India: Structural Strategy

August 29, 2003

MARCH 20, 2003

Nishith Desai Associates
Legal & Tax Counseling Worldwide

MUMBAI ● SILICON VALLEY ● BANGALORE

www.nishithdesai.com
nda@nishithdesai.com

India: Structural Strategy

93-B MITTAL COURT, NARIMAN POINT
MUMBAI 400 021 INDIA.
TEL: +91 – 22 - 2282 0609
FAX: +91 - 22 - 2287 5792

220 CALIFORNIA AVENUE, SUITE 201,
PALO ALTO, CA 94306. USA.
TEL: +1 – 650 – 325-7100
FAX: +1 - 650 - 325-7300

ASTER VILLA, THE TAJ WEST END
25, RACE COURSE ROAD,
BANGALORE 560001 INDIA.
TEL: +91 – 80 – 5662 3456
FAX: +91 – 80 – 5662 3457

Nishith Desai Associates (www.nishithdesai.com) is a research-based, multi-skilled law firm with offices in Mumbai & Bangalore (India) and Silicon Valley (U.S.A.). NDA specializes in the globalisation of Indian corporates, corporate and securities law, media & entertainment law, international tax & transfer pricing, offshore funds, ADRs, M&A and technology & telecommunications law. The firm has structured and acted for the largest number of private equity funds focused on India. NDA has served as the underwriters' counsel in Infosys Technologies' and Satyam Infoway's American Depository Receipt (ADR) offerings in the USA. It also represented Rediff.com, Silverline Technologies and Wipro in their ADR listings. NDA was involved in the first cross-border stock swap merger out of India, namely BFL's acquisition of MphasiS, and was also involved in Silverline's acquisition of Seranova.

IFLR (a Euromoney publication) presented the firm with the "Indian Law Firm of the Year-2000" and "Asian Law Firm of the Year-2001 (Pro Bono)" awards.

The firm is intensely research-oriented and has undertaken studies in different areas of law and tax, some of which can be found on its website. The firm prepared a comprehensive report on the comparative business and legal practices in Hollywood and Bollywood. The firm did an extensive research study for the Global Information Infrastructure Commission (GIIC) on legal and tax issues relating to e-commerce. NDA was also involved in preparing a study for the European Commission on the Market Access Barriers in the Telecommunications Sector in India. The firm assisted the State Government of Andhra Pradesh in drafting the Andhra Pradesh Infrastructure Development Enabling Act.

Introduction

The recently concluded India Today Conclave held in Delhi focused on the theme of "India 2003: Global Giant or Pygmy?" One of the distinguished speakers invited to share their views, former U.S. President Bill Clinton, stated: "*The world cannot afford for India to be a pygmy. You [India] have to be a giant and the right kind of giant*."

India is an amalgam of a vibrant democracy, a large reservoir of skilled manpower, an economy at the cutting edge of new technology and above all, a large and growing domestic market. The Indian economy is growing annually at a healthy rate of 5.6%; second generation reforms are underway; infrastructural advancements are being made; exchange controls are being relaxed; and the government is committed to moving towards more transparency and simplification of the regulatory and tax regime (to bring it on par with the best international practices). All of these factors are key ingredients in making India an attractive investment destination.

This paper focuses on the entry strategies available to a foreign investor and some of the issues that he would have to bear in mind with respect to the regulation of business and the safety of his investments.

I. Investment Climate in India

By and large, foreign direct investment is now permitted in almost all sectors in India via the "automatic route," save for some exceptional cases such as defense, housing and real estate, print media, etc. (commonly referred to as the "negative list"). Under the automatic route, the details of the investments must be filed with the Reserve Bank of India ("**RBI**") within the prescribed time. However, if the investment is not in accordance with the prescribed guidelines or if the activity falls under the negative list, approval has to be obtained from the Foreign Investment Promotion Board ("**FIPB**"). Further, the transfer of existing shares from a resident to a non-resident in any industry also requires the FIPB's prior approval.

II. Form of the Indian Entity

A foreign company can establish its presence in India as a Liaison Office ("**LO**"), branch, limited liability company or a partnership. Some of the important regulatory and tax requirements under each of these options are discussed below:

<u>Liaison Office</u>

A foreign company can establish an LO in India only with the RBI's prior approval. Such approvals are granted on a case-by-case basis, provided the activities of the LO are restricted to the permitted activities. Furthermore, the LO is not permitted to generate any income on its own account and the parent must reimburse the LO for costs it incurs for its operations.

<u>Branch Office</u>

A foreign company can set up a branch in India only with the prior approval of the RBI. Such approvals are granted on a case-by-case basis, provided the activities of the branch are restricted to the permitted activities, which include the exportation/importation of goods; the rendering of professional or consultancy services; and the rendering of services in information technology and software development in India.

Subsidiary

A subsidiary of a foreign company is treated in the same manner, in almost all respects, as a company that has resident Indian shareholders. The wholly-owned subsidiary in India ("**WOS**") presents certain advantages over a branch office, such as greater flexibility with respect to the activities that can be carried out in India by the WOS. Furthermore, the branch may not be eligible for certain tax incentives available in India.

The WOS could be incorporated under the Indian Companies Act, 1956 ("**COA**") either as a private limited company or a public limited company. However, in the case of a private company, there are certain restrictions on the transfer of its shares, the number of members, a total prohibition on invitations to the public for share subscriptions and acceptance of deposits from outsiders.

Additionally, in certain cases, the private company can be treated as a public company because of its foreign parent's status or that of the second tier holding company. To avert this possibility, it may be advisable for the shares of the Indian WOS to be held by two body corporates outside India. This can be done by allotting one share to another foreign body corporate (which could be an associate / group company).

Moreover, the Indian company would have to register with other regulatory authorities, e.g., under the Shops and Establishments Act that governs the terms of employment under the Income Tax Act, the Provident Funds Act, etc.

Partnerships

Subject to certain conditions, such as the non-repatriation of funds, Non-resident Indians ("**NRIs**") and Persons of Indian Origin ("**PIOs**") can contribute to a partnership's capital on an automatic basis. Investments on a repatriation basis by foreign residents, NRIs, and PIOs would require the FIPB's prior approval.

India currently does not permit the formation of Limited Partnerships ("**LPs**"). However, in his budget speech for the fiscal year 2003-2004, the Finance Minister, Mr. Jaswant Singh, announced that the Government of India is in the process of formulating LP legislation. The specific legislation and exchange control restrictions on foreign investment in India have yet to be enacted.

III. Direct Taxes

The taxability of any entity in India depends on its residential status. A resident taxpayer is subject to tax in India with respect to its global income. A company incorporated in India is a tax resident in India. Moreover, in the case of any other company, if the control and management of such a company occur entirely in India during a fiscal year, the company is considered to be a tax resident in India, for that year. Once a company is a tax resident of India, it is subject to tax in India on its global income.

Corporate Tax Rate

Domestic companies are currently taxed at the rate of 35%.[1] Foreign companies and branches of foreign companies (which would be regarded as Permanent Establishments (**"PEs"**) of their parents in India) would be subject to tax at the rate of 40%.

Tax Holiday

Currently, under the Indian Income Tax Act, 1961 ("**ITA**"), there are three major provisions regarding direct tax incentives for the Information Technology sector. These are:

- Deductions for units established in any Free Trade Zone ("**FTZ**"), Electronic Hardware Technology Park, Software Technology Park ("**STP**") or Special Economic Zone;
- Deductions for 100% export-oriented units (**EOUs**);
- Deductions for the export of computer software or for providing technical services outside India in connection with the export of computer software.

The Government of India intends to phase out all of these incentives. No deduction under the first two categories will be available to any unit on April 1, 2009 and thereafter. With respect to the third category, no tax incentive will be available on or after April 1, 2005. Further, FTZs are not a preferred option, as few have been set up in India thus far.

The Finance Act, 2003 ("**Act 2003**") has recently introduced a change regarding the availability of the above exemptions in the case of an amalgamation or a demerger. As per this change, the amalgamated / resulting company, to which a unit enjoying the tax holiday is transferred, will enjoy the tax holiday for the balance of the period to which the amalgamating / transferor company would have been entitled. However, the amalgamating/transferor company will not be entitled to claim any tax holiday benefit with respect to the transferred unit for the fiscal year in which such reorganization takes place and in subsequent years.

Dividends

Pursuant to the amendments to the provisions of the ITA by the Act 2003, dividends are tax exempt in the hands of the shareholders (residents as well as non-residents). However, the Indian company declaring the dividends is required to pay an additional corporate tax called a "dividend distribution tax" ("DDT") at the rate of 12.5%. Such a DDT is not a withholding tax, and hence the benefit of lower withholding tax rates provided under the Double Tax Avoidance Agreement ("DTAA") entered into by India with other countries may not be available.

[1] Unless specified otherwise, the rates mentioned in this paper are exclusive of the currently applicable surcharge of 10% in the case of individuals having taxable income over Rs. 850,000 and 2.5% in all other income scenarios.

Further, this DDT would also apply to income distributions made by a mutual fund (except for open-ended, equity-oriented mutual funds during the period commencing on April 1, 2003 and ending on March 31, 2004).

Interest

Under the ITA, interest received by a non-resident is generally taxable at the rate of 20%, which can be reduced to 15% under some of the tax treaties entered into by India with other countries. Tax is required to be withheld at the source by the resident payer at the time of making payments. Moreover, interest is a tax-deductible expense for the Indian resident (e.g., the wholly-owned subsidiary) only if the applicable tax has been withheld before making the payments to the non-resident.

Royalties / Fees for Technical Services

Payments towards Royalties and Fees for Technical Services ("**FTS**") currently attract a withholding tax of 20%, on a gross basis. Under the various tax treaties that India has entered into with other countries, this rate is often reduced to 10%. Additionally, most of the Indian tax treaties contain a provision that, if such payments were effectively connected to a PE in India, such payments would be taxed as business profits in accordance with the provisions of the domestic laws. Due to a non obstante clause in Section 44D of the ITA, all such payments, even when connected with a PE in India, were taxed on a gross basis. Now, due to a change introduced by the Act 2003, royalties paid under agreements entered into subsequent to April 1, 2003, will be taxed on a net basis at a rate of 40%.

However, where the provisions of the DTAA between India and the country of residence of such non-resident are more favorable to the non-resident, the same may be adopted.

Capital Gains

Currently, capital gains are bifurcated into short-term capital gains and long-term capital gains under the ITA. Shares of a company, securities listed on a recognized Indian stock exchange, and specified units of a mutual fund are treated as long-term capital assets if held for more than 12 months. In other cases, a long-term capital asset is one that is held for a period of more than 36 months. Gains on the sale of listed securities are currently subject to tax at a concessional rate of 10% in the hands of a company. In the case of a foreign company, if the relevant DTAA provides a lower rate, it would be taxed at the lower rate. Short-term capital gains are taxed at normal rates (e.g., 40% in the case of a foreign company and 35% in the case of an Indian company).

Pursuant to the Act, 2003, long-term capital gains resulting from the transfer of shares of certain specified listed companies purchased between March 1, 2003 and March 1, 2004 are not subject to tax in India.

Minimum Alternate Tax

Under the provisions of the ITA, when the income tax payable on the total income as computed under the provisions of the Act is less than 7.5% of the book profits of a company, the company is subject to the Minimum Alternate Tax ("**MAT**"). In such an instance, the book profit is deemed to be the total income of the company for the purpose of tax, and this book profit is subject to tax at the rate of 7.5%. The MAT mechanism ensures that every company pays a tax of at least 7.5% of its book profits. However, certain income -- such as income from the export of software -- is excluded from the purview of the MAT. Hence, the MAT's provisions do not generally apply to software companies.

Transfer Pricing

India has enacted transfer-pricing regulations and thus any international transactions between two associated enterprises would have to be on an arm's length basis.

Terms such as "international transaction," "associated enterprise," "arm's length pricing," and the "methods of computation of the arm's length price" have been specifically defined in the ITA.

The ITA prescribes the methods that can be adopted for determining the arm's length price. These include the Comparable uncontrolled price method; Resale price method; Cost plus method; Profit split method; Transactional net margin method; and any such other method as may be prescribed by the Central Board of Direct Taxes (CBDT).

Thin Capitalization Rules

India does not have any thin capitalization rules in force currently. Accordingly, a foreign company has the flexibility to capitalize the Indian subsidiary either by equity or debt. However, the ITA confers the power on the revenue authorities to disallow payments made to related parties that they consider "unreasonable" and are not on an arm's length basis.

IV. Indirect Taxes

Customs Duties

Customs duties are levied on the importation of goods/equipment into India. Units set up in specified areas such as STPs enjoy a customs duty exemption on imports, for which the unit is required to meet certain export obligations.

Sales Tax

A sales tax is levied on the sale of moveable goods at varying rates, which depends upon the type and nature of the goods, and the state in which the sale takes place. In the case of the movement of goods from one state to another, the sale is governed by the Central Sales Tax Act, which is central (federal) legislation and applies uniformly in all the states of India. Registered dealers are liable to pay tax on interstate sales at a rate of 4%. However, with the introduction of the Value Added Tax ("**VAT**"), this rate may be phased out, reducing it to 2% and subsequently to 0%.

Value Added Tax

While introducing the Finance Bill 2003, the Finance Minister announced that India proposes to shift to the VAT system from April 2003. For a variety of reasons, this deadline was shifted to June 2003. However, to date no progress has been made in this respect and hence, the sales tax regime as discussed above still prevails in India.

Service Tax

A service tax is levied at the rate of 8% on specified services such as management consulting, consultancy or technical services by a consulting engineer, and services by a practicing chartered accountant, to name a few. The Finance Act, 2003 has added seven new services within the tax net, including "business auxiliary services," which clearly covers within its ambit back office processing services, except call center services and information technology services.

III. Structuring Issues

Investing in an Indian company through an intermediate holding company in a tax-favourable jurisdiction offers various advantages. It helps in pooling offshore investments and also helps in the globalisation or restructuring of a company at a later stage. India has favourable treaties with quite a few countries including Mauritius, Cyprus and the Netherlands.

Mauritius is a favoured route for inbound investments into India, as it offers all the tax benefits mentioned above. For example, the dividend withholding tax is reduced to 5% if the Mauritius company holds more than 10% of the shareholding of the Indian company, and the capital gains would be tax exempt in India. Mauritius provides an underlying tax credit[2] under its domestic law and the India-Mauritius Tax Treaty and STP units can take advantage of the tax sparing clause under the India-Mauritius Tax Treaty. However, setting up an intermediate holding company in Mauritius needs to be backed by a sound commercial justification and care needs to be taken to ensure that the control and management of the Mauritius holding company is not *wholly* situated in India.

Controversy over India-Mauritius Tax Treaty

On May 31, 2002, the Delhi High Court ("**Delhi HC**") quashed Circular No. 789 dated April 13, 2000, issued by the Central Board of Direct Taxes ("**CBDT**"), which, *inter alia,* stated that the "Certificate of Residence" issued by the Mauritius tax authorities would constitute sufficient evidence as to residence and beneficial ownership in Mauritius for entitlement to the benefits of the India-Mauritius Tax Treaty. The Delhi HC Order ("**Order**") was the outcome of two separate public interest lawsuits initiated by a not-for-profit organization, Azadi Bachao Andolan, and an ex-Commissioner of Income Tax, Mr. Shiv Kant Jha. In the combined Order, the Delhi HC *obiter* stated that Mauritius was being abused by non-residents of India who were setting up post box companies in Mauritius merely to become eligible for the beneficial provisions under the Tax Treaty. By

[2] "Underlying tax credit" refers to a tax credit for corporate taxes paid by the overseas subsidiary on the profits from which dividends are declared. This credit is in addition to the tax credit for taxes withheld when the dividends are paid.

quashing the Circular, the Order had raised uncertainty amongst foreign investors regarding their tax liability in relation to their investments in India.

In October 2002, the Government of India and CBDT, respondents before the Delhi HC, filed a Special Leave to Petition ("**SLP**") in the Supreme Court of India ("**SC**"). An independent SLP was filed by the Global Business Institute ("**GBI**"), a not-for-profit organisation incorporated under the laws of Mauritius. On November 18, 2002, the Supreme Court granted a stay of the Order, pending the final hearing of the two SLPs. The Judges heard the matter on an expedited basis, with hearings being held thrice a week, beginning January 28, 2003. The last and final hearing was on February 25, 2003. Since the matter involves important issues of international law, the Judges have reserved their decision. The ruling is expected within four to eight weeks.

IV. Exit Strategy

A sale of shares in an Indian company (either to a third party, i.e., an M&A transaction, or via an Initial Public Offering ("**IPO**") or issue of ADR/GDRs), a buyback of shares in an Indian company and a liquidation of an Indian company are commonly used exit options available. Subject to certain conditions, a buyback of shares is permitted up to 25% of the aggregate of the paid-up capital and the free reserves of the company. Further, in any given financial year, the buyback of shares cannot be in excess of 25% of the paid-up capital of the company. A buyback of shares is permitted out of free reserves, a securities premium account, or from proceeds of any shares or other specified securities. Liquidation of an Indian company is a time-consuming process and could take a couple of years. Further, the entry and exit pricing of foreign investors under the FDI route do not apply if the foreign investor is registered with the Securities Exchange Board of India as a venture capitalist. However, the sale of shares of an Indian company would be subject to capital gains taxes at the applicable rates.

Conclusion

Apart from being a formidable market for goods and an IT centre, India has tremendous potential to develop into a prosperous BPO hub in the Asian region. Strategic geographic location, quality of human capital, tech-savviness, a well-defined legal system and state-of-the-art communication systems are some of the factors that work in India's favour. The 21st century will be dominated by knowledge-driven sectors like IT and biotechnology. Having already proven itself in the IT sector, the Indian economy is well positioned to make its presence felt in the BPO and biotechnology sectors as well.