-resident to another non-resident.	
In case of swap of capital instruments	Indian Company & Overseas entity issuing shares	Irrespective of the amount, valuation involved in the swap arrangement will have to be made by a Merchant Banker registered with SEBI or an Investment Banker outside India registered with the appropriate regulatory authority in the host country

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The above pricing guidelines shall not be applicable for investment in capital instruments by a person resident outside India on non-repatriation basis.

2.12 Reporting requirements

The reporting requirement for any investment in India by a person resident outside India is as follows:

- I. Form Foreign Currency-Gross Provisional Return (FC-GPR): An Indian company issuing capital instruments to a person resident outside India and where such issue is reckoned as FDI shall report such issue in Form FC-GPR to the Regional Office concerned of the RBI under whose jurisdiction the Registered office of the company operates, not later than 30 days from the date of issue of capital instruments. Issue of 'participating interest/ rights' in oil fields shall be reported in Form FC-GPR.
- II. Annual Return on Foreign Liabilities and Assets (FLA): An Indian company which has received FDI or an LLP which has received investment by way of capital contribution in the previous year including the current year, should submit form FLA to the RBI on or before the 15th day of July of each year (to be reckoned as April to March).
- III. Form Foreign Currency-Transfer of Shares (FC-TRS):
 - (a) Form FC-TRS shall be filed for transfer of capital instruments between:
 - (i) a person resident outside India holding capital instruments in an Indian company on a repatriable basis and person resident outside India holding capital instruments on a non-repatriable basis; and
 - (ii) a person resident outside India holding capital instruments in an Indian company on a repatriable basis and a person resident in India.

The onus of reporting shall be on the resident transferor / transferee or the person resident outside India holding capital instruments on a non-repatriable basis, as the case may be.
 - (b) Transfer of capital instruments on a recognised stock exchange by a person resident outside India shall be reported by such person in Form FC-TRS to the Authorised Dealer bank.

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- (c) Transfer of capital instruments on deferred payment basis as provided for in the FDI Regulations 2017 shall be reported in Form FC-TRS on receipt of every tranche of payment. The onus of reporting shall be on the resident transferor / transferee.
- (d) Transfer of 'participating interest/ rights' in oil fields shall be reported Form FC-TRS.

Form FCTRS is to be filed with the Authorised Dealer bank within 60 days of transfer of capital instruments or receipt / remittance of funds whichever is earlier.

- IV. Form Employees' Stock Option (ESOP): An Indian company issuing employees' stock option to persons resident outside India who are its employees / directors or employees / directors of its holding company/ joint venture/ wholly owned overseas subsidiary/ subsidiaries shall submit Form-ESOP to the Regional Office concerned of the RBI under whose jurisdiction the registered office of the company operates, within 30 days from the date of issue of employees' stock option.
- V. Form Depository Receipt Return (DRR): The Domestic Custodian shall report in Form DRR, to the RBI, the issue/ transfer of depository receipts issued in accordance with the Depository Receipt Scheme, 2014 within 30 days of close of the issue.
- VI. Form LLP (I): A Limited Liability Partnerships (LLP) receiving amount of consideration for capital contribution and acquisition of profit shares shall submit Form LLP (I) to the Regional Office of the RBI under whose jurisdiction the Registered Office of the Limited Liability Partnership is situated, within 30 days from the date of receipt of the amount of consideration.
- VII. Form LLP (II): The disinvestment/ transfer of capital contribution or profit share between a resident and a non-resident (or vice versa) shall be reported in Form LLP(II) to the Authorised Dealer Bank within 60 days from the date of receipt of funds.
- VIII. Downstream Investment: An Indian company making downstream investment in another Indian company which is considered as indirect foreign investment for the investee company in terms of these Regulations, shall notify the Secretariat for Industrial Assistance, DIPP and file Form DI within 30 days of such investment and, even if capital instruments have not been allotted along with the modality of

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investment in new/existing ventures (with/without expansion programme).

IX. Form Convertible Notes (CN):

- (a) The Indian startup company issuing Convertible Notes to a person resident outside India shall report such inflows to the Authorised Dealer bank in Form CN within 30 days of such issue.
- (b) A person resident in India, who may be a transferor or transferee of Convertible Notes issued by an Indian start-up company shall report such transfers to or from a person resident outside India, as the case may be, in Form CN to the Authorised Dealer bank within 30 days of such transfer.
- (c) The Authorised Dealer bank shall submit consolidated statements to the RBI.

2.12.1 Reporting by the Authorised Dealer Category I banks:

- (a) LEC (FII): The Authorised Dealer Category I banks shall report to the RBI in Form LEC (FII) the purchase/ transfer of capital instruments by FPIs on the stock exchanges in India.
- (b) LEC (NRI): The Authorised Dealer Category I banks shall report to the RBI in Form LEC (NRI) the purchase / transfer of capital instruments by NRIs or OCIs on the stock exchanges in India.

2.12.2 Delays in reporting: The person/ entity responsible for filing the reports provided above shall be liable for payment of late submission fee, as may be decided by the RBI, in consultation with the central government, for any delays in reporting.

2.12.3 Reporting through Single Master Form: With the objective of integrating the extant reporting structures of various types of foreign investment in India, RBI in its First Bi-monthly Monetary Policy Review on 5 April 2018, had proposed to introduce an online reporting facility through Single Master Form (SMF) which would subsume all reporting requirements, irrespective of the instrument through which the foreign investment is made.

Accordingly, the RBI has, on 7 June 2018, laid down a roadmap for implementation of the reporting of foreign investments through SMF.

SMF provides a facility for reporting total foreign investment by non-resident in an Indian entity viz. Company, LLP and other Investment Vehicle viz. Real

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Estate Investment Trusts (REITs) / Infrastructure Investment Trusts (Invlts) / Alternative Investment Funds (AIFs).

SMF has subsumed the following forms for reporting of foreign investment:

- Form FC-GPR - issue of capital instruments by an Indian company
- Form FC-TRS - transfer of capital instruments of an Indian company
- Form LLP-I - FDI in LLP through capital contribution and profit shares
- Form LLP-II – Disinvestment / transfer of capital contribution and profit shares in LLP
- Form ESOP - issue of ESOPs / sweat equity shares/ shares against exercise of ESOP by an Indian company
- Form CN - issue or transfer of convertible notes
- Form DRR – issue / transfer of Depository Receipts
- Form DI – Reporting of downstream investment (indirect foreign investment) in a company or LLP
- Form InVi- Reporting of investment in an Investment vehicle

Prior to implementation of SMF, RBI had provided an online interface to existing company, LLP and start-ups (Indian entities) for filing information on total foreign investment for a period of 15 days from 28 June 2018 to 12 July 2018 (which was subsequently extended to 20 July 2018) in a prescribed Entity Master Form.

SMF reporting is now active on the portal provided by RBI.

Indian entities not complying with this pre-requisite i.e. filing of Entity Master Form will not be able to receive foreign investment (including indirect foreign investment) and will be considered as non-compliant with FEMA and regulations made thereunder.

2.13 Other provisions

2.13.1 Conversion of ECB into Equity: Indian companies have been granted general permission for conversion of External Commercial Borrowings (ECB) (excluding those deemed as ECB) in convertible foreign currency into equity shares/fully compulsorily and mandatorily convertible preference shares, subject to the following conditions and reporting requirements:

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1. The activity of the company is under the Automatic Route for FDI or the company has obtained government approval for foreign equity in the company;
2. The foreign equity after conversion of ECB into equity is within the sectoral cap, if any;
3. Pricing guidelines have been complied with;
4. Compliance with the requirements prescribed under any other statute and regulation in force; and
5. The conversion facility is available for ECBs availed under the automatic or government route and is applicable to ECBs, due for payment or not, as well as secured/unsecured loans availed from non-resident collaborators.

2.13.2 Issue against Royalty / Technical know-how fees: General permission is also available for issue of shares/preference shares against lump sum technical know-how fee, royalty due for payment, subject to entry route, sectoral cap and pricing guidelines and compliance with applicable tax laws.

2.13.3 Issue against other dues: Issue of equity shares against any other funds payable by the investee company, remittance of which does not require prior permission of the Government of India or RBI under FEMA, 1999 or any rules/ regulations framed or directions issued thereunder, or has been permitted by the RBI under the Act or the rules and regulations framed or directions issued thereunder is permitted subject to compliance with the specified conditions.

A wholly owned subsidiary set up in India by a non-resident entity, operating in a sector where 100% foreign investment is allowed in the automatic route and there are no FDI linked conditionalities, may issue equity shares or preference shares or convertible debentures or warrants to the said non-resident entity against pre-incorporation/ pre-operative expenses incurred by the said non-resident entity up to a limit of 5% of its capital or USD 500,000 whichever is less, subject to compliance with specified conditions.

Issue of equity shares under the FDI policy is allowed under the Government route for the following subject to compliance with specified conditions:

- (I) import of capital goods/ machinery/ equipment (excluding second-hand machinery)

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- (II) pre-operative/pre-incorporation expenses (including payments of rent etc.)

2.13.4 Issue of Rights / Bonus Shares: FEMA provisions allow Indian companies to freely issue Rights/Bonus shares to existing non-resident shareholders, subject to adherence to sectoral cap, if any. However, all applicable laws / statutes like the Companies Act, SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009 (in case of listed companies), etc. shall have to be complied with for such issue of bonus/rights shares. The offer on right basis to the persons resident outside India shall be:

- (i) In the case of shares of a company listed on a recognized stock exchange in India, at a price as determined by the company;
- (ii) In the case of shares of a company not listed on a recognized stock exchange in India, at a price which is not less than the price at which the offer on right basis is made to resident shareholders.

2.13.5 Transfer of capital instruments on deferred payment basis: In case of transfer of capital instruments between a person resident in India and a person resident outside India, an amount not exceeding 25% of the total consideration:

- (a) can be paid by the buyer on a deferred basis within a period not exceeding 18 months from the date of the transfer agreement; or
- (b) can be settled through an escrow arrangement between the buyer and the seller for a period not exceeding eighteen months from the date of the transfer agreement; or
- (c) can be indemnified by the seller for a period not exceeding eighteen months from the date of the payment of the full consideration, if the total consideration has been paid by the buyer to the seller.

However, the total consideration finally paid for the shares shall be compliant with the applicable pricing guidelines.

2.13.6 Acquisition of shares under Scheme of Merger/Demerger/Amalgamation

1. Where a Scheme of merger or amalgamation of two or more Indian companies or a reconstruction by way of demerger or otherwise of an Indian company, has been approved by the National Company Law Tribunal (NCLT) / Competent Authority, the transferee company or the new company, as the case may be, may issue capital instruments to

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the existing holders of the transferor company resident outside India, subject to the following conditions, namely:

- (a) The transfer or issue is in compliance with the entry routes, sectoral caps or investment limits, as the case may be, and the attendant conditionalities of investment by a person resident outside India;

Where the percentage is likely to breach the sectoral caps or the attendant conditionalities, the transferor company or the transferee or new company may obtain necessary approvals from the central government.

- (b) The transferor company or the transferee company or the new company shall not engage in any sector prohibited for investment by a person resident outside India; and

2. Where a scheme of arrangement for an Indian company has been approved by the NCLT / competent authority, the Indian company may issue non-convertible redeemable preference shares or non-convertible redeemable debentures out of its general reserves by way of distribution as bonus to the shareholders resident outside India, subject to the following conditions, namely:

- (a) The original investment made in the Indian company by a person resident outside India is in accordance with the FDI Regulations 2017 and the conditions specified in the relevant schedule;
- (b) The said issue is in accordance with the provisions of the Companies Act, 2013 and the terms and conditions, if any, stipulated in the scheme approved by the NCLT / Competent Authority have been complied with;
- (c) The Indian company shall not engage in any activity / sector in which investment by a person resident outside India is prohibited.

2.13.7 Issue of Employees Stock Option Scheme (ESOPs) / Sweat Equity: An Indian company may issue ESOP and / or sweat equity shares to its employees / directors or employees / directors of its holding company or joint venture or wholly owned overseas subsidiary / subsidiaries who are resident outside India, provided that :

1. The scheme has been drawn either in terms of regulations issued

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under the SEBI Act, 1992 or the Companies (Share Capital and Debentures) Rules, 2014 notified by the central government under the Companies Act 2013, as the case may be.

2. The issue of ESOP / sweat equity shares under the applicable rules / regulations are in compliance with the applicable sectoral cap to the said company.
3. If the issue is by a company where foreign investment is under the approval route, prior approval of Government of India shall be required.
4. Issue of ESOP / sweat equity shares to a citizen of Bangladesh / Pakistan shall require prior approval of the Government of India.
5. The issuing company shall furnish to the Regional Office of the RBI, Form-ESOP, within 30 days from the date of issue of ESOP or sweat equity shares.

Provided an individual who is a person resident outside India exercising an option which was issued when he/ she was a person resident in India shall hold the shares so acquired on exercising the option on a non-repatriation basis.

2.13.8 Share Swap: Approval of the government shall not be required for investment in automatic route sectors by way of swap of shares. However, approval of the government will be a prerequisite for investment by swap of shares for sector under government approval route.

In cases of investment by way of swap of shares, irrespective of the amount, valuation of the shares will have to be made by a merchant banker registered with SEBI or an investment banker outside India registered with the appropriate regulatory authority in the host country.

2.13.9 Remittance of sale proceeds / Remittance on winding up / Liquidation of Companies

- (a) Such remittance should be in compliance with the Foreign Exchange Management (Remittance of Assets) Regulations, 2016.
- (b) AD Category-I Bank can allow the remittance of sale proceeds of a security (net of applicable taxes) to the seller of shares resident outside India, provided the security has been held on repatriation basis, the sale of security has been made in accordance with the

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prescribed guidelines and NOC / tax clearance certificate from the Income Tax Department has been produced.

- (c) AD Category-I banks have been allowed to remit winding up proceeds of companies in India, which are under liquidation, subject to payment of applicable taxes. Liquidation may be subject to any order issued by the court winding up the company or the official liquidator in case of voluntary winding up under the provisions of the Companies Act, as applicable. AD Category-I banks shall allow the remittance provided the applicant submits:
- a. No objection or Tax clearance certificate from Income Tax Department for the remittance.
 - b. Auditor's certificate confirming that all liabilities in India have been either fully paid or adequately provided for.
 - c. Auditor's certificate to the effect that the winding up is in accordance with the provisions of the Companies Act, as applicable.
 - d. In case of winding up otherwise than by a court, an auditor's certificate to the effect that there are no legal proceeding pending in any court in India against the applicant or the company under liquidation and there is no legal impediment in permitting the remittance.

2.13.10 Repatriation of Dividend: Dividends are freely repatriable without any restrictions (net after tax deduction at source or Dividend Distribution Tax, if any, as the case may be). The repatriation is governed by the provisions of the FEMCAT Rules, as amended from time to time.

2.13.11 Repatriation of Interest: Interest on fully, mandatorily and compulsorily convertible debentures is also freely repatriable without any restrictions (net of applicable taxes). The repatriation is governed by the provisions of the FEMCAT Rules, as amended from time to time.

3. Entry Options

A foreign entity can establish its presence in India depending on the proposed activities of such entity, either through the opening of a liaison office, a project office, a branch office or by directly investing in an incorporated entity such as a company or a LLP.

3.1 Unincorporated Entities

3.1.1 Liaison Office (LO): Foreign corporations are permitted to open liaison offices in India which act as a communication channel between the head office of foreign corporations and parties in India. Such offices are normally established by foreign corporations to promote their business interests by spreading awareness about their products and also to explore opportunities to set up a more permanent presence in the country.

An LO in India is permitted by the RBI to undertake the following activities:

- (i) Represent the parent company or group companies in India
- (ii) Promote export and import from and to India
- (iii) Promote technical and financial collaborations between parent and group companies and companies in India
- (iv) Act as a communication channel between the parent and Indian companies

An LO is not allowed to undertake any commercial / trading / industrial activity in India. Expenses of such offices are to be met entirely through inward remittances of forex from the head office outside India.

3.1.2 Branch Office (BO): In relation to a company means any establishment described as such by the company. A branch can be opened for specific purposes; it should be engaged in the same activities as the parent company.

A BO in India is permitted by the RBI to represent the parent / group companies and undertake the following activities:

- (i) Export and import goods.
- (ii) Render professional or consultancy services.
- (iii) Carrying out research work in which the parent company is engaged.
- (iv) Promote technical or financial collaborations between Indian companies and parent or overseas group company.
- (v) Represent the parent company in India and act as buying / selling agents in India.
- (vi) Rendering services in Information Technology and development of software in India.

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- (vii) Render technical support for the products supplied by parent or group companies.
- (viii) Representing a foreign airline/shipping company.

BO is not allowed to carry out retail trading, manufacturing, except manufacturing within Special Economic Zones (SEZ), or processing activities in India.

BO provides the advantage of ease-of-operation and uncomplicated closure. However, since such operations are strictly regulated by exchange control guidelines, a branch may not provide a foreign corporation with the optimum structure for its expansion and diversification plans.

3.1.3 Project Office (PO): A foreign corporation that has secured a contract from an Indian company to execute a project in India can establish a project office in the country without obtaining prior permission of the RBI provided:

- (i) The project is funded directly by inward remittance from abroad; or
- (ii) The project is funded by a bilateral or multilateral international financing agency; or
- (iii) The project has been cleared by an appropriate authority; or
- (iv) A company or entity in India awarding the contract has been granted term loan by a public financial institution or a bank in India for the project.

PO is a place of business to represent the interest of the foreign company executing a project in India. Foreign companies planning to execute Engineering, Procurement, and Construction (EPC) / turnkey or any other projects in India can set up temporary project / site offices through PO set-up in India.

3.2 Entry through Incorporated Entities

3.2.1 General Partnership and LLP: FDI in a General Partnership is permitted subject to prior RBI approval.

LLP aims to provide the benefits of limited liability to a company, and simultaneously allow its members the flexibility of organizing their internal management on the basis of mutual agreement. LLP is a corporate body and legal entity that has perpetual succession and is separate from its partners. The liability of the partners is limited to their agreed contribution to the LLP.

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FDI is permitted under the automatic route in LLPs operating in sectors/activities where 100 per cent FDI is allowed, through the automatic route and there are no FDI-linked performance conditions.

3.2.2 Local Indian Subsidiary Companies: Foreign corporations can set-up a wholly-owned subsidiary (WOS) in India in the form of a private company, subject to prescribed FDI guidelines. Foreign corporations can also establish a joint venture company with an Indian or foreign partner.

As compared to LO / BO / PO, a subsidiary company provides the maximum flexibility to conduct business in India. A company can be funded through a mix of equity, debt (both foreign and local) and internal accruals. However, the liquidation procedure for companies is relatively more cumbersome.

High level comparison between Indian subsidiary and Indian branch office from an Indian income-tax perspective:

Particulars	Indian subsidiary of a foreign company	Indian branch office of a foreign company
Residential status	Resident	Non-resident
Tax base for Indian tax purposes	Net profits of the Indian subsidiary (including foreign sourced income / profits of foreign branch offices)	Net profits of the Indian branch office
Eligibility to claim tax treaty benefits in India	Yes (relating to foreign tax credit)	Yes
Corporate tax rate	25% / 30% (plus applicable surcharge and cess)	40% (plus applicable surcharge and cess)
Minimum Alternate Tax (MAT) rate	18.5% (plus applicable surcharge and cess) of the book profits	18.5% (plus applicable surcharge and cess) of the book profits
Dividend distribution tax (DDT) rate	17.65% (plus applicable surcharge and cess) of the	Not applicable

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Particulars	Indian subsidiary of a foreign company	Indian branch office of a foreign company
	dividends distributed, including on transactions deemed to be dividend distributions such as, inter alia, reduction of its capital by the Indian subsidiary or liquidation of the Indian subsidiary	
Branch profit tax (BPT)	Not applicable	BPT was proposed to be introduced vide the Direct Tax Code, but has still not been introduced till date
Deduction of head office expenses	Not applicable	Certain head office expenses (subject to conditions) are be deductible in computing the profits under section 44C of the Income-tax Act, 1961 ("Act")
Availability of tax incentives	Yes	Yes (though certain tax incentives such as, inter alia, concessional tax rate of 10% on royalty from patents under section 115BBF of the Act or concessional tax rate of 25% on new manufacturing companies under

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Particulars	Indian subsidiary of a foreign company	Indian branch office of a foreign company
		section 115BA of the Act, are available only to Indian residents / Indian companies)
Applicability of Indian Transfer Pricing regulations	Yes	Yes

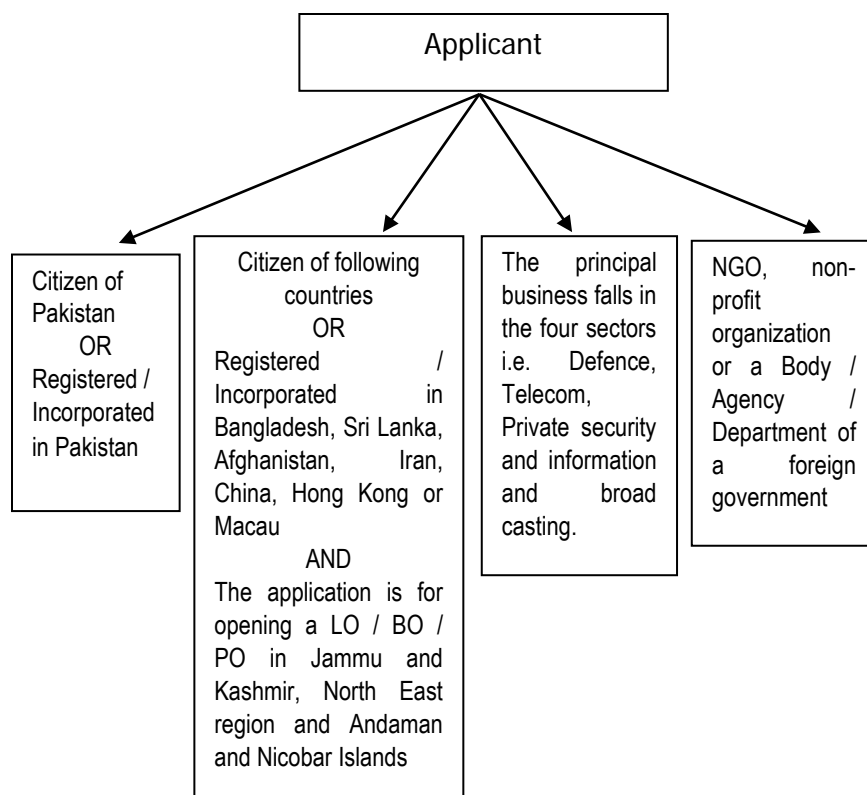
4. Guidelines for establishment of LO / BO / PO in India by foreign entities

Setting-up of liaison office, project office or branch office is governed by the Foreign Exchange Management (Establishment in India of a branch office or a liaison office or a project office or any other place of business) Regulations, 2016, read with the RBI's Master Direction on Establishment of Branch Office (BO) / Liaison Office (LO) / Project Office (PO) in India by foreign entities, as amended from time to time.

4.1 Prior Approval of RBI

A body corporate incorporated outside India, desirous of opening a LO / BO / PO in India shall require prior approval of RBI in the following cases:

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In the case of proposal for opening a PO relating to the defence sector, no separate reference or approval of Government of India shall be required if the said non-resident applicant has been awarded a contract by / entered into an agreement with Ministry of Defence or Service Headquarters or Defence Public Sector Undertakings.

Foreign insurance companies can establish Liaison offices in India only after obtaining prior approval from Insurance Regulatory and Development Authority (IRDA).

Foreign banks can establish BO / LO in India only after obtaining prior approval from the Department of Banking Regulation (DBR), RBI.

Other than above, a body corporate incorporated outside India, desirous of opening a LO / BO / PO in India can set-up such office with the approval of Authorised Dealer (AD) Bank in India and does not require prior approval of RBI.

4.2 Application Procedure

The application for establishing LO / BO / PO in India is to be submitted by the non-resident entity in Form FNC to a designated AD bank along with the prescribed documents. The AD bank shall after exercising due diligence in respect of the applicant's background and satisfying itself as regards adherence to the eligibility criteria for establishing LO / BO / PO and compliance with the extant KYC norms, grant approval to the foreign entity for establishing LO / BO / PO in India.

Before issuing the approval letter to the applicant for LO / BO / PO, the AD category-I bank shall forward a copy of the Form FNC along with details of the approval proposed to be granted by it to RBI for allotment of Unique Identification Number (UIN) to each LO / BO. UIN is not allotted for PO. After receipt of UIN from RBI, AD bank shall issue the approval letter to the entity for establishment of LO / BO in India.

4.3 Registration with State Police Authorities by LO / BO / PO

Applicants from Bangladesh, Sri Lanka, Afghanistan, Iran, China, Hong Kong, Macau or Pakistan opening a LO / BO / PO in India shall have to register with the concerned state police authorities. Copy of approval letter shall be marked by the AD bank to the Ministry of Home Affairs, Internal Security Division-I, Government of India, New Delhi.

4.4 Eligibility Criteria

The following eligibility criteria will be considered by the AD Bank while sanctioning approval for setting up of BO / LO of foreign entities:

4.4.1 Track Record of Profits

- **For Branch Office** – Foreign company should have a profit making track record during the immediately preceding 5 financial years in the home country.
- **For Liaison office** – Foreign company should have a profit making track record during the immediately preceding 3 financial years in the home country.

4.4.2 Net Worth

- **For Branch Office** – Net worth of foreign company should not be less than US\$ 100,000 or its equivalent.

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- **For Liaison office** – Net worth of foreign company should not be less than US\$ 50,000 or its equivalent.

Net Worth means total of paid-up capital and free reserves, less intangible assets as per the latest Audited Balance Sheet or Account Statement certified by a Certified Public Accountant or any Registered Accounts Practitioner by whatever name called.

An applicant that is not financially sound and is a subsidiary of another company may submit a Letter of Comfort (LOC) from its parent/ group company, subject to the condition that the parent/ group company satisfies the prescribed criteria for net worth and profit.

4.4.3 Other conditions related to approval: In case the LO / BO / PO for which approval has been granted is not opened within six months from the date of the approval letter, the approval shall lapse. In cases where the non-resident entity is not able to open the office within the stipulated time frame due to reasons beyond its control, the AD Category-I bank may consider granting extension of time for a further period of six months for setting up the office. Any further extension of time shall require prior approval of RBI.

4.5 Validity and extension

The validity of an LO is generally for three years except in the case of Non-Banking Finance Companies (NBFCs) and those entities engaged in construction and development sectors, for whom the validity is two years only. LOs opened by such entities (excluding infrastructure development companies) shall not be allowed any extension of time. Upon expiry of the validity period, the LOs shall have to either close down or be converted into a Joint Venture / Wholly Owned Subsidiary in conformity with the extant Foreign Direct Investment policy.

Requests for extension of time for LOs may be submitted before the expiry of the validity of the approval, to the AD Category-I bank concerned under whose jurisdiction the LO/Nodal office is located. The designated AD Category - I bank may extend the validity period of LO/s for a period of 3 years from the date of expiry of the original approval / extension granted subject to compliance with specified conditions.

The validity period of the project office is for tenure of the project. There is no such validity period for Branch offices.

4.6 Branch Office in SEZ

RBI has given general permission to foreign companies for establishing branch/unit in SEZs to undertake manufacturing and service activities. The general permission is subject to the following conditions:

- Such units are functioning in those sectors where 100 per cent FDI is permitted;
- Such units comply with part XI of the Companies Act, 2013;
- Such units function on a stand-alone basis.

5. Procedures post approval relating to set up

Once foreign company establishes a place of business in India, a LO / BO / PO or any other place of business by whatever name called is required to register with the Registrar of Companies (ROC) as required under the Companies Act, 2013.

A foreign company which has established a place of business in India should file required documents with the Registrar of Companies for registration within 30 days of establishment of place of business in India in Form FC-1.

5.1 Opening of Bank Account

5.1.1 Liaison offices: LO may open an account with the designated AD category I Bank in India for receiving remittances from its head office outside India. It may be noted that LO shall not maintain more than one bank account at any given time without the prior permission of RBI. The permitted credits and debits to the account are laid down in the Master Direction on Establishment of LO / BO / PO in India by foreign entities

5.1.2 Branch offices: BO may open an account with the designated AD category I Bank in India for its business operations in India. Credits to the account should represent the funds received from head office through normal banking channels for meeting the expenses of the office and any legitimate receivables arising in the process of its business operations. Debits to this account shall be for the expenses incurred by the BO and towards remittance of profit/winding up proceeds.

5.1.3 Project offices: Any foreign entity except an entity from Pakistan who has been awarded a contract for a project by the government authority / Public Sector Undertaking or is permitted by the AD bank to operate in India may open a bank account without any prior approval of the RBI. An entity

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from Pakistan shall need prior approval of Reserve Bank of India to open a bank account for its project office in India.

AD bank can open non-interest bearing foreign currency account for PO in India subject to the following:

- The PO has been established in India, with general / specific permission of RBI, having the requisite approval from the concerned project sanctioning authority.
- The contract governing the project specifically provides for payment in foreign currency.
- Each PO can open 2 foreign currency accounts – usually one denominated in USD and the other one in home currency provided both are maintained with the same AD bank.
- The permissible debits to the account shall be payment of project related expenditure and credits shall be foreign currency receipts from the project sanctioning authority and remittances from parent company / group company abroad or bilateral / multilateral international financing agency.
- AD bank shall ensure that only approved debits and credits are allowed in the foreign currency account. Further, the accounts shall be subject to 100 per cent scrutiny by the concurrent auditor of the respective bank.
- The foreign currency accounts have to be closed at the completion of the Project.

Each LO / BO / PO is required to transact through one designated AD bank only who shall be responsible for the due diligence and KYC norms of the LO / BO / PO. LO / BO / PO present in multiple locations, is required to transact through their designated AD. However, the AD of the nodal office is required to comply with all the reporting norms.

LO / BO / PO can change their existing AD Category-I bank subject to both the AD banks giving consent in writing for the transfer and the transferring AD bank confirming submission of all AACs and absence of any adverse features in conducting the account by the BO/LO/PO.

5.2 Application for additional offices and activities

Requests for establishing additional BOs / LOs may be submitted to the AD

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Category-I bank in a fresh FNC form. However, the documents mentioned in form FNC need not be resubmitted, if there are no changes to the documents already submitted earlier.

- (i) If the number of offices exceeds 4 (i.e. one BO / LO in each zone viz; East, West, North and South), the applicant has to justify the need for additional office/s and it shall require prior approval of RBI.
- (ii) The applicant may identify one of its offices in India as the Nodal Office, which will coordinate the activities of all of its offices in India.
- (iii) Whenever the existing BO/LO is shifting to another city in India, prior approval from the AD Category-I bank is required. However, no permission is required if the LO/BO is shifted to another place in the same city subject to the condition that the new address is intimated to the designated AD Category-I bank. Changes in the postal address may be intimated to the CO Cell, New Delhi by the AD Category-I bank at the earliest.

Requests for undertaking activities in addition to what has been permitted initially (Annex C) by RBI/ AD Category-I bank would require prior RBI approval.

5.3 Reporting Requirements

The Annual Activity Certificate (AAC) as at the end of March 31 each year along with the documents laid down needs to be submitted by the following:

- In case of a sole LO / BO / PO, by the LO / BO / PO concerned;
- In case of multiple LO / BO, a combined AAC in respect of all the offices in India by the nodal office of the BOs / LOs.

The LO/BO needs to submit the AAC to the designated AD Category -I bank as well as Director General of Income Tax (International Taxation), New Delhi whereas the PO needs to submit the AAC only to the designated AD Category -I bank.

5.4 Acquisition and Transfer of Immovable Property

Acquisition of property by BO / PO shall be governed by the guidelines issued under Foreign Exchange Management (Acquisition and transfer of immovable property outside India) Regulations.

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5.5 Remittance of profit or surplus

BO may remit outside India profit of the branch net of applicable Indian taxes, on production of the following documents to the satisfaction of the Authorised Dealer bank through whom the remittance is effected:

- A certified copy of the audited Balance Sheet and Profit and Loss account for the relevant year.
- A Chartered Accountant's certificate certifying the manner of arriving at the remittable profit and that the entire remittable profit has been earned by undertaking the permitted activities and that the profit does not include any profit on revaluation of the assets of the branch.

Authorised Dealer bank may permit intermittent remittances by POs pending winding up / completion of the project provided they are satisfied with the *bonafides* of the transaction subject to submission of the following:

- The PO submits an Auditors' / Chartered Accountants' Certificate to the effect that sufficient provisions have been made to meet the liabilities in India including Income Tax, etc.
- An undertaking from the PO that the remittance will not, in any way, affect the completion of the project in India and that any shortfall of funds for meeting any liability in India will be met by inward remittance from abroad.

6. Closure of LO / BO / PO

Requests for closure of the BO / LO/ PO and for remittance of winding-up proceeds may be submitted to the designated AD Category - I bank by the BO/ LO/PO or their nodal office, as the case may be along with the following documents:

- (i) Copy of the RBI approval for establishing the BO/LO/PO.
- (ii) Auditor's certificate:
 - Indicating the manner in which the remittable amount has been arrived at and supported by a statement of assets and liabilities of the applicant and indicating the manner of disposal of assets;
 - Confirming that all liabilities in India including arrears of gratuity and other benefits to employees, etc. of the office have been either fully met or adequately provided for; and

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- Confirming that no income accruing from sources outside India (including proceeds of exports) has remained un-repatriated to India.
- (iii) Confirmation from the applicant / parent company that no legal proceedings in any Court in India are pending and there is no legal impediment to the remittance.
- (iv) A report from the ROC regarding compliance with the provisions of the Companies Act, 2013, in case of winding up of the office in India.
- (v) The designated AD Category - I banks has to ensure that the LO / BO / PO had filed their respective AACs.
- (vi) Any other documents, specified by RBI/AD Category-I bank while granting approval.

Designated AD Category-I bank may allow remittance of winding up proceeds in respect of offices of banks and insurance companies, after obtaining copies of permission of closure from the sectoral regulators along with the documents mentioned above.

6.1 Transfer of assets of LO / BO / PO

Proposals for transfer of assets may be considered by the AD Category-I bank only from LO / BO / PO who are adhering to the operational guidelines such as submission of AACs (up to the current financial year) at regular annual intervals with copies endorsed to DGIT (International Taxation); have obtained PAN from IT Authorities and have got registered with ROC under the Companies Act 2013, if necessary. Also:

- (i) Transfer of assets by way of sale to the Joint Venture (JV) / Wholly Owned Subsidiary (WOS) be allowed by AD Category-I bank only when the non-resident entity intends to close their LO / BO / PO operations in India.
- (ii) A certificate is to be submitted from the Statutory Auditor furnishing details of assets to be transferred indicating their date of acquisition, original price, depreciation till date, present book value or written down value (WDV) value and sale consideration to be obtained. Statutory Auditor should also confirm that the assets were not re-valued after their initial acquisition. The sale consideration should not be more than the book value in each case.

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- (iii) The assets should have been acquired by the LO / BO / PO from inward remittances and no intangible assets such as good will, pre-operative expenses should be included. No revenue expenses such as lease hold improvements incurred by the BO / LO can be capitalised and transferred to JV/WOS.
- (iv) AD Category-I bank must ensure payment of all applicable taxes while permitting transfer of assets.
- (v) Credits to the bank accounts of LO / BO / PO on account of such transfer of assets will be treated as permissible credits.
- (vi) Donation by LO / BO / PO of old furniture, vehicles, computers and other office items etc. to NGOs or other not-for-profit organisations may be permitted by the AD category-I banks after satisfying itself about the *bona fides* of the transaction.

7. Overview of Companies Act, 2013 – registration of companies

FDI in India by way of setting up a company can take two forms viz., private company and public company. It should be noted that One Person Company (OPC) structure is not an option for FDI into corporates as only a natural person who is an Indian citizen is eligible to incorporate an OPC in India.

The Companies (Amendment) Act, 2015, amending the 2013 Act, has done away with the minimum capitalization norms for public and private companies in India. Earlier, the minimum paid-up capital requirement in case of a public limited company in India (i.e. companies which can raise capital from the public) was INR 500,000, whereas that in case of a private limited company (i.e. companies prohibited from raising capital from the public) was INR 100,000.

A high-level comparison of a private company and public company is given below:

Particulars	Private Company	Public Company
Members		
Minimum	2	3
Maximum	200	No limit

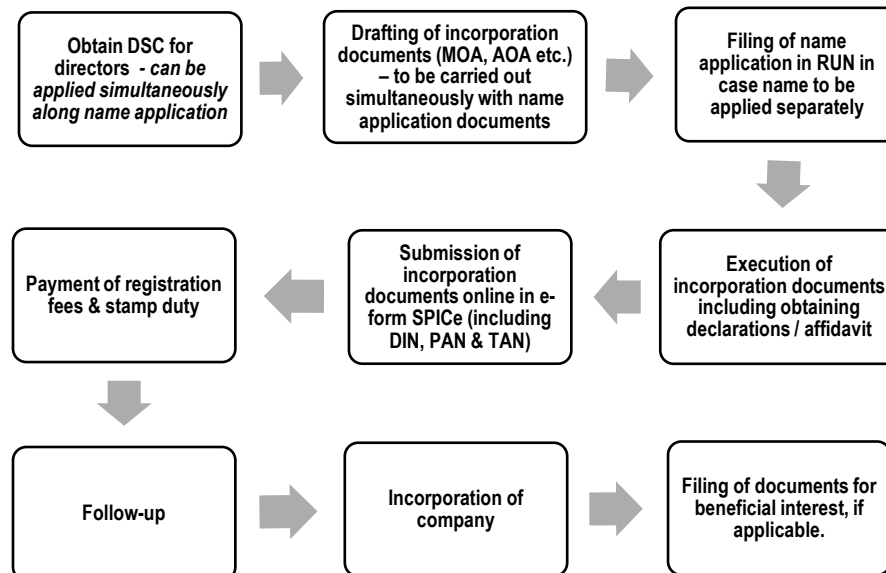
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Particulars	Private Company	Public Company
Directors (Individuals only)		
Minimum	2 (excluding joint-holders, employees, ex-employees)	3
Minimum Paid-up Capital	Minimum Paid-up Capital shall be such sum as may be prescribed by Government of India (GOI), same is yet to be prescribed	
Transferability of shares and marketability thereof	Restricted	No restrictions
Issue of Prospectus	Prohibited from inviting public for subscription of its shares / debentures etc.	Can issue Prospectus

The Ministry of Corporate Affairs (MCA) has been constantly trying to simplify the process of incorporation. The Companies (Amendment) Act, 2017 has further simplified the process of incorporation by replacing affidavits with simple declarations from the first subscribers and directors. A new Reserve Unique Name (RUN) process has also been introduced by the MCA for name application by prospective companies.

An overview of the process of incorporation of a company is given below:

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8. Importance of inbound investment structure

Foreign investment in India has come a long way. In 1991, the Coca Cola Company re-entered our country followed by Pepsi and various other multinational companies followed the trend. After opening up of the retail sector, in the recent past, we are able to see global players like IKEA, WalMart etc. in our vicinity. StarBucks Coffee in India is the best example of country's liberalization policy.

The government gave the red carpet treatment to multi-national companies / foreign companies who wanted to enter into a joint venture with Indian companies and were ready to infuse capital for setting up, expansion or development of projects.

India is currently among the most attractive destinations for FDI in the world. Among several factors favouring India as an investment destination are a large skilled and young work-force, a large English-speaking population and cheap labour cost.

The present government at the Centre has taken various measures for ease of doing business in India, including amendments to the FDI Policy which has led to a revival of investment sentiment in India. Both retail and institutional investors have started investing in financial assets. With the general

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perception about the government changing, NRIs would also be looking to gain from the strong investment scenario.

NRIs are investing in NRE fixed deposit which is the most favoured destination for NRI funds. With the rupee falling, real estate has also been a lucrative investment option for NRIs. RBI's regulations in this regard are fairly simple and one does not have to take any prior permission from the regulatory authorities.

It is the intent and objective of the Government of India to attract and promote FDI in order to supplement domestic capital, technology and skills, for accelerated economic growth. FDI, as distinguished from portfolio investment, has the connotation of establishing a 'lasting interest' in an enterprise that is resident in an economy rather than an 'investor mindset'.

Since coming to power in May 2014, the government has liberalised the FDI limit in crucial sectors like defence, insurance, real estate, railways, broadcasting content services and medical devices. These measures were aimed at improving India's ranking in the World Bank's Ease of Doing Business index, where India now stands at 100th amongst 190 countries.

Source References:

- Foreign Exchange Management Act, 1999
- Companies Act, 2013
- Income-tax Act, 1961
- Foreign Exchange Management (Transfer or Issue of Security by a Person Resident outside India) Regulations, 2017 ('FDI Regulations 2017' or 'the Regulations')
- Consolidated FDI Policy issued by the DIPP, Ministry of Commerce
- Foreign Exchange Management (Establishment in India of a branch office or a liaison office or a project office or any other place of business) Regulations, 2016
- RBI Master Direction on Establishment of Branch Office (BO) / Liaison Office (LO) / Project Office (PO) in India by foreign entities

Broad procedures related to Import

This section covers:

- *Overview of 'import' from the perspective of indirect tax laws including customs*
- *Broad procedure for import under Customs Act, 1962*

1. Import

Import trade refers to bringing goods from a foreign country to India. The procedure for import trade differs from country to country depending upon the import policy, statutory requirements and customs policies of different countries. In almost all countries of the world import trade is controlled by the government. The objectives of these controls are proper use of foreign exchange restrictions; prevent entry of contraband goods and psychotropic substances, protection of indigenous industries etc. The imports of goods have to follow certain procedures which may involve a number of steps namely:

1.1 Trade Enquiry

The first stage in an import transaction, like any other transaction of purchase and sale relates to making trade enquiries. An enquiry is a written request from the intending buyer or his agent for information regarding the price and the terms on which the exporter will be able to supply goods.

1.2 Procurement of Import Licence

A person or a firm cannot import goods into India without a valid Import Export code (IEC) obtained from the Directorate General of Foreign Trade.

1.3 Obtaining Foreign Exchange

After obtaining the IEC licence, the importer has to make arrangement for obtaining necessary foreign exchange since the importer has to make payment for the imports in the currency of the exporting country.

1.4 Placing the Indent or Order

After the initial formalities are over, the next step in the import of goods is that of placing the order. This order is known as Indent. An indent is an order placed by an importer with an exporter for the supply of certain goods.

1.5 Despatching a Letter of Credit:

Generally, foreign traders are not acquainted with each other and so the exporter before shipping the goods wants to be sure about the creditworthiness of the importer. The exporter wants to be sure that there is no risk of non-payment. Usually, for this purpose he asks the importers to send a letter of credit to him.

1.6 Obtaining Necessary Documents:

After despatching a letter of credit, the importer does not have much to do. On receipt of the letter of credit, the exporter arranges for the shipment of goods and sends Advice Note to the importer immediately after the shipment of goods. An Advice Note is a document sent to a purchaser of goods to inform him that goods have been despatched. It may also indicate the probable date on which the ship is expected to reach the port of destination.

For importing services, importer is required to abide by the Goods and Services Tax law.

Import of goods shall be freely allowed by the Indian Government except when regulated by way of prohibition, restriction or exclusive trading through State Trading Enterprises(STEs) as laid down in Indian Trade Classification (Harmonised System) 'ITC(HS)' of Exports and imports.

We have listed down broad procedure as required by Customs Act, 1962, that any importer shall be required to follow in order to import goods into India:

2. Import/Arrival Manifest

Goods imported into the country attract Customs Duty and are also required to conform to relevant legal requirements. Thus, unless the imported goods are not meant for Customs clearance at the port/airport of arrival such as those intended for transit by the same vessel/aircraft or transshipment to another Customs station or to any place outside India, detailed Customs clearance formalities have to be followed by the importers.

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According to Section 52 to 56 of the Customs Act, 1962 the goods mentioned in the IGM/Import Report for transit to any place outside India or meant for transshipment to another Customs station in India are allowed transit without payment of duty.

In case of goods meant for transshipment to another Customs station, simple transshipment procedure has to be followed by the carrier and the concerned agencies at the first port/airport of landing and the Customs clearance formalities have to be complied with by the importer after arrival of the goods at the other Customs station. There could also be cases of transshipment of the goods after unloading to a port outside India. For this purpose a simple procedure is prescribed, and no duty is required to be paid.

Person-in-charge of vessel, aircraft or vehicle carrying imported goods has to submit Import report. In case of vessel or aircraft, IGM to be submitted electronically prior to arrival of a vessel or aircraft. Import report in case of vehicle has to be submitted within 12 hours of arrival in the customs station.

After delivery of arrival/import manifest or if customs officer is satisfied that there are sufficient reasons for not delivering the import manifest, customs officer shall grant 'entry inwards' under section 31 of Customs Act (Grant of 'entry inwards' is required for vessel but not for aircraft or vehicle)

2.1 Documents required for goods clearance

The following mandatory documents for import of goods into India are required to be filed:

- (a) Bill of Entry(BoE) / Integrated Declaration form
- (b) Bill of Lading/Airway bill/Lorry receipt/Railway receipt/Postal receipt
- (c) Commercial invoice cum Packing List (as per Circular no 1/2015-Cus dated 12/1/2015 separate commercial invoice and packing list would also be accepted)
- (d) Insurance Certificate
- (e) Import License
- (f) Purchase Order/ Letter of Credit
- (g) Technical Write-up/ Literature etc.

For goods which are subject to any restrictions/ policy conditions etc., regulatory authority may demand additional documents for import.

Broad procedures related to Import

The importers have to obtain an Importer-Export Code (IEC) number from the Directorate General of Foreign Trade (DGFT) prior to filing of Bill of Entry for clearance of imported goods.

BoE is a very vital document which every importer has to electronically submit to customs officer in respect of imported goods other than goods intended for transit or transshipment. The importers have the option to either:

- (a) clear the goods for home consumption after payment of duties leviable; or
- (b) clear the goods for warehousing without immediate discharge of the duties leviable in terms of the warehousing provisions of the Customs Act, 1962.

The importer who presents the BoE shall ensure to comply with below mentioned points:

- (a) BoE is required to be submitted within one day (excluding holiday) after the arrival of conveyance carrying goods to be cleared for home consumption or warehousing failure of submission without sufficient cause may lead to levy of penalty by Customs authorities;
- (b) the accuracy and completeness of information given to Customs Authorities;
- (c) the authenticity and validity of any document supporting BoE;
- (d) compliance with the restriction or prohibition, if any, relating to the goods;
- (e) BoE should include all goods mentioned in Bill of Lading or other receipt given by carrier to consignor;
- (f) the importer to declare that contents of BoE are true and provide invoice or such other support documents as prescribed by the Customs statute to substantiate their claims.

It is permissible to file bill of entry/import manifest 30 days in advance of the expected date of arrival of conveyance to save time on sorting out tariff classification, valuation and Input tax credit (ITC) formalities.

2.2 Provisions relating to conveyances carrying imported or exported goods

Section 32 of Customs Act provides that only those goods mentioned in the

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arrival manifest can be unloaded. Such unloading can be only at approved place and under supervision of Customs officer.

No imported goods shall be unloaded from any conveyance on any Sunday or on any holiday observed by the Customs Department or on any other day after the working hours, except after giving the prescribed notice and on payment of the prescribed fees, if any.

2.3 Valuation of goods

Section 14 provides that for the purposes of the imposition of customs duties, the value shall be the transaction value of the goods, ie the price actually paid or payable for the goods, when sold for export to India / export from India, for delivery at the time and place of importation / exportation, where the buyer and seller of the goods are not related, and price is the sole consideration for the sale.

Section 14 also provides that the acceptance of the transaction value is subject to other conditions as may be specified in the valuation rules.

The first proviso to section 14 provides that the transaction value shall include, in addition to the price for the goods, certain amounts paid or payable for costs or services related to the goods.

Customs Valuation rules provide for the circumstances in which the buyer and seller shall be deemed to be related, the manner of determination of value when there is no sale or the buyer and seller are related or price is not the sole consideration for sale or in other specified cases, and the manner for acceptance or rejection of the declared value in case the proper officer has reason to doubt the truth or accuracy of such value and determination of value in such a case.

Therefore, if for any reason the transaction value cannot be applied, the value for customs purposes has to be determined in accordance with the relevant rules.

Customs Valuation rules prescribe that the importer or his agent shall furnish–

- (a) a declaration disclosing full and accurate details relating to the value of imported goods;
- (b) any other statement, information or document including an invoice of the manufacturer or producer of the imported goods where the goods are imported from or through a person other than the manufacturer or

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producer, as considered necessary by the proper officer for determination of the value of imported goods under these rules.

If the value declared by the importer is rejected, the Assessing officer can value imported goods on other basis e.g. value of identical goods, value of similar goods etc as provided in the said rules

2.4 Types of Customs duty leviable

Import duty generally consists of the following types:

- (a) Basic customs duty (BCD): It may be at the standard rate or, in the case of import from some countries, at the preferential rate. Basic duty is applicable to all goods unless specifically exempted
- (b) Additional duty of customs: Such duty shall be leviable on petroleum products, tobacco products, alcoholic liquors
- (c) Integrated Goods and Services Tax (IGST) : It is applicable to all goods unless specifically exempted and goods not covered under GST such as petrol, diesel, natural gas, liquor for human consumption, Aviation turbine fuel and crude
- (d) Goods and Services Tax (GST) compensation cess: It is applicable to specific products
- (e) National calamity contingent duty (NCCD): It is applicable to specified imports as notified by central government
- (f) Anti-dumping duty/safeguard duty: It is applicable to specified imports as notified by central government
- (g) Social welfare surcharge: applicable to all goods unless specifically exempted

2.5 Applicability of GST on imports

Supply of goods into the territory of India shall be deemed to be supply of goods in the course of Inter-state trade and IGST shall be levied on imports, unless the goods are specifically exempted from duty by way of notification issued by the Central Government.

2.6 Self-assessment, provisional assessment and re-assessment of imported goods

Section 17 of the Customs Act, 1962 (Customs Act) provides for self-

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assessment of duty on imported goods by the importer by filing a BoE. Thus, the importer should ensure that he declares the correct classification, applicable rate of duty, value, and benefit of exemption notifications claimed.

The declaration filed by the importer may be verified by the proper officer when so interdicted by the Risk Management Systems (RMS). If the self-assessment is found incorrect, the duty may be reassessed. In cases where there is no interdiction, there will be no cause for the declaration filed by the importer to be taken up for verification, and such Bills of Entry will be straightaway facilitated for clearance without assessment and examination, on payment of duty, if any.

For the purpose of verification, the proper officer may order for examination or testing of the imported goods. The proper officer may also require the production of any relevant document or ask the importer to furnish any relevant information. Thereafter, if the self-assessment of duty is not found to have been done correctly, the proper officer may re-assess the duty. This is without prejudice to any other action that may be warranted under the Customs Act. On re-assessment of duty, the proper officer shall pass a speaking order, if so desired by the importer, within 15 days of re-assessment.

There may be situations when the proper officer of Customs finds that verification of self-assessment in terms of Section 17 requires testing / further documents / information, and the goods cannot be re-assessed quickly but are required to be cleared by the importer on urgent basis. In such cases, provisional assessment may be done in terms of Section 18 of the Customs Act, 1962, once the importer furnishes security as deemed fit by the proper officer of Customs for differential duty equal to duty provisionally assessed by him and the duty payable after re-assessment.

In order to facilitate genuine trade and reduce dwell time, it has been decided that genuine clarification sought by officers from importers / exporters are raised in one go and not in piecemeal manner. Further, the field formation could consider listing of the queries frequently raised in course of assessment and disseminate them through Public notice or sensitize trade about the same so that importers should take preventive action to avoid such queries or to be prepared to reply to such queries.

2.7 Bill of Entry for bond/warehousing

A separate form of Bill of Entry is used for clearance of goods for warehousing. All documents, as are required to be attached with a Bill of

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Entry for home consumption are also required with the Bill of Entry for warehousing which is assessed in the same manner and duty payable is determined.

However, since duty is not required to be paid at the time of warehousing, the purpose of assessing the duty at this stage is only to secure the duty in case the goods do not reach the warehouse. For this purpose the importer is required to furnish a bond with the customs authorities covering the applicable duty on the imported goods.

The duty is paid at the time of ex-bond clearance of goods for which an Ex-Bond Bill of Entry is filed. The rate of duty applicable to imported goods cleared from a warehouse is the rate in- force on the date of filing of Ex-Bond Bill of Entry

2.8 Conversion from home consumption to warehousing and vice-versa

It may so happen that an importer has filed the bill of entry for home consumption. He may subsequently find that he is not in a position to pay duty and remove the goods for home consumption.

He may seek permission to substitute the bill of entry for home consumption with a bill of entry for warehousing. The reverse proposition is also permissible. In either case, the proper officer of customs has to be satisfied that this request is made on genuine grounds and not a device to avoid duty.

2.9 Amendment of Bill of Entry

Whenever mistakes are noticed after submission of documents, amendments to the Bill of Entry is carried out with the approval of Deputy/Assistant Commissioner.

The request for amendment may be submitted with the supporting documents. For example, if the amendment of container number is required, a letter from shipping agent is required.

On sufficient proof being shown to the Deputy/Assistant Commissioner amendment in Bill of Entry may be permitted after the goods have been given out of charge i.e. goods have been cleared.

2.10 Prior filing of Bill of Entry:

For faster clearance of the goods, Section 46 of the Customs Act, 1962 allows filing of Bill of Entry prior to arrival of goods.

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This Bill of Entry is valid if vessel/aircraft carrying the goods arrives within 30 days from the date of presentation of Bill of Entry

2.11 Relevant date for rate and valuation of Import duty:

The rate of duty and tariff valuation, if any, applicable to any imported goods, shall be the rate and valuation in force,-

- (a) in the case of goods entered for home consumption under section 46, on the date on which a bill of entry in respect of such goods is presented under that section;
- (b) in the case of goods cleared from a warehouse on the date on which the bill of entry for home consumption is presented under section 68;
- (c) in the case of any other goods, on the date of payment of duty.

2.12 Execution of bonds

Wherever necessary, for availing duty free assessment or concessional assessment under different schemes and notifications, execution of end use bonds with Bank Guarantee or other surety is required to be furnished. These have to be executed in prescribed forms before the assessing officer.

For instance, when the import of goods is made under Export Promotion schemes, the importer is required to execute bonds with the Customs authorities for fulfilment of conditions of respective notifications.

If the importer fails to fulfil the conditions, he has to pay the duty leviable on those goods. The amount of bond and bank guarantee is determined in terms of the instruction issued by the Board as well the conditions of the relevant notification etc.

2.13 Risk Management System in import:

'Risk Management System' (RMS) has been introduced in Customs locations where the EDI System (ICES) is operational. This is one of the most significant steps in the ongoing Business Process Re-engineering of the Customs Department.

RMS has dispensed with the practice of routine assessment, concurrent audit and examination and the present focus is on quality assessment, examination and Post Clearance Audit of selected Bills of Entry.

2.14 Re-importation of goods

If goods are imported into India after exportation therefrom, such goods shall be liable to duty and be subject to all the conditions and restrictions, if any, to which goods of the like kind and value are liable or subject, on the importation thereof. However there are certain exemptions granted to some goods subject to fulfilment of specified conditions and satisfaction of the Deputy/ Assistant Commissioner of Customs.

2.15 Advance rulings

Any importer not able to ascertain the tariff, classification or duty amount or to avoid any re-assessment in future date shall before importation of goods. file an application for advance ruling.

The application shall be filed in the prescribed form stating the question on which the advance ruling is sought.

The question on which the advance ruling can be sought are:

- (a) classification of goods under the Customs Tariff Act, 1975;
- (b) applicability of a notification issued under sub-section (1) of section 25, having a bearing on the rate of duty;
- (c) the principles to be adopted for the purposes of determination of value of the goods under the provisions of this Act;
- (d) applicability of notifications issued in respect of tax or duties under Customs Act or Customs Tariff Act, 1975 or any tax or duty chargeable under any other law for the time being in force in the same manner as duty of customs leviable under this Act or The Customs Tariff Act
- (e) determination of origin of the goods in terms of the rules notified under the Customs Tariff Act, 1975 and matters relating thereto;
- (f) any other matter as the central government may, by notification, specify.

2.16 Powers of Government in case of non-compliance

Customs Act provided several powers to the Government which can be exercised in case the importer does not abide by the provisions of the law, namely:

- (a) Power to stop and search conveyances

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- (b) Power to inspect and examine and person
- (c) Penalty for failure to furnish information return
- (d) Power to search premises of the importer
- (e) Power to search suspected persons entering or leaving India
- (f) Seizure of goods, documents and things
- (g) Confiscation of improperly imported goods

There is enormous, untapped potential for enhancing India's economy. Thus, improving ease of business is a high priority area for the Indian government. Several initiatives have been taken or are in the pipeline for simplification of import procedures and promote digitalisation of various processes involved in trade transactions, to ensure maintaining a balance between meeting the needs of a growing economy and promotion of domestic industries.

Source References:

- The Customs Act, 1962
- Customs Valuation (Determination of Value of Imported Goods) Rules, 2007
- Foreign Trade Policy FY 15-20
- Handbook of Procedures
- CBEC's Customs Manual

Chapter 5

FEMA Guidelines on Import Remittances

This section covers:

- *Regulatory framework under FEMA for imports*
- *General guidelines for imports*
- *Time limit for settlement of import payments*
- *Third party payments for imports*
- *Operational Guidelines for imports*
- *Write-off*
- *Merchanting trade*

1. Introduction and Regulatory Framework

The term “import” is understood to signify bringing into India, goods and services from any place outside India. It is a significant avenue for the government to generate revenue by the levy of import duty on such imported goods. Import trade is regulated by the Directorate General of Foreign Trade (DGFT) which is constituent of the Ministry of Commerce and Industry.

A country as well as the constituent entities of the economy witness various benefits on facilitation of imports, as follows:

- (a) **Access to scarce / region specific resources:** Certain resources are either not available in a particular geographic territory or are very highly priced making it unviable for local production. Hence, procuring the same from a region in which the same is readily available is facilitated through imports.
- (b) **New and high quality products:** Import facilitates technologically advanced goods or services to enter the economy. The Indian market with an emerging middle class, increasing disposable income and healthy population growth is an ideal market for overseas entities to enter.

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- (c) **Cost savings:** If the cost of production to manufacture a product or provide a certain service in India is potentially higher than procuring the same from a foreign country, importing the same is more cost-effective.
- (d) **Increase in tax collection:** Import of goods attracts various import duties and cesses under the Customs Act, 1962, and related laws which becomes a considerable source of revenue for the government.

Import of Goods and Services into India is facilitated by section 5 of FEMA along with Foreign Exchange Management (Current Account Transaction) Rules, 2000. The RBI has issued Master Direction No. 17/2016-17, dated 1 January 2016 which is updated from time to time (Master Direction on Imports) and contains detailed directions on import of goods and services.

In this publication, only those provisions are discussed, knowledge of which helps reader to understand basic administrative procedure in relation to import of goods and services. For detailed rules and regulation, one can refer above referred Master Direction which can be downloaded from the RBI website www.rbi.org.in

2. General guidelines

The Master Direction on Imports sets out the Rules and Regulations to be followed by the AD Category – I banks from the forex angle while undertaking import payment transactions on behalf of their clients. In sectors or cases where no specific regulation is stated, the actions of AD Category – I banks may be governed by normal trade practices. On part of the AD Category – I banks, adherence to "Know Your Customer" (KYC) Guidelines issued by RBI (Department of Banking Regulation) is compulsory in all their dealings.

AD Category I Banks may allow remittance for making payments for imports into India, after ensuring that all the requisite details are made available by the importer and the remittance is for *bona fide* trade transactions as per applicable laws in force.

Except for goods included in the negative list which require licence under the FTP in force, AD Category - I banks may freely open letters of credit and allow remittances for import.

2.1 Time Limit for Settlement of Import Payments

A. Normal Imports

- (i) Except in cases where amounts are withheld towards guarantee of performance, etc. remittances against imports should be completed not later than six months from the date of shipment.
- (ii) AD Category-I banks may permit settlement of import dues delayed due to disputes, financial difficulties, etc. However, interest if any, on such delayed payments, usance bills or overdue interest is payable only for a period of up to three years from the date of shipment and may be permitted in terms of the directions specified in the Master Direction on Imports.

B. Deferred Payment Arrangements

Deferred payment arrangements (including suppliers' and buyers' credit) up to five years, are treated as trade credits for which the procedural guidelines as laid down in the Master Circular for External Commercial Borrowings and Trade Credits may be followed.

C. Import of Books

Remittances against import of books may be allowed without restriction as to the time limit, provided, interest payment, if any, is as per the directions specified in the Master Direction on Imports.

2.2 Extension of Time

AD Category-I banks can consider granting extension of time for settlement of import dues up to a period of six months at a time (maximum up to the period of three years) irrespective of the invoice value for delays on account of disputes about quantity or quality or non-fulfilment of terms of contract; financial difficulties and cases where importer has filed suit against the seller. In cases where sector specific guidelines have been issued by RBI for extension of time (i.e. rough, cut and polished diamonds), the same will be applicable.

While granting extension of time, AD Category-I banks must ensure that:

- (a) The import transactions covered by the invoices are not under investigation by Enforcement Directorate / Central Bureau of Investigation or other investigating agencies;
- (b) While considering extension beyond one year from the date of

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remittance, the total outstanding of the importer does not exceed USD one million or 10 per cent of the average import remittances during the preceding two financial years, whichever is lower; and

- (c) Where extension of time has been granted by the AD Category – I banks, the date up to which extension has been granted may be indicated in the 'Remarks' column.

Cases not covered by the above instructions / beyond the above limits, may be referred to the concerned Regional Office of RBI.

2.3 Import of Forex / Indian Rupees

Except as otherwise provided in the Regulations, no person shall, without the general or special permission of RBI, import or bring into India, any foreign currency. Import of foreign currency, including cheques, is governed by Section 6(3)(g) of FEMA and the Foreign Exchange Management (Export and Import of Currency) Regulations 2015, issued by the RBI vide Notification No. FEMA 6(R)/2015-RB dated 29 December 2015, as amended from time to time.

2.3.1 Import of Forex into India: Any person may, without any limit, send into India forex in any form other than currency notes, bank notes and travellers cheques;

Any person may, without limit, bring into India from any place outside India, forex in any form other than unissued notes, subject to the condition that such person, on arrival in India, makes a declaration to the Custom Authorities at the Airport in the Currency Declaration Form (CDF). Such CDF shall not be required where:

1. The aggregate value of forex in the form of currency notes, bank notes or travellers cheques brought in by such person at any one time does not exceed USD 10,000 (US Dollars ten thousand) or its equivalent; and/or
2. The aggregate value of foreign currency notes (cash portion) alone brought in by such person at any one time does not exceed USD 5,000 (US Dollars five thousand) or its equivalent.

2.3.2 Import of Indian Currency and Currency Notes

- (i) Any person resident in India who had gone out of India on a temporary visit, may bring into India at the time of his return from any place outside India (other than from Nepal and Bhutan), currency notes of

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government of India and RBI notes up to an amount not exceeding INR 25,000 (Rupees twenty five thousand only).

- (ii) A person may bring into India from Nepal or Bhutan, currency notes of Government of India and RBI for any amount in denominations up to INR 100.

2.4 Third Party Payment for Import Transactions

Subject to the following conditions, AD category I banks are allowed to make payments to a third party for import of goods:

- (a) Firm irrevocable purchase order / tripartite agreement should be in place. However this requirement may not be insisted upon in case where documentary evidence for circumstances leading to third party payments / name of the third party being mentioned in the irrevocable order / invoice has been produced.
- (b) AD bank should be satisfied with the *bonafides* of the transactions and should consider the Financial Action Task Force (FATF) Statement before handling the transactions;
- (c) The Invoice should contain a narration that the related payment has to be made to the (named) third party;
- (d) Bill of Entry should mention the name of the shipper as also the narration that the related payment has to be made to the (named) third party;
- (e) Importer should comply with the related extant instructions relating to imports including those on advance payment being made for import of goods.

2.5 Issue of Guarantees by an Authorised Dealer

An Authorised Dealer may give a guarantee in respect of any debt, obligation or other liability incurred by a person resident in India and owned to a person resident outside India, as an importer, in respect of import on deferred payment terms in accordance with the approval by the RBI for import on such terms.

An Authorised Dealer may give guarantee, Letter of Undertaking or Letter of Comfort in respect of any debt, obligation or other liability incurred by a person resident in India and owned to a person resident outside India (being an overseas supplier of goods, bank or a financial institution), for import of

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goods, as permitted under the FTP announced by Government of India from time to time and subject to such terms and conditions as may be specified by RBI from time to time.

An Authorised Dealer may, in the ordinary course of his business, give a guarantee in favour of a non-resident service provider, on behalf of a resident customer who is a service importer, subject to such terms and conditions as stipulated by RBI from time to time subject to the following:

- (a) No guarantee for an amount exceeding USD 500,000 or its equivalent shall be issued on behalf of a service importer other than a Public Sector Company or a Department / Undertaking of the Government of India / state government.
- (b) Where the service importer is a Public Sector Company or a Department / Undertaking of the Government of India / state government, no guarantee for an amount exceeding USD 100,000 or its equivalent shall be issued without the prior approval of the Ministry of Finance, Government of India.

An Authorised Dealer may, subject to the directions issued by the RBI in this behalf, permit a person resident in India to issue corporate guarantee in favour of an overseas lessor for financing import through operating lease effected in conformity with the FTP in force and under the provisions of the FEMCAT Rules and the Directions issued by RBI under FEMA from time to time.

3. Operational Guidelines for Imports

3.1 Advance Remittance for Import of Goods

Advance remittance for import of goods may be allowed by AD Category-I bank without any ceiling subject to the following conditions:

- If the amount of advance remittance exceeds USD 200,000 or its equivalent, an unconditional, irrevocable standby Letter of Credit or a guarantee from an international bank of repute situated outside India or a guarantee of an AD Category – I bank in India, if such a guarantee is issued against the counter-guarantee of an international bank of repute situated outside India, is obtained.
- In cases where the importer (other than a Public Sector Company or a Department/Undertaking of the Government of India/state government/s) is unable to obtain bank guarantee from overseas

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suppliers and the AD Category – I bank is satisfied about the track record and *bonafides* of the importer, the requirement of the bank guarantee / standby Letter of Credit may not be insisted upon for advance remittances up to USD 5,000,000 (US Dollar five million). AD Category – I banks may frame their own internal guidelines to deal with such cases as per a suitable policy framed by the bank's Board of Directors.

- A Public Sector Company or a Department / Undertaking of the Government of India / state government/s which is not in a position to obtain a guarantee from an international bank of repute against an advance payment, is required to obtain a specific waiver for the bank guarantee from the Ministry of Finance, Government of India before making advance remittance exceeding USD 100,000.

3.2 Advance Remittance for the Import of Services

AD Category–I bank may allow advance remittance for import of services without any ceiling subject to the following conditions:

- Where the amount of advance exceeds USD 500,000 or its equivalent, a guarantee from a bank of international repute situated outside India, or a guarantee from an AD Category – I bank in India, if such a guarantee is issued against the counter-guarantee of a bank of international repute situated outside India, should be obtained from the overseas beneficiary.
- In the case of a Public Sector Company or a Department/ Undertaking of the Government of India/ state governments, approval from the Ministry of Finance, Government of India for advance remittance for import of services without bank guarantee for an amount exceeding USD 100,000 (USD One hundred thousand) or its equivalent would be required.
- AD Category – I banks should also follow-up to ensure that the beneficiary of the advance remittance fulfils his obligation under the contract or agreement with the remitter in India, failing which, the amount should be repatriated to India.

3.3 Interest on Import Bills

AD Category – I bank may allow payment of interest on usance bills or overdue interest on delayed payments for a period of less than three years

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from the date of shipment at the rate prescribed for trade credit from time to time.

In case of pre-payment of usance import bills, remittances may be made only after reducing the proportionate interest for the unexpired portion of usance at the rate at which interest has been claimed or LIBOR of the currency in which the goods have been invoiced, whichever is applicable. Where interest is not separately claimed or expressly indicated, remittances may be allowed after deducting the proportionate interest for the unexpired portion of usance at the prevailing LIBOR of the currency of invoice.

3.4 Remittances against Replacement Imports

Where goods are short-supplied, damaged, short-landed or lost in transit and the Exchange Control Copy of the import licence has already been utilised to cover the opening of a letter of credit against the original goods which have been lost, the original endorsement to the extent of the value of the lost goods may be cancelled by the AD Category – I bank and fresh remittance for replacement imports may be permitted without reference to RBI, provided, the insurance claim relating to the lost goods has been settled in favour of the importer. It may be ensured that the consignment being replaced is shipped within the validity period of the license.

3.5 Guarantee for Replacement Import

In case replacement goods for defective import are being sent by the overseas supplier before the defective goods imported earlier are reshipped out of India, AD Category-I banks may issue guarantees at the request of importer client for dispatch/return of the defective goods, according to their commercial judgment.

3.6 Physical imports

In case of all imports, irrespective of the value of foreign exchange remitted / paid for import into India, it is obligatory on the part of the AD Category– I bank through which the relative remittance was made, to ensure that the importer submits:-

- I. The importer shall submit BoE number, port code and date for marking evidence of import under IDPMS.
- II. Customs Assessment Certificate or Postal Appraisal Form, as declared by the importer to the Customs Authorities, where import has been made by post, or Courier BoE as declared by the courier

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companies to the Customs Authorities in cases where goods have been imported through couriers, as evidence that the goods for which the payment was made have actually been imported into India, or

- III. For goods imported and stored in FTWZ or SEZ Unit warehouses or Customs bonded warehouses, etc., the Exchange Control Copy of the Ex-Bond BoE or BoE issued by Customs Authorities by any other similar nomenclature the importer shall submit applicable BoE number, port code and date for marking evidence of import under IDPMS.

3.7 Evidence of import in lieu of BoE

AD Category I banks may accept in lieu of exchange control copy of BoE for home consumption, a certificate from the CEO or auditor of the company that the goods for which remittance was made have actually been imported into India provided:

- I. The amount of foreign exchange remitted is less than USD 1,000,000 or its equivalent; and
- II. The importer is a company listed on a stock exchange in India and whose net worth is not less than INR 100 crore as on the date of its last audited balance sheet, or, the importer is a public sector company or an undertaking of the Gol or its departments.

3.8 Non-physical Imports

Where imports are made in non-physical form, i.e., software or data through internet / data-com channels and drawings and designs through e-mail / fax, a certificate from a Chartered Accountant that the software / data / drawing/ design has been received by the importer, may be obtained.

AD Category – I bank should advise importers to keep Customs Authorities informed of the imports made by them under this clause.

3.9 Extension and Write Off

AD Category I banks shall give extension for submission of BoE beyond the prescribed period in terms of the extant guidelines on the matter. Such extension as well as the date up to which extension is granted will also be reported/ indicated in IDPMS.

AD Category I banks can consider closure of Bill of Exchange (BoE) / Outward Remittance Message (ORM) in Import Data Processing and Monitoring System (IDPMS) that involves write off to the extent of 5 per cent

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of invoice value in cases where the amount declared in BoE varies from the actual remittance due to operational reasons and AD bank is satisfied with the reason/s submitted by the importer.

AD Category I banks may close the BoE for such import transactions where write off is on account of quality issues, short shipment or destruction of goods by the port/ customs/ health authorities in terms of extant guidelines on the matter subject to submission of satisfactory documentation by the importer irrespective of the amount involved.

While allowing write off, AD Category - I banks must ensure that:

- The case is not the subject matter of any pending civil or criminal suit;
- The importer has not come to the adverse notice of the Enforcement Directorate or the Central Bureau of Investigation or any such other law enforcement agency; and
- There is a system in place under which internal inspectors or auditors of the AD category – I banks (including external auditors appointed by authorised dealers) should carry out random sample check / percentage check of write-off of import bills.

Extension and write off cases not covered by the extant guidelines may be referred to the concerned Regional Office of RBI for necessary approval.

3.10 Import Factoring

AD Category – I bank may enter into arrangements with international factoring companies of repute, preferably members of Factors Chain International, without the approval of RBI.

They will have to ensure compliance with the extant forex directions relating to imports, FTP in force and any other guidelines/directives issued by RBI in this regard.

3.11 Merchanting Trade

For a trade to be classified as Merchanting Trade following conditions should be satisfied:

- (a) Goods acquired should not enter the Domestic Tariff Area, and
- (b) The state of the goods should not undergo any transformation.

AD Category – I bank may handle bona fide Merchanting Trade Transactions and ensure that:

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- (a) Goods involved in the transactions are permitted for export / import under the prevailing FTP of India as on the date of shipment and all the rules, regulations and directions applicable to export (except Export Declaration Form) and import (except Bill of Entry) are complied with for the export leg and import leg, respectively.
- (b) Both the legs of a Merchanting Trade Transaction are routed through the same AD bank. The bank should verify the documents like invoice, packing list, transport documents and insurance documents (if originals are not available, non-negotiable copies duly authenticated by the bank handling documents may be taken) and satisfy itself about the genuineness of the trade.
- (c) The entire Merchanting Trade Transactions should be completed within an overall period of nine months and there should not be any outlay of forex beyond four months.
- (d) The commencement of Merchanting Trade would be the date of shipment / export leg receipt or import leg payment, whichever is first. The completion date would be the date of shipment / export leg receipt or import leg payment, whichever is the last.
- (e) Short-term credit either by way of suppliers' credit or buyers' credit will be available for Merchanting Trade Transactions, to the extent not backed by advance remittance for the export leg, including the discounting of export leg LC by an AD bank, as in the case of import transactions.
- (f) In case advance against the export leg is received by the Merchanting Trader, AD bank should ensure that the same is earmarked for making payment for the respective import leg. However, AD bank may allow short-term deployment of such funds for the intervening period in an interest bearing account.
- (g) Merchanting Traders may be allowed to make advance payment for the import leg on demand made by the overseas seller. In case where inward remittance from the overseas buyer is not received before the outward remittance to the overseas supplier, AD bank may handle such transactions by providing facility based on commercial judgement. It may, however, be ensured that any such advance payment for the import leg beyond USD 200,000 per transaction, should be made against Bank Guarantee / LC from an international

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bank of repute, except in cases and to the extent where payment for export leg has been received in advance;

- (h) Letter of Credit to the supplier is permitted against confirmed export order keeping in view the outlay and completion of the transaction within nine months.
- (i) Payment for import leg may also be allowed to be made out of the balances in EEFC account of the Merchant Trader.
- (j) AD bank should ensure one-to-one matching in case of each Merchanting Trade transaction and report defaults in any leg by the traders to the concerned Regional Office of RBI, on half yearly basis within 15 days from the close of each half year, i.e. June and December.
- (k) Defaulting Merchanting Traders, whose outstandings reach 5 per cent of their annual export earnings, would be caution-listed.
- (l) The KYC and AML guidelines should be observed by the AD bank while handling such transactions.

Merchanting Traders have to be genuine traders of goods and not mere financial intermediaries. Confirmed orders have to be received by them from the overseas buyers. AD banks should satisfy themselves about the capabilities of the Merchanting Trader to perform the obligations under the order. The overall Merchanting Trade should result in reasonable profits to the Merchanting Trader.

3.12 Settlement of Import transactions in currencies not having a direct exchange rate

To further liberalize the procedure and facilitate settlement of import transactions where the invoicing is in a freely convertible currency and the settlement takes place in the currency of the beneficiary, which though convertible, does not have a direct exchange rate, it has been decided that AD Category-I banks may permit settlement of such import transactions (excluding those put through the ACU mechanism), subject to conditions as under:

1. Importer shall be a customer of the AD Bank.
2. Signed contract / invoice is in a freely convertible currency.
3. The beneficiary is willing to receive the payment in the currency of

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beneficiary instead of the original (freely convertible) currency of the invoice / contract, LC as full and final settlement.

4. AD bank is satisfied with the *bonafides* of the transactions, and
5. The counterparty to the importer of the AD bank is not from a country or jurisdiction in the updated FATF Public Statement on High Risk & Non Co-operative Jurisdictions on which FATF has called for counter measures.

Source References:

- Foreign Exchange Management Act, 1999
- Foreign Exchange Management (Current Account Transaction) Rules, 2000
- RBI Master Direction on Imports (MD No. 17/2016-17)
- Foreign Exchange Management (Export and Import of Currency) Regulations 2015

Chapter 6

FEMA Guidelines on Outbound Investments

This section covers:

- *Regulatory framework for direct investment outside India*
- *Key Definitions*
- *Prohibitions on Direct Investments*
- *General Permission*
- *Investment under Automatic Route*
- *Investments (or Financial Commitment (FC)) through SPV under Automatic Route*
- *Issue of guarantee by an Indian Party to step down subsidiary of JV / WOS*
- *Method of Funding*
- *Investments (or FC) in Financial Services Sector*
- *Investment in Equity of Companies Registered Overseas / Rated Debt Instruments*
- *Investment under Approval Route*
- *Investment Abroad by Proprietary / Unregistered Partnerships*
- *Overseas Investment by Registered Trust / Society*
- *Post Investment Changes / Additional Investment in Existing JV / WOS*
- *Restructuring of the balance sheet of the overseas entity involving write off of capital and receivables*
- *Acquisition of a foreign company through bidding or tender procedure*
- *Obligations of Indian Party (IP) and Resident Individual (RI)*
- *Transfer by way of sale of shares of a JV / WOS*

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- *Transfer by way of sale of shares of a JV / WOS involving write off of the investment (or FC)*
- *Pledge of shares*
- *Rollover of guarantees*
- *Creation of charge on domestic and foreign assets*
- *Hedging of ODI*
- *Opening of Foreign Currency Account abroad by an Indian Party*
- *General Permission for Purchase / Acquisition of Foreign Securities in certain cases*
- *General Permission to Individual Residents for acquisition of security as Qualification/ Right Shares etc.*
- *Issue of Indian Depository Receipts (IDRs)*
- *Investment (or FC) in unincorporated / incorporated entities overseas in oil sector under the Automatic Route*
- *Overseas Direct Investments by Resident Individuals*
- *Investment under Liberalised Remittance Scheme (LRS)*

1. General Background

Overseas investments (or financial commitment) in Joint Ventures (JV) and Wholly Owned Subsidiaries (WOS) have been recognised as important avenues for promoting global business by Indian entrepreneurs. JVs are perceived as a medium of economic and business co-operation between India and other countries. Transfer of technology and skill, sharing of results of R&D, access to wider global market, promotion of brand image, generation of employment and utilisation of raw materials available in India and in the host country are other significant benefits arising out of such overseas investments (or financial commitment). They are also important drivers of foreign trade through increased exports of plant and machinery and goods and services from India and also a source of forex earnings by way of dividend earnings, royalty, technical know-how fee and other entitlements on such investments (or financial commitment).

In keeping with the spirit of liberalisation, which has become the hallmark of economic policy in general, and forex regulations in particular, the RBI has

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been progressively relaxing the rules and simplifying the procedures both for current account as well as capital account transactions.

Section 6 of FEMA empowers the RBI to specify, in consultation with the Government of India, the classes of permissible capital account transactions and limits up to which forex is admissible for such transactions. Section 6(3) of FEMA empowers the RBI to prohibit, restrict or regulate various transactions referred to in the sub-clauses of that sub-section, by making Regulations. In exercise of these powers, RBI has issued Notification No. 120 dated 7th July, 2004 to regulate outbound investments by a person resident in India. Overseas Investment (or financial commitment) can be made under two routes viz. (i) Automatic Route and (ii) Approval Route

2. Regulatory framework

The framework governing outbound investments under FEMA is thus governed by the Foreign Exchange Management (Transfer or Issue of Any Foreign Security) Regulations, 2004 (ODI Regulations) read with RBI's Master Direction on Direct Investment by Residents in JV / WOS abroad (ODI Master Direction), as amended from time to time.

3. Definitions

Let us examine some of the important definitions under the ODI Regulations / Master Direction:

3.1 Direct investment outside India

Means investment by way of contribution to the capital or subscription to the Memorandum of Association of a foreign entity or by way of purchase of existing shares of a foreign entity either by market purchase or private placement or through stock exchange, but does not include portfolio investment.

3.2 Financial Commitment

Means the amount of direct investment by way of contribution to equity, loan and 100 per cent of the amount of guarantees and 50 per cent of the performance guarantees issued by an Indian Party to or on behalf of its overseas JV Company or WOS.

3.3 Foreign Currency Convertible Bond (FCCB)

Means a bond issued by an Indian company expressed in foreign currency,

and the principal and interest in respect of which is payable in foreign currency.

3.4 Indian Party

Means a company incorporated in India or a body created under an Act of Parliament or a partnership firm registered under the Indian Partnership Act, 1932, or an LLP registered under the LLP Act, 2008 making investment in a JV or WOS abroad, and includes any other entity in India as may be notified by the RBI.

When more than one such company, body or entity make an investment in the foreign entity, all such companies or bodies or entities shall together constitute the “Indian Party”.

3.5 Joint Venture (JV)

Means a foreign entity formed, registered or incorporated in accordance with the laws and regulations of the host country in which the Indian Party makes a direct investment.

3.6 Net worth

Means paid-up capital and free reserves

3.7 Real estate business

Means buying and selling of real estate or trading in Transferable Development Rights (TDRs) but does not include development of townships, construction of residential/commercial premises, roads or bridges.

3.8 Wholly Owned Subsidiary (WOS)

Means a foreign entity formed, registered or incorporated in accordance with the laws and regulations of the host country, whose entire capital is held by the Indian Party.

4. Aspects of Investment outside India

The various aspects of investment outside India are as follows:

- Prohibitions on Direct Investments
- General Permission
- Investment under Automatic Route

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- Investments (or FC) through SPV under Automatic Route
- Issue of guarantee by an Indian Party to step down subsidiary of JV / WOS
- Method of Funding
- Capitalisation of exports and other dues
- Investments (or FC) in Financial Services Sector
- Investment in Equity of Companies Registered Overseas / Rated Debt Instruments
- Investment under Approval Route
- Investment Abroad by Proprietary / Unregistered Partnerships
- Overseas Investment by Registered Trust / Society
- Post Investment Changes / Additional Investment in Existing JV / WOS
- Restructuring of the balance sheet of the overseas entity involving write off of capital and receivables
- Acquisition of a foreign company through bidding or tender procedure
- Obligations of Indian Party (IP) and Resident Individual (RI)
- Transfer by way of sale of shares of a JV / WOS
- Transfer by way of sale of shares of a JV / WOS involving write off of the investment (or FC)
- Pledge of shares
- Rollover of guarantees
- Creation of charge on domestic and foreign assets
- Hedging of ODI
- Opening of Foreign Currency Account abroad by an Indian Party
- Procedure for Overseas Investments
- Allotment of Unique Identification Number (UIN)
- Overseas Direct Investments by Resident Individuals
- Investment under Liberalised Remittance Scheme (LRS)
- Opening of Foreign Currency Account abroad by an Indian Party

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- General Permission for Purchase / Acquisition of Foreign Securities in certain cases
- General Permission to Individual Residents for acquisition of security as Qualification/ Right Shares etc.
- Issue of Indian Depository Receipts (IDRs)
- Investment (or FC) in unincorporated / incorporated entities overseas in oil sector under the Automatic Route

4.1 Prohibitions on Direct Investments

Indian parties are prohibited from making investment in a foreign entity engaged in real estate business or banking business, without the prior approval of the RBI.

An overseas entity, having direct or indirect equity participation by an Indian Party, shall not offer financial products linked to Indian Rupee (e.g. non-deliverable trades involving foreign currency, rupee exchange rates, stock indices linked to Indian market, etc.) without the specific approval of the RBI.

4.2 General Permission

General permission has been granted to residents in India for purchase /acquisition and sale of shares / securities so acquired -

- (a) Out of funds held in RFC account; and
- (b) As bonus shares on existing holding of foreign currency shares; and
- (c) When not permanently resident in India, out of their foreign currency resources outside India.

4.3 Investment under Automatic Route

An Indian Party is permitted to make financial commitment (FC) in a JV/ WOS abroad up to 400 per cent of its net worth (as per the last audited balance sheet) for any bona fide business activity. Any FC exceeding USD 1 (one) billion (or its equivalent) in a financial year would require prior approval of the RBI even when the total FC of the Indian Party is within the eligible limit under the automatic route.

For the purpose of reckoning net worth of an Indian party, the net worth of its holding company (which holds at least 51 per cent stake in the Indian Party) or its subsidiary company (in which the Indian party holds at least 51 per cent

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stake) may be taken into account to the extent not availed of by the holding company or the subsidiary independently, and the holding / subsidiary company, as the case may be, has furnished a letter of disclaimer in favour of the Indian Party.

For the purpose of making investment / undertaking financial commitment in overseas JV / WOS, the Indian Party should approach an Authorised Dealer Category - I bank with an application in Form ODI (Master Document on Reporting) and prescribed enclosures / documents for effecting such remittances.

The total financial commitment of the Indian Party in all the JV / WOS shall comprise of the following:

- (a) 100 per cent of the amount of equity shares and / or Compulsorily Convertible Preference Shares (CCPS);
- (b) 100 per cent of the amount of other preference shares;
- (c) 100 per cent of the amount of loan;
- (d) 100 per cent of the amount of guarantee (other than performance guarantee) issued by the Indian Party;
- (e) 100 per cent of the amount of bank guarantee issued by a resident bank on behalf of JV or WOS of the Indian Party provided the bank guarantee is backed by a counter guarantee / collateral by the Indian Party.
- (f) 50 per cent of the amount of performance guarantee issued by the Indian Party provided that if the outflow on account of invocation of performance guarantee results in the breach of the limit of the financial commitment in force, prior permission of the RBI is to be obtained before executing remittance beyond the limit prescribed for the financial commitment.

Such investments are subject to the following conditions:

- (a) The Indian entity may extend loan / guarantee to an overseas concern in which it has equity / CCPS participation. Financial commitments without equity/ CCPS participation will require prior RBI approval provided that the laws of the host country permit incorporation of a company without equity participation by the Indian Party.

Indian entities may offer any form of guarantee - corporate or personal (including the personal guarantee by the indirect resident individual

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promoters of the Indian Party) / primary or collateral / guarantee by the promoter company / guarantee by group company, sister concern or associate company in India provided that:

- (i) All the financial commitments, including all forms of guarantees and creation of charge are within the overall ceiling prescribed for the Indian Party.
 - (ii) No guarantee should be 'open ended' i.e. the amount and period of the guarantee should be specified upfront. In the case of performance guarantee, time specified for the completion of the contract shall be the validity period of the related performance guarantee.
 - (iii) In cases where invocation of the performance guarantee breaches the ceiling for the financial commitment, the Indian Party shall seek the prior approval of the RBI before remitting funds from India, on account of such invocation.
 - (iv) As per Guarantee regulations, an authorised dealer in India may also give a Bank guarantee/ issue SBLC to a joint venture company or a wholly-owned subsidiary of a company in India in connection with its business abroad provided that the terms and conditions stipulated in Foreign Exchange Management (Transfer and Issue of Foreign Security) Regulations, 2000 for promoting or setting up such company or subsidiary are continued to be complied with;
 - (v) As in the case of corporate guarantees, all guarantees (including performance guarantees and Bank Guarantees / SBLC) are required to be reported to the Reserve Bank in Form ODI-Part I. Guarantees issued by banks in India in favour of WOS / JV outside India would be subject to prudential norms issued by the Reserve Bank of India (Department of Banking Regulation) from time to time.
- (b) The Indian entity should not be on the RBI's Exporters caution list / list of defaulters to the banking system circulated by the RBI / Credit Information Bureau (India) Ltd (CIBIL) or any other credit information company as approved by the RBI or under investigation by any investigation / enforcement agency or regulatory body.
- (c) All transactions relating to a JV / WOS should be routed through one

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branch of an authorised dealer bank to be designated by the Indian entity.

- (d) In case of partial / full acquisition of an existing foreign company, where the investment is more than USD 5 million, valuation of the shares of the company shall be made by a Category I Merchant Banker registered with SEBI or an Investment Banker / Merchant Banker outside India registered with the appropriate regulatory authority in the host country; and, in all other cases by a Chartered Accountant or a Certified Public Accountant.
- (e) In cases of investment by way of swap of shares, in all cases irrespective of the amount, valuation of the shares will have to be done by a Category I Merchant Banker registered with SEBI or an Investment Banker outside India registered with the appropriate regulatory authority in the host country. Government approval is case specific.
- (f) In case of investment in overseas JV / WOS abroad by a Registered Partnership firm, where entire funding for such investment is done by the firm, it will be in order for individual partners to hold shares for and on behalf of the firm in the overseas JV / WOS if the host country regulations or operational requirements warrant such holdings.
- (g) An Indian Party may acquire shares of a foreign company engaged in a bona fide business activity, in exchange of ADRs / GDRs issued to the latter in accordance with the Scheme for issue of Foreign Currency Convertible Bonds and Ordinary Shares (through Depository Receipt Mechanism) Scheme, 1993, and the guidelines issued there under from time to time by the Government of India, provided:
 - (i) ADRs / GDRs are listed on any stock exchange outside India.
 - (ii) ADR and / or GDR issued for the purpose of acquisition is backed by underlying fresh equity shares issued by the Indian Party.
 - (iii) The total holding in the Indian entity by persons resident outside India in the expanded capital base, after the new ADR and / or GDR issue, does not exceed the sectoral cap prescribed under the relevant regulations for such investment under FDI.
 - (iv) Valuation of the shares of the foreign company shall be:
 - (a) as per the recommendations of the Investment Banker if

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the shares are not listed on any recognized stock exchange; or

- (b) based on the current market capitalisation of the foreign company arrived at on the basis of monthly average price on any stock exchange abroad for the three months preceding the month in which the acquisition is committed and over and above, the premium, if any, as recommended by the Investment Banker in its due diligence report in other cases.

Investment out of balances held in Exchange Earners' Foreign Currency (EEFC) account of the Indian party or out of funds raised through ADRs/GDRs will be in addition to the ceiling of 400 per cent of the net worth.

Investments in Nepal are permitted only in Indian rupees.

Investments in Bhutan are permitted in Indian Rupees as well as in freely convertible currencies.

All dues receivable on investments made in freely convertible currencies, as well as their sale / winding up proceeds are required to be repatriated to India in freely convertible currencies only.

Investments / financial commitments by an Indian Party are not permitted in an overseas entity located in the countries identified by the Financial Action Task Force (FATF) as “non-co-operative countries and territories” as per list available on FATF website www.fatf-gafi.org or as notified by the RBI from time to time. Investments / financial commitments in Pakistan by Indian Parties are permissible under the approval route.

4.4 Investments (or FC) through SPV under Automatic Route

Investments (or FC) in JV/WOS abroad by Indian Parties through the medium of a Special Purpose Vehicle (SPV) are also permitted under the Automatic Route subject to fulfillment of the stipulated conditions. Indian Parties whose names appear in the defaulters' list require prior approval of the RBI.

4.5 Issue of guarantee by an Indian Party to step down subsidiary of JV / WOS

Indian Parties are permitted to issue corporate guarantees on behalf of their first level step down operating JV / WOS set up by their JV / WOS operating

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as either an operating unit or as a Special Purpose Vehicle (SPV) under the Automatic Route, subject to the condition that the financial commitment of the Indian Party is within the extant limit. Such guarantees will have to be reported to the RBI in Form ODI.

Further, the issuance of corporate guarantee on behalf of second generation or subsequent level step down operating subsidiaries will be considered under the Approval Route, provided the Indian Party indirectly holds 51 per cent or more stake in the overseas subsidiary for which such guarantee is intended to be issued.

4.6 Method of Funding

Investment in an overseas JV / WOS may be funded out of one or more of the following sources: -

- (i) Drawal of forex from an AD bank in India;
- (ii) Capitalisation of exports;
- (iii) Swap of shares (subject to valuation as mentioned above);
- (iv) Proceeds of ECBs / FCCBs;
- (v) In exchange of ADRs / GDRs issued in accordance with the Scheme for issue of Foreign Currency Convertible Bonds and Ordinary Shares (through Depository Receipt Mechanism) Scheme, 1993, and the guidelines issued thereunder from time to time by the Government of India;
- (vi) Balances held in Exchange Earner's Foreign Currency (EEFC) account of the Indian Party; and
- (vii) Proceeds of foreign currency funds raised through ADR / GDR issues.

As regards Sr. No. (vi) and (vii) above, the ceiling of 400 per cent of net worth will not apply. However, all investments in the financial service sector will be subject to further compliance of the specific conditions hereinafter, irrespective of the method of funding.

General permission has been granted to persons resident in India for purchase / acquisition of securities in the following manner:

- (i) Out of funds held in RFC account;
- (ii) As bonus shares on existing holding of foreign currency shares; and
- (iii) When not permanently resident in India, out of their foreign currency resources outside India

4.7 Capitalisation of exports and other dues

Indian Party is permitted to capitalise the payments due from the foreign entity towards exports, fees, royalties or any other dues from the foreign entity for supply of technical know-how, consultancy, managerial and other services within the ceilings applicable. Capitalisation of export proceeds remaining unrealised beyond the prescribed period of realization will require prior approval of the RBI.

Indian software exporters are permitted to receive 25 per cent of the value of their exports to an overseas software start-up company in the form of shares without entering into Joint Venture Agreements, with prior approval of the RBI.

4.8 Investments (or FC) in Financial Services Sector

1. An Indian Party seeking to make investment (or FC) in an entity outside India, which is engaged in the financial sector, should fulfill the following additional conditions:
 - (i) Be registered with the regulatory authority in India for conducting the financial sector activities;
 - (ii) Has earned net profit during the preceding three financial years from the financial services activities;
 - (iii) Has obtained approval from the regulatory authorities concerned both in India and abroad for venturing into such financial sector activity; and
 - (iv) Has fulfilled the prudential norms relating to capital adequacy as prescribed by the concerned regulatory authority in India.
2. Any additional investment (or financial commitment) by an existing JV / WOS or its step down subsidiary in the financial services sector is also required to comply with the above conditions.
3. Regulated entities in the financial sector making investments (or financial commitment) in any activity overseas are required to comply with the above guidelines. Unregulated entities in financial services sector in India may invest in non-financial sector activities subject to compliance with the general conditions for ODI mentioned above. Trading in commodities exchanges overseas and setting up JV / WOS for trading in overseas exchanges will be reckoned as financial services activity and require clearance from SEBI.

4.9 Investment in Equity of Companies Registered Overseas / Rated Debt Instruments

4.9.1 Portfolio investments by listed Indian companies: Listed Indian companies are permitted to invest up to 50 per cent of their net worth as on the date of the last audited balance sheet in (i) shares and (ii) bonds / fixed income securities, rated not below investment grade by accredited / registered credit rating agencies, issued by listed overseas companies.

4.9.2 Investment by Mutual Funds: Indian Mutual Funds who are registered with SEBI within an overall cap of USD 7 billion are permitted to invest in following securities:-

- i) ADRs / GDRs of the Indian and foreign companies;
- ii) Equity of overseas companies listed on recognised stock exchanges overseas;
- iii) Initial and follow on public offerings for listing at recognized stock exchanges overseas;
- iv) Foreign debt securities in the countries with fully convertible currencies, short-term as well as long-term debt instruments with rating not below investment grade by accredited / registered credit agencies;
- v) Money market instruments rated not below investment grade;
- vi) Repos in the form of investment, where the counterparty is rated not below investment grade. The repos should not, however, involve any borrowing of funds by mutual funds;
- vii) Government securities where the countries are rated not below investment grade;
- viii) Derivatives traded on recognized stock exchanges overseas only for hedging and portfolio balancing with underlying as securities;
- ix) Short-term deposits with banks overseas where the issuer is rated not below investment grade; and
- x) units / securities issued by overseas Mutual Funds or Unit Trusts registered with overseas regulators and investing in (a) aforesaid securities, (b) Real Estate Investment Trusts (REITS) listed on recognized stock exchanges overseas, or (c) unlisted overseas securities (not exceeding 10 per cent of their net assets).

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Investments made by listed Indian companies and Mutual Funds in accordance with the above, are to be reported online on a monthly basis by the AD Banks in the format as prescribed by the RBI from time to time.

A limited number of qualified Indian Mutual Funds, are permitted to invest cumulatively up to USD 1 billion in overseas Exchange Traded Funds as may be permitted by SEBI.

Domestic Venture Capital Funds / Alternative Investment Funds registered with SEBI may invest in equity and equity linked instruments of off-shore Venture Capital Undertakings, subject to an overall limit of USD 500 million.

Accordingly, Mutual Funds/ Venture Capital Funds/ Alternative Investment Funds desirous of availing this facility may approach SEBI for necessary permission.

General permission is available to the above categories of investors for sale of securities so acquired.

Investments made by Venture Capital Fund (VCF) / Alternate Investment Fund (AIF), may be reported in the online application.

4.10 Investment under Approval Route

Prior approval of the RBI would be required in all other cases of direct investment (or FC) abroad. For this purpose, application together with necessary documents should be submitted in Form ODI through their Authorised Dealer Category – I banks.

RBI would, inter alia, take into account the following factors while considering such applications:-

- (a) *Prima facie* viability of the JV / WOS outside India;
- (b) Contribution to external trade and other benefits which will accrue to India through such investment (or financial commitment);
- (c) Financial position and business track record of the Indian Party and the foreign entity; and
- (d) Expertise and experience of the Indian Party in the same or related line of activity as of the JV / WOS outside India.

4.11 Investment Abroad by Proprietary / Unregistered Partnerships

Keeping in view the changes in the definition / classification of the exporters

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as per the Foreign Trade Policy (FTP) of the Ministry of Commerce and Industry, issued from time to time, the following revised terms and conditions are required to be complied with for considering the proposal of overseas direct investment (or financial commitment), by a proprietorship concern / unregistered partnership firm in India, by the RBI under the approval route:

- (a) The proprietorship concern / unregistered partnership firm in India is classified as 'Status Holder' as per the FTP issued by the Ministry of Commerce and Industry, Govt. of India from time to time;
- (b) The proprietorship concern / unregistered partnership firm in India has a proven track record, i.e., the export outstanding does not exceed 10 per cent of the average export realisation of the preceding three years and a consistently high export performance;
- (c) The AD bank is satisfied that the exporter is KYC (Know Your Customer) compliant, is engaged in the proposed business and has turnover as indicated;
- (d) The exporter has not come under adverse notice of any government agency like Enforcement Directorate, Central Bureau of Investigation (CBI) and does not appear in the exporters' caution list of the RBI or in the list of defaulters to the banking system in India; and
- (e) The amount of proposed investment (or FC) outside India does not exceed 10 per cent of the average of last three years' export realization or 200 per cent of the net owned funds of the proprietorship concern / unregistered partnership firm in India, whichever is lower.

4.12 Overseas Investment by Registered Trust / Society

Registered Trusts and Societies engaged in manufacturing / educational / hospital sector are allowed to make investment in the same sector(s) in a JV/WOS outside India, with the prior approval of the RBI.

Eligibility Criteria:

(A) Trust

- (i) The Trust should be registered under the Indian Trust Act, 1882;
- (ii) The Trust deed permits the proposed investment overseas;
- (iii) The proposed investment should be approved by the trustee/s;
- (iv) The AD Category – I bank is satisfied that the Trust is KYC compliant and is engaged in a bona fide activity;

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- (v) The Trust has been in existence at least for a period of three years;
- (vi) The Trust has not come under the adverse notice of any Regulatory / Enforcement agency like the Enforcement Directorate, CBI, etc.

(B) Society

- (i) The Society should be registered under the Societies Registration Act, 1860.
- (ii) The Memorandum of Association and rules and regulations permit the Society to make the proposed investment which should also be approved by the governing body / council or a managing / executive committee.
- (iii) The AD Category - I bank is satisfied that the Society is KYC compliant and is engaged in a bona fide activity;
- (iv) The Society has been in existence at least for a period of three years;
- (v) The Society has not come under the adverse notice of any Regulatory / Enforcement agency like the Enforcement Directorate, CBI etc.

In addition to the registration, the activities which require special license / permission either from the Ministry of Home Affairs, Government of India or from the relevant local authority, as the case may be.

4.13 Post Investment Changes / Additional Investment in Existing JV / WOS

A JV / WOS set up by the Indian entity as per the ODI Regulations may diversify its activities / set up step down subsidiary / alter the shareholding pattern in the overseas entity subject to the Indian entity reporting to the RBI, the details of such decisions taken by the JV / WOS within 30 days of the approval of those decisions by the competent authority concerned of such JV / WOS in terms of local laws of the host country, and, include the same in the Annual Performance Report (APR) required to be forwarded annually to the AD Category-I bank.

4.14 Restructuring of the balance sheet of the overseas entity involving write off of capital and receivables

Indian promoters who have set up WOS abroad or have at least 51 per cent stake in an overseas JV, may write off capital (equity / preference shares) or other receivables, such as, loans, royalty, technical knowhow fees and

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management fees in respect of the JV /WOS, even while such JV /WOS continues to function as under:

- (i) Listed Indian companies are permitted to write off capital and other receivables up to 25 per cent of the equity investment in the JV / WOS under the Automatic Route; and
- (ii) Unlisted companies are permitted to write off capital and other receivables up to 25 per cent of the equity investment in the JV / WOS under the Approval Route.

The write-off / restructuring have to be reported to the RBI within 30 days of write-off/ restructuring. The write-off / restructuring is subject to the condition that the Indian Party should submit the following documents for scrutiny along with the applications to the designated AD Category –I bank under the Automatic as well as the Approval Routes:

- (a) A certified copy of the balance sheet showing the loss in the overseas WOS / JV set up by the Indian Party; and
- (b) Projections for the next five years indicating benefit accruing to the Indian company consequent to such write off / restructuring.

4.15 Acquisition of a foreign company through bidding or tender procedure

An Indian entity may remit earnest money deposit or issue a bid bond guarantee for acquisition of a foreign company through bidding and tender procedure and also make subsequent remittances through an AD Category - I bank in accordance with the provisions of the ODI Regulations.

4.16 Obligations of Indian Party (IP) and Resident Individual (RI)

4.16.1 An IP and RI which has made direct investment abroad is under obligation to:

- (a) Receive share certificate or any other document as an evidence of investment in the foreign entity to the satisfaction of the RBI within six months, or such further period as RBI may permit, from the date of effecting remittance or the date on which the amount to be capitalised became due to the Indian Party or the date on which the amount due was allowed to be capitalized.

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- (b) Repatriate to India all dues receivable from foreign entity, like dividend, royalty, technical fees etc., within 60 days of its falling due, or such further period as the RBI may permit; and
- (c) Submit to the RBI, through the designated Authorised Dealer, every year on or before December 31, an Annual Performance Report (APR) in Part II of Form ODI in respect of each JV or WOS outside India, and other reports or documents as may be prescribed by the RBI from time to time. The APR, so required to be submitted, has to be based on the audited annual accounts of the JV / WOS for the preceding year, unless specifically exempted by the RBI.

4.16.2 Where the law of the host country does not mandatorily require auditing of the books of accounts of JV / WOS, the APR may be submitted by the Indian Party based on the un-audited annual accounts of the JV / WOS provided:

- (a) The Statutory Auditors of the Indian Party certify that law of the host country does not mandatorily require auditing of the books of JV / WOS and the figures in the APR are as per the un-audited accounts of the overseas JV / WOS; and
- (b) That the un-audited annual accounts of the JV / WOS have been adopted and ratified by the Board of the Indian Party.

This exemption is not available for JV / WOS in a country / jurisdiction under the observation / enhanced due diligence by FATF or any other country as prescribed by RBI

4.16.3 An annual return on Foreign Liabilities and Assets (FLA) is required to be submitted directly by all the Indian companies which have received FDI and/or made FDI abroad (i.e. overseas investment) in the previous year(s) including the current year, to the Director, External Liabilities and Assets Statistics Division, Department of Statistics and Information Management (DSIM), RBI.

4.17 Transfer by way of sale of shares of a JV / WOS

Indian entities may also disinvest to another Indian Party or to a person resident outside India without prior approval of the RBI, subject to the following conditions:

- (i) The sale does not result in any write off of the investment (or FC) made.

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- (ii) The sale is effected through a stock exchange where the shares of the overseas JV/ WOS are listed;
- (iii) If the shares are not listed on the stock exchange and the shares are disinvested by a private arrangement, the share price is not less than the value certified by a Chartered Accountant / Certified Public Accountant as the fair value of the shares based on the latest audited financial statements of the JV / WOS;
- (iv) The Indian Party does not have any outstanding dues by way of dividend, technical know-how fees, royalty, consultancy, commission or other entitlements and / or export proceeds from the JV or WOS;
- (v) The overseas concern has been in operation for at least one full year and the APR together with the audited accounts for that year has been submitted to RBI;
- (vi) the Indian Party is not under investigation by CBI / DoE / SEBI / IRDA or any other regulatory authority in India.

Sale proceeds of shares / securities shall be repatriated to India immediately on receipt thereof and in any case not later than 90 days from the date of sale of the shares / securities and details of the disinvestment to be submitted through the designated AD bank within 30 days from the date of disinvestment.

4.18 Transfer by way of sale of shares of a JV / WOS involving write off of the investment (or FC)

Indian Party may disinvest, without prior approval of the RBI, in any of the following cases where the amount repatriated after disinvestment is less than the original amount invested:

- (i) In case where the JV / WOS is listed on the overseas stock exchange;
- (ii) In cases where the Indian Party is listed on a stock exchange in India and has a net worth of not less than INR 100 crore;
- (iii) Where the Indian Party is an unlisted company and the investment (or FC) in the overseas venture does not exceed USD 10 million, and
- (iv) Where the Indian Party is a listed company with net worth of less than INR 100 crore but investment (or FC) in an overseas JV / WOS does not exceed USD 10 million.

Such disinvestments shall also be subject to conditions listed under previous para.

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An Indian Party, which does not satisfy the conditions laid down above for undertaking any disinvestment in its JV / WOS abroad, shall have to apply to the RBI for prior permission.

4.19 Pledge of shares

An Indian Party may create charge, by way of pledge, on the shares of JV or WOS or SDS outside India as a security in favour of an Authorized Dealer or a public financial institution in India or an overseas lender, for availing of fund based or non-fund based facility for itself (i.e. the Indian Party) or for its JV / WOS / SDS whose shares have been pledged, or for any other JV / WOS / SDS of the Indian Party subject to the terms and conditions prescribed under the ODI Regulations.

4.20 Rollover of guarantees

Renewal / rollover of an existing / original guarantee, which is part of the total FC of the Indian Party will not be treated as a fresh FC, provided that:-

- (a) The existing / original guarantee was issued in terms of the then extant / prevailing FEMA guidelines;
- (b) There is no change in the end use of the guarantee, i.e. the facilities availed by the JV / WOS / Step Down Subsidiary;
- (c) There is no change in any of the terms & conditions, including the amount of the guarantee except the validity period;
- (d) The reporting of the rolled over guarantee would be done in Form ODI - Part I; and
- (e) If the Indian Party is under investigation by any investigation / enforcement agency or regulatory body, the concerned agency / body shall be kept informed about the same.

In case, however, the above conditions are not met, the Indian Party shall obtain prior approval of the RBI for rollover / renewal of the existing guarantee through the designated AD bank.

4.21 Creation of charge on domestic and foreign assets

- (a) An Indian Party may create charge (by way of mortgage, pledge, hypothecation or otherwise) on its assets [including the assets of its group company, sister concern or associate company in India, promoter and / or director] in favour of an overseas lender as security

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for availing of the fund based and / or non-fund based facility for its JV or WOS or SDS outside India subject to the terms and conditions prescribed under the ODI Regulations read with A.P. (DIR Series) Circular No.54 dated December 29, 2014.

- (b) An Indian Party may create charge (by way of mortgage, pledge, hypothecation or otherwise) on the assets of its overseas JV or WOS or SDS in favour of an AD bank in India as security for availing of the fund based and / or non-fund based facility for itself or its JV or WOS or SDS outside India subject to the terms and conditions prescribed under the ODI Regulations read with Circular No.54 dated December 29, 2014.

4.22 Hedging of ODI

Resident entities having overseas direct investments (or FC) are permitted to hedge the forex rate risk arising out of such investments (or FC). AD Category - I banks may enter into forward / option contracts with resident entities who wish to hedge their overseas direct investments (in equity and loan), subject to verification of such exposure.

If a hedge becomes naked in part or full owing to shrinking of the market value of the overseas direct investment (or financial commitment), the hedge may continue to the original maturity. Rollovers on the due date are permitted up to the extent of market value as on that date.

4.23 Opening of Foreign Currency Account abroad by an Indian Party

An eligible Indian Party may open, hold and maintain Foreign Currency Account (FCA) abroad for the purpose of overseas direct investments subject to the following terms and conditions:

1. The host country regulations stipulate that the investments into the country are required to be routed through a designated account.
2. FCA shall be opened, held and maintained as per the regulation of the host country.
3. The remittances sent to the FCA by the Indian party should be utilized only for making overseas direct investment into the JV / WOS abroad.

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4. Any amount received in the account by way of dividend and / or other entitlements from the subsidiary shall be repatriated to India within 30 days from the date of credit.
5. The Indian Party should submit the details of debits and credits in the FCA on yearly basis to the designated AD bank with a certificate from the Statutory Auditors of the Indian party certifying that the FCA was maintained as per the host country laws and the extant FEMA regulations / provisions as applicable.

The FCA so opened shall be closed immediately or within 30 days from the date of disinvestment from JV / WOS or cessation thereof.

4.24 Procedure for Overseas Investments

On an application made before AD, banks may allow investments up to the permissible limits on receipt of application in form ODI together with form A-2, duly filled in, from the Indian entity /entities making investments in a JV / WOS abroad subject to their complying with the conditions specified in the ODI Regulations. Investment in financial services should also comply with additional norms stipulated in the ODI Regulations. While forwarding the report of remittance in respect of investment in financial services sector, AD banks may certify that approval from the Regulatory Authorities in India and abroad have been obtained. Before allowing the remittance AD banks are required to ensure that the necessary documents, as prescribed in form ODI, have been submitted. Form ODI and other documents should not be submitted to the RBI but submitted to Authorised Dealers.

4.25 Allotment of Unique Identification Number (UIN)

On receipt of the form ODI from the AD bank, the RBI will allot a unique identification number to each JV or WOS abroad, which is required to be quoted in all the future correspondence by the AD banks or the Indian entity with the RBI. AD banks may allow additional investment in an existing overseas concern set up by an Indian party, in terms of the ODI Regulations only after the RBI has allotted necessary UIN to the overseas project.

4.26 Overseas Direct Investments by Resident Individuals

A resident individual may undertake direct investment in equity shares /

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compulsorily convertible preference shares of a JV / WOS outside India, up to the limit prescribed under Liberalised Remittance Scheme (LRS) (i.e. currently USD 2,50,000 per financial year), subject to the following:

- (i) Resident individual is prohibited from making direct investment in a JV or WOS abroad which is engaged in the real estate business or banking business or in the business of financial services activity.
- (ii) The JV or WOS abroad shall be engaged in *bona fide* business activity.
- (iii) No direct investment shall be made in a JV / WOS located in countries identified by the Financial Action Task Force (FATF) as "non-co-operative countries and territories".
- (iv) The resident individual shall not be on the RBI's Exporters Caution List or List of defaulters to the banking system or under investigation by any investigation / enforcement agency or regulatory body.
- (v) At the time of investments, the permissible ceiling shall be within the overall ceiling prescribed for the resident individual under LRS as prescribed by the RBI from time to time. The investment made out of the balances held in EEFC/RFC account shall also be restricted to the limit prescribed under LRS.
- (vi) The JV or WOS, to be acquired / set up by a resident individual under this Schedule, shall be an operating entity *only* and no step down subsidiary is allowed to be acquired or set up by the JV or WOS.
- (vii) Valuation to be undertaken as prescribed norms.

4.27 Investment under Liberalised Remittance Scheme (LRS)

LRS was introduced by the government as a liberalisation measure to facilitate resident individuals to remit funds abroad for permitted current or capital account transactions or combination of both. Under the LRS, Authorised Dealers may freely allow remittances by resident individuals up to USD 2,50,000 per financial year (April – March) for any permitted current or capital account transaction or a combination of both. The Scheme is not available to corporates, partnership firms, HUF, Trusts etc.

The Scheme is available to all resident individuals including minors. Remittances under the Scheme can be consolidated in respect of family members subject to individual family members complying with its terms and

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conditions. However, clubbing is not permitted by other family members for capital account transactions, such as opening a bank account / investment / purchase of property, if they are not the co-owners/co-partners of the overseas bank account / investment / property. Further, a resident cannot gift to another resident, in foreign currency, for the credit of the latter's foreign currency account held abroad under LRS.

All other transactions which are otherwise not permissible under FEMA and those in the nature of remittance for margins or margin calls to overseas exchanges / overseas counterparty are not allowed under LRS.

The permissible capital account transactions by an individual under LRS are:

- (i) Opening of foreign currency account abroad with a bank;
- (ii) Purchase of property abroad;
- (iii) Making investments abroad - acquisition and holding shares of both listed and unlisted overseas company or debt instruments; acquisition of qualification shares of an overseas company for holding the post of Director; acquisition of shares of a foreign company towards professional services rendered or in lieu of Director's remuneration; investment in units of Mutual Funds, Venture Capital Funds, unrated debt securities, promissory notes;
- (iv) Setting up WOS and JVs outside India for bona fide business.
- (v) Extending loans including loans in Indian Rupees to Non-resident Indians (NRIs) who are relatives as defined in the Companies Act, 2013.

The limit of USD 2,50,000 per financial year under LRS also subsumes remittances for current account transactions (viz. private visit; gift / donation; going abroad on employment; emigration; maintenance of close relatives abroad; business trip; medical treatment abroad; studies abroad) available to resident individuals under the FEMCAT Rules. Release of forex exceeding USD 2,50,000, requires prior permission from the RBI.

4.28 General Permission for Purchase / Acquisition of Foreign Securities in certain cases

- I. General permission has been granted to a person resident in India who is an individual:
 - (a) To acquire foreign securities as a gift from any person resident outside India; or

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- (b) To acquire shares under Cashless Employees Stock Option Scheme issued by a company outside India, provided it does not involve any remittance from India, or
 - (c) To acquire shares by way of inheritance from a person whether resident in or outside India;
 - (d) to purchase equity shares offered by a foreign company under its ESOP Schemes if he is an employee, or, a director of an Indian office or branch of a foreign company, or, of a subsidiary in India of a foreign company, or, an Indian company in which foreign equity holding, either direct or through a holding company / SPV, is not less than 51 per cent. Authorised Dealer banks are permitted to allow remittances for purchase of shares by eligible persons under this provision irrespective of the method of operationalisation of the scheme i.e. where the shares under the scheme are offered directly by the issuing company or indirectly through a trust / a SPV / SDS, provided (i) the company issuing the shares effectively, directly or indirectly, holds in the Indian company, whose employees / directors are being offered shares, not less than 51 per cent of its equity, (ii) the shares under the ESOP Scheme are offered by the issuing company globally on uniform basis, and (iii) An Annual Return is submitted by the Indian company to the RBI through the Authorised Dealer bank giving details of remittances / beneficiaries /etc.
- II. A person resident in India may transfer by way of sale the shares acquired as stated above provided that the proceeds thereof are repatriated immediately on receipt thereof and in any case not later than 90 days from the date of sale of such securities.
- III. Foreign companies are permitted to repurchase the shares issued to residents in India under any ESOP Scheme provided (i) the shares were issued in accordance with the Rules / Regulations framed under FEMA (ii) the shares are being repurchased in terms of the initial offer document and, (iii) An annual return is submitted through the Authorised Dealer bank giving details of remittances / beneficiaries, etc.

- IV. In all other cases, not covered by general or special permission, approval of the RBI is required to be obtained before acquisition of a foreign security.

4.29 General Permission to Individual Residents for acquisition of security as Qualification/ Right Shares etc.

Residents are permitted to acquire a foreign security, if it represents –

- (a) Qualification shares for becoming a director of a company outside India provided the extent of acquiring the qualification shares is as per the law of the host country where the entity is located, and the limit of remittance for acquiring such qualification shares shall be within the overall ceiling prescribed for the resident individuals under the LRS in force at the time of acquisition.
- (b) Part / full consideration of professional services rendered to the foreign company or in lieu of Director's remuneration. The limit of acquiring such shares in terms of value is restricted to the overall ceiling prescribed for the resident individuals under the LRS in force at the time of acquisition.
- (c) Rights shares provided that the rights shares are being issued by virtue of holding shares in accordance with the provisions of law for the time being in force.
- (d) Purchase of shares of a JV / WOS abroad of the Indian promoter company by the employees / directors of Indian promoter company which is engaged in the field of software where the consideration for purchase does not exceed the ceiling as stipulated by the RBI from time to time; the shares so acquired do not exceed 5 per cent of the paid-up capital of the JV / WOS outside India; and after allotment of such shares, the percentage of shares held by the Indian promoter company, together with shares allotted to its employees is not less than the percentage of shares held by the Indian promoter company prior to such allotment.
- (e) An Indian company in the knowledge based sector may allow its resident employees (including working directors) to purchase foreign securities under the ADR / GDR linked stock option schemes. The issue of employees' stock option by a listed company shall be

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governed by the SEBI Regulations and the issue of employees stock option by an unlisted company shall be governed by the guidelines issued by the Government of India for issue of ADR / GDR linked stock options. The consideration for the purchase should not exceed the ceiling as stipulated by the RBI from time to time.

4.30 Issue of Indian Depository Receipts (IDRs)

Eligible companies resident outside India may issue IDRs through a Domestic Depository. The permission has been granted subject to compliance with the relevant provisions of the Companies (Registration of Foreign Companies) Rules, 2014 and the SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009.

In case of raising of funds through issuance of IDRs by financial/banking companies having presence in India, either through a branch or subsidiary, the approval of the sectoral regulator(s) should be obtained before the issuance of IDRs.

4.31 Investment (or FC) in unincorporated / incorporated entities overseas in oil sector under the Automatic Route

Investments (or financial commitment) in unincorporated / incorporated entities overseas in the oil sector (i.e. for exploration and drilling for oil and natural gas, etc.) by Navaratna PSUs, ONGC Videsh Ltd (OVL) and Oil India Ltd (OIL) may be permitted by AD Category - I banks, without any limit, provided such investments are approved by the competent authority.

Other Indian companies are also permitted under the Automatic Route to invest in unincorporated entities overseas in the oil sector up to the limit prescribed provided the proposal has been approved by the competent authority and is duly supported by certified copy of the Board resolution approving such investment. Investment in excess of the prescribed limit shall require prior approval of the RBI.

5. Overview of Companies Act, 2013 – making investment outside India

The key provisions under the 2013 Act likely to have an impact in respect of an Indian company making investments are as follows:

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- Approval of the Board of Directors for making investments under Section 179(3)(e) of the 2013 Act. This power may be delegated by the Board, by a resolution passed at a meeting, to any committee of directors, the managing director, the manager or any other principal officer of the company.
- Approval of the Audit Committee, if applicable, under section 177(4) of the 2013 Act.
- Approval of the Board and shareholders (as applicable) for inter-corporate investments under 2013 Act.
- Approval of the Board / shareholders, as applicable, for related party transactions under section 188 of the 2013 Act.

6. Importance of outbound investment structure

Entities in India and abroad can participate in business and economic cooperation by way of investments and co-ownerships. Investment in overseas entities in the form of a joint venture or a wholly owned subsidiary are the primary modes of investments by Indian entities in the global business platforms. Entities are involved in sharing of access to wider global markets, effective and efficient utilization of raw materials, promotion of their respective brand image, cooperation in R&D and sharing of results of R&D, technology & skill and generation of employment in respective domestic markets.

Outbound investing entities could be involved in diversification wherein they invest in entities carrying out activities other than the investing company's core activities. This strategy leads to lowering of overall business risk as the business is spread out into different sectors and can avoid sectoral imbalance.

Outbound investments enhance the brand image of the Indian investing party. They are a source of forex earnings by way of earning of income from passive sources such as dividend earnings, royalty, technical know-how fee and other entitlements on such investments.

India has come a long way since introduction of FEMA. Today, though theoretically rupee is not convertible on capital account, hardly any difficulty is faced on drawal of forex for bona fide business activities abroad and pragmatic policy for outbound investments has enabled many multi-billion

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dollar acquisitions by the Indian corporate in the recent past resulting into increase in global footprint of the Indian multinationals.

Source References:

- Foreign Exchange Management Act, 1999
- RBI Notification No. 120 dated 7th July, 2004
- Foreign Exchange Management (Transfer or Issue of Any Foreign Security) Regulations, 2004 (ODI Regulations)
- RBI's Master Direction on Direct Investment by Residents in JV / WOS abroad (ODI Master Direction)
- RBI's Master Direction on Liberalised Remittance Scheme (LRS)

Chapter 7

External Commercial Borrowing Guidelines

External Commercial Borrowing Guidelines

This section covers:

- *Key definitions*
- *External Commercial Borrowings framework*
- *Issuance of Guarantee, etc. by Indian banks and Financial Institutions*
- *Parking of ECB proceeds*
- *Procedure of raising ECB*
- *Reporting Requirements*
- *Powers delegated to AD Category I banks to deal with ECB cases*
- *Special Dispensations for Start-ups under the ECB framework*
- *Compliance with the guidelines*

External Commercial Borrowing (ECB) means borrowing by an eligible resident entity from outside India in accordance with the framework decided by RBI. In the post reform period i.e. after India opened its markets to the world, ECBs have emerged a major form of foreign capital.

For Corporates having an international presence, ECB is a dependable and easy to option to obtain funds and helps them to meet their business expansion and growth needs.

Instruments such as commercial bank loans, buyers' credit, suppliers' credit, securitized instruments such as Floating Rate Notes and Fixed Rate Bonds etc., credit from official export credit agencies and commercial borrowings from Multilateral Financial Institutions are forms of ECB. Following are the advantages of ECB:

1. ECBs provide opportunity to borrow large volume of funds
2. The funds are available for relatively long term

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3. Interest rate are also lower compared to domestic funds
4. ECBs are in the form of foreign currencies. Hence, they enable the corporate to have foreign currency to meet the import of machineries etc.
5. Corporate can raise ECBs from internationally recognised sources such as banks, export credit agencies, international capital markets etc.

A well designed ECB policy has been put in place by the RBI, which puts restrictions on amount of loan that can be obtained by a company, end user restrictions, interest rate ceiling for ECBs, maturity period etc.

The provisions dealing with borrowing and lending in foreign exchange and Indian Rupees, has been notified by the Reserve Bank of India (RBI) as Foreign Exchange Management (Borrowing and Lending) Regulations, 2018 (the Borrowing and Lending Regulation) on 17 December 2018.

In furtherance to the above and to rationalise and provide operational framework for ECB and Rupee denominated bonds, on 16 January 2019, RBI announced the New External Commercial Borrowing Framework (New ECB Framework).

1. Key definitions:

Let us look at some of the important definitions under the Borrowing and Lending Regulation and the New ECB framework:

1.1 External Commercial Borrowing

External Commercial Borrowing (ECB) means borrowing by an eligible resident entity from outside India in accordance with the framework decided by RBI.

1.2 Trade Credit

Trade Credit refers to the credits extended by the overseas supplier, bank /financial institution for imports into India in accordance with the Trade Credit framework decided by the RBI in consultation with the Government.

Explanation: Depending on the source of finance, such trade credits include both suppliers' credit and buyers' credit. Suppliers' credit relates to the credit for imports into India extended by the overseas supplier, while buyers' credit refers to loans for payment of imports into India arranged by the importer

from overseas bank or financial institution. Imports should be as permissible under the extant Foreign Trade Policy of the Director General of Foreign Trade (DGFT).

1.3 All-in-Cost

It includes rate of interest, other fees, expenses, charges, guarantee fees, Export Credit Agency (ECA) charges, whether paid in foreign currency or Indian Rupees (INR) but will not include commitment fees and withholding tax payable in INR. In the case of fixed rate loans, the swap cost plus spread should not be more than the floating rate plus the applicable spread. Additionally, for Foreign Currency Convertible Bonds (FCCBs) the issue related expenses should not exceed 4% of issue size and in case of private placement, these expenses should not exceed 2% of the issue size, etc. Various components of all-in-cost have to be paid by the borrower without taking recourse to the drawdown of ECB/ TC, i.e., ECB/TC proceeds cannot be used for payment of interest/charges.

1.4 Approval route

Under the ECB/TC framework, ECB/TC can be raised either under the automatic route or under the approval route. Under the approval route, the prospective borrowers are required to send their requests to the RBI through their Authorised Dealer (AD) Banks for examination.

1.5 Automatic route

For the automatic route, the cases are examined by the AD Category-I banks.

1.6 Benchmark rate

Benchmark rate in case of foreign currency denominated ECB/ TC (FCY ECB/TC) refers to 6-month London Interbank Offered Rate (LIBOR) rate of different currencies or any other 6-month interbank interest rate applicable to the currency of borrowing, for eg., Euro Interbank Offered Rate (EURIBOR). Benchmark rate in case of Rupee denominated ECB (INR ECB) will be prevailing yield of the Government of India securities of corresponding maturity.

1.7 ECB liability-Equity ratio

For the purpose of ECB liability-equity ratio, ECB amount will include all outstanding amount of all ECBs (other than INR denominated) and the

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proposed one (only outstanding ECB amounts in case of refinancing) while equity will include the paid-up capital and free reserves (including the share premium received in foreign currency) as per the latest audited balance sheet. Both ECB and equity amounts will be calculated with respect to the foreign equity holder. Where there are more than one foreign equity holders in the borrowing company, the portion of the share premium in foreign currency brought in by the lender(s) concerned shall only be considered for calculating the ratio. The ratio will be calculated as per latest audited balance sheet.

1.8 FATF compliant country

A country that is a member of Financial Action Task Force (FATF) or a member of a FATF-Style Regional Body; and should not be a country identified in the public statement of the FATF as (i) A jurisdiction having a strategic Anti-Money Laundering or Combating the Financing of Terrorism deficiencies to which counter measures apply; or (ii) A jurisdiction that has not made sufficient progress in addressing the deficiencies or has not committed to an action plan developed with the Financial Action Task Force to address the deficiencies.

1.9 Foreign Currency Convertible Bonds (FCCBs)

It refers to foreign currency denominated instruments which are issued in accordance with the Issue of Foreign Currency Convertible Bonds and Ordinary Shares (Through Depositary Receipt Mechanism) Scheme, 1993 as amended from time to time. Issuance of FCCBs shall also conform to other applicable regulations. Further, FCCBs should be without any warrants attached.

1.10 Foreign Currency Exchangeable Bonds (FCEBs)

It refers to foreign currency denominated instruments which are issued in accordance with the Issue of Foreign Currency Exchangeable Bonds Scheme, 2008 as amended from time to time. FCEBs are exchangeable into equity share of another company, to be called the Offered Company, in any manner, either wholly, or partly or on the basis of any equity related warrants attached to debt instruments. Issuance of FCEBs shall also conform to other applicable regulations.

1.11 Foreign Equity Holder

It means (a) direct foreign equity holder with minimum 25% direct equity holding by the lender in the borrowing entity, (b) indirect equity holder with minimum indirect equity holding of 51%, or (c) group company with common overseas parent.

1.12 Infrastructure Sector

It has the same meaning as given in the Harmonised Master List of Infrastructure sub-sectors approved by Government of India vide Notification F. No. 13/06/2009-INF as amended / updated from time to time. For the purpose of ECB, "Exploration, Mining and Refinery" sectors will be deemed as in the infrastructure sector.

1.13 Infrastructure space companies

Companies in infrastructure sector, Non-Banking Finance Companies (NBFCs) undertaking infrastructure financing, Holding Companies/ Core Investment Companies undertaking infrastructure financing, Housing Finance Companies (HFCs) regulated by National Housing Bank (NHB) and Port Trusts (constituted under the Major Port Trusts Act, 1963 or Indian Ports Act, 1908).

1.14 Real Estate Activity

Real Estate Activity means any activity involving own or leased property for buying, selling and renting of commercial and residential properties or land and also includes activities either on a fee or contract basis assigning real estate agents for intermediating in buying, selling, letting or managing real estate.

However, this would not include development of integrated township, purchase/ long term leasing of industrial land as part of new project/modernization or expansion of existing units or any activity under 'infrastructure sector' definition.

1.15 Indian Entity

Indian Entity means a company incorporated in India under the Companies Act, 2013, as amended from time to time, or a Limited Liability Partnership formed and registered in India under the Limited Liability Partnership Act, 2008, as amended from time to time.

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2. ECB framework:

2.1 The framework for raising loans through ECB comprises the following two options:

Sr. No.	Parameters	Foreign Currency denominated ECB	INR denominated ECB
i.	Currency of borrowing	Any freely convertible Foreign Currency	Indian Rupee (INR)
ii.	Forms of ECB	Loans including bank loans; floating/ fixed rate notes/ bonds/ debentures (other than fully and compulsorily convertible instruments); Trade credits beyond 3 years; FCCBs; FCEBs and Financial Lease.	Loans including bank loans; floating/ fixed rate notes/ bonds/ debentures/ preference share (other than fully and compulsorily convertible instruments); Trade credits beyond 3 years; and Financial Lease. Also, plain vanilla Rupee denominated bonds issued overseas (RDBs), which can be either placed privately or listed on exchanges as per host country regulations.
iii.	Eligible borrowers	All entities eligible to receive FDI. Further, the following entities are also eligible to raise ECB: a) Port Trusts; b) Units in SEZ; c) SIDBI; d) EXIM Bank; and e) Registered entities engaged in micro-finance activities, viz., registered Not for Profit companies, registered societies/trusts/cooperatives and Non-Government Organisations (permitted only to	

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Sr. No.	Parameters	Foreign Currency denominated ECB	INR denominated ECB
		raise INR ECB).	
iv.	Recognised lenders	<p>The lender should be resident of FATF or IOSCO compliant country, including on transfer of ECBs. However,</p> <p>a) Multilateral and Regional Financial Institutions where India is a member country will also be considered as recognised lenders;</p> <p>b) Individuals as lenders can only be permitted if they are foreign equity holders or for subscription to bonds/debentures listed abroad; and</p> <p>c) Foreign branches / subsidiaries of Indian banks are permitted as recognised lenders only for FCY ECB (except FCCBs and FCEBs). Foreign branches / subsidiaries of Indian banks, subject to applicable prudential norms, can participate as arrangers/underwriters/market-makers/traders for Rupee denominated Bonds issued overseas. However, underwriting by foreign branches/subsidiaries of Indian banks for issuances by Indian banks will not be allowed.</p>	
v.	Minimum Average Maturity Period	<p>Minimum average maturity period (MAMP) will be 3 years. However, manufacturing sector companies may raise ECBs with MAMP of 1 year for ECB up to USD 50 million or its equivalent per financial year. Further, if the ECB is raised from foreign equity holder and utilised for working capital purposes, general corporate purposes or repayment of Rupee loans, MAMP will be 5 years. The call and put option, if any, shall not be exercisable prior to completion of minimum average maturity.</p>	
vi.	All-in-cost ceiling per annum	Benchmark rate plus 450 bps spread.	
vii.	Other costs	Prepayment charge/ Penal interest, if any, for default	

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Sr. No.	Parameters	Foreign Currency denominated ECB	INR denominated ECB
		or breach of covenants should not be more than 2% over and above the contracted rate of interest on the outstanding principal amount and will be outside the all-in-cost ceiling.	
viii.	End-uses (Negative list)	<p>The negative list, for which the ECB proceeds cannot be utilised, would include the following:</p> <ul style="list-style-type: none"> a) Real estate activities. b) Investment in capital market. c) Equity investment. d) Working capital purposes except from foreign equity holder. e) General corporate purposes except from foreign equity holder. f) Repayment of Rupee loans except from foreign equity holder. g) On-lending to entities for the above activities. 	
ix.	Exchange rate	Change of currency of FCY ECB into INR ECB can be at the exchange rate prevailing on the date of the agreement between the parties concerned for such change or at an exchange rate, which is less than the rate prevailing on the date of agreement, if consented to by the ECB lender.	For conversion to Rupee, exchange rate shall be the rate prevailing on the date of settlement.
x.	Hedging provision	The entities raising ECB are required to follow the guidelines for hedging issued, if any, by the concerned sectoral or prudential regulator in	The overseas investors are eligible to hedge their exposure in Rupee through permitted derivative products with AD Category I banks in

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Sr. No.	Parameters	Foreign Currency denominated ECB	INR denominated ECB
		<p>respect of foreign currency exposure. Infrastructure space companies shall have a board approved risk management policy. Further, such companies are required to mandatorily hedge 70% of their ECB exposure in case average maturity of ECB is less than 5 years. The designated AD Category-I bank shall verify that 70% hedging requirement is complied with during the currency of ECB and report the position to RBI through Form ECB 2 returns. The following operational aspects with respect to hedging should be ensured:</p> <p>a) Coverage: The ECB borrower will be required to cover principal as well as coupon through financial hedges. The financial hedge for all exposures on account of ECB should start from the time of each such exposure (i.e. the day liability is created</p>	<p>India. The investors can also access the domestic market through branches / subsidiaries of Indian banks abroad or branches of foreign banks with Indian presence on a back to back basis.</p>

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Sr. No.	Parameters	Foreign Currency denominated ECB	INR denominated ECB
		<p>in the books of the borrower).</p> <p>b) Tenor and rollover: A minimum tenor of one year of financial hedge would be required with periodic rollover duly ensuring that the exposure on account of ECB is not unhedged at any point during the currency of ECB.</p> <p>c) Natural Hedge: Natural hedge, in lieu of financial hedge, will be considered only to the extent of offsetting projected cash flows / revenues in matching currency, net of all other projected outflows. For this purpose, an ECB may be considered naturally hedged if the offsetting exposure has the maturity/cash flow within the same accounting year. Any other arrangements/ structures, where revenues are indexed to foreign currency will not be considered as natural</p>	

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Sr. No.	Parameters	Foreign Currency denominated ECB	INR denominated ECB
		hedge.	
xi.	Change of currency of borrowing	Change of currency of ECB from one freely convertible foreign currency to any other freely convertible foreign currency as well as to INR is freely permitted.	Change of currency of ECB from one freely convertible foreign currency to any other freely convertible foreign currency as well as to INR is freely permitted.

Note: ECB framework is not applicable in respect of the investment in Non-Convertible Debentures in India made by Registered Foreign Portfolio Investors.

2.2 Limit and leverage

Under the aforesaid framework, all eligible borrowers can raise ECB up to USD 750 million or equivalent per financial year under auto route. Further, in case of foreign currency denominated ECB raised from direct foreign equity holder ECB liability-equity ratio for ECBs raised under the automatic route cannot exceed 7:1. However, this ratio will not be applicable if outstanding amount of all ECBs, including proposed one, is up to USD 5 million or equivalent. Further, the borrowing entities will also be governed by the guidelines on debt equity ratio issued, if any, by the sectoral or prudential regulator concerned.

3. Issuance of Guarantee, etc. by Indian banks and Financial Institutions

Issuance of any type of guarantee by Indian banks, All India Financial Institutions and NBFCs relating to ECB is not permitted. Further, financial intermediaries (viz., Indian banks, All India Financial Institutions, or NBFCs) shall not invest in FCCBs/ FCEBs in any manner whatsoever.

4. Parking of ECB proceeds

ECB proceeds are permitted to be parked abroad as well as domestically in the manner given below:

4.1 Parking of ECB proceeds abroad

ECB proceeds meant only for foreign currency expenditure can be parked abroad pending utilization. Till utilisation, these funds can be invested in the following liquid assets (a) deposits or Certificate of Deposit or other products offered by banks rated not less than AA (-) by Standard and Poor/ Fitch IBCA or Aa3 by Moody's; (b) Treasury bills and other monetary instruments of one-year maturity having minimum rating as indicated above and (c) deposits with foreign branches/ subsidiaries of Indian banks abroad.

4.2 Parking of ECB proceeds domestically

ECB proceeds meant for Rupee expenditure should be repatriated immediately for credit to their Rupee accounts with AD Category I banks in India. ECB borrowers are also allowed to park ECB proceeds in term deposits with AD Category I banks in India for a maximum period of 12 months cumulatively. These term deposits should be kept in unencumbered position.

5. Procedure of raising ECB

All ECBs can be raised under the automatic route if they conform to the parameters prescribed under this framework. For approval route cases, the borrowers may approach the RBI with an application in prescribed format (Form ECB – Annex I) for examination through their AD Category I bank. Such cases shall be considered keeping in view the overall guidelines, macroeconomic situation and merits of the specific proposals. ECB proposals received in the RBI above certain threshold limit (refixed from time to time) would be placed before the Empowered Committee set up by the RBI. The Empowered Committee will have external as well as internal members and the RBI will take a final decision in the cases taking into account recommendation of the Empowered Committee. Entities desirous to raise ECB under the automatic route may approach an AD Category I bank with their proposal along with duly filled in Form ECB.

6. Reporting Requirements

Borrowings under ECB Framework are subject to following reporting requirements apart from any other specific reporting required under the framework:

6.1 Loan Registration Number (LRN)

Any draw-down in respect of an ECB should happen only after obtaining the LRN from the RBI. To obtain the LRN, borrowers are required to submit duly certified Form ECB, which also contains terms and conditions of the ECB, in duplicate to the designated AD Category I bank. In turn, the AD Category I bank will forward one copy to the Director, Balance of Payments Statistics Division, Department of Statistics and Information Management (DSIM), Reserve Bank of India, Bandra-Kurla Complex, Mumbai – 400 051. Copies of loan agreement for raising ECB are not required to be submitted to the Reserve Bank.

6.2 Changes in terms and conditions of ECB

Changes in ECB parameters in consonance with the ECB norms, including reduced repayment by mutual agreement between the lender and borrower, should be reported to the DSIM through revised Form ECB at the earliest, in any case not later than 7 days from the changes effected. While submitting revised Form ECB the changes should be specifically mentioned in the communication.

6.3 Monthly Reporting of actual transactions

The borrowers are required to report actual ECB transactions through Form ECB 2 Return (Annex II) through the AD Category I bank on monthly basis so as to reach DSIM within seven working days from the close of month to which it relates. Changes, if any, in ECB parameters should also be incorporated in Form ECB 2 Return.

6.4 Late Submission Fee (LSF) for delay in reporting

Any borrower, who is otherwise in compliance of ECB guidelines, can regularize the delay in reporting of drawdown of ECB proceeds before obtaining LRN or delay in submission of Form ECB 2 returns, by payment of late submission fees as detailed in the following matrix:

Sr. No.	Type of Return/Form	Period of delay	Applicable LSF
1.	Form ECB 2	Up to 30 calendar days from due date of submission	INR 5,000
2.	Form ECB	Up to three years from due	INR 50,000 per

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Sr. No.	Type of Return/Form	Period of delay	Applicable LSF
	2/Form ECB	date of submission/date of drawdown	year
3.	Form ECB 2/Form ECB	Beyond three years from due date of submission/date of drawdown	INR 100,000 per year

6.5 Standard Operating Procedure (SOP) for Untraceable Entities

The following SOP has to be followed by designated AD Category-I banks in case of untraceable entities who are found to be in contravention of reporting provisions for ECBs by failing to submit prescribed return(s) under the ECB framework, either physically or electronically, for past eight quarters or more.

- i. **Definition:** Any borrower who has raised ECB will be treated as 'untraceable entity', if entity/auditor(s)/director(s)/ promoter(s) of entity are not reachable/responsive/reply in negative over email/letters/phone for a period of not less than two quarters with documented communication/ reminders numbering 6 or more and it fulfills both of the following conditions:
 - a) Entity not found to be operative at the registered office address as per records available with the AD Bank or not found to be operative during the visit by the officials of the AD Bank or any other agencies authorized by the AD bank for the purpose;
 - b) Entities have not submitted Statutory Auditor's Certificate for last two years or more;
- ii. **Action:** The followings actions are to be undertaken in respect of 'untraceable entities':
 - a) File Revised Form ECB, if required, and last Form ECB 2 Return without certification from company with 'UNTRACEABLE ENTITY' written in bold on top. The outstanding amount will be treated as written-off from external debt liability of the country but may be retained by the lender in its books for recovery through judicial/ non-judicial means;

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- b) No fresh ECB application by the entity should be examined/processed by the AD bank;
- c) Directorate of Enforcement should be informed whenever any entity is designated 'UNTRACEABLE ENTITY'; and
- d) No inward remittance or debt servicing will be permitted under auto route.

7. Powers delegated to AD Category I banks to deal with ECB cases:

The designated AD Category I banks can approve any requests from the borrowers for changes in respect of ECBs, except for FCCBs/FCEBs, duly ensuring that the changed conditions, including change in name of borrower/lender, transfer of ECB and any other parameters, comply with extant ECB norms and are with the consent of lender(s). Further, the following changes can be undertaken under automatic route:

7.1 Change of the AD Category I bank

AD Category I bank can be changed subject to obtaining no objection certificate from the existing AD Category I bank.

7.2 Cancellation of LRN

The designated AD Category I banks may directly approach DSIM for cancellation of LRN for ECBs contracted, subject to ensuring that no draw down against the said LRN has taken place and the monthly ECB-2 returns till date in respect of the allotted LRN have been submitted to DSIM.

7.3 Refinancing of existing ECB

The designated AD Category I bank may allow refinancing of existing ECB by raising fresh ECB provided the outstanding maturity of the original borrowing (weighted outstanding maturity in case of multiple borrowings) is not reduced and all-in-cost of fresh ECB is lower than the all-in-cost (weighted average cost in case of multiple borrowings) of existing ECB. Further, refinancing of ECBs raised under the previous ECB framework may also be permitted, subject to additionally ensuring that the borrower is eligible to raise ECB under the extant framework. Raising of fresh ECB to part refinance the existing ECB is also permitted subject to same conditions. Indian banks are permitted to participate in refinancing of existing ECB, only for highly rated corporates (AAA) and for Maharatna/Navratna public sector undertakings.

7.4 Conversion of ECB into equity

Conversion of ECBs, including those which are matured but unpaid, into equity is permitted subject to the following conditions:

- (i) The activity of the borrowing company is covered under the automatic route for FDI or Government approval is received, wherever applicable, for foreign equity participation as per extant FDI policy.
- (ii) The conversion, which should be with the lender's consent and without any additional cost, should not result in contravention of eligibility and breach of applicable sector cap on the foreign equity holding under FDI policy;
- (iii) Applicable pricing guidelines for shares are complied with;
- (iv) In case of partial or full conversion of ECB into equity, the reporting to the Reserve Bank will be as under:
 - a. For partial conversion, the converted portion is to be reported in Form FC-GPR prescribed for reporting of FDI flows, while monthly reporting to DSIM in Form ECB 2 Return will be with suitable remarks, viz., "ECB partially converted to equity".
 - b. For full conversion, the entire portion is to be reported in Form FC-GPR, while reporting to DSIM in Form ECB 2 Return should be done with remarks "ECB fully converted to equity". Subsequent filing of Form ECB 2 Return is not required.
 - c. For conversion of ECB into equity in phases, reporting through Form FC-GPR and Form ECB 2 Return will also be in phases.
- (v) If the borrower concerned has availed of other credit facilities from the Indian banking system, including foreign branches/subsidiaries of Indian banks, the applicable prudential guidelines issued by the Department of Banking Regulation of Reserve Bank, including guidelines on restructuring are complied with;
- (vi) Consent of other lenders, if any, to the same borrower is available or at least information regarding conversions is exchanged with other lenders of the borrower.
- (vii) For conversion of ECB dues into equity, the exchange rate prevailing on the date of the agreement between the parties concerned for such conversion or any lesser rate can be applied with a mutual agreement

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with the ECB lender. It may be noted that the fair value of the equity shares to be issued shall be worked out with reference to the date of conversion only.

7.5 Security for raising ECB

AD Category I banks are permitted to allow creation/ cancellation of charge on immovable assets, movable assets, financial securities and issue of corporate and/ or personal guarantees in favour of overseas lender / security trustee, to secure the ECB to be raised / raised by the borrower, subject to satisfying themselves that:

- (i) the underlying ECB is in compliance with the extant ECB guidelines,
- (ii) there exists a security clause in the Loan Agreement requiring the ECB borrower to create/ cancel charge, in favour of overseas lender / security trustee, on immovable assets / movable assets / financial securities / issuance of corporate and / or personal guarantee, and
- (iii) No objection certificate, as applicable, from the existing lenders in India has been obtained in case of creation of charge.

Once the aforesaid stipulations are met, the AD Category I bank may permit creation of charge on immovable assets, movable assets, financial securities and issue of corporate and / or personal guarantees, during the currency of the ECB with security co-terminating with underlying ECB, subject to the following:

- (i) **Creation of Charge on Immovable Assets:** The arrangement shall be subject to the following:
 - (a) Such security shall be subject to provisions contained in the Foreign Exchange Management (Acquisition and Transfer of Immovable Property in India) Regulations, 2000.
 - (b) The permission should not be construed as a permission to acquire immovable asset (property) in India, by the overseas lender/ security trustee.
 - (c) In the event of enforcement / invocation of the charge, the immovable asset/ property will have to be sold only to a person resident in India and the sale proceeds shall be repatriated to liquidate the outstanding ECB.

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- (ii) **Creation of Charge on Movable Assets:** In the event of enforcement/ invocation of the charge, the claim of the lender, whether the lender takes over the movable asset or otherwise, will be restricted to the outstanding claim against the ECB. Encumbered movable assets may also be taken out of the country subject to getting 'No Objection Certificate' from domestic lender/s, if any.
- (iii) **Creation of Charge over Financial Securities:** The arrangements may be permitted subject to the following:
 - a) Pledge of shares of the borrowing company held by the promoters as well as in domestic associate companies of the borrower is permitted. Pledge on other financial securities, viz. bonds and debentures, Government Securities, Government Savings Certificates, deposit receipts of securities and units of the Unit Trust of India or of any mutual funds, standing in the name of ECB borrower/promoter, is also permitted.
 - b) In addition, security interest over all current and future loan assets and all current assets including cash and cash equivalents, including Rupee accounts of the borrower with ADs in India, standing in the name of the borrower/promoter, can be used as security for ECB.
 - c) In case of invocation of pledge, transfer of financial securities shall be in accordance with the extant FDI/FII policy including provisions relating to sectoral cap and pricing as applicable read with the Foreign Exchange Management (Transfer or Issue of Security by a Person Resident outside India) Regulations, 2000.
- (iv) **Issue of Corporate or Personal Guarantee:** The arrangement shall be subject to the following:
 - a) A copy of Board Resolution for the issue of corporate guarantee for the company issuing such guarantee, specifying name of the officials authorised to execute such guarantees on behalf of the company or in individual capacity should be obtained.
 - b) Specific requests from individuals to issue personal guarantee indicating details of the ECB should be obtained.
 - c) Such security shall be subject to provisions contained in the Foreign Exchange Management (Guarantees) Regulations, 2000.

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- d) ECB can be credit enhanced / guaranteed / insured by overseas party/ parties only if it/ they fulfil/s the criteria of recognised lender under extant ECB guidelines.

7.6 Additional Requirements

While permitting changes under the delegated powers, the AD Category I banks should ensure that:

- (i) The changes permitted are in conformity with the applicable ceilings / guidelines and the ECB continues to be in compliance with applicable guidelines. It should also be ensured that if the ECB borrower has availed of credit facilities from the Indian banking system, including foreign branches/subsidiaries of Indian banks, any extension of tenure of ECB (whether matured or not) shall be subject to applicable prudential guidelines issued by Department of Banking Regulation of Reserve Bank including guidelines on restructuring.
- (ii) The changes in the terms and conditions of ECB allowed by the ADs under the powers delegated and / or changes approved by the Reserve Bank should be reported to the DSIM through revised Form ECB at the earliest, in any case not later than 7 days from the changes effected. While submitting revised Form ECB to the DSIM, the changes should be specifically mentioned in the communication. Further, these changes should also get reflected in the Form ECB 2 returns appropriately.

8. Special Dispensations under the ECB framework for Start-ups:

AD Category-I banks are permitted to allow Start-ups to raise ECB under the automatic route as per the following framework:

- (i) **Eligibility:** An entity recognised as a Start-up by the Central Government as on date of raising ECB.
- (ii) **Maturity:** Minimum average maturity period will be 3 years.
- (iii) **Recognised lender:** Lender / investor shall be a resident of a FATF compliant country. However, foreign branches/subsidiaries of Indian banks and overseas entity in which Indian entity has made overseas direct investment as per the extant Overseas Direct Investment Policy will not be considered as recognized lenders under this framework.

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- (iv) **Forms:** The borrowing can be in form of loans or non-convertible, optionally convertible or partially convertible preference shares.
- (v) **Currency:** The borrowing should be denominated in any freely convertible currency or in Indian Rupees (INR) or a combination thereof. In case of borrowing in INR, the non-resident lender, should mobilise INR through swaps/outright sale undertaken through an AD Category-I bank in India.
- (vi) **Amount:** The borrowing per Start-up will be limited to USD 3 million or equivalent per financial year either in INR or any convertible foreign currency or a combination of both.
- (vii) **All-in-cost:** Shall be mutually agreed between the borrower and the lender.
- (viii) **End uses:** For any expenditure in connection with the business of the borrower.
- (ix) **Conversion into equity:** Conversion into equity is freely permitted subject to Regulations applicable for foreign investment in Startups.
- (x) **Security:** The choice of security to be provided to the lender is left to the borrowing entity. Security can be in the nature of movable, immovable, intangible assets (including patents, intellectual property rights), financial securities, etc. and shall comply with foreign direct investment / foreign portfolio investment / or any other norms applicable for foreign lenders / entities holding such securities. Further, issuance of corporate or personal guarantee is allowed. Guarantee issued by a non-resident(s) is allowed only if such parties qualify as lender under ECB for Start-ups. However, issuance of guarantee, standby letter of credit, letter of undertaking or letter of comfort by Indian banks, all India Financial Institutions and NBFCs is not permitted.
- (xi) **Hedging:** The overseas lender, in case of INR denominated ECB, will be eligible to hedge its INR exposure through permitted derivative products with AD Category – I banks in India. The lender can also access the domestic market through branches/ subsidiaries of Indian banks abroad or branches of foreign bank with Indian presence on a back to back basis.

Note: Start-ups raising ECB in foreign currency, whether having natural hedge or not, are exposed to currency risk due to exchange

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rate movements and hence are advised to ensure that they have an appropriate risk management policy to manage potential risk arising out of ECBs.

- (xii) **Conversion rate:** In case of borrowing in INR, the foreign currency - INR conversion will be at the market rate as on the date of agreement.
- (xiii) **Other Provisions:** Other provisions like parking of ECB proceeds, reporting arrangements, powers delegated to AD banks, borrowing by entities under investigation, conversion of ECB into equity will be as included in the ECB framework. However, provisions on leverage ratio and ECB liability: Equity ratio will not be applicable. Further, the Start-ups as defined above as well as other start-ups which do not comply with the aforesaid definition but are eligible to receive FDI, can also raise ECBs under the general ECB route/framework.

9. Compliance with the guidelines

The primary responsibility for ensuring that the borrowing is in compliance with the applicable guidelines is that of the borrower concerned. Any contravention of the applicable provisions of ECB guidelines will invite penal action under the FEMA. The designated AD Category I bank is also expected to ensure compliance with applicable ECB guidelines by their constituents.

Source References:

- Foreign Exchange Management (Borrowing and Lending) Regulations, 2018
- RBI's External Commercial Borrowing Framework dated 16 January 2019

Chapter 8

Broad procedures related to Export

This section covers:

- *Overview of 'export' from the perspective of indirect tax laws including customs*
- *Broad procedure for export under Customs Act, 1962 and Foreign Trade Policy (FTP)*

1. Introduction - Export

Export refers to taking the goods outside from India to a foreign country. The procedure for export trade differs from country to country depending upon the export policy, statutory requirements and customs policies of different countries.

The objectives of these controls are proper use of foreign exchange restrictions, protection of indigenous industries etc. This procedure involves a number of steps namely:

1.1 Procurement of Export Licence:

A person or a firm cannot export goods outside India without a valid Import Export code (IEC) obtained from the Directorate General of Foreign Trade.

1.2 Obtaining Permanent Account Number (PAN):

Export income is subject to a number of exemptions and deductions under different sections of the Income Tax Act. For claiming these exemptions and deductions, exporters are required to register their organisation with the Income Tax Authorities and obtain the Permanent Account Number (PAN). PAN is also necessary for obtaining IEC number.

1.3 Opening Bank Account:

Exporters are required to open a current account in the name of their firms or companies with a commercial bank which is authorised by the RBI to deal in foreign currency transactions. All financial transactions of the exporter organisation are routed through this account. Such bank also serves as a source of pre-shipment and post-shipment finance for the exporters.

1.4 Obtaining necessary authorization to claim export benefits:

All the exporters intending to export under the export promotion scheme need to get their licences / advance authorisation / DFIA etc. registered at the Customs Station. For such registration, original documents are required. Exporter should also register with Export Promotion Council and get RCMC (Registration cum membership certificate).

For exporting services, exporter is required to abide by the Goods and Services Tax law.

Exports of goods shall be 'free' except when regulated by way of prohibition, restriction or exclusive trading through State Trading Enterprises (STEs) as laid down in Indian Trade Classification (Harmonised System) 'ITC(HS)' of Exports and imports.

The list of prohibited or restricted goods include arms, ammunitions, explosives, Special Chemicals, Organisms, Materials, Equipment & Technologies (SCOMET), live animals etc. Special license/permission/ forms or No Object Certificate (NOC) shall be required to be obtained from government/respective ministries to be able to export such restricted/prohibited items.

We have listed down broad procedure as required by Customs Act, 1962 and Foreign Trade Policy (FTP), that any exporter shall be required to follow in order to export goods from India:

- Submit Shipping Bill electronically for export to customs authorities
- Noting of Shipping Bill by customs officer
- Self-assessment of customs duty
- Verification of self-assessment on selective basis by customs officer
- Pay export duty, if applicable
- The 'Export Value Declaration' should be in form given in Annexure
- 'Let Export' Order by Customs officer'

Mandatory documents required for export of goods from India:

- Bill of Lading / Airway Bill / Lorry Receipt / Railway Receipt / Postal Receipt

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- Commercial Invoice cum Packing List (Separate Commercial Invoice and Packing List would also be accepted)
- Shipping Bill / Bill of Export

For export of specific goods, which are subject to restrictions, regulatory authority may notify additional documents or information.

Export with its grammatical variations and cognate expressions, means taking out of India to a place outside India. Thus exporter in relation to any goods at any time between their entry for export and the time when they are exported, includes any owner, beneficial owner or any person holding himself out to be the exporter

2. Procedure

Detailed procedure for exporting goods from India to other countries is elaborated below:

2.1 Shipping bill or Bill of export by Exporter:

Every exporter has to submit electronically 'shipping bill' for export by sea or air and 'Bill of export' for export by road.

Shipping bill form requires details like:

- (i) Name of exporter, consignee
- (ii) Invoice number
- (iii) Details of packing
- (iv) Description and quantity of goods
- (v) Free on board (FOB) value etc.

The exporter who presents the shipping bill or Bill of export shall ensure to comply with below mentioned points:

- (i) The accuracy and completeness of information given to Customs Authorities;
- (ii) The authenticity and validity of any document supporting BoE;
- (iii) Compliance with the restriction or prohibition, if any, relating to the goods;

Manual submission of shipping bill is an exception to be exercised only in rare cases for which proper record should be kept.

The exporter to make appropriate declarations to claim export benefits such as duty drawback, advance authorisation etc.

2.2 Self-assessment, provisional assessment and re-assessment of exported goods

Section 17 of the Customs Act, 1962 (Customs Act) provides for self-assessment of duty on exported goods by the exporter.

The declaration filed by the exporter may be verified by the proper officer when so interdicted by the Risk Management Systems (RMS).

If the self-assessment is found incorrect, the duty may be reassessed and the proper officer shall pass a speaking order, if so desired by the exporter, within 15 days of re-assessment

If the export consignment is not selected for verification, then exporter to submit documents as per checklist and Compulsory compliance requirements (CCR) and challan/proof payment of export duty (if applicable) post which customs officer will make order permitting clearance of goods for loading for export (Let export order)

For the purpose of verification, the proper officer may order for examination or testing of the exported goods. The proper officer may also require the production of any relevant document or ask the exporter to furnish any relevant information.

2.3 Export duty

All goods shall attract 'Nil' rate of export duty unless specifically provided in the Customs Tariff Act.

Thus, exporter to ensure timely payment of export duty, if applicable on the goods exported.

2.4 Risk Management System in export:

Risk Management System (RMS) in Export has been introduced with effect from 15 July 2013. The RMS in exports allows low risk consignments to be cleared based on self-assessment of the declarations by exporters. This enables the department to enhance the level of facilitation and speed up the process of export clearance.

By expediting the clearance of compliant export cargo, the RMS in exports will contribute to reduction in dwell time, thereby achieving the desired

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objective of reducing the transaction cost in order to make the business internationally competitive. It will also provide appropriate control measures for proper and speedy disbursement of drawback and other export incentives.

With the introduction of the RMS in exports, the practice of routine verification of self-assessment and examination of Shipping Bills has been discontinued and the focus is on quality assessment, examination and post clearance audit (PCA) of Shipping Bills selected by the RMS.

Shipping Bills filed electronically in ICES through the Service Centre or the ICEGATE will be processed by RMS through a series of steps/corridors and an electronic output will be produced for the ICES. This output from RMS will determine the flow of the Shipping Bill in ICES i.e. whether the Shipping Bill will be taken up for Customs control (verification of self-assessment or examination or both) or to be given "Let Export Order" directly after payment of Export duty (if any) without any verification of self-assessment or examination.

The selection of Shipping Bills for verification of Self-assessment and/or examination will be based on the output given by RMS to ICES. However, owing to some technical reasons if the RMS fails to provide output to ICES or RMS output is not received at ICES end in time, the existing norms of assessment and examination will be applicable.

2.5 Entry outward:

The vessel intending to start loading of export goods for outward movement should be granted 'Entry Outward' by customs officer. Loading can start only after entry outward is granted

Export goods can be loaded only after shipping bill or Bill of export, duly passed by Customs officer is handed over by exporter to the person-in-charge of conveyance.

Steamer agents can file application for 'entry outwards' 14 days in advance so that intending exporters can start submitting shipping bills. This ensures that formalities are completed as quickly as possible and loading in ships starts quickly.

2.6 Export General Manifest / Departure Manifest (EGM):

This is the most important responsibility cast on the person-in-charge of the

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conveyance. He has to give to the Customs Authorities a complete list of the cargo exported from India and taken by the conveyance under his charge.

Section 41(1) of the Customs Act, 1962 provides that the person-in-charge of a conveyance carrying export goods shall, before the departure of the conveyance from a Customs station, deliver to the proper officer, in the case of a vessel or aircraft an export manifest by presenting electronically, and in the case of a vehicle, an export report in the prescribed form.

However, in cases where it is not feasible to deliver export manifest by presenting them electronically, the Principal Commissioner/ Commissioner of Customs may, allow the same to be delivered in any other manner.

The person delivering the export manifest or export report shall make and subscribe a declaration as to the truth of its contents as a footnote thereof.

If the proper officer is satisfied that the export manifest or the export report is in any way incorrect and there was no fraudulent intention, he may permit such manifest or report to be amended or supplemented.

2.7 Examination of goods:

The goods brought for the purpose of export are allowed entry to the Dock on the strength of the check list and other declarations filed by the exporter in the Service Center.

After the receipt of the goods in the Docks, the exporter/ Customs Broker may contact the Customs Officer designated for the purpose, and present the check list with the endorsement of custodian and other declarations along with all original documents such as Invoice and Packing list, etc.

The Customs Officer may verify the quantity of the goods actually received and entered into the system and thereafter mark the Electronic Shipping Bill and also hand over all original documents to the Dock Appraiser who assigns a Customs Officer for examination and indicate the officers' name and the packages to be examined, if any, on the check list and return it to the exporter/ Customs Broker.

2.8 Valuation of goods:

As per Rule 7 of Customs Valuation Rules, the exporters have to file declaration about full 'value' of goods. The 'Export Value declaration' should be in form as prescribed in customs circular.

2.8.1 Let Export Order: Customs officers will verify the contents and after

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being satisfied that goods are not prohibited or restricted and that export duty, if applicable and other charges are paid, will remit clearance.

2.8.2 Authorised Economic Operator Programme (AEO): AEO is a programme under the aegis of the World Customs Organization (WCO) SAFE Framework of Standards to secure and facilitate Global Trade.

The programme aims to enhance international supply chain security and facilitate movement of legitimate goods.

AEO encompasses various players in the International supply chain. Under this programme, an entity engaged in international trade is approved by Customs as compliant with supply chain security standards and granted AEO status & certain benefits.

AEO is a voluntary programme. It enables Indian Customs to enhance and streamline cargo security through close cooperation with the principle stakeholders of the international supply chain viz. importers, exporters, logistics providers, custodians or terminal operators, custom brokers and warehouse operators. The Government by way of various circulars, notifications and instructions has further liberalized, simplified and rationalized the AEO accreditation process so as to promote ease of doing Business and to emulate global best practices.

Central Board of Indirect Tax (CBIC) has initiated numerous measures to facilitate the Customs clearance process and reduce transaction costs. The objective is to make the Customs clearance process in India a world class experience by reducing dwell time of cargo, which in turn improves the competitiveness of businesses. Some of these measures are presently a work-in-progress and their present importance is in the fact that these highlight the approach of the Board towards ensuring the ease of doing business.

Source References:

- The Customs Act, 1962
- Customs Valuation (Determination of Value of Export Goods) Rules, 2007
- Foreign Trade Policy FY 15-20
- Handbook of Procedures
- CBEC's Customs Manual

Chapter 9

Export Incentives under Indirect Tax Laws

This section covers:

- *Export incentives under indirect tax laws*

1. Introduction-Export Incentives

Exports of a country play an important role in the economy. The Government always endeavors to encourage exports by introducing various export promotion schemes. Consequently, there are various promotional measures under Foreign Trade Policy 2015-20 (FTP) and other schemes operated under Ministry of Commerce through various Export Promotion Councils.

As per World Trade Organization, export incentives cannot be given to the exporters as such otherwise there would be no free competition. Hence, all the export promotion schemes in India are directed towards ensuring that the inputs as well as final products are made tax-free.

Various Incentives are listed below:

1. Duty Exemption and remission scheme
2. Reward schemes (MEIS, SEIS and Status holders):
3. Export Promotion Capital Goods (EPCG Scheme)
4. EOU, EHTP, STP and BTU Schemes
5. Special Economic Zones
6. Deemed Exports

1.1. Duty Exemption and remission scheme:

These schemes enable duty free import of inputs for export production with export obligation. These scheme consists of:-

- A Duty exemption schemes: Under duty exemption schemes, exporter can import the inputs duty free for export production. The two duty exemption schemes are as follows:-

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- a) Advance Authorization Scheme
- b) Duty Free Import Authorization Scheme (DFIA)
- B Duty remission schemes: Under duty remission scheme, duty on inputs and input services used in the export product is either replenished or remitted. Duty Drawback (DBK) Scheme is designed for this purpose.

A Duty exemption schemes

- (a) Advance Authorization scheme

Under this scheme, duty free import of inputs are allowed, that are physically incorporated in the export product (after making normal allowance for wastage) with minimum 15% value addition.

Advance Authorization (AA) is issued for inputs in relation to resultant products as per Standard Input Output Norms (SION). If SION for a particular item is not fixed, AA can be issued on self-declaration by applicant, except certain specified products.

AA normally have a validity period of 12 months for the purpose of making imports.

Period for fulfilment of Export Obligation shall be 18 months from the date of issue of authorisation.

AA and/ or materials imported thereunder will be with actual user condition. It will not be transferable even after completion of export obligation. However, Authorization holder will have an option to dispose-off product manufactured out of duty free inputs once export obligation is completed.

AA is issued either to a manufacturer exporter or merchant exporter tied to a supporting manufacturer(s). Such Authorization can also be issued for:

- Physical exports
 - Intermediate supply
 - Supplies made to specified categories of deemed exports
- (b) Duty free Import Authorization scheme
 - DFIA is issued to allow duty free import of inputs, with a minimum value addition requirement of 20%.
 - DFIA shall be exempted only from the payment of basic customs duty.
 - DFIA shall be issued on post export basis for products for which SION has been notified.

Export Incentives under Indirect Tax Laws

- Provisions applicable to Advanced Authorisation are broadly applicable in case of DFIA. However, these Authorizations shall be issued only for products for which SION have been notified.
- After completion of exports and realization of export proceeds, request for issuance of transferable DFIA may be made within a period of 12 months from the date of export or 6 months (or additional time allowed by RBI for realization) from the date of realization of export proceeds, whichever is earlier.
- No DFIA shall be issued for an export product where SION prescribes 'Actual User' condition for any input and/or FTP prescribes pre-import condition on any inputs

B Duty exemption schemes

(c) Duty Drawback on imported materials used in the manufacture of goods which are exported

- Drawback means the refund of customs duty that are chargeable on imported materials used in the manufacture of exported goods.
- Rate of duty drawback is to be determined by All Industry rate (AIR) as determined by the central government on several products.
- Where AIR is not available or is less than 80% of actual duties paid, application can be made for fixation of brand rate or special brand rate respectively.
- Duty drawback cannot be claimed on IGST charged. Separate refund application in accordance to the GST law to be filed to claim the IGST paid on such exports.

(d) Duty Drawback on materials imported and exported as such:

- In case of goods which were earlier imported on payment of duty and are later sought to be exported within a specified period, Customs Duty paid at the time of import of the goods, with certain cuts, can be claimed as Duty Drawback at the time of export of such goods.
- Such Duty Drawback is granted in terms of Section 74 of the Customs Act, 1962 read with Re-export of Imported Goods (Drawback of Customs Duty) Rules, 1995. For this purpose, the identity of export goods is cross verified with the particulars furnished at the time of import of such goods.
- Where the goods are not put into use after import, 98% of Duty Drawback is admissible under Section 74 of the Customs Act, 1962.

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- In cases the goods have been put into use after import, Duty Drawback is granted on a sliding scale basis depending upon the extent of use of the goods. However, no Duty Drawback is available if the goods are exported 18 months after import.

1.2 Reward schemes (MEIS, SEIS and Status holders):

Reward schemes are the schemes which entitle the exporters to duty credit scrips subject to various conditions. These scrips can be used for payment of customs duties on import of inputs/ goods including notified capital goods. These scrips are transferable, i.e. they can be sold in market, if the holder of duty credit scrip does not intend to import goods against the scrips. Following are schemes for exports of merchandise and services:

- A Merchandise Exports from India Scheme (MEIS)
- B Service Exports from India Scheme (SEIS)
- C Status holder
- A Merchandise Exports from India Scheme (MEIS)

The objective of MEIS scheme is to compensate infrastructural inefficiencies and associated costs involved in export of goods/products, which are produced/manufactured in India, especially goods having high export intensity, employment potential and thereby enhancing India's export competitiveness.

Under MEIS, exports of notified goods/products to notified markets shall be eligible for reward at the specified rate(s). Unless otherwise specified, the basis of calculation of reward would be on the basis of free on board (FOB) value of export

The list and rates are given in Appendix 3B as amended from time to time in FTP. The rate of duty scrips ranges from 2%-7%.

Some exports categories/ sectors ineligible for Duty Credit Scrip entitlement under MEIS are listed below:

- EOUs / EHTPs / BTPs/ STPs who are availing direct tax benefits/exemption
- Supplies made from Domestic Tariff Area units to Special Economic Zone (SEZ) units
- Exports through trans-shipment, i.e., exports that are originating in third country but trans-shipped through India

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- Deemed Exports
- SEZ/EOU/EHTP/BPT/FTWZ products exported through DTA units
- Export products which are subject to Minimum export price or export duty

B Service Exports from India Scheme (SEIS)

The objective of SEIS scheme is to encourage export of notified services from India

The scheme applies to export of services made after 1 April, 2015. For earlier period the earlier applicable schemes will apply.

A service provider (with active IEC at the time of rendering services) located in India, providing notified services rendered in the specified manner shall be eligible for reward at the notified rate(s) on net foreign exchange earned provided the minimum net free foreign exchange earnings of such service provider in preceding financial year is USD 15,000.

For individual service providers and sole proprietorship, minimum net free foreign exchange earnings of such service provider in preceding financial year is USD 10,000.

Service provider means a person providing:

- (a) Supply of a 'service' from India to any other country; (Mode 1- Cross border trade)
- (b) Supply of a 'service' from India to service consumer(s) of any other country in India; (Mode 2- Consumption abroad)
- (c) Supply of a 'service' from India through commercial presence in any other country; (Mode 3- commercial presence)
- (d) Supply of a 'service' from India through the presence of natural persons in any other country ; (Mode 4- presence of natural persons)

Only export of services falling under clause (a) and (b) are eligible for SEIS scrips

Net foreign exchange is computed as follows:

Net Foreign exchange earnings = Gross Earnings of Foreign Exchange (-)
Total expenses/ payment/ remittances of Foreign Exchange by the IEC holder,
relating to service sector in the financial year

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The list of eligible services and rates are given in Appendix 3D as amended from time to time in FTP. The rate of duty scrips ranges from 2% -7% of Net Foreign exchange earnings for different services. These cover services such as-

- Professional Services
- Research and Development Services
- Rental/Leasing Services without Operators
- Construction and Related Engineering Services
- Educational Services
- Environmental Services
- Health and Social Services
- Tourism and Travel Services
- Recreational, Cultural and Sporting Services
- Transport & Auxiliary Services
- Other Business Services

Services to/by EOU are not eligible for SEIS benefits

Services provided by SEZ unit outside India are eligible for SEIS benefits

C Status holders

Status Holders are business leaders who have excelled in international trade and have successfully contributed to country's foreign trade. All exporters of goods, services and technology having an IEC shall be eligible for recognition as a status holder.

Status holders are expected to contribute towards India's exports and provide guidance and hand-holding to new entrepreneurs.

Status holders means an exporter recognised as one to five star Export House by DGFT/Development Commissioner

An applicant shall be categorized as status holder upon achieving export performance during current and previous three financial years. However, for Gems & Jewellery Sector, the performance during the current and previous two financial years shall be considered for recognition as status holder.

The required export performance as specified in FTP is as follows:

Export Incentives under Indirect Tax Laws

Sr No	Status Category	Export Performance (In US \$ Million)
1	One Star Export House	3
2	Two Star Export House	25
3	Three Star Export House	100
4	Four Star Export House	500
5	Five Star Export House	2000

Points for consideration while computing export performance for grant of status:

Export performance will be counted on the basis of FOB value of export earnings in free foreign exchange

For deemed export, Freight on road and rails (FOR) value of exports in Indian Rupees shall be converted in US\$.

For calculating export performance for grant of One Star Export House Status category, exports by IEC holders under the following categories shall be granted double weightage:

- (a) Micro, Small & Medium Enterprises (MSME)
- (b) Manufacturing units having International Organisation for Standardisation (ISO) /Bureau of Indian Standards (BIS)
- (c) Units located in North Eastern States and Jammu & Kashmir
- (d) Units located in Agri Export Zones.

Export performance of one IEC holder shall not be permitted to be transferred to another IEC holder. Hence, calculation of exports performance based on disclaimer shall not be allowed.

Exports made on re-export basis shall not be counted for recognition.

Export of items under authorization, including Special chemicals, Organisms, Materials, Equipment and Technology (SCOMET) items, would be included for calculation of export performance.

Certain privileges of Status holders are listed down below:

- Authorisation and customs clearance on self-declaration basis.

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- Input-Output norms (SION) shall be fixed on priority within 60 days by the Norms Committee.
- Exemption from furnishing of Bank Guarantee for schemes under FTP, unless specified otherwise anywhere in FTP or HBP.
- Exemption from compulsory negotiation of documents through banks, Remittance/Receipts, however, would be received through banking channel.
- Two Star Export Houses and above permitted to establish Export House Warehouses as per Department of Revenue guidelines.
- Three Star Export Houses and above entitled to get the benefit of Accredited Clients Programme (ACP) as per the guidelines of Central board of Indirect Taxes (CBIC).
- Manufacturers who are status-holders (3/4/5 Star Export Houses) will be enabled to certify their manufactured goods as originating from India with a view to qualify for preferential treatment under different preferential trading agreements (PTAs), Free Trade Agreements (FTAs), Comprehensive Economic Cooperation Agreements (CECA) and Comprehensive Economic Partnership Agreements (CEPA). Subsequently, the scheme may be extended to the remaining status-holders.

1.3 Export Promotion Capital Goods (EPCG Scheme)

EPCG scheme allows import of capital goods including spares for pre-production, production and post production at zero duty subject to an export obligation of 6 times of duty saved on capital goods imported under EPCG scheme, to be fulfilled in 6 years reckoned from Authorization issue date.

EPCG scheme covers:

- Manufacturer exporters with or without supporting manufacturer(s)/ vendor(s);
- Merchant exporters tied to supporting manufacturer(s);
- Service providers.

EPCG authorization holder can export either directly or through third party / (parties).

Export Incentives under Indirect Tax Laws

Export proceeds are to be realized in freely convertible currency except for deemed exports.

Import of capital goods imported under the EPCG scheme shall be subject to Actual User condition till export obligation is completed.

There are two types of export obligation that are mandatory:

- First, Annual Average in which export obligation is over and above, the average level of exports achieved by the authorization holder in the preceding three licensing years for the same and similar products within the overall export obligation period including extended period, if any.
- Secondly, Specific Average which is 6 times the duty saved amount in which the Authorization holder shall also fulfill a minimum of 50% export obligation in each block of years - the first block being of 4 years and the second block is of 2 years.

Import of capital goods under EPCG authorisations can also be availed which are covered under Scheme for Project Imports notified by CBIC

1.4 EOU, EHTP, STP and BTU Scheme

Units under Export Oriented Unit (EOU) Scheme, Electronics Hardware Technology Park (EHTP) Scheme, Software Technology Park (STP) Scheme or Bio-Technology Park (BTP) Scheme export their entire production of goods and services (except permissible sales in DTA).

Objective of EOU, EHTP, STP and BTP units is to promote exports, enhance foreign exchange earnings, attract investment for export production and employment generation

STP/EHTP/BTP schemes are similar to EOU schemes and provisions are more/ less identical. EOU scheme is administered by Ministry of Commerce and Industry, while STP/EHTP/BTP schemes are administered by their respective administrative ministries.

Such units can import inputs and capital goods without payment of basic customs duty.

EOU units may be set up for manufacture of goods, including repair, re-making, reconditioning, re-engineering, rendering of services, development of software, agriculture etc.

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EOU units can be set up anywhere in India, either in specified zone like SEZ or stand-alone unit.

Trading units are not covered under these schemes.

Only projects having a minimum investment of 1 crore in building and plant & machinery shall be considered for establishment as EOUs. However, this shall not apply to units in EHTP/ STP/ BTP, Handicrafts/ Agriculture/ Floriculture/ Aquaculture/ Animal Husbandry/ Information Technology Services, Brass hardware and handmade jewellery sectors. Board of Approvals may also allow establishment of EOUs with a lower investment criteria.

Supplies from DTA to EOU/ EHTP/ STP/ BTP units will be regarded as "deemed exports" and DTA supplier shall be eligible for relevant entitlements for deemed exports, besides discharge of export obligation, if any, on the supplier;

Such units can be set up with 100% foreign investment, except in few sectors where compulsory licensing is required eg arms and ammunition, explosives, tobacco, drugs, narcotics etc.

1.5 Special Economic Zones

A Special Economic Zone (SEZ) is a geographically bound zone where the economic laws in matters related to export and import are more broadminded and liberal as compared to other parts of the country.

SEZ is considered to be a place outside India for all tax purposes. SEZ units are self-contained and integrated having their own infrastructure and support services. Within SEZs, a unit may be set-up for the manufacture of goods and other activities including processing, assembling, trading, repairing, reconditioning, making of gold/ silver, platinum jewellery etc.

Goods supplied to SEZs from DTA are treated as exports from India and goods supplied from the SEZ to the DTA are treated as imports into India.

The provisions relating to SEZ are contained in Special Economic Zone Act, 2005 and SEZ Rules, 2006.

Any proposal for setting up of SEZ unit in the Private/ Joint/ State Sector is routed through the concerned State Government which in turn forwards the same to the Department of Commerce with its recommendations for consideration.

Export Incentives under Indirect Tax Laws

The main objectives of the SEZ Act are:

- Export of goods and services without taxes
- Generation of additional economic activity
- Promotion of exports of goods and services
- Promotion of investment from domestic and foreign sources
- Creation of employment opportunities
- Development of infrastructure facilities
- Providing exemption from duties and taxes on procurement
- Single window clearance: It is expected that this will trigger a large flow of foreign and domestic investment in SEZs, in infrastructure and productive capacity, leading to generation of additional economic activity and creation of employment opportunities.
- Simplified procedures for development, operation, and maintenance of the Special Economic Zones and for setting up units and conducting business in SEZs.
- Duty free import / domestic procurement of goods for development, operation and maintenance of SEZ units.

1.6 Deemed Exports

Deemed Exports refer to those transactions in which goods manufactured in India are supplied to specified projects or to specific categories of consumers.

In deemed exports, goods supplied do not leave the country and payment for such supplies is received either in Indian rupees or in free foreign exchange by the recipient of the goods.

The objective of deemed exports is to ensure that the domestic suppliers are not in disadvantageous position vis-a-vis foreign suppliers in terms of the fiscal concessions.

The underlying theory is that foreign exchange saved must be treated at par with foreign exchange earned by placing Indian manufacturers at par with foreign suppliers. Deemed exports broadly cover three areas.

- (i) Supplies against AA/DFIA
- (ii) Supplies to EOU/EHTP/STP/BTP

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- (iii) Supplies of capital goods against EPCG authorisation
- (iv) Supply of marine freight containers
- (v) Supplies to projects with zero customs duty
- (vi) Supplies to projects/ purposes that involve international competitive bidding.
- (vii) Supplies to infrastructure projects of national importance.

Trade facilitation is a priority of the government for cutting down the transaction cost and time, thereby rendering Indian exports more competitive. Government introduces various schemes from time to time in the direction to make global trade hassle free and more favourable vis-à-vis other countries.

Source References:

- Foreign Trade Policy FY 15-20
- Handbook of Procedures

Chapter 10

FEMA Guidelines for Export Receivables

This section covers:

- *Regulatory framework under FEMA for exports*
- *Realization and repatriation of export proceeds, export procedures etc.*
- *Third party payment for exports / imports*
- *Counter-Trade arrangement*
- *Export factoring on non-recourse basis*
- *Project Exports and Service Exports*
- *Other provisions pertaining to exports such as export of goods through post, receipt of advance against exports, extension of time for realization of export proceeds etc.*

1. Introduction and Regulatory Framework

The term export is understood to signify sending goods and services from India to a place outside India. Exports are perceived as a major source of generating forex for the Government.

Exports benefit the local economy in the following manner:

- a) **Creation of employment:** Export of goods stimulated by higher demand acts as a stimulant for higher employment.
- b) **Higher profit margins:** Due to scarcity of a resource in a particular country and abundance of the same in the other, the value of a resource in the particular country might be higher than that in the other. This provides an opportunity for the exporters of the other country to sell the resource in the first country as it may fetch a higher profit margin than in the domestic market.
- c) **Generation of forex:** Forex reserves play an important role in the economy as they represent purchasing power in the international

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markets. Higher exports from India will help to generate forex and make India a global contender in international trade.

- d) **Increase in productivity:** To compete with international markets in terms of cost as well as quality, Indian exporters will eventually need to innovate themselves, adopt state of the art technology and reduce overheads. This will not only increase efficiency and competitive capacity of the Indian exporters, but will lead to greater market efficiency in the Indian domestic markets as well.

Export trade is regulated by the Directorate General of Foreign Trade (DGFT) and its regional offices, functioning under the Ministry of Commerce and Industry, Department of Commerce, Government of India. Policies and procedures required to be followed for exports from India are announced by the DGFT, from time to time.

Export of Goods and Services from India is governed by section 7(1)(a) and section 7(3) and section 47(2) of Foreign Exchange Management Act, 1999 read with the FEMCAT Rules and the Foreign Exchange Management (Export of Goods & Services) Regulations, 2015.

The RBI has issued Master Direction No. 16/2015-16, dated 1 January 2016 which is updated from time to time (Master Direction on Export of Goods and Service) and contains detailed directions on export of goods and services.

In this publication, only those provisions are discussed, knowledge of which helps reader to understand basic administrative procedure in relation to export of goods and services. For detailed rules and regulation, one can refer above referred Master Direction which can be downloaded from the RBI website www.rbi.org.in

2. Invoicing of Exports

There is no restriction on invoicing of export contracts in Indian Rupees. Further, in terms of FTP 2015-20, "All export contracts and invoices shall be denominated either in freely convertible currency or Indian rupees but export proceeds shall be realized in freely convertible currency. However, export proceeds against specific exports may also be realized in rupees, provided it is through a freely convertible Vostro account of a non-resident bank situated in any country other than a member country of Asian Clearing Union (ACU) or Nepal or Bhutan." Indian Rupee is not a freely convertible currency, as yet.

3. Realization and repatriation of proceeds of export of goods / software / services

It is obligatory on the part of the exporter to realize and repatriate the full value of goods / software / services to India within **nine** months from the date of export for all exporters including Units in Special Economic Zones (SEZs), Status Holder Exporters, Export Oriented Units (EOUs), Units in Electronic Hardware Technology Parks (EHTPs), Software Technology Parks (STPs) & Bio-Technology Parks (BTPs). In case of goods exported to a warehouse established outside India, the same may be realized within **fifteen** months from the date of shipment of goods.

4. Declaration forms and the procedures thereof

4.1 Export of Goods – EDF

When physical goods leave Indian borders, from any port of shipment, the exporter is required to declare value of goods to Customs authorities. In India, this was done through a form called GR form (PP form in case of exports by post office) for non- Electronic Data Interchange (EDI) ports and SDF for EDI ports, along with invoice and other supporting documents. With effect from 1 October 2013, as a part of simplification of the process, the GR and PP form have been substituted by a new form called “EDF” (Export Declaration Form) and SDF has been merged with shipping bill.

Realization of export proceeds in respect of export of goods / software from third party should be duly declared by the exporter in the appropriate declaration form.

Please refer RBI circulars. RBI/2013-14/254 A.P. (DIR Series) Circular No. 43 13 September 2013 and RBI//2014-15/599, A.P. (DIR Series) Circular No. 101, 14 May 2015.

4.2 Export of software - SOFTEX Forms

- (i) All software exporters can now file single as well as bulk SOFTEX form in the form of a statement in excel format to the competent authority for certification. Since the SOFTEX data from STPI / SEZ are being transmitted in electronic format to RBI, the exporters now have to submit the SOFTEX form in duplicate as per the revised procedure. STPI / SEZ will retain one copy and handover duplicate copy to exporters after due certification. As hitherto, the exporters have to

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provide information about all the invoices including the ones lesser than USD 25,000, in the bulk statement in excel format.

- (ii) A common "SOFTEX Form" has been devised to declare single as well as bulk software exports.
- (iii) RBI has extended the facility for online generation of the EDF Form Number and the SOFTEX Form Number (Single as well as Bulk for use in off-site software exports). The facility of manual allotment of single as well bulk SOFTEX form number by Regional Offices of RBI has been dispensed with accordingly.

4.3 Export of Services

In respect of export of services to which none of the forms specified in the Export Regulations apply, the exporter may export such services without furnishing any declaration, but shall be liable to realise the amount of forex which becomes due or accrues on account of such export, and to repatriate the same to India in accordance with the provisions of FEMA, and the Export Regulations, as also other rules and regulations made under FEMA.

5. Exemption from Declaration

Export of goods / software may be made without furnishing the declaration in the following cases, namely:

- (a) trade samples of goods and publicity material supplied free of payment;
- (b) personal effects of travellers, whether accompanied or unaccompanied;
- (c) ship's stores, trans-shipment cargo and goods supplied under the orders of central government or of such officers as may be appointed by the central government in this behalf or of the military, naval or air force authorities in India for military, naval or air force requirements;
- (d) by way of gift of goods accompanied by a declaration by the exporter that they are not more than INR 500,000 in value
- (e) aircrafts or aircraft engines and spare parts for overhauling and/or repairs abroad subject to their reimport into India after overhauling /repairs, within a period of six months from the date of their export;
- (f) goods imported free of cost on re-export basis;

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- (g) the following goods which are permitted by the Development Commissioner of the SEZs, EHTPs, STPs or FTZs to be re-exported, namely:
 - (1) imported goods found defective, for the purpose of their replacement by the foreign suppliers/collaborators;
 - (2) goods imported from foreign suppliers/collaborators on loan basis;
 - (3) goods imported from foreign suppliers/collaborators free of cost, found surplus after production operations.
- (ga) goods listed at items (1), (2) and (3) of clause (g) to be re-exported by units in SEZs, under intimation to the Development Commissioner of SEZs / concerned Assistant Commissioner or Deputy Commissioner of Customs
- (h) replacement goods exported free of charge in accordance with the provisions of Foreign Trade Policy in force, for the time being.
- (i) goods sent outside India for testing subject to re-import into India;
- (j) defective goods sent outside India for repair and re-import provided the goods are accompanied by a certificate from an authorised dealer in India that the export is for repair and re-import and that the export does not involve any transaction in forex.
- (k) exports permitted by the RBI, on application made to it, subject to the terms and conditions, if any, as stipulated in the permission.

6. Importer-Exporter Code

The importer-exporter code (IEC) number allotted by the DGFT under Section 7 of the Foreign Trade (Development & Regulation) Act, 1992 shall be indicated on all copies of the declaration forms submitted by the exporter to the specified authority and in all correspondence of the exporter with the authorised dealer or the RBI, as the case may be.

7. Manner of payment of export value of goods

Unless otherwise authorised by the RBI, the amount representing the full export value of the goods exported shall be realised through an AD Bank.

8. Third party payments for export / import transactions

The RBI, while taking into account the evolving international trade practices, has decided to permit third party payments for export / import transactions, provided that:

1. Firm irrevocable order backed by a tripartite agreement should be in place. However, it may not be insisted upon in cases where documentary evidence for circumstances leading to third party payments / name of the third party being mentioned in the irrevocable order/ invoice has been produced subject to:
 - (i) AD bank should be satisfied with the bona-fides of the transaction and export documents, such as, invoice / FIRC.
 - (ii) AD bank should consider the FATF statements while handling such transaction.
2. Third party payment should be routed through the banking channel only;
3. The exporter should declare the third party remittance in the EDF and it would be responsibility of the Exporter to realize and repatriate the export proceeds from such third party named in the EDF;
4. Reporting of outstanding, if any, in the Export Outstanding Statement (XOS) would continue to be shown against the name of the exporter. However, instead of the name of the overseas buyer from where the proceeds have to be realized, the name of the declared third party should appear in the XOS;
5. In case of shipments being made to a country in Group II of Restricted Cover Countries, (e.g. Sudan, Somalia, etc., i.e. country which experiences chronic political and economic problems as well as balance of payment difficulties), payments for the same may be received from an Open Cover Country.

9. Settlement of Export transactions in currencies not having a direct exchange rate

The RBI, with a view to further liberalize the procedure and facilitate settlement of export transactions, where the invoicing is in a freely

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convertible currency and the settlement takes place in the currency of the beneficiary, which though convertible, does not have a direct exchange rate, has allowed settlement of such export transactions through the AD Bank (excluding those put through the ACU mechanism), subject to conditions as under:

1. Exporter shall be a customer of the AD Bank,
2. Signed contract / invoice is in a freely convertible currency,
3. The beneficiary is willing to receive the payment in the currency of beneficiary instead of the original (freely convertible) currency of the invoice/ contract, Letter of Credit as full and final settlement,
4. AD bank is satisfied with the *bonafides* of the transactions, and
5. The counterparty to the exporter/ importer of the AD bank is not from a country or jurisdiction in the updated FATF Public Statement on High Risk & Non Co-operative Jurisdictions on which FATF has called for counter measures.

10. Counter-Trade Arrangement

Counter trade proposals involving adjustment of value of goods imported into India against value of goods exported from India in terms of an arrangement voluntarily entered into between the Indian party and the overseas party through an Escrow Account opened in India in US dollar will be considered by the RBI subject to following conditions:

1. All imports and exports under the arrangement should be at international prices in conformity with the FTP and FEMA and the Rules and Regulations made there under.
2. Application for permission for opening an Escrow Account may be made by the overseas exporter / organization through his / their AD Category – I bank to the Regional Office concerned of the RBI.
3. Interest will not be payable on balances standing to the credit of the Escrow Account. However, the funds temporarily rendered surplus may be held in a short-term deposit up to a total period of three months in a year and the banks may pay interest at the applicable rate.
4. No fund based / or non-fund based facilities would be permitted against the balances in the Escrow Account.

11. Forfaiting

Forfaiting is a financial transaction involving the purchase of receivables from exporters by a forfaiter. EXIM Bank and AD Category – I banks have been permitted to undertake forfaiting, for financing of export receivables. Remittance of commitment fee / service charges, etc., payable by the exporter as approved by the EXIM Bank / AD Category – I banks concerned may be done through an AD bank. Such remittances may be made in advance in one lump sum or at monthly intervals as approved by the authority concerned.

12. Export factoring on non-recourse basis

AD banks have been permitted to factor the export receivables on a non-recourse basis, so as to enable the exporters to improve their cash flow and meet their working capital requirements subject to conditions as under:

- (a) AD banks may take their own business decision to enter into export factoring arrangement on non-recourse basis. They should ensure that their client is not over financed. Accordingly, they may determine the working capital requirement of their clients taking into account the value of the invoices purchased for factoring. The invoices purchased should represent genuine trade invoices.
- (b) In case the export financing has not been done by the Export Factor, the Export Factor may pass on the net value to the financing bank / institution after realising the export proceeds.
- (c) AD bank, being the Export Factor, should have an arrangement with the Import Factor for credit evaluation & collection of payment.
- (d) Notation should be made on the invoice that importer has to make payment to the Import Factor.
- (e) After factoring, the Export Factor may close the export bills and report the same in the Export Data Processing and Monitoring System (EDPMS) of the RBI.
- (f) In case of single factor, not involving Import Factor overseas, the Export Factor may obtain credit evaluation details from the correspondent bank abroad.
- (g) KYC and due diligence on the exporter shall be ensured by the Export Factor.

13. Project Exports and Service Exports

Export of engineering goods on deferred payment terms and execution of turnkey projects and civil construction contracts abroad are collectively referred to as “Project Exports”. Indian exporters are required to obtain the approval of the AD Category – I banks / Exim Bank at post-award stage before undertaking execution of such contracts. Regulations relating to ‘Project Exports’ and ‘Service Exports’ are laid down in the revised Memorandum of Instructions on Project and Service Exports (PEM-July 2014).

Accordingly, AD banks / Exim Bank may consider awarding post-award approvals without any monetary limit and permit subsequent changes in the terms of post award approval within the relevant FEMA guidelines / regulations. Project and service exporters may approach AD banks / Exim Bank based on their commercial judgment. The respective AD bank / Exim Bank should monitor the projects for which post-award approval has been granted by them.

In order to provide greater flexibility to project & service exporters in conducting their overseas transactions, facilities have been provided as under:

- (a) Inter-Project transfer of machinery - The stipulation regarding recovery of market value (not less than book value) of the machinery, etc., from the transferee project has been withdrawn. Further, exporters may use the machinery / equipment for performing any other contract secured by them in any country subject to the satisfaction of the sponsoring AD Category – I bank(s) / Exim Bank and also subject to the reporting requirement and would be monitored by the AD Category – I bank(s) / Exim Bank.
- (b) Inter-Project transfer of funds - AD Category – I bank(s) / Exim Bank may permit exporters to open, maintain and operate one or more foreign currency account/s in a currency/currencies of their choice with inter-project transferability of funds in any currency or country. The Inter-project transfer of funds will be monitored by the AD Category – I bank(s) / Exim Bank.
- (c) Deployment of temporary cash surpluses - Subject to monitoring by the AD Category – I bank(s) / Exim Bank, Project / Service exporters may deploy their temporary cash surpluses, generated outside India

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investments in short-term paper abroad including treasury bills and other monetary instruments with a maturity or remaining maturity of one year or less and the rating of which should be at least A-1/AAA by Standard & Poor or P-1/-AAA by Moody's or F1/AAA by Fitch IBCA etc., and as deposits with branches / subsidiaries outside India of AD Category – I banks in India.

- (d) Repatriation of funds in case of On-site Software Contracts - The requirement of repatriation of 30 per cent of contract value in respect of on-site contracts by software exporter company / firm has been dispensed with. They should, however, repatriate the profits of on-site contracts after completion of the contracts.

14. Export of goods on lease, hire, etc.

Prior approval of the RBI is required for export of machinery, equipment, etc., on lease, hire basis under agreement with the overseas lessee against collection of lease rentals/hire charges and ultimate re-import. Exporters should apply for necessary permission, through an AD Category – I banks, to the Regional Office concerned of the RBI, giving full particulars of the goods to be exported.

15. Export of Currency

In terms of the Foreign Exchange Management (Export and Import of Currency) Regulations 2015, issued by the RBI vide Notification No. FEMA 6(R)/2015-RB dated 29 December 2015, as amended from time to time, permission of the RBI is required for any export of Indian currency except to the extent permitted under any general permission granted under the Regulations as under:

- (i) Any person resident in India may take outside India (other than to Nepal and Bhutan) currency notes of Government of India and RBI up to an amount not exceeding INR 25,000 (Rupees twenty five thousand only); and
- (ii) Any person resident outside India, not being a citizen of Pakistan and Bangladesh and also not a traveler coming from and going to Pakistan or Bangladesh, and visiting India may take outside India currency notes of Government of India and RBI notes up to an amount not exceeding INR 25,000 (Rupees twenty five thousand only) while exiting only through an airport.

16. Export of goods through Post

Postal authorities shall allow export of goods by post only if the original copy of the EDF has been countersigned by an AD. Therefore, EDF which involves sending goods by post, should be first presented by the exporter to an AD for counter signature. The procedure is as under:

- (i) AD shall countersign EDF after ensuring that the parcel has been addressed to their branch or correspondent bank in the country of import and return the original copy to the exporter, who shall then submit the EDF to the post office with the parcel.
- (ii) The duplicate copy of EDF shall be retained by the AD to whom the exporter shall submit relevant documents together with an extra copy of invoice for negotiation / collection, within the prescribed period of 21 days.
- (iii) The concerned overseas branch or correspondent shall be instructed to deliver the parcel to consignee against payment or acceptance of relative bill.
- (iv) AD may, however, countersign EDF covering parcels addressed direct to the consignees, provided:
 - a) An irrevocable letter of credit for the full value of export has been opened in favor of the exporter and has been advised through the AD concerned.
Or
 - b) The full value of the shipment has been received in advance by the exporter through an AD.
Or
 - c) The AD is satisfied, on the basis of the standing and track record of the exporter and the arrangements made for realization of the export proceeds.

In such cases, particulars of advance payment / LC / AD's certification of standing, etc., of the exporter should be furnished on the form under proper authentication.

- (v) Any alteration in the name and address of consignee on the EDF form should also be authenticated by AD under its stamp and signature.

17. Mid-sea trans-shipment of catch by deep sea fishing vessels

Since deep sea fishing involves continuous sailing outside the territorial limit, trans-shipment of catches takes place in the high sea leading to procedural constraints in regulatory reporting requirement viz. the Declaration of Export in terms of the Foreign Exchange Management (Export of Goods & Services) Regulations, 2015.

For mid-sea trans-shipment of catches by Indian owned vessels, as per the norms prescribed by the Ministry of agriculture, Government of India, the EDF declaration procedure in this regard has been rationalized in consultation with the Government of India as outlined below should be followed by the exporter in conformity with Foreign Exchange Management (Export of Goods & Services) Regulations, 2015.

1. The exporters may submit the EDF, duly signed by the Master of the vessel in lieu of Custom certification, indicating the composition of the catch, quantity, export value, date of shipment (date of transfer of catch), etc. duly supported by a certificate from an international cargo surveyor.
2. Bill of Lading / receipt of trans-shipment issued by the carrier vessel should include the EDF Number.
3. The prescribed period of realization and repatriation should be reckoned with reference to the date of transfer of catch as certified by the Master of the vessel or the date of the invoice, whichever is earlier.
4. The EDF, both original and duplicate, should indicate the number and date of Letter of Permit issued by Ministry of Agriculture for operation of the vessel.
5. The exporter will complete the EDF in duplicate and both the copies may be submitted to the Customs at the registered port of the vessel or any other port as approved by Ministry of Agriculture. EDF (Original) will be retained by the Customs for capturing of data in Customs' Electronic Data Interchange.
6. Customs will give their running serial number on both the copies of EDF and will return the duplicate copy to the exporter as the value certification of the export has already been done as mentioned above.
7. Rules, Regulations and Directions issued in respect of the procedure

for submission of the EDF by exporter to the AD Category-I banks, and the disposal of these forms by these banks will be same as applicable to the other exporters.

18. Invoicing of software exports

- (a) For long duration contracts involving series of transmissions, the exporters should bill their overseas clients periodically, i.e., at least once a month or on reaching the 'milestone' as provided in the contract entered into with the overseas client and the last invoice / bill should be raised not later than 15 days from the date of completion of the contract. It would be in order for the exporters to submit a combined SOFTEX form for all the invoices raised on a particular overseas client, including advance remittances received in a month.
- (b) Contracts involving only 'one-shot operation', the invoice / bill should be raised within 15 days from the date of transmission.
- (c) The exporter should submit declaration in Form SOFTEX in quadruplicate in respect of export of computer software and audio / video / television software to the designated official concerned of the Government of India at STPI / EPZ / FTZ / SEZ for valuation / certification not later than 30 days from the date of invoice / the date of last invoice raised in a month, as indicated above. The designated officials may also certify the SOFTEX Forms of EOUs, which are registered with them.
- (d) The invoices raised on overseas clients as at (a) to (c) above will be subject to valuation of export declared on SOFTEX form by the designated official concerned of the Government of India and consequent amendment made in the invoice value, if necessary.

19. Receipt of advance against exports

- (a) In cases where an exporter receives advance payment (with or without interest), from a buyer outside India, the exporter shall ensure that the shipment of goods is made within one year from the date of receipt of advance payment.

Further, the rate of interest, if any, payable on the advance payment should not exceed London Inter-Bank Offered Rate (LIBOR) + 100 basis points. The documents covering the shipment should be routed

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through the AD Category – I bank through whom the advance payment is received.

However, in case if the exporter is unable to make the shipment, partly or fully, within one year from the date of receipt of advance payment, no remittance towards refund of unutilized portion of advance payment or towards payment of interest, shall be made after the expiry of the said period of one year, without the prior approval of the RBI.

- (b) AD Category- I banks can also allow exporters having a minimum of three years' satisfactory track record to receive long term export advance up to a maximum tenor of 10 years to be utilized for execution of long term supply contracts for export of goods, subject to conditions as under:
- (i) Firm irrevocable supply orders and contracts should be in place. The contract with the overseas party / buyer should be vetted and the same shall clearly specify the nature, amount and delivery timelines of the products over the years and penalty in case of non-performance or contract cancellation. Product pricing should be in consonance with prevailing international prices.
 - (ii) Company should have capacity, systems and processes in place to ensure that the orders over the duration of the said tenure can actually be executed.
 - (iii) The facility is to be provided only to those entities, which have not come under the adverse notice of Enforcement Directorate or any such regulatory agency or have not been caution listed.
 - (iv) Such advances should be adjusted through future exports.
 - (v) The rate of interest payable, if any, should not exceed LIBOR plus 200 basis points.
 - (vi) The documents should be routed through one Authorized Dealer bank only.
 - (vii) Authorised Dealer bank should ensure compliance with AML / KYC guidelines
 - (viii) Such export advances shall not be permitted to be used to liquidate Rupee loans classified as NPA.

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- (ix) Double financing for working capital for execution of export orders should be avoided.
 - (x) Receipt of such advance of US\$ 100 million or more should be immediately reported to the Trade Division, Foreign Exchange Department, RBI, Central Office, Mumbai.
 - (xi) In case Authorized Dealer banks are required to issue bank guarantee (BG) / Stand by Letter of Credit (SBLC) for export performance, then the issuance should be rigorously evaluated as any other credit proposal keeping in view, among others, prudential requirements based on board approved policy.
 - (a) BG / SBLC may be issued for a term not exceeding two years at a time and further rollover of not more than two years at a time may be allowed subject to satisfaction with relative export performance as per the contract.
 - (b) BG / SBLC should cover only the advance on reducing balance basis.
 - (c) BG / SBLC issued from India in favor of overseas buyer should not be discounted by the overseas branch / subsidiary of bank in India.
 - (xii) AD Category – I banks may allow the purchase of forex from the market for refunding advance payment credited to EEFC account only after utilizing the entire balances held in the exporter's EEFC accounts maintained at different branches / banks.
- (c) AD Category- I banks may allow exporters to receive advance payment for export of goods which would take more than one year to manufacture and ship and where the export agreement provides for shipment of goods extending beyond the period of one year from the date of receipt of advance payment subject to the following conditions:-
- (i) The KYC and due diligence exercise has been done by the AD Category – I bank for the overseas buyer;
 - (ii) Compliance with the Anti-Money Laundering standards has been ensured;
 - (iii) The AD Category-I bank should ensure that export advance

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received by the exporter should be utilized to execute export and not for any other purpose i.e., the transaction is a *bona fide* transaction;

- (iv) Progress payment, if any, should be received directly from the overseas buyer strictly in terms of the contract;
- (v) The rate of interest, if any, payable on the advance payment shall not exceed London Inter-Bank Offered Rate (LIBOR) + 100 basis points;
- (vi) There should be no instance of refund exceeding 10 per cent of the advance payment received in the last three years;
- (vii) The documents covering the shipment should be routed through the same authorised dealer bank; and
- (viii) In the event of the exporter's inability to make the shipment, partly or fully, no remittance towards refund of unutilized portion of advance payment or towards payment of interest should be made without the prior approval of the RBI.

20. EDF Approval for Trade Fair/Exhibitions abroad

Firms / Companies and other organizations participating in Trade Fair / Exhibition abroad can take / export goods for exhibition and sale outside India without the prior approval of the RBI. Unsold exhibit items may be sold outside the exhibition / trade fair in the same country or in a third country. Such sales at discounted value are also permissible. It would also be permissible to 'gift' unsold goods up to the value of US\$ 5000 per exporter, per exhibition / trade fair. AD Category – I banks may approve EDF of export items for display or display-cum-sale in trade fairs / exhibitions outside India subject to the following:

1. The exporter shall produce relative Bill of Entry within one month of re-import into India of the unsold items.
2. The exporter shall report to the AD Category – I banks the method of disposal of all items exported, as well as the repatriation of proceeds to India.
3. Such transactions approved by the AD Category – I banks will be subject to 100 per cent audit by their internal inspectors / auditors.

21. EDF approval for export of goods for re-imports

- (i) AD Category – I banks may consider request from exporters for granting EDF approval in cases where goods are being exported for re-import after repairs / maintenance / testing / calibration, etc., subject to the condition that the exporter shall produce relative Bill of Entry within one month of re-import of the exported item from India.
- (ii) Where the goods being exported for testing are destroyed during testing, AD Category – I banks may obtain a certificate issued by the testing agency that the goods have been destroyed during testing, in lieu of Bill of Entry for import.

22. Setting up of Offices abroad and acquisition of immovable property for Overseas Offices

- (i) At the time of setting up of the office, AD Category – I banks may allow remittances towards initial expenses up to 15% of the average annual sales / income or turnover during the last two financial years or up to 25 per cent of the net worth, whichever is higher.
- (ii) For recurring expenses, remittances up to 10 per cent of the average annual sales / income or turnover during the last two financial years may be sent for the purpose of normal business operations of the office (trading / non-trading) / branch or representative office outside India subject to the following terms and conditions:
 - (a) The overseas branch / office has been set up or representative is posted overseas for conducting normal business activities of the Indian entity;
 - (b) Any contract or agreement in contravention of the Act, Rules or Regulations shall not be entered by the overseas branch / office / representative.
 - (c) The overseas office (trading / non-trading) / branch / representative should not create any financial liabilities, contingent or otherwise, for the head office in India and also not invest surplus funds abroad without prior approval of the Reserve Bank. Any funds rendered surplus should be repatriated to India.

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- (iii) The details of bank accounts opened in the overseas country should be promptly reported to the AD Bank.
- (iv) AD Category – I banks may also allow remittances by a company incorporated in India having overseas offices, within the above limits for initial and recurring expenses, to acquire immovable property outside India for its business and for residential purpose of its staff.
- (v) The overseas office / branch of software exporter company/firm may repatriate to India 100 per cent of the contract value of each “off-site” contract.
- (vi) In case of companies taking up “on site” contracts, they should repatriate the profits of such “on site” contracts after the completion of the said contracts.
- (vii) An audited yearly statement showing receipts under “off-site” and “on-site” contracts undertaken by the overseas office, expenses and repatriation thereon may be sent to the AD Category – I banks.

23. Consignment Exports

1. When goods have been exported on consignment basis, the AD Category-I bank, while forwarding shipping documents to his overseas branch/ correspondent, should instruct the latter to deliver them only against trust receipt / undertaking to deliver sale proceeds by a specified date within the period prescribed for realization of proceeds of the export. This procedure should be followed even if, according to the practice in certain trades, a bill for part of the estimated value is drawn in advance against the exports.
2. The agents / consignees may deduct expenses, normally incurred towards receipt, storage and sale of the goods, such as landing charges, warehouse rent, handling charges, etc. from sale proceeds of the goods and remit the net proceeds to the exporter.
3. The account sales received from the Agent/Consignee should be verified by the AD Category – I banks. Deductions in Account Sales should be supported by bills/receipts in original except in case of petty items like postage/cable charges, stamp duty, etc.
4. Freight and marine insurance must be arranged in India if the goods are exported on consignment basis.

5. AD Category – I banks may allow the exporters to abandon the books, which remain unsold at the expiry of the period of the sale contract. Accordingly, the exporters may show the value of the unsold books as deduction from the export proceeds in the Account Sales.

24. Opening / hiring of warehouses abroad

AD Category – I banks may consider the applications received from exporters and grant permission for opening / hiring warehouses abroad subject to the following conditions:

- (i) Applicant's export outstanding does not exceed 5% of exports made during the previous financial year.
- (ii) Applicant has a minimum export turnover of USD 100,000 during the last financial year.
- (iii) Period of realization should be as applicable.
- (iv) All transactions should be routed through the designated branch of the AD Banks.
- (v) The above permission may be granted to the exporters initially for a period of one year and renewal may be considered subject to the applicant satisfying the requirement above.
- (vi) AD Category – I banks granting such permission / approvals should maintain a proper record of the approvals granted.

25. Reduction in invoice value

- (a) If, after a bill has been negotiated or sent for collection, its amount is to be reduced for any reason, AD Category – I banks may approve such reduction, if satisfied about genuineness of the request, provided:
 - (i) The reduction does not exceed 25% of invoice value.
 - (ii) It does not relate to export of commodities subject to floor price stipulations.
 - (iii) The exporter is not on the exporters' caution list of the RBI.
 - (iv) The exporter is advised to surrender proportionate export incentives availed of, if any.
- (b) In the case of exporters who have been in the export business for more than three years, reduction in invoice value may be allowed,

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without any percentage ceiling, subject to the above conditions as also subject to their track record being satisfactory, i.e., the export outstanding do not exceed 5% of the average annual export realization during the preceding three financial years.

- (c) For the purpose of reckoning the percentage of export bills outstanding to the average export realizations during the preceding three financial years, outstanding of exports made to countries facing externalization problems may be ignored provided the payments have been made by the buyers in the local currency.

26. Change of buyer / consignee

Prior approval of the RBI is not required if, after goods have been shipped, they are to be transferred to a buyer other than the original buyer in the event of default by the latter, provided the reduction in value, if any, involved does not exceed 25% of the invoice value and the realization of export proceeds is not delayed beyond the period of 9 months from the date of export. Where the reduction in value exceeds 25%, all above relevant conditions stipulated above for reduction in invoice value should also be satisfied.

27. Export of goods by Special Economic Zones (SEZs)

- (i) Units in SEZs are permitted to undertake job work abroad and export goods from that country itself subject to the conditions that:
 - (a) Processing / manufacturing charges are suitably loaded in the export price and are borne by the ultimate buyer.
 - (b) The exporter has made satisfactory arrangements for realization of full export proceeds subject to the usual EDF procedure.
- (ii) AD Category – I banks may permit units in DTAs to purchase forex for making payment for goods supplied to them by units in SEZs. Authorised Dealer Banks are permitted to sell forex to a unit in the DTA for making payment in forex to a unit in the SEZ for the services rendered by it (i.e. a unit in SEZ) to a DTA unit. It must be ensured that in the Letter of Approval (LoA) issued to the SEZ unit by the Development Commissioner (DC) of the SEZ, the provisions pertaining to the goods / services supplied by the SEZ unit to the DTA unit and for payment in forex for the same should be mentioned.

28. Extension of time

- (a) The AD Category – I banks are permitted to extend the period of realization of export proceeds beyond stipulated period of realization from the date of export, up to a period of six months, at a time, irrespective of the invoice value of the export, subject to the following conditions:
- The export transactions covered by the invoices are not under investigation by Enforcement Directorate / Central Bureau of Investigation or other investigating agencies.
 - The AD Category – I bank is satisfied that the exporter has not been able to realize export proceeds for reasons beyond his control.
 - The exporter submits a declaration that the export proceeds will be realized during the extended period.
 - While considering extension beyond one year from the date of export, the total outstanding of the exporter does not exceed USD one million or 10% of the average export realizations during the preceding three financial years, whichever is higher.
 - In cases where the exporter has filed suits abroad against the buyer, extension may be granted irrespective of the amount involved / outstanding.
- (b) Cases which are not covered by the above instructions would require prior approval from the concerned Regional Office of the RBI.
- (c) Reporting should be done in EDPMS.

29. Shipments lost in transit

- (i) When shipments from India for which payment has not been received either by negotiation of bills under letters of credit or otherwise are lost in transit, the AD Category – I banks must ensure that insurance claim is made as soon as the loss is known.
- (ii) In cases where the claim is payable abroad, the AD Category - banks must arrange to collect the full amount of claim due on the lost shipment, through the medium of their overseas branch/correspondent and release the duplicate copy of EDF only after the amount has been collected.

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- (iii) A certificate for the amount of claim received should be furnished on the reverse of the duplicate copy.
- (iv) AD Category – I banks should ensure that amounts of claims on shipments lost in transit which are partially settled directly by shipping companies / airlines under carrier's liability abroad are also repatriated to India by exporters.

30. Write-off of unrealized export bills:

- (a) An exporter who has not been able to realize the outstanding export dues despite best efforts, may either self-write off or approach the AD Category – I banks, who had handled the relevant shipping documents, with appropriate supporting documentary evidence. The limits prescribed for write-offs of unrealized export bills are as under:

Self-write-off by an exporter (Other than Status Holder Exporter)	5%*
Self-write-off by Status Holder Exporters	10% *
Write-off by Authorized Dealer Bank	10%*
*of the total export proceeds realized during the previous calendar year.	

- (b) The above limits will be related to total export proceeds realized during the previous calendar year and will be cumulatively available in a year.
- (c) The above write-off will be subject to conditions that the relevant amount has remained outstanding for more than one year, satisfactory documentary evidence is furnished in support of the exporter having made all efforts to realize the dues, and the case falls under any of the undernoted categories:
 - (i) The overseas buyer has been declared insolvent and a certificate from the official liquidator indicating that there is no possibility of recovery of export proceeds has been produced.
 - (ii) The overseas buyer is not traceable over a reasonably long period of time.
 - (iii) The goods exported have been auctioned or destroyed by the Port / Customs / Health authorities in the importing country.

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- (iv) The unrealized amount represents the balance due in a case settled through the intervention of the Indian Embassy, Foreign Chamber of Commerce or similar Organization.
 - (v) The unrealized amount represents the undrawn balance of an export bill (not exceeding 10 per cent of the invoice value) remaining outstanding and turned out to be unrealizable despite all efforts made by the exporter.
 - (vi) The cost of resorting to legal action would be disproportionate to the unrealized amount of the export bill or where the exporter even after winning the Court case against the overseas buyer could not execute the Court decree due to reasons beyond his control.
 - (vii) Bills were drawn for the difference between the letter of credit value and actual export value or between the provisional and the actual freight charges but the amounts have remained unrealized consequent on dishonor of the bills by the overseas buyer and there are no prospects of realization.
- (d) The exporter has surrendered proportionate export incentives if any, availed of in respect of the relative shipments. The AD Category – I banks should obtain documents evidencing surrender of export incentives availed of before permitting the relevant bills to be written off.
- (e) In case of self-write-off, the exporter should submit to the concerned AD bank, a Chartered Accountant's certificate, indicating the export realization in the preceding calendar year and also the amount of write-off already availed of during the year, if any, the relevant EDF to be written off, Bill No., invoice value, commodity exported, country of export. The CA certificate may also indicate that the export benefits, if any, availed of by the exporter have been surrendered.
- (f) However, the following would not qualify for the write off facility:
- (i) Exports made to countries with externalization problem i.e. where the overseas buyer has deposited the value of export in local currency but the amount has not been allowed to be repatriated by the central banking authorities of the country.

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- (ii) EDF which are under investigation by agencies like, Enforcement Directorate, Directorate of Revenue Intelligence, Central Bureau of Investigation, etc. as also the outstanding bills which are subject matter of civil / criminal suit.
- (g) AD banks should report write off of export bills through EDPMS to the Reserve Bank.
- (h) AD banks are advised to put in place a system under which their internal inspectors or auditors (including external auditors appointed by authorised dealers) should carry out random sample check / percentage check of write-off outstanding export bills.
- (i) Cases not covered by the above instructions / beyond the above limits, may be referred to the concerned Regional Office of RBI.

31. Write off – Relaxation

As announced in the Foreign Trade Policy (FTP), 2015-20, realization of export proceeds shall not be insisted upon under any of the Export Promotion Schemes under the said FTP, subject to the following conditions:

- (a) The write off on the basis of merits is allowed by the RBI or by AD Category – I bank on behalf of the RBI, as per extant guidelines;
- (b) The exporter produces a certificate from the Foreign Mission of India concerned, about the fact of non-recovery of export proceeds from the buyer; and
- (c) This would not be applicable in self write off cases.

32. Set-off of export receivables against import payables

AD category-I banks may deal with the cases of set-off of export receivables against import payables, subject to following terms and conditions:

- (a) The import is as per the FTP in force.
- (b) Invoices / Bills of Lading / Airway Bills and Exchange Control copies of Bills of Entry for home consumption have been submitted by the importer to the Authorized Dealer bank.

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- (c) Payment for the import is still outstanding in the books of the importer.
- (d) Both the transactions of sale and purchase may be reported separately in R>Returns and FETERS.
- (e) The relative EDF will be released by the AD bank only after the entire export proceeds are adjusted / received.
- (f) The set-off of export receivables against import payments should be in respect of the same overseas buyer and supplier and that consent for set-off has been obtained from him.
- (g) The export / import transactions with ACU countries should be kept outside the arrangement.
- (h) All the relevant documents are submitted to the concerned AD bank who should comply with all the regulatory requirements relating to the transactions.

33. Netting-off of export receivables against import payments – Units in Special Economic Zones (SEZs)

AD Category - I banks may allow requests received from exporters for 'netting off' of export receivables against import payments for units located in Special Economic Zones subject to the following:

- (i) The netting off of export receivables against import payments is in respect of the same Indian entity and the overseas buyer / supplier (bilateral netting) and the netting may be done as on the date of balance sheet of the unit in SEZ.
- (ii) The details of export of goods are documented in EDF (O) forms / DTR as the case may be while details of import of goods / services are recorded through A1 / A2 form as the case may be. The relative EDF will be treated as complete by the designated AD Category – I banks only after the entire proceeds are adjusted / received.
- (iii) Both the transactions of sale and purchase in R- Returns under FETERS are reported separately.
- (iv) The export / import transactions with ACU countries are kept outside the arrangement.

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- (v) All the relevant documents are submitted to the concerned AD Category – I banks who should comply with all the regulatory requirements relating to the transactions.

34. Issue of Guarantees by an Authorised Dealer

- (a) An authorized dealer may give guarantee in respect of any debt, obligation or other liability incurred by a person resident in India and owned to a person resident outside India, where the debt, obligation or other liability is incurred by the person resident in India as an exporter, on account of exports from India.
- (b) An authorised dealer may give a guarantee in respect of any debt, obligation or other liability incurred by a person resident outside India, in the following cases, namely:
 - (i) Where such debt, obligation or liability is owned to a person resident in India in connection with a *bona fide* trade transaction.

However, the guarantee given under this clause should be covered by a counter-guarantee of a bank of international repute resident abroad;
 - (ii) As a counter-guarantee to cover guarantee issued by his branch or correspondent outside India, on behalf of Indian exporter in cases where guarantees of only resident banks are acceptable to overseas buyers.

35. Agency commission on exports

- I. AD Category – I banks may allow payment of commission, either by remittance or by deduction from invoice value, on application submitted by the exporter. The remittance on agency commission may be allowed subject to conditions as under:
 - (a) Amount of commission has been declared on EDF/SOFTEX form and accepted by the Customs authorities or Ministry of Information Technology, Government of India / EPZ authorities as the case may be. In cases where the commission has not been declared on EDF/SOFTEX form, remittance may be allowed after satisfying the reasons adduced by the exporter for

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not declaring commission on Export Declaration Form, provided a valid agreement/written understanding between the exporters and/or beneficiary for payment of commission exists.

(b) The relative shipment has already been made.

II. AD Category – I banks may allow payment of commission by Indian exporters, in respect of their exports covered under counter trade arrangement through Escrow Accounts designated in US Dollar, subject to the following conditions:

(i) The payment of commission satisfies the conditions as at (a) and (b) stipulated in paragraph (i) above.

(ii) The commission is not payable to Escrow Account holders themselves.

(iii) The commission should not be allowed by deduction from the invoice value.

III. Payment of commission is prohibited on exports made by Indian Partners towards equity participation in an overseas joint venture / wholly owned subsidiary as also exports under Rupee Credit Route except commission up to 10% of invoice value of exports of tea & tobacco.

36. Refund of export proceeds

AD Category – I banks, through whom the export proceeds were originally realized may consider requests for refund of export proceeds of goods exported from India and being re-imported into India on account of poor quality. While permitting such transactions, AD Category – I banks are required to:

(i) Exercise due diligence regarding the track record of the exporter

(ii) Verify the bona-fides of the transactions

(iii) Obtain from the exporter a certificate issued by DGFT / Custom authorities that no incentives have been availed by the exporter against the relevant export or the proportionate incentives availed, if any, for the relevant export have been surrendered.

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- (iv) Obtain an undertaking from the exporter that the goods will be re-imported within three months from the date of remittance and
- (v) Ensure that all procedures as applicable to normal imports are adhered to.

Source References:

- Foreign Exchange Management Act, 1999
- Foreign Exchange Management (Export of Goods & Services) Regulations, 2015
- Foreign Exchange Management (Current Account Transactions) Rules, 2000 (FEMCAT Rules)
- Foreign Exchange Management (Export and Import of Currency) Regulations 2015
- Master Direction on Master Direction on Export of Goods and Service (MD No. 16/2015-16)
- Foreign Trade Policy 2015-20

Chapter 11

Treaty Provisions with Reference to Cross Border Remittances

This section covers:

- *Background of tax treaties*
- *Need for tax treaties*
- *Process for entering into tax treaties*
- *Types of tax treaty models – OECD Model and UN Model*
- *Interpretation of tax treaties*
- *Treaty provisions:*
 - *Article 5 – Permanent Establishment (“PE”)*
 - *Article 7 – Attribution of business profits to PE*
 - *Article 10 – Taxability of dividend paid by an Indian company to a non-resident shareholder*
 - *Article 11 – Taxability of interest paid by an Indian borrower to a non-resident lender*
 - *Article 12 – Taxability of royalty / technical service fees paid by an Indian payer to a non-resident*
 - *Article 13 - Taxability of remittance by an Indian payer to a non-resident involving income under the head Capital Gains*

1. Background

Apart from the permissibility of the various kinds of cross border remittances under the provisions of the Indian Exchange Control Regulations (i.e. FEMA and rules/regulations etc. issued thereunder), the other critical aspect is the Indian taxability in India of these cross border remittances in the hands of the non-resident payee, and any attendant withholding tax / other payments that the Indian payer is required to make to the Indian Government in respect of the Indian tax liability on these cross border remittances.

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In the current era, business is not restricted to a single geography, but spans across countries, where residents of a particular country extend their sphere of business operations to other countries as well. Where a taxpayer who is resident of a particular country (country of residence) earns income in another country (source country), it gives rise to possible double taxation of such income in the hands of the taxpayer, i.e. in the source country as well as in his country of residence. This has led to a tremendous growth of Double Tax Avoidance Agreements (DTAAs) (or tax treaties) between countries to resolve such cross border tax conflicts. India now has tax treaties with close to 100 countries.

2. Need for tax treaties

It is relevant to understand why is there a need for separate rules in the form of tax treaties for resolving such cross border tax conflicts.

There are broadly 2 systems of taxation:

- Source based system, where income earned in a country is taxed in that country in the hands of the recipient of the income
- Residence based system, whereby the worldwide income of a resident of a country is taxed in that country

India follows the residence based system, coupled with source based taxation of specified India-sourced income of non-residents by virtue of provisions of section 9 of the Income-tax Act, 1961 ("the Act").

Hence, it can now be appreciated as to how a typical tax conflict in a cross border transaction arises due to different tax systems followed by different countries, by considering an example – a German consulting firm provides technical services to an Indian resident. India may seek to tax the service fees paid by the Indian resident to the German firm under its source rule, while Germany will also tax such service fees (i.e. the same income) under its residence rule. The German firm cannot be required to pay tax on the same income in both the countries, and therefore, there is a need for specific rules to resolve such conflict. Tax treaties resolve such conflicts - in this context, the India-Germany tax treaty provides that India has only has a limited right to tax such fees, i.e. at a concessional tax rate of 10%, coupled with Germany allowing the German firm a credit of the taxes paid in India in respect of such service fees against the German tax liability on such service fees.

Typically, countries will seek to protect as well as enhance their tax base, especially in respect of cross border transactions. This is especially true in today's age where several of the developed countries are also facing a high income disparity and there is a critical need to increase their tax revenues to meet their welfare and other expenditure. However, the correlation between a favourable investment climate for foreign investors and the tax environment including favourable provisions in tax treaties, cannot be overemphasized. This gets further accentuated by competition between countries, especially emerging economies, to attract foreign investment. Hence, Governments continue to use a liberal tax policy (including favourable provisions in their tax treaties) as a tool to attract foreign investment.

3. Process for entering into tax treaties

It is relevant to understand what is the legal framework in India to enable entering into tax treaties.

Article 246 of the Constitution deals with the *Subject matter of laws made by Parliament and by the Legislatures of States*. The Parliament has exclusive power to legislate on items falling under the Union List, which includes the power to enter into international treaties (entries 10 and 14). This is the "source" of the power of the Government to enter into these tax treaties.

Further, Article 73 of the Constitution deals with the *Extent of the executive power of the Union*. The Central Government's executive power extends to all matters on which the Parliament has the power to legislate upon. Since the Constitution does not prescribe any prior or post facto legislation as a condition precedent for entering/enforcing/applying a tax treaty, the Central Government has an inherent power under Article 73 to enter/enforce/apply tax treaties without requiring Parliamentary approval or ratification – this is also specifically provided in section 90 of the Act. For further details, reference may be made to the landmark Supreme Court judgement in the case of *Azadi Bachao Andolan [2003] 263 ITR 706 (SC)*.

Section 90 also provides that tax treaty provisions will override domestic tax law provisions to the extent the tax provisions are more beneficial to the taxpayer, however, the Government can specifically legislate to exempt any provisions from the application of this general rule, e.g. the General Anti-avoidance Rules (GAAR) override tax treaties by virtue of section 90(2A) of the Act.

4. Types of tax treaty models

Tax treaty models form basis for tax treaty negotiations between countries.

There are broadly 2 tax treaty models:

- *OECD Model* – OECD being predominantly an association of developed countries, it tilts towards residence based taxation
- *UN Model* – on the other hand, the UN Model tilts towards source based taxation in order to give a tax revenue share to countries within which the income is earned

India's existing tax treaties are predominantly based on the UN Model.

It may be noted that as an outcome of the BEPS project, to some extent, source based taxation is being incorporated in the OECD Model as well, given the current economic situation in several developed countries. It may also be noted that the working of tax treaties would change to an extent once the Multilateral Instrument ("MLI") comes to be widely adopted alongside the tax treaties.

The common objective of Governments while negotiating tax treaties, irrespective of the Model which is used as a base, is to ensure that tax revenues are shared in a manner most optimal to both countries, such that it facilitates free movement of goods, capital, services, technology and persons between countries, without the burden of double taxation.

5. Interpretation of tax treaties

It is important to understand the difference in approach of interpretation of tax treaties vis-à-vis interpretation of statutes. Under Indian law, a tax treaty is not a statute, but an agreement documenting an understanding between two countries to facilitate achieving common goals. Principles around interpretation of treaties are enshrined in the *Vienna Convention on the Law of Treaties (1969)*.

Under Article 31 of the *Vienna Convention*, the broad theme around interpretation of treaties is that they need to be interpreted as under:

- in good faith
- in accordance with the ordinary meaning of the language in the context it is used
- as per the object and purpose of the treaty

Tax treaties would also need to be interpreted harmoniously with reference to supplementary material like Protocols and Technical Memoranda. The OECD and UN Commentaries also serve as important aids to interpretation, a proposition that Indian Courts have accepted in several cases.

Another important concept that is quite unique to tax treaty interpretation is whether a static approach or an ambulatory (i.e. adaptive) approach of interpreting tax treaty provisions (qua the domestic tax law provisions) is to be followed. The static approach involves interpreting the tax treaty provisions with reference to the domestic tax law provisions at they stood at the time the tax treaty was entered into. The ambulatory approach involves interpreting the tax treaty provisions harmoniously with the extant domestic tax law provisions keeping in view the changes therein. The predominant view is that the ambulatory approach is more appropriate except where there is a very significant change in the domestic tax law provisions which makes the tax treaty provisions nugatory if an ambulatory approach is adopted.

Applicable Indian tax treaty provisions on select cross border remittances

We shall now briefly discuss the applicable Indian tax treaty provisions on select cross border remittances.

6. Taxability of remittance to a non-resident who has a PE in India including attribution of profits to the PE (Article 5 & 7)

A non-resident conducting the business in a contracting state is taxable in the Source country. The profits attributable to such activities is taxable in accordance with the taxation laws in the source country. The concept of 'business profit' is generally defined in Article 7 of the various tax treaties. Further, Article 7 of UN as well as OECD Model deals with profits arising from business carried on through the Permanent Establishments (PE). Article 7 of the tax treaty provides that business profits of the resident of a Contracting State can be taxed in Source country only if the foreign entity of the Contracting State has a PE in the Source country. Furthermore, only so much of profits can be taxed in the State of Source as is attributable to the PE situated therein. Profits attributable to such PE are computed in accordance with the ordinary commercial principles after allowing deduction for legitimate business in accordance with the laws of the Source country.

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A detailed discussion on the attribution of profits to the PE is covered in the subsequent paragraphs. Before we discuss the same, it is important to know as to what constitutes a PE.

6.1 Treaty provisions

The term “Permanent Establishment” is defined in Article 5 of the most treaties. As per OECD model convention, Model Tax Convention on Income and on Capital 2017 the PE is defined as under:

I Article 5 – Permanent Establishment

Article 5(1) provides that the PE means a fixed place of business through which the business of an enterprise is wholly or partly carried on.

Article 5(2) provides for an illustrative list of facilities constituting a PE.

- (a) A place of management.
- (b) A branch.
- (c) An office.
- (d) A factory.
- (e) A workshop.
- (f) A mine, an oil or gas well, a quarry or any other place of extraction of natural resources.
- (g) A warehouse used for delivery of goods (only in case of UN Model).

Article 5(3) A building site, construction, installation of a project constitutes a permanent establishment only if it lasts more than twelve months.

Further, Article 5(4) also provides for certain exclusions from the scope of PE:-

- (a) Use of facilities for mere storage or display of goods of the concern.
- (b) Maintenance of a fixed place for mere storage and display of goods of the concern
- (c) Use of facilities/maintenance of fixed place for mere delivery of goods belonging to the enterprise is also excluded. In other words, such places shall not constitute as a PE
- (d) Maintenance of fixed place for purchase of goods or collecting information.

- (e) Maintenance of a fixed place of business for preparatory or auxiliary activities; this is so because the auxiliary activities are in the nature of preparatory services and are remote from the realisation of profit.
- Questions often arise as to which are auxiliary or preparatory activities. It will depend upon the facts of each case.
- (f) Maintenance of stock of goods/merchandise belonging to the enterprise solely for processing by another enterprise.
- (g) A subsidiary is not necessarily considered a PE similarly, a holding company is also not necessarily a PE unless it acts as a dependent agent. If the facts suggest that the subsidiary / holding co. are acting as a dependent agent and / or a P.E, profits may be attributable to the Source country and provisions of the law shall apply accordingly.

The definition of PE under UN Model convention is also quite similar to OECD convention with few exceptions.

Recently, the OECD/ G20 Action Plan on Base Erosion and Profit Shifting (BEPS) called for a review of the definition of PE to prevent the use of certain common tax avoidance strategies, such as:

- Use of Commissionaire arrangements and similar strategies;
- Splitting-up of construction contracts for avoidance of construction PE; and
- Fragmentation of activities for taking undue advantage of PE-exclusion provisions in tax treaties.

The various types of PE are discussed in the following paragraphs.

6.1.1 Fixed Place PE

As per Article 5(1), PE means a fixed place of business through which the business of an enterprise is wholly or partly carried on. Based on the Commentaries to the OECD and UN Double Tax Avoidance Conventions, for a fixed place PE, following tests ought to be cumulatively satisfied:

- (a) Permanence Test
- Place of business must be fixed – Location and duration Test
 - Existence of Link between the place of business and a specific geographical location would be sufficient
 - Location test requires that place of business to be located at a single place

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- Equipment constituting the place of business is not specifically required to be actually fixed to the soil on which it stands. Even if the equipment remains on a particular site, it would have met the permanence test
- **Both geographical and commercial coherence** are necessary, the fact that activities may be carried on within a limited geographical area should not result in that area being considered as a single place of business
- An isolated activity cannot lead to establishment of fixed place of PE as the ingredients of regularity, continuity and repetitiveness are essentially missing
- No minimum threshold has been prescribed under Act. Therefore if a non-resident is carrying on its activities through a place which is exclusively available to its business in India then that place will be deemed to be its fixed place PE even if it is used for a single day³
- subsidiary company⁴ will not become Fixed place PE under article 5(1) merely because there is interaction or cross transactions between Indian subsidiary and foreign Principal;

(b) Disposal test

- It generally covers any premises, facilities or installations used for carrying on business;
- The place should be at the disposal of the enterprise. The said place need not be owned by the enterprise and can be situated in the business facility of another enterprise
- Being at the disposal would mean right to use and having a control over that place / equipment⁵
- The tax payers contracting with a 100% subsidiary and the work comprised of outsourcing business activities to such subsidiary, would not lead to a PE⁶

³ Formula One World Championship Ltd. V CIT (80 taxmann.com 347) (SC)

⁴ M/s E-Funds IT Solution Inc. (Civil Appeal No. 6082 of 2015) (SC)

⁵ Master Card Asia Pacific Pte In. re [2018] 94 taxmann.com 195 – AAR New Delhi

⁶ M/s E-Funds IT Solution Inc. (Civil Appeal No. 6082 of 2015) (SC)

(c) Business Activity Test

- The enterprise must use such premise to wholly or partly to carry out its business through it
- Activities need not be permanent in the sense that no interruptions of operations, but operations must be carried on regular basis. No requirement for human intervention
- Main business and revenue earning activity of taxpayers should be carried on through a fixed business place in India⁷.

Fixed Place PE in an Indian context

The Andhra Pradesh High Court in the Vishakhapatnam Port Trust Case 144 ITR 146(AP) observed and ruled “The words ‘Permanent Establishment’ postulate the existence of a substantial element of an enduring or permanent nature of a foreign enterprise in another country, which can be attributed to a fixed place of business in that country. It should be of such a nature that it would amount to a virtual projection of the foreign enterprise of one country into the soil of another country”

The Authority for Advance Ruling (AAR) in the case of XYZ/ ABC Equity Fund (2001) 250 ITR 194, has held that whether or not a non-resident has a PE in India should be decided in each year. Merely because of the fact that there was no PE in a particular year does not mean that the non-resident cannot have a PE in India in a subsequent year. Further, the burden of proof is upon the revenue to prove the existence of a PE⁸. Article 5 covers not only commercial or industrial establishments, but also professional service⁹. Further, merely because a person happens to be a qualified professional does not mean that the activity carried out cannot be considered as business¹⁰.

In light of the above, the following principles would emerge:-

- There must be a fixed place of business
- Business of the entity must be carried on through that fixed place either wholly or in part.

⁷ M/s E-Funds IT Solution Inc. (Civil Appeal No. 6082 of 2015) (SC)

⁸ Decca Survey Overseas Ltd UK V/s. ITO [2004- TIOL-102-ITAT-Mum

⁹ Linklaters LLP V/s. ITO (2010) 132 TTJ 20 (Mum)

¹⁰ Clifford Chance V/s. DCIT (2002) 82 ITD 106 (Mum)

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The High Court in the ruling of **E-Funds IT Solution**¹¹ has observed that as per the UN Commentary, for the place of business to constitute PE, the enterprise using it must carry on its business wholly or partly "**through**" it, though the activity need not be productive in character and need not be permanent in the sense that there is no disruption, but the operations must be carried out on regular basis. It must be demonstrated that the activities carried on continuously / regularly / habitually from such fixed place are its own core business activities. The performance of merely **preparatory or auxiliary activities** from such fixed place would not constitute a PE under Article 5(1) of the DTAA.

Exclusions for Preparatory or auxiliary services

Article 5(4) of the OECD Model Convention contains a list of activities that are considered as exceptions to the general PE rule. This includes activities viz. maintaining a facility/ stock of goods solely for storage, display, delivery, maintaining a place of business solely for purchase of goods or collection of information etc.

Furthermore, Article 5(4) has provided specific activity exemptions from preparatory and auxiliary namely:-

- Storage, display and delivery of goods may not qualify for exemption if such activities are essential and significant part of the activities of an enterprise as a whole
- If stock are maintained at warehouse maintained by independent agent, no PE since place is not at disposal. However, if unlimited access has been provided, PE may trigger if storage, display and delivery of goods does not constitute preparatory and auxiliary character
- Goods held for processing – mere presence of goods would not make premise as PE but unlimited access is provided (which would give raise to disposal. Maintenance of such goods shall constitute preparatory or auxiliary to avail exemption. Exemptions are subject to Anti-fragmentation rule
- Exemption is not available in a situation where the overall activity of the enterprise consists of selling goods and where the purchasing activity represents a core function of the enterprises' business

¹¹ (2014) 42 taxmann.com 50 (Delhi High Court)

From the above, it may be appreciated that the preparatory activity includes an activity aimed at creating conditions to exercise the principal business activity and precedes the commencement of execution of the principal business activity. Auxiliary activity is an activity that ensures the continuation of the principal business activity. For determining whether an activity is of a preparatory or auxiliary character, the decisive criterion is whether or not the activity in itself forms an essential and significant part of the activity of the enterprise as a whole; if a part of the activities performed directly contributes to the earning of revenue by the foreign entity, then such activities cannot be treated as 'preparatory or auxiliary'¹². An enterprise formed solely for the purpose of advertising or supply or gathering information would form an example for the aforesaid activity.

BEPS Considerations

BEPS Action 7 dealing with 'artificial avoidance of PE' proposes to amend Article 5(4) and insert the condition that the activities must be 'preparatory and auxiliary' in the context of the business of the enterprise in order to qualify for the exception. Post BEPS, the applicability of 'preparatory and auxiliary' is extended to all activities referred in Article 5(4).

For instance, there is a specific exclusion in Article 5(4) of the OECD Model for maintenance of a facility for delivery of goods. However, post BEPS this exclusion may not apply in the case of an ecommerce company where delivery is an important business activity. For the same reason, logistics companies and courier agencies may also not be eligible to claim the exclusion.

BEPS Action Plan has also provided illustration of permissible and impermissible and preparatory and auxiliary activities:-

Permissible

New Illustrations

- Training employees at one place before these employees are sent to work at remote work sites located in other countries, the training that takes place at the first location constitutes a preparatory activity for that enterprise
- Bonded warehouse with special gas facilities that an exporter of fruit from one State maintains in another State for the sole purpose of

¹² Amadeus Global Travel Distribution SA (11 taxmann.com 153) (Delhi ITAT)

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storing fruit in a controlled environment during the custom clearance process in that other State.

- Fixed place of business that an enterprise maintained solely for the delivery of spare parts to customers for machinery sold to those customers.
- An investment fund sets up an office in a State solely to collect information on possible investment opportunities in that State
- An insurance enterprise that sets up an office solely for the collection of information, such as statistics, on risks in a particular market

Existing Illustrations

- Pipeline used by an oil company to transport its own oil to a refinery in another country
- Maintenance of stock of goods for processing by another enterprise where the company is a mere distributor of products manufactured by other enterprises
- Maintaining an office in another State to research on the local market and lobby the Government for changes to enable the company to set up stores in that State
- Newspaper bureau set up in a State solely to collect information on possible news stories without engaging in any advertising activities
- Place of business used for supply of information which does not consist of say, plans specially developed for the purposes of an individual customer
- Scientific research (no manufacture involved)
- Servicing patents and know-how (where this is not the principal purpose of the enterprise)
- Sale of merchandise displayed at a fair/convention at the end of the fair/convention

Impermissible

New Illustrations

- Maintaining a large warehouse for storage and delivery of goods sold online and where large number of employees work in the warehouse and the warehouse is an important asset of the enterprise

- Premises used only for purchasing of goods by an enterprise where the overall activity of the enterprise comprises of selling these goods

Existing Illustrations

- Management office set up to manage the entire or part of an enterprise (e.g. all subsidiaries, branches, offices in a state)
- Delivery¹³ of spare parts to customers for machinery as well as maintenance or repairs of such machinery
- Income derived by an owner/ operator of cables/ pipelines that cross the territory of a country and are used by other enterprises
- Combination of activities undertaken by the same fixed place of business

Anti-fragmentation rule

BEPS Action 7 has also provided the anti-fragmentation rule. The said rule which operates to view complementary functions that are part of a cohesive business operation and undertaken by the same enterprise or a closely related enterprise at a fixed place/ place(s) of business in the same state in the aggregate for determining whether the overall activity resulting from combination of activities is of preparatory or auxiliary character.

- Paragraph 4 of Article 5 of OCED convention shall not apply to a fixed place of business that is used or maintained by an enterprise if the same enterprise or a closely related enterprise carries on business activities at the same place or at another place in the same Contracting State and
 - that place or other place constitutes a permanent establishment for the enterprise or the closely related enterprise under the provisions of this Article; or
 - the overall activity resulting from the combination of the activities carried on by the two enterprises at the same place, or by the same enterprise or closely related enterprises at the two places, is not of a preparatory or auxiliary character,
- Provided that the business activities carried on by the two enterprises

¹³ It may be noted that certain of India's tax treaties eg. Belgium, Brazil, Denmark, France, Italy, Japan, Luxembourg, Netherlands, UK etc. do not contain the term 'delivery' as part of exclusions under Article 5(4) of the respective tax treaty.

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at the same place, or by the same enterprise or closely related enterprises at the two places, constitute complementary functions that are part of a cohesive business operation.

6.2 Service PE

The concept of Service PE is relevant in the context of Indian treaties. This has been borrowed from UN Model convention and it is present in majority of the Indian treaties.

A service PE is created by the foreign enterprise in India if the employees /other personnel of foreign enterprise furnish or perform services in India for a specified period of time. Furnishing of services by a foreign entity in India through its **employees or other personnel** exceeding a specified threshold period would constitute a service PE. This clause not only includes furnishing or performance of services by the employees of the foreign enterprise but also of any other person (for eg. a subsidiary, sub-contractor, etc)

Typically, expats are seconded to India for a short duration for providing assistance to the Indian group subsidiary during its initial set-up phase or for the purpose of training the employees of the Indian entity. In such a case, it can be viewed that the foreign entity through its employees/other personnel is providing services to the Indian entity and if the number of days presence of such expats in India exceed in aggregate the threshold specified in the DTAA, this would trigger a Service PE of the foreign entity in India.

Nevertheless, in this case, the interplay between the Service PE clause and the fees for technical services article in the DTAA needs to be analyzed. If the relevant DTAA provides that the threshold of service PE would not consider the number of days presence of the expats in India for providing services which qualify as fees for technical services then in such a case the same would not be considered while determining a service PE of the foreign entity. However, for triggering the fees for technical services article, apart from the other criteria then main condition is that there has to be some consideration paid by the Indian entity to the foreign entity for provision of such services. In the absence of any consideration the question of triggering the article of fees for technical services does not arise.

Service PE in an Indian context

It has been held by Delhi High Court in the case of Centrica India Offshore

(P.) Ltd.¹⁴ that employees seconded by the overseas group entity to the Indian entity did not become employees of the Indian entity but continued to remain employees of the group entity during the secondment period. Accordingly, presence of the employees of the foreign group companies in India constitutes Service PE of the foreign entity in India. Further services provided by seconded employees are 'technical or consultancy' in nature and also 'make available' their know-how to the taxpayer for future consumption. Therefore, it was treated as 'Fees for Technical/Included Services'.

Additionally it needs to be highlighted that if the activities performed by the expats in India are in the nature of stewardship then this would not be regarded as constituting service PE.

Stewardship functions are essentially in the nature of supervisory activities. Generally, such stewardship functions involve monitoring the overall outsourcing operations so as to ensure maintenance of quality standards. Thus, in the case of stewardship, the services are not solicited by the service provider, however to protect interest of shareholders, these functions are effectively performed for entity availing of such service.

Supreme court in the case of Morgan Stanley & Co ¹⁵has held that under article 5(3)(e) activities which are preparatory or auxiliary in character which are carried out at a fixed place of business will not constitute a P.E. Article 5(3) commences with a non obstante clause. It states that notwithstanding what is stated in article 5(1) or under article 5(2) the term P.E. shall not include maintenance of a fixed place of business solely for advertisement, scientific research or for activities which are preparatory or auxiliary in character.

The following are the key considerations which have been evolved from various judicial precedents in the context of in a secondment of employees of a foreign entity to its Indian subsidiary:

- Who is responsible for the work of the employees?
- Under whose direction; control and supervision will such employees work?
- Does the deputing entity retain lien / right to recall back such employees?

¹⁴ (2014) 364 ITR 336 (Delhi High Court)

¹⁵ 162 Taxman 165

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- Does the deputing entity retain the right to replace any such deputed employee?
- Who has the right to terminate the employment of such employees?
- Who will be responsible to pay the salary cost of such employees?
- Who will bear all the risks in respect of work performed by the employees and benefits from the output of the employees?

The above issue is most frequent in BPO / KPO industry wherein the employees are seconded to the Indian entity, though their payroll continues with the foreign parent. In this situation, if the secondees work under supervision and control of the parent, serve parents clients, and continue his foreign payroll; then there is an exposure that the foreign parent can be construed as having a PE in India due to presence of its employee.

The judicial authorities have time and again analyzed the above scenario and held that in the presence of right of lien along with certain other facts, the expat would be in substance considered as an employee of the foreign entity. Thus, the reimbursement of salary has been considered as a consideration paid for the services provided by the foreign entity to the Indian entity. However, such reimbursements of expenditures need to be analysed for applicability of Indian withholding tax implications.

Reliance can be placed on following judicial precedents in order to determine the service PE of the foreign entity.

- MasterCard Asia Pacific Pte. Ltd¹⁶, In re. - Employees of MasterCard visiting India constituted a service PE of Master Card in India
- Centrica India Offshore (P.) Ltd¹⁷.- PE created since employees on the payroll of the foreign entity
- Morgan Stanley & Co¹⁸ has held that a deputationist who has a lien on his employment with the foreign entity will remain under the control of the foreign entity. Accordingly, the foreign entity will have a Service PE in India on account of the presence of the deputationist in India.
- Morgan Stanley International Incorporated¹⁹ has held that the employee secondment by the US company to its Indian subsidiary creates Service PE.

¹⁶ [2018] 406 ITR 43 (AAR – New Delhi)

¹⁷ (2014) 364 ITR 336 (Delhi High Court)

¹⁸ (2007) 292 ITR 416 (Supreme Court)

¹⁹ (2014) I.T.A. No.6882/Mum/2011 (Mumbai Tribunal)

6.3 Agency PE

The primary test for an agency PE is the ability of the agent to bind the principal to a third party. If the agent is an independent Agent, then it is not construed as PE as he has legal and economic independence.

As per OCED guidance, dependent agency PE may be created under Article 5(5) if a person (other than an agent of independent status) acting on behalf of a foreign enterprise has 'authority to conclude contract in the name of the enterprise'. Presently, it is possible to avoid PE under Article 5(5) in situations where contracts though substantially negotiated in one State were finalized/ signed/ authorized abroad. Consequently, the person habitually exercising authority to conclude contracts can still be construed as an independent agent in spite of being closely related enterprise.

As per Article 5(6), Article 5(5) does not apply if the business of the foreign enterprise was carried on in the other state by a broker, general commission agent or any other agent of independent status. In order to overcome dependent agency PE, most commonly the commissionaire arrangements are being employed and the goods are sold by an agent in its own name in the other State on behalf of the foreign enterprise.

BEPS considerations

BEPS Action Plan 7 proposes to amend the rule for creation of agency PE to include not only a person who habitually concludes contracts but also a person who habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise. To appreciate the impact of the proposed change, one would need to examine the entire spectrum of activities carried out by an agent to determine the dividing line between 'principal role' and 'support role'.

Post implementing BEPS recommendations, dependent agency PE would be created under Article 5(5) if a person acting in a Contracting state on behalf of an enterprise in another State either;

- habitually concludes contracts, or
- habitually plays the **principal role** leading to the conclusion of contracts that are **routinely concluded** without **material modification** by the enterprise; or
- Contract for provision of services and for the transfer of the ownership of, or for the granting of the right to use, property owned by an

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enterprise or that the enterprise has the right to use have been included under Article 5(5) **in addition to** contracts entered into by the agent **in the name of the enterprise**

- Where the requirements set out in Article 5(5) are met, a PE of the enterprise exists to the extent that the person acts for the latter, i.e. not only to the extent that such a person exercises the authority to conclude contracts.

The phrase “habitually concludes contracts” means

- Conclusion of contracts as per relevant law governing contracts of the country
- It has not been expressly mentioned whether contract law of country of residence or source or any other country has to be applied.
- Contract may be concluded in the state in which a person acting on behalf of a foreign enterprise accepts an offer made by a third party to enter into a contract/ negotiates all elements and details of the contract, even if contract is signed outside that state (i.e. oral contract within the state to be followed by written contract outside the state)
- Contract may be concluded without any active negotiation of the terms of that contract (i.e.) (in case of a standard contract) by reason of a person accepting, on behalf of an enterprise, the offer made by a third party to enter into a standard contract with that enterprise.
- As per Article 5(6), if a person acting in a Contracting state on behalf of an enterprise in another State either exclusively or almost exclusively on behalf of one or more enterprises to which it is closely related, that person shall not be considered to be an independent agent.

The expression ‘closely related to an enterprise’ means

- One enterprise possesses directly or indirectly more than 50 per cent of the beneficial interest/ 50 per cent of the aggregate vote and value of the company’s shares in the other; or
- If another person possesses directly or indirectly more than 50 per cent of the beneficial interest (or, in the case of a company, more than 50 per cent of the aggregate vote and value of the company’s shares or of the beneficial equity interest in the company) in the person and the enterprise

Agency PE in an Indian context

- *Modification of agency rule under the domestic laws in line with BEPS recommendations*

Under the Act, the expression 'Business connection' includes business activities carried on by non-resident through dependent agents. The Finance Act 2018, has amended Explanation 2 to section 9(1)(i) of the Act 'business connection'. Business connection as per the amended definition will now include any business activities carried on through a person who on behalf of the non-resident:-

- habitually concludes contracts or plays the principal role leading to the conclusion of contracts where contracts are-
 - in the name of a non-resident or;
 - for transfer of the ownership or for granting of the right to use, property owned by the non-resident or it has right to use or;
 - for the provision of service by the non-resident.
- does not conclude contract, but habitually maintains a stock of goods in India or merchandise from which he regularly delivers goods or merchandise; or
- habitually secures orders in India, mainly for the non-resident or for other non-residents under a common management.

As a result of the above amendment, the expression 'business connection' now provides that the agent also includes a person who habitually plays a principal role leading to the conclusion of contracts.

BEPS recommendations with respect to agency PE are now also included in MLI (to which India is a signatory). MLI provisions will, as a result, automatically modify India's DTAA's covered by MLI (provided the treaty partner has also opted for the same). In the absence of any amendment under section 9(1)(i), Dependent Agent PE provisions under India's DTAA, as modified by MLI, would have become wider than the domestic laws. Consequently, the modified DTAA provisions could have been ineffective in view of section 90(2) of the Act since the Act or the DTA whichever is more beneficial to apply. Thus, it was essential to amend the provisions of section 9(1)(i) of the Act are in line with MLI provisions.

The earlier provisions of the Act provided for an exclusion in respect of activities carried on by the agent which were confined to purchase of goods

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or merchandise for the non resident. However, the said exclusion has been removed post the amendment through Budget 2018.

6.4 Installation PE

A building site or construction or installation project constitutes a permanent establishment only if it lasts for more than **twelve months (OECD Model/ US Model) / 6 Months (UN Model)**.

A building site or construction or installation project includes:

- construction of roads, bridges or canals
- renovation (involving more than mere maintenance or redecoration) of buildings, roads, bridges or canals
- Laying of pipelines
- excavating and dredging
- installation of new equipment in an existing building or outdoors
- onsite planning and supervision of the construction of a building

Where an office / workshop is used for a number of construction projects, then even if none of the projects continues for more than 6 months, it will be considered as PE under Article 5(2) if it satisfies the condition of Article 5.

Supervisory activities

The supervisory activities will constitute a PE if such activity is carried out only in connection with a building site, a construction, assembly or installation project and not otherwise. A PE is constituted if the supervisory activities exceed the time limit. It is immaterial whether the individual building site, a construction, assembly or installation project (in respect of which the supervisory services are rendered) meets the time test.

- Minimum threshold in case of supervisory activities covered under a separate and independent contract must be considered from the date when such activities start and not from the date of commencement of the entire project ²⁰
- There is no condition that the person performing supervisory activities should also be providing installation service.
- OECD Commentary provides that the threshold time limit has to be determined separately for each individual site or project

²⁰ Krupp UDHE GmbH (28 SOT 254) (Mum)

- **Time spent previously on other sites or project (which are unconnected) should not be counted**
- The threshold limit applies to each site or project except where such sites or projects form a coherent whole commercially or geographically²¹
- No aggregation of duration if projects were separate²²
- The 'duration test' is to be applied on each independent contract separately unless the activities undertaken are so inextricably interconnected or interdependent that these are essentially required to be viewed as a coherent whole ²³
- Aggregation of the activities of unconnected projects is unwarranted, in the absence of aggregation provision under the India Germany treaty²⁴

BEPS considerations

BEPS Action plan 7, provides for certain action points in order to determine the Installation PE of the entity.

- Measure to counter splitting-up of contracts in the context of Article 5(3)

It is proposed to amend Article 5(3) to include in addition to the threshold for creation of installation PE an additional clause to aggregate time spent on connected projects by related enterprise at the same building/ installation site (each exceeding 30 days). It is also expected that the Principal Purpose Test rule in the Report on Action 6 will address the BEPS concerns on abusive splitting up of contracts.
- Principal Purpose Test (PPT) to determine the splitting-up of contract (detailed in Action 6 – Preventing granting of Treaty benefits in inappropriate circumstances)
- Whether appropriate to aggregate the time that 2 related parties worked on a construction project because it is reasonable to conclude that one of the principal purpose of splitting of contract is to obtain benefit of 12 months

²¹ Sumitomo Corp - 110 TTJ 302 (Del)

²² Tiong Woon Project and Contracting Pte. Ltd. 338 ITR 386 (AAR)

²³ M/s Valentine Maritime (Mauritius) Limited 130 TTJ 417 (Mum)

²⁴ Krupp UDHE GmbH (28 SOT 254) (Mum)

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- Activities carried on for not more than 30 days would not be aggregated with the other period of activities
 - Relevant questions for principal purpose test;
 - Whether contract is concluded with related persons?
 - Whether conclusion of additional contract is a logical sequence of the previous?
 - Whether activities could have been covered in single contract in the absence of planning?
 - Whether nature of work is same or differed?
 - Whether same employees are performing the work under different contracts?

6.5 Subsidiary PE

Article 5 para 7 of the OECD model states that it is generally accepted that the existence of a subsidiary company does not, of itself, constitute that subsidiary company to be a permanent establishment of its parent company.

However, the parent company may have PE in a State where a subsidiary has a place of business if, any space or premises belonging to the subsidiary that is at the disposal of the parent company. Further, a parent will be deemed to have a permanent establishment in a State in respect of any activities that its subsidiary undertakes for it if the conditions of specified for agency PE are satisfied unless it is an independent agent.

Subsidiary PE in an Indian context

Recently, the AAR in case of MasterCard Asia Pacific Pte. Ltd., In re [2018] 406 ITR 43 (AAR - NewDelhi), the AAR observed that when employees of MasterCard visited India and services performed by such employees, such as taking customer feedback, providing information about new products, and monitoring the efficiency of operations were an integral part of the transaction processing services provided by the MasterCard Asia Pacific to Indian customers.

These services could not constitute stewardship activities, and accordingly the AAR held that a service PE of the MasterCard Asia Pacific was constituted in India.

In the recent decision of Delhi Tribunal in case of Nokia Network OY vs JCIT [2018] 94 taxmann.com 111, the dissenting member has observed that a

subsidiary can be viewed as a PE of a foreign enterprise if it steps into the shoes of its parent entity. In such a case of indirect PE, the disposal test vis-à-vis foreign enterprise is irrelevant for indirect PE. “Indirect PE” are hypothetical PEs and such PEs need not necessarily and cannot always satisfy the disposal tests vis-à-vis foreign enterprise. Further, the minority member also observed that the OECD commentary on Article 5(6) dealing with subsidiary as a PE is not binding.

Having discussed various types of PEs, we now analyse taxability of profits attributable to PE as ‘business profits’

7. Attribution of business profits to PE (Article 7)

Article 7 OECD Model tax treaty provides for the international tax principles for attribution of profits to PE.

As per Article 7(2) of the OECD Model Convention, the profits to be attributed to the PE would be the profits that the PE might be expected to make if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed through the permanent establishment and through other parts of the enterprise. Further, it has also been clarified that this rule applies with respect to the dealings between the permanent establishment and the other parts of the enterprise.

Article 7 further provides that profits that are attributable to the PE are to be determined under the fiction that PE is a separate enterprise and that such an enterprise is independent from rest of the enterprise of which it is a part as well as from any other person. The second part of the fiction corresponds to the arms length principle.

OECD prescribes two-step process for attribution of profits

- (i) Undertake a functional analysis and factual analysis, which attributes to the PE the functions performed, assets used and risks assumed (FAR) by the enterprise in respect of the business it carries on through the PE.
- (ii) Determine the pricing on an arm’s length basis, which determines an arm’s length return for the FAR attributed to the PE.

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Force of attraction

Under most of India's tax treaties, if a non-resident has a PE in India, its business profits are taxable in India only to the extent attributable to the PE. Thus, Indian treaties generally do not include a full force of attraction provision. However, there are a number of Indian treaties which contain a limited force of attraction provision whereby any income attributable to goods sold or services rendered in India by the head office without involvement of the PE, is taxable in India if those goods sold or services rendered by the head office are the same or similar to the goods sold or services rendered by the Indian PE. Such a provision is called as a 'force of attraction' of rule. This rule is included in India's tax treaties with Belarus, Belgium, Canada, Cyprus, Denmark, Italy, Kenya, Mongolia, New Zealand, Norway, Poland, Portugal, Romania, Spain, Sri Lanka, Thailand and the United States.

The Indian tax treaties normally provide for a deduction of actual expenses incurred. However, if the domestic law specifies a ceiling (e.g. section 44C of the Act, discussed above, with regard to the deductibility of head office expenses) for the deductibility of specific expenses, then such a ceiling would apply.

Additional guidance by OECD on attribution of profits to PE

OECD on 22 March 2018 has released additional guidance on the attribution of profits to a PE under action 7 of the BEPS. The 2018 guidance provides that there should be no double taxation when attributing profits to a PE, either through the double counting of risks or in the combined application of Articles 7 and 9 of the Model Tax Convention. It also reaffirms that the net profit attributable to a PE may be positive, negative, or a loss. Finally, the 2018 guidance continues to provide that countries may keep implementing administratively convenient procedures for recognizing the existence of a PE and collecting the tax in the host country, regardless of whether they have adopted the Authorized OECD Approach (AOA). However, there is no recommendation or requirement that they do so.

Attribution of profits under the provisions of the Act

- As per Section 9(1)(i) of the Act all income accruing or arising, whether directly or indirectly, through or from any business connection in India, or through or from any property in India, or through or from any asset or source of income in India, or through the transfer of a capital asset situate in India."

- Explanation 1(a) to section 9(1)(i) of the Act, provides that “in the case of a business of which all the operations are not carried out in India, the income of the business deemed under this clause to accrue or arise in India shall be only such part of the income as is reasonably attributable to the operations carried out in India”.
- Rule 10 of the Income tax Rules 1962 (the Rules), provides for determination of profits in case of non-residents in cases where the same cannot be definitely ascertained on the basis of domestic tax law.
 - Method 1: percentage of turnover. The tax officer may determine income taxable in India “on the basis of the percentage of the turnover” as the tax officer may consider to be reasonable (e.g. hypothetically, 5% of turnover). Under this method, the income is computed at such percentage of the turnover as the AO may consider reasonable. For the said purposes, ad hoc profits are estimated as attributable to the operations in India.
 - Method 2: proportionate profit. The tax officer may determine taxable profit on the following basis: global profits of the relevant business × (total receipts of the relevant business in India/total global receipts of the relevant business).
 - Under this method, the profits are computed in ratio of India receipts to total receipts of the business. This is a difficult method as worldwide income of the enterprise is to be computed under the Act before applying proportionate method. In case of different businesses, relevant business income needs to be considered
 - Method 3: residual method. The tax officer may compute income in some other manner as he deems fit.

Rule 10 does not suggest that the methods be followed in a particular order. One of the methods requires calculation under the provisions of Indian tax law of the worldwide income of the non-resident from the business. However, it may be difficult to apply the provisions of Indian tax law to the worldwide income, as the method of accounting followed outside India and the nature of income and expenses outside India may differ from the Indian practice.

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Section 44C of the Act restricts the deduction for head office expenses incurred by a non-resident taxpayer. The deduction under section 44C of the Act is limited to 5% of the adjusted total income or the actual expenditure of the PE, whichever is lower. The term adjusted total income and average adjusted incomes are defined in the explanation to section 44C of the Act. However, in case the “adjusted total income” of the taxpayer is a loss, the deduction shall be computed after considering the 5% of the “average adjusted total income” of the taxpayer or the head office expenditure incurred, whichever is less.

In addition to the above, reference can be drawn to various judicial precedents, which have dealt with the issue of attribution of profits to the PE:-

- There was no need to attribute further profits to the PE of the foreign company where the transaction between the two was held to be at arm’s length, taking into account all the risk-taking functions of the enterprise²⁵.
- If a fair price is paid by the assessee to the agent for the activities of the assessee in India through the Dependent Agent PE and the said price is taxed in India at the hands of the agent, then no question of taxing the assessee again would arise. This principle is applicable if the transfer pricing analysis is being undertaken in accordance with section 92 of the Act²⁶.
- In case the agent is remunerated at arm’s length by the foreign principal, the tax liability of the foreign principal (which would arise in case it is regarded to have a PE in India) would stand extinguished.²⁷
- If an agent is compensated on an arm’s length basis for its agency services in India, there should be no additional income attribution in the hands of the non-resident tax payer²⁸.
- Attribution of profits to PE should be made by transfer pricing principles as laid down by Hon’ble Supreme Court in case of Morgan Stanley²⁹.

²⁵ DIT (Intl Taxation) vs. Morgan Stanley and Co Inc (292 ITR 416)(SC)

²⁶ Rolls Royce Singapore Pte Ltd. vs. ADIT [2012] 347 ITR 192 (Delhi)

²⁷ SET Satellite (Singapore) Pte Ltd. (218 CTR 452) (Bombay HC)

²⁸ BBC Worldwide Ltd. vs DDIT (2010-TIOL-59-ITAT-DEL)

²⁹ Convergys Customer Management Group Inc vs ADIT [TA No 1443/Del/2012 and 5243/Del/2011]

- Further, following are certain principles laid by various judicial precedents with respect to attribution of profits to the PE:-
 - Profit apportionment on the basis of business activities, manufacturing profits taxable in the jurisdiction where manufacturing takes place³⁰
 - Profits attribution to PE based on functions assets and risks analysis³¹
 - FAR analysis should be carried out based on the overall functions carried out by the company and not limited to the management or support services provided to the associated enterprise³²
 - Transfer pricing principles should be applied to determine profits attributable to PE³³
 - Even if supply is considered to be integral part of installation, supply is not attributable to PE because it is at arm's length; Direct billing to customer represents arm's length³⁴
 - While invoking Rule 10, the tribunal noted that the tax officer could consider net profit only in accordance with published accounts, and could not make any further adjustments without reasonable grounds³⁵
 - Even if the subsidiary of a foreign company is considered as its PE, only such income as is attributable in terms of paragraphs 1 and 2 of Article 7 can be brought to tax³⁶
 - In certain situations, the courts have resorted to adhoc attributions based on the facts of the case³⁷

If a foreign company has established a PE in India, the payments made to the foreign company shall be made after withholding tax at

³⁰ Ahmedbhai Umarbhai & Co (1950) SCR 335

³¹ Morgan Stanley (292 ITR 416) (SC)

³² Daikin Industries Ltd vs ACIT [2018] 94 taxmann.com 299 – Delhi ITAT

³³ Rolls Royce Singapore Pvt Ltd (ITA No 1278/2010) (Delhi HC)

³⁴ Hyundai Heavy Industries : 291 ITR 482 (SC)

³⁵ ZTE Corp. v. Addl DIT (ITA No 5870/Del/2012)

³⁶ Adobe Systems Inc vs. ADIT (Delhi High Court) [2016] (69 taxmann.com 228)

³⁷ *Annimalis Timber* 41 ITR 781 (Madras HC); *NETWORKS, OY* : 96 TTJ 1 (Delhi ITAT, SB);

Galileo International Inc : 114 TTJ 289 (Del. ITAT); *eFunds* 42 SOT 165 (Delhi ITAT)

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the rate of 40% (plus applicable surcharge and cess) on net basis i.e. after allowing eligible expenses incurred for earning such income.

8. PE in digital economy and interplay business connection

Considering the nature of ecommerce transactions, an online seller of goods is presently able to avoid a taxable presence in the market country in spite of having a large warehouse with significant number of personnel, which is essential for proximity to customers and quick delivery.

In addition to the BEPS recommendations discussed in the preceding paragraphs, BEPS Action plan 1 has recommended certain points in order to overcome the challenge of business connection in the digital economy. It outlines conclusions regarding the digital economy, the BEPS issues, the resultant tax challenges and the recommended next steps. The said Action Plan is aimed to avoid -

- Minimization of taxation in the market country by avoiding taxable presence;
- Shifting gross profits by shifting trading structures or reducing net profit by maximising deductions;
- Low or nil withholding tax at source;
- Low or no taxation at the level of recipient via intra-group arrangements;
- No current taxation of the low-tax profit at the level of the ultimate parent;

Action Plan 1 has suggested the following while determining the significant economic presence of any enterprise:

- Revenue based factor – Revenue generated as potential indicators of the existence of a significant economic presence. Due consideration required for
 - transactions covered (whether or not to include only revenues generated from digital transactions concluded within the country);
 - level of the threshold (to prescribe threshold in absolute terms and in local currency);

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- administration of the threshold (ability of the country to identify and measure remote sales activities of the non-resident enterprise).
- Digital factor - The ability to reach significant numbers of customers. Factors considered to include
 - local domain name and local digital platform
 - Local payment options
- User-based factors
 - Monthly active users (number of monthly active users on the digital platform that are habitually resident in a given country in a taxable year)
 - Online contract conclusion (conclusion of contracts via a digital platform without the need for the intervention of local personnel or dependent agents)
- Possible combinations of the revenue factor with the other factors
 - BEPS Action 1 suggests that income factors should be combined with other factors, such as digital factors and/or user-based factors that indicate a purposeful and sustainable interaction with economic life in the country concerned.

Data collected (the volume of digital content collected with specific focus on the origin of the data collected, irrespective of the data warehouse. The range of data captured by the threshold would cover also, e.g. user created content, product reviews, and search histories.

Under the domestic provisions of the Act, Finance Act 2018 has introduced the concept of Significant Economic Presence ('SEP'). SEP introduced from 1 April 2018

- It expands the scope of income of a non-resident arising on account of 'business connection' in India for that non-resident. The resulting income, attributable to the SEP, is taxable in India
- SEP is defined to mean that
 - any transaction in respect of any goods, services or property carried out by a non-resident in India, including the provision of download of data or software in India, subject to payment threshold to be prescribed; or

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- Systematic and continuous soliciting of business activities or engaging in interaction with such number of users as may be prescribed, in India through digital means

The aforesaid amendment in line with recommendations under BEPS Action Plan 1 on addressing tax challenges of the digital economy. However, though the definition of business connection is widen under the domestic provisions of the Act, a non-resident may still claim the beneficial provisions of the tax treaties and income shall not be taxable in India. This is because, in most cases, the restrictive PE definition in the various tax treaties would override the definition of 'business connection' under the Act.

Therefore, till the time corresponding modifications are made to the tax treaties, the existing tax law would continue to apply. However, it would be important to know how MLI provisions may widen the definition of business connection under the tax treaties.

9. Taxability of dividend paid by an Indian company to a non-resident shareholder (Article 10)

Background

Dividend is defined in section 2(22) of the Act in an inclusive manner. Other than ordinary dividend as per the provisions of the applicable Company Law, dividend for the purposes of the Act also includes distribution of accumulated profits of the company to its shareholders through other means such as:

- distribution entailing release of assets to shareholders
- allotment of bonus debentures etc to shareholders
- allotment of bonus shares to preference shareholders
- distribution on reduction of capital
- distribution on liquidation
- closely held companies giving loans / advances to shareholders / related concerns subject to satisfaction of prescribed shareholding / control related conditions (deemed dividend)

(There are certain exclusions carved out from the definition of dividend).

Under section 8 of the Act, dividend is taxable upon declaration, distribution or payment of the same, whichever is earlier.

Indian companies declaring, distributing or paying dividend are liable to pay DDT at the rate of 15% (plus applicable surcharge and cess). In case of deemed dividend, the DDT rate applicable is 30% (plus applicable surcharge and cess).

Dividend is exempt from tax in the hands of the shareholder.

Taxability of dividend under the tax treaty

Given that dividend is exempt from tax in India in the hands of the non-resident shareholder, the provisions in the tax treaty relating to taxation of dividend may have limited application in the Indian context.

We have given below a clause-by-clause analysis of the Dividend Article (Article 10) of the UN Model. The language of the Dividend Article in the OECD Model is more or less similar.

- I. *Dividends paid by a company which is a resident of a Contracting State to a resident of the other Contracting State may be taxed in that other State.*

This rule allows full taxation of dividend received from a company resident in the country who is a party to a particular tax treaty (i.e. source country) by a shareholder resident in the country who is the other party to that tax treaty (i.e. country of residence of the shareholder), in the country of residence of the shareholder. This is of course subject to the domestic tax law of the country of residence of the shareholder. For instance, such dividend may not be taxable in the country of residence of the shareholder if its domestic tax law exempts from tax, either generally or subject to certain conditions, foreign sourced dividend. In this context, the term "paid" has been regarded in international commentaries / jurisprudence as not only comprising of an actual payment but also other modes where such dividend is made unconditionally available to the shareholder. Interestingly, the India-Greece tax treaty (Article 8) provides for taxation of dividend only in the source country – it has no clause analogous to Article 10(1) allowing taxation in the country of residence of the shareholder.

- II. *However, such dividends may also be taxed in the Contracting State of which the company paying the dividends is a resident and according to the laws of that State, but if the beneficial owner of the dividends is a resident of the other Contracting State, the tax so charged shall not exceed:*

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(a) ___ per cent (the percentage is to be established through bilateral negotiations) of the gross amount of the dividends if the beneficial owner is a company (other than a partnership) which holds directly at least 25 per cent of the capital of the company paying the dividends throughout a 365 day period that includes the day of the payment of the dividend (for the purpose of computing that period, no account shall be taken of changes of ownership that would directly result from a corporate reorganisation, such as a merger or divisive reorganisation, of the company that holds the shares or that pays the dividend);

(b) ___ per cent (the percentage is to be established through bilateral negotiations) of the gross amount of the dividends in all other cases.

The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of these limitations.

This paragraph shall not affect the taxation of the company in respect of the profits out of which the dividends are paid.

This rule allows taxation of dividend paid by a company resident in the source country to a non-resident shareholder (who is resident in the country of residence), in the source country. However, this rule places a certain fetters on such taxation by the source country. Notably, where the non-resident shareholder is a company and is the beneficial owner of the dividend and the shareholding of the non-resident shareholder in the payer company meets the prescribed threshold, the dividend may be taxable at a lower concessional rate in the source country. The threshold for the period of holding of 365 days given in Article 10(2)(a) is in sync with Article 8(1) of the MLI. In India's provisional reservations on the MLI, India has opted to apply Article 8(1) of the MLI and has also specified a list of India's tax treaties which already provide for a concessional tax rate on dividend based on a shareholding threshold. However, the eventual applicability of Article 8(1) of the MLI to these tax treaties will depend on whether the treaty partners also chose to notify the tax treaty with India as a CTA and/or adopt Article 8(1) of the MLI with respect to the tax treaty with India. India has also excluded the India-Portugal tax treaty which provides for a holding period of 2 years (i.e. longer than 365 days) in Article 10(2).

There may be different concessional rates where the non-resident shareholder has a substantial shareholding (25% in both the UN and OECD Models) in the payer company for a certain period of time (365 days in both the UN and OECD Models). Changes in shareholding resulting from reorganizations of the non-resident shareholder or the payer company during the above 365 day window are ignored.

International commentaries / jurisprudence has laid down the principle that a beneficial owner is typically a person who profits economically from the income / asset or who is fully entitled to enjoy its benefit directly or who can freely avail the income / asset and deal with it without being accountable to any other person. It is worthwhile to note that the CBDT has issued a Circular (Circular No 789 dated April 13, 2000) in the context of taxation under the India-Mauritius tax treaty of dividend and income from sale of Indian company's shares, wherein it has clarified that a TRC issued by the Mauritian authorities would constitute sufficient evidence for accepting the Mauritian residency of the shareholder as well as his beneficial ownership of the Indian company's shares. This Circular has been upheld by the Supreme Court in *Union of India vs Azadi Bachao Andolan* [2003] 263 ITR 706 (SC). This principle laid down in this Circular has been extended by Indian judicial authorities not only to residents of other countries but also to other income streams; see *DIT vs Universal International Music B.V.* [2013] 31 taxman.com 223 (Bom HC), *HSBC Bank (Mauritius) Limited vs DCIT* [ITA No. 1708/Mum/2016] (Mum –Trib). The Supreme Court in the case of *Vodafone International Holding B.V. vs Union of India* [2012] 1 SCR 573 (SC) though has held that the TRC would not be a conclusive evidence of eligibility of the non-resident to claim benefits under the tax treaty, and cannot prevent inquiry by the tax department around any potentially abusive arrangements / colourable devices (such as interposition of the non-resident company before the sale of shares without any commercial reason merely to obtain benefits under the tax treaty etc).

The term "capital" is not defined in tax treaties and is typically understood in the sense of its meaning under the applicable corporate law. Debt regarded as capital under thin cap

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provisions may fall within “capital” [para 15(d) of the OECD Commentary on Article 10 (2017)].

It may be noted that taxation as per the tax treaty / non-taxation of dividend by the source country in the hands of the non-resident shareholder is subject to the domestic tax law of the source country. For instance, India charges the dividend declared by an Indian company to DDT (which is an additional income-tax charged on the payer Indian company), and exempts the non-resident shareholder from Indian tax liability on the dividend altogether.

It may also be noted that Article 10(2) also applies in the context of triangular cases, i.e. the source country has a right to impose tax on dividend paid by a company resident in the source country to a PE in a third country of a non-resident shareholder (who is resident in the country of residence).

It is a matter of an ongoing debate as to whether the rate of DDT has to be limited to the rate prescribed in the applicable tax treaty where the dividend is being paid to a shareholder resident in that country; see *SGS India Pvt Ltd vs Addl CIT [2017] 165 ITD 583 (Mum - Trib)*.

III. *The term “dividends” as used in this Article means:*

income from

- *shares, “jouissance” shares or “jouissance” rights, mining shares, founders’ shares or*
- *other rights, not being debt claims, participating in profits,*
- *as well as income from other corporate rights which is subjected to the same taxation treatment as income from shares by the laws of the State of which the company making the distribution is a resident.*

Dividend is also specifically defined in a tax treaty for the purposes of application of that tax treaty and is not premised on definition of dividend under the domestic tax law of the concerned countries. Apart from dividend on ordinary shares, dividend on certain other classes of shares (which are not prevalent in India) is also regarded as dividend under the tax treaty. Also, income from other rights (not being shares or debt

claims against the payer company) participating in profits is also regarded as dividend under the tax treaty. However, in certain situations, income from debt where the lender effectively shares the risks of the borrower company could also be regarded as “dividend” [para 25 of the OECD Commentary on Article 10 (2017)]. Further, income from other corporate rights which is subjected to the same taxation treatment as income from shares by the domestic tax law of source country is also regarded as dividend under the tax treaty. There is a difference in certain tax treaties in the language of this last limb of the definition of dividend, e.g. the India-UK tax treaty uses the term “any other item” instead of “other corporate rights” – the term used in the India-UK tax treaty being wider in nature, it could potentially encompass deemed dividend as well (which would not have qualified as other corporate rights).

- IV. *The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the dividends, being a resident of a Contracting State, carries on business in the other Contracting State of which the company paying the dividends is a resident, through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the holding in respect of which the dividends are paid is effectively connected with such permanent establishment or fixed base. In such case the provisions of Article 7 or Article 14, as the case may be, shall apply.*

This rule seeks to establish a precedence between the application of the specific and general provisions of the tax treaty in a situation where the non-resident shareholder has a PE / fixed base in the source country and the holding in the shares of the payer company is effectively connected to such PE / fixed base – in such a situation, this rule provides that the taxation of dividend in the source country as well as the country of residence of the shareholder in accordance with the Business Profits / IPS Articles. Accordingly, the source country will then tax the dividend as business profits earned by the non-resident shareholder in the source country, while the country of residence will regard the dividend as part of foreign sourced profits of the shareholder.

The term “effectively connected”, not being defined in tax

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treaties or the Indian domestic tax law, would then need to be understood as per common parlance as held in international commentaries / jurisprudence – accordingly, shareholding effectively connected to the PE would in the context denote a live economic nexus or real, perceptible and intimate connection or a clear correlation between the shareholding and the PE.

- V. *Where a company which is a resident of a Contracting State derives profits or income from the other Contracting State, that other State may not impose any tax on the dividends paid by the company, except in so far as such dividends are paid to a resident of that other State or in so far as the holding in respect of which the dividends are paid is effectively connected with a permanent establishment or a fixed base situated in that other State, nor subject the company's undistributed profits to a tax on the company's undistributed profits, even if the dividends paid or the undistributed profits consist wholly or partly of profits or income arising in such other State.*

In simple terms, this rule prohibits extra-territorial taxation by a country (Country A) of the dividend paid by or undistributed profits of a company resident in another country (Country B) even though the company earns profits in Country A. The only situations that allow Country A to tax such dividend are as under:

- Where such dividend is received by a resident of Country A
- Where the shareholding of the payer company on which such dividend is paid, is effectively connected to a PE in Country A of a resident of Country B or any other country

However, it may be noted that this provision places no embargo on Country A to tax the profits of the payer company in Country A if permissible under CFC rules.

Special provisions in certain select tax treaties with respect to dividend taxation

The Protocol to the India-Hungary tax treaty contains a provision that potentially may allow making the DDT paid by the payer Indian company to a Hungarian resident as income in the hands of the Hungarian resident as well as limit DDT liability of the payer Indian company to 10%. Such provision

may have presumably been enacted to put taxation under the DDT regime on par with the classical dividend taxation regime, as well as enable the Hungarian resident to seek a tax credit of the DDT in Hungary under its domestic tax law read with the India-Hungary tax treaty.

Select recent controversies with respect to dividend taxation

The Indian Company Law allows an Indian company to buy back its shares from its own shareholders, subject to certain conditions. Statutorily, payment to shareholders upon buy back of their shares by the Indian company was not regarded as distribution of dividend by the Indian company by virtue of the exclusion under section 2(22)(iv) of the Act, but as capital gains in the hands of the shareholders under section 46A of the Act. Where such shareholders were eligible to avail relief under tax treaties that exempted taxation of such capital gains in India (e.g. erstwhile Mauritius, Singapore, Cyprus tax treaties), the buyback proceeds were not taxable in India at all.

In 2012, the AAR in the case of *Otis* (AAR No. P of 2010) regarded a buy back to a colourable device to distribute profits to shareholders by avoiding Indian taxes thereon altogether, and accordingly, regarded the transaction as declaration of dividend under judicial anti-avoidance principles. In 2013, the CBDT plugged this perceived route by introducing buy back tax payable by an unlisted Indian company while exempting the shareholder from any capital gains tax thereon, on the similar lines as the DDT regime. While one would have assumed that CBDT Circular No. 3/2016 would have lent a quietus to the pre-2013 position that a buy back does not trigger dividend, this dividend taxability point is being re-agitated by the tax department in the ongoing case of *Fidelity Business Services India Pvt Ltd vs ACIT [2018] 95 taxmann.com 253 (Kar HC)*.

10. Taxability of interest paid by an Indian borrower to a non-resident lender (Article 11)

Background

Interest is defined in section 2(28A) of the Act to mean “*interest payable in any manner in respect of any moneys borrowed or debt incurred (including a deposit, claim or other similar right or obligation) and includes any service fee or other charge in respect of the moneys borrowed or debt incurred or in respect of any credit facility which has not been utilized*”.

Further, section 2(28B) of the Act defines “interest on securities” to mean

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“interest on any security of the Central Government or a State Government or on debentures or other securities for money issued by or on behalf of a local authority or a company or a corporation established by a Central, State or Provincial Act”.

Under section 9(1)(v) of the Act, interest is taxable in India in the hands of a non-resident lender in the following cases:

- Interest payable by the Central Government or State Government
- Interest payable by a resident, except where the underlying borrowing is used for a business carried on outside India or earning income from a source outside India
- Interest payable by a non-resident where the underlying borrowing is used for a business carried on in India
- Interest payable by an Indian branch of a foreign bank to the head office or any other overseas office of the foreign bank

(Certain kinds of interest are not taxable in India under the Act).

Interest could be taxable in India under the Act in the hands of the non-resident at various rates ranging from 5% to 20% (on gross basis) depending on nature, terms etc. of underlying borrowings and the category of the non-resident taxpayer.

Taxability of interest under the tax treaty

We have given below a clause-by-clause analysis of the Interest Article (Article 11) of the UN Model. The language of the Interest Article in the OECD Model is more or less similar.

- I. Interest arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State.*

This rule allows full taxation of interest that arises in a country who is a party to a particular tax treaty (i.e. source country) to the lender resident in the country who is the other party to that tax treaty (i.e. country of residence of the lender), in the country of residence of the lender. This is of course subject to the domestic tax law of the country of residence of the lender. For instance, such interest may not be taxable in the country of residence of the lender if its domestic tax law exempts from tax, either generally or subject to certain conditions, foreign sourced interest. In this context, the term “paid” has been

regarded in international commentaries / jurisprudence as not only comprising of an actual payment but also other modes where such interest is made unconditionally available to the lender.

- II. *However, such interest may also be taxed in the Contracting State in which it arises and according to the laws of that State, but if the beneficial owner of the interest is a resident of the other Contracting State, the tax so charged shall not exceed ___ per cent (the percentage is to be established through bilateral negotiations) of the gross amount of the interest. The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of this limitation.*

This rule allows taxation of interest arising in the source country to a non-resident lender (who is resident in the country of residence), in the source country (*Article 11(5) discussed subsequently deals with whether the interest is said to accrue in either of the countries that are a party to a particular tax treaty*). However, this rule places a certain fetters on such taxation by the source country. Notably, where the non-resident lender (who is resident in the country of residence) is the beneficial owner of the interest, the interest may be taxable at a lower concessional rate in the source country.

International commentaries / jurisprudence has laid down the principle that a beneficial owner is typically a person who profits economically from the income / asset or who is fully entitled to enjoy its benefit directly or who can freely avail the income / asset and deal with it without being accountable to any other person. It is worthwhile to note that the CBDT has issued a Circular (Circular No 789 dated April 13, 2000) in the context of taxation under the India-Mauritius tax treaty of dividend and income from sale of Indian company's shares, wherein it has clarified that a TRC issued by the Mauritian authorities would constitute sufficient evidence for accepting the Mauritian residency of the shareholder as well as his beneficial ownership of the Indian company's shares. This Circular has been upheld by the Supreme Court in *Union of India vs Azadi Bachao Andolan [2003] 263 ITR 706 (SC)*. This principle laid down in this Circular has been extended by Indian judicial authorities not

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only to residents of other countries but also to other income streams; see *DIT vs Universal International Music B.V.* [2013] 31 *taxman.com* 223 (Bom HC), *HSBC Bank (Mauritius) Limited vs DCIT* [ITA No. 1708/Mum/2016] (Mum –Trib). The Supreme Court in the case of *Vodafone International Holding B.V. vs Union of India* [2012] 1 SCR 573 (SC) though has held that the TRC would not be a conclusive evidence of eligibility of the non-resident to claim benefits under the tax treaty, and cannot prevent inquiry by the tax department around any potentially abusive arrangements / colourable device (such as interposition of the non-resident company before the sale of shares without any commercial reason merely to obtain benefits under the tax treaty etc).

It may be noted that taxation as per the tax treaty / non-taxation of interest by the source country in the hands of the non-resident lender is subject to the domestic tax law of the source country. For instance, India exempts interest paid to certain non-residents under its domestic tax law itself under section 10(15) of the Act.

It may also be noted that Article 11(2) also applies in the context of triangular cases, i.e. the source country has a right to impose tax on interest paid to a PE in a third country of a non-resident lender (who is resident in the country of residence).

III. *The term “interest” as used in this Article means:*

- income from debt claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor’s profits,

and in particular,

- income from government securities and income from bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures.

Penalty charges for late payment shall not be regarded as interest for the purpose of this Article.

Interest is also specifically defined in a tax treaty for the purposes of application of that tax treaty and is not premised on definition of interest under the domestic tax law of the

concerned countries. Income from debt claims (secured or unsecured, and participating or non-participating) is included in the definition of interest. The term “debt claim” is not defined in tax treaties and will be generally fact specific including being dependant on the provisions of the proper law governing the contract / arrangement / instrument etc – hence, a factual assessment may be needed to determine if the return from / on such contract / arrangement / instrument etc qualifies as interest under the tax treaty or not. Apart from the interest on government securities, bonds and debentures, any premiums attached to such instruments is also included in the definition of interest. However, it is clarified that penalty charges for late payment are specifically excluded from the definition as interest under the tax treaty.

- IV. *The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the interest, being a resident of a Contracting State, carries on business in the other Contracting State in which the interest arises, through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the debt claim in respect of which the interest is paid is effectively connected with (a) such permanent establishment or fixed base, or with (b) business activities referred to in (c) of paragraph 1 of Article 7. In such cases the provisions of Article 7 or Article 14, as the case may be, shall apply.*

This rule seeks to establish a precedence between the application of the specific and general provisions of the tax treaty in a situation where the non-resident lender has a PE / fixed base in the source country and the lending is effectively connected to (1) such PE / fixed base or (2) the business activities falling under the Force of Attraction Rule of the Business Profits Article (*the OECD Model does not contain this second limb*) – in such a situation, this rule provides that the taxation of interest in the source country as well as the country of residence of the lender in accordance with the Business Profits / IPS Articles. Accordingly, the source country will then tax the interest as business profits earned by the non-resident lender in the source country, while the country of residence will regard the interest as part of foreign sourced profits of the lender.

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The term “effectively connected”, not being defined in tax treaties or the Indian domestic tax law, would then need to be understood as per common parlance as held in international commentaries / jurisprudence – accordingly, borrowing effectively connected to the PE would in the context denote a live economic nexus or real, perceptible and intimate connection or a clear correlation between the borrowing and the PE.

- V. *Interest shall be deemed to arise in a Contracting State when the payer is a resident of that State. Where, however, the person paying the interest, whether he is a resident of a Contracting State or not, has in a Contracting State a permanent establishment or a fixed base in connection with which the indebtedness on which the interest is paid was incurred, and such interest is borne by such permanent establishment or fixed base, then such interest shall be deemed to arise in the State in which the permanent establishment or fixed base is situated.*

As far as the countries who are a party to particular tax treaty are concerned, interest is deemed to arise in that country (i.e. source country):

(1) where the borrower is resident, or

(2) in which there is a PE / fixed base of the borrower (whether a resident of the country who is the other party to that tax treaty or not) in respect of which the borrower has availed the borrowing and which has borne the interest.

However, in scenario (2), a clear cut economic link between the borrowing and the PE / fixed base in a country which is a party to a particular tax treaty is necessary for the interest to be deemed to arise in that country, and hence, a case of the Head Office borrowing generally and using the proceeds for several Branch Offices would not be covered under scenario (2) [para 27, 27(c) of the OECD Commentary on Article 11 (2017)].

This rule does not deal with a scenario where the interest is paid by a resident of one of the countries which is a party to a particular tax treaty to a resident of the other country which is the other party to that tax treaty but where the interest is borne by a PE / fixed base that the borrower has in a third country – in such scenario, taxation of the same interest in the third country

is also likely and such triangular cases will have to be resolved separately by the concerned countries [para 28-31 of the OECD Commentary on Article 11 (2017)].

- VI. *Where, by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the interest, having regard to the debt claim for which it is paid, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In such case, the excess part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this Convention”.*

This rule incorporates the arm’s length principle, and provides that on account of a special relationship between the payer and the beneficial owner or between both of them and some other person, the actual interest payable exceeds the amount that would have payable under the arm’s length principle having regard to the nature of the debt claim, only the arm’s length amount of interest will be subject to the taxation rules of Article 11. The balance amount will be taxed as per the domestic tax laws of the concerned countries read with the other provisions of the tax treaty.

11. Taxability of royalty / technical service fees paid by an Indian payer to a non-resident (Article 12)

11.1 Royalty and Fee for Technical Services

11.1.1 Introduction: The provisions in respect to Royalties and Fee for Technical Services (‘FTS’) are generally contained in Article 12 of Double Taxation Avoidance Agreements (‘DTAAs’ or ‘treaties’). In most DTAAs, the taxability of royalties and FTS are discussed under the same article.

While royalty is associated generally with Intellectual Property, FTS is mostly associated with the rendering of managerial (in some treaties), technical or consultancy services. Personal services are generally dealt with under Article 14–‘Independent Personal Services’ (‘IPS’). The tax law in India (the Income-tax Act, 1961 or the ‘Act’) contains extensive provisions in respect of taxation

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of both - royalty and FTS. These are defined specifically in Section 9 of the Act.

The transfer, sharing and use of IPs is crucial to the survival of modern business and creating a conducive environment which promotes the availability of technology so as to augment the growth of industry and the economy. The taxation system plays a vital role in creating that environment.

The basic provisions with respect to royalty and FTS under treaties have been discussed in the ensuing paragraphs including a brief discussion on the relevant aspects under the Act. The key issues being addressed here are highlighting the broader differences between the definitions under the Act vis-à-vis the Model Conventions and the controversies that have emanated therefrom.

11.1.2 Definition of Royalty: The term 'royalty' has been defined under the Act as well as under the Model Conventions (OECD Model, UN Model and US Model). Though the definition under Model Conventions is broadly as per the Act; however, there are some points of differentiation discussed in the table below:

Provisions of:	Points of differentiation	
	Definition	Taxation
Act	<ul style="list-style-type: none"> • Royalty has been broadly defined under the Act. • Considers payment made for transfer of rights in IPs, transfer of right for use or right to use a computer software (including granting of a license) • Possession, control and location of IPs not a relevant consideration • Excludes capital gain derived from the outright transfer of IPs 	Taxable on source basis in India
OECD MC	Excludes: <ul style="list-style-type: none"> • Payment made for transfer 	Taxed only in country of residence of beneficial

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Provisions of:	Points of differentiation	
	Definition	Taxation
	of right in IPs and transfer of right for use or right to use a computer software <ul style="list-style-type: none"> • Payment made for films or rentals used for radio or television broadcasting • Payment for leasing of commercial scientific, industrial equipment (equipment royalty) 	recipient of royalty
US MC	Broadly follows the OECD Model Includes³⁸: Gain derived from alienation of IPs which are contingent on the productivity, use or disposition thereof	Taxed only in country of residence of beneficial recipient of royalty ³⁹
UN MC	Broadly follows the definition under the Act Excludes: Payment made for transfer of right in IPs are not considered as royalty	Taxed in country of residence or source

Royalty under India DTAA's

Most DTAA's entered into by India, are based on the UN Model Convention. Each DTAA has its own definition of the term royalty. Some distinctive features of the royalty Article are as under:

- (i) The definition of the term 'Royalty' does not contain the provision for equipment royalty i.e. the words "use or right to use industrial,

³⁸ As per Technical Explanation to the Convention and Protocol between USA and India

³⁹ Except in certain circumstances where the Limitation of Benefits ('LOB') clause is not satisfied

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commercial or scientific equipment” are not present (e.g. DTAAAs with Belgium, Israel, The Netherlands and Sweden). Further, the India-France DTAA has a specific paragraph on “payment for the use of equipment”.

- (ii) Some DTAAAs (e.g. Canada, United Mexican States, Switzerland, USA) have a specific clause covering gains derived from alienation of IPs, which are contingent upon productivity or use or disposition thereof, within the ambit of royalty.
- (iii) Some DTAAAs (e.g. Turkmenistan, Russia, Morocco and Trinidad and Tobago) specifically include payments for “use of or right to use computer software” within the ambit of royalty.
- (iv) The DTAAAs with Greece and United Arab Republic (Egypt), the right to tax royalty income has been provided only to the source state. In most other DTAAAs, both, the source state as well as the state of residence of the recipient have the right to tax royalty income.
- (v) Some DTAAAs have a ‘Most Favoured Nation’ (MFN) clause pursuant to which a restrictive meaning may be accorded to the term royalty. (e.g. Belgium, France, Finland, Hungary, The Netherlands, Spain, Sweden etc.)
- (vi) India-UK DTAA provides that provisions of royalty Article will not apply where the main purpose of the creation / assignment of rights in relation to which the royalties are paid is to take advantage of the DTAA.
- (vii) The recently notified India-Hong Kong DTAA prescribes that the benefits of the Article will not apply if the main purpose or one of the main purposes concerned with the creation or assignment of the rights in respect of which such royalties are paid, is to take advantage of the royalty article by means of such creation or assignment.

Accordingly, it would be critical to examine how the term has been defined in the relevant DTAA and what are the corresponding provisions under the Act.

Based on judicial rulings, some important aspects to be kept in mind while examining the characterization of royalty are as under:

- Ownership/possession of licence rights to the underlying asset with respect to which the payment is made and retention of ownership/licence rights therein;

- Purpose for which the payment is made;
- Substance of the whole arrangement;
- Whether it is for transfer of copyright or rights in copyrighted article;
- Whether the rendering of service is incidental to use of IPs
- Characterization of the payment in the RBI/ Government approval, if any

Deemed accrual of royalty under the Act

In addition to the taxpayers that carry out their business operations in India, royalty income could still be taxable in India for others having no presence in India under the 'deemed source' rule per section 9(1)(vi) of the Act. Income by way of royalty would be deemed to accrue or arise in India if payable to a non-resident by any of the following persons:

- (a) Government;
- (b) a **resident, except** where royalty is payable in respect of any right, property or information used or services utilized for the purposes of a **business or profession carried** on by such person **outside India** or for the purposes of making or earning any **income from any source outside India**; or
- (c) a **non-resident, where** the royalty is payable in respect of any right, property or information used or services utilized for the purposes of a **business or profession carried** on by such person **in India** or for the purposes of making or earning any **income from any source in India**

In both sub-clauses (b) and (c) above, the key criterion is whether the royalty payment is for the purpose of:

- a business/ profession in India; or
- earning any income from any source in India

Once either of these conditions is satisfied, irrespective of whether the payment is made by a resident or a non-resident, the income would be deemed to accrue or arise in India and consequently taxable in India.

Deemed royalties under the India's DTAA's

Under the DTAA's, there are three circumstances under which royalties are deemed to arise. These are discussed below:

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- (a) **Payer Rule** – In most DTAA's, royalties are deemed to arise in a state when payer is that state itself, a political sub-division, a local authority, or a resident of that State. In other words, the royalties are taxable based on the residence of the payer.
- (b) **Permanent Establishment ('PE') Rule** – Most DTAA's prescribe a PE source rule of taxation for royalties. As per the rule, the royalties are deemed to arise where the payer has a PE or fixed base in connection with which the liability to pay the royalties was incurred and such royalties are borne by such PE or fixed base.
- (c) **Place of use of IPs Rule/ Use Rule** – The India-Finland DTAA provides the most restrictive rule for taxation of royalties. As per this rule, where the IP for which the royalties are paid is used within a Contracting State then such royalties shall be deemed to arise in the State in which the IP is used. The definition provided under the India-Finland DTAA may be accorded to some other DTAA's by way of the MFN clause such as France, Sweden, Spain, The Netherlands, Belgium, Hungary etc.

In the case of Qualcomm⁴⁰, it was held that when a royalty is for the use of a technology in manufacturing, it is to be taxed at situs of manufacturing of the product, and, when royalty is for use of technology in functioning of product so manufactured, it is to be taxed at situs of use.

In view of the above, it can be construed that the source rule under the DTAA plays a vital role while examining the taxability of royalties and may actually provide a benefit vis-à-vis provisions of the Act.

11.1.3 Some practical aspects/ controversies on royalty: Principles emanating from select judicial rulings with respect to different payment types are discussed below:

Payment for software – Copyright vs Copyrighted article

Taxation of software is perhaps one of the most litigious issue on taxation of royalty. Courts have taken divergent views, while the majority of the rulings remain in favour of the taxpayer. Unlike a typical sales contract, a precursor to a software sale is the entering into of a license agreement. The Revenue Authorities contend that granting of a license to use the software is a right to use granted to the purchaser and hence, the payments are in the nature of royalties. On the other hand, the taxpayers contend that software being a

⁴⁰ Qualcomm Incorporated v. ADIT [2015] (56 Taxmann.com 179) (Delhi ITAT)

product (just like a book), it is akin to a copyrighted article and hence a distinction needs to be drawn between a 'use of a copyright' vis-à-vis 'use of a copyrighted article'.

One of the key argument on 'use of a copyrighted article' is that there is no commercial exploitation by the purchaser of the embedded copyright (e.g. ability to create multiple copies of the software for onward sale, etc.). Consequently, it cannot be construed as 'use of the copyright' but is essentially a purchase transaction involving simple purchase of a copyrighted article. The judicial view is divided on this and the retrospective amendment to the definition of royalty incorporating 'use of computer software' under the Act by Finance Act 2012 has amplified the dispute.

Judicial view - Right to make a copy is part of the Copyright itself

The Karnataka High Court in the case of Samsung Electronics⁴¹ has held that payments for off the shelf software amounts to royalty not only under the Act, but also under the US treaty. There are various rulings⁴² before and after the retrospective amendment as stated above wherein a similar view has been upheld.

Judicial view - Copyrighted article is different from 'Copyright' itself

The Delhi High Court in the case of Infrasoftware⁴³ has observed that the license granted to the licensee permitting him to download the computer programme and storing it on a computer system for his own use was only incidental to the facility extended to the licensee to make use of the copyrighted product for his internal business purposes.

The Delhi High Court in the case of Nokia Networks⁴⁴, held that there is a clear distinction between royalty paid on transfer of copyrights and consideration for transfer of copyrighted articles. There are various rulings⁴⁵ before and after the amendment wherein this view has been upheld.

⁴¹ CIT vs Samsung Electronics Co. Ltd. [2012] 345 ITR 494 (Kar)

⁴² Sunray Computers (2011) (Kar HC); Solid Works Corporation (2012) (Mum ITAT); P.S.I. Data Systems (2012) (Kar HC); Microsoft Regional Sales (2013) (Del ITAT)

⁴³ DIT vs Infrasoftware Ltd. [2013] 39 Taxmann 88 (Del)

⁴⁴ DIT vs Nokia Networks OY [2012] 25 Taxmann 225 (Del)

⁴⁵ Novell Inc. (2011) (Mum ITAT); Convergys Customer Management Group Inc. (2013) (Del ITAT); Micro Focus Ltd v. DCIT([2018] 94 Taxmann.com 173); Principal CIT vs M. Tech India (P.) Ltd. ([2016] 67 Taxmann.com 245); Cienna India (P) Ltd v. ITO(Intl. tax)[(2018) 96 Taxmann.com 17]

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Currently, a special leave petition has been admitted by the Supreme Court for adjudication on this matter and ultimately the apex court would need to draw a line and settle this controversy.

Taxation of Foreign Telecasting Channels - Use of Satellite / Transponder Hire charges

Satellite operators and their customers (including broadcasting and telecommunication enterprises) frequently enter into “transponder leasing” agreements under which the satellite operator allows the customer to utilise the capacity of a satellite transponder to transmit over large geographical areas. Payments made by customers under typical “transponder leasing” agreements are made for the use of the transponder transmitting capacity.

Payment for satellite transponder charges is an important taxation issue. As per the Act, the term royalty inter-alia covers the consideration for use of “process”. Further, by virtue of the amendment made by Finance Act 2012, process is deemed to include transmission by satellite, whether or not such process is secret. However, as per most DTAAAs, royalty includes consideration received for the use of “secret process” and not merely a “process” in order to qualify as royalty.

The main controversy in these cases is whether the use of a satellite is a “process” or not. The Indian Tax Authorities tend to take a view that the series of acts undertaken within the transponder are done to achieve a particular result, i.e. to make the signals viewable, and this clearly qualifies as a “process” and the consideration for the “use” of which would amount to royalty. On the other side, taxpayers argue that while providing transmission services to its customers, the control of the satellite always remains with the satellite operator and the customers are only given access to the transponder capacity. The customer does not therefore use the satellite or the “process” of the satellite itself and therefore, the consideration for use of transponder capacity would not amount to royalty.

The Delhi High Court in the case of Asia Satellite⁴⁶ held that no income is deemed to accrue in India from the use of Satellite outside India to beam TV signals into India even if bulk of revenue arises due to viewers in India since the control or possession of the satellite was not parted with in the transaction. The retrospective amendment made by the Finance Act, 2012 overruled these principles under the Act. However, there have been

⁴⁶ Asia Satellite Telecommunications Co. Ltd Vs DIT [2011] 332 ITR 340 (Del)

subsequent rulings wherein it has been held that unilateral amendment made into the Act cannot be read into the treaty unless the latter is amended/ renegotiated. Consequently, reliance upon the beneficial treaty provisions would continue to apply⁴⁷.

Contrary to the above rulings, the Mumbai Tribunal in the case of Viacom⁴⁸ held that the use of a transponder involves use of a process. As the term process is not defined under the India-US DTAA, the same is required to be interpreted as per Explanation 6 of section 9(1)(vi) of the Act. The payment in question therefore qualifies as royalty.

Currently, a special leave petition has been admitted by the Supreme Court in case of New Skies Satellite BV for adjudication on this matter and ultimately the apex court would need to lay down the principles and settle this controversy.

Subscription charges for online access to Database/ Server/ Portal

The question here is whether the payment of subscription to access an online database, server, portal, journals, reports, etc. falls within the ambit of the term 'imparting of any information concerning technical, industrial, commercial or scientific knowledge, experience or skill' so as to constitute royalty. The view of the judiciary is divided on this issue and there are judicial precedents on both sides which are briefly discussed below:

Judicial view – subscription fee does not amount to royalty

In the case of HEG Limited⁴⁹, the assessee subscribed to a journal which gave commercial information on a particular industry. The Revenue Authority held the view that such subscription charges were in the nature of royalty since the journal was of commercial nature. The High Court held that the mere characteristic of the journal being commercial in nature would not make it a thing for which royalty would be payable. Some sort of expertise or skill was required. So, in the absence of such skill in the journal, payments made to it would not be royalty. In the case of Factset Research System and Dun and Bradstreet⁵⁰, a similar view has been taken.

⁴⁷ B4U International Holdings Ltd. Vs. DCIT [2012] 21 Taxmann.com 529 (Mum ITAT); DIT v. New Skies Satellite BV [2016] 68 Taxmann.com 8 (Delhi)

⁴⁸ Viacom 18 Media (P.) Ltd. vs. ADIT [2014] 66 SOT 18 (Mumbai ITAT).

⁴⁹ CIT vs HEG [2003] 130 Taxmann 72 (MP)

⁵⁰ Factset Research System Inc. (2009) (182 Taxman 268) (AAR); Dun and Bradstreet Espana S.A. (142 Taxman 284) (AAR)

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Judicial view – subscription fee amounts to royalty

In the case of WIPo Ltd.⁵¹, it was held that though subscription access to journal may seem different from a software license, it is nothing but a license to use ('right to use') the journal and hence, will amount to royalty. Following the ruling in case of WIPo, Mumbai ITAT in case of Gartner⁵² has held that the subscription fee to subscribe to a research product sold by assessee, a foreign company, amounts to royalty. The ruling in the case of ONGC⁵³ is also against the taxpayer on this issue.

As there are divergent views on this issue, the matter would be set at rest by a decision of the Supreme Court, laying down the law finally, to be followed by all the Courts and Tribunals including the AAR.

Use of IPs incidental to business activities/ rendering of services

In some instances, the use of IPs such as trade-marks, trade-name, logo etc. may be incidental to carrying on a business activity or rendering of a service. In such a scenario, the issue arises whether the use of such IPs being an incidental activity could be construed as royalty income or business profits.

In case of Sheraton International⁵⁴, the Delhi High Court held that the main service rendered by taxpayer to its clients-hotels was advertisement, publicity and sales promotion keeping in mind their mutual interest and in that context, use of trademark, trade name or other enumerated service referred to in agreement with assessee were incidental to said main service and, therefore, payments received were neither in nature of royalty nor were in nature of FTS under the Act as well as Article 12 of the DTAA.

In case of Formula One⁵⁵, the Delhi High Court has held that the amounts payable by Jaypee to the taxpayer under the race promotion agreement are for the predominant purpose of hosting and staging the championship race and not for the use of trademark i.e. F1 mark. The use of F1 mark by Jaypee had been strictly confined and limited to use only for promotion of event, and for no other purpose and in no other manner whatsoever. Accordingly, relying on the ruling of Sheraton International (supra), it was held that the

⁵¹ CIT vs WIPo Ltd. [2011] 203 Taxmann 621 (Kar)

⁵² Gartner Ireland Ltd. Vs ADIT [2013] 37 Taxmann.com 16 (Mumbai - Trib.)

⁵³ ONGC Videsh (2013) (Del ITAT) [20 ITR(Trib.) 767]

⁵⁴ DIT Vs. Sheraton International Inc. [2009] 178 Taxman 84 (Delhi)

⁵⁵ Formula One World Championship Ltd. Vs. CIT [2016] 76 taxmann.com 6 (Delhi);

use of the trademarks was purely incidental and therefore, the amounts paid to Formula One by Jaypee were held as business profits.

In view of the above, it can be construed that where the predominant purpose of the arrangement is to carry out a business activity or to render services, then the use of such IPs would not be considered as the principal purpose and hence no portion of the consideration can be held to be royalty.

11.1.4 Granting space or distribution rights for online advertisements:

The characterisation of payments in the digital and online space has been a vexed issue. The revenue authorities contend that such payments are in the nature of 'royalty' and therefore taxable in India whereas the taxpayers contend that these payments are in the nature of business profits and hence, should not be taxable in the absence of a PE in India.

The Mumbai Tribunal in the case of Yahoo India⁵⁶ held the payment made by assessee to Yahoo Holdings Hong Kong Ltd ('YHHL') for services of uploading and display of banner advertisement of the Department of Tourism of India on its portal was not in the nature of royalty as defined in the Act. The Tribunal held the consideration received by YHHL to be in the nature of business profits and in the absence of a PE of YHHL in India, the same is not chargeable to tax in India.

Similar views were taken by the Mumbai ITAT in the cases of Pubmatic India⁵⁷, Pinstorm Technologies⁵⁸ and eBay International⁵⁹.

In the case of Right Florists⁶⁰, the Kolkata Tribunal held that online advertising fee paid to foreign search engine company are not fees for technical services and hence, not taxable in India in the absence of a PE of such foreign company in India.

In the case of Google India⁶¹, the Bangalore Tribunal created a link between the AdWord Distributor Agreement and the Service Agreement, under which

⁵⁶ Yahoo India (P) Ltd vs DCIT: 140 TTJ 195;

⁵⁷ ITO vs Pubmatic India (P) Ltd: 60 SOT 54;

⁵⁸ Pinstorm Technologies (P) Ltd vs. ITO: (2012) 154 TTJ 173;

⁵⁹ eBay International AG vs. DDIT: (2012) 151 TTJ 769;

⁶⁰ ITO v. Right Florists Pvt. Ltd, [2013] 143 ITD 445(Kol);

⁶¹ Google India (P.) Ltd. v. Joint DIT (Int. Tax), Range-1, Bengaluru [2018] 93 taxmann.com 183 (Bangalore - Trib.);

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Google India was licenced to use trade marks, IPRs, brand features, derivative works and other intangibles etc.,. It ruled that the activities performed by Google India under the AdWord agreement was not just for providing advertisement space only but also for utilising the search engine technology, and the attendant IPR and features that was required for performing various activities including accepting advertisements and providing pre and post sales services. Therefore, the consideration paid by Google India to Google Ireland was in the nature of royalty.

The Finance Act, 2016 had introduced the concept of an equalisation levy to be charged at the rate of 6% of the amount of consideration for specified services (online advertisement, provision of digital advertisement space, etc.) received or receivable by a non-resident not having a PE in India. Further, income from such specified services shall be exempt once it is subject to equalisation levy.

The Bangalore Tribunal noted that equalization levy is charged on the consideration for specified services and not for the services provided in the present case (i.e. use of IPR, copyright, etc.). The ITAT stated that since Google India had acquired a license to use IPRs, copyright and other intangibles to provide better services, either to Google Ireland or to the advertisers, the introduction of equalization levy would not convert the nature of payment made by Google India to Google Ireland.

11.2 Definition of FTS

FTS as per the Act

The Act defines FTS to mean consideration (including any lump sum consideration) for rendering of any **managerial, technical or consultancy services** (including the provision of services of technical or other personnel) **but does not include** consideration for any construction, assembly, mining or like project undertaken by the recipient or consideration which would be income of the recipient chargeable under the head 'Salaries'.

Source rule for taxation of FTS as per the Act and DTAA

FTS will be taxable per the source rule of taxation as provided under the Act or DTAA whichever is more beneficial to the taxpayer. The source rule of taxation of FTS is similar to the source rule of taxation of royalties as discussed at para 2.2 and 2.3 above.

FTS under the Model Conventions

The OECD Model Convention and the US Model Convention do not contain the concept of FTS. It normally forms part of Article 7 ('Business Profits'). Most treaties India has entered into provide a FTS clause which is dealt with in Article 12 along with royalties. Generally, the FTS clause provides a right to tax to the country of source. In simple terms, if the source of such income is from India, then the overseas service provider will be subjected to tax in India.

Recently, the UN Model Convention in its 2017 version (released in May 2018) inserted Article 12A providing for a source based taxation for FTS in a contracting state. The scope of FTS is wide enough to cover any payment of a managerial, technical or consultancy nature.

The term FTS as used in the Convention means any payment in consideration for any service of a 'managerial', 'technical' or 'consultancy' nature, unless the payments are made:

- (a) to an employee of the person making the payment; or
- (b) for teaching in an educational institution or for teaching by an educational institution; or
- (c) by an individual for services for the personal use of an individual.

FTS under the India DTAA's

Most DTAA's which India has entered into, are based on the UN model convention. Each DTAA has its own definition of the term FTS. Some distinctive features of India DTAA's are discussed in ensuing paragraphs.

11.2.1 Absence of article/ clause on FTS in the DTAA: It is interesting to note that, in some DTAA's⁶² India has entered into do not contain the FTS clause/ article. In such a case, an ambiguity arises as to whether such income would be taxed under the article dealing with 'Business Profits' or residuary article 'Other Income' or under the provisions of the Act.

This issue is of significant importance to the Source State as classification of such income as 'Business Profits' may result in income not being taxed at all in the absence of a PE in the source state. There are divergent views on this issue which are given below:

⁶² DTAA's with Brazil, Thailand, Greece, Mauritius, Philippines, Sri Lanka, Syria, UAE, Saudi Arabia, Myanmar, Bangladesh

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- (a) **Taxable as 'Business Profits'** – In absence of FTS clause, the income would be governed under the Business Profits' Article where the fee is earned by rendering services in the normal course of its business. Hence would be taxable in India only if the taxpayer has a PE in India⁶³
- (b) **Taxable as 'Other Income'** – Another view is that in absence of FTS clause, the taxability of the income needs to be evaluated under the 'Other Income' Article⁶⁴
- (c) **Taxable as per the Act** – There is yet another view that if a DTAA is silent on a particular type of income, such income cannot be automatically construed as 'Business Profits' or 'Other Income' and reference should be made to the provisions of the Act⁶⁵.

On the basis of the available judicial precedents and the general rules of interpretation of the DTAAs, a view can be taken that where the FTS clause is absent in a DTAA, the income could be covered in the 'Business Profits' or 'Other Income' Article depending upon the nature of the services rendered and its correlation with the business activities of the service provider.

11.2.2 Absence of 'Managerial' from the definition: It is pertinent to note that, in some DTAAs⁶⁶ the definition of the term 'FTS' includes only technical and consultancy services and does not contain the word 'managerial'. In case the services do not qualify as technical or consultancy services, it is possible to take a position that the payment is not covered within the purview of Article 12. Thus, the same qualifies as business income under Article 7 and would be taxed only if the non-resident has a PE in India.

In the case of Raymond⁶⁷, it has been held that managerial services being outside the purview of the definition of FTS, no part of the fees for 'managerial services' could be considered as fees for technical services and therefore could not be charged to tax. A similar view was taken in the context of India-US DTAA in the case of Raytheon⁶⁸.

⁶³ ACIT vs Viceroy Hotels Ltd. (2011) 11 Taxmann 216 (Hyd); Mckinsey & Co (Thailand) Co. Ltd. vs DDIT(2013) 36 Taxmann 375(Mum); Golf In Dubai, In re [2008] 174 Taxman 480 (AAR)

⁶⁴ Lanka Hydraulik Institute Ltd, In Re (2011) 199 Taxmann 232

⁶⁵ CIT vs TVS Electronics (2012) 22 Taxmann 215 (Chennai)

⁶⁶ DTAAs with Australia, Netherlands, Canada, Spain, Portugal, UK, USA

⁶⁷ Raymond Ltd vs DCIT (2003) 80 TTJ 120 (Mum)

⁶⁸ Raytheon Ebasco Overseas Ltd. [2016] 68 Taxmann.com 133 (Mum ITAT)

11.2.3. DTAA's having restrictive scope – 'Make Available' criteria to be satisfied: Some DTAA's⁶⁹ entered into by India contain a narrower definition of FTS owing to the inclusion of a 'make available' clause. DTAA's that contain this clause restrict the taxability of FTS only to those situations where the services make available technical knowledge, experience, skill know-how or processes, or consist of the development and transfer of a technical plan or technical design to the recipient of services. In other words, where FTS do not make available technical knowledge, know-how or skill etc., the same will not be taxable.

The Karnataka High Court, in case of De Beers⁷⁰ has held that the services will be said to be made available to the recipient where recipient of services is enabled and empowered to make use of the technical knowledge by itself in its business or for its own benefit without recourse to the original service provider in the future.

The term 'make available' has not specifically been defined. However, the guidance is provided in the Memorandum of Understanding (MOU) appended to the India-US DTAA. The explanation provided in the MOU is as follows:

- Technology will be considered 'made available' when the person acquiring the service is enabled to apply the technology
- Provision of requiring technical input by the person providing the service does not per se mean that technical knowledge, skills, etc., are made available
- Use of a product which embodies technology shall not per se be considered as making the technology available

The MOU provides by way of examples certain services wherein technology is made available. The specified illustrative services include bio-technical services, environmental and ecological services, food processing, geological surveys, scientific services, technical training etc.

An issue arises whether the explanation/ MOU to the India-US DTAA can be applied while interpreting the 'make available' clause in other DTAA's.

The AAR in case of Intertek⁷¹ and Kolkata ITAT in case of C.E.S.C.⁷² have

⁶⁹ DTAA's with Australia, Canada, Netherlands, Portugal, USA, UK, Singapore, Netherlands, Cyprus

⁷⁰ CIT v De Beers India Minerals (P) Ltd 346 ITR 467 (Karnataka HC)

⁷¹ Intertek Testing Services India Pvt. Ltd., [2008] (175 Taxmann 375) (AAR).

⁷² C.E.S.C Ltd vs. DCIT [2003] (80 TTJ 806) (Kolkata ITAT)

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held that the explanation as provided in the MOU to the India-US DTAA should be equally applicable to all other Indian DTAA's wherein the 'make available' criteria is provided.

11.2.4 Principle Purpose Test (PPT) clause in India-Hong Kong DTAA:

The recently notified India-Hong Kong DTAA prescribes that the benefits of the Article will not apply if the main purpose or one of the main purposes concerned with performance of services in respect of which the technical fees are paid, is to take advantage of the FTS Article by means of such performance of services.

11.2.5 Some practical aspects/ controversies on FTS: Principles emanating from select judicial rulings with respect to different payment types are discussed below:

Use of Standard Facilities does not constitute as Technical Services

There are instances of service which employ technology as well as IP like copyrights, patents and secret processes and know-how. But the question that arises is whether the service could be held to be technical service even in the absence of service or transfer of any experience or such similar intellectual property to the customer.

In the case of Skycell⁷³ the Taxpayer was a mobile network service operator, and the Revenue Authorities claimed that technical services were provided. The Court held that mere collection of a fee for use of a standard facility provided to all those willing to pay for it does not amount to the fee having been received for technical services.

In case of Bharti Cellular⁷⁴, it has been held that the word 'technical' has to be read along with 'managerial' and 'consultancy services'. Both 'managerial' and consultancy services involve some human element. The word technical as appearing in the expression should also have some human element. In the present case, there is no human interface. Therefore, it cannot be said that there is technical service.

Based on the above, it would appear that a technical service cannot be a standard generic service, and that there has to be involvement of human interface with constant human endeavour.

⁷³ Skycell Communications Ltd. v. DCIT (251 ITR 53)

⁷⁴ CIT vrs Bharti Cellular Limited (Delhi) 330 ITR 239 (SC)

Reimbursement of salary under Secondment arrangement vs. FTS

A secondment agreement is typically used when an employee working in a country (home country) is deputed to work for another entity in another country (host country) for certain duration and his salary is paid/ borne by the entity in host country. Generally, the seconded employees work under the control and supervision of the entity in host country. However, he continues to be employed in the home country as his social security contribution is paid in his home country.

Ongoing controversy in such arrangements is that where the salary cost is re-charged by the home country to host country, whether such payments would qualify as pure reimbursement of salary cost or as FTS. There are divergent views on this issue which are discussed below:

Judicial view – salary cost construed as reimbursement and not taxable

In the case of Morgan Stanley⁷⁵, the Mumbai ITAT has held that the payment in question being reimbursement of salary is not FTS in light of relevant provisions of the Act and India-Singapore DTAA. Further, there is no dispute that the assessee has made payment towards the reimbursement of salary expenditure, which clearly shows that there is no element of profit in the said payment as supported by the agreement. It has been further held that even otherwise, the entire amount of salary received by the seconded employee, has been subjected to tax in India and accordingly falls under the exception provided in the definition of FTS under the Act.

In case of Abbey Business Services⁷⁶, the Bangalore ITAT has held that where an Indian company pays all expenses incurred by a foreign parent company towards employees seconded to Indian company, such payment, being pure reimbursement, cannot be regarded as income in hands of foreign company; neither can it amount to FTS.

Judicial view – salary cost construed as FTS, therefore taxable

In the case of AT&S⁷⁷, it has been observed that under the secondment agreement, the applicant is required to compensate the Austrian company for all costs directly or indirectly arising from the secondment of personnel and the compensation is not limited to salary, bonus, benefits, personal travel, etc., though salary, bonus, etc., and the amounts referred to in secondment

⁷⁵ Morgan Stanley Asia (Singapore) Pte. Ltd. - [2018] 95 Taxmann.com 165 (Mumbai - Trib.)

⁷⁶ Abbey Business Services (India) (P.) Ltd. Vs DCIT [2012] 23 Taxmann.com 346 (Bang.)

⁷⁷ AAR vs AT&S India Private Limited (287 ITR 421)

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agreement form part of compensation. Accordingly, the payments made by the applicant to AT&S Austria in respect of seconded personnel were held to be FTS as per the Act as well as India-Austria DTAA.

In case of Flughafen Zurich⁷⁸, the payments made under the secondment arrangement have been held as FTS on account of the reason that the skilled personnel were seconded for rendering managerial services by the non-resident entity engaged in providing operations and management services to airports.

In view of the above, one needs to be cognisant of the above controversies while entering into secondment arrangements. Further, there is controversy on creation of a PE in India under secondment arrangements (the same has not been discussed here).

Are professional services FTS?

Most DTAA's, entered into by India contain a specific exclusion for IPS⁷⁹ (e.g. Belarus, Belgium, Czech Republic, Hungary, Ireland, Russia, UK, USA etc.). However, some of DTAA's (e.g. Austria, China, Germany, Israel etc.) do not provide for this specific exclusion of IPS from FTS. In such cases, where specific carve-out is not provided, a conflict arises on which Article will prevail over the other.

It has been held by various judicial rulings⁸⁰, that once the services are covered as IPS under Article 14 then it is immaterial whether or not the same is covered by the FTS of Article 12. In other words, if more beneficial provisions are available to a taxpayer, application of lesser beneficial provisions would be irrelevant, even though the services might have been covered by the definition of such lesser beneficial provisions.

Accordingly, the provisions of IPS Article, being specific provisions for professional services, will override the relatively general provisions of FTS Article.

⁷⁸ Flughafen Zurich, AG Vs DDIT [2017] 79 Taxmann.com 199 (Bangalore - Trib.)

⁷⁹ Per UN Model Convention, IPS covers "professional services" that are defined to include especially the services of independent scientific, literary, artistic, educational or teaching activities as well as the independent activities of physicians, lawyers, engineers, architects, dentists and accountants.

⁸⁰ Maharashtra State Electricity Board v. DCIT (2004) (90 ITD 793) (Mum ITAT); Graphite India Ltd. v. CIT (86 ITD384) (Kol ITAT); Dieter Eberhard Gustav Van Der Mark v. CIT (1999) (235 ITR 698) (AAR)

Conclusion: Based on the peculiarities involved in the definitions of royalty and FTS under the Act as well as DTAA's and ongoing controversies as discussed above, it is apparent that the characterization of a particular transaction as a royalty or FTS is complex and often debatable.

12. Most Favoured Nation (MFN) clause (generally applicable to Articles 10, 11 and 12)

A tax treaty between two countries (or the Protocol thereto) may provide that certain beneficial provisions of tax treaties concluded by either of the two countries with certain other countries need to be additionally applied while applying the tax treaty between the two countries – such provision is referred to as the Most Favoured Nation (or MFN) clause. A MFN clause in a tax treaty between two countries enables certain beneficial provisions of tax treaties that the two countries conclude with certain other countries to be extended to / transposed into the tax treaty between the two countries as well so that the residents of the two countries are also eligible to obtain the tax benefits emanating from these beneficial provisions. For example, the concessional rate for taxation of FTS in the tax treaty between Country A and Country B is 15% and this tax treaty has a MFN clause. Subsequently, Country A concludes a tax treaty with Country C which provides for a concessional rate for taxation of FTS of 10%. Due to the operation of the MFN clause in the tax treaty between Country A and Country B, residents of Country B will also be subject to a concessional tax rate on FTS of 10% (emanating from the tax treaty between Country A and Country C) in Country A in respect of FTS arising in Country A.

Typically, in India's case, tax treaties with certain OECD countries (e.g. France, Sweden, Switzerland) have the MFN clause that is linked to future tax treaties that India may conclude with other OECD countries. In the case of *Steria India Limited [2016] 386 ITR 390 (Delhi)*, Steria India had made payments for managerial services to Steria France. While the India-France tax treaty covers managerial services within the definition of FTS, the Protocol to the India-France tax treaty also has a MFN clause, which allow importing into the India-France tax treaty a lower tax rate on FTS as well as a restricted scope of taxability of FTS contained in a future tax treaty that India enters with any other OECD country. The India-UK tax treaty entered into subsequently has a narrower definition of FTS and payments for managerial services do not fall under FTS under the India-UK tax treaty. Steria India's position (as a payer-deductor) around non-taxability of these payments for

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managerial services to Steria France on the basis of the MFN clause in the Protocol to the India-France tax treaty read with the India-UK tax treaty, was eventually upheld by the Delhi High Court.

13. Taxability of remittance by an Indian payer to a non-resident involving income under the head Capital Gains (Article 13)

Background

Section 2(14) defines a “capital asset” to mean property of any kind, subject to certain exclusions (e.g. stock in trade, personal effects). Section 2(47) defines “transfer” and includes transfer by various modes as well as certain transactions that are deemed to be a “transfer”. Under section 45, Capital Gains is chargeable upon “transfer” of a “capital asset”.

Apart from Capital Gains earned by Indian residents, India also levies a tax on the Capital Gains earned by non-residents from transfer of capital assets situated in India under section 9(1)(i) (last limb). Vide the Finance Act, 2012, section 9(1)(i) was retrospectively amended by inserting certain Explanations therein to provide that shares of / interest in a company / other entity established outside India will be deemed to be situated in India if the shares derive their value substantially (i.e. more than 50% of their value) from assets located / situated in India, thereby extending Indian taxability to gains earned by non-residents from indirect transfer of Indian assets in the above circumstances.

The tax rate on Capital Gains varies between 10% and 40% depending on various factors such as constitution of the taxpayer, type of asset, period of holding etc.

Taxability of Capital Gains under the tax treaty

We have given below a clause-by-clause analysis of the Capital Gains Article (Article 13) of the UN Model. The language of the Capital Gains Article in the OECD Model is more or less similar.

- (a) *Gains derived by a resident of a Contracting State from the alienation of immovable property referred to in Article 6 and situated in the other Contracting State may be taxed in that other State.*

This rule allows full taxation of the gains on transfer of immovable property located in the country who is a party to a

particular tax treaty (i.e. source country), in the hands of the transferor who is resident in the country who is the other party to that tax treaty (i.e. country of residence of the transferor), in the source country. The immovable property in this context is the immovable property referred to in Article 6 (Income from Immovable Property).

Article 6(2) provides that the term “immovable property” shall have the meaning which it has under the law of the Contracting State in which the property in question is situated. It further provides for certain inclusions in and exclusions from what constitutes immovable property, e.g. property accessory to immovable property. It specifically excludes aircrafts and ships as the Capital Gains on transfer of these assets is separately dealt with in Article 13(3). Shares of / interest in a company / other entity that derives its value from immovable property is also not included under this clause as the Capital Gains on transfer of such assets is separately dealt with in Article 13(4). This rule also covers immovable property forming part of assets of a PE / fixed base that the non-resident transferor may have in the source country.

This rule is silent on other aspects of taxation of transfer of immovable property (e.g. manner of taxation, rate of tax, any exemption from taxation etc) prevalent in the source country, and hence, will be fully subject to the domestic tax law of the source country.

This rule does not preclude taxation / exemption from taxation in the country of residence of the transferor as per the domestic tax law of the country of residence of the transferor.

- (b) *Gains from the alienation of movable property forming part of the business property of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State or of movable property pertaining to a fixed base available to a resident of a Contracting State in the other Contracting State for the purpose of performing independent personal services, including such gains from the alienation of such a permanent establishment (alone or with the whole enterprise) or of such fixed base, may be taxed in that other State.*

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This rule allows full taxation of the gains on transfer of movable property forming part of assets of a PE / fixed base that the transferor who is resident in a particular country who is a party to the tax treaty (i.e. country of residence of the transferor) may have in the country who is the other party to that tax treaty (i.e. source country), in the hands of the transferor, in the source country. Such movable property may also be located outside the source country. Taxation under this rule can be resorted to even after cessation of the PE / fixed base. However, assets of the transferor located / situated in the source country but not forming part of a PE / fixed base of the transferor in the source country (if any) will not be covered by this rule.

Movable property has not been defined and would typically be interpreted in accordance with the law of the country where the property is situated. In the Indian context, movable property means all property other than immovable property (section 3(36) of the General Clauses Act, 1867).

This rule is also extended to cover cases of transfer of the movable property forming part of assets of a PE / fixed base upon transfer of the PE / fixed base or even the enterprise itself.

This rule is silent on other aspects of taxation of transfer of movable property (e.g. manner of taxation, rate of tax, any exemption from taxation etc) prevalent in the source country, and hence, will be fully subject to the domestic tax law of the source country.

This rule does not preclude taxation / exemption from taxation in the country of residence of the transferor as per the domestic tax law of the country of residence of the transferor.

- (c) *Gains that an enterprise of a Contracting State that operates ships or aircraft in international traffic derives from the alienation of such ships or aircraft, or of movable property pertaining to the operation of such ships or aircraft, shall be taxable only in that State.*

This rule provides for exclusive taxation of the gains on transfer of ships and aircrafts operated in international traffic and other movable property pertaining to such operation, in the hands of the transferor who is resident in the country who is a party to the tax treaty (i.e. country of residence of the transferor), in the

country of residence of the transferor only. Article 13(3) being a specific rule takes precedence over Article 13(2) which is a general rule applicable to movable property in general.

This rule is silent on other aspects of taxation of transfer of ships and aircrafts (e.g. manner of taxation, rate of tax, any exemption from taxation etc) prevalent in the country of residence, and hence, will be fully subject to the domestic tax law of the country of residence.

- (d) *Gains derived by a resident of a Contracting State from the alienation of shares or comparable interests, such as interests in a partnership or trust, may be taxed in the other Contracting State if, at any time during the 365 days preceding the alienation, these shares or comparable interests derived more than 50 per cent of their value directly or indirectly from immovable property, as defined in Article 6, situated in that other State.*

This rule allows full taxation of the gains on transfer of shares of / interest in a company / other entity that derive more than 50% of their value directly or indirectly from immovable property situated in a particular country that is a party to a tax treaty (i.e. source country) at any time during a certain period of time (365 days in both the UN and OECD Models), in the hands of the transferor who is resident in the country who is the other party to that tax treaty (i.e. country of residence of the transferor), in the source country. The shares / interest in question could also be of a company / other entity established in a third country. There is no scope for limiting taxation in the source country of such gain proportionate to the immovable property situated in the source country. The usage of the term 'directly or indirectly' serves as a 'look through' provision allowing taxation in a scenario where the ownership of the immovable property situated in the source country is through a multi-tier holding structure and the transfer of shares / interest is of a upper tier company / other entity. The immovable property in this context is the immovable property referred to in Article 6 (Income from Immovable Property). There is also no de-minimus shareholding threshold for this rule to trigger.

This rule applies to shares / interests of all kinds (e.g. listed or unlisted) and irrespective of the manner of transfer (e.g.

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corporate reorganization or liquidation). This rule does not apply to transfer of other instruments such as debentures, bonds etc of such company / other entity.

This rule is silent on other aspects of taxation of transfer of the shares (e.g. manner of taxation, rate of tax, any exemption from taxation etc) prevalent in the source country, and hence, will be fully subject to the domestic tax law of the source country.

This rule does not preclude taxation / exemption from taxation in the country of residence of the transferor as per the domestic tax law of the country of residence of the transferor.

This rule is somewhat akin to the indirect transfer rules introduced in India's domestic tax law, but limited to immovable property situated in India.

- (e) *Gains, other than those to which paragraph 4 applies, derived by a resident of a Contracting State from the alienation of shares of a company, or comparable interests, such as interests in a partnership or trust, which is a resident of the other Contracting State, may be taxed in that other State if the alienator, at any time during the 365 days preceding such alienation, held directly or indirectly at least ___ per cent (the percentage is to be established through bilateral negotiations) of the capital of that company.*

This rule is present only in the UN Model. This rule and Article 13(4) are mutually exclusive and hence this covers shares other than those covered under Article 13(4).

This rule allows full taxation of the gains on transfer of shares of / interest in a company / other entity which is resident in a particular country that is a party to a tax treaty (i.e. source country), in the hands of the transferor who is resident in the country who is the other party to that tax treaty (i.e. country of residence of the transferor), in the source country, if the transferor has a substantial shareholding (to be agreed in bilateral negotiations) in the concerned company / other entity at any time during a certain period of time (365 days in both the UN and OECD Models). Several tax treaties do away with this minimum shareholding condition altogether and make the gains on transfer of shares etc taxable in the source country in all cases.

This rule applies to shares / interests of all kinds (e.g. listed or unlisted) and irrespective of the manner of transfer (e.g. corporate reorganization or liquidation). This rule does not apply to transfer of other instruments such as debentures, bonds etc of such company / other entity.

This rule is silent on other aspects of taxation of transfer of the shares (e.g. manner of taxation, rate of tax, any exemption from taxation etc) prevalent in the source country, and hence, will be fully subject to the domestic tax law of the source country.

This rule does not preclude taxation / exemption from taxation in the country of residence of the transferor as per the domestic tax law of the country of residence of the transferor.

- (f) *Gains from the alienation of any property other than that referred to in paragraphs 1, 2, 3, 4 and 5 shall be taxable only in the Contracting State of which the alienator is a resident.*

This is a residual rule provides for exclusive taxation of the gains on all other assets not covered by other clauses of Article 13, though taxable in a particular country who is a party to the tax treaty (i.e. source country), in the hands of the transferor who is resident in the country who is the other party to that tax treaty (i.e. country of residence of the transferor), in the country of residence of the transferor only.

This rule is silent on other aspects of taxation of transfer of such assets (e.g. manner of taxation, rate of tax, any exemption from taxation etc) prevalent in the country of residence, and hence, will be fully subject to the domestic tax law of the country of residence.

Special provisions in select tax treaties with respect to taxation in India of transfer of Indian shares

Erstwhile tax treaties with countries such as Mauritius, Singapore and Cyprus did not have a clause analogous to Article 13(5), and hence, most Indian shares were covered by the residuary clause, that provided for taxation only in the country of residence of the transferor (in case of Singapore, this exemption was subject to certain conditions known as the Limitation of Benefits (LOB) clause). Since these jurisdictions did not levy a capital gains tax under their domestic tax law, such gains were not taxable at all in the

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hands of the transferors. This led to a huge inflow of FDI into India from these countries, including third country residents routing their investment in India through holding companies resident in these countries. This consequently led to litigation with the Indian tax authorities, who assailed such holding structures as being tax avoidance. A case in point is the case of *Aditya Birla Nuvo Ltd vs DDIT [2012] 342 ITR 308 (Bom)*. International commentaries / jurisprudence has laid down the principle that a beneficial owner is typically a person who profits economically from the income / asset or who is fully entitled to enjoy its benefit directly or who can freely avail the income / asset and deal with it without being accountable to any other person. It is worthwhile to note that the CBDT has issued a Circular (Circular No 789 dated April 13, 2000) in the context of taxation under the India-Mauritius tax treaty of dividend and income from sale of Indian company's shares, wherein it has clarified that a TRC issued by the Mauritian authorities would constitute sufficient evidence for accepting the Mauritian residency of the shareholder as well as his beneficial ownership of the Indian company's shares. This Circular has been upheld by the Supreme Court in *Union of India vs Azadi Bachao Andolan [2003] 263 ITR 706 (SC)*. This principle laid down in this Circular has been extended by Indian judicial authorities to residents of other countries as well. The Supreme Court in the case of *Vodafone International Holding B.V. vs Union of India [2012] 1 SCR 573 (SC)* though has held that the TRC would not be a conclusive evidence of eligibility of the non-resident to claim benefits under the tax treaty, and cannot prevent inquiry by the tax department around any potentially abusive arrangements / colourable devices (such as interposition of the non-resident company before the sale of shares without any commercial reason merely to obtain benefits under the tax treaty etc). Considering the above tax environment, India renegotiated the tax treaties with these countries, whereby gains earned on transfer of Indian shares acquired from April 1, 2017 will be fully taxable in India (there is a concessional tax rate of 50% of the applicable tax rate applicable to divestments of such shares made before April 1, 2019 - in case of Singapore, this exemption is subject to the LOB clause). Gains on transfer of Indian shares acquired prior to April 1, 2017 continued to remain exempt from tax in India (in case of Singapore, this exemption continues to be subject to the LOB clause).

However, India still has tax treaties with certain countries where India does not have rights to tax gains on transfer of Indian shares, e.g. Netherlands (transfers between non-residents as well as certain other transfers); Belgium, Denmark, France, Spain & Korea (provisions analogous to Article 13(5),

though the threshold in case of Korea is 5% instead of 10%); Sweden (as long as the gains are taxable in Sweden); Philippines (no conditions attached). Hence, investors coming from these countries may still enjoy a limited capital gains tax exemption in India. It may be noted that Article 9(4) of the MLI allows taxation in the source country of gains derived by a non-resident from transfer of shares / interest in an entity deriving more than 50% of their value directly or indirectly from immovable property (real property) situated in the source country at any time during the 365 days preceding the transfer (Article 13(4) discussed above is also in sync with Article 9(4) of the MLI). In India's provisional reservations on the MLI, India has opted to apply Article 9(4) of the MLI. India has also specified a list of India's tax treaties which already provide for taxation in India where the shares / interest deriving more than a certain threshold of their value from immovable property (real property) situated in India as required under Article 9(1) of the MLI. However, the eventual applicability of Article 9 of the MLI to India's tax treaties will depend on whether the treaty partners also chose to notify the tax treaty with India as a CTA and/or adopt Article 9 of the MLI with respect to the tax treaty with India.

Taxation of indirect transfer under select tax treaties

Internationally, the situs of shares of a company has been held by Courts to be in its place of incorporation – very often, the company is also a resident of the same country where it is incorporated.

While the Indian indirect transfer rules deemed shares of / interest in a company / other entity outside India to be situated in India under certain circumstances, several tax treaties do not contain such provisions. The fact that these shares etc are deemed to be situated in India does not make the company etc a resident of India. Hence, though transfer of shares etc of a foreign company etc may be taxable in India under the indirect transfer rules, such transfer would be exempt from tax in India under the residuary clause of several Indian tax treaties. The India-US and India-UK are some startling exceptions to this as full Capital Gains taxation rights have been ceded to the source country in these tax treaties. In the case of *Sanofi Pastuer Holding SA vs DoR, MoF [2013] 354 ITR 316 (AP)*, Sanofi purchased shares of a French holding company (whose significant asset was shares in an Indian company), from some French residents. The Indian tax authorities argued before the AAR that the transaction in question was effectively a transfer of the stake in the Indian company from the French residents to Sanofi and that India had the right to tax such an indirect transfer both under the indirect

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transfer rules as well as under Article 14(5) of the India-France tax treaty, which was accepted by the AAR. The Andhra Pradesh High Court, on the other hand, while appreciating that the French holding company was not a sham but had a commercial purpose as the holding company for India investments, and also that it continued to be the owner of the Indian company's shares even after the transaction in question, held that the transaction in question was a transfer of shares of the French holding company by French residents, which was not taxable in India under the India-France tax treaty. The Sanofi matter is now *subjudice* before the Supreme Court.

Source References:

- The Income-tax Act, 1961
- The General Clauses Act, 1867
- OECD Model Tax Convention on Income and on Capital - 2017
- UN Model Double Taxation Convention between Developed and Developing Countries – 2017
- OECD Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting
- <https://www.incometaxindia.gov.in/Pages/default.aspx>
- www.taxmann.com
- The Income-tax Act, 1961
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Chapter 12

Place of Effective Management in India

This section covers:

- *Place of Effective Management in India (PoEM) – concept and definitions*
- *Guidelines for determination of PoEM*
- *Transitional provisions*

1. Background

Place of effective management (PoEM) is generally used as a tiebreaker test⁸¹ to determine the residential status of a company under tax treaties. Internationally, the concept of PoEM for determining residency of a company is not new. For instance, countries such as Switzerland, Germany, China, South Africa, Italy, Russia etc. have PoEM as one of the criteria for determining residency of a company. The OECD and UN commentary have also provided clarification and definition on the concept of PoEM. In the Indian context, in absence of specific provisions under the Income Tax Act, 1961 (the ITA), the Indian judiciary⁸² has interpreted the PoEM in diverse manner.

Under the erstwhile law, a foreign company was held to be resident in India if during that year, the control and management of its affairs was situated wholly in India. The term 'control and management' of its affairs has been a subject matter of interpretation. Indian courts have interpreted the term as under:

- The control and management refers to de facto control and not the de

⁸¹ In terms of Article 4 of the tax treaties

⁸² P No. 9 of 2995 In re, (1996) 224 ITR 337; Integrated Container Feeder Services v. CIT (2005) 278 ITR (AT) 182 (Mum); Saraswati Holding Corpn Inc v. DDIT (2207) 111 TTJ 334 (Del), P No. 10 of 1996, In re (1997) 224 ITR 473; DLJMB Mauritius Investment Co. v. CIT (1997) 228 ITR 268 (AAR); Pearl Logistics & Ex-IM Corporation v. ITO [2017] 80 taxmann.com 217 (Rajkot – Trib.); ADIT v. Bay Lines [2018] 91 taxmann.com 110 (Mumbai - Trib)

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jure and refers to controlling and directive power often described as 'head and brain'. The term 'situated' implies the functioning of such power at a particular place with some degree of permanence⁸³.

- The control and management contemplated is not the carrying on of day to day business by servants, employees or agents. The real test to be applied is, where is the controlling and directing power, or rather, where does the controlling and directing power function or to put it in a different language there is always a seat of power or the head and brain, and what has got to be ascertained is, where is this seat of power, or the head and brain⁸⁴.
- The head and brain of a company is the Board of Directors, and if the Board of Directors exercise complete local control, then the company is also deemed to be resident⁸⁵.
- As the Board of Directors subject to supervision of the shareholders actually controls and manages the affairs of the company effectively as against day to day operations, the situs of the Board of Directors should be the place of control and management. Even 99% shareholding in a company may not empower the shareholder to take decisions regarding the management of the company⁸⁶.

The Finance Act, 2015 has amended the provision with regard to tax residency⁸⁷ of companies in India. Under the amended provisions, a foreign company would be treated as tax resident of India, if it's PoEM, in the year under consideration is in India. The Finance Act, 2016 deferred the PoEM provision to be applicable from 1 April 2017 i.e. from AY 2017-18 and subsequent assessment years.

⁸³ Erin Estate, Galah, Ceylon vs. CIT 34 ITR 1 (SC), Subbayya Chettaiar (HUF) vs. CIT 19 ITR 168 (SC)

⁸⁴ Narottam and Pereira Ltd vs. CIT 23 ITR 454 (Bom-HC)

⁸⁵ CIT v. Nandlal Gandadal [1960] 40 ITR 1 (SC)

⁸⁶ Radha Rani Holdings (P.) Ltd v. ADIT Intl Taxation [2007] 16 SOT 495 (Delhi)

⁸⁷ Section 6(3)(ii)

Change in definition

Erstwhile Provisions under the IT Act	New Provisions under the ITA
A company is said to be resident in India if: <ul style="list-style-type: none">• It is an Indian company;• During that year, the control and management of its affairs is situated wholly in India	A company is said to be resident in India if: <ul style="list-style-type: none">• It is an Indian company;• Its place of effective management in that year is in India
PoEM has been defined to mean a place where key management and commercial decisions that are necessary for the conduct of the business of an entity as a whole are, in substance made	

The Explanatory Memorandum (EM) to Finance Act 2015 explains the need for this amendment. It provides that the current stipulation that the requirement of 'whole' of control and management should be situated in India, rendered it practically inapplicable, as a company could easily avoid becoming a resident by simply holding a board meeting outside India. This facilitated creation of shell companies which are incorporated outside but controlled from India. It also states that PoEM is an internationally recognized concept for determination of residence of a company and modification in the condition of residence in respect of a company by including the concept of effective management would align the provisions of the ITA with the tax treaties entered into by India with other countries and would also be in line with international standards.

1.1 If PoEM is in India

If the PoEM of a foreign company is situated in India, then it would become a tax resident in India. In such case, some of the key tax implications on such company in India are as under:

- (i) The foreign company shall be liable to pay tax in India on its worldwide income;
- (ii) It is required to file a return of income in India by 30 September / 30 November immediately following the end of the tax year ending 31 March;
- (iii) It may be required to pay advance tax in India taking into account its global income. Also, there would be interest implications for default in payment of advance tax;
- (iv) The company may also be required to withhold taxes on payment to various parties and there are interest and penal consequences for non-compliance with tax withholding requirements;

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- (v) Various registrations are required to be carried out in India by a resident company in India; such as Permanent Account Number, Tax Deduction Account Number, etc;
- (vi) The resident company may be required to prepare its books of accounts for India tax purposes. Failure to maintain / retain books of accounts, documents, etc. may attract interest and penal consequences;
- (vii) Transfer pricing provisions may also be applicable.

The CBDT through Notification No. 29/2018 dated 22 June 2018 has notified the transition provision for a foreign company that is considered as a tax resident of India for the first time.

1.2 International perspective

The definition of the term 'PoEM' under the ITA is kept in line with the OECD Commentary. Therefore, the interpretation of the term PoEM may be derived from the OECD commentary. In relation to PoEM, the OECD Commentary further provides that,

- All relevant facts and circumstances must be examined to determine the place of effective management;
- An entity may have more than one place of management, but it can have only one place of effective management at any one time.

On determining the PoEM of a company, the OECD provides various factors⁸⁸ to be considered:

- (i) Place where meetings of the Board of Directors or equivalent body of the company are usually held;
- (ii) Place where the chief executive officer and other senior executives usually carry on their activities;
- (iii) Place where the senior day-to-day management of the person is carried on;
- (iv) Place where the person's headquarters are located;
- (v) Place of which country's laws govern the legal status of the person;
- (vi) Place where its accounting records are kept.

⁸⁸ Para 24.1 to Article 4 of Commentary to the OECD Model Convention

Place of Effective Management in India

Interestingly, India has provided its reservation to the OECD interpretation of PoEM. In its view, the place where the 'main and substantial activity of the entity' is carried on is also to be taken into account while determining PoEM.

The OECD through its November 2017 update has approved the changes to the Model Convention, essentially incorporating amendments pursuant to the recommendations under the BEPS Action Plans. The 2017 Update has amended the tie-breaker rule to provide that in case of dual resident entities, the residential status shall be resolved through Mutual Agreement Procedure (MAP) between the two involved countries, having regard to the PoEM, the place of incorporation or any other relevant factors.

Similar to OECD, the United Nations (UN) Commentary also considered the PoEM as preferential criteria for determining the residential status of tax payers other than individuals. Though it does not define the term PoEM, UN Commentary provides the following factors to be considered in analyzing a PoEM in a particular jurisdiction:

- (i) Where a company is actually managed and controlled;
- (ii) Where the decision-making at the highest level on the important policies essential for the management of the company takes place;
- (iii) The place that plays a leading part in the management of a company from an economic and functional point of view; and
- (iv) Where the most important accounting books are kept.

The Protocol to the India-Belarus tax treaty also considers the factors provided under the UN Commentary in interpreting the term PoEM.

In the past, Indian judiciary has interpreted the term PoEM in diverse manner (mostly in the context of India-Mauritius tax treaty), a brief summary of which is given below:

- The word PoEM refers to the place from where, factually and effectively, the day to day affairs of the companies are carried on and not to the place in which may reside the ultimate control of the company; the general meeting of the company held in Mauritius, hence the PoEM is in Mauritius⁸⁹.

⁸⁹ P. No. 9 of 1995 220 ITR 377 (AAR) Natwest case. Also refer - Integrated Containers Feeder Services v. CIT 278 ITR 182 (2005)

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- The place from which the control emanates should be considered as the PoEM⁹⁰
- The place where the Board of Directors meeting takes place, where the policy decisions are taken is the place of PoEM⁹¹
- Place from wherein order is given for undertaking the main business activity of the company may be considered as PoEM⁹²
- PoEM not in India since the Board resolutions for investment decisions were passed from Mauritius / USA⁹³

1.3 Definition of 'PoEM'

Under the ITA, PoEM is defined to mean a place where key management and commercial decisions that are necessary for the conduct of the business of entity as a whole are, in substance made.

The definition uses various expressions viz. 'effective', 'manage', 'key', 'management', 'commercial decisions', 'as a whole' and 'in substance'. These expressions are not defined in the Act. Accordingly, reliance is placed on the general meaning of these expressions and support may also be drawn from the international model commentaries.

- **'Effective'** - Successful in producing a desired or intended result⁹⁴. Term **"effective"** should be understood in the sense of the French **"effective"** which means **"real"** ⁹⁵. **'Effective' implies realistic, positive management** ⁹⁶
- **'Manage'** - Be in charge of (a business, organization, or undertaking); run⁹⁷.
- **'Key'** - Important, main, crucial, significant, vital, strategic decision.
- **'Management'** - Management includes the act of managing by direction, or regulation or administration or control or

⁹⁰ P. No 10 of 1996 224 ITR 473 (AAR)

⁹¹ DLJMB Mauritius Investment Co. v. CIT, 228 ITR 268 (AAR)

⁹² SMR Investment Ltd v. DDIT 2010-TII-66-ITAT-DEL-INTL

⁹³ Saraswati Holding Corporation Ltd v. DDIT 111 TTJ 334 (2007) (Delhi – Trib.)

⁹⁴ Little Oxford English Dictionary (9th edition) Page 591

⁹⁵ Trevor Smallwood Trust - [2010] EWCA Civ 778 (UK)

⁹⁶ Wensleydale's Settlement Trustees v Commissioners of Inland Revenue - [1996] STC 241 (UK)

⁹⁷ Little Oxford English Dictionary (9th edition) Page 607

superintendence⁹⁸. One meaning of the term 'management' is the Board of Directors or the apex body or executive committee at the helm, which guides, regulates, supervises, directs and controls the affairs of the Society. In this sense it may not include the individuals who under the overall control of the governing body or committee, in the day to day business of the Society⁹⁹.

Based on the same, one may contend that management decisions as covered in the definitions of PoEM, refer to those strategic decisions which are generally taken by the apex body of the company which are by nature of guiding and controlling the business.

- **'Commercial'** - 'engaged in commerce' and 'commercialise'¹⁰⁰. The term 'commercial' can cover wide range of activities carried out in the course of carrying on a business. In context of PoEM, one can contend that key commercial decisions refers to strategic commercial decisions concerning the business of the company.
- **'As a whole'** - These words mean taking the totality of the matters in respect of which the appellant was being dealt with by the Crown Court¹⁰¹.
- **'In substance'** - The words 'in substance' indicate that in making the necessary comparison, form should be disregarded¹⁰². This test signifies that PoEM is a substance over form test. Illustratively, if the decisions are in substance made by some people in one country and then formally documented by the Board of Directors in another country; then the PoEM shall said to be located at the place where the decisions were actually taken.

From the above analysis of key words, it can be said that determining PoEM of a company remains that place where strategic decisions concerning the business as whole of a company are taken. This principle will have to be read with the substance test, i.e. the PoEM test is one of substance over form. It therefore requires a determination of those persons in a company who actually 'call the shots' and exercise 'realistic positive management'.

⁹⁸ Wharton's Law Lexicon 15th edition, Page 1668

⁹⁹ Wharton's Law Lexicon 15th edition, Page 1614

¹⁰⁰ K.J. Aiyar, Judicial Dictionary 15th Edition 2011 - Volume 1

¹⁰¹ Judicial Dictionary – K J Aiyar – 15th Addition 2011 Page 426

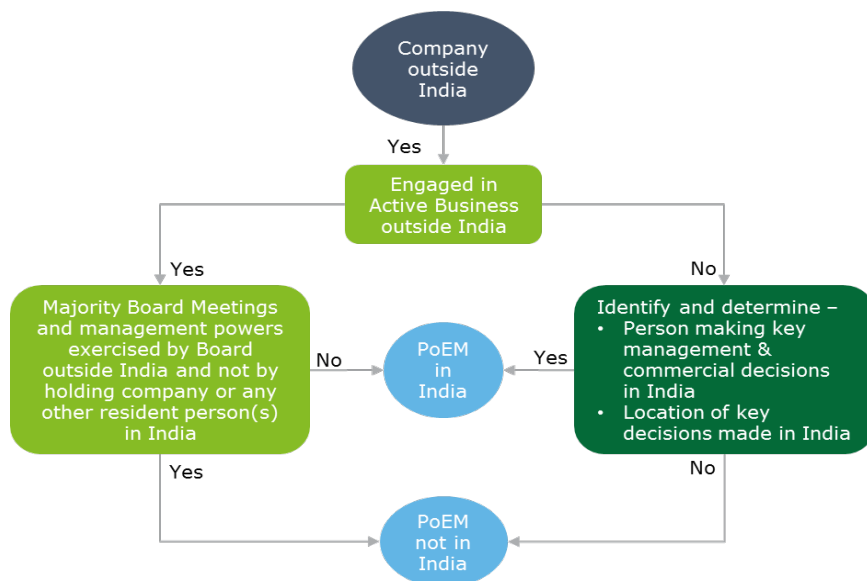
¹⁰² The Law Lexicon – 3rd Edition 2012 Page 494

1.4 Guidelines for determination of PoEM

The Memorandum to the Finance Act, 2015 had indicated that a set of guiding principles will be issued for the benefit of the taxpayers as well as, tax administration which will be useful in determination of PoEM. The CBDT through its Circular dated 24 January 2017¹⁰³ has issued the guidelines for determination of PoEM.

The CBDT through a press release¹⁰⁴ dated 24 January 2017 and Circular¹⁰⁵ dated 23 February 2017 has further clarified that the PoEM guidelines shall not apply to companies having turnover or gross receipts of INR 50 crore or less in a financial year. The CBDT has also clarified that the intent is to target shell companies and companies which are created for retaining income outside India although real control and management of affairs is located in India. It is emphasised that these guidelines are not intended to cover foreign companies or to tax their global income, merely on the ground of presence of Permanent Establishment or business connection in India.

The determination of PoEM by way of pictorial depiction for ease of understanding:



¹⁰³ Circular No. 6 of 2017 dated 24 January 2017

¹⁰⁴ CBDT Press Release dated 24 January

¹⁰⁵ CBDT Circular No. 8 of 2017 dated 23 February 2017

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The guidelines provide the following principles to follow in determination of PoEM in India:

- Determination of PoEM depends on the facts and circumstances of a given case;
- Recognizes the concept of substance over form;
- PoEM differs from a place of management and an entity can have only one place of effective management at any point in time;
- Based on the facts and circumstances if it is determined that during the previous year the PoEM is in India and also outside India then PoEM shall be presumed to be in India if it has been mainly/ predominantly in India;
- Determination of PoEM shall be an annual exercise;
- Process of determining PoEM would be primarily based on the fact whether or not the company is 'engaged in active business outside India';
- In case the Assessing Officer proposes to hold a company as resident in India on the basis of PoEM, then prior approval of the Principal Commissioner or Commissioner will be required.

The guidelines also provide the following factors to be considered for companies other than in active business:

- Location of Board Meeting
- Location of Executive committee
- Location of Head office
- Use of modern technology
- Circular resolutions or Round robin voting
- Shareholders – Effective management
- Secondary factors – place where main and substantial activity is carried out or accounting records are kept

The detailed PoEM guidelines are summarised as under:

1.4.1 Active Business Outside India (ABOI):

- A company is said to be engaged in ABOI if the passive income¹⁰⁶ is

¹⁰⁶ Passive income means aggregate of

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not more than 50% of its total income; and -

- (i) less than 50% of its total assets are situated in India; and
- (ii) less than 50% of total number of employees are situated / resident in India; and
- (iii) payroll expenses incurred on such employees is less than 50% of its total payroll expenditure.

The final guidelines further provide explanation¹⁰⁷ on the terms 'income', 'value of assets', 'number of employees', 'payroll' used for determination of ABOI.

- It has been clarified that any income by way of interest shall not be considered to be passive income in case a company is engaged in the business of banking or is a public finance institution (PFIs), and its

(i) income from the transactions where both the purchase and sale of goods of a company is from / to its associated enterprises and

(ii) income by way of royalty, dividend, capital gains, interest or rental income. However, any income by interest shall not be considered to be passive income in case of company engaged in the business of banking or is a public finance institution, and its activities are regulated as such under the applicable laws of the country of incorporation.

¹⁰⁷ Explanation: For the aforesaid purposes,

- (A) the income shall be, -
 - (a) as computed for tax purpose in accordance with the laws of the country of incorporation; or
 - (b) as per books of account, where the laws of the country of incorporation does not require such a computation.
- (B) the value of assets, -
 - (a) In case of an individually depreciable asset, shall be the average of its value for tax purposes in the country of incorporation of the company at the beginning and at end of the previous year; and
 - (b) In case of pool of a fixed assets being treated as a block for depreciation, shall be the average of its value for tax purposes in the country of incorporation of the company at the beginning and at end of the year;
 - (c) In case of any other asset, shall be its value as per books of account;
- (C) the number of employees shall be the average of the number of employees as at the beginning and at the end of the year and shall include persons, who though not employed directly by the company, perform tasks similar to those performed by the employees;
- (D) the term "pay roll" shall include the cost of salaries, wages, bonus and all other employee compensation including related pension and social costs borne by the employer.

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activities are regulated as such under the applicable laws of the country of incorporation.

- In case of a company engaged in an ABOI, the PoEM shall be presumed to be outside India if the majority of board meetings of the company are held outside India.
- Where it is established that such powers of management are exercised by the holding company / other person(s) resident in India, then the PoEM shall be in India.

For this purpose, merely because the Board of Directors (BoD) follows general and objective principles of global policy of the group laid down by the parent entity which may be in the field of payroll functions, accounting, human resource (HR) functions, IT infrastructure and network platforms, supply chain functions, routine banking operational procedures, and not being specific to any entity or group of entities per se; would not constitute a case of BoD of the company standing aside.

1.4.2 Other cases (i.e. Companies not engaged in ABOI)

- In case of companies other than those engaged in active business outside India, the determination of PoEM would be a two-stage process, namely:
 - (i) identification or ascertaining of person(s) who actually make the key management and commercial decision for conduct of the company's business as a whole; and
 - (ii) determination of place where these decisions are in fact being made.
- The place where the key management and commercial decisions are taken would be more important than the place where such decisions are implemented.

As regards determination of PoEM in case of companies other than those engaged in ABOI, certain guiding principles are provided such as location of Board meetings, location of head office, etc.

1.4.3 Guiding principles for determination of PoEM for companies other than in ABOI

Location of Board Meeting

- The location where a company's Board meets regularly and makes

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decisions would be relevant provided that the Board:

- (i) retains and exercises its authority to govern the company; and
 - (ii) does, in substance, make the key management and commercial decisions necessary for the conduct of the company's business as a whole.
- If the key decisions are in fact taken by the directors elsewhere, or such decisions are delegated by the Board to senior management or any other person including shareholder, promoter, strategic or legal or financial advisor etc located elsewhere and the Board routinely ratifies the decisions, such other place shall be the PoEM of the company.

Delegation by Board

- Where the company's Board delegates some/all of its authority to a committee(s) consisting of key members of senior management, PoEM would be the location where the members of the committee are based and where it develops and formulates the key strategies for mere formal approval by the full Board.

Location of Head Office

- The location of a company's head office will be a very important factor as it often represents the place where key decisions are made. The guidelines provide for various points which are to be considered for determination of the location of head office depending on whether the management is centralized or decentralized and cases where the members of the senior management participate in meetings via telephone or video conferencing.
- The CBDT through Circular¹⁰⁸ dated 23 October 2017 clarified that so long as the regional headquarter in India operates for subsidiaries/group companies in a region within the general and objective principles of global policy of the group laid down by the parent entity in the field of payroll functions, accounting, human resource functions, IT infrastructure and network platforms, supply chain functions, routine banking operational procedures, and not being specific to any entity or group entities per se; it would, in itself, not constitute a case of board of directors of companies standing aside and such activities of regional headquarter in India alone will not be a basis for establishment of PoEM for such subsidiaries/group companies.

¹⁰⁸ Circular no. 25 of 2017 dated 23 October 2017

Meetings through VC/technology

- The use of modern technology may not necessitate persons taking decision to be physically present at a particular location. Therefore physical location of board meeting or executive committee meeting or meeting of senior management may not be where the key decisions are in substance being made. In such cases, the place where the directors or the persons taking the decisions or majority of them usually reside, may also be a relevant factor.

Circular resolution or round robin voting

- In case decisions are made through circular resolutions or round robin voting, the frequency with which it is used, the type of decisions made in that manner and where the parties involved in those decisions are located etc., needs to be considered. The location of the person who has the authority and who exercises the authority to take decisions would be more important in determination of PoEM.

Shareholders activity

- Decisions taken by the shareholder, which are reserved for them under the company law, which typically affect the existence of the company itself or the rights of the shareholders as such (rather than the conduct of the company's business from a management or commercial perspective) are not relevant for the determination of PoEM.
- Whether the shareholder involvement is crossing the line into that of effective management is one of fact and has to be determined on case-to-case basis only.

Secondary factors

- If the above factors do not lead to clear identification of PoEM, secondary factors such as place where main and substantial activity of the company is carried out or place where the accounting records of the company are kept can be considered.

Non-relevant factors

- Day to day routine operational decisions in relation to oversight of the day-to-day business operations and activities of a company undertaken by junior and middle management shall not be relevant for the purpose of determination of PoEM.

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Examples of PoEM not being established on isolated facts

- The guidelines emphasize that the determination of PoEM is based on all the relevant facts rather than isolated facts. The following examples illustrate where PoEM is not established based on isolated facts:
 - the fact that a foreign company is completely owned by an Indian company
 - the fact that there exists a Permanent Establishment of a foreign company in India
 - cases where one/some of the directors of a foreign company reside in India
 - the fact of local management situated in India in respect of activities carried out by a foreign company in India
 - the existence of support functions in India that are preparatory and auxiliary

Additional clarification provided

- The place where management decisions are taken would be more important than the place where such decisions are implemented.
- The principles for determining PoEM are only for guidance purposes and no principle is decisive in itself.
- The activities performed over a period of time, during the previous year, needs to be considered. A 'snapshot' approach is not to be adopted.
- In cases where PoEM is determined to be in India and also outside India, then the PoEM shall be presumed to be in India if it has been mainly/predominantly in India.

Administrative safeguards

- Administrative safeguards have been incorporated in the guidelines by mandating that the Assessing officer (AO), before initiating inquiry for POEM in a case of a taxpayer, will seek approval from Principal Commissioner / Commissioner. The AO shall also obtain approval from Collegium of Principal Commissioners of Income-tax before holding that PoEM of a non-resident company is in India. The collegium so constituted shall provide an opportunity of being heard to the company before issuing any directions in the matter.

Illustrations

- The guidelines also include illustrations on interpretation and determination of PoEM. Specifically, the illustration clarifies that,
 - (i) Only transactions where both purchase and sale is from/to associated enterprise needs to be considered in computing passive income;
 - (ii) All conditions viz. income, value of assets and number of employee in India and payroll expenses needs to be seen on a collective basis.
 - (iii) For a company engaged in ABOI, even in a case wherein all the directors are Indian residents, the PoEM shall be presumed to be outside India if the majority of the board meetings have been held outside India.
 - (iv) In case shareholders involvement results in effective management of the company, then the same needs to be considered in determination of PoEM.
 - (v) Merely because the PoEM of an intermediate holding company is in India, the PoEM of its subsidiaries shall not be taken to be in India. Each subsidiary needs to be examined separately.

1.5 Tax residency under tax treaties

- Under the Indian income tax laws, if a non-resident taxpayer with whose country India has a tax treaty, the provisions of the ITA would apply only to the extent the same are more beneficial than the provisions of such a tax treaty. Article 4 of the tax treaty deals with determining residence of a person covered under a tax treaty. Article 4(1) of the tax treaty provides a definition of the expression "resident of a Contracting State" for the purposes of the convention. The definition refers to the concept of residence adopted in domestic laws. For criteria for taxation as a resident, the definition mentions domicile, residence, place of management or any other criterion of a similar nature.
- If a company is considered to be resident of both Contracting States by virtue of any of the above criteria, it will be regarded as resident of both the Contracting States. In such a case, the tax residency of that company will have to be determined based on Article 4(3) of the tax

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treaty which generally indicates that company shall be deemed to be a resident of the state in which its PoEM is situated¹⁰⁹. If the PoEM of a company is situated in both the Contracting States, some tax treaties¹¹⁰ with India provide that residency of such company will be decided by the Competent Authorities. In other cases, the tax authority may determine the PoEM of a company in India based on the above factors.

Another question which may arise is, since the definition of PoEM may vary from country to country, while determining whether PoEM of a company is located in India, which definition of PoEM needs to be followed. Here, as per Article 3(2)¹¹¹ of a tax treaty, unless the term PoEM is defined under the tax treaty, definition as provided under the ITA should apply. However, if PoEM is defined in a tax treaty¹¹², that definition will override the definition provided under the ITA.

For determination of tax residency under tax treaty, attention is also drawn to Article 4(1) of the MLI which provides that tax residency shall be determined by competent authorities under MAP. For such determination, the PoEM, the place where it is incorporated or otherwise constituted and any other relevant factors shall be considered by the competent authorities. It also provides that if an agreement is not reached through the MAP then such dual resident entities shall not be entitled to treaty benefits except to the extent and in such manner as may be agreed upon by the competent authorities of the respective jurisdictions. The resolution under MAP could take substantial time

¹⁰⁹ Notable DTAA with – Australia, Bangladesh, Belgium, Brazil, Bulgaria, Denmark, Egypt, France, Germany, Italy, Kenya, Malta, Mauritius, Mongolia, Morocco, Netherlands, Oman, Poland, Russia, Saudi Arabia, Singapore, Spain, Switzerland, Syria, Turkmenistan, UAE, UK, Ukraine, Uzbekistan, Vietnam, Zambia

¹¹⁰ Notable DTAA with – Armenia, Austria, Belarus, Botswana, Croatia, Czech Republic, Egypt, Ethiopia, Georgia, Hungary, Iceland, Ireland, Israel, Jordan, Kazakhstan, Korea, Kuwait, Kyrgyz Republic, Luxembourg, Malaysia, Montenegro, Mozambique, Myanmar, Namibia, Nepal, New Zealand, Norway, Philippines, Portugal, Qatar, Romania, Serbia, Slovenia, South Africa, Sudan, Sweden, Syrian Arab Republic, Tajikistan, Tanzania, Trinidad and Tobago, Uganda

¹¹¹ Article 3(2) of the OECD Model Convention - As regards the application of the Convention at any time by a Contracting State, any term not defined therein shall, unless the context otherwise requires, have the meaning that it has at that time under the law of that State for the purposes of the taxes to which the Convention applies, any meaning under the applicable tax laws of that State prevailing over a meaning given to the term under other laws of that State.

¹¹² India-Belarus tax treaty

and the tax payers may face uncertainty along with potential tax cost in case dual tax resident companies.

1.6 Transition provisions

The implementation of the PoEM based residence rule poses its own set of practical challenges especially on a foreign company being considered a tax resident of India for the first time. In this regard, the Finance Act, 2016 introduced section 115JH to provide a transition mechanism for a company incorporated outside India and having its tax residency in India for the first time. It empowered the CBDT to issue notification providing such exception, modification and adaptation if a foreign company becomes a tax resident in India due to its PoEM being in India. It provides that such exception, modification and adaptation can be relating to computation of income, treatment of unabsorbed depreciation, setoff or carry forward and set-off of losses, special provision relating to avoidance of tax and the collection and recovery of taxes.

In this regard, the CBDT through Notification No. 29/2018 dated 22 June 2018 has notified the transition provision for a foreign company that is considered as a tax resident of India for the first time. The transition provisions seek to clarify various aspects which were impeding the practical implementation of the PoEM provisions, while at the same time enabling taxability in India for foreign companies constituting a PoEM in India. Some of the key features of the Notification are as under:

- (i) Determination of the opening Written Down Value (WDV) of depreciable assets for the purpose of computation of depreciation
 - If the foreign company is assessed to tax in a foreign jurisdiction and depreciation is required to be taken into consideration while computing taxable income - the WDV of the depreciable assets as per the tax record in the foreign jurisdiction as on the 1st day of the previous year shall be deemed to be the opening WDV of the depreciable assets.
 - If the foreign company is not assessed to tax in a foreign jurisdiction or where depreciation is not allowed as deduction while computing taxable income - WDV of the depreciable asset as appearing in the books of accounts (maintained in accordance with the laws of the foreign jurisdiction) as on the 1st day of the previous year shall be adopted as opening WDV.

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- (ii) Determination of unabsorbed depreciation and brought forward losses–
- If the foreign company is assessed to tax in a foreign jurisdiction – to be determined year wise on the basis of the taxpayer's tax record in foreign jurisdiction on the 1st day of the previous year
 - If the foreign company is not assessed to tax in a foreign jurisdiction - to be determined year wise on the basis of the taxpayer's books of account prepared in accordance with the laws of foreign jurisdiction on the 1st day of the previous year.
 - It may be noted that the brought forward loss/unabsorbed depreciation shall be allowed to be carried forward and set off in accordance with the provisions of the ITA for the remaining period calculated from the year in which they first occurred by considering such year as the first year.
- (iii) Foreign company shall be liable to prepare multiple financial statements, viz.
- from a specific date¹¹³ to 31st March of the year i.e. the broken period
 - from 1 April to 31 March of the period till the foreign company remains a resident in India
 - for succeeding period of 12 months (1st April to 31st March)

The accounting year for the purpose of brought forward losses and unabsorbed depreciation,

- Where the aforesaid broken period is less than six months, it shall form part of the immediately preceding accounting year in which the company becomes resident in India.
- Where the broken period is equal to or more than six months, then consider that as a separate accounting year. The tax losses and UAD as per tax record or books of account of the foreign company (as the case may be) are to be allocated on proportionate basis.

¹¹³ The specific date is the date on which the accounting year immediately following the last accounting year of the foreign company begins

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- (iv) A foreign company shall continue to be treated as a foreign company even if it is said to be resident in India as per the PoEM test and all the provisions of the ITA shall apply accordingly;
- (v) Where there is a conflict between the provisions applicable to resident as well as foreign company, the provision applicable to the foreign company alone shall prevail. If more than one provision relating to TDS are applicable to foreign company (as a non-resident and resident in India), the provision applicable to the foreign company shall prevail;
- (vi) The losses and unabsorbed depreciation of the foreign company shall be allowed to be set off only against such income of the foreign company which has become chargeable to tax in India on account of it becoming an Indian resident;
- (vii) The Notification does not apply to such income of any foreign company which was taxable in India irrespective of the residence status of such foreign company;
- (viii) Tax rate for a foreign company to remain the same, i.e. 40 per cent (plus applicable surcharge and cess) even where it is deemed to be an Indian resident company;
- (ix) The company shall be entitled to credit of foreign tax paid outside India in accordance with the provisions of sections 90/91 of the ITA. The relief in the form of foreign tax credit shall be provided in the same proportion in which income is offered to tax in India in accordance with the Foreign Tax Credit rules contained under Rule 128 of the Income Tax Rules, 1962;
- (x) Transactions of foreign companies to remain unaltered on the basis of such companies becoming India resident on account of the PoEM test. This seems to suggest that the transfer pricing provisions shall continue to apply even if a foreign associated enterprise is considered resident in India as per the PoEM test.

The transition provisions provide much needed clarity in case of foreign companies becomes a tax resident in India. However, there are some key unaddressed issues in terms of the transition provisions which may require further clarification especially on non-applicability of penal and prosecution provisions for tax non-compliances (viz. return of income, advance tax, withholding tax provision, etc) till the PoEM is finally determined by collegium or under MAP proceedings.

1.7 Conclusion

PoEM has to be determined based on facts of each case after looking into the activities of the foreign company in India as a whole and in substance. The guidelines, definition and illustrations provided by CBDT may assist in determining the PoEM of a company but may not be comprehensive and all relevant facts and circumstances must be examined on a case-by-case basis. There are generally various facts that are required to be taken into account, often involving multiple locations, and from those facts and locations it is necessary to determine a single principal place where effective management is located. Stakeholders need to be mindful of the Indian PoEM provisions as they undertake their business and manage their effective tax cost in India.

Critical Aspects of Transfer Pricing

This section covers:

- *Introduction to Transfer Pricing (TP) in India*
- *Applicability of TP Regulations*
- *TP compliance in India*
- *TP aspects of cross border investments*
- *Recent developments – BEPS landscape and additional compliances*
- *Penalty provisions*
- *Dispute Resolution Mechanism*
 - *APA programme*
 - *MAP programme*

1. Introduction

The Finance Act 2001 substituted section 92 of the Income-tax Act, 1961 (the Act), with new sections, namely, 92 and 92A to 92F; collectively referred to as Indian transfer pricing regulations (TP regulations). In summary, these provisions lay down that income arising from an international transaction between associated enterprises shall be computed having regard to the arm's length price. It further provides that the allowance of expense or interest arising from an international transaction shall also be determined having regard to the arm's length price.

The basic intention underlying the TP regulations was to prevent shifting out of profits resulting from manipulation of prices charged or paid in international transactions, which may lead to erosion of the country's tax base.

Over the years, there have been significant developments in the TP regulations. Some of the key developments are as follows:

The Finance Act 2012 introduced significant amendments including inter-alia clarifying the coverage of the term 'international transactions' (Explanation to

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Section 92B, refer below), expanding the scope of TP regulations to specified domestic transactions (Section 92BA) and providing an Advance Pricing Agreement framework (Section 92CC and Section 92CD).

Further, section 92B extended application of TP regulations to transactions entered into by an Indian entity with a resident independent third party, in certain circumstances.

The Finance Act 2016, in line with Organisation for Economic Co-operation and Development (OECD) recommendations - Base Erosion and Profit Shifting (BEPS) Action Plan 13; inserted section 286 for furnishing of country-by-country report (CbC) and inserted proviso to section 92D(1) for maintenance of Master File (MF), with effect from Financial Year 2016-17.

The CBDT thereafter released the final rules on CbC reporting and MF requirements in India (vide notification no. 92/2017 dated 31 October 2017).

Finance Act, 2017 introduced secondary adjustment provisions requiring cash repatriation of the differential amount arising on account of a TP adjustment. It also provided that upon failure to repatriate cash (within 90 days), the amount would be deemed as an advance to an associated enterprise and would be subject to interest.

Besides the above, the existing penalty provisions have been rationalized along-with insertion of additional penalties for non-furnishing/non-maintenance of CbC report and MF.

2. Applicability of TP regulations

At the outset, the TP regulations are applicable only if there are two or more associated enterprises and the transaction is an international transaction (as per the Section 92B) or specified domestic transaction (as per the Section 92BA).

Towards the same, understanding of following terms is imperative:

2.1 Enterprise

Section 92F(iii) of the Act defines an 'enterprise'. The definition is wide and it attempts to cover almost every type of business or activity that a person (including a permanent establishment of such person) would normally be engaged in i.e. if such person is or has been or is proposed to be engaged in, specified categories of activities or business, mentioned below:

- (a) any activity relating to the production, storage, supply, distribution,

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acquisition or control of articles or goods or know-how, patents, copyrights, trademarks, licenses, franchises or any other business or commercial rights of similar nature or any data, documentation, drawing or specification relating to any patent, invention, model, design, secret formula or process, of which the other enterprise is the owner or has exclusive rights;

- (b) any activity relating to the provision of services of any kind in carrying out any work in pursuance to contract;
- (c) investment activity;
- (d) activity relating to providing of loans;
- (e) business of acquiring, holding, underwriting or dealing with shares, debenture or other securities of any body corporate.

The definition provides that a person would be an enterprise if it carries on the specified activities/business directly or through one or more of its units or divisions or subsidiaries.

As per section 92F(iii) "permanent establishment", referred to in clause (iii), includes a fixed place of business through which the business of the enterprise is wholly or partly carried on.

2.2 Associated Enterprises

The definition of "associated enterprise" is based on the generally accepted criterion of participation in control, management or capital. Indian TP regulations have extended the scope by including situations such as complete dependence on intellectual property, substantial participation in debt, extensive sourcing of raw materials by one enterprise from another enterprise, etc.

Under section 92A(1) of the Act, an enterprise would be regarded as 'associated enterprise (AE) of another enterprise, if:

- (a) it participates, directly or indirectly, or through one or more intermediaries, in the management or control or capital of the other enterprise; or
- (b) the persons participating, directly or indirectly or through one or more intermediaries in its management or control or capital also participate in the management or control or capital of the other enterprise.

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Section 92A(2) clarifies that where any of the criteria specified below is fulfilled, two enterprises shall be deemed to be an associated enterprises, if at any time during the previous year:

- (a) One enterprise holds, directly or indirectly, shares carrying at least 26 per cent voting power in the other enterprise.
- (b) Any person or enterprise holds, directly or indirectly, shares carrying at least 26 per cent voting power in both these enterprises.
- (c) A loan advanced by one enterprise to the other enterprise constitutes at least 51 per cent of the book value of the total assets of the other enterprise.
- (d) One enterprise guarantees at least 10 per cent of the total borrowing of the other enterprise.
- (e) More than half of the board of directors or members of the governing board or one or more of the executive directors or members of the governing board of one enterprise is appointed by the other enterprise.
- (f) More than half of the directors or members of the governing boards or one or more of the executive directors or members of governing board of each of the two enterprises are appointed by the same person or persons.
- (g) The manufacture or processing of goods or articles or business carried out by one enterprise is wholly dependent upon the use of know-how, patents, copyrights, trademarks, licenses, franchises or any other business or commercial rights of similar nature or any data, documentation, drawings or specification relating to any patent, invention, model, design, secret formula or process of which the other enterprise is the owner or has exclusive rights.
- (h) 90 per cent or more of the raw materials and consumables required for the manufacture or processing of goods or articles carried out by one enterprise, are supplied by the other enterprise or by the persons specified by the other enterprise and the prices and other conditions relating to the supply are influenced by such other enterprise.
- (i) The goods or articles manufactured or processed by one enterprise, are sold to the other enterprise or to persons specified by the other enterprise, and the prices and other conditions relating thereto are influenced by such other enterprise.

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- (j) Where one enterprise is controlled by an individual, the other enterprise is also controlled by such individual or his relative or jointly by such individual and relative of such individual.
- (k) Where one enterprise is controlled by a HUF, the other enterprise is controlled by a member of such HUF or by a relative of a member of such HUF, or jointly by such member and his relative.
- (l) Where one enterprise is a firm, AOP or BOI, the other enterprise holds at least 10% interest in such firm, AOP or BOI.
- (m) There exists between two enterprises, any relationship of mutual interests, as may be prescribed.

Out of the aforementioned sub-clauses (a) to (c) cover specific instances of cross border investment that may trigger AE relationship.

2.3 Interplay between section 92A(1) and section 92A(2)

Section 92A(1) provides generic test for determining the AE relationship and section 92A(2) gives certain specific thresholds, thereto. Further, the opening words of section 92A(2) are “*For the purposes of sub-section (1), two enterprises shall be deemed to be associated enterprises if.....*”.

On a plain reading of this section, an interpretation emerges that Section 92A(1) is the main provision and section 92A(2) extends the main provision by creating a deeming fiction. In essence, if the requirements of section 92A(1) are met, then there is no need to additionally satisfy the requirements of section 92A(2).

The aforesaid interpretation finds place in case of ***Kaybee (P.) Ltd. v. ITO***¹¹⁴ wherein the Honourable Tribunal held that:

*“The meaning of AEs as provided u/s (1) of section 92A and if the condition provided in clause (a) and (b) of section (1) are independently satisfied **then the two enterprises for the purpose of section 92B to 92E of the Act will be treated as AEs.**”*

Whilst another interpretation could be that unless the requirements of section 92A(2) are met, AE relationship cannot be said to have been established even if the requirements of section 92A(1) are met. This finds support from the Explanatory Memorandum to the Finance Bill, 2002. The Chennai

¹¹⁴ [2015] 57 taxmann.com 449 (Tribunal Mumbai)

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Tribunal has in case of *Orchid Pharma Ltd v. DCIT*¹¹⁵ clearly adopted¹¹⁶ this interpretation wherein it was held that:

*“.. the mere fact of participation of one enterprise in the management or control or capital of the other enterprise, or the participation of one or more persons in the management or control or capital of both the enterprises **shall not make them associated enterprises, unless the criteria specified in sub-section (2) are fulfilled.**”*

The Tribunal further stated that:

“.. in order to constitute relationship of an AE, the parameters laid down in both sub-sections (1) and (2) should be fulfilled.”

Considering the above discussion, a conservative approach may be adopted for identification of AEs till further clarity is provided (by the legislators).

2.4 Transaction

Section 92F(v) defines ‘transaction’ to include an arrangement, understanding or action in concert:

- (a) Whether or not such arrangement, understanding or action is formal or in writing; or
- (b) Whether or not such arrangement, understanding or action is intended to be enforceable by legal proceedings.

This definition is an inclusive definition and therefore, wider in its scope. As per this definition, a transaction includes any arrangement, understanding or action in concert, whether formal or informal, whether oral or in writing, whether legally enforceable or not.

2.5 International Transaction

The definition of “international transaction”, as outlined in section 92B of the Act, is broad and includes any transaction that has a bearing on the profits, income, losses or assets of an enterprise. Transactions relating to cost contribution and cost allocation are also specifically covered, as are transactions in tangible and intangible property; capital financing (including guarantee); and business restructurings and reorganization with an AE.

¹¹⁵ [2016] 76 taxmann.com 63 (Chennai – Trib)

¹¹⁶ Refer para 10 and para 12

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Aforementioned transaction(s) should be between two or more AEs, either or both of which could be non-residents.

Besides the above, transactions between unrelated parties may be deemed to be international transaction under certain circumstances.

The Finance Act 2012 has inserted explanation to section 92B to clarify the meaning of term 'international transactions'. This amendment is applicable retrospectively from 1st April, 2002.

Explanation.—For the removal of doubts, it is hereby clarified that—

- (i) the expression "international transaction" shall include—
 - (a) the purchase, sale, transfer, lease or use of tangible property including building, transportation vehicle, machinery, equipment, tools, plant, furniture, commodity or any other article, product or thing;
 - (b) the purchase, sale, transfer, lease or use of intangible property, including the transfer of ownership or the provision of use of rights regarding land use, copyrights, patents, trademarks, licences, franchises, customer list, marketing channel, brand, commercial secret, know-how, industrial property right, exterior design or practical and new design or any other business or commercial rights of similar nature;
 - (c) capital financing, including any type of long-term or short-term borrowing, lending or guarantee, purchase or sale of marketable securities or any type of advance, payments or deferred payment or receivable or any other debt arising during the course of business;
 - (d) provision of services, including provision of market research, market development, marketing management, administration, technical service, repairs, design, consultation, agency, scientific research, legal or accounting service;
 - (e) a transaction of business restructuring or reorganisation, entered into by an enterprise with an associated enterprise, irrespective of the fact that it has bearing on the profit, income, losses or assets of such enterprises at the time of the transaction or at any future date;

Clause (c) above expressly covers the cross border investments.

2.6 Arm's length Price

The basic intention underlining the TP regulations is to prevent shifting of profits by manipulating prices charged or paid in international transactions, thereby eroding the country's tax base. The provisions are not applied in cases where the adoption of arm's length price determined under the regulations would result in decrease in the overall tax incidence in India in respect of the parties involved in the international transaction.

In commercial parlance, an arm's length price is the price at which independent enterprises deal with each other, where the conditions of their commercial and financial relations ordinarily are determined by market forces. Section 92F(ii) of the Act, however, defines the term 'arm's length price' as a price which is applied or proposed to be applied in a transaction between persons other than associated enterprises, in uncontrolled conditions.

The steps involved in the determination of the arm's length price can be summarized as follows:

- (i) identification of the "international transaction/(s)";
- (ii) deciding if the international transactions are closely linked – Rule 10A(d);
- (iii) identification of the functions performed, assets employed and risks assumed by the taxpayer and the associated enterprise being parties to the transaction/(s);
- (iv) deciding the characterisation of the entities who are party to the transaction based on the analysis of functions performed, assets employed and risks assumed;
- (v) identification / selection of the tested party (for application of resale price method, cost plus method and transactional net margin method);
- (vi) identification of the most appropriate method which will inter-alia include
 - (a) identification of an "uncontrolled transaction" - Rule 10A (ab);
 - Review of existing internal uncontrolled transaction, if any;
 - Determination of available sources of information on external comparables where such external comparables

are needed taking into account their reliability.

- Identification and comparison of specific characteristics embodied in international transactions and uncontrolled transactions - Rule 10B (2).
- (b) finding out whether uncontrolled transactions and international transactions can be compared by reconciling/resolving differences, if any - Rule 10B (3);
- (vii) ascertaining the most appropriate method by applying the tests laid down - Rule 10C;
- (viii) determination of the arm's length price by applying the method chosen - Rule 10B (1).

3. Transfer Pricing Compliance in India

3.1 Report from an Accountant

As per section 92E of the Act, every person who has entered into an international transaction or specified domestic transaction during a previous year shall obtain a report from an Accountant in Form No. 3CEB and furnish such report on or before due date (i.e. 30th November). From AY 2012-13, CBDT has made it mandatory for enterprises to file their Form No. 3CEB online, with a view to make the process faster and less error prone.

Disclosures for cross border investments in Form No. 3CEB are primarily governed by three clauses i.e. Clause 14, 15 and 16.

3.2 Contemporaneous Documentation

Section 92D of the Act provides that every person who has undertaken an international transaction or specified domestic transaction shall keep and maintain such information and documents as may be specified by rules made by the Board. The documentation required to be maintained has been prescribed under Rule 10D.

Detailed documentation is needed only if transaction value exceeds INR 1 crore.

The proviso to section 92D(1) provides that the person, being a constituent entity of an international group, shall also keep and maintain such information and document in respect of an international group as may be prescribed. Further, the person referred to in the proviso to sub-section (1)

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shall furnish the information and document referred to in the said proviso to the authority prescribed under sub-section (1) of section 286, in such manner, on or before the date, as may be prescribed.

Aforementioned *proviso* relates to the MF compliances – discussed in the subsequent section of this chapter.

4. Transfer Pricing aspects of cross border investments

Indian companies are permitted to issue equity shares; fully compulsorily convertible debentures (CCDs); fully compulsorily convertible preference shares; warrants; and partly paid equity shares, subject to certain conditions, pricing guidelines/valuation norms and reporting requirements. The RBI has also permitted the raising of funds from overseas markets by the issue of rupee-denominated bonds, popularly known as “Masala bonds”.

Key transfer pricing aspects in relation to some of these instruments are discussed below:

4.1 Issue of equity shares

Applicability of TP regulations for issue of equity shares by Indian company to a foreign AE was heavily litigated in India. However the Bombay High Court in the case of Vodafone India Services Private Limited vs. Union of India (writ petition no. 871 of 2014), has provided the much-needed guidance thereto.

Hon'ble Bombay High Court held that the TP regulations are applicable only to international transactions that give rise to taxable income. Neither the capital receipt on issue of equity shares nor the shortfall (if any) in share premium can be considered as taxable income within the ambit of the Act. Further, there is no specific provision in the Act for treating inflow of funds from shares issued to non-residents as taxable income. Hence, TP provisions do not apply to issue of equity shares to a non-resident.

The above ruling was a welcome relief for taxpayers that have been facing huge transfer pricing adjustments on account of alleged undervaluation of shares and subsequent re-characterization of the same as a loan.

Bombay High Court in the case of Shell India Markets Pvt Ltd v. ACIT and others [Writ petition 1205 of 2013] followed its earlier decision in Vodafone (supra) and held that the TP provisions should not be applied to issue of

equity shares in the absence of any income arising from a particular transaction.

Even the CBDT accepted the above decision of the Bombay High Court and issued Instruction No. 2/2015, dated 29-1-2015, directing that the ratio decidendi of the judgement must be adhered to by the field officers in all cases where this issue is involved i.e. the decision will also have a bearing on similar cases as the government has decided not to appeal on such cases in higher courts. This decision has attained finality on the long-standing issue of whether TP provisions are applicable to the issue of shares.

It may be noted that there is no change in disclosure or reporting requirements due to the said judicial pronouncement or instruction.

Having regard to the above and considering the penal implications of non-reporting/furnishing inaccurate particulars, it may be appropriate to report the transaction of issue of equity shares in Form No.3CEB.

Besides the above, even subscription/ purchase of equity shares of any foreign AE by an Indian investor would be considered as an international transaction and accordingly TP provisions would be applicable.

4.2 Sale of equity shares (of Indian company) by non-resident

On a plain reading of section 92, if income arises from international transaction (say, sale of equity shares by non-resident, in the instant case) - it would warrant transfer pricing compliance in the hands of non-resident.

Whilst, there are contradictory tax rulings with respect to the applicability of transfer pricing provisions in case of exempt/non-taxable income; taking a conservative approach may be appropriate, from TP perspective (if the sale is made to an AE).

4.3 Capital Reduction

Capital reduction involves extinguishment of rights of the shareholder which is regarded as transfer. Accordingly, reduction of share capital is covered under "transfer of tangible property" and falls within the definition of international transaction if the transaction is between AEs.

However, if the capital reduction is deemed as dividend under section 2(22)(d) and no capital gain under section 50CA arises in the hands of shareholders, TP provisions may not apply in view of the Vodafone decision but still the transaction may be reported out of abundant caution.

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Further, if transaction of capital reduction results in capital gain in the hands of shareholders (under section 50CA of the Act) both Indian entity and the overseas AE would have to report the transaction in Form No.3CEB and arm's length price of the transaction may be determined based on fair market valuation determined by an independent valuer.

4.4 Debentures

4.4.1 Issue and redemption of debentures: Debentures are debt instruments that carry a coupon rate and which may or may not get converted into equity at a future point of time. Definition of international transaction covers all the transactions of capital financing including any type of long-term or short-term borrowing, lending etc. Hence, issuance and redemption of debentures, being capital financing transactions, would fall within the definition of an international transaction and would be required to be reported in Form No.3CEB.

In this context, the arm's length nature of the CCDs may need to be substantiated appropriately considering the overall scheme namely viz. issue price, interest rate, conversion price, time of conversion and other terms and conditions.

4.4.2 Conversion of debentures into equity shares: Applying provisions of section 47 of the Act, one may argue that conversion of debentures into equity shares is not a transfer and no capital gain arises on the conversion.

The Act considers CCDs and resultant shares after conversion as a single instrument. Whenever the shares issued on conversion are sold later by the shareholder, the date of issue of CCD is taken as date of acquisition. The price at which CCDs were issued is considered the cost of acquisition of the shares. This is primarily on the logic that the same profits cannot be taxed twice. If the profit on conversion is taxed as interest income, and later capital gains arises on the same profit at the time of sale of shares, it amounts to double taxation. Accordingly, a view may be taken that, no international transaction arises from conversion of CCDs, and hence does not fall within the ambit of TP.

From TP compliance standpoint, since conversion of debentures involves issuance of equity shares (specifically required to be reported), it would be prudent to report the issuance of equity shares transaction in Form No.3CEB; and appropriate disclosure, indicating that the overall scheme was analysed at the time of issuance of debentures, may be provided.

Conversion of debentures in the hands of shareholder - in a situation where conversion of debentures into shares gives rise to any income in the hands of shareholder, then, the shareholder would be required to report the relevant transaction(s) in Form No.3CEB.

4.5 Preference Shares

Preference shares are instruments that carry a fixed dividend rate and which may or may not get converted into equity (at a future point of time). Under Ind AS, some financial instruments are to be re-characterized. For example, preference shares as akin to borrowings and preference dividend as interest paid.

Accordingly, from a TP perspective, the treatment on issue, redemption and conversion of preference shares should take into consideration the aspects discussed in section above dealing with issue/ conversion of debentures.

4.6 Loans and guarantee

The definition of international transaction specifically includes any long-term or short-term borrowing, lending or guarantee. Accordingly, availing or providing inter-company loans and guarantees ought to be reported in Form No.3CEB.

It is pertinent to note that although inter-company loans and guarantees are considered as international transactions, the arm's length price is determined having regard to the interest and commission or fees paid/received pursuant to the said transactions.

4.7 Inter-company loans

Tribunals have passed a plethora of judicial rulings on the arm's length determination of the interest rate for inter-company loans (provided by Indian company to AEs).

There have been judicial pronouncements¹¹⁷ wherein it has been held that the ALP interest should be computed corresponding to the currency of the inter-company loan.

Besides the above, other salient aspects of inter-company loans to be analysed from TP perspective include:

- Economic and commercial aspects;

¹¹⁷ Siva Industries & Holdings Ltd (Tribunal) and Cotton Naturals (Delhi HC)

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- Whether the advance can be considered as quasi-capital in nature;
- Interest component (interest free loan, currency of interest vis-à-vis loan, etc.);
- Approach to determine rate of interest (basis credit rating of borrower, comparability analysis with third party lenders)

Another aspect is that even though India does not have thin capitalization rules; with the introduction of Section 94B in the Act, deduction for interest paid to AEs is capped at 30% of EBITDA. Accordingly, it is imperative to evaluate this provision holistically.

4.8 Corporate guarantee

With respect to corporate guarantee, there had been judicial pronouncements¹¹⁸ whereby corporate guarantee was not considered as an international transaction since the condition precedent with regard to 'bearing on the profits, income, losses or assets' set out in the main section 92B (1) may not be fulfilled.

However, vide explanation to section 92B of the Act (inserted in Finance Act 2012) the definition of international transaction was expanded to include corporate guarantees as an international transaction. Accordingly, corporate guarantee(s) be considered as international transaction; requiring disclosure in Form No.3CEB.

From an arm's length perspective, corporate guarantees are generally based on economic models - namely, interest saved approach, yield approach, etc. These are recognised by Indian tax authorities, as well.

5. Indian Safe Harbour Rules for loans and corporate guarantees

The safe harbour concept was introduced in the Indian TP Regulations in 2009 with an objective to provide a certain degree of certainty to taxpayers in the context of TP. The CBDT issued the final safe harbour rules for international transactions vide notification dated 18 September 2013 by insertion of rules 10TA to 10TG to the Income-tax Rules, 1962. In June 2017, the CBDT vide a notification dated 7 June 2017 rationalised the existing safe harbour rules. The rules cover international transactions in eight

¹¹⁸ Siro Clinpharm Private Limited v. DCIT (ITA no. 2618/Mumbai/2014), Micro Ink Limited v. ACIT (ITA no. 2873/Ahm/10), Bharti Airtel Limited v. ACIT (ITA no. 5816/Del/2012).

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categories/sectors, i.e. IT, IT-enabled services, Knowledge process outsourcing (KPO) services, contract R&D in the IT and pharmaceutical sectors, **financial transactions (outbound loans and corporate guarantees)**, low value added intra-group services (LVIGS) and auto ancillary manufacturing.

Snapshot of safe harbour provisions for inter-company loans and guarantee are tabulated below:

Sr. No.	Eligible International Transaction	Circumstances
1	Advancing of intra-group loans referred to in item (iv) of rule 10TC where the amount of loan is denominated in Indian Rupees (INR).	<p>The interest rate declared in relation to the eligible international transaction is not less than the one-year marginal cost of funds lending rate of State Bank of India as on 1st April of the relevant previous year plus,-</p> <ul style="list-style-type: none"> (i) 175 basis points, where the associated enterprise has CRISIL credit rating between AAA to A or its equivalent; (ii) 325 basis points, where the associated enterprise has CRISIL credit rating of BBB-, BBB or BBB+ or its equivalent; (iii) 475 basis points, where the associated enterprise has CRISIL credit rating between BB to B or its equivalent; (iv) 625 basis points, where the associated enterprise has CRISIL credit rating between C to D or its equivalent; or (v) 425 basis points, where credit rating of the associated enterprise is not available and the amount of loan advanced to the associated enterprise including loans to all associated enterprises in Indian Rupees does not

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Sr. No.	Eligible International Transaction	Circumstances
		exceed a sum of one hundred crore rupees in the aggregate as on 31st March of the relevant previous year.
2	Advancing of intra-group loans referred to in item (iv) of rule 10TC where the amount of loan is denominated in foreign currency	<p>The interest rate declared in relation to the eligible international transaction is not less than the six-month London Inter-Bank Offer Rate of the relevant foreign currency as on 30th September of the relevant previous year plus, -</p> <ul style="list-style-type: none"> (i) 150 basis points, where the associated enterprise has CRISIL credit rating between AAA to A or its equivalent; (ii) 300 basis points, where the associated enterprise has CRISIL credit rating of BBB-, BBB or BBB+ or its equivalent; (iii) 450 basis points, where the associated enterprise has CRISIL credit rating between BB to B or its equivalent; (iv) 600 basis points, where the associated enterprise has CRISIL credit rating between C to D or its equivalent; or (v) 400 basis points, where credit rating of the associated enterprise is not available and the amount of loan advanced to the associated enterprise including loans to all associated enterprises does not exceed a sum equivalent to one hundred crore Indian rupees in the aggregate as on 31st March of the relevant previous year.
3	Providing corporate guarantee referred to	The commission or fee declared in relation to the eligible international transaction is at

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Sr. No.	Eligible International Transaction	Circumstances
	in sub-item (a) or (b) of item (v) of rule 10TC.	the rate not less than 1 per cent per annum on the amount guaranteed.

6. Transfer pricing aspects under business restructuring

The definition of international transaction includes transaction in the nature of 'business restructuring'. As per the relevant extract of section 92B, the definition of international transaction is as follows:

The expression "international transaction" shall include:

"(e) a transaction of business restructuring or reorganisation, entered into by an enterprise with an associated enterprise, irrespective of the fact that it has bearing on the profit, income, losses or assets of such enterprises at the time of the transaction or at any future date."

Based on the above, it needs to be evaluated whether transactions pertaining to cross border investments can be covered within the ambit of "business restructuring".

It is pertinent to note here that there is no explicit definition of business restructuring or reorganisation in the context of TP in the Act. In this regard, attention is drawn to the definition of business restructuring or business reorganization under OECD Guidelines and ICAI guidance note, provided in the below paras:

6.1 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations

OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations – July 2017 provides valuable insights on business restructuring topic. OECD guidelines defines business restructuring as the cross border redeployment by a multinational enterprise of functions, assets and/or risks.

"9.1 There is no legal or universally accepted definition of business restructuring. In the context of this chapter, business restructuring refers to the cross-border reorganisation of the commercial or financial relations

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between associated enterprises, including the termination or substantial renegotiation of existing arrangements.”

From the above it can be seen that a business restructuring may involve cross-border re-organisation of the commercial or financial relations between AEs.

6.2 Guidance note of the ICAI on Report under Section 92E of the IT Act (Transfer Pricing)

Revised guidance note of the Institute of Chartered Accountants of India (“ICAI guidance note”) on the report on Section 92E of the Act (Transfer Pricing), has also drawn reference from the OECD definition on “business restructuring”. Para 4.3 of ICAI guidance note states, “Restructuring could be in the form of operational change (in functional, asset and risk profile of the entity) or organizational change (in ownership structure/ management of the entity). It could include:

- a change in the nature or scope of transactions among controlled entities;
- a shift in the allocation of risks; and
- a change in responsibility for specific functions or commencement or termination of a relationship, etc.”

Based on the above, cross border investments need to be evaluated at a granular level having regard to the business restructuring aspect, thereto.

7. Recent developments – BEPS landscape & additional compliances

Under the BEPS framework, Multinational Enterprises (“MNEs”) are required to comply with additional reporting requirements – namely, CbC Reporting and MF:

Under Action 13 of BEPS Action Plan, OECD adopted a three-tiered approach regarding documentation; and suggested significant changes to the compliance and reporting of global information for risk assessment and for TP purposes. The said approach includes:

- (a) Preparation of CbC report to provide a global financial snapshot of MNE;
- (b) Maintenance of MF to provide a high-level view of a group’s business operations and global TP policies; and

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- (c) Maintenance of a local file that will provide an entity level and transaction level TP analysis for each jurisdiction.

In keeping with commitment to implement the recommendations of the BEPS Action 13, India introduced CbC reporting and MF regime in the Act through Finance Act 2016.

On 31 October 2017, the CBDT released the final rules on CbC reporting and MF requirements in India vide notification no. 92/2017.

7.1 CbC Reporting

The CbC Report requires aggregate tax jurisdiction-wide information relating to the global allocation of the income, the taxes paid, and certain indicators of the location of economic activity among tax jurisdictions in which the group operates. The report also requires listing of all the Constituent Entities for which financial information is reported (including the tax jurisdiction of incorporation, where different from the tax jurisdiction of residence), as well as the nature of the main business activities carried out by that Constituent Entity.

CbC reporting will be applicable to an international group having consolidated revenues exceeding INR 5,500 crores [Rule 10DB(6)].

Further, MNEs not headquartered in India, having group companies resident in India will be required to notify [in Form No. 3CEAC] Indian authorities of the details of their parent entity/alternate reporting entity and its jurisdiction.

The information requirements of the CbC report (as per existing Indian regulations) are similar to those prescribed by the OECD BEPS Action Plan 13. There are penalties prescribed for non-compliance (refer 'penalty' section below).

7.2 Master file

The memorandum to the Finance Bill 2016 introduced the concept of MF, whereby entities being constituent of an international group shall be required to maintain and furnish the MF.

Thereafter, final rules on MF requirements in India were prescribed vide notification no. 92/2017 dated 31 October 2017.

Rule 10DA of the Rules is newly inserted prescribing information and documents to be kept and maintained under proviso to sub-section (1) of section 92D and to be furnished in terms of sub-section (4) of section 92D.

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As per the rules, if the following mentioned conditions are fulfilled then the constituent entity would have to file the complete MF in Form No. 3CEAA (Part A and B):

- Consolidated group revenue exceeded INR 500 crores in accounting year as followed by foreign parent; and
- Indian entity's related party transactions (in same accounting year) exceeded INR 50 crores or, intangible related transactions exceeded INR 10 crores.

However, the rules require that every constituent entity (resident and non-resident) of the MNE (which has entered into international transactions) file Part A of the MF – in India; irrespective of meeting the aforementioned thresholds.

The contents of the MF (as per existing Indian regulations) are largely aligned to those prescribed by the OECD BEPS Action Plan 13, with few additional information.

There are penalties prescribed for non-compliance (refer 'penalty' section below).

7.3 Local file

The Indian TP regulations under section 92D of the Act read with Rule 10D of the Rules require every person who has entered into an international transaction or specified domestic transaction to maintain prescribed information / documents for substantiating the arm's length price of its transactions with the related parties, these regulations persist.

Currently, no changes have been proposed to the existing documentation requirements to align with the requirements of the Local File as per BEPS Action Plan 13. Thus, the existing Indian regulations on local TP documentation specified in Section 92D of the Act read with Rule 10D of the Rules continue to persist.

8. Penalty provisions relating to transfer pricing

Stringent penalty provisions are outlined in the Act in relation to TP.

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A snapshot of the penalty provisions is provided below:

Section	Nature of penalty	Penalty (Amount in INR)
271(1)(c)(iii) [up to AY 2017-18] 270A [on or after AY 2017-18]	Concealment of income or furnishing inaccurate particulars of such income	100% to 300% of tax amount
270A(7)	Under reporting of income	50% of the amount of tax payable on the under-reported income
270A(8)	Misreporting of income	200% of the amount of tax payable on under-reported income
271AA(1)	a) failure to maintain prescribed documents and information as required by sub section (1) or sub section (2) of section 92D; b) failure to report any such transaction which is required to be reported; or c) maintains or furnishes any incorrect information or documents	2% of the value of each international transaction or SDT
271AA(2)	Failure to furnish MF by prescribed date	INR 500,000
271BA	Failure to furnish a report from an Accountant as required by section 92E	INR 100,000
271G	Failure to furnish any such information or document as required by sub section (3) of section 92D	2% of the value of international transaction or SDT

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Section	Nature of penalty	Penalty (Amount in INR)
271J	Incorrect information furnished by accountants, merchant bankers and registered valuers in reports	INR 10,000
271GB(1)	Failure to furnish CbC report, in cases where it is required to be maintained by the India parent entity of the international group: a. Where period of failure is equal to or less than 1 month b. Where period of failure is greater than 1 month	INR 5,000 per day INR 150,000 + INR 15,000 per day
271GB(2)	Failure to produce the information and documents as per Section 286(4) within 30 days (extendable by maximum 30 days)	INR 5,000 per day
271GB(3)	Continuing default after service of penalty order under Section 271GB(1) or Section 271GB(2)	INR 50,000 per day for default beyond date of service of penalty order
271GB(4)	Furnishing of inaccurate particulars (subject to certain conditions)	INR 5,00,000

9. India APA programme – boon for MNEs

The Finance Act 2012 inserted sections 92CC and 92CD relating to APA. This provision is aimed to reduce the number of TP disputes and provide certainty to the taxpayers. APA is entered between CBDT with the approval of central government and the assessee w.r.t an international transaction wherein the arm's length price of the international transaction is agreed upon by the parties in advance by applying the prescribed method(s). The APAs entered into may be unilateral, bilateral or multilateral APAs. APAs presents a proactive measure for resolving TP disputes in a cooperative manner.

The APA remains valid for a term provided in the agreement not exceeding five years with a leeway (provided to applicants) to also apply for a rollback for the preceding four years.

The second CBDT annual report on APA performance for FY 2017-18 gives statistical data on the progress on APA initiatives in FY 2017-18, along with statistical details about APAs concluded during six APA cycles from FY 2012-13 to FY 2017-18. As per the report, 985 APA application were filed and 219 APAs (199 unilateral and 20 bilateral APAs) concluded, till March 31, 2018.

The concluded APAs covered varied international transactions (including interest, corporate guarantee fees, and the like) across varied industries.

Overall, the APA programme TP pricing aspects with Indian Tax Authorities.

10. Mutual Agreement Procedure (MAP) – To avoid double taxation and provide relief

MAP is an alternate dispute resolution mechanism incorporated into tax treaties for the resolution of international tax disputes giving rise to double taxation. The resolution of disputes is made through the intervention of competent authorities of each State who negotiate and agree to a mutually acceptable solution.

The primary areas of disputes resolved under MAP pertain to TP adjustments, determination of PE and profit attribution, Characterization / classification of income, etc. A taxpayer may seek relief through MAP irrespective of remedies available under domestic tax laws. In some cases, like the US, the UK, Korea, Denmark and Sweden, India has entered into a Memorandum of understanding (MOU) for the suspension of tax demand during the pendency of the MAP application. In these cases, the taxpayer can keep the payment of tax demand in abeyance by furnishing a bank guarantee of the equivalent amount to the tax authorities.

The resolution under MAP is not binding on the taxpayer and it need not accept the same if it is detrimental to the taxpayer. Accordingly, the taxpayer may not accept the resolution arrived at between the two competent authorities. In that case, the MAP resolution does not apply to the case and the tax dispute can be resolved through normal litigation. However, if the resolution is accepted by the taxpayer, the final demand is raised by the AO as per the MAP resolution and the taxpayer withdraws the appeal against such dispute pending before any appellate authority.

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The OECD's release on MAP statistics 2017 provides that the average time taken for completion of TP MAP cases started before 1 January 2016 is 42.67 months and for cases started as from 1 January 2016 is 7.91 months.

In India, MAP negotiations have progressed significantly over last three years after the opening of the India- US MAP negotiations from January 2015 and bilateral APA with India from February, 2016. Indian Government willingness to enter into bilateral APA and MAP negotiations with all treaty partners and relaxing the applicability of norms Article 9(2) in the relevant Double Taxation Avoidance Agreement has further spur the competent authority negotiations.

Source References:

- The Income-tax Act, 1961
- The Income-tax Rules, 1962
- Guidance note of the ICAI on Report under Section 92E of the IT Act (Revised)
- OECD TP Guidelines for Multinational Enterprises and Tax Administrations (July 2017)

Chapter 14

FEMA Regulations on Cross Border Mergers

This section covers:

- *Regulatory framework under FEMA for cross border mergers – inbound and outbound*
- *Valuation norms*
- *Reporting etc.*

1. Introduction

With the increasing advent of globalisation, cross border mergers have become a reality. Under the Companies Act, 1956, merger of a foreign company with an Indian company (i.e. inbound merger) was possible. However, merger of an Indian company with a foreign company (i.e. outbound merger) required a change in law which was brought about by section 234 of the Companies Act, 2013 (2013 Act). Section 234 of the 2013 Act which was notified on 13 April 2017 has paved the way for both inbound and outbound mergers. Corresponding enabling provision has also been made in the Companies (Compromise, Arrangement and Amalgamation) Rules, 2016. This is expected to facilitate cross border M&A activity.

The Regulatory framework under FEMA for cross border mergers has been laid down by the RBI under the Foreign Exchange Management (Cross Border Merger) Regulations, 2018, (Cross Border Regulations).

Any transaction on account of a cross border merger undertaken in accordance with the Cross Border Regulations shall be deemed to have prior approval of the RBI as required under Rule 25A of the Companies (Compromises, Arrangement and Amalgamations) Rules, 2016.

The salient features of the Cross Border Regulations governing both inbound and outbound mergers are summarised below.

1.1 Inbound mergers

1. The resultant company may issue or transfer any security and / or a

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foreign security, as the case may be, to a person resident outside India in accordance with the pricing guidelines, entry routes, sectoral caps, attendant conditions and reporting requirements for foreign investment as laid down in the FDI Regulations, 2017.

However, where the foreign company is a JV / WOS of the Indian company, or where the inbound merger of the JV / WOS results into acquisition of the Step down subsidiary of JV/ WOS of the Indian party, such acquisition shall comply with the conditions laid down in the ODI Regulations.

2. An office outside India of the foreign company, pursuant to the sanction of the Scheme of cross border merger shall be deemed to be the branch / office outside India of the resultant company in accordance with the Foreign Exchange Management (Foreign Currency Account by a person resident in India) Regulations, 2015, and the resultant company may undertake any transaction as permitted to a branch / office under the aforesaid Regulations.
3. The guarantees or outstanding borrowings of the foreign company from overseas sources which become the borrowing of the resultant company or any borrowing from overseas sources entering into the books of resultant company shall conform, within a period of two years, to the ECB norms or Trade Credit norms or other foreign borrowing norms, as laid down under Foreign Exchange Management (Borrowing or Lending in Foreign Exchange) Regulations, 2000 or Foreign Exchange Management (Borrowing or Lending in Rupees) Regulations, 2000 or Foreign Exchange Management (Guarantee) Regulations, 2000, as applicable. However, exemption has been granted from the end-use restrictions under ECB norms for such borrowings. During such transition period of two years, no remittance for repayment of such borrowings is to be made from India.
4. The resultant company may acquire and hold any asset outside India which an Indian company is permitted to acquire under the provisions of FEMA, rules or regulations framed thereunder. Such assets can be transferred in any manner for undertaking a transaction permissible under FEMA or rules or regulations framed thereunder.
5. Where the asset or security outside India is not permitted to be acquired or held by the resultant company under FEMA, rules or regulations, the resultant company shall sell such asset or security

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within a period of two years from the date of sanction of the Scheme by NCLT and the sale proceeds shall be repatriated to India immediately through banking channels. Where any liability outside India is not permitted to be held by the resultant company, the same may be extinguished from the sale proceeds of such overseas assets within the period of two years.

6. The resultant company may open a bank account in foreign currency in the overseas jurisdiction for the purpose of putting through transactions incidental to the cross border merger for a maximum period of two years from the date of sanction of the Scheme by NCLT.

1.2 Outbound mergers

1. A person resident in India may acquire or hold securities of the resultant company in accordance with the ODI Regulations.
2. A resident individual may acquire securities outside India provided that the fair market value of such securities is within the limits prescribed under the LRS laid down in FEMA or rules or regulations framed thereunder.
3. An office in India of the Indian company, pursuant to sanction of the Scheme of cross border merger, may be deemed to be a branch office in India of the resultant company in accordance with the Foreign Exchange Management (Establishment in India of a branch office or a liaison office or a project office or any other place of business) Regulations, 2016. Accordingly, the resultant company may undertake any transaction as permitted to a branch office under the aforesaid Regulations.
4. The guarantees or outstanding borrowings of the Indian company which become the liabilities of the resultant company shall be repaid as per the Scheme sanctioned by the NCLT in terms of the Companies (Compromises, Arrangement or Amalgamation) Rules, 2016.
5. However, the resultant company shall not acquire any liability payable towards a lender in India in Rupees which is not in conformity with FEMA or rules or regulations framed thereunder. An no-objection certificate to this effect should be obtained from the lenders in India of the Indian company.
6. The resultant company may acquire and hold any asset in India which a foreign company is permitted to acquire under the provisions of

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FEMA, rules or regulations framed thereunder. Such assets can be transferred in any manner for undertaking a transaction permissible under FEMA or rules or regulations framed thereunder.

7. Where the asset or security in India cannot be acquired or held by the resultant company under FEMA rules or regulations, the resultant company shall sell such asset or security within a period of two years from the date of sanction of the Scheme by NCLT and the sale proceeds shall be repatriated outside India immediately through banking channels. Repayment of Indian liabilities from sale proceeds of such assets or securities within the period of two years shall be permissible.
8. The resultant company may open a Special Non-Resident Rupee Account (SNRR Account) in accordance with the Foreign Exchange Management (Deposit) Regulations, 2016 for the purpose of putting through transactions under these Regulations. The account shall run for a maximum period of two years from the date of sanction of the Scheme by NCLT.

1.3 Valuation

The valuation of the Indian company and the foreign company shall be done in accordance with Rule 25A of the Companies (Compromises, Arrangement or Amalgamation) Rules, 2016, which requires the transferee company to ensure that valuation is conducted by valuers who are members of a recognised professional body in the jurisdiction of the transferee company and further that such valuation is in accordance with internationally accepted principles on accounting and valuation.

1.4 Others

Compensation by the resultant company, to a holder of a security of the Indian company or the foreign company, as the case may be, may be paid, in accordance with the Scheme sanctioned by the NCLT.

The companies involved in the cross border merger shall ensure that regulatory actions, if any, prior to merger, with respect to non-compliance, contravention, violation, as the case may be, of FEMA or the Rules or the Regulations framed thereunder shall be completed.

1.5 Reporting

The resultant company and/or the companies involved in the cross border

merger shall be required to furnish reports as may be prescribed by the RBI, in consultation with the Government from time to time.

2. Tax implications of cross border mergers

2.1 Provisions in the Income-tax Act, 1961 dealing with merger / amalgamation

Section 2(1B) defines “amalgamation” as the merger of one or more companies with another company or the merger of two or more companies to form one new company in such a manner that—

- (i) all the property of the amalgamating company or companies immediately before the amalgamation becomes the property of the amalgamated company by virtue of the amalgamation;
- (ii) all the liabilities of the amalgamating company or companies immediately before the amalgamation become the liabilities of the amalgamated company by virtue of the amalgamation;
- (iii) shareholders holding not less than 75% in value of the shares in the amalgamating company or companies (other than shares already held therein immediately before the amalgamation by, or by a nominee for, the amalgamated company or its subsidiary) become shareholders of the amalgamated company by virtue of the amalgamation,

otherwise than as a result of the acquisition of the property of one company by another company pursuant to the purchase of such property by the other company or as a result of the distribution of such property to the other company after the winding up of the first-mentioned company.

Section 47(vi) provides that any transfer of a capital asset by the amalgamating company to the amalgamated company in a scheme of amalgamation, shall not be regarded as a “transfer” for the purposes of charging capital gains tax in the hands of the amalgamating company, if the amalgamated company is an **Indian company**. Also, receipt of assets of the amalgamating company by the amalgamated company by virtue of such amalgamation that is exempt under section 47(vi), is also not subject to receipt based taxation regime of section 56(2)(x).

Further, section 47(vii) provides that any transfer (by way of extinguishment) of the shares of the amalgamating company in a scheme of amalgamation, shall not be regarded as a “transfer” for the purposes of charging capital

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gains tax in the hands of the shareholders of the amalgamating company, if the amalgamated company is an **Indian company**, and such transfer is in consideration of the allotment to him of shares in the amalgamated company (except where the shareholder in question is the amalgamated company itself). Also, receipt of such shares of the amalgamated company by the shareholders of the amalgamating company by virtue of such amalgamation that is exempt under section 47(vii), is also not subject to receipt based taxation regime of section 56(2)(x).

2.2 Merger of a foreign amalgamating company with an Indian amalgamated company

Merger of a foreign company with an Indian company was allowed even in the context of the Companies Act, 1956 and the above provisions of the Income-tax Act were designed to consider such transactions. Now that merger of an Indian company with a foreign company is allowed under section 234 of the Companies Act, 2013, one has to consider how the provisions of the Income-tax Act apply to such merger (which was not contemplated when these provisions were introduced).

Where the merger meets the above definition of “amalgamation” given in section 2(1b) and where the Indian amalgamated company allots shares to the shareholders of the foreign amalgamating company, the entire transaction is likely to be tax neutral for all parties concerned, i.e. the foreign amalgamating company, the Indian amalgamated company and the shareholders of the foreign amalgamating company. However, when the consideration paid/allotted to the shareholders of the foreign amalgamating company consists of cash/other instruments of the Indian amalgamated company (in addition to its shares, if any, which may be allotted), then such transaction does not strictly meet the conditions of section 47(vii) and one has to then consider whether there may be capital gains tax implications and receipt based tax implications (under section 56) in the hands of the shareholders of the foreign amalgamating company. It may be noted here that such shareholders who are non-residents may also be eligible to claim an exemption under the Capital Gains / Other Income Articles of an applicable tax treaty, if any.

2.3 Merger of an Indian company with a foreign company

There are no specific provisions in the Income-tax Act analogous to sections

47(vi) & (vii) that provide tax neutrality to a merger of an Indian company with a foreign company. Accordingly, till the time such provisions are introduced in the law, one needs to consider the tax implications in the hands of all parties concerned, i.e. the Indian amalgamating company, the foreign amalgamated company and the shareholders of the Indian amalgamating company, under first principles. While there are arguments to contend that there should be no capital gains tax liability in the hands of the Indian amalgamating company on first principles on account of it not receiving any consideration pursuant to the merger, there may be capital gains tax implications and receipt based tax implications (under section 56) in the hands of the shareholders of the Indian amalgamating company as well as the foreign amalgamated company. Further, while there is strictly no distribution of any assets by the Indian amalgamating company to its shareholders, it will also need to be considered if “dividend” is triggered upon merger of the Indian amalgamating company with a foreign amalgamated company, as the same may have implications under the Dividend Distribution Tax (DDT) provisions. The provisions of applicable tax treaties, if any, will also have to be considered to see if any exemption can be sought by these parties from such taxation in India.

2.4 Other points

There are also provisions in section 72A in relation to transfer of past tax losses and unabsorbed tax depreciation of the amalgamating company to the amalgamated company pursuant to the amalgamation, that will need to be tested with respect to such transaction.

Source References:

- Companies Act, 2013
- Income-tax Act, 1961
- Companies (Compromise, Arrangement and Amalgamation) Rules, 2016
- Foreign Exchange Management (Cross Border Merger) Regulations, 2018