Paper 19

Joint Ventures©

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Synopsis

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3. Sale of shares by non-resident to resident
4. Sale of shares by non-resident to another non-resident

A. NATURE OF AND REASONS FOR JOINT VENTURES

A joint venture may be defined for present purposes as any arrangement whereby two or more parties co-operate in order to run a business or to achieve a commercial objective[1]. This co-operation may take various forms and may involve the running of a business on a long-term basis or on the realisation of a particular project. The business may be entirely new, or it may be an existing business, which it is believed will benefit from the introduction of a further participant. A joint venture is, therefore, a highly flexible concept, and the nature of any particular joint venture will depend to a very large extent on its own facts and on the resources and wishes of the parties.

The reasons for establishing a joint venture may, for example, include the following:

- The parties may wish to use co-operation as a means of limiting the capital investment required for a business or project and the exposure to risks; this is particularly the case in joint venture businesses involving heavy expenditure on research and development or which are set up to carry out major construction projects.

- Co-operation may be a way of reducing manufacturing costs or other overheads by achieving economies of scale.

- The parties may have complementary skills or resources to contribute to the joint venture; or the parties may have experience in different industries which it is hoped will produce synergistic benefits.

- The involvement of a locally based party may be necessary or desirable in countries where it is difficult for a foreign company to penetrate the market or where the local law does not allow enterprises to be wholly owned by foreigners.

Clearly, some advantage of this kind should exist to make it worthwhile to sacrifice the simplicity of structure and ease of control of a wholly owned business.

B. JOINT VENTURE OPTIONS

In setting up a joint venture, use has to be made of the relevant provisions of company law, partnership law, contract law and exchange control regulations. Other areas of law may also become applicable as a result of the nature of the transaction, in particular, laws relating to taxation, competition, intellectual property and environment. Although joint ventures vary greatly, three main types may be distinguished.

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[1] *Source* : "Joint Venture Forms and Precedents", Butterworths, October 1997.

(1) Joint venture companies

A corporate vehicle is very commonly used as the means of setting up a joint venture ("**JV**") which will continue for a long or indefinite period. It has the advantage of limited liability and is backed by a well known structure of company law, which is also highly adaptable. A foreign entity desirous of establishing a joint venture concern in India may do so in either of the following ways:

(a) Incorporating a separate Joint Venture Company (“JV Co”)

Here the parties to the JV would jointly incorporate a company under the Companies Act, 1956 ("**CA**") and would subscribe to the shares of such company in the agreed upon proportions. The documents of incorporation, *i.e.* the Memorandum of Association (the "**MoA**") and Articles of Association (the “**AoA**”) of the JV Co would be suitably drafted so as to reflect the rights, intentions and obligations of the parties. This route is preferred since it allows structural flexibility in terms of creating an entity, which is tailor made to suit the specifications of both the parties.

(b) Investing in the share capital of an existing company

In this scenario, the investor would buy into the share capital of an existing company. Such company may be a subsidiary of the local JV partner or the JV partner itself. In order to ensure that the intentions, rights and obligations of the parties are suitably reflected, the MoA and AoA of the existing company would have to be amended in accordance with the JV agreement and in the manner specified in the CA. Prior to such investment, the investor would have to conduct a legal/financial due diligence in order to identify the contingent liabilities/exposures faced by the company. This would enable the foreign investor to undertake an informed risk analysis and obtain the requisite representations and indemnities from the JV partner in respect of acts done prior to the investment. Sometimes it may happen that an overseas party would like to purchase an overseas JV partner's stake in an Indian JV Co. In such cases a thorough due diligence, including review of the existing JV agreement, would have to be undertaken.

Further, investment can also be classified on the basis of the manner of investment, *i.e.* primary investment (subscription of fresh shares) or secondary market investment (purchase of existing shares). Ordinarily, it is comparatively easier to obtain regulatory approvals for the former, which results in an expansion of the capital base of the company.

(2) Partnerships

A partnership is in many respects simpler and less public than a company, and may perhaps be regarded as a halfway house between a corporate joint venture and a purely contractual arrangement. This is reflected in the tax regime, whereby partners are separately assessed even though the profits are computed as if the partnership were a separate entity. However, there are practical difficulties in running any substantial business through a partnership, where there is no corporate vehicle to hold assets and liabilities. A further major disincentive to using a partnership is the unlimited liability which it involves. As a result, partnerships are not normally used for major businesses except by professionals such as solicitors and accountants or where there are specific tax advantages.

(3) Unincorporated organizations (contractual arrangements)

A joint venture may be established by purely contractual means, without using any formal legal structure or vehicle. Such arrangements, known as consortium agreements, collaboration agreements, *etc.* are most commonly used where the parties wish to co-operate for a limited period or for a limited purpose, such as submitting a joint bid for a construction contract. Some of these come close to being true partnerships, but the parties normally seek to avoid the joint and several liability for each other's actions which a partnership would involve by not formally establishing a joint business.

Though it is generally considered commercially viable to enter into a JV so as to avail of the local partner's experience, goodwill, marketing network, *etc.,* in India, it is possible for a foreign investor to obtain the necessary governmental approvals and invest up to 100% in the equity share capital of an Indian company (subject to certain pre-conditions and barring a few reserved sectors, such as real estate, insurance, railways etc.). Several investors choose to avoid the JV route and conduct their business through wholly owned subsidiaries in India.

The investment of the parties may either be in cash or kind. For *e.g*., the foreign investor may choose to transfer assets to the JV Co and receive shares in lieu thereof. The particulars of the form of investment (cash or kind) would have to be disclosed to the regulatory authorities at the time of obtaining the requisite investment approvals. Generally, cash investments are looked upon more favourably by the regulatory authorities.

C. TYPES OF COMPANIES

Based on the facts, circumstances and the requirements of each situation, it is essential to identify the type of company which would best cater to the requirements of the foreign investor. The CA broadly classifies companies into private companies and public companies.

(1) Private companies

A private company is defined to mean a company which, by its AoA, restricts the transferability of shares, limits the number of members to fifty and prohibits any invitation to the public to invest in its share capital[2]. A private limited company enjoys various privileges under the CA such as it can have a minimum of two directors[3] that can be appointed for life[4]. A private company can have a minimum of two members[5] who can call a shareholders' meeting. It can give loans and invest in other companies without any restrictions.

Section 43A companies. As per the provisions of the CA[6], a private company would be deemed to be a public company for all practicable purposes if it satisfies any of the following criteria:

(a) if 25% or more of its equity share capital is held by a public company; or
(b) if the said private company holds 25% or more of the equity share capital of a public company; or
(c) if its annual turnover exceeds INR 100 million; or
(d) if it accepts deposits from the public.

A deemed public company is, however, permitted to retain the characteristics of a private company, *i.e.* restrictions on transferability of shares, *etc.* However, it has to comply with the various provisions of the Companies Act applicable to public limited companies. However, since the parties ordinarily wish to ensure restrictions on transferability of shares, a public company is not suitable.

(2) Public companies

A public company is defined as a company which is not a private company[7]. A public company cannot restrict the transferability of its shares in any manner. A public company can be a listed or unlisted.

(a) Listed companies

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2 Section 3(1)(iii) of the CA.
3 A public company is required to have a minimum of 3 directors.
4 Two thirds of the directors of public companies are appointed subject to retirement by rotation every year.
5 A public company must have a minimum of 7 members.
6 Section 43A
7 Section 3(1)(iv) of the CA

A public company may, upon fulfilling certain criteria, come out with a public issue of shares[8] and get listed on a recognised stock exchange. A public listed company is required to comply with the various Guidelines for Disclosure and Investor Protection[9] issued by the Securities and Exchange Board of India (the "**SEBI**"). In case of preferential allotments to investors[10], the SEBI's guidelines for preferential allotments[11] would apply. Additionally, in case of preferential allotments to non-residents, the Reserve Bank of India (the "**RBI**") guidelines for preferential allotments[12] would also apply. The Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, 1996 would also be applicable in case of investments in listed companies.

(b) Unlisted companies

A public company that is not listed on any of the recognised stock exchanges is an unlisted company.

D. FOREIGN INVESTMENT IN A JV CO

The Foreign Exchange Regulation Act, 1973 ("**FERA**"), is the gateway legislation for investing in India. Pursuant to the FERA, foreign investment in India requires the general or specific approval of the RBI. The New Industrial Policy of 1991 ("**NIP**"), contains the basic policy relating to foreign investment and technology transfer.

This section does not touch upon the acquisition of shares by foreign investors from existing holders. It deals only with fresh issue of shares by Indian companies to foreign companies/persons.

The foreign investor investing in a JV Co can pursue any of the following routes:

(1) Foreign direct investment by investors other than Non-Resident Indians ("**NRIs**")
 (a) Automatic
 (b) Non-automatic
(2) Investment by NRIs

8 Section 73 of the CA states that if a company makes a public issue of shares or debentures then it would have to get the same listed on a recognized stock exchange.

9 Issued by the Securities and Exchange Board of India on June 11, 1992. There are XXI clarifications following the original guidelines.

10 Special resolution of the shareholders of the company making the preferential allotment to shareholders other than the existing shareholders, is required under section 81(1A) of the CA.

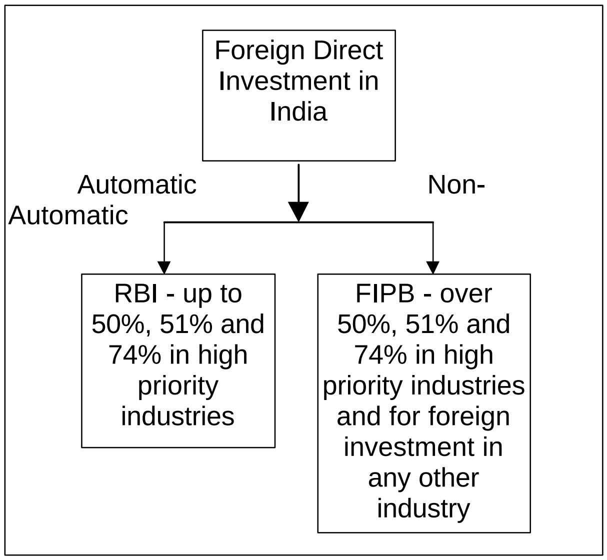
11 SEBI Guidelines for Preferential Allotment of Shares or Warrants/FCDs/PCDs to select group of persons u/s. 81(1A) of the CA, dated August 4, 1994.

12 RBI - AD (MA Series) Circular No. 12, dated June 16, 1995.

(3) Investment in export trading houses

(1) Foreign Direct Investment ("FDI") by investors other than NRIs

Foreign investment is permitted in India only through a separately incorporated company and not through a branch, which is possible only in respect of air, sea or banking industries.



(a) Automatic approval

As per the Ministry of Industry (“**MoI**”) press note dated June 24, 1991, the NIP provides for foreign investment up to 51% on an automatic basis, in 35 high priority industries listed in Annexure III ("**Annex III**") to the NIP (classified under the Indian Trade Classification (“**ITC**”) coding system).

On January 17, 1997, the government expanded the Annex III list of industries so as to include additional industries in the high priority sector for which foreign investment up to 50%, 51% and up to 74% (depending on the industry) would be permitted on an automatic basis. The expanded list was later revised based on the National Industrial Classification (“**NIC**”) coding system[13]. There are three industries mainly concerned with mining, for which foreign investment up to 50% will be allowed on an automatic basis. There are around 21 industries for which foreign investment up to 51% will be allowed

[13] Press Note No. 14, dated October 8, 1997, Department of Industrial Policy & Promotion, Ministry of Industry, Government of India.
Earlier, under the NIP, the RBI required the parties to describe the articles to be manufactured in accordance with the ITC. The RBI now requires the applicants to quote the relevant NIC codes in respect of industries/products/items along with the description of the product items in their applications for foreign investment under the automatic approval scheme of the RBI.

on an automatic basis and a further 9 industries in which foreign investment up to 74% will be permitted on an automatic basis[14].

Pursuant to the RBI notification[15] dated January 13, 1998, the RBI has simplified the procedure for FDI under the automatic route by dispensing with the need for its prior approval for foreign investment up to 50%, 51% and 74% (depending upon the industry) in the Annex III list of industries. Henceforth, the foreign collaborators investing in the Annex III industries can directly make the remittance to the Indian company and the Indian companies can issue shares to the foreign investors. Thus, the RBI's decision to grant general permission under FERA obviates the need for Indian companies to approach it for in principle approval before getting inward remittance and issuing of shares to foreign investors. However, the investee company would be required to report such foreign investment to the concerned regional office of the RBI within 30 days after the issue of shares to the foreign investors[16]. In case of technology transfer by the foreign collaborator (i.e. technical collaboration) the procedure for applying to the RBI for prior approval on Form FT(RBI) continues.

In case of investments requiring FIPB approval, after approval of the FIPB has been received, foreign investors would not have to approach the RBI. The procedure detailed hereinabove is only with respect to foreign direct investment in Indian companies and does not apply to the transfer of shares from residents to non-residents.

(b) Non-automatic approval

Where foreign investment is sought either for participation in excess of 50%, 51% and 74% (depending on which industry the foreign investment is proposed to be made) in the Annex III industries or for any foreign investment in non-Annex III industries, special approval from the Foreign Investment Promotion Board ("**FIPB**") or the Cabinet Committee on Foreign Investment ("**CCFI**") has to be obtained. The FIPB may exempt an investor from any of the restrictions imposed by the various regulations in force. Such approval by the FIPB is granted on a case-by-case basis and may take up to 60-90 days to process.

Foreign Investment Promotion Board

To facilitate and promote foreign investment in India not covered by the automatic clearance process, the government had in the NIP provided for a special board known as the FIPB. On July 9, 1996, the union cabinet streamlined the procedures relating to

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14 Government of India, Ministry of Industry, Department of Industrial Policy & Promotion vide Press note No. 2 (1997 series), dated January 17, 1997.

15 Notification No. F.E.R.A. 180/98 RB dated January 13, 1998, issued by the RBI.

16 A declaration has to be made to the RBI on Form FC(RBI).

FDI by granting to the FIPB the powers to accept or reject proposals for investments up to INR 6 billion[17].

Applications to the FIPB for foreign investment should be filed on Form FC(SIA) along with a detailed proposal. The original application and proposal must be accompanied by nine copies[18] and must contain the following information:

- Profile of the Investor
- Project Description
- Financing Plan
- Key benefits from the JV Co. to the Indian economy
  - economic benefits;
  - employment benefits;
  - technology contributions; and
  - anticipated contribution to infrastructure projects.

Cabinet Committee on Foreign Investment

All megaprojects involving more than INR 6 billion of overseas investment will have to be submitted to the CCFI[19]. Once the CCFI approves the proposal, the final approval would be issued by the Industry Minister.

Cabinet Committee on Economic Affairs

All projects involving foreign investment in the public sector would be considered by the Cabinet Committee on Economic Affairs.

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17 *Source*: "Recast FIPB to clear projects up to Rs. 600 cr", Business Standard, July 10, 1996.
Cf. Previously, proposals for FDI up to INR 3 billion were recommended by the FIPB and sent to the Empowered Committee on Foreign investment ("**ECFI**") after which it was finally approved by the FIPB; and proposals above INR 3 billion were sent by the FIPB to the CCFI. Once the proposals were cleared by the FIPB and/or the CCFI, approval letters were issued by Secretariat for Industrial Approvals, Ministry of Industry.

18 The application must be addressed to:
The Chairman
Foreign Investment Promotion Board
Ministry of Industry
Department of Industrial Policy and Promotion
Udyog Bhavan
New Delhi 110 011
India

19 See supra note 15.

Investment in Non Banking Finance Companies

The guidelines relating to the equity limits for international investors in Non-Banking Finance Companies ("**NBFCs**") were streamlined by the Government on March 26, 1997[20] with regard to the minimum levels of investment and the extent of foreign holding in such companies. All investment proposals in NBFCs are to be referred to the FIPB. Foreign investment is allowed in 14 areas of financial services, other than banking, which are merchant banking, underwriting, portfolio management services, custodial services, factoring, financial consultancy, investment advisory, stockbroking, asset management, venture capital firms credit reference agencies and credit rating agencies, leasing finance and housing finance.

The minimum capitalisation of foreign equity sought to be invested in NBFCs is as follows:

- 51% or less : $500,000 (to be brought in upfront)
- More than 51% but not more than 75% : $5,000,000 (to be brought in upfront)
- More than 75%: $50,000,000 (of which $7,500,000 of the investment amount will have to be brought upfront and the balance over a period of 24 months)

Wholly foreign owned NBFCs function as holding companies and subsidiary outfits arising out of such companies are required to have a minimum domestic equity of 25%. Furthermore, 10% domestic equity is to be invested upfront with the balance being invested over a period of 24 months.

(2) Non-Resident Indian Investment

With a view to attracting foreign investment from Non-resident Indians or persons of Indian origin[21] ("**NRIs**") and Overseas Corporate Bodies ("**OCBs**")[22] owned to the extent

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20 *Source*: Department of Economic Affairs, Finance Ministry vide their Press Release No. 1/21/92-FI&F dated March 21, 1997

21 10C.2 of the Foreign Exchange Control Manual 1996 has been amended, vide Circular No. 19, dated September 27, 1996, issued by the Exchange Control Department of the RBI. The revised paragraph is as follows:
For the purpose of the facility of opening and maintenance of various types of bank accounts and making investments in shares and securities in India, a foreign citizen (not being a citizen of Pakistan or Bangladesh) is deemed to be of Indian origin if (i) he at any time held an Indian passport, or (ii) he or either of his parents or any of his grand parents was a citizen of India by virtue of the Constitution of India or Citizenship Act, 1955 (57 of 1955). A spouse (not being a citizen of Pakistan of Bangladesh) of an Indian citizen or of a person of Indian origin is also treated as a person of Indian origin for the above purposes provided the bank accounts are opened or investments in shares/securities in India are made by such persons only jointly with their NRI spouses.

22 OCBs include overseas companies, partnership firms, societies and other corporate bodies which are owned, directly or indirectly, to the extent of at least 60% by NRIs or individuals of Indian nationality

of 60% or more by NRIs, the RBI is providing them with special incentives. NRIs and OCBs are allowed to invest in India either on a non-repatriation basis or on a repatriation basis. NRIs/OCBs can operate through a branch or partnership structure while investing on non-repatriation basis.

- On a non-repatriation basis, they are permitted to invest up to 100% in any business (except in agricultural and plantation activities) in India[23].
- They can invest up to 24% in any business (except in agricultural and plantation activities) on a full repatriation basis[24], with the remaining 76% being held on a non-repatriation basis.
- They can also invest up to 100% in Annexure III industries on a full repatriation basis[25].
- Furthermore, NRIs or OCBs can invest up to 100% in the new issue of equity share or convertible debentures of Indian companies engaged in real estate business activities[26] with full repatriation benefits[27]. However, there is a lock-in period of three years on the original amount invested[28].
- In areas outside the Annexure III industries[29], special approval of the FIPB would be required if investment is sought in excess of 24% on a repatriation basis, as in the case of other foreign investors.
- *40% scheme.* NRIs and OCBs are also permitted to invest in the new issues of shares (both equity and preference) and convertible debentures of any new or existing company, with full repatriation benefits. However, the aggregate issue to non-residents qualifying for the facility of repatriation cannot exceed 40% of the face value of the new issue. Such investment can be made only in private or public limited companies raising capital either for the establishment of new industrial or manufacturing projects, or for the expansion or diversification of their existing industrial or manufacturing activities. Investment under this scheme can also be

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or origin resident outside India as also overseas trusts in which at least 60% of the beneficial interest is irrevocable held by such persons.

23 No prior approval of the RBI is required.

24 Prior approval of the RBI is required. An application on Form ISD(R) is required to be submitted to the RBI.

25 Prior approval of the RBI is required. An application on Form ISD(R) is required to be submitted to the RBI.

26 I.e.:
- development of serviced plots and construction of built-up residential premises;
- real estate covering construction of residential and commercial premises including business centres and offices;
- development of township;
- city and region level urban infrastructure facilities including roads and bridges;
- manufacturing of building materials; and
- financing of housing development.

27 Approval of the FIPB would be required. An application on Form FC(SIA) must be made to the FIPB.

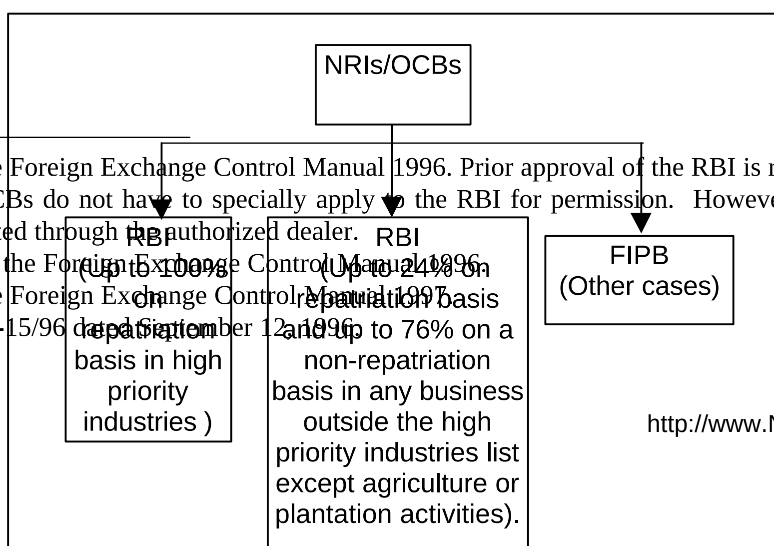
28 10C.13 of the Foreign Exchange Control Manual 1996.

29 *Infra* Attachment.

made in new or existing companies engaged in hospitals, hotels and shipping activities[30].

- *Portfolio investment scheme.* NRIs and OCBs are allowed to purchase in the secondary market under the portfolio investment scheme directly in the shares or debentures of an Indian listed company either on a repatriation or on a non-repatriation basis provided that the aggregate of the NRI and OCB investment does not exceed 5% of the total paid-up share capital of the Indian company[31]. This is further subject to the total NRI/OCB and Foreign Institutional Investor holding (under the portfolio investment scheme) not exceeding 24% (or 30% if the shareholders of the company have passed a special resolution approving the same) of the total paid-up capital of the company. However, if the General Body of the investee company has passed a resolution stating that it has no objection to NRIs or OCBs purchasing shares or debentures up to 24%, then aggregate portfolio investment could be up to 24%[32]. Although each NRI/OCB may invest any amount (up to the ceiling (5% or 24%) detailed above), in case of repatriable investment, the holding of each NRI/OCB should not exceed 1% of the paid-up capital of the company[33].

Although the investment/principal amount of deposits/loans made/held by NRI/OCB's on non-repatriation basis under these schemes continue to be non-repatriable, the RBI[34] permits full repatriation of net income/interest *etc.* earned (*i.e.* after payment of tax) on such investments/deposits/loans made after April 1, 1996.



30 10C.11 of the Foreign Exchange Control Manual 1996. Prior approval of the RBI is required.
31 NRIs and OCBs do not have to specially apply to the RBI for permission. However, the investment has to be routed through the authorized dealer.
32 10C.23(ii) of the Foreign Exchange Control Manual 1996.
33 10C.21 of the Foreign Exchange Control Manual 1997.
34 Ref: AD/MA-15/96 dated September 12, 1996.

3. Investment in export trading companies

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

To be eligible for certification by the Ministry of Commerce, the average net foreign exchange earned relating to eligible exports during the preceding three licensing years, in INR, must be:[35]

- INR 100 million for Export Houses;
- INR 500 million for Trading Houses;
- INR 2.50 billion for Star Trading Houses; and
- INR 7.50 billion for Super Star Trading Houses.

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

- INR 150 million for Export Houses;
- INR 750 million for Trading Houses;
- INR 3.75 billion for Star Trading Houses; and
- INR 11.25 billion for Super Star Trading Houses.

In the case of existing companies already registered as Export or Trading or Star Trading or Super Star Trading Houses, the RBI grants automatic approval for foreign

[35] *Source*: Chapter XII, 137. Criterion for recognition, Export and Import Policy, Ministry of Commerce, Government of India.

investment up to 51% equity only subject to the condition that the company resolves, as per the provisions of the Companies Act, 1956, to give preferential fresh equity to the foreign investor in compliance with the pricing requirements[36] for the new equity.

E. TAXATION AND TAX REDUCTION SCHEMES

The Indian Income-tax Act, 1961 (the "**ITA**") is the central taxing statute in India. There are no state level income taxes. Furthermore, even though the tax rates are high, net profits are calculated after allowing deductions for relevant expenses and incentives, which mitigates the overall impact of the high level of taxation. According to a study conducted by the Center for Monitoring Indian Economy, the effective tax rate on Indian companies is less than 20% even though the nominal rate is around 35%[37].

(1) Taxation of Indian companies

Indian companies are taxed at the rate of 35% on their net profits. Long-term capital gains in the hands of Indian companies are taxed at the rate of 20%. Short-term gains are treated as ordinary income and are therefore taxed at 35%.

The Finance Act, 1997 abolished the classical system of taxation. Dividend paid by an Indian company on or after June 1, 1997 is exempt in the hands of shareholders (including foreign shareholders). This exemption was introduced by the last budget of 1997-98. Instead, an additional income tax[38] (referred to as tax on distributed profits) of 10 % is payable by domestic companies. Within India, no tax credit is available to the shareholders. But, depending upon the tax treaty provisions, foreign shareholders may be able to get a tax credit in their home country against the additional tax borne by the Indian company.

Type of income	Indian residents	Foreign residents	Indian corporations	Foreign corporations

[36] Indian companies intending to raise foreign equity through preferential allotment of shares to non-residents are required to comply with the guidelines issued by the Government of India, Reserve Bank of India, the Securities and Exchange Board of India, and other regulatory authorities.

[37] *Source*: "Tax potential", The Economic Times, June 12, 1996.

[38] Section 115-O of the ITA.

Dividend	-	-	-	-
Interest	30%	20%[39]	35%	20%[40]
Long term capital gains	20%	20%	20%	20%
Short-term capital gains	30%	30%	35%	48%
Business income	30%	30%	35%	48%

(2) Taxation of Foreign companies

Foreign companies are taxed at the rate of 20% in respect of their income by way of interest and long-term capital gains from shares and listed securities. Royalties and fees for technical services are taxed at 20%. Ordinary income, including short-term capital gains is taxed at the rate of 48%. Dividends earned by foreign companies are tax free. However, these rates can be considerably reduced if the benefits under an agreement for avoidance of double taxation which India has with several countries are availed of.

The ITA also prescribes that the income of certain foreign residents is taxed at prescribed percentages of their turnover. This approach is known as presumptive taxation. When foreign residents are taxed on a presumptive basis, they are not entitled to those deductions normally allowed to persons carrying on a business or professional activity.

(3) Tax Treaties

India has over 55 agreements for the avoidance of double taxation ("**tax treaties**") with different countries. The provisions of the tax treaties override the domestic tax laws. However, Indian tax laws are unique as they offer the foreign resident a choice between the provisions of the treaty and the Indian tax laws. Foreign residents can adopt those provisions which are more favorable[41].

Most tax treaties provide for a lower tax rate as compared to the rates prevailing under the ITA. As mentioned earlier, dividends paid by a domestic company are now tax exempt in the hands of all shareholders including foreign shareholders. Under the provisions of the tax treaties entered into with Cyprus, Mauritius and the United Arab Emirates, capital gains arising from the investments made from these countries could be tax exempt. Thus, tax treaties play an extremely important role in devising an entry strategy and thereafter for structuring business transactions.

(4) Incentives for exports

[39] Applicable on gross income.
[40] Applicable on gross income.
[41] Section 90(2) of the ITA provides for such an option.

There are several schemes available to a JV Co whereby the incidences of direct taxes can be reduced to a large extent. Some major incentives include partial or total tax exemptions in respect of export of goods and services and industries set up in backward states.

Some of the schemes relate to benefits that accrue to export oriented JV Co's. An exclusively Export Oriented Unit ("**100% EOU**")[42] which undertakes not to sell any of its products in the domestic market, is entitled to substantial exemptions from customs duty and income tax. Suitable structuring of the operations of a 100% EOU could even result in a complete tax exemption vis-a-vis import duties and direct taxes.

In keeping with its policy of export encouragement, the Government has established Export Processing Zones ("**EPZs**")[43]. The EPZs, set up as enclaves separated from the Domestic Tariff Areas by physical barriers, are intended to provide an international competitive duty free environment for producing goods and services for export at a low cost. This enables the products to be priced competitively in the international markets. A foreign investor may, subject to compliance with certain prescribed pre-conditions, set up a wholly owned 100% EOU in such a EPZ.

Another important scheme, which can be availed of by JV Co's intending to exploit the domestic markets as well as export markets, is the Export Promotion Capital Goods Scheme ("**EPCG Scheme**"). Under the terms and conditions of this scheme, if the JV Co undertakes to export:

(i) 4 times the value of the capital goods imported over a period of 5 years, the JV Co shall be liable to pay customs duty at a concessional rate of 10%;

(ii) 6 times the value of the capital goods imported over a period of 8 years, the JV Co shall avail of a complete waiver of the customs duty payable (where the CIF (cost, insurance and freight) value of the capital goods imported is Rs. 200,000,000 (Rupees two hundred million) or more).

F. TECHNOLOGY TRANSFER

[42] Government of India vide resolution dated Dec. 31, 1980 (subsequently amended *vide* resolution dated Nov 21, 1983).

[43] EPZs are set up by the GoI with the support of the respective State Governments and are administered by the Commerce Ministry. Currently, there are eight EPZs in India.

(1) Technology transfer

Exchange control regulations in India limit the amount of royalty/technical license fee that may be paid to the foreign investor under a technology transfer arrangement. Ordinarily, the said limits are as follows:

- 5% of the domestic sales and 8% of the export sales subject to an overall limit of 8% of the total net sales (*i.e.* net ex-factory sale price of the product, exclusive of excise duties, cost of the standard bought out components and the landed cost of imported components, irrespective of the source of procurement, including ocean freight, insurance, customs duties, *etc.*) over a 10 year period from date of agreement or for a period of 7 years from the date of commencement of production, whichever is earlier[44]; or

- A lumpsum payment of US$ 2 million[45] (*i.e.* approximately Rs. 80 million) payable in a minimum of 3 installments *i.e.* (a) first 1/3rd at the time of signing of the agreement; (b) second 1/3rd on delivery of know-how documentation; and (c) third and final 1/3rd on the commencement of commercial production

The said limits may be exceeded with the prior approval of the FIPB. From an indirect tax perspective it must be ensured that the terms and conditions of the agreement lay more emphasis on an obligation to provide continuing technical assistance and not on the actual transfer of drawings and designs. In view of the fact that the technology transfer agreement would have to be submitted to the RBI for its approval, the governing law of the contract must be Indian law.

Employment of foreign technicians/foreign nationals. The RBI[46] is now allowing foreign nationals who are not permanently resident in India but are in regular employment with Indian firms/companies to make, through their authorised dealers recurring remittances for family maintenance, *etc.*, in excess of 75% of their net salary provided the foreign national concerned is in receipt of perquisites in India, such as free housing, conveyance and medical facilities and his family (wife and/or children) is resident outside India. RBI has also decided to permit payment of salaries abroad to the employees deputed by foreign companies to their Indian joint ventures to the extent of 75% of the net salary (tax to be paid in full in India). The balance amount of the salary is required to be paid in India.

(2) Hotel and tourism related industries

[44] *vide* A.D. (M.A. Series) Circular No. 15.
[45] *id*
[46] *vide* circular no. 51, dated December 15, 1997.

On March 21, 1995, the Government[47] modified the guidelines relating to technology transfer in respect of the hotel and tourism related industries it issued in December 1991[48] under the NIP as under:

- technical and consultancy services including fees for architect, design, *etc.*, up to 3% of the capital cost of the project (less cost of land and finance);
- franchising and marketing/publicity support fee up to 3% of net turnover (*i.e*. gross receipts less credit card charges, travel agent's commission, sales tax, statutory payments, *etc*.)
- management fees (including incentive fee) up to 10% of gross operating profit.

The revised norms are applicable provided the collaboration is proposed with companies running/managing hotel(s) with at least 500 rooms. Furthermore, approval of the Secretariat for Industrial Assistance, Ministry of Industry, would be required.

G. STRUCTURING AN INDIAN JOINT VENTURE

We have hereinabove, briefly, examined the exchange control and tax regulations. Both these major issues need to be reconciled adequately. Typically, the questions that need to be addressed are: Should the foreign investor set up a 100% owned holding company in India and then plan downline JVs with various partners? Or, should the foreign investor instead, have direct JVs or wholly owned operating subsidiaries in India? Further, should the foreign investor invest directly from the home country or through a tax-efficient treaty partner country? Should the foreign investor own 51% equity in the Indian JV or settle for 50:50 ownership? What happens if the foreign investor accepts minority holding in the JV? There are no ready-made answers to these questions. They depend, not only on legal and tax considerations but also on business strategy and philosophy. Let us now deal with some aspects of the questions raised above.

With regard to investing in India through a 100% holding company, under the NIP, 100% ownership would require the FIPB's approval. Such approval is given on a case-by-case basis, unless the proposal is from an NRI/OCB on a non-repatriation basis. The downside is that it could be a time consuming exercise and permission may or may not be eventually granted. For financial services companies, capitalization requirements are high. Also, 100% subsidiaries are generally not allowed to make royalty payments to their parent companies.

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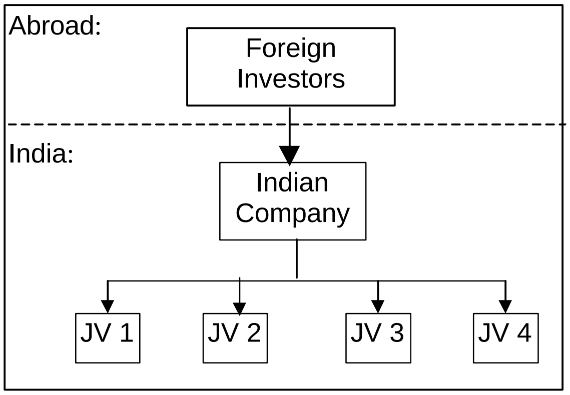
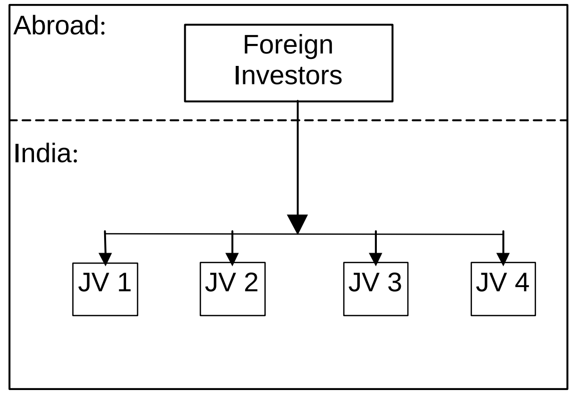
[47] Press Note No. 1 from the Ministry of Industry, dated March 21, 1997

[48] *December 1991 parameters*: lumpsum fee towards technical and consultancy services up to $ 200,000; franchising and marketing etc. fee up to 3% of the gross room sales; and management fees up to 10% of the foreign exchange earnings to the foreign collaborator if the equity participation is at least 25%.

Another aspect to be borne in mind is that once permission for the holding company is obtained, repetitive approvals (from the FIPB) for downline JVs would be required.





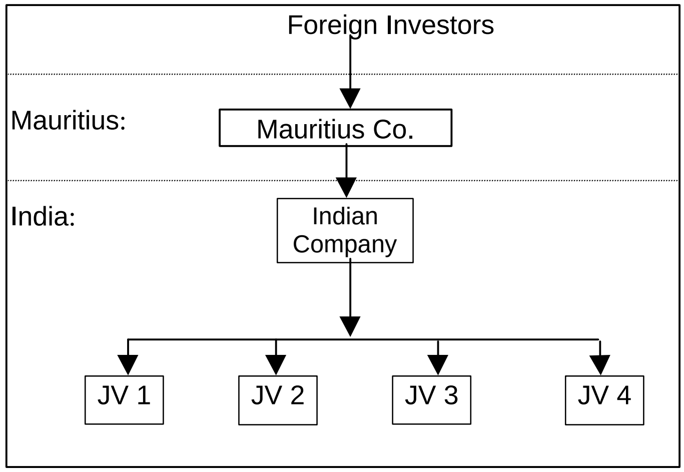
The question that arises next is whether the foreign investor should invest directly from its home country or through a tax-efficient treaty partner country. Foreign investors generally consider offshore jurisdictions, which provide them with significant tax benefits for routing their investments into India. Mauritius and a few other countries like Cyprus and the United Arab Emirates have favorable tax treaties with India. Mauritius has, however, become a popular jurisdiction, and most of the foreign investment in India is routed through Mauritius mainly because:

(i) Mauritius companies investing in the stock of Indian corporates would be exempt from the payment of capital gains (long-term or short-term) tax arising on disposal of such stock, provided that the same does not form part of the assets of a permanent establishment in India;

(ii) of a reduction in Indian withholding tax on royalty payments by an Indian company to a Mauritius company from 20% (under the ITA) to 15%; and

(iii) of a complete exemption from Indian withholding tax on interest payments by an Indian company to a Mauritius resident bank or an offshore company creditor where the loan has been specifically approved by the Government of India. If the loan is not so approved, the withholding tax rate on interest payments will be 20% (as under the ITA).

Mauritius is imposing a tax of 15% on all companies incorporated in Mauritius on or after July 1, 1998. However, investors into Mauritius could claim tax credits in their home country thereby setting-off the taxes paid in Mauritius.



We now come to the question as to whether the foreign investor should own 51% equity in the Indian JV or settle for 50:50 ownership. Incidentally, minority shareholding in an Indian JV, by itself, does not mean that it is deprived of all management rights. On the contrary, if strategically structured, the MoA & AoA of the company, could provide equal control over the JV by both the parties. Once so provided, the MoA & AoA cannot be altered unless 75% majority approval is obtained. Therefore, minority rights cannot be taken away. Thus, under Indian Company law, the real line of control is 75% and not 51%. In practical terms, 51% ownership is only a psychological barrier. There would actually be very little difference between 26% and 51% ownership if the MoA & AoA are properly drafted. On the other hand one has to bear in mind that foreign companies (especially from the US) need 51% equity for consolidating their accounts, and business exigencies may need the Indian partner to give in. If understood properly, this common conflict can be handled skillfully without losing effective control.

H. MAJOR ISSUES WHICH ARISE IN ALL JOINT VENTURES

Although the parties to a joint venture come together with a common purpose in mind, all joint ventures, whatever their form, contain the potential for conflict, as it is unlikely that the interests and ambitions of the parties will always coincide. Some of the major issues that need to be considered are set out below.

(1) Scope of the venture

It is important to establish the nature of the business or the project which the parties have in mind, the main objectives of the parties including the type of activity and its geographical scope, the extent to which any party is committed to it to the exclusion of other similar activities and restricting the parties from competing with the joint venture is commonly included.

(2) The name of the JV Co.

The name may be sensitive if it is closely related to the name of one or more parties, and it is usually to provide that if for any reason the relevant party does not become, or ceases to be a shareholder the company will change its name so as not to include the sensitive word. Problems may also arise if a word used in the company's name is also a trademark, and safeguards may be needed to prevent the use of the trademark in an inappropriate manner or context.

(3) MoA and AoA

The main requirement in the MoA will be to make the main object clause sufficiently wide to cover the company's proposed activities. The AoA will contain such of the basic rules of the company as are not set out in the agreement and will set out the different class rights (if any) of shareholders. In order to avoid conflicts arising between the agreement and the AoA. It is usual to include a provision in the JV agreement to the effect that if the MoA and AoA are inconsistent with the provisions of the JV agreement, then the parties will amend the MoA and AoA accordingly. In India, the AoA and MoA prevail over the JV agreement and the CA prevails over the MoA and AoA.

(4) Auditors and Bankers

It will be important to agree upon a firm of accountants which has the confidence of all parties to act as auditors. However, when determining the price for any buy-out of shares under the agreement, it may be necessary to provide for agreement between the parties' respective firms of accountants, with a third party deciding the matter in case of failure to agree.

A good banking relationship may be essential to the company, especially if it is intended to raise large amounts of finance by bank borrowings.

(5) Percentage of participation in the venture

It will have to be decided in what proportions the parties will share profits and losses, and this will also have implications in deciding who has effective control of the business and what protection a minority participant may require.

(a) A shareholder or group of shareholders with 75% or more of the issued capital has almost complete control over the company, including the power to pass special resolutions[49], subject only to the statutory provisions for the protection of minorities.

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[49] Section 189 of the CA.

(b) The holding of over 50% of the issued capital gives effective control over the company, as it allows the holder to pass ordinary resolutions, for example to appoint and dismiss directors or to increase the share capital

(c) A party holding less than 50% but more than 25% of the issued capital will have the power to block special resolutions in general meetings, and is therefore able, for example, to prevent the objects of the company as set out in the memorandum of association, or articles of association, being amended without his agreement.

(d) A holder of 10% or more of the paid-up capital may requisition the calling of an extraordinary general meeting, and a holder of 10% or more of the issued capital may apply to the court for cancellation of resolutions concerning financial assistance or petition for an investigation of the company’s affairs.

(6) Financing the venture

Provision must be made for the joint venture to be adequately financed, both at the initial stage and in the future. In the case of a corporate joint venture, there is a choice between equity or loan capital or a mixture of the two. Shares may be of different classes and loans may be on a variety of different terms. Guarantees by the participants may also be needed. In practice, the choice between different methods of financing may well be determined largely by tax considerations.

(7) Management of the business

In some cases one party effectively runs the business, with appropriate safeguards for the other party or parties; in others some form of joint management structure is set up. In either event it needs to be made clear who has actual authority and can appoint and direct the employees. A major issue will be the composition of the board of directors and their respective voting rights and the appointment of the managing director.

If it is not possible for the foreign investor to depute its personnel to India on wholetime basis, `alternate directors’[50] may be appointed to attend the meetings on behalf of the original directors appointed by the foreign investors The board may be designed so as to allow for the parties to be equally represented, or there may be a chairman who is given a casting vote in the event of disagreement. The chairman is sometimes a completely neutral outside person. A company is required to have a minimum of 4 meetings every year, one in each quarter[51] and the directors are required to be physically present and voting.

The CA provides that resolutions regarding certain matters cannot be passed without the approval of the shareholders in general meeting. This approval may be either by special resolution (requiring a 75% majority) or by an ordinary resolution (requiring more than

[50] Section 313 of the CA.
[51] Section 285 of the CA.

50% majority). For *e.g.* an amendment to the AoA would require the approval of the shareholder by special resolution. However, it must be noted that the above mentioned percentages relate to the number of the shareholders present and voting at the meeting. Consequently it is necessary to provide that a valid quorum for a shareholders meeting would require the presence of the authorised representative of the foreign investor.

(8) Transferability of participation

The parties to a JV rarely allow each other complete freedom to transfer the shares in the JV Co, as the unique characteristics and resources of the other party or parties are likely to have played a major role in their decision to proceed with the joint venture.

Pre-emptive rights. The AoA often provide that the shares of an intending transferor must first be offered for sale to the other members of the same class of shareholders (if any) and failing acceptance, to the members of the other class or classes; only if the shares are still unsold may they then be transferred to a third party.

Sometimes complete freedom of transfer is allowed between members of the same class, and it is also common to provide that a corporate shareholder may transfer its shares to another member of the same group of companies. If a new shareholder is brought in by such a transfer, whether or not it is a member of the same group, the other parties will wish to ensure that the transferee becomes a party to and bound by all the obligations under the joint venture agreement. A related question is whether a party to the JV should be allowed to charge its shares in the company as security for its own borrowings.

Call/Put option. In some joint ventures, changes in the percentage of participation are expressly contemplated. The joint venture may be seen as a half-way stage to the complete acquisition of the business by one party, or a party may wish to be sure of being able to sell out after a certain number of years from the start of the venture. In these circumstances, the agreement will contain call and/or put options over one party's shares, exercisable at a fixed time or within a certain period and either all at once or in specified tranches.

Whether pre-emption rights or options are adopted, the problem of valuing the shares arises. In the case of options, there is usually a precise formula to calculate the option price, for example based on the average earnings of the company over a specified period. Such a formula may also be used when pre-emption rights are exercised, or alternatively it may be left to the auditors to fix a fair value. It may also be desired to vary the price formula according to the circumstances, in which the sale takes place, for example whether the transferor wishes to sell or is required to do so by the agreement.

(9) Protection of minority interests

Except in a 50/50 joint venture between two parties, there will always be one or more parties who are actually or potentially in a minority position, and they will want their interests to be adequately protected. This is commonly done by setting up appropriate mechanisms for voting in the board and general meetings or other decision-making organs of the joint venture, and/or by giving the minority an effective veto over certain categories of major decisions.

The list of matters requiring consent typically includes changes in the nature of the company's business, in its capital structure or shareholdings or in its MoA or AoA; resolutions to wind up the company without insolvency; and various types of transactions by the company, including acquiring or disposing of businesses, setting up subsidiaries, borrowing or lending money, giving debentures, guarantees or other security, entering into transactions over a certain figure or entering into or altering the terms of service of the managing director or other senior executives. If the company has or may in the future have subsidiaries, it is also necessary to provide that similar transactions may not be carried out by any subsidiary without consent.

Minority shareholders have certain further statutory remedies irrespective of the percentage of their participation. In particular, they may petition for the company to be wound up on the grounds that it is just and equitable to do so. If this is not a suitable remedy, the court may make such order as it thinks fit where any shareholder shows that the company's affairs are being or have been conducted in a manner which is unfairly prejudicial to the interests of some part of the members (including at least himself) or that any actual or proposed act or omission of the company (including an act or omission on its behalf) is or would be so prejudicial. A shareholder may also sue the directors in the event of a breach of their fiduciary duty to act in the interests of all shareholders

(10) Deadlock and dispute resolution

A deadlock may arise in a joint venture if a major disagreement over policy arises between the shareholders, which cannot be resolved by the exercise of one side's superior voting power. This may be the case in an equally balanced 50/50 joint venture or because a minority has an effective right of veto either through its class rights or because of a contractual provision requiring its consent. In fact, a deadlock is likely to be the result of the minority protection measures, which have been discussed above. It may also be impossible to hold a meeting of shareholders or of directors because the representatives of one party fail to attend, so that there is no quorum; it is therefore useful to provide in the agreement that if a further formal meeting has been called and there is either no agreement or no quorum, a deadlock is deemed to have arisen.

There are various possible ways of dealing with a deadlock. It may be provided that in this situation one of the parties is deemed to have given notice to transfer his shares to the other or others and be bought out according to a predetermined formula or a price fixed by the auditors. Alternatively, it may be necessary to provide for the winding up of the company.

Arbitration or some form of third party decision is sometimes suggested as a means of resolving a deadlock, but although an expert or arbitrator may be able to decide on the facts and the applicable law, such a solution will rarely be appropriate where, as is usually the case, the deadlock arises from a difference over commercial policy.

(11) Termination and its consequences

As well as deadlock, there are other cases in which it may be appropriate to bring the joint venture to an end. The main examples, which are also common to many other types of agreement, are (a) a serious unremedied breach of the terms of the agreement by a party; (b) the insolvency of a party; or (c) a change in the control of a party.

Other cases may also apply, *e.g.* the expiration of a fixed period laid down for the joint venture. A party should, of course, also cease to be a party to the agreement if that party no longer holds any shares in the company. So far as change of control is concerned, the clause may have to be extended to cover hidden transfers of control of a shareholder company, such as transfers of the beneficial ownership of shares, or even changes in the composition of the shareholder’s senior management.

If there are more than two parties to the venture, it must be decided whether, in the event of one party defaulting or becoming insolvent, the whole agreement should come to an end, or whether it should continue in force between the remaining parties. The answer will probably depend on the commercial realities of the particular joint venture.

As regards the consequences of termination, once again the basic alternatives are for the defaulting party to be bought out by the other (possibly at a price which takes due account of the consequences of the default to the joint venture) or for the joint venture company to be liquidated. Again, which of these is appropriate will depend on the circumstances.

If one party withdraws, it will probably be necessary for any loans or guarantees provided by that party to be repaid or cancelled. It may be necessary to change the name of the company if it is a sensitive name associated with a particular shareholder.

Careful consideration should also be given to the question whether any ancillary agreement entered into as part of the joint venture should also terminate or be allowed to continue in force.

(12) Taxation

It goes without saying that any business transaction must be made to work satisfactorily from a tax point of view, and this will be a major consideration in devising a suitable structure·

(13) Governing law

The one question to be discussed is whether the parties could choose any law in the world, however alien it may be to the factual character of the agreement, or should their choice be restricted to the law of some country with which the agreement is already factually connected.

The problem of ascertaining the governing law is more perplexing in the case of agreements than in almost any other topic, as in the case of a agreement there may be a multiplicity of connecting factors such as the place where it is made; the place of performance; the domicile, nationality or business center of the parties; the situation of the subject matter and so on.

(14) Confidentiality

The parties to the JV should undertake that it and each of its affiliates and employee shall not, without limit in point of time, divulge or communicate to any third party (except as may be necessary for such party to perform its obligations hereunder or as may be required by law) or use for its own purpose any information about the private affairs of the JV Co or the other party hereto, except such information as may have come into public knowledge otherwise than by reason of a breach of this undertaking, or with the prior written approval of the other party.

I. KEY LEGISLATIONS

In the course of doing business in India, the terms and conditions of the following key areas of law are of relevance.

(1) Environment protection

The major legislation in this regard is the Environment (Protection) Act, 1986. The Central Government is given wide powers under the said Act to take all such measures it deems necessary to protect and improve the environment and also preventing and controlling environmental protection. Some key areas of action being:

(a) Laying down standards for the quality of environment and emission or discharge of pollutants.

(b) Restriction of areas in which any industries, operations or processes shall not be carried out or stipulations for carrying out of the same.
(c) Examination of manufacturing process, materials and substances used etc.
(d) Closure of any industry, restriction of any operation or process involved therein.
(e) Power to enter premises to take samples.

Necessary approvals may have to be obtained from the Ministry of Environment and Forests in order to establish extensive manufacturing concerns since such activities may have substantial environmental ramifications.

(2) Labour laws

India has a large number of welfare and regulatory legislations, which mandate the provision of monetary and other benefits to the employees of an establishment. These legislations only provide the minimum levels of compliance and a company is free to provide benefits in excess of the prescribed limits. The Acts also provide for periodic regulatory compliances in terms of filing requirements, etc. and the maintenance of registers in prescribed formats. There are statutory restrictions on the manner and time frame within which an employer may terminate the services of an employee.

(3) Monopolies and Restrictive Trade Practices Act, 1969 ("Anti-Trust")

The Monopolies and Restrictive Trade Practices Act, 1969 (the "**MRTP Act**") prohibits the commission of restrictive trade practices which would have the effect of distorting market forces so as to adversely affect the interests of the consumers. The provisions of this Act would become relevant if the parties propose to enter into transactions containing exclusivity or non-compete requirements.

(4) Intellectual property rights

Indian courts have granted recognition to cross border reputations, implying that even if a particular trademark is not registered in India but has substantial international recognition, protection from infringement can be granted. However, though the injunctive remedies in this regard are fairly efficacious, the courts are very conservative in their approach to punitive/exemplary damages.

(5) Alternative dispute resolution

JV agreements in India almost invariably provide for conciliation/arbitration as the means of resolving deadlocks between the parties. Earlier, the Indian Arbitration Act, 1940 was not perceived as a commercially viable option and parties used to provide that the arbitration proceedings would be governed by the laws of a foreign country. However, the Indian Arbitration Act, 1940 has been recently replaced and a new Indian Arbitration and Conciliation Act, 1996 has been formed in keeping with the UNCITRAL (United Nations Commission on International Trade Law) model and the choice of foreign law is no longer a necessity. The parties to the JV agreement are advised to draft a detailed arbitration clause with regard to the mechanism to be adopted in the event of a dispute arising.

J. DISINVESTMENT AND EXIT POLICY

Generally, any differences/disputes arising between the parties to the JV are resolved in accordance with the terms of the JV agreement and the AoA of the JV Co. However, a situation may arise when the parties to the JV are not in a position to reconcile their views and therefore decide to part amicably. The following options are available to a JV partner desirous of ending the JV agreement:

1. Sale of shares by residents to other residents
2. Sale of shares by a resident (local JV partner) to a non-resident (foreign JV partner)
3. Sale of shares by a non-resident to a resident
4. Sale of shares by a non-resident to another non-resident

(1) Sale of shares by residents to other residents

As the sale of shares by a resident to another resident amounts to a transfer between local partners, no approval is required to be obtained from the RBI.

However, in case of transfer of shares as per clauses 2 and 3 hereinbelow, if at the time of obtaining the approval for formation of the JV Co, the GoI department had specified that the shares should not be transferred between the JV partners or if it had specified any other conditions which would require prior approval of the GoI in case of change in the JV partners, then such further approval would be required to be taken before affecting the transfer of shares between the residents and/or non-residents. Such a situation is common in the case of infrastructure projects *i.e.* port, telecommunication, power.

(2) Sale of shares by a resident (local JV partner) to a non-resident (foreign JV partner)

In the case of sale of shares by the local JV partner in favour of the foreign partner, FIPB approval is required to be obtained. The application to the FIPB should be made on Form FC/IL SIA[52]. After obtaining the FIPB approval, the foreign company has to apply to the RBI on form FNC 7 for purchasing the shares of the Indian partner.

Generally, at the time of formation of the JV Co, the parties to the JV provide an exit clause in the JV agreement and a formula for the valuation of shares. In the event of termination or disinvestment by any party to the JV, the valuation of the shares is done based on either the pre-determined sale price as per the JV agreement or at a price mutually agreed upon by the parties.

The methodology for arriving at the price at which disinvestment of equity shares by residents to non-residents is approved by the RBI on the basis outlined hereinbelow:

(a) Disinvestment of shares of unlisted and closely held public limited companies

(i) The book value of the shares based on the Controller of Capital Issues formula [53] (the "**CCI formula**"); or

(ii) The agreed price between the parties, which ever is higher.

(b) Disinvestment of shares of listed companies

(i) Transfer of shares on stock exchange(s)

The sale of shares will have to be made on the stock exchanges at the prevailing market price through a registered merchant banker or a stockbroker.

(ii) Transfer of shares by private arrangement

- The shares are proposed to be sold at the prevailing market price; or
- The agreed price between the parties, which ever is higher

(3) Sale of shares by a non-resident to a resident

In the event of sale of shares by non-resident investors in favour of residents, an application is required to be made to the RBI in form TS1 together with the documents mentioned therein. The methodology for arriving at the price at which the disinvestment

[52] *vide* Press Note No. 18 (1997 series) dated December 26, 1997, Department of Industrial Policy and Promotion.

[53] CCI formula is an average of the aggregate of share price based in (i) Net assets value (NAV) per share and the (ii) Profit earning capacity value (PECV) per share.

of equity shares by non-residents to residents is approved by the RBI, is outlined hereinbelow:

(a) Disinvestment of shares of listed companies[54]

(i) Transfer of shares on stock exchange(s)

Application[55] for such transfer will be cleared on an automatic basis under section 19(5) of FERA[56] but the sale of shares will have to be made on the stock exchanges at the prevailing market price through a registered merchant banker or a stock broker.

(ii) Transfer of shares by private arrangement

In such cases of transfer, the RBI will satisfy itself that:

- The shares are proposed to be sold at a price that is arrived at by taking the average quotations (average of daily high and low) for one week preceding the date of application with a provision for variation up to 5%, either side;
- In cases where the disinvestment of shares by the foreign collaborators/promoters of the Indian companies is in favour of the existing Indian promoters with the objective of passing management control in favour of the resident promoter, the applications will be cleared by the RBI at a price which is higher by up to a ceiling of 25% over the price arrived at as above.

(b) Disinvestment of shares of thinly traded companies[57]*/unlisted companies*[58]

[54] *Source*: A.D. (M.A. Series) Circular No. 20, dated October 28, 1996.

[55] On Form TS 1.

[56] Notwithstanding anything contained in any other law, no transfer of any share, bond, or debenture of a company registered in India made by a person resident outside India or by a national of a foreign state to another person resident in India shall be valid unless such transfer is confirmed by the RBI in any application made to it in this behalf by the transferor or the transferee.

[57] According to the RBI, a share will be considered as thinly traded if on the main exchange(s) in India, the annualized trading volume in that share during the six calendar months prior to the month in which the application is submitted, is less than 2% of the total number of shares of the listed stock. In case of securities with a history of listing and trading less than six months, the trading turnover may be annualized with reference to the actual number of days for which the stock had been listed

(i) Applications will be cleared on an automatic basis if the gross sale consideration is less than or equal to Rs. 2 million per seller, per company, per annum and the price at which the divestment takes place is based on any valuation methodology currently in vogue.

(ii) In respect of transactions exceeding Rs. 2 million, the non-resident seller will have the following options:

- To sell the shares at the higher of the price based on earnings per share linked to price earning multiple ("**P/E Multiple**")[59] and that based on the net asset value ("**NAV**") linked to book value multiple ("**BVM**")[60]; or
- To sell the shares with the prior approval of the RBI on stock exchange at the prevailing market price is small lots so that the entire holding is sold in not less than 5 working days through screen based trading system; or
- To sell the shares with the prior approval of the RBI, at a price which is lower of the two independent valuations, one by the statutory auditors and the other by a chartered accountant or SEBI registered category-I merchant bankers, giving a reasoned report in respect of the price.

(4) Sale of shares by a non-resident to another non-resident

In the event of sale of shares by non-residents investors in favour of other non-residents, a application is required to be made to the RBI in form FNC 7 together with the documents mentioned therein. The non-resident transferee requires permission under FERA[61] for purchase of the shares of the Indian company and also for registering the transfer in its favor[62].

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58 *Source*: A.D. (M.A. Series) Circular No. 20, dated October 28, 1996.

59 The average P/E Multiple of the BSE National Index for the calendar month immediately preceding the month in which the application was made, discounted by 40%, will be used.

60 The average book value multiple of the BSE National Index during the calendar month immediately preceding the month in which the application is made, discounted by 40%, will be used.

61 Section 29(1)(b).

62 Section 19(4) of FERA.