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September - 2016 Vol . IV | No. 12

FOREIGN DIRECT INVESTMENT IN INDIA

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Full Day Seminar on "Non-Resident Taxation and FEMA Implications" held on 3rd September, 2016 at West End Hotel

CA Hitesh R. Shah, President delivering opening speech. Seen from L to R : S/Shri CA Paresh P. Shah, Chairman, CA Shabbir Motorwala, Faculty and CA Rutvik Sanghvi, Co-ordinator.

CA Paresh P. Shah, Chairman, welcoming the speaker. Seen from L to R : S/Shri CA Shabbir Motorwala, Faculty, CA Hitesh R. Shah, President and CA Rutvik Sanghvi, Co-ordinator.

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The Chamber made effective Representation on GST on various issues and also gave its written representation on the same to Hon'ble Finance Minister for State Maharashtra Shri Mungantiwar on Wednesday, 7th September, 2016 at Sahyadri Guest House. Shri Hitesh R. Shah, President, Shri Ajay R. Singh, Vice-President, Shri Hinesh R. Doshi, Hon. Jt. Secretary, Shri Vikram Mehta, Chairman, Shri Naresh Sheth, Vice Chairman, Indirect Taxes Committee and Members Shri Deepak Thakkar, Shri Rajat Talathi, Shri Manish Gadia, Shri Aalok Mehta & Shri Pranav Kapadia represented team Chamber.

CONTENTS

Vol. IV No. 12
September – 2016

Editorial .... *K. Gopal* 5
From the President .... *Hitesh R. Shah* 6
Chairman's Communication .... *Vipul Choksi* 9

1. **SPECIAL STORY : Foreign Direct Investment in India**
   1. Foreign Investment in India: An Overview .... *Anup P. Shah* 11
   2. Guideline of Foreign Investment Promotion Board and Select Industrial/Sectoral Policy .... *Paresh P. Shah* 17
   3. Indirect Foreign Investment and Downstream investments .... *Naresh Ajwani* 34
   4. Investment in LLPs, Partnership Firms & Proprietorships .... *N. C. Hegde* 57
   5. Portfolio Investments .... *Vijay K. Gupta* 63
   6. Transfer/Divestment of Shares & CCDs – Documentation and Reporting .... *Mayur B. Nayak* 72
   7. Remittance of sale proceeds and on winding up/liquidation of companies .... *Chandresh Bhimani, Harshal Kamdar & Jigar Mehta* 81
   8. Liaison, Branch, Project Office of the Non-Residents .... *Hinesh R. Doshi, Shital H. Desai & Ashish J. Mehta* 86
   9. Investments by FVCI and Investments in AIF & REITs by Foreign Investors under FEMA .... *Nirav Panchmia* 94
2. **HOT SPOT**
   Applicability of MVAT on works contract transactions involving barter with special thrust on MSTT decision in the case of M/s Sumer Corporation vs. State of Maharashtra.... *C. B. Thakar* 103
3. **DIRECT TAXES**
   - Supreme Court .... *B. V. Jhaveri* 109
   - Tribunal .... *Jitendra Singh & Sameer Dalal* 114
4. **INTERNATIONAL TAXATION**
   - Case Law Update .... *Tarunkumar Singhal & Sunil Moti Lala* 117
5. **INDIRECT TAXES**
   - Central Excise .... *Hasmukh Kamdar* 130
   - Indirect Taxes – VAT Update .... *Nikita Badheka* 132
   - Service Tax – Statute Update .... *Rajkamal Shah & Naresh Sheth* 135
   - Service Tax – Case Law Update .... *Bharat Shemlani* 137
6. **CORPORATE LAWS**
   - Company Law Update .... *Janak C. Pandya* 142
7. **OTHER LAWS**
   - FEMA .... *Mayur Nayak, Natwar Thakrar & Pankaj Bhuta* 145
8. **BEST OF THE REST** .... *Ajay Singh & Namrata Bhandarkar* 150
9. **FAT TAX? WHAT NEXT?** .... *Ninad Karpe* 155
10. **THE CHAMBER NEWS** .... *Hinesh R. Doshi & Haresh P. Kenia* 156

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Editorial

By the time this issue of the Chamber's Journal is in your hands, the campaign to make the Income Disclosure Scheme, 2016, a success, would be at its peek. The Scheme is providing opportunity to the citizens to become compliant of tax laws by making a disclosure and paying the taxes. The departmental authorities, while counting the benefits of the scheme to the assessees, are suggesting the assessees that on the conclusions of the scheme if any of the assessee is found wanting to comply with the tax laws, then consequences may be severe. As far as the departmental authorities are spreading awareness about the Income Disclosure Scheme, 2016, we professionals do not have any problem. Even a veiled threat of consequences to be followed may not give rise to a very strong case for objection. We professionals do not have any objection if the departmental authorities come down heavily on the citizens who are tax defaulters. Our problem is the indiscriminate use of discretionary powers vested with the authorities. The departmental authorities cannot paint all the assessees with the same brush. We earnestly request the Finance Minister and the Central Board of Direct Taxes to lay down elaborate guidelines so that provisions of Income-tax Act, 1961 and the provisions of Section 197 of the Finance Act, 2016 are not misused against law abiding citizens. We have full confidence in the Prime Minister, the Finance Minister and the Central Board of Direct Taxes that they will walk the talk as far as catching the tax defaulters are concerned. At the same time, they will ensure that honest taxpayers are not harassed.

The September issue of Chamber's Journal carries the special story on Foreign Direct Investment in India. Eminent professionals have contributed on various topics of the special story. I thank them for the support. I hope in the coming months, as the investment pours from across the sea, this issue of the Chamber's Journal will come in handy to the professionals. I thank all the contributors to this issue of Chamber's Journal for taking out time for the Journal.

K. GOPAL
Editor

From the President

Dear Members:

This is a peak season for all practising Chartered Accountants and Tax Practitioners as they are busy in preparing and finalising the tax audit reports (TAR) and filing the returns of Income before 30-9-2016 for the Financial year ended on 31-3-2016. At the same time last date for making disclosure under Income Disclosure Scheme 2016 is 30-9-2016. This has added additional work load on practising Chartered Accountants and Tax Practitioners. Considering the clashing of due Date, CBDT has extended due date for filing return of Income and Tax Audit to 17-10-2016. This has eased pressure on practising Chartered Accountants and Tax Practitioners. The Chamber had represented before CBDT to either extend the last date of filing declaration under Income Declaration Scheme 2016, if that is not possible, then to extend the last date of filing tax audit report and return of income.

Income Disclosure Scheme 2016 (IDS) has not yet taken off in a big way due to inherent weakness in the scheme. Hon'ble Finance Minister Shri Arun Jaitley has stated that this is a last chance to a person to come clean under IDS since it provides an opportunity to person to declare their undisclosed domestic income and assets.

Tax avoidance concept is global phenomena. Recently **Apple Inc** was ordered to pay a record 13-billion euros ($14.5 billion) plus interest and was one of the first companies caught up in the EU's backlash against corporate tax-avoidance.

Statistics show that India has highest cash transactions to the extent of 78% as against 24% in USA. **CBDT is examining the possibility of banning cash** transactions over ` 3 lakh and restricting cash holding with individual and industry to ` 15 lakh in a bid to clamp down on black money or to curb illegal wealth in the country.

Presently under the Income-tax sufficient mechanism is available to curb the use of cash as well as tackling of such cash transactions such as collection of tax at source @1% on cash Transactions exceeding ` 200,000, disallowance of cash expenditure in excess of ` 20,000/-, non-acceptance or repayment of loan or deposit in cash exceeding ` 20,000. Will introducing such ban help the Govt to achieve the purpose? Or will it create more bureaucratic approach and Red-tapism?

Limit of cash transactions above ` 3 lakh is too small considering the cost of inflation and cash requirement at various places more particularly for medical treatment or any other emergencies.

On the contrary Government should encourage more transactions happening through electronic mode or by use of credit card by giving more and more incentives to the people thereby covering all people under the tax net.

With cell phones becoming a crucial part of banking, the RBI has made it mandatory for banks to allow customers to register their cell phone numbers through any ATM and to allow payment to be done through cell phones called **'Unified Payment Interface (UPI)'. It is a revolutionary step towards Digital India and India is the first country to introduce the same**. Each mobile will now work as ATM or POS machine and as a result fraud arising due to use of credit card will get minimised. **Such step will also help in reducing use of cash in economy**.

A recently released National Crime Record Bureau (NCRB) report shows investors in Maharashtra, Delhi and Bihar have lost highest amount between 2011-15 in different scams mainly through Ponzi schemes and recovering investments made in fraudulent schemes was difficult due to multiplicity of agencies probing them. **Hence there is a strong need to enact a Central law on such Ponzi scheme. In past the Chamber has made representations on such Ponzi scheme before the Parliamentary Committee on Finance and made a strong pitch for enactment of central law. It will be endeavour of the Chamber to assist Government in enactment of such law.**

Much has been talked about infrastructural deficit to deal with 21.3 million cases currently pending in various Courts in India including Supreme Court. However **specification of time limit** should also be considered as a distinctive feature of process of reforms across jurisdiction that have been able to quantifiably minimise judicial delays.

With passing of **GST Bill** by 17 States and the President signing the Constitutional amendment into law the **stage is set for forming the GST Council. However it is the politics of GST implementation that is daunting**. The mechanics of implementation getting the GST Network up and running, training tax officials to handle the new system, and nudging companies to instal the necessary software and hardware at their ends will be a challenge hard enough. GST is as huge a political project. **There are political issues left unaddressed and these include, first, fixing rates for hundreds of products and services, arriving at a dispute settlement mechanism, and agreeing on how States will be compensated for revenue losses. Keeping these in mind it will be practically difficult to lay down exact time period for effective implementation of GST and** even Hon'ble Finance Minister has also raised its concern over the deadline of 1-4-2017 for effective implementation.

RBI Governor, Raghuram Rajan's three year tenure ended on 4th September 2016. He ended up doing a 'deep surgery' of banks while at RBI. **Mr. Urjeet Patel has been appointed as 24th Governor of Reserve Bank of India. The real challenge lies before him is while keeping inflation under control whether he brings humane touch to address the larger issue of poverty and inequality which continue to define the Indian economy and society.**

Passion and professionalism is a key to success. Olympic stars P. V. Sindhu, Sakshi Malik and Dipa Karmakar were conferred India's highest sporting honour – the Rajiv Gandhi Khel Ratna and this demonstrates that Indian women are equally capable to men in all respects. **Splendid performance by Indian athletes at Paralympics shows that their abilities are greater than their disabilities.** It is a pride for the entire nation and Chamber salutes such sportspersons.

In last one month, Chamber **has made several representations** such as **fallacious reasons for selecting cases under limited scrutiny**, seeking **clarifications on Income Disclosure Scheme, difficulties for issue of TDS certificate under Section 197** of the Income Tax Act, **Generation of TDS Certificate, on Dispute Resolution Scheme** which also includes extending the scheme to disputes pending before all levels of appeals. **Representation before the Commissioner of VAT**

for Maharashtra alongwith other associations **seeking clarification on** various issues arising under **Settlement of Arrears in Dispute Act, 2016 was made** and as a result immediate clarifications were issued. Representation before **the Hon'ble Finance Minister for State of Maharashtra Shri Sudhir Mungantiwar** on Model GST Laws was made and suggestions made were appreciated.

The Office bearers of Chamber had met the members of National Company Law Tribunal members and felicitated them. NCLT members were appraised about the activities carried by the Chambers.

During the period, Chairmen of the Committees organised many successful programmes including outstations programmes and all programme received good response from the participants.

Delhi Chapter of Chamber had organised programme on Insolvency and Bankruptcy Law – Emerging Issues, Challenges and Professional Opportunities.

As a yearly feature this year too Chamber had organised **football match** wherein eight teams participated and **Shri Y. P. Trivedi, Past President of Chamber was the Chief Guest** who distributed prizes to winning team. It was a spectacular show by all the team players and the team from BDO was declared as winner.

Even for September many events have been planned despite busy period for Chartered Accountants and Tax Practitioners. Study course on GST Model Laws planned in the month of September 2016 with the sole intention to make people learn the Model GST Law which has received overwhelming response. I am extremely sorry to all those members who could not be accommodated. However considering the request received, the Chamber has decided to announce second such course in the month of November 2016.

To create awareness on UPI the Chamber has organised programme on Unified Payment Interface which will be addressed by Mr. Sanjay Saxena, CFO of National Payment Corporation of India.

The Special Story for the month, 'Foreign Direct Investment in India' designed by Shri Paresh Shah deserves appreciation. The issue covers different types of foreign investments, regulatory agencies dealing with FDI and indirect investments and downstreams etc. I am sure it will be used as reference material by our members for a long time to come.

As you all know this month is of a festive period and my best wishes to all members on this festive period.

And I end my communiqué with

ß meJexYeJevlegmegKeveë ~	Om, May All become Happy,
meJexmevlegefvej ece³eeë ~	May All be Healthy (Free from Illness)
meJexYeêeefCe HeM³evleg~	May All See what is Auspicious,
cee keÀef½eled oegKe YeeiYeJesled~	May no one Suffer in any way.

HITESH R. SHAH
President

Chairman's Communication

Dear Readers,

The largest sports carnival of the Globe, the Olympics 2016 at Rio is over and Indian contingent's below par performance ranking 67th in medal tally was a subject of much debate and discussion post the event. P. V. Sindhu and Sakshi Malik have saved India from the disgrace of zero medals at the Games particularly in the backdrop of tweet by a writer "Goal of Team India at the Olympics. Rio jao, Selfies Lo. Khaali haat wapas aao. What a waste of money and opportunity". Great Britain's brilliant performance at Rio, after their extremely poor showing at the previous Olympics came in for close scrutiny. What was the secret of this turnaround, and what lessons can India learn from them? Champions don't emerge from no where; they have to be identified at a young age, nurtured, motivated, trained relentlessly and supported by the Government. Thankfully, our Prime Minister has set up a task force for the next two Olympics in 2020 and 2024. Let us hope that the entire system will be revamped and the shameless act of according second class treatment to the sports persons and first class treatment to sports official will be stopped. Hopefully India's flag will fly high in the forthcoming Olympics!

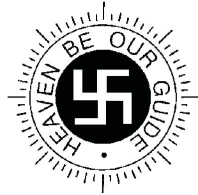
In the past, the CBDT has refused to grant extension for filing of income tax returns despite genuine reasons and representations by the professional bodies. If at all, the extension was granted at the eleventh hour which was not of much help to the taxpayers and the professionals. This year extension for filing of income tax returns for certain categories of taxpayers to 17th October from the due date of 30th September was least expected and came as a surprise since the tax returns were notified well in advance and there were no representations made for extension! The reason given in the notification is that the last date for making declaration under the Income Declaration Scheme, 2016 is 30th September 2016 which coincides with the date for filing of income tax returns for certain categories of taxpayers. Therefore with a view to remove inconveniences, the date has been extended. I am sure, all the professionals are geared up to file the tax audit reports and the tax returns much before the extended date.

Twenty five years ago, the then Prime Minister of India, Mr. P. V. Narasimha Rao, scripted India's biggest turnaround story by opening the Indian Economy. Post these reforms there have been continuous changes from time-to-time in Foreign Direct Investments (FDI) policies for various sectors. The present Government announced, what it termed, a "radical liberalisation" of the FDI regime by easing norms for a host of important sectors including defence, civil aviation and pharmaceuticals, opening them up for complete foreign ownership. Considering the major changes in FDI policy, a special story on FDI was considered necessary. I sincerely thank my Council colleague Shri Paresh P. Shah for structuring the design and also for his efforts in overall co-ordination of the special story on FDI.

This issue would not have been possible without the efforts of all the eminent authors who specialise in this subject and have dealt with the issues, relevant to the topic, in the best possible manner. Sincere thanks to them for sparing their valuable time and for their selfless efforts.

Wishing you all Happy Navratri and a Happy Dussehra!

VIPUL K. CHOKSI
Chairman – Journal Committee



The Chamber of Tax Consultants

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The Chamber of Tax Consultants (The Chamber) shall be a powerhouse of knowledge in the field of fiscal laws in the global economy.

The Chamber shall contribute to the development of law and the profession through research, analysis and dissemination of knowledge.

The Chamber shall be a voice which is heard and recognised by all Government and Regulatory agencies through effective representations.

The Chamber shall be pre-eminent in laying down and upholding, among the professionals, the tradition of excellence in service, principled conduct and social responsibility.

CA Anup P. Shah

Foreign Investment in India: An Overview

1. Introduction

India received Foreign Direct Investment ***(FDI)*** worth US $ 424 billion during the 16-year period of April 2000 to March 2016! This highlights the importance of FDI to the Indian economy. FDI is a much preferred form of foreign investment as compared to other forms, such as, Portfolio Investment, Foreign Institutional Investment, etc. This is because the FDI flows are considered to be relatively more long-term in nature.

2. Regulations and Agencies

2.1 The FDI Framework in India stands on a three-legged tripod consisting of three Regulations — the Foreign Exchange Management Act, 1999 along with its Regulations, the Consolidated FDI Policy, and the Circulars to Authorised Persons issued from time-to-time by the Reserve Bank of India.

2.2 Interestingly, just as there are three Regulations, there are also three Agencies / Ministries / Regulators which are involved in the FDI Regime – the Reserve Bank of India (RBI), the Department of Industrial Policy and Promotion (DIPP), Ministry of Commerce & Industry and the Foreign Investment Promotion Board (FIPB), Ministry of Finance. Each of these three agencies has an important role to play.

3. FEMA and RBI

3.1 The Foreign Exchange Management Act, 1999 ***(FEMA)*** is a Central Statute of the Parliament and is the supreme Act when it comes to regulating all foreign transactions in India, including those pertaining to FDI. The FEMA also consists of Regulations issued by the RBI from time-to-time. The relevant Regulations for FDI are the ***Foreign Exchange Management (Transfer or Issue of Security by Persons Resident Outside India) Regulations, 2000*** (referred to as ***"the FEMA Regulations"***) issued by Notification No. FEMA 20/2000-RB dated May 3, 2000. U/s. 46 of the FEMA, the RBI has power to make Rules to carry out the provisions of the Act. Further, u/s. 47, it has powers to make Regulations to carry out the provisions of the Act and the Rules. The FEMA Regulations provide that unless provided, no Indian company can issue any security to a foreign resident or register a transfer of security in favour of a foreign resident. This prohibition stems from s. 6(2) of the FEMA which empowers the Central Government/the RBI to specify any class of capital account transactions which are permissible, i.e., capital account transactions are prohibited unless expressly permitted by the RBI.

3.2 One feature of the FEMA Regulations are the Directions issued by the RBI u/s. 10(4)

and 11(1) of the FEMA to various Authorised Persons, popularly known as *"A.P.(DIR Series) Circulars".* Thus, these Circulars are operational instructions from the RBI to Banks, etc. The legal validity of these Circulars has been upheld by the Bombay High Court in the case of *Prof. Krishnaraj Goswami vs. the RBI, 2007 (6) Bom CR 565.* Interestingly, while the RBI has issued Master Directions (which have subsumed all Circulars) for all major FEMA Regulations, it has not yet done so for foreign investment. Hence, one may still refer to the Master Circular dated 1st July 2015 on Foreign Investment in India. The Master Directions have greater force of law as compared to a Master Circular which at best could be referred to for guidance.

4. CFDIP and DIPP

4.1 The DIPP frames the Foreign Direct Investment Policy in India which lays down the sectors in which FDI is allowed, the conditions attached and the sectoral caps. It also lays down the sectors in which FDI is Automatic and those in which it requires Approval of the Government of India. The FDI Policy is prepared in the form of the ***Consolidated FDI Policy ("CFDIP").*** The Policy defines FDI to mean investment by non-resident entities in the capital of an Indian company under Schedule 1 of FEMA No. 20/2000-RB dated May 3, 2000.

4.2 The power of the Government to lay down economic policy has been the subject-matter of great judicial interest. The validity of the FDI Policy issued by the Government has come in for review by various Courts. In the decision of *Radio House vs. UOI, 2008 (2) Kar. LJ 695 (Kar.),* the High Court held, while dealing with the definition of 'wholesale trading' laid down in an earlier version of the FDI Policy, that the task of defining the term 'cash and carry wholesale trade' was best left to the Government, which had formulated the policy of inviting the FDI. No directions could be given to the Government to accept a particular definition of the term 'cash and carry wholesale trade' in preference to or to the exclusion of its other definitions from other sources. A similar view was again taken in *Federation of Associations of Maharashtra vs. UOI, W.P. (C) Nos. 9568-70 of 2003 (Del.).*

The Supreme Court, in *Manohar Lal Sharma vs. UOI, (2013) 33 taxmann.com 33 (SC),* had an occasion to examine the Government's FDI Policy in respect of retail trading. It upheld the superiority of the Government to enact such Policy. It held that the DIPP was empowered to make policy pronouncements on FDI and that the competence of the Central Government to formulate a policy relating to investment by a non-resident entity/person resident outside India, in the capital of an Indian company was beyond doubt. The RBI was empowered to prohibit, restrict or regulate various types of foreign exchange transactions, including FDI, in India by means of necessary regulations. The RBI Regulated foreign investment in India in accordance with Government of India's policy.

The Delhi High Court in *Dr. Subramanian Swamy vs. UOI, [2014] 44 taxmann.com 281 (Delhi)* was faced with a Public Interest Litigation over whether the FDI Policy permitted FDI in existing airlines only and not in proposed or new airlines. It held that Policy preparation was the exclusive domain of the Government.

5. FIPB

The Foreign Investment Promotion Board ***(FIPB)*** is a part of the Department of Economic Affairs, Ministry of Finance. FDI could be Automatic or it may require the Approval of the Government of India. The FIPB is a nodal authority for approving all FDI proposals which require prior Government Approval. The FIPB provides a single-window mechanism for all such FDI proposals which are not permissible under the automatic route.

6. CFDIP vs. FEMA, which prevails?

6.1 One question which has often been raised has been which is supreme – ***the FDI Policy or***

the FEMA Regulations? The answer to this is very simple, it is the FEMA and the Regulations issued thereunder which are superior to the FDI Policy. The FDI Policy is notified by the RBI as amendments to the Foreign Exchange Management (Transfer or Issue of Security by Persons Resident Outside India) Regulations, 2000. Schedule 1 of these Regulations deals with "Foreign Direct Investment Scheme". Para 2 of Schedule 1 gives recognition to the FDI Policy by providing that the Automatic Route for FDI is available to a company in accordance with Annex B to the Schedule and the provisions of the FDI Policy, as notified by the Ministry of Commerce, from time-to-time. Annex B contains the ***"Foreign Investment Caps and Entry Route in Various Sectors".*** This Annex B is based on the FDI Policy issued by the DIPP. It is here that the conditions and sectoral caps for various sectors, such as, defence, telecom, broadcasting, trading, etc., are laid down.

6.2 *The FDI Policy itself provides that **in the case of any conflict** with the FEMA Regulations, the FEMA Notifications would prevail.*

7. Meaning of FDI

7.1 FDI means investment by a person resident outside India in the capital of an Indian entity. Thus, the foreign exchange flows directly into the Indian company. On the other hand, under Foreign Portfolio Investment, foreign entities buy shares of Indian companies from existing shareholders. Thus, the money does not flow directly into the Indian company. FDI can be bifurcated on the basis of its repatriation qualities into **Repatriable**, i.e., where principal, gains and current income can be freely sent back to the foreign investor and **Non-repatriable,** i.e., where only current income, such as dividend and interest can be sent back from India to the foreign investor.

7.2 FDI can also be bifurcated on the basis of its approval into **Automatic Route,** i.e., where FDI does not require the prior approval of the Government of India and there is only a *post facto* filing with the Reserve Bank of India and **Approval Route,** i.e., where the prior approval of the Foreign Investment Promotion Board is required. Whether FDI in a particular company is under Automatic Route or Approval Route, depends upon the Sectoral Policy applicable to that company.

7.3 There are a few sectors where FDI in any form, whether with FIPB approval or otherwise is prohibited. Thus, these are sectors which are only open to domestic investment.

8. Entities for FDI

8.1 The next question which arises is that which entities can be selected for receiving the FDI? Is FDI restricted only to companies? The answer is as follows:

(a) Companies, both private and public limited, are the most popular route for FDI.

(b) Partnership Firms, subject to conditions.

(c) FDI in Limited Liability Partnerships ***(LLPs)*** is now permissible with prior FIPB approval and subject to several conditions.

(d) FDI in a Venture Capital Fund (in the form of a Trust)/Alternative Investment Fund registered with the SEBI is permissible with FIPB approval.

9. Instruments

9.1 One of the questions to be addressed is which instrument would be used for the investment? The instruments which are considered for FDI are as follows:

(a) Equity Shares

(b) Compulsorily Convertible Preference Shares (**CCPS**). Redeemable Preference Shares or Optionally Convertible Preference Shares are not treated as capital and are treated as Foreign Debt.

(c) Compulsorily Convertible Debentures (**CCDs**). The end-use restrictions and interest-rate applicable to External Commercial Borrowings are not applicable to CCDs.

(d) Warrants and Partly paid-up shares – However, these requires the prior permission of the FIPB.

There is a proposal by the RBI to permit FDI in optionally convertible instruments. However, the same needs to be permitted by the Ministry of Finance.

9.2 The RBI has now expressly permitted equity instruments with built-in put and call options, subject to conditions and valuation norms. However, any form of assured return to the foreign investor is prohibited.

9.3 The issue price of shares issued under the FDI route must be as per the pricing guidelines specified by the RBI:

- On the basis of SEBI guidelines in case of listed companies.
- Not less than fair value of shares determined by a SEBI registered Merchant Banker or a Chartered Accountant as per any Internationally Accepted Pricing Methodology in the case of unlisted companies. This could include, discounted cash flow, net asset value, earnings capitalisation, price earning multiple, etc.

9.4 The price/conversion formula of convertible capital instruments should be determined upfront at the time of issue of the instruments. The price at the time of conversion should not in any case be lower than the fair value worked out, at the time of issuance of such instruments, in accordance with the FEMA regulations.

10. Downstream Investment

Can a company which has FDI in an FDI compliant sector make a downstream investment in a company which is in a sector which is not FDI compliant? If the investor Indian company is a company owned and controlled by resident Indian citizens, then the downstream investment would be treated as domestic investment. The criteria for considering whether a company is owned and controlled by resident Indian citizens, is that the resident Indian citizens must own more than 50% of the capital (capital means equity shares, compulsorily convertible preference shares and compulsorily convertible debentures) of that company and to determine control they should have right to appoint majority of the directors or to control the management or policy decisions exercisable by a person or persons acting individually or in concert, directly or indirectly, including by virtue of their shareholding or management rights or shareholders agreements or voting agreements or in any other manner. Thus, investment by such a company in another company is treated as if it is a domestic investment and not an indirect foreign investment. Accordingly, it is possible for such a company to invest in an non-FDI compliant project.

11. FDI vs. FII / PIS

11.1 While on the subject of FDI, it would not be out of place to highlight the distinction between FDI inflows on the one hand and inflows from Foreign Institutional Investment (FII)/Portfolio Investment Schemes (PIS) on the other hand. FDI is primary market investment by non-resident entities in the capital of an Indian company, i.e., money directly comes to the Indian company. FII and PIS on the other hand are secondary market investment in which foreign investment is made by acquiring the shares of an Indian company from other resident/non-resident shareholders. It may be noted that FII investment is not subject to the sectoral caps and conditions laid down in the CFDIP. In cases where the RBI also wants to prevent, investment under the FII/ PIS, it has expressly done so. For instance, earlier, FII / NRI investment was prohibited under in the print media sector. No such restriction is now found

except that portfolio investment is not permitted in the shares of a company which is in the real estate business or construction of farm houses or trading in TDRs..

11.2 Various Portfolio Investment classes (except those by NRIs) have now been subsumed into one consolidated class called the *Registered Foreign Portfolio Investor* (***RFPI***). Thus, now, FIIs, Sub-Accounts, foreign body corporates, foreign investment funds, etc., are replaced by one class called RFPI.

12. Different types of Foreign Investment

12.1 The various types of foreign investment which are possible may be enumerated as follows:

(a) ***Foreign Direct Investment*** – this is repatriable foreign investment which is invested directly in an Indian entity. This is governed by Schedule 1 of the FEMA Regulations.

(b) ***Non-repatriable FDI*** – Under Schedule 4 of the FEMA Regulations, only Non-resident Indians can invest in non-repatriable FDI. Unlike normal FDI there are no sectoral caps or conditions for this type of FDI. However, certain sectors, such as, real estate business, agricultural, etc., are not open for investment even under this scheme. Only non-resident Indians/ foreign entities owned and controlled by NRIs are eligible to invest on a non-repatriable basis.

(c) ***Portfolio Investment*** – RFPIs can invest in shares under the Portfolio Investment Scheme available under Schedule 2A of the FEMA Regulations. A similar Portfolio Investment Scheme is available for NRIs under Schedule 3 of the FEMA Regulations. There are no sectoral restrictions in either case.

(d) ***Foreign Venture Capital Investors*** – FVCIs registered with the SEBI can buy shares under Schedule 6. These investments carry no pricing restrictions or FDI conditions. However, they are allowed only in startups or in 10 specified sectors. The investee company can also give a fixed return to the FVCI. An FVCI can make FDI also but both must be bifurcated and separate records should be maintained for both.

(e) ***LLPs*** – FDI in an LLP is permissible under Schedule 9 on an automatic route in those sectors where 100% FDI is allowed and there are no FDI linked performance conditions. Hence, sectors, such as, real estate, trading, financial services, etc., are ineligible for FDI in an LLP.

(f) ***Transfer of Shares*** – Foreign investment is also possible by a transfer of shares from a resident to a non-resident. The price for transfer in case of unlisted shares must be at or above the fair market value determined as per any internationally accepted pricing methodology. Payment of 25% of the consideration in instalments is allowed subject to certain conditions. An NRI can sell shares to another NRI and any person resident outside India (other than an NRI) can sell shares to another non-resident/NRI on an automatic basis without any adherence to any pricing/ reporting guidelines.

(g) ***Specified Situations*** – The FEMA Regulations permit foreign investors to acquire shares under certain specified situations, such as, merger/demerger of an Indian company having foreign investments; issue of ESOPs by an Indian company; issue of bonus/rights shares by an Indian company; gift of shares to a non-resident; issue of bonus debentures/preference shares; swap of shares of foreign company in return for issue of shares of Indian company; pledge of shares to foreign lenders and issue of shares for consideration other than cash.

Each of these come with their own terms and conditions.

(h) ***Other Investments*** – Under Schedule 5 of the FEMA Regulations, RFPIs and NRIs have permission to purchase certain other types of securities, such as, Government Securities, mutual fund units, commercial papers, etc. One of the most important type of securities which RFPIs can purchase under this Schedule are listed non-convertible debentures issued by Indian companies. These can be purchased irrespective of the sector of the Indian company, e.g., retail trading, defence, telecom, real estate, etc., however, this is subject to an aggregate limit of US$51 billion for all corporates put together. Such an issue is not even considered as an ECB for the issuer company. Most importantly, the company can give an assured/fixed/ guaranteed return to the investor. This route along with the FVCI route is fast becoming a key source of foreign funds.

12.2 The foreign investment in an Indian company is the sum total of all types of investments enumerated above.

13 Reporting

13.1 Receipt of FDI carries certain reporting obligations to the RBI by the issuer company. These include, the Advance Reporting Form, the KYC Report, the Form FC-GPR, the Valuation Report and the Compliance Certificate. These must be filed within the prescribed time limits in the specified formats.

13.2 Transfer of shares in favour of a non-resident requires the filing of Form FC-TRS, the Valuation Report and various supporting documents.

13.3 Every Indian company having any sort of foreign investment in its capital must file an Annual Return of Foreign Liabilities and Assets in the prescribed form every year by the 15th of July with the RBI.

14. Structuring Issues

Structuring of FDI in an Indian entity gives rise to a multitude of issues and one can dedicate reams of paper to their discussion. However, for the sake of illustration, these may include, selection of Jurisdiction of the investor, using an Intermediate Holding Company, Treaty Shopping, GAAR, Round Tripping, capital structure of the Indian entity, etc. Due care should be given to each of these or else there is a great risk for the investor / investee.

15. Exit

The aim of any investment is to make money by exiting. Hence, exit options should be duly considered at the structuring stage itself. Popular routes include, public listing, buyback, reduction of capital, buyout by promoters, voluntary liquidation, etc. Each route has its own tax and regulatory considerations which must be duly weighed before arriving at a decision.

16. Conclusion

India's FDI policy is sometimes labelled as being complex and ambiguous. However, of late it has been simplified a great deal. However, a more stable policy would go a long way in attracting valuable foreign capital. As Justice Kapadia, in the celebrated decision of *Vodafone International Holdings, 341 ITR 1 (SC)* has observed:

"…FDI flows towards location with a strong governance infrastructure which includes enactment of laws and how well the legal system works. Certainty is integral to rule of law. Certainty and stability form the basic foundation of any fiscal system…"

It would be advantageous if India has a clear FDI Policy devoid of confusion and vagueness. In the current global economic and political turmoil, India is one of the few shining stars. A lucid foreign investment regime would ensure that foreign investors flock to India like bees to a honeycomb!

CA Paresh P. Shah

Guideline of Foreign Investment Promotion Board and Select Industrial/Sectoral Policy

1. Background to India's Economic Reforms

The reform process in India was initiated with the aim of accelerating the pace of economic growth and eradication of poverty. The process of economic liberalisation in India can be traced back to the late 1970s. However, the reform process began in earnest only in July 1991. It was only in 1991 that the Government signalled a systemic shift to a more open economy with greater reliance upon market forces, a larger role for the private sector including foreign investment, and a restructuring of the role of Government.

The reforms have unlocked India's enormous growth potential and unleashed powerful entrepreneurial forces, successive governments, across political parties, have carried forward the country's economic reform agenda.

1.1 Reforms in Industrial Policy

Industrial policy was restructured to a great extent and most of the Central Government industrial controls were dismantled. Industrial licensing by the Central Government was almost abolished except for a few hazardous and environmentally sensitive industries. The list of industries reserved solely for the public sector — which used to cover 18 industries, is drastically reduced to three: defence aircrafts and warships, atomic energy generation, and railway transport.

1.2 Reforms in Trade Policy

It was realised that the import substituting inward looking development policy was no longer suitable in the modern globalising world. Before the reforms, trade policy was characterised by high tariffs and pervasive import restrictions. Imports of manufactured consumer goods were completely banned.

Import licensing was abolished relatively early for capital goods and intermediates which became freely importable in 1993, simultaneously with the switch to a flexible exchange rate regime. Quantitative restrictions on imports of manufactured consumer goods and agricultural products were finally removed on April 1, 2001.

1.3 Financial sector reforms

Financial sector reforms have long been regarded as an integral part of the overall policy reforms in India. The reforms have been driven by a thrust towards liberalisation and several initiatives such as liberalisation in the interest rate and reserve requirements have been taken on this front. At the same time, the Government has emphasised on stronger regulation aimed at strengthening prudential norms, transparency and supervision to mitigate the prospects of systemic risks.

2. Industrial Policy

The sectoral reforms are carried out by Government of India in specific Industries/

activity through amendments to the India's Industrial Policy where:

a. Certain Industries were reserved for Public Sector where it was not possible for private sector or non-residents to participate currently only

b. Industries reserved for small sector now pruned to very few industries as specified in Micro, small and Medium enterprises. Act, 2006.

c. Hazardous industries where licensing is compulsory such as chemical, explosives, etc.

d. Sector Specific Guideline are specified where participation of Non-Resident is mentioned against each sector at a certain percentage known as Cap of the capital of the Indian Entity with certain conditions either due to regulation of this Industry (such as Broadcasting Industry) or due to capitalisation norms (such as Financial Services) or due to security reasons (such as Telecommunication).

   These upper caps for the non-Residents have been relaxed and conditions have been liberalised from time-to-time as the domestic players' experience in these Industries has grown gradually and share of domestic players in the respective sector is increased.

   It is also clarified by the policy that the sector which is not specified in the policy may be available for Investment without any cap as well as conditions.

2.1 FDI Policy, Sectoral Caps, etc.

i) Caps on Investments: In the sectors/activities, FDI up to the limit indicated against each sector/activity is allowed to the Non-Residents, subject to applicable laws/regulations, security and other conditionalities. In sectors/activities not listed in the policy, FDI is permitted up to 100% on the automatic route, subject to applicable laws/regulations; security and other conditionalities. The caps in various sector(s) are detailed in Chapter 5 of the Policy.

   Investments by non-residents can be permitted in the capital of a resident entity in certain sectors/activity with entry conditions. Such conditions may include norms for minimum capitalisation, lock-in period, etc.

   Wherever there is a requirement of minimum capitalisation, it shall include share premium received along with the face value of the share, only when it is received by the company upon issue of the shares to the non-resident investor.

ii) *Sectoral cap* i.e. the maximum amount which can be invested by foreign investors, in an entity, unless provided otherwise, is composite and includes all types of foreign investments, direct and indirect, regardless of whether the said investments have been made under Schedule 1 (FDI), 2 (FII), 2A (FPI), 3 (NRI), 6 (FVCI), 9 (LLPs), 10 (DRs) and 11 (Investment Vehicle) of FEMA (Transfer or Issue of Security by Persons Resident Outside India) Regulations.

iii) Foreign investment in sectors under Government approval route may result in transfer of ownership and/or control of Indian entities from resident Indian citizens to non-resident entities then such transfer will also be subject to Government approval.

   Foreign investment in sectors under automatic route but with conditionalities (NBFC Activities), may result in transfer of ownership and/or control of Indian entities from resident Indian citizens to non-resident entities, then such transfer will also be subject to compliance of such conditionalities as were applicable to transferor of shares.

iv) The sectors which are already under 100% automatic route (such as Software or Training, R&D, etc.) and are without conditionalities would not be affected and hence will not require Government approval.

v) In case of portfolio investment, up to aggregate foreign investment level of 49% or sectoral/statutory cap, whichever is lower, will not be subject to either Government approval or compliance of sectoral conditions, as the case may be, if such investment does not result in transfer of ownership and/or control of Indian entities from resident Indian citizens to non-resident entities which is very obvious in case of portfolio investment.

vi) Any existing foreign investment already made in accordance with the policy in existence would not require any modification to conform to amendments introduced through Press Note 8 (2015 Series).

vii) The onus of compliance of above provisions will be on the investee company.

The policy is revised from time to time and the latest revision of the policy is of June 2016 herein referred to as "the Policy"

2.2 Certain sectors are totally prohibited for the foreign investors in

(a) Lottery Business, including Government/private lottery, online lotteries, etc.

(b) Gambling and Betting including casinos etc.

(c) Chit funds

(d) Nidhi company

(e) Trading in Transferable Development Rights (TDRs)

(f) Real Estate Business or Construction of Farm Houses 'Real estate business' shall not include development of townships, construction of residential/commercial premises, roads or bridges and Real Estate Investment Trusts (REITs) registered and regulated under the SEBI (REITs) Regulations, 2014

(g) Manufacturing of cigars, cheroots, cigarillos and cigarettes, of tobacco or of tobacco substitutes

(h) Activities/sectors not open to private sector investment e.g. (I) Atomic Energy and (II) Railway operations (other than permitted activities mentioned in para 5.2 of the Policy).

Foreign technology collaboration in any form, including licensing for franchise, trademark, brand name, management contract, is also prohibited for Lottery Business and Gambling and Betting activities.

2.3 Foreign investment into/downstream investment by eligible Indian entities

The Guidelines for calculation of total foreign investment, both direct and indirect in an Indian company/LLP, at every stage of investment, including downstream investment, have been detailed in the Policy and in a dedicated article of this publication.

2.4 For the purpose of the Policy

(i) 'Downstream investment' means indirect foreign investment, by an eligible Indian entity, into another Indian company/LLP, by way of subscription or acquisition. Annexure 5 of the Policy provides the guidelines for calculation of indirect foreign investment, with conditions specified in paragraph 1.2 (v).

(ii) 'Foreign Investment' would have the same meaning as in Annexure 5 of the Policy

2.5 Foreign investment into an Indian company engaged only in the activity of investing in the capital of other Indian company/ies (regardless of its ownership or control)

Foreign investment into an Indian company, engaged only in the activity of investing in

the capital of other Indian company/ies/LLP, will require prior Government/FIPB approval, regardless of the amount or extent of foreign investment. Foreign investment into Non-Banking Finance Companies (NBFCs), carrying on activities approved for FDI, is subject to the conditions specified in paragraph 5.2.26 of the Policy Circular.

2.6 Those companies, which are Core Investment Companies (CICs), will have to additionally follow RBI's Regulatory Framework for CICs.

2.7 For undertaking activities which are under automatic route and without foreign investment linked performance conditions, Indian company which does not have any operations and also does not have any downstream investments, will be permitted to have infusion of foreign investment under automatic route. However approval of the Government will be required for such companies for infusion of foreign investment for undertaking activities which are under Government route, regardless of the amount or extent of foreign investment. Further, as and when such a company commences business(s) or makes downstream investment, it will have to comply with the relevant sectoral conditions on entry route, conditionalities and caps.

Foreign investment into other Indian companies/LLPs would be in accordance/compliance with the relevant sectoral conditions on entry route, conditionalities and caps.

2.8 Downstream investment by an eligible Indian entity, which is not owned and/or controlled by resident entity/ies, into another Indian company, would be in accordance/compliance with the relevant sectoral conditions on entry route, conditionalities and caps, with regard to the sectors in which the latter Indian company is operating.

2.9 Investments can be made by non-residents in the equity shares/fully, compulsorily and mandatorily convertible debentures/fully, compulsorily and mandatorily convertible preference shares of an Indian company, through the Automatic Route or the Government Route. As referred under the Automatic Route, the non-resident investor or the Indian company does not require any approval from Government of India for the investment. Under the Government Route, prior approval of the Government of India is required. Proposals for foreign investment under Government route, are considered by FIPB.

3. FEMA and FDI

The Department of Industrial Policy and Promotion (DIPP), Ministry of Commerce & Industry, Government of India makes policy pronouncements on FDI through Press Notes/Press Releases which are notified by the Reserve Bank of India as amendments to the Foreign Exchange Management (Transfer or Issue of Security by Persons Resident Outside India) Regulations, 2000 (notification No. FEMA 20/2000-RB dated May 3, 2000). These notifications take effect from the date of issue of Press Notes/Press Releases, unless specified otherwise therein. In case of any conflict, the relevant FEMA Notification will prevail. The procedural instructions are issued by the Reserve Bank of India *vide* A.P. (DIR Series) Circulars.

The aforesaid FEMA Notification 20 (hereinafter referred to as the 'Notification') deals with Foreign Direct Investment Policy *vide* Schedule I. Accordingly, it would be useful to consider the stipulations under Schedule I which are as under:

3.1 Eligible persons: A person resident outside India (other than a citizen of Bangladesh or Pakistan) or an entity incorporated outside India (other than an entity in Bangladesh or Pakistan), may purchase shares or convertible debentures or warrants of an Indian company under Foreign Direct Investment Scheme, subject to the terms and conditions specified in Schedule 1 of the notification.

It is clarified that

a) The instruments may be issued with the option but there cannot be any offer of an assured return to the investor

b) A citizen of Bangladesh and or entity in Bangladesh can invest with the prior approval of the FIPB in accordance with the conditions of the Schedule 1 of the Notification and

c) in case of Citizen and entity of Pakistan they can also do so with the prior approval of FIPB pertaining except in defence, space and atomic energy and sectors/activities prohibited for foreign investment.

3.2 Automatic Route of Investment by purchase by a person resident outside India of shares or convertible debentures or warrants issued by an Indian company

An Indian company, not engaged in any prohibited activity/sector can issue shares or convertible debentures or warrants to a person resident outside India, subject to the limits prescribed in Annex B to Schedule 1 of the said Notification, in accordance with the Entry Routes specified and the provisions of Foreign Direct Investment Policy, as notified by the Ministry of Commerce & Industry, Government of India, from time-to-time with following conditions.

a. In the sectors/activities mentioned in the Annex B to the Schedule, foreign investment up to the limit indicated against each sector/activity is allowed subject to the conditions of the extant policy on specified sectors and applicable laws/regulations; security and other conditionalities. In sectors/activities not listed therein, foreign investment is permitted up to 100% on the automatic route, subject to applicable laws/regulations; security and other conditionalities.

b. Wherever there is a requirement of minimum capitalisation it shall include share premium received along with the face value of the share, only when it is received by the company upon issue of the shares to the non-resident investor. Amount paid by the transferee during post-issue transfer of shares beyond the issue price of the share, cannot be taken into account while calculating minimum capitalisation requirement.

c. "Sectoral cap" i.e. the maximum amount which can be invested by foreign investors in an entity, unless provided otherwise, is composite and includes all types of foreign investments, direct and indirect, regardless of whether the said investments have been made under Schedules 1, 2, 2(A), 3, 6, 8, 9 and 10 of FEMA (Transfer or Issue of Security by Persons Resident Outside India) Regulations, 2000. FCCBs and DRs having underlying of instruments which can be issued under Schedule 5, being in the nature of debt, shall not be treated as foreign investment. However, any equity holding by a person resident outside India resulting from conversion of any debt instrument under any arrangement shall be reckoned as foreign investment under the composite cap. Sectoral cap is as per table appended to Schedule I in Annexure B thereof.

d. Total foreign investment, direct and/or indirect, in an entity will not exceed the sectoral/statutory cap.

e. Foreign investment in sectors under Government approval route resulting in transfer of ownership and/or control of Indian entities from resident Indian citizens to non-resident entities will be subject to Government approval. Foreign investment in sectors under automatic route but with conditionalities, resulting in transfer of ownership and/or control of Indian entities from resident Indian citizens to non-resident entities, will be subject to compliance of such conditionalities.

f. Notwithstanding anything contained in paragraphs (a), (b) and (e) above, portfolio investment up to aggregate foreign investment level of 49% or sectoral/ statutory cap, whichever is lower, will not be subject to either Government approval or compliance of sectoral conditions, as the case may be, if such investment does not result in transfer of ownership and/ or control of Indian entities from resident Indian citizens to non-resident entities. Other foreign investments will be subject to conditions of Government approval and compliance of sectoral conditions as laid down in the FDI policy.

g. The onus of compliance with the sectoral/ statutory caps on foreign investment and attendant conditions, if any, shall be on the company receiving foreign investment

Explanation: A company which proposes to embark on expansion programme to undertake activities or manufacture items included in Annex B to the Schedule I may issue shares or convertible debentures or warrants out of fresh capital proposed to be issued by it for the purpose of financing expansion programme, up to the extent indicated in Annex B, subject to compliance with the provisions of this paragraph.

3.2.1 Indian company which observes the conditions of the Schedule 1, can also issue shares to PROI:

i. Being a provider of technology/ technical know-how, against Royalty/Lump-sum fees due for payment;

ii. Against External Commercial Borrowing (ECB) (other than import dues deemed as ECB or Trade Credit as per RBI Guidelines;

iii. Against import of capital goods by units in SEZs, subject to the valuation by a Committee consisting of Development Commissioner and the appropriate Customs officials;

iv. Against any other funds payable by the investee company, remittance of which does not require prior permission of the Government of India or Reserve Bank of India under FEMA, 1999 or any rules/ regulations framed or directions issued thereunder.

3.2.2 Shares can be issued by way of swap of shares, provided the company in which the investment is made is engaged in an automatic route sector, subject to the condition that irrespective of the amount, valuation of the shares involved in the swap arrangement will have to be made by a Merchant Banker registered with SEBI or an Investment Banker outside India registered with the appropriate regulatory authority in the host country.

3.2.3 Shares can be issued by way of subscription to Memorandum of Association at face value irrespective of price as per the valuation rules subject to eligibility to invest under this Schedule.

3.2.4 A company which is reckoned as Micro and Small Enterprise (MSE) (earlier Small Scale Industrial Unit) in terms of the Micro, Small and Medium Enterprises Development (MSMED) Act, 2006, including an Export Oriented Unit or a Unit in a Free Trade Zone or in an Export Processing Zone or in a Software Technology Park or in an Electronic Hardware Technology Park, can issue eligible instruments, subject to the limits prescribed in Annex B to Schedule 1, in accordance with the Entry Routes specified therein and the provision of the Foreign Direct Investment Policy, as notified by the Ministry of Commerce & Industry, Government of India, from time-to-time.

3.2.5 Any Industrial undertaking, with or without Foreign Direct Investment, which is not an MSE, having an industrial licence under the provisions of the Industries

(Development & Regulation) Act, 1951 for manufacturing items reserved for manufacture in the MSE sector can issue shares to persons resident outside India to the extent of 24 per cent of its paid-up capital. Issue of shares in excess of 24 per cent of paid-up capital shall require prior approval of the Foreign Investment Promotion Board of the Government of India and shall be in compliance with the terms and conditions of such approval.

3.3 Issue of shares by a company requiring the Government approval

An Indian company intending to issue shares to a person resident outside India in accordance with these Regulations directly against foreign inward remittance (or by debit to NRE account/ FCNR account) or against consideration other than inward remittance i.e., against royalty/ lump sum fee due for payment/import of capital goods shall obtain prior approval of the Foreign Investment Promotion Board (FIPB) of Government of India, if the Indian company;

a. is engaged or proposes to engage, in any activity specified in Annex A to this Schedule; or

b. proposes to issue shares to a person resident outside India beyond sectoral limits or the activity of the Indian company falls under the FIPB route, as stipulated in Annex B to this Schedule;

c. proposes to issue shares to a person resident outside India against import of capital goods/machinery/equipment (excluding second-hand machinery) subject to compliance with the conditions specified by the Government of India and the Reserve Bank from time-to-time; or

d. proposes to issue shares to a person resident outside India against pre-operative/pre-incorporation expenses (including payments of rent etc.), subject to compliance with the conditions specified by the Government of India and the Reserve Bank from time-to-time

3.4 Issue price / Valuation Rules:

Price of shares issued to persons resident outside India shall not be less than—

a. the price worked out in accordance with the SEBI guidelines, as applicable, where the shares of the company is listed on any recognised stock exchange in India;

b. the valuation of shares done as per any internationally accepted pricing methodology for valuation of shares on arm's length basis, duly certified by a Chartered Accountant or a SEBI registered Merchant Banker where the shares of the company are not listed on any recognised stock exchange in India.

3.5 Acquisition of right shares

3.5.1 A person resident outside India may purchase equity or preference shares or convertible debentures offered on right basis by an Indian company which satisfies the conditions specified in sub-regulation (2).

3.5.2 An Indian company which satisfies the following conditions, may offer to a person resident outside India, equity or preference shares or convertible debentures on right basis, namely:—

(i) The offer on right basis does not result in increase in the percentage of foreign equity already approved, or permissible under the Foreign Direct Investment Scheme in terms of these Regulations;

(ii) The existing non-resident shareholders may apply for issue of additional shares, and the investee company may allot the same subject to the condition that the overall issue of shares to non-residents in

the total paid-up capital does not exceed the sectoral cap;

(iii) The existing shares or debentures against which shares or debentures are issued by the company on right basis were acquired and are held by the person resident outside India in accordance with these Regulations;

(iv) The offer on right basis to the persons resident outside India shall be

(a) In the case of shares of a company listed on a recognised stock exchange in India, at a price as determined by the company.

(b) In the case of shares of a company not listed on a recognised stock exchange in India, at a price which is not less than the price at which the offer on right basis is made to resident shareholders."

3.5.3 The right shares or debentures purchased by the person resident outside India shall be subject to same conditions including restrictions in regard to repatriability as are applicable to the original shares against which right shares or debentures are issued.

3.6 Acquisition of Bonus shares

An Indian company may issue bonus shares to its non resident shareholders, subject to the following conditions:

(a) The shares against which bonus shares are issued by the company (hereinafter referred to as 'the original shares') were acquired or held by the non-resident shareholder in accordance with the Rules/ Regulations applicable to such acquisition;

(b) The bonus shares acquired by the non-resident shareholder shall be subject to the same conditions including restrictions in regard to repatriability as are applicable to the original shares.

3.7 Acquisition of warrants

An Indian company may issue warrants to a person resident outside India subject to terms and conditions stipulated by the Reserve Bank in this behalf from time-to-time.

3.8 Issue and acquisition of shares after merger or demerger or amalgamation of Indian companies

3.8.1 Where a Scheme of merger or amalgamation of two or more Indian companies or a reconstruction by way of demerger or otherwise of an Indian company, has been approved by a Court in India, the transferee company or, as the case may be, the new company may issue shares to the shareholders of the transferor company resident outside India, subject to the following conditions, namely:

a) The percentage of shareholding of persons resident outside India in the transferee or new company does not exceed the percentage specified in the approval granted by the Central Government or the Reserve Bank, or specified in these Regulations:

Provided that where the percentage is likely to exceed the percentage specified in the approval or the Regulations, the transferor company or the transferee or new company may, after obtaining an approval from the Central Government, apply to the Reserve Bank for its approval under these Regulations;

b) The transferor company or the transferee or new company shall not engage in agriculture, plantation or real estate business or trading in TDRs; and

c) the transferee or the new company files a report within 30 days with the Reserve Bank giving full details of the shares held by persons resident outside India in the transferor and the transferee or the new company, before and after the merger/amalgamation/reconstruction, and also furnishes a confirmation that all the terms and conditions stipulated in the scheme approved by the Court have been complied with.

3.8.2 Where a Scheme of Arrangement for an Indian company has been approved by a Court in India, the Indian company may issue non-convertible redeemable preference shares or debentures out of its general reserves by way of distribution as bonus to the shareholders resident outside India, subject to the following conditions, namely:

a. The original acquisition of shares/convertible debentures (including non-convertible/optionally convertible/partially convertible preference shares issued as on and up to April 30, 2007 and optionally convertible/partially convertible debentures issued up to June 7, 2007 under Foreign Direct Investment Scheme and treated as eligible (FDI) compliant instruments under the then applicable guidelines) of the Indian company by non-resident shareholders entitling them to hold non-convertible redeemable preference shares or debentures is in accordance with these Regulations and the conditions specified in the relevant Schedule;

b. In accordance with the provisions of the Companies Act, as applicable and the terms and conditions, if any, stipulated in the scheme approved by the Court in India have been complied with;

c. The Indian company or transferee company or a new company has a 'No objection certificate' from Income Tax authority; and

d. The Indian company shall not engage in any activity/sector mentioned in Annex A to Schedule 1 to these Regulations.

3.9 Issue of shares under Employees Stock Options Scheme to persons resident outside India

An Indian company may issue "employees' stock option" and/or "sweat equity shares" to its employees/directors or employees/directors of its holding company or joint venture or wholly owned overseas subsidiary/subsidiaries who are resident outside India, provided that:

a. The scheme has been drawn either in terms of regulations issued under the Securities Exchange Board of India Act, 1992 or the Companies (Share Capital and Debentures) Rules, 2014 notified by the Central Government under the Companies Act, 2013, as the case may be.

b. The "employee's stock option"/sweat equity shares issued to non-resident employees/directors under the applicable rules/regulations are in compliance with the sectoral cap applicable to the said company.

c. Issue of "employee's stock option"/sweat equity shares in a company where foreign investment is under the approval route shall require prior approval of the Foreign Investment Promotion Board (FIPB) of Government of India.

d. Issue of "employee's stock option"/sweat equity shares under the applicable rules/regulations to an employee/director who is a citizen of Bangladesh/Pakistan shall require prior approval of the Foreign Investment Promotion Board (FIPB) of Government of India.

3.10 Issue of shares under ADR/GDR

Indian company is also permitted to issue shares under the sponsored ADR/GDR scheme by converting the shares into ADR/GDR to the PROI without increasing the Capital of the Indian company under the Guideline of the Government of India 1993 as amended.

3.11 Downstream Investments

The rules regarding downstream Investment are covered in other article of the publication and hence it is not covered here.

4. Constitution of FIPB

4.1.1 FIPB comprises the following Secretaries to the Government of India:

(i) Secretary to Government, Department of Economic Affairs, Ministry of Finance – Chairperson

(ii) Secretary to Government, Department of Industrial Policy & Promotion, Ministry of Commerce & Industry

(iii) Secretary to Government, Department of Commerce, Ministry of Commerce & Industry

(iv) Secretary to Government, Economic Relations, Ministry of External Affairs

4.1.2 The Board would be able to co-opt other Secretaries to the Central Government and top officials of financial institutions, banks and professional experts of Industry and Commerce, as and when necessary.

4.2 Levels of Approvals for Cases under Government Route

4.2.1 The Minister of Finance who is in-charge of FIPB would consider the recommendations of FIPB on proposals with total foreign equity inflow of and below ` 5,000 crore.

4.2.2 The recommendations of FIPB on proposals with total foreign equity inflow of more than ` 5,000 crore would be placed for consideration of Cabinet Committee on Economic Affairs (CCEA).

4.2.3 The CCEA would also consider the proposals which may be referred to it by the FIPB/the Minister of Finance (in-charge of FIPB).

4.3 Cases which do not require Fresh Approval

4.3.1 Companies may not require fresh prior approval of the Government i.e. Minister in-charge of FIPB/CCEA for bringing in additional foreign investment into the same entity, in the following cases:

(i) Entities the activities of which had earlier required prior approval of FIPB/Cabinet Committee on Foreign Investment (CCFI)/CCEA and which had, accordingly, earlier obtained prior approval of FIPB/CCFI/CCEA for their initial foreign investment but subsequently such activities/sectors have been placed under automatic route;

(ii) Entities the activities of which had sectoral caps earlier and which had, accordingly, earlier obtained prior approval of FIPB/CCFI/CCEA for their initial foreign investment but subsequently such caps were removed/increased and the activities placed under the automatic route; provided that such additional investment along with the initial/original investment does not exceed the sectoral caps; and

(iii) Additional foreign investment into the same entity where prior approval of FIPB/CCFI/CCEA had been obtained earlier for the initial/original foreign investment due to requirements of Press Note 18/1998 or Press Note 1 of 2005 and prior approval of the Government under the FDI policy is not required for any other reason/purpose; and

(iv) Additional foreign investment into the same entity within an approved foreign equity percentage/or into a wholly owned subsidiary

Guidelines for e-filing of applications, filing of amendment applications and instructions to applicants are available at FIPB's website (http://finmin.nic.in/) and (http://www.fipb.gov.in).

5. Manufacturing Sector

5.1 The sector is open to all the non-residents for engaging into any type of manufacturing activity in India without any local participation of Resident Indian except in cases where manufactured products are sold under Brand names in India. If the sale of manufactured products are not under any brand/s then there is no restriction in manufacture sector to sell the manufactured products.

Indian Entity is free to sale the products under single or multiple Brands retail or through Electronic Commerce either on B-to-B basis or B-to-C basis if brand is owned and controlled by a Resident Indian Citizens.

5.2 Until November 2015

a) There was no such restriction as to ownership of such brand by Resident Indian Citizens in the manufacturing Sector in order to carry out sale by such entities either as single Brand, Multiple Brand or sale through Electronic medium of the manufactured product by such an entity.

b) It was always possible to engage into any type of the sale by such an entity.

c) The conditions for sale by such entities through above mode now may be sought to be restricted through the conditions available as a note to the guideline on Retail Trading.

d) Manufacturer was allowed to sell through any of the modes either wholesale or retail basis under any Brand name or through electronic mode and trading guidelines were never applicable to the manufacture as essentially manufacturer can never be trader unless it starts selling the products not manufactured by it.

5.3 The above restriction is evident from following paragraph of the press note dated 12th November, 2015:

An Indian manufacturer is permitted to sell its own branded products in any manner i.e. wholesale, retail, including through e-commerce platforms. For the purposes of FDI Policy Indian manufacturer would be the investee company, which is the owner of the Indian brand and which manufactures in India, in terms of value, at least 70% of its products in house, and sources, at most 30% from Indian manufacturers. Further Indian brands should be owned and controlled by resident Indian citizens and/or companies, which are owned and controlled by resident Indian citizens.

5.4 This restriction needs clarification as to why a new condition in Manufacturing sector is introduced in regard to ownership of Brand when they were permitted to sell their products in any manner with 100 percentage ownership of the company by non-residents.

Thus it may mean that these conditions may not apply to Investment prior to Nov 2015 in manufacturing sector selling their products. In suitable cases a clarification may be sought as these provisions are restrictive in manner and hence it should not apply as these conditions can apply only to SBRT and not to manufacturing Sector.

5.5 Manufacture is now defined under the policy as

"Manufacture, with its grammatical variations, means a change in a non-living physical object or article or thing–(a) resulting in transformation of the object or article or thing into a new and distinct object or article or thing having a

different name, character and use; or (b) bringing into existence of a new and distinct object or article or thing with a different chemical composition or integral structure".

Policy distinguishes the manufacture from the service industry and hence whereever possible, sectors are to be read as either a manufacturing or a service activity and accordingly the guideline will apply.

6. Cash & Carry Wholesale Trading/ Wholesale Trading (including sourcing from MSEs)

Sector is open for Investment by non-resident without any Investment cap with certain conditions under Automatic Route subject to reporting requirements.

6.1 Definition: Cash & Carry Wholesale Trading/ Wholesale Trading, would mean sale of goods/merchandise to retailers, industrial, commercial, institutional or other professional business users or to other wholesalers and related subordinated service providers. Wholesale trading would, accordingly, imply sales for the purpose of trade, business and profession, as opposed to sales for the purpose of personal consumption. The yardstick to determine whether the sale is wholesale or not would be the type of customers to whom the sale is made and not the size and volume of sales. Wholesale trading would include resale, processing and thereafter sale, bulk imports with ex-port/ex-bonded warehouse business sales and B2B e-Commerce.

6.2 Guidelines for Cash & Carry Wholesale Trading/Wholesale Trading (WT)

(a) For undertaking WT, requisite licences/ registration/permits, as specified under the relevant Acts/Regulations/Rules/Orders of the State Government/Government Body/Government Authority/Local Self-Government Body under that State Government should be obtained.

(b) Except in case of sales to Government, and non-profit making organisations or charities, sales made by the wholesaler would be considered as 'cash & carry wholesale trading/wholesale trading' with valid business customers, only when WT are made to the following entities:

(I) Entities holding sales tax/VAT registration/service tax/excise duty registration; or

(II) Entities holding trade licences i.e. a licence/registration certificate/ membership certificate/registration under Shops and Establishment Act, issued by a Government Authority/ Government Body/Local Self-Government Authority, reflecting that the entity/person holding the licence/registration certificate/ membership certificate, as the case may be, is itself/ himself/herself engaged in a business involving commercial activity; or

(III) Entities holding permits/licence etc., for undertaking retail trade (like tehbazari and similar licence for hawkers) from Government Authorities/Local Self Government Bodies; or

(IV) Institutions having certificate of incorporation or registration as a society or registration as public trust for their self-consumption.

Note: An entity, to whom WT is made, may fulfil any one of the 4 conditions.

(c) Full records indicating all the details of such sales like name of entity, kind of entity, registration/licence/permit etc. number, amount of sale etc., should be maintained on a day to day basis.

(d) WT of goods would be permitted among companies of the same group. However it should not exceed 25% of the total turnover of the wholesale venture.

(e) WT can be undertaken as per normal business practice, including extending credit facilities subject to applicable regulations.

(f) A wholesale/cash & carry trader can undertake single brand retail, subject to the conditions guidelines of the SBRT. An entity undertaking wholesale/cash and carry as well as retail business will be mandated to maintain separate books of account for these two arms of the business and duly audited by the statutory auditors. Conditions of the FDI policy for wholesale/cash and carry business and for retail business have to be separately complied with by the respective business arms.

6.3 Wholesale Trading and Group Activity in India: Thus it may be noted that there is a restriction on group trading activities beyond a certain level of the activities. This is due to the fact that a segregation of the activity in different sectors by the same Non-Resident Group may facilitate proper monitoring and understanding of the sectoral compliances which may at time be conflicting E.g. It may be possible for a wholesale trader to sale the goods to Single Brand retail trader which may then qualify for local sources condition, which effectively may not involve the local manufacturer's participation as anticipated.

7. E-Commerce

Subject to provisions of FDI policy, e-commerce entities would engage only in Business to Business (B2B) e-commerce and not in Business to Consumer (B2C) e-commerce and Investment is available to them on a 100% basis under an Automatic Route.

7.1 Definitions

i) E-Commerce: E-Commerce means buying and selling of goods and services including digital products over digital & electronic network.

ii) E-Commerce entity: E-Commerce entity means a company incorporated under the Companies Act 1956 or the Companies Act 2013 or a foreign company covered under section 2 (42) of the Companies Act, 2013 or an office, branch or agency in India as provided in section 2(v)(iii) of FEMA 1999, owned or controlled by a person resident outside India and conducting the e-commerce business.

iii) Inventory based model of E-Commerce: Inventory based model of E-Commerce means an E-Commerce activity where inventory of goods and services is owned by E-Commerce entity and is sold to the consumers directly.

iv) Marketplace based model of e-commerce: Marketplace based model of e-commerce means providing of an information technology platform by an e-commerce entity on a digital & electronic network to act as a facilitator between buyer and seller.

7.2 Guidelines for Foreign Direct Investment on E-Commerce sector

i) 100% FDI under automatic route is permitted in marketplace model of E-Commerce.

ii) FDI is not permitted in inventory based model of E-Commerce.

7.3 Other Conditions

i) Digital & electronic network will include network of computers, television channels and any other internet application used in automated manner such as web pages, extranets, mobiles etc.

ii) Marketplace E-Commerce entity will be permitted to enter into transactions with sellers registered on its platform on B2B basis.

iii) E-Commerce marketplace may provide support services to sellers in respect of warehousing, logistics, order fulfillment, call centre, payment collection and other services.

iv) E-Commerce entity providing a marketplace will not exercise ownership over the inventory i.e., goods purported to be sold. Such an ownership over the inventory will render the business into inventory based model.

v) An E-Commerce entity will not permit more than 25% of the sales affected through its marketplace from one vendor or their group companies.

vi) In marketplace model goods/services made available for sale electronically on website should clearly provide name, address and other contact details of the seller. Post sales, delivery of goods to the customers and customer satisfaction will be responsibility of the seller.

vii) In marketplace model, payments for sale may be facilitated by the E-Commerce entity in conformity with the guidelines of the Reserve Bank of India.

viii) In marketplace model, any warranty/guarantee of goods and services sold will be responsibility of the seller.

ix) E-Commerce entities providing marketplace will not directly or indirectly influence the sale price of goods or services and shall maintain level playing field.

x) Guidelines on cash and carry wholesale trading as given in the Policy above will apply on B2B E-Commerce.

7.4 E-Commerce and Wholesale Trading

Subject to the conditions of FDI policy on services sector and applicable laws/regulations, security and other conditionalities, sale of services through E-Commerce will be under automatic route.

It may be noted here that B2B E-Commerce represents two distinguished sectors, one the provider of E-Commerce infrastructure and the participating Industry essentially players involved in a Cash and Carry Wholesale Trading where Group activity amongst themselves is also restricted to a certain level for obvious reasons as explained earlier.

8. Single Brand Product Retail Trading

8.1 This sector is available to non-residents on automatic basis up to 49% of the Equity and Government approval will be required for participation beyond 49% and that is available up to 100% to non-residents.

8.2 Foreign Investment in Single Brand product retail trading is aimed at encouraging increased sourcing of goods from India, and enhancing competitiveness of Indian enterprises through access to global practices.

8.3 FDI in Single Brand product retail trading would be subject to the following conditions:

(a) Products to be sold should be of a 'Single Brand' only.

(b) Products should be sold under the same brand internationally.

(c) 'Single Brand' product retail trading would cover only products which are branded during manufacturing.

(d) A non-resident entity or entities, shall be permitted to undertake 'single brand' product retail trading in the country for the specific brand, on their own or through a contractual agreement.

(e) In respect of proposals involving foreign investment beyond 51%, sourcing of 30% of the value of goods purchased, will be done from India, preferably from MSMEs, village and cottage industries, artisans and craftsmen, in all sectors. This procurement requirement would have to be met, in the first instance, as an average of five years' total value of the goods purchased beginning 1st April of the year of the commencement of the business i.e., opening of the first store. Thereafter, it would have to be met on an annual basis. Government may relax sourcing norms for entities where local sourcing may be difficult.

(f) Single brand retail trading entity operating through brick and mortar stores, is permitted to undertake retail trading through E-Commerce.

8.4 Application seeking permission of the Government for FDI exceeding 49% in a company which proposes to undertake single brand retail trading in India would be made to the Secretariat for Industrial Assistance (**SIA**) in the Department of Industrial Policy & Promotion.

8.5 Applications would be processed in the Department of Industrial Policy & Promotion, to determine whether the proposed investment satisfies the notified guidelines, before being considered by the FIPB for Government approval.

8.6 **SBRT and other Group Activity of Non-Resident:** There is no restriction as to sale of the goods to group entity in this case of SBRT for obvious reason that possibility of conflicting situation of the conditionalities will be almost a null set. SBR Trader could either sale the goods/product to group entity who could well be a manufacturer or a wholesaler or a participating purchaser on an electronic model thus group concern is certainly under lower level of conditionalities.

9. Multi-Brand Retail Trading

9.1 FDI in multi-brand retail trading, in all products, is available up to cap of 51% under Govt. Approval route subject to conditions listed below.

9.2 Fresh agricultural produce, including fruits, vegetables, flowers, grains, pulses, fresh poultry, fishery and meat products, may be unbranded.

9.3 Minimum amount to be brought in, as FDI, by the foreign investor, would be US $ 100 million.

9.4 At least 50% of total FDI brought in the first tranche of US $ 100 million, shall be invested in 'back-end infrastructure' within three years, where 'back-end infrastructure' will include capital expenditure on all activities, excluding that on front-end units; for instance, back-end infrastructure will include investment made towards processing, manufacturing, distribution, design improvement, quality control, packaging, logistics, storage, ware-house, agriculture market produce infrastructure etc. Expenditure on land cost and rentals, if any, will not be counted for purposes of backend infrastructure. Subsequent investment in backend infrastructure would be made by the MBRT retailer as needed, depending upon its business requirements.

9.5 At least 30% of the value of procurement of manufactured/processed products purchased shall be sourced from Indian micro, small and medium industries. The 'small industry' status would be reckoned only at the time of first engagement with the retailer and such industry shall continue to qualify as a 'small industry' for this purpose. Sourcing from agricultural co-operatives and farmers co-operatives would also be considered in this category. The procurement requirement would have to be met, in the first instance, as an average of five years' total value of the manufactured/processed products purchased, beginning 1st April of the year during which the first tranche of FDI is

received. Thereafter, it would have to be met on an annual basis.

9.6 Retail sales outlets may be set up only in cities with a population of more than 10 lakh as per 2011 census or any other cities as per the decision of the respective State Governments, and may also cover an area of 10 kms. around the municipal/urban agglomeration limits of such cities; retail locations will be restricted to conforming areas as per the Master/Zonal Plans of the concerned cities and provision will be made for requisite facilities such as transport connectivity and parking.

9.7 Government will have the first right to procurement of agricultural products.

9.8 The above policy is an enabling policy only and the State Governments/Union Territories would be free to take their own decisions in regard to implementation of the policy. Therefore, retail sales outlets may be set up in those States/Union Territories which have agreed, or agree in future, to allow FDI in MBRT under this policy.

9.9 Retail trading, in any form, by means of e-commerce, would not be permissible, for companies with FDI, engaged in the activity of multi-brand retail trading.

9.10 Applications would be processed in the Department of Industrial Policy & Promotion on Resident only under prior approval route up to 51% with conditions to determine whether the proposed investment satisfies the notified guidelines, before being considered by the FIPB for Government approval.

9.11 **SBRT and MBRT**

It may be noted that Sourcing condition in SBRT is less vigorous than that in MBRT as there is some flexibility to SBR trader as compared to MBR trader where sourcing of product has to be from MSME and it may be processed or manufactured goods only. MBRT does not permit E-Commerce Trading because Ecommerce is essentially a cash and carry wholesale trading and obviously under lower level of compliance as compared to MBRT.

Strangely it requires sourcing of 30% of processed and manufactured goods (as against 'goods 'in SBRT) however if there is no sourcing of manufactured or processed products then clarification may be sought whether any types of goods can be procured from MSME or other local sources as available to SBR trader.

10. Construction-development projects

10.1 Project includes development of townships, construction of residential/commercial premises, roads or bridges, hotels, resorts, hospitals, educational institutions, recreational facilities, city and regional level infrastructure, townships

It is clarified that FDI is not permitted in an entity which is engaged or proposes to engage in real estate business of dealing in land and immovable property with a view to earning profit from construction of farm houses and trading in transferable development rights (TDRs); however earning of rent/income on lease of the property, not amounting to transfer, will be permitted.

10.2 Eligible Project

10.2.1 New Project: The project shall conform to the norms and standards, including use requirements and provision of community amenities and common facilities, as laid down in the building control regulations, bye-laws, rules, and other regulations of the State Government/Municipal/Local Body concerned. Each phase of the construction development project would be considered as a separate project. Now there are no conditions as to minimum project development area or the amount of minimum investment by the non-resident.

10.2.2 Existing Project: 100% FDI under automatic route is permitted in completed

projects for operation and management of townships, malls/ shopping complexes and business centres. Consequent to foreign investment, transfer of ownership and/or control of the investee company from residents to non-residents is also permitted. However, there would be a lock-in period of three years, calculated with reference to each tranche of FDI, and transfer of immovable property or part thereof is not permitted during this period.

10.3 Exit for the Investor:

10.3.1 The investor will be permitted to exit on completion of the project or after development of infrastructure i.e. roads, water supply, street lighting, drainage and sewerage.

10.3.2 A foreign investor will be permitted to exit and repatriate foreign investment before the completion of project under automatic route, provided that a lock-in period of three years, calculated with reference to each tranche of foreign investment has been completed. Further, transfer of stake from one non-resident to another non-resident, without repatriation of investment will neither be subject to any lock-in period nor to any Government approval.

10.3.4 Exit from the investment in the completed Project: There would be a lock-in period of three years, calculated with reference to each tranche of FDI, and transfer of immovable property or part thereof is not permitted during this period. Development of the trunk Infrastructure, approval from the local authority, etc. does not arise.

10.4 Condition on Investee Company: The Indian investee company will be permitted to sell only developed plots i.e., plots where trunk infrastructure i.e., roads, water supply, street lighting, drainage and sewerage, have been made available.

The Indian investee company shall be responsible for obtaining all necessary approvals, including those of the building/layout plans and complying with all requirements as prescribed under applicable rules/bye-laws/regulations of the State Government/Municipal/Local Body concerned.

The State Government/Municipal/Local Body concerned, which approves the building/ development plans, will monitor compliance of the above conditions by the developer.

11. Conclusion: Residual Sector / Activity

Current policy of June 2016 has number of sectors and activity which is explained in the Policy However question arises as to whether a sector or an activity which is not mentioned in the policy is available to non-resident without any cap or the conditionalities of the sector or that there are security reasons but not found in the policy. In such cases it is always advisable to consider the guidance of the SIA to venture into such sector unless it is made abundantly clear by precedent or the historical experience that such an activity is freely available without any conditionalities. E.g., Film production activity is not found in the sectoral policy however it may be noted that earlier there were minimum capitalisation norms as well as KYC norms for the non-residents to venture in to this sector. Thus activity is free from all conditionalities in the current policy and available to non-resident on 100% basis without Local participation.

CA Naresh Ajwani

Indirect Foreign Investment and Downstream investments

Executive Summary

1. Foreign Direct Investment **(FDI)** can be made directly in the Indian company, or indirectly through an intermediate Indian company. Investment by an intermediate Indian company (which is owned or controlled by foreigners) into **another Indian entity** is considered as **Indirect Foreign Investment (IFI)** or downstream investment. IFI rules apply across all levels of downstream investment. IFI rules are amongst the most complicated rules. With multiple regulators and multiple laws, it has become a complex subject.

2. The **basic policy** behind IFI rules is — **What can be done directly can be done indirectly. What cannot be done directly cannot be done indirectly.**

3. **Implications of Indirect Foreign Investment** — All IFI have to comply with all FEMA rules – **sectoral caps, conditions or restrictions** of FDI policy. This includes capitalisation norms, valuation rules, optionality clauses, etc. Where approvals are required, the same have to be obtained. **Thus even though the transactions may be between Indian entities, if one of them is Indirect foreign investor, FEMA applies.**

   The responsibility for compliance of IFI rules is on the investee company at all levels. Thus even small start-up companies which receive investment from a Venture fund, will need to consider whether the VCF is domestic investment or foreign investor.

   The **first level Indian company** which has received Direct Foreign Investment, is required to get a certificate from the auditor annually that downstream investment rules have been complied with (including its subsidiaries).

4. IFI can be undertaken by an Indian company, Limited Liability Partnership or an Investment Vehicle (VCF/AIF). Investment includes equity shares and fully convertible instruments.

   If an Indian company or LLP is owned to the extent of 50% or more by non-residents or foreign citizens; or is controlled by non-residents or foreign citizens, it will be considered as **indirect foreign investor.** FEMA rules have to be complied with. On the other hand, only if the Indian company or LLP has Resident Indian citizen investment of more than 50% AND is controlled by Resident Indian citizen, it

The article has important contributions from Mr. Rashmin Sanghvi and Mr. Rutvik Sanghvi.

will be considered as **domestic investor**. The manner in which rules are made, it is possible that the financial interest in the downstream company may be more than 50% but still it will be considered as domestic investor. It should also be noted that **residence and citizenship**, both have to be considered.

In case of investment by Investment Vehicle, if the fund's sponsor or manager is foreign owned or controlled, then the investment by Investment vehicle will not be considered as domestic investment. Foreign investment in units of IV will not be considered to determine whether IV is domestic or foreign.

If Indian entity is considered as indirect foreign investor, the entire investment will be considered as IFI. **There is no proportionality.** Thus if there is foreign investment of 60% in Indian company, investment by Indian company in downstream company will be entirely considered as IFI. IFI will not be restricted to 60%. This method has to be considered for every downstream company at every level.

It should however be noted that there are some sectors which are totally prohibited for foreign investment like agriculture, atomic energy, etc. Even if the Indian company is owned and controlled by Indian resident citizens, but has slightest foreign investment, it cannot invest in these sectors.

6. To determine the extent of foreign investment in Indian entity (whether it is 50% or more), **all categories of foreign investments have to be considered** – FDI, FII, NRI repatriable, FVCI, etc. In fact now for considering the sectoral cap in the first level company also, all categories of foreign investment have to be considered. Thus if FDI is 20%, but together with other foreign investments, total foreign investment crosses 50%, the company will be considered as foreign investor for downstream investment.

   NRI Investment on Non-Repatriation basis (Schedule 4) is not counted as foreign investment for these purposes. Share issued as Sweat equity or under employee stock option plans are also not to be considered.

7. Indian companies/LLPs have to bring in requisite **funds from abroad** for making downstream investment. Downstream investments can also be made through **internal accruals** also. Internal accruals mean profits transferred to reserve account after payment of taxes.

   Indian entity however cannot borrow and invest. They can raise debt for their business, but not for further downstream investments.

8. DIPP press notes for Indirect Foreign investment were issued on 13-2-2009. FEMA notification was issued effective from 21-6-2013. Transactions between 13-2-2009 and 20-6-2013 (between the dates of issue of DIPP press notes and FEMA Notification) need to be examined whether these fall within the guidelines. If they do fall within the guidelines, suitable action should be taken.

Detailed article

1. Background

1.1 Foreign Direct Investment **(FDI)** has been welcomed in India since 1991. Investment by foreigner (non-resident) in an Indian entity is considered as Direct Foreign Investment. Investment by an Indian company (which is owned or controlled by foreigners) into **another Indian entity** is considered as **Indirect Foreign Investment (IFI).** It is also known as downstream investment.

1.2 Prior to 2009, there were no clear rules on Indirect Foreign Investment. There were some rules for Telecom, broadcasting, insurance and infrastructure service sectors. DIPP issued press notes in February 2009 bringing in the concept of IFI. These guidelines were notified by RBI only in June 2013. The delay was due to differences between RBI and Government of India. There have been some amendments after June 2013. In 2015-16, several notifications under FEMA have been issued which have brought in a lot of clarity.

1.3 IFI rules are amongst the most complicated rules. Drafting of the law could be far more simple. Further there are multiple regulators dealing with foreign investment as under:

RBI – For administering, reporting, compounding and approval for some transactions.

DIPP – For issuing policy measures and approvals in some sectors like NRI investment and retail trading.

FIPB – Approval for foreign investment not falling within automatic route.

Ministries – Approvals/licences for specific matters like defense, insurance, etc.

Apart from the above, other laws also may be applicable – SEBI, Company law, NBFC, Income-tax, etc.

1.4 There have been controversies. This article discusses the rules for Indirect Foreign Investment from FEMA angle considering the latest rules.

A) Abbreviations used in this article:

AIF - Alternative Investment Fund

FDI - Foreign Direct Investment

FII - Foreign Institutional Investor

FPI - Foreign Portfolio Investment

IC - Indian company which has foreign investment and which is making downstream investment

IFI - Indirect Foreign Investment/Downstream investment, or Indirect Foreign Investor (as may be relevant)

IV - Investment Vehicle

LLP - Limited Liability Partnership

QFI - Qualified Foreign Investor

RBI - Reserve Bank of India

VCF - Venture Capital Fund

B) Terms frequently used in this article:

Domestic investor – Indian company which does NOT have any Indirect foreign investor (i.e. foreign ownership and control is less than the prescribed threshold). It is in contrast with IFI. ("Domestic investment" means 'investment made by such Domestic investor'.)

Downstream investment – Investment made by Indian company/LLP, in another Indian company/LLP. ("Downstream company" means the 'investee company/LLP in which downstream investment is made'.)

Foreign investment – Investment in an Indian company/LLP by a non-resident person.

C) **Relevant law** – The relevant law for IFI is as under:

Press Notes 2, 3 and 4 of 2009 (while these are now subsumed within the Consolidated FDI Policy), these form the basis. (Issued by DIPP.)

FEMA Notification No. 20 on Foreign Investment – especially Regulation 14. (Issued by RBI.)

Specific Notification Nos. 278, 354, 355, 362 (including the corrigendum), and 363 which have amended FEMA Notification No. 20. (Issued by RBI.)

(Generally these are referred to as "rule/s" in this article.)

2. Basic policy for Indirect Foreign Investment (IFI)

The basic policy behind IFI rules is – **What can be done directly can be done indirectly. What cannot be done directly cannot be done indirectly.**

3. Where are IFI rules relevant?

3.1 IFI rules are most relevant where there are **sectoral caps, conditions or restrictions** for foreign investment, or where **Government approval** is required. Fortunately the list of such industries is now small.

All investments by IFI has to comply with Schedule 1 of FEMA notification No. 20 (FDI policy). Thus if investment is in NBFC activity, capitalisation norms have to be complied with.

3.2 IFI rules are also relevant for past investments which may not have been as per IFI rules and involved investment in industries where there were sectoral caps and conditions. (E.g. real estate development sector had condition of minimum area of 50,000 sq. metres of built-up area.)

3.3 For the remaining industries which are under **automatic route,** the regular compliance of conditions for foreign investment – valuation rules, allotment/refund of share application rules etc. have to be complied with for IFI. **This is an area which is missed out by many. Even though the transactions may be between Indian entities, if one of them is Indirect foreign investor, FEMA applies. (See para 16.)**

3.4 Thus IFI rules are relevant where:

- Foreign investment is not allowed – e.g. agriculture.
- There are sectoral caps for foreign investment – e.g. Scheduled air transport.
- There are conditions prescribed for foreign investment – e.g. Real Estate Development.
- There are minimum capitalisation norms prescribed for foreign investment – e.g. NBFC.

- Transfer of capital or control from residents to non-residents.

- Compliance with regular conditions – e.g. allotment or refund of share application within 180 days, valuation rules, etc.
- Reporting.

IFI rules apply throughout all levels in a multi-level structure.

4. Person responsible for compliance of IFI rules

4.1 **The responsibility for compliance of IFI rules is on the investee company.** For example if there are ten levels of companies, all companies from second to tenth level are required to see that they are eligible to receive investment from the preceding level company! If first company has invested in the second company, the second company has invested in the third company and so on, and if there is a violation of some FEMA regulation at tenth level, all the investee companies in between may have to file for Compounding. AP circular 73 dated 26-5-2016 provides for a framework as per which compounding fee will be levied.

To consider another practical example, if an Indian Venture Capital Fund or Alternative Investment Fund has invested in an Indian company, the investee company will have to consider whether the VCF or AIF is foreign controlled or not. Usually companies receiving investment from VCFs or AIFs are small companies/start-ups. They do not have the capability to examine. Yet responsibility is with them.

4.2 The **first level Indian company** which has received Direct Foreign Investment, is required to get a certificate from the auditor that downstream investment rules have been complied with for all its subsidiaries. (See para 12.)

5. Key issues to be checked for IFI

Key issues to be checked for IFI are:

- Whether the **Indian investor entity** is Indian owned and controlled and therefore domestic investor; or it is foreign owned or foreign controlled and therefore foreign investor. (Paras 7 and 8).
- What kind of foreign investment in IC is considered for determining whether Indian investor entity is considered as Indirect foreign investor. (Para 9).
- The guidelines for Indian investor company to invest in downstream companies. (Paras 11 to 15).

6. Entities eligible to undertake IFI

Following Indian entities can undertake IFI:

A company.

A Limited Liability Partnership.

An Investment Vehicle.

Investment includes equity shares and fully convertible instruments. Investment does not include loans, Non-convertible or partly convertible debentures/preference shares.

7. Indirect Foreign Investment (IFI)

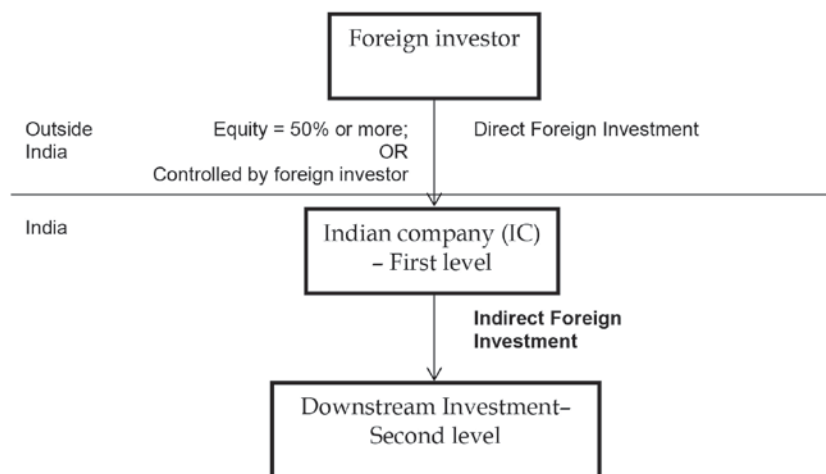
7.1 IFI has been defined in Regulation 14(1)(v) of FEMA Notification No. 20 as under:

"'Indirect foreign investment' means entire investment in other Indian companies by an Indian company (IC), having foreign investment in it provided (a) IC is not 'owned and controlled' by resident Indian citizens and/or Indian companies which are owned and controlled by resident Indian citizens or (b) where the IC is owned or controlled by non-residents.

However, as an exception, the indirect foreign investment in the 100% owned subsidiaries of operating-cum-investing/investing companies will be limited to the foreign investment in the operating-cum-investing/ investing company."

A simple chart (A) explains IFI :

Chart A



Thus if the IC has foreign investment of 50% or more; OR is controlled by non-resident through the board of directors or any other agreement; it will be considered **Indirect foreign investor.** On the other hand, only if IC has Resident Indian citizen investment of more than 50% AND is controlled by Resident Indian citizen, it will be considered as **domestic investor.**

In the First level IC, there can only be Direct foreign investment. IFI can be there in Second level companies and further downstream companies.

If IC is considered as indirect foreign investor, the entire investment by IC will be considered as IFI. **There is no proportionality**. Thus if there is foreign investment of 60% in IC, investment by IC in downstream company will be entirely considered as IFI. IFI will not be restricted to 60%. See Chart B. As a corollary, if foreign investment in IC is say 40%, entire investment by IC in downstream company will be considered as domestic investment.

This method has to be considered for every downstream company at every level.

FEMA rules apply if IC invests in Downstream companies.

7.2 The definition of Indirect Foreign Investment has two limbs as under:

Limb 1 – *"'Indirect foreign investment' means entire investment in other Indian companies by an Indian company (IC), having foreign investment in it.*

Limb 2 – *provided (a) IC is not 'owned and controlled' by resident Indian citizens and/or Indian companies which are owned and controlled by resident Indian citizens or (b) where the IC is owned or controlled by non-residents.*

The first limb provides that investment by "IC which has foreign investment" will be considered as IFI provided…. Thus if there is no foreign investment at all, there is no question of considering it as IFI.

The second limb provides a further condition that investment by IC will be considered as IFI where IC is either "owned" or "controlled" by non-resident.

Take case where a foreign pharma company provides APIs to Indian formulation manufacturing Indian company. The Indian company is held 100% by Indian residents and citizens. However there is an agreement

between the foreign pharma company and the Indian company through which all key business decisions for manufacturing and formulations is undertaken by the foreigner. If the Indian company does not perform as per instructions of the foreign pharma company, the business of the Indian company will stop. If the Indian pharma company wants to invest in a downstream company, does FEMA apply? Will the Indian company be considered as IFI as "control" is with the foreign company? (Such situations are rare but possible.)

In the above example, if the non-resident had just 1 share and then it would have control of Indian company, investment by IC will be IFI.

The purpose of IFI is that if non-resident owns or controls an IC, FEMA should apply for downstream investment.

However technically, if the first limb does not apply, the rest of the definition fails. Thus if there is no foreign investment at all in IC, the Indian company will not be considered as IFI even if it is controlled by foreigner.

If the Government wants control also to be a determining factor, then drafting could have been better.

7.3 If the IC has to invest abroad, IFI rules do not apply. It is not considered as "Reverse Round Tripping".

7.4 "Total Foreign Investment" has been defined in Regulation 14(1)(x) as under:

"'Total foreign investment' in an Indian Company would be the sum total of direct and indirect foreign investment."

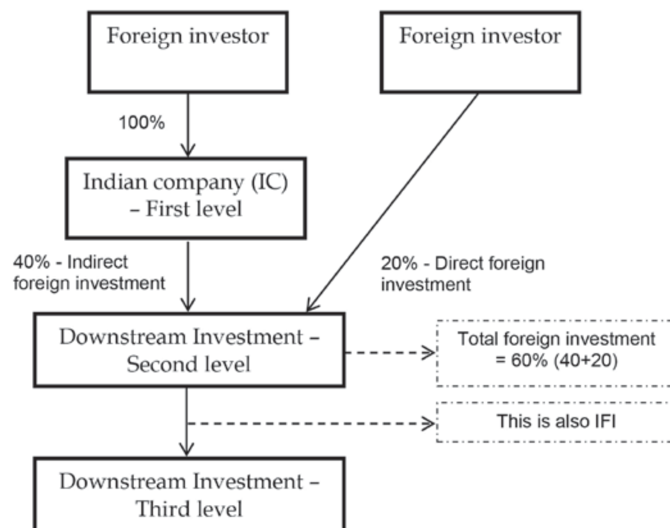
"Direct foreign investment" has been defined in Regulation 14(1)(ii) as under:

"Direct foreign investment" shall mean investment received by an Indian company from non-resident entities regardless of whether the said investments have been made under Schedules 1, 2, 2A, 3, 6 and 8 of the Notification No. FEMA 20/2000-RB dated May 3, 2000, as amended from time-to-time."

IFI is added to Direct foreign investment to arrive at Total foreign investment in an Indian company. Based on the Total foreign investment, investment in further downstream companies can be considered.

Total foreign investment has to be considered in Second level companies and further downstream companies. A chart is given below:

Chart B

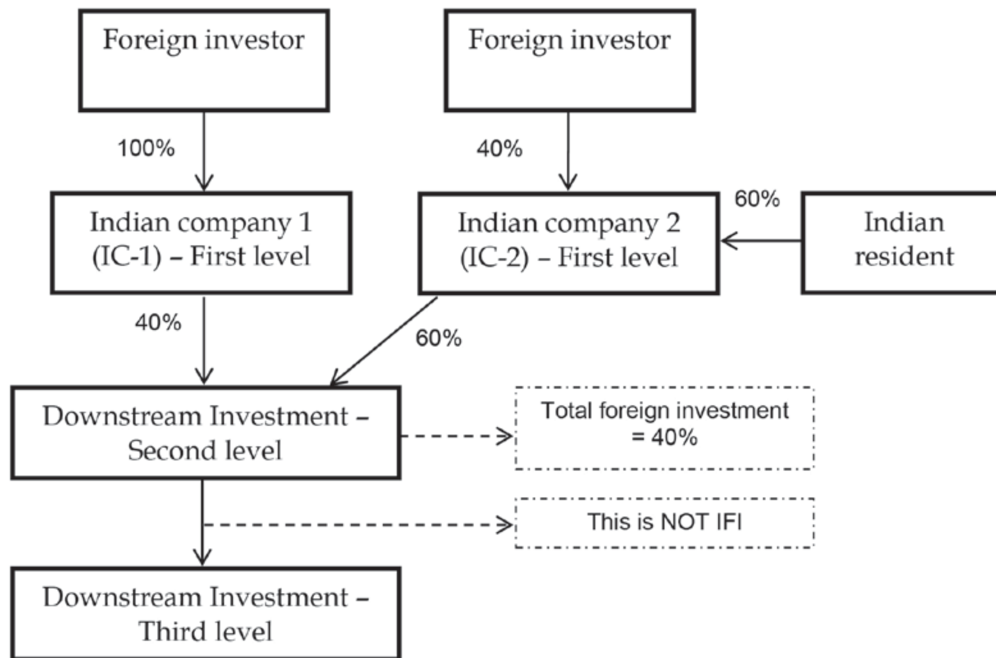


In this illustration, even if Foreign Direct Investment in IC was say 60%, while computing IC's downstream investment in the Second level company, entire 40% will be considered as Foreign investment, and not just 24%.

In case of investment by the Second level company in the Third level company, as the Third level company is a 100% subsidiary, the foreign investment in Third level will be considered as 60%. If there was however resident investment in the Third level company (however small), the entire stake of Second level company would have been considered as IFI.

Take another illustration.

Chart C



In the above chart, foreigners own 64% in Second level company [40% through IC-1 and 24% through IC-2 (40x60%)]. **However IC-2 is considered as domestic investor as it is owned (and controlled) by Indian resident.** Therefore foreign investment in second level company is considered as only 40%. As a result, Second level company is also domestic investor. Consequentially investment in Third level will not be foreign investment.

Contrast this with the earlier Chart B. Foreigners have 60% stake and is considered as foreign investment. Whereas in Chart C, despite having 64%, it is not considered as foreign investment.

Can one say the Third level company is controlled by foreigners – otherwise than by direct shareholding? No. Such a control is not the purpose of the rules. The control has to be considered based on directorship and agreements. Financial ownership control is not to be considered. (See para 8.)

7.5 If IC is owned or controlled by non-residents, FEMA rules apply. The meaning of ownership and control is explained below in para 8.

8. Owned and controlled

"Owned" and "Controlled" are separate terms. One has to consider the meanings separately. **This is the crux of the IFI guidelines**.

IFI can happen through a company, LLP or Investment Vehicle in India. Therefore the meaning is also different for a company, LLP and Investment Vehicle. The meanings for different entities are discussed below.

8.1 Indian company (IC)

8.1.1 Regulation 14(1)(i)(a) defines "owned" as under:

"a company shall be considered as owned by resident Indian citizens if more than 50% of the capital in it is beneficially owned by resident Indian citizens and/ or Indian companies, which are ultimately owned and controlled by resident Indian citizens."

Regulation 14(1)(i)(b) provides a converse definition – *"A company owned by non-residents shall mean an Indian company that is not owned by resident Indian citizens."*

If shareholders of IC are Indian companies, those companies should also be owned and controlled by Indian resident citizens for IC to be considered as domestic investor. This applies to all levels of investments upward and downward.

8.1.2 Importance has been given to Residence and Citizenship. It is one of the very few provisions where citizenship is being considered as one of the criteria. If a person is a foreign citizen though an Indian resident, IC will be considered as foreign owned for IFI purposes.

Consider two situations:

i) A foreign citizen resident in India owns 100% shares of IC. The IC wants to make downstream investment.

ii) There is foreign investment in the IC. That IC also has investment by foreign citizen resident in India. Such IC wants to make downstream investment.

Can the IC make downstream investments under IFI rules?

It may be interesting to understand that FEMA does not regulate transactions based on citizenship. Then how is it that for rules for IFI, citizenship is being considered? (Rules are subordinate to the law.)

FEMA regulates transactions based on whether these are Capital Account transactions or Current Account Transactions. **Foreign investment is a Capital Account Transaction.** Unless permitted by rules, it cannot be undertaken. **While permitting the IFI rules, conditions/criteria can be provided.** One of the criteria is citizenship. The citizenship criteria has been provided for "foreign investment" which can be regulated under FEMA.

Contrast this with rules for acquiring Immovable property in India by non-residents. These provide that citizens of some countries like Pakistan, etc. cannot acquire property in India. While such citizens are non-residents, restrictions are permissible under FEMA. **However if such citizens are Indian residents, FEMA does not apply at all.** If FEMA law does not apply, the rules also cannot apply. To the extent the immovable property rules put restrictions on foreign citizens who are Indian residents to acquire property, these are *ultra vires* the FEMA. Can this argument be applied to a foreign citizen resident in India?

FEMA rules cannot travel beyond the law. In situation (i) where the foreign citizen is an Indian resident, FEMA does not apply. Even definition of IFI refers to IC which has foreign investment. (See para 7.2). Therefore in situation (i), IC should be able to make downstream investment without considering FEMA.

However in situation (ii), once there is foreign investment, then conditions can be applied as it comes within the FEMA purview.

This is another example where drafting can be better.

Thus a foreign citizen resident in India, can make investment in an Indian company freely. FEMA applies only if a person is a "non-resident" under FEMA (irrespective of citizenship). However for considering IFI, such a person will NOT be considered as domestic investor if there is foreign investment in the IFI.

8.1.3 **Shares in downstream Indian company held through LLP / other entities** — There is no mention of shares being held in downstream company by other Indian entities (like LLP). Thus if non-resident has invested 51% of capital in Indian LLP and that LLP holds shares in downstream company, will it be considered as IFI in downstream company? [The meaning of "owned" in case of downstream LLP includes shareholding by any "entity". (See para 8.2.1 below).]

In my view, if the Indian LLP is foreign owned, downstream investment by LLP will be considered as IFI. One cannot take a view that investor is IFI, but recipient of investment is receiving domestic investment! One should consider investment by any Indian entity in the downstream company for the purpose of IFI rules. FEMA is a Policy law. It is advisable to consider the policy and not just technical interpretation.

8.1.4 The reference here is to foreign "capital" of the IFI. (Regulation 2(ii) of FEMA Notification No. 20). However how does one consider investment in Fully Convertible Debentures if price of conversion has not been decided as yet. The guidelines do not give any answer.

8.1.5 Regulation 14(1)(ia) defines "control" as under:

"Control' shall include the right to appoint a majority of the directors or to control the management or policy decisions including by virtue of their shareholding or management rights or shareholders agreements or voting agreements."

8.2 Indian Limited Liability Partnership (LLP):

8.2.1 Regulation 14(1)(i)(a) defines "owned" as under:

"A Limited Liability Partnership will be considered as owned by resident Indian citizens if more than 50% of the investment in such an LLP is contributed by resident Indian citizens and/or entities which are ultimately 'owned and controlled by resident Indian citizens' and such resident Indian citizens and entities have majority of the profit share."

Contribution to capital by any Indian entity also has to be considered. Further share in the profit also has to be considered.

8.2.2 Regulation 14(1)(ia) defines "control" as under:

"For the purpose of Limited Liability Partnership, 'control' shall mean right to appoint majority of the designated partners, where such designated partners, with specific exclusions to others, have control over all the policies of Limited Liability Partnership."

8.3 Indian Investment Vehicle (IV)

8.3.1 Foreign investment has been permitted in Indian companies, or Indian LLPs. Foreign Venture Capital Investors (FVCIs) which are registered with SEBI have been permitted to invest in Venture Capital Funds (VCFs) registered with SEBI.

Venture Capital Fund Regulations of 1996 under SEBI law have been replaced with Alternative Investment Fund (AIF) regulations of 2014. Under the AIF regulations, various categories of AIFs can be registered.

Under Regulation 5(10) of FEMA Notification No. 20 (inserted *vide* Notification No. 355 dated 16-11-2015), non-residents have been permitted to invest in "Investment Vehicle". Investment Vehicle is defined in Regulation 2(iif) of FEMA Notification No. 20 as under:

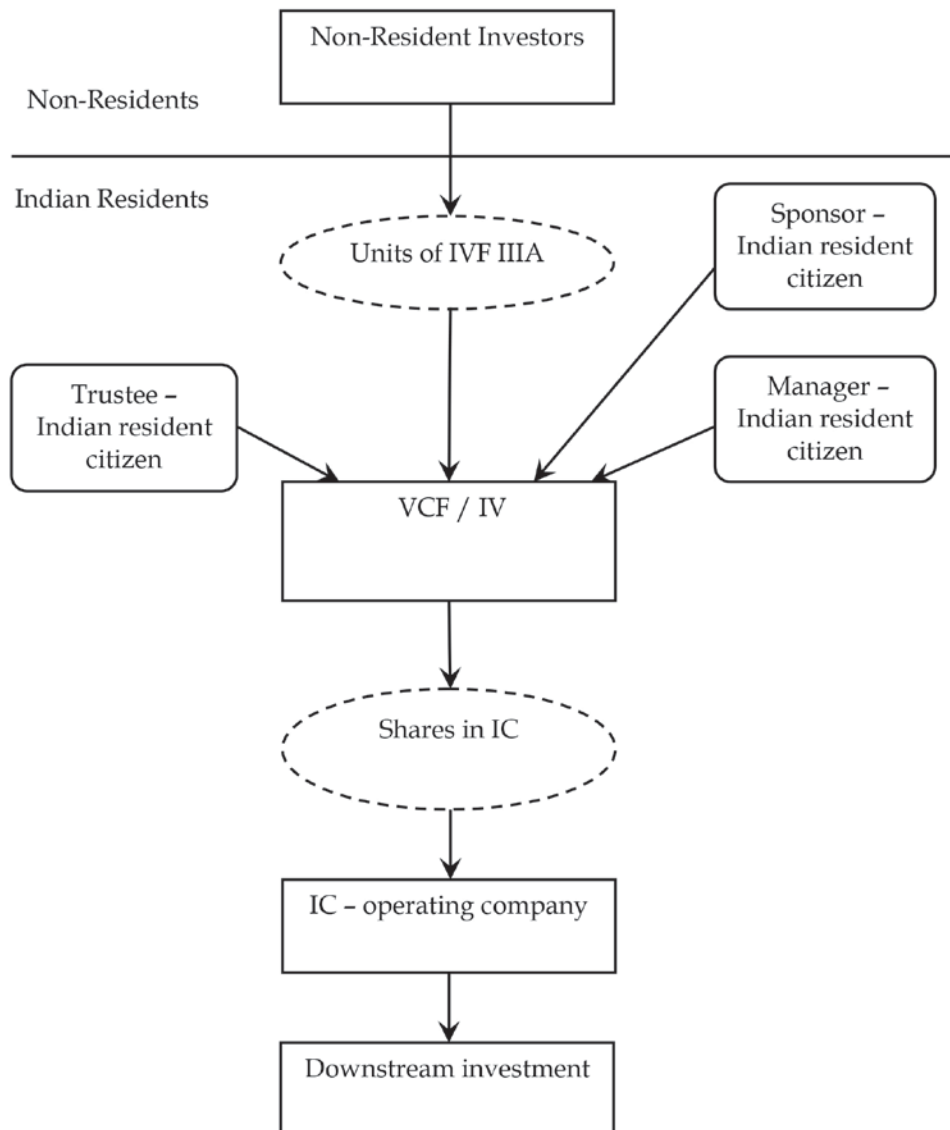
'Investment Vehicle' shall mean an entity registered and regulated under relevant regulations framed

by SEBI or any other authority designated for the purpose and shall include Real Estate Investment Trusts (REITs) governed by the SEBI (REITs) Regulations, 2014, Infrastructure Investment Trusts (InvIts) governed by the SEBI (InvIts) Regulations, 2014 and Alternative Investment Funds (AIFs) governed by the SEBI (AIFs) Regulations, 2012."

Schedule 11 of FEMA Notification No. 20 (inserted vide Notification No. 355 dated 16-11-2015 and substituted by Notification No. 362 dated 15-2-2016) lays down guidelines for non-residents to invest in IVs.

The chart below depicts a typical Venture Capital Fund structure:

Chart D



In the above chart, the non-residents invest in units. They do not invest in "equity capital". The VCF/IV is managed by Indian resident citizens. Investment by such a VCF will be considered as domestic investment and not IFI.

8.3.2 Hitherto, IFI rules applied to investment by ICs. IFI rules clearly did not apply to IVs. IVs are funds which are usually sponsored and managed by Indian residents. Non-resident investors have no say in management of IVs. However in some cases, FIPB has taken a view that IFI rules apply to investment in IVs also irrespective of the fact that they are managed by Indian resident citizens/entities owned and controlled by such Indian resident citizens.

Now under clause 4 of Schedule 11, IFI rules can apply to IVs. It states as under:

"Downstream investment by an Investment Vehicle shall be regarded as foreign investment if either the Sponsor or the Manager or the Investment Manager is not Indian 'owned and controlled' as defined in Regulation 14 of the principal Regulations.

Provided *that for sponsors or managers or investment managers organised in a form other than companies or LLPs, SEBI shall determine whether the sponsor or manager or investment manager is foreign owned and controlled.*

Explanation 1: Ownership and control is clearly determined as per the extant FDI policy. AIF is a pooled investment vehicle. 'Control' of the AIF should be in the hands of 'sponsors' and 'managers/investment managers', with the general exclusion to others. In case the 'sponsors and 'managers/investment managers' of the AIF are individuals, for the treatment of downstream investment by such AIF as domestic, 'sponsors' and 'managers/investment managers' should be resident Indian citizens.

Explanation 2: The extent of foreign investment in the corpus of the Investment Vehicle will not be a factor to determine as to whether downstream investment of the Investment Vehicle concerned is foreign investment or not."

8.3.3 In case of companies or LLPs, "ownership" and "control" – both are considered to determine whether the company or the LLP is Indian owned and controlled. **In case of IVs, only "control" is considered. Foreign investment in IV will not be considered to determine whether the investment by IV is IFI.**

To determine "control", the status of sponsor, manager or investment manager will be considered.

If the sponsors or managers are individuals, they should be Indian residents and citizens for the IV to be considered as domestic investor.

If the sponsor or manager is an Indian company, the meaning of control as given in Regulation 14 will apply. The company should be Indian owned and controlled for the IV to be considered as domestic investor.

If the sponsor and manager is an LLP or any other entity, SEBI will determine whether the sponsor and manager is Indian owned and controlled.

8.3.4 If the IV is Indian owned and controlled, then downstream investment can be made without FEMA restrictions. However if IV is considered as foreign controlled, then the downstream investment will be governed by FEMA rules (Schedule I for investment in companies and Schedule 9 for investment in LLPs).

8.4 Insurance, Information and Broadcasting, Defence industries have specific guidelines. Or their regulators also have ownership and control guidelines. Those will also apply.

8.5 **Change in rules** – What happens if the IC has not been considered as IFI hitherto but it becomes an IFI due to change in law? Consider Chart D above. Assume that IC had received invested from IV. IV is owned by non-residents. It was not a foreign investor for IFI. FEMA

conditions have not been complied with as it IC was not considered as IFI.

Vide Notification No. 355 from November 2015, IV has been considered as foreign investor as it is owned by non-resident. Will the past investment made by IV in IC be considered as IFI? I believe that past investments cannot be considered as IFI. However fresh investments will be considered as IFI. Fresh investments in existing downstream company will mean a mix of domestic investment and IFI. Will sale of such investments be considered as sale by IFI? Will valuation rules have to be complied with?

In such situations, it will be advisable to inform RBI. Based on directions from RBI, further action may be taken.

9. What kind of foreign investment in IC is considered for IFI?

9.1 Foreign Direct Investment and Foreign Portfolio Investment have been treated separately. For Direct Foreign Investment, Schedule I of FEMA Notification No. 20 applies. However for computing Total foreign investment, Direct foreign investment and Indirect foreign investment have slightly different meanings. Thus there are practically 3 meanings of foreign investment:

i) Meaning of foreign investment for FDI in the first level company. (Para 9.2)

ii) Meaning of direct foreign investment in first level company for Indirect Foreign Investment in second level company. (Para 9.4)

iii) Meaning of Indirect foreign investment in second level company for Indirect Foreign Investment in third level company (and so on for further levels) (Para 9.5)

For IFI rules, we are concerned with (ii) and (iii) above. However for the sake of completeness, item (i) also has been discussed below in brief.

9.2 Meaning of foreign investment for FDI in the first level company

9.2.1 FDI in Indian companies is permitted under Regulation 5 subject to Schedule I of FEMA notification No. 20 and the FDI policy. For certain industries there are sectoral caps. Foreign investment can come in up to the sectoral cap under Schedule I.

Other kinds of investment – e.g. FII, FPI, FVCI have separate schedules. Investment can be made under those schedules separately. Each schedule has its own conditions / limits. (e.g. FPIs can invest up to 10% separately and 24% collectively.) Unless specified in the rules, **each schedule is separate**. Investment can come in separately. Together the foreign investment may cross the sectoral cap in Schedule I.

This is the normal meaning of foreign Investment in **first level company.**

9.2.2 *Vide* Notification No. 354 dated 30-10-2015, proviso (c) has been inserted after clause 2(1) in Schedule 1 (FDI) to FEMA Notification No. 20. It states as under:

""Sectoral cap" i.e. the maximum amount which can be invested by foreign investors in an entity, unless provided otherwise, is composite and includes all types of foreign investments, direct and indirect, regardless of whether the said investments have been made under Schedule 1, 2, 2(A), 3, 6, 8, 9 and 10 of FEMA (Transfer or Issue of Security by Persons Resident Outside India) Regulations, 2000. FCCBs and DRs having underlying of instruments which can be issued under Schedule 5, being in the nature of debt, shall not be treated as foreign investment. However, any equity holding by a person resident outside India resulting from conversion of any debt instrument under any arrangement shall be reckoned as foreign investment under the composite cap. Sectoral cap is as per table appended below."

Hitherto inclusion of all kinds of foreign investment was relevant for determining whether IFI can be made. Now this applies to Direct foreign investment itself. This may not

have much significance as most of the sectors where there are caps, also have other regulators which have their own foreign investment conditions – like Banking, Insurance, etc.

There are 17 sectors where there are caps. (Some other sectors are also there where automatic route has a cap and beyond that investment can be made with Government approval.) For example, if there is a sectoral cap of 49% and the company has received 49% FDI, then other investors cannot invest.

NRI investment under Schedule 4 is not to be considered. (See paras 9.4.3 and 9.8 also).

9.3 We now come to IFI. Essentially we have to see foreign investment in first level company for investment in second level company and foreign investment in second level and subsequent levels for further downstream investments.

9.4 Meaning of direct foreign investment in first level company for Indirect Foreign Investment in second level company:

9.4.1 For second level company, direct investment in first level company is defined in Regulation 14(1)(ii) as under:

""Direct foreign investment" shall mean investment received by an Indian Company from non-resident entities regardless of whether the said investments have been made under Schedules 1, 2, 2A, 3, 6 and 8 of the Notification No. FEMA 20/2000-RB dated May 3, 2000, as amended from time-to-time."

Thus following investments will be considered as foreign investment:

Schedule 1 – FDI in Indian company

Schedule 2 – FII portfolio investment

Schedule 2A – FPI portfolio investment

Schedule 3 – NRI Portfolio investment (repatriation basis)

Schedule 6 – FVCI investment in Indian company; and Investment Vehicle (subject to Schedule 11)

Schedule 8 – QFI investment in equity shares

Schedule 11 – IV if it is controlled by non-resident or foreign citizen.

9.4.2 Category of FIIs and QFIs will be considered as FPIs after following the process under SEBI rules. The investments made as FII and QFI will be considered as foreign investment till then.

Schedule 11 has not been included as foreign investment as per the rules. However if one considers Schedule 11, investment by IV will be counted as FDI under Schedule 1 of FEMA Notification No. 20 (sectoral caps) if IV is controlled by non-resident or foreign citizen. One cannot take a view that investment by foreign owned or controlled IV will be considered as FDI but the recipient company will not be considered to have received FDI. Therefore Schedule 11 also has to be considered.

Thus even if FDI is 20%, but together with other investments it crosses 50%, the second level company will be considered as foreign investor for downstream investment.

9.4.3 **NRI Investment on Non-Repatriation basis (Schedule 4)** is not counted as foreign investment for these purposes. NRI can invest in an Indian firm or LLP or company. The Schedule has very few restrictions compared to restrictions or conditions for FDI under Schedule 1. That Indian entity can invest in downstream companies to undertake activities where FDI is restricted. (See para 9.8 also).

Further, a **company, trust or partnership outside India which is owned and controlled by NRIs,** can invest in Indian entities under this Schedule 4. Thus foreigners can invest in India through this route in almost any sector. Earlier also, OCBs (foreign entities in which NRIs held 60% or more) were permitted to invest liberally

compared to foreign investors. This route was misused in the past. The OCB as an entity was derecognised in 2003 after stock market scam by a share broker. Now this route has been brought back after 12 years. It will again lead to misuse.

9.4.4 For foreign investment in LLP, Schedule 9 has to be considered. Investment cannot come in the LLP under any other schedule.

9.5 Meaning of <u>Indirect foreign investment</u> in second level company for Indirect Foreign Investment in <u>third level company</u> (and so on for <u>further levels</u>):

9.5.1 For third level company, Indirect foreign investment in second level company has been defined as under:

Regulation 14(3)(i) of FEMA Notification No. 20 defines Indirect foreign investment as under:

*"**Counting of direct foreign investment :** All investments made directly by non-resident entities into the Indian company would be counted towards "Direct foreign investment".*

*(ii) **Counting of indirect foreign investment** : For the purpose of computation of indirect foreign investment, foreign investment in an Indian company shall include all types of foreign investments regardless of whether the said investments have been made under Schedules 1, 2 (FII holding as on March 31), 2A (FPI holding as on March 31), 3, 6, 8, 9 and 10 of FEMA (Transfer or Issue of Security by Persons Resident outside India) Regulations, 2000. FCCBs and DRs having underlying of instruments which can be issued under Schedule 5, being in the nature of debt, shall not be treated as foreign investment. However, any equity holding by a person resident outside India resulting from conversion of any debt instrument under any arrangement shall be reckoned as foreign investment."*

Thus it will include:

Schedule 1 – FDI in Indian company

Schedule 2 – FII portfolio investment

Schedule 2A – FPI portfolio investment

Schedule 3 – NRI Portfolio investment

Schedule 6 – FVCI investment in Indian company; and Investment Vehicle (subject to Schedule 11)

Schedule 8 – QFI investment in equity shares

Schedule 9 – FDI in LLP

Schedule 10 – Investment in Indian Depository Receipts

Schedule 11 – IV if it is controlled by non-resident or foreign citizen.

Regulation 14 – Investment by first level company if it has foreign investment as mentioned in para 9.4 above.

9.5.2 Here also, Schedule 11 has not been included as foreign investment as per the rules. As explained in para 9.4.1 above, Schedule 11 also has to be considered.

Under Schedule 10 Indian company can issue Depository Receipts (DRs) for securities which can be issued to foreign investors under Schedules 1, 2, 2A, 3, 5 and 8. The securities are themselves issued to foreign depository. It is a mechanism of issue of securities to foreigners. DRs could be covered in the list of foreign investors stated in para 9.4 itself – i.e. for second level company itself.

DRs are considered as FDI for first level company (see para 9.2.2).

NRI investment under Schedule 4 is not to be considered. (see para 9.4.3 and 9.8 also).

9.6 The shares under portfolio investment acquired by FIIs and FPIs have to be considered as on 31st March of the immediately preceding year in which the Indirect foreign investment takes place. This is because portfolio investors keep fluctuating.

However investment made by NRIs and QFIs have to be considered as on the date of IFI investment transaction. Earlier even NRI and

QFI investment was also to be considered as on 31st March. (see definition of "Counting of Indirect Foreign Investment" in para 9.5.1).

9.7 Regulation 14(1)(x) of FEMA Notification No. 20 defines Total foreign investment as under:

"(x) "Total foreign investment" in an Indian Company would be the sum total of direct and indirect foreign investment.

[Explanation:

(i) Total Foreign Investment shall include all types of foreign investments, direct and indirect, regardless of whether the said investments have been made under Schedule 1, Schedule 2, Schedule 2A, Schedule 3, Schedule 6, Schedule 8, Schedule 9 and Schedule 10 of Foreign Exchange Management (Transfer or Issue of Security by a Person Resident outside India) Regulations, 2000.

(ii) Foreign Currency Convertible Bonds (FCCB) and Depository Receipts (DR) having underlying of instruments which can be issued under Schedule 5, being in the nature of debt, shall not be treated as foreign investment. However, any equity holding by a person resident outside India resulting from any conversion of any debt instrument under any arrangement shall be reckoned as foreign investment."

9.8 It should be noted that Schedule 4 investment **(NRI investment on non-repatriable basis)** will not be considered for determining whether the IC is foreign owned or not. NRI investment is sought to be treated as domestic investment. The meaning of NRI has been amended *vide* Notification No. 361 dated 15-2-2016. **It includes Indian citizens and OCI cardholders.** Foreign citizens of Indian origin are no longer considered as NRIs unless they acquire an OCI card.

Similarly, investment by **foreign company, trust and firm which are owned and controlled by NRI** are also eligible for investment in India on non-repatriable basis under Schedule 4. Their investment also will not be counted for IFI.

9.9 Shares issued as **sweat equity** or under **Employee Stock Option Plan** under Regulation 8 will not be counted for determining total foreign investment. These are not issued under any of the Schedules.

9.10 Listed companies have serious difficulties about determining whether they are owned by residents or non-residents. Their shares are bought and sold frequently on the stock market. Not only FIIs invest, but even other companies (which they may themselves be owned by non-residents) invest. Such companies' status may change from domestic investor to indirect foreign investor and vice-versa frequently due to trading by investors!

10. Some Ownership issues

10.1 The objective is to consider ownership and control of Indian entities, by non-residents and foreign citizens. In other words, ***prima facie*** IFI rules apply to,

– Investment in Indian entities and not investment in foreign entities.

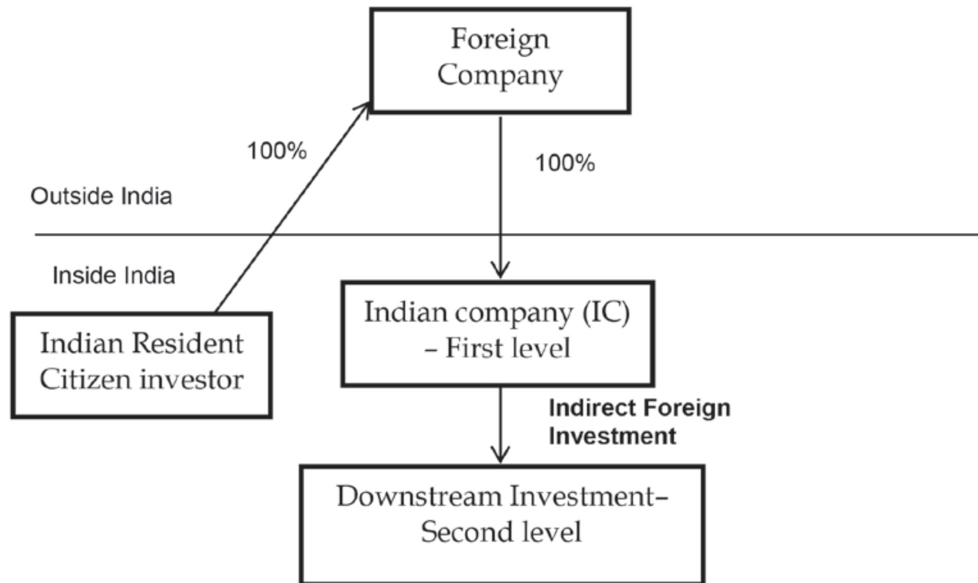
– Investment by non-residents and foreign citizens and not by Indian resident citizens.

Thus if IC invests in an overseas company, IFI rules do not apply. Overseas investment rules (FEMA Notification No. 120 will apply independently.)

Consider a situation, where the foreign company is owned by Indian resident citizens. That foreign company has invested in an Indian company. (It is round tripping. However assume that it has been considered as *bona fide* structure and has been specifically permitted by RBI.)

The structure is given below:

Chart D



In this situation, will IFI rules have to be considered? *Prima facie,* IFI rules apply, from the first level Indian company – i.e. IC. Investment in IC is Direct foreign investment. One does not have to see beyond the foreign company as far as IFI rules are concerned.

IFI rules however refer to investment through companies owned and controlled by Indian resident citizens. IC is ultimately owned and controlled by Indian residents. Can one say that IFI rules do not apply? In my view, for the sake of conservatism, one should apply the IFI rules (separately, under the Income-tax Act, if control is in India, it may lead to foreign company being treated as tax resident of India on account of Place of Effective Management (POEM) being in India. There are of course differences in the meaning of "POEM" under Income-tax Act and "control" under FEMA. However that is beyond the scope of this article).

10.2 Differential Voting rights

Assume that the Indian company has variations of following equity structures:

Variation 1:

Share type (held by)	No. of Shares	FV (`)	Total (`)
A shares (Non-Resident)	26,000	1	26,000
B shares (Indian Resident)	74	1000	74,000
		Total	1,00,000

Equity capital share of non-resident shareholder is only 26%. However control is with the non-resident.

Variation 2:

Share type (held by)	No. of Shares	FV (`)	Total (`)
A shares (Non-Resident)	26,000	10	2,60,000
B shares (Indian Resident)	74,000	1	74,000
		Total	3,34,000

Voting rights of Resident shareholder is 74%. However equity capital share of the Non-resident is 77.8%.

Under both the variations, the Indian company will be considered as foreign owned.

10.3 Convertible debentures/instruments

Convertible instruments also have to be counted for considering the extent of foreign investment. FCCBs and Depository Receipts also have to be considered (except those which are issued with underlying securities referred to under Schedule 5). There can be difficulties in determining the percentage holding in case the price of conversion has not been decided upfront.

11. Downstream investments

Once it is determined that IC is a foreign owned or controlled company, IFI rules apply. Regulation 14(6) provides for regulations for IC to undertake downstream investment:

11.1 Operating Indian Company - Downstream investment by IC, will have to comply with sectoral conditions on entry route, conditionalities and caps.

If the investment is permitted under automatic route, investment can be made without any permission.

Regulation 14(6)(ii) specifies the compliances as under:

"The IC has to notify SIA, DIPP and FIPB of its downstream investment in the form available at http://www.fipb.gov.in within 30 days of such investment. Even if securities have not been allotted, the form has to be filed. The modality of investment in new/existing ventures (with/without expansion programme) have to be stated.

A resolution of the Board of Directors and shareholders agreement should be provided.

Issue/transfer/pricing/valuation of shares shall be in accordance with applicable SEBI/RBI guidelines."

11.2 **Investing Company** – If the Indian company does not have business activity, but only invests in other Indian companies, it requires prior approval of FIPB for accepting Foreign investment. The amount of foreign investment is not relevant.

11.3 **NBFC** – FDI conditions will be applicable for foreign investment in NBFCs.

Core Investment Companies (CICs) will have to additionally follow RBI's Regulatory Framework for CICs.

11.4 **No operations and no investment** – Indian companies which do not have any operations and investments, can receive foreign investment under automatic route. Subsequently if the Indian company wants to invest in downstream companies, it will have to comply with the FDI norms. If activities of downstream investments require FIPB approval, the same will have to be obtained.

11.5 **Prohibited sectors**

If an IC has foreign investment but is owned and controlled by Indian resident citizens, can it make downstream investment in prohibited sectors like agriculture? Let us consider the provisions.

FEMA (Permitted Capital Account Transactions) Regulations (Notification No. 1) is the

fundamental notification. Regulation 4(b) provides that a non-resident cannot make investment in India, in any form, in any company, firm, proprietorship or any entity whether incorporated or not which is engaged in:

i) Chit fund,

ii) Nidhi company,

iii) Agricultural or plantation activities,

iv) Real estate business of construction of farm houses,

v) Trading in TDRs.

(Some real estate activities are not considered as Real estate business, Hence those are not prohibited).

It is an all-encompassing provision.

Further Explanation after Regulation 5(7A) to FEMA Notification No. 20 also states no class of foreign investor referred to in Regulations 5(1) to 5(7A) (i.e. FDI, FII etc.) can invest in sectors stated in FEMA (Permitted Capital Account Transactions) Regulations. (It does not refer to investment in LLP. However that is not necessary).

Regulation 2(1) of Schedule 1 of FEMA notification No. 20 also states that Indian company can issue shares which is not engaged in any sector in Annex A of the Schedule 1. This is the prohibited list for FDI. It includes following 5 other sectors:

i) Lottery business,

ii) Gambling,

iii) Cigarettes, etc.,

iv) Atomic energy,

v) Railway operations.

These ten sectors are prohibited completely for FDI. Therefore if there is slightest foreign investment in IC, it cannot make downstream investment in these ten sectors.

One may technically argue that investment by NRIs under Schedule 4 does not have all these restrictions. Further investment by foreign entities which are owned and controlled by NRIs also do not have all these restrictions. Can foreigner invest in such entities abroad and invest? In my view in these sectors no foreign investment can be accepted in any manner.

12. Audit

12.1 The **FDI recipient Indian company at the first level** is responsible for ensuring compliance with the FDI conditionalities for indirect foreign investment. It is also responsible for downstream investment made by its subsidiary companies at all subsequent levels.

The first level company is required to obtain a **certificate to this effect from its statutory auditor on an annual basis** regarding the status of compliance with the instructions on downstream investment and compliance with FEMA provisions.

The **Director's report** in the Annual report of the Indian company has to mention that the statutory auditor has certified that the company is in compliance with the regulations as regards downstream investment and other FEMA prescriptions.

12.2 If the statutory auditor has given a **qualified report,** the same has to be immediately brought to the notice of the Reserve Bank of India, Foreign Exchange Department (FED), Regional Office (RO) of the Reserve Bank in whose jurisdiction the Registered Office of the company is located and shall also **obtain acknowledgement** from the RO of having intimated it about the qualified auditor report.

The RO will direct the corrective steps to be taken. RO has to file the action taken report to the Chief General Manager-in-Charge, Foreign

Exchange Department, Reserve Bank of India, Central Office, Central Office Building, Shahid Bhagat Singh Road, Mumbai 400 001.

12.3 Very few companies and auditors are aware of this requirement. It is in the interest of companies and auditors to comply with this provision.

13. Indian LLP

Schedule 9, clause 4 of FEMA Notification No. 20 provides that an LLP, having foreign investment, is permitted to make downstream investment in another company or LLP which is engaged in sectors where 100% FDI is allowed under the automatic route, and there are no FDI-linked performance conditions. Thus real estate sector where 100% FDI is allowed on automatic basis, cannot be permitted as there are conditions prescribed.

It further provides that onus is on the Indian LLP accepting downstream investment to ensure compliance with the conditions.

14. Transfer of shares or control

14.1 Industries under automatic route

For transfer of "shares" from an Indian resident to an Indirect Foreign Investor, one has to consider the valuation guidelines for the transfer.

For transfer of "control", there are no restriction, guidelines and rules. As there are no rules, it does not require any FEMA compliance.

14.2 Industries under approval route

Wherever the sector is under Government approval route, transfer of shares or control from an Indian resident to an Indirect Foreign investor requires an approval from FIPB (Regulation 14(5)). The transfer may happen in any manner – through mergers, demergers, restructuring, agreements, etc.

15. Sources of funds for IFI

Regulation 14(6)(ii)(d) specifies how can IFI be funded.

15.1 Permitted funding

Indian companies/LLPs have to bring in requisite **funds from abroad** for making downstream investment. Thus the investor company will have to bring in foreign investment. If there are upper level companies in the chain, the first level company will have to bring in foreign investment and pass it on downstream.

Downstream investments can also be made through **internal accruals** also. Internal accruals mean profits transferred to reserve account after payment of taxes.

Thus for example, if resident investors have invested in the IC, those funds cannot be used for investment downstream.

15.2 Funding not permitted

IC cannot leverage funds from the domestic market. Thus they cannot borrow and invest. Of course downstream companies/LLPs, with operations, can raise debt in the domestic market for their business, but not for further downstream investments.

In other words, acquisition of downstream companies is possible either from foreign funds or internal accruals.

15.3 With effect from 31st day of July, 2012, Downstream investment by a foreign owned/ controlled **banking company,** under Corporate Debt Restructuring (CDR), or other loan restructuring mechanism, or in trading books, or for acquisition of shares due to defaults in loans, shall not count towards indirect foreign investment. However, their "strategic downstream investment" shall count towards indirect foreign investment. For this purpose, 'strategic downstream investments' means investment by these banking companies in their subsidiaries, joint ventures and associates.

15.4 Shares can be issue to foreigners against knowhow and some other permitted transactions under Direct Investment route. Normally what

can be done directly, can be done indirectly. However due to the above regulation, issue of shares to IFI can only be in cash.

16. Regular matters affected by IFI rules

If investment is considered as foreign investment, regular FEMA regulations apply (Regulation 14(6)(ii)(c). One has to consider the following issues and comply with the same.

16.1 Issue of shares to the investor has to consider valuation rules under FEMA (Schedule 1 of FEMA Notification No. 20).

The provisions of Schedule 1 which cannot be complied with are – receipt of funds for shares in foreign exchange, filing of Advance Reporting Form, FC-GPR form, FC-TRS form.

16.2 IC cannot give loans to Indian residents as this will amount to loan from IFI.

16.3 It has to allot the shares or refund the money within 180 days. (Under Companies Act the allotment has to happen within 60 days).

16.4 Partly paid shares have to be made into fully paid shares within 12 months.

16.5 In case of securities other than equity shares, investment can be made only in fully and compulsorily convertible instruments.

16.6 Sale of shares by the investor should be as per valuation rules of FEMA. (Thus even the buyer also has to consider whether the seller is foreign owned or Indian owned!)

16.7 If the investor purchases shares, it will have to be as per valuation rules of FEMA. (Thus even the seller also has to consider whether the buyer is foreign owned or Indian owned!)

16.8 There cannot be any guaranteed return to the indirect foreign investor. There can be optionality clauses but cannot have an assured price for exit.

16.9 Transfer of shares by NRI to a foreign owned Indian company will require RBI approval. (Regulation 9(2)(ii) of FEMA Notification No. 20).

16.10 Sale of shares by an erstwhile OCB to foreign owned Indian company will require an RBI approval.

16.11 Deferred payment consideration for sale of shares should be as permitted under the FEMA rules (Regulation 10A).

16.12 Shares cannot be issued against knowhow and certain other non-cash consideration. Alternatively, an FIPB approval may be obtained. (see para 15.)

16.13 FLA returns – **This is an exception**. A company which has FDI is required to file a FLA return. However downstream company which has no direct foreign investment, is not required to file FLA return. (The first level company will capture the foreign investment in its FLA return.)

Further the VCF/IV which has issued **units** to the foreign investor also **does not have to file the FLA return** as there is no equity capital which is issued to the non-residents.

The above transactions are Indian transactions. Hence there is no question of reporting the investment or transfer in Form FC-GPR or Form FC-TRS. However conditions have to be complied with.

17. Past investment

What is the date for considering whether IFI is valid or not? What happens to the past investments?

The Press notes by DIPP were issued on 13-2-2009 (press note nos. 2 and 3). The FEMA notification No. 278 was issued on 7-6-2013. It was notified on 21-6-2013. The related AP circular (No. 1) was issued on 4-7-2013.

DIPP press notes are not the law. These are only policy. These became law on 21-6-2013 when the same were notified.

Thus there are 3 periods during which IFI could have been made:

- Before 13-2-2009 (the date when DIPP press notes were issued).
- Between 13-2-2009 and 20-6-2013 (between the dates of issue of DIPP press notes and FEMA Notification).
- After 20-6-2013 (date of FEMA Notification).

17.1 **Investment made before 13-2-2009:**

Investment made prior to 13-2-2009 as per guidelines existing then, do not require any modifications to confirm to IFI rules. (Para 3(ii) of AP circular No. 1 dated 4-7-2013). In other words any downstream investment is all right (provided the investment was as per the then FEMA rules).

17.2 **Investment made between 13-2-2009 and 20-6-2013:**

For investment made between February 13, 2009 and 20-6-2013, Indian companies had to intimate within 90 days from the date of the AP circular, the details of issue/transfer of shares or downstream investment which was not in conformity of IFI rules (Para 3(iii) of the circular). The intimation had to be sent through the bank to the concerned Regional Office of the Reserve Bank, in whose jurisdiction the Registered Office of the company is located. Reserve Bank would have considered treating such cases as compliant with these guidelines within a period of six months or such extended time as considered appropriate by RBI in consultation with Government of India.

If the investment is not in line with the IFI rules, the companies are required to regularise it (by disinvesting or restructuring).

If the reporting did not take place within the period of 90 days, then there can be compounding.

Again this is a requirement which few people are aware.

Period of violation

If investments are made prior to 21-6-2013 which are not in compliance with IFI rules, and they continue thereafter, the period of violation will be considered from 21-6-2013. However "reporting violation" is likely to be considered from the date of investment.

Example – An IC had made investment in Cable TV operation downstream company on 1-1-2014 beyond 49% (sectoral cap limit). It continued the investment after 21-6-2013 till 31-12-2015 and did not report within 90 days from 21-6-2013. In this case, as the IFI rules were notified on 21-6-2013, the sectoral cap violation will be considered from 21-6-2013 till 31-12-2015. However as the transaction was between 13-2-2009 and 20-6-2013, the reporting violation (as required by para 3(iii) of AP circular 1) would be considered from 1-1-2014.

Example – The IC invested in share application money on 1-1-2013. The shares were allotted on 30-9-2013 (well beyond 180 days). This is a case where the transaction became IFI from 21-6-2013. Prior to that it was not an IFI. It was Indian transaction and FEMA did not apply. From 21-6-2013, the shares were allotted within 180 days. Hence it will not be considered as FEMA violation.

The difference compared to the first example of cable TV investment is that in that case, from 21-6-2013 itself, it became a violation. Further no intimation was filed with RBI within 90 days. Whereas in case of share application money, there was time available of 180 days to refund from the date it became IFI.

There can be several permutations. Each one has to be analysed on its own merits.

17.3 **Investment made after 20-6-2013:**

Investment made after 20-6-2013 should be as per the IFI rules.

There could be a series of investments made in a company, some of which may be prior to 13-2-2009 and some could be after it. The compliances will apply accordingly.

18. Summary

Indirect Foreign Investment rules have been amongst most complex rules. It has led to many unintended violations. The company receiving the investment should check from the investors whether they are foreign owned or domestic. It may be necessary to take an indemnity from them.

Auditors and management should conduct a FEMA compliance audit annually.

All this till FEMA is abolished!

Regulations in brief before IFI rules

Prior to introduction of IFI rules, any downstream investment by an Indian company which had FDI, required an approval from the Government. Even 1 share of FDI in first level company required FIPB approval for downstream investment. Earlier there were two levels of approval. The first was for foreign investment in a holding company or holding-cum-operating company. Second one was for the holding company or holding-cum-operating company, to invest in downstream company. (Press Note No. 3 of 1997 and Press Note No. 9 of 1999).

In 1999, *vide* Press note No. 9 dated 12-4-1999, it was decided to do away with the second approval as long as the investment was in sectors which were under automatic route. For operating companies, an approval had to be taken to convert itself from operating company to operating-cum-holding company.

With IFI rules, the ownership and control of investor company will determine whether the investor will be considered as foreign investor or not.

"We reap what we sow. We are the makers of our own fate. The wind is blowing; those vessels whose sails are unfurled catch it, and go forward on their way, but those which have their sails furled do not catch the wind. Is that the fault of the wind?....... We make our own destiny."

• ***Swami Vivekananda***

CA N. C. Hegde

Investment in LLPs, Partnership Firms & Proprietorships

India is now considered as one of the most open countries as far as welcoming FDI is concerned. Starting from 1991, when the Industrial Policy was announced, the Government has been liberalising the investment regime from time-to-time and recently sectors like defence have also been opened up to foreign investment

In terms of the policy, the Government had initially encouraged investment only in companies. However when it comes to investment on a repatriable basis in entities such as Partnership Firm, Proprietary concerns, Trusts (other than Venture Capital Funds registered and regulated by SEBI, LLPs and Investment Vehicles registered and regulated by SEBI), the same was strictly regulated.

As far as LLPs (Limited Liability Partnerships are concerned, they are a recent phenomenon and the law on investment in LLPs is still evolving.. Based on the recommendations of the Naresh Chandra Committee, a LLP Bill was introduced which was finally incorporated as the LLP Act in 2008. The Naresh Chandra Committee had then recommended that there was a need to enact a law to allow LLPs so as to enable professionals to have an organisation which can limit the liability.

Thus the LLP Act was introduced to enable a corporate business vehicle that enables professional expertise and entrepreneurial initiative to combine and operate in a flexible, innovative and efficient manner. This vehicle would provide benefits of limited liability while allowing its members the flexibility for organising their internal structure as a partnership.

LLPs, introduced in 2008, are hybrid entities with advantages of a company (especially, separate legal entity status and limited liability of stakeholders) and operational flexibilities of a partnership. While the LLP Act cleared the deck for setting up of LLPs as well as conversion of companies into LLPs, FDI in such vehicles required a prior approval of the Government .

FEMA regulations

As discussed earlier, though the LLP Act came into force in 2008, the FDI policy on such LLPs took a while to crystallise. In the year 2011, the Government, through the Press Note No. 1(2011 Series) dated 20th May, 2011 permitted FDI in LLPs through an approval route, subject to specified conditions. However, there was no corresponding amendment in the FEMA Regulations which led to ambiguity about the reporting and procedural aspects.

Later in 2014, RBI issued the operational guidelines with respect to FDI in LLPs by way of a circular (A.P. (DIR Series) Circular No. 123 dated 16th April, 2014). These guidelines came in to force retrospectively from 20th May, 2011 i.e. the date when the Press Note No. 1(2011) was released.

With the new Government intent on making India a destination which is easy to do business there was an expectation that LLPs be opened up for foreign investment.The Department of Industrial Policy & Promotion (DIPP), has *vide* Press Note No. 12 (2015) dated 24th November, 2015 liberalised FDI in LLPs.

The FDI policies and FEMA regulations applicable to proprietary concerns, partnership firms and LLPs have been discussed in detail a little later. Before looking at the specific policy as applicable to them, it is also important to highlight two changes brought in by the Press Note No. 7 (2015 series) which would have implications on the FDI policy, especially as far as investments by Non-Resident Indians are concerned.

Change in definition of Non-Resident Indian

By way of Press Note No. 7 (2015 Series) dated 3rd June, 2015, the Government of India introduced further changes to the Foreign Direct Investment (FDI) Policy relating to NRI investments. For the purposes of foreign investment an NRI was earlier defined to mean a non-resident person who is a citizen of India or one who is a Person of Indian Origin (PIO). However, in January 2015, the Government of India did away with the concept of PIO by effectively merging it with the Overseas Citizen of India (OCI). An OCI is defined in section 7A of the Citizenship Act, 1955 in a manner similar to that of the PIO, but in more restrictive terms. Given this transition from PIO to OCI under the new Press Note, an NRI under the foreign investment regulations would now mean an overseas resident who is either a citizen of India or an OCI cardholder. It is believed that this change in the foreign investment policy is largely driven by the changes to the Citizenship Act, and the need to harmonise the policies.

Investment by NRIs on non-repatriable basis deemed as domestic investment

In addition to above, Press Note No. 7 discussed in the earlier paragraph has amended, the FDI policy to provide that NRI investments made on a non-repatriable basis in accordance with Schedule 4 of the FEMA (Transfer or Issue of Security by Persons Resident Outside India) Regulations, 2000 ("Inbound Regulations") will be deemed to be domestic investment at par with the investment made by residents. The new change is significant as NRI investments on a non-repatriable basis would now been treated as domestic investments for various purposes, including sectoral caps, pricing guidelines, types of investment instruments, downstream investments, and the like. Additionally the Government *vide* Press Note No. 12 of 2015 dated 24th November, 2015, has clarified that NRI investment through incorporated entities outside India viz. companies, trusts and partnership firms, that are owned and controlled by NRIs, on non-repatriation basis (like investment by NRIs) would be treated as deemed domestic investment at par with the investment made by residents. These investment will be treated at par with NRIs for investment in India.

FDI in Proprietary and Partnership Firms

Foreign investments in proprietary concerns and partnership firms are permissible as per the FDI policy. These entities are generally used for operations which are in the small and medium sector. With a view to attract investment from Non-Residents of Indian origin, the Government had allowed investments by Non Residents of Indian origin in these entities on a non-repatriable basis even before the Industrial Policy of 1991 was announced. Further as detailed in the earlier paragraph, NRI investments as per Schedule 4 of inbound regulations on non-repatriable basis would now be treated as domestic investment. However investment by other Non-residents has been allowed very selectively. Thus this window has largely been used for encouraging investment by NRIs and corporate bodies owned by them.

The investment by person resident outside India by way of contribution to the capital of a firm or a proprietary concern or any association of persons in India is regulated by Foreign

Exchange Management (Investment in Firm or Proprietary Concern in India) Regulations, 2000 in the manner as stated below –

Investments by NRI / PIO

Non-Resident Indian (NRI) and Person of Indian Origin (PIO) resident outside India are permitted to invest by way of capital contribution in proprietary and partnership firms both on a repatriation[1] basis or non-repatriation basis. It may be noted that the term PIO still continues to be a part of this regulation and no changes have been made to the definition of NRI in line with the Inbound Regulations.

A) Non-repatriation basis

A NRI or PIO resident outside India can invest in the capital of a firm / proprietary concern on non-repatriation basis subject to the following conditions:

- Amount is invested by inward remittance or out of NRE / FCNR(B) / NRO account maintained with Authorised Dealers/ Authorised banks.
- The firm or proprietary concern is not engaged in any agricultural/plantation or real estate business or print media sector. It may be noted that real estate business would mean dealing in land and immovable property with a view to earning profit or earning income therefrom.
- Amount invested shall not be eligible for repatriation outside India.

In addition to above, the Schedule 4 of Inbound Regulations also states that an NRI may contribute, on non-repatriation basis, to the capital of a partnership firm or proprietary firm without any limit.

Thus, investment in a partnership or a proprietary firm shall be in compliance with both the regulations.

B) Repatriation basis

For making investments on a repatriation basis in partnership firm/proprietary concern, the NRI/PIO has to obtain prior permission of RBI who shall decide the same in consultation with the Government of India.

An NRI or PIO is not allowed to invest in a firm or proprietorship concern engaged in any agricultural/plantation activity or real estate business or print media.

Investments by non-residents other than NRI/ PIO

Other than a NRI/PIO, any person resident outside India can also make investments in partnership firm/proprietary concern in India. Such non-residents have to seek prior approval of RBI for making investment in the capital of a firm or a proprietorship concern or an association of persons in India. The application will be decided in consultation with the Government of India.

Opening up of opportunities for NRIs/ entities owned by them

It may thus be seen that there are opportunities to invest in proprietary firms/partnerships firms on a non-repatriable basis. As the investment is now deemed to be domestic investment, the various sectoral caps and the FDI performance linked conditions norms would not apply. Therefore NRIs and bodies owned by them would be entitled to invest in areas where there are otherwise conditions like minimum capitalisation or other stipulations like in real estate/retail trade for Non Resident investment, subject to compliance with Foreign Exchange Management (Investment in Firm or Proprietary Concern in India) Regulations, 2000.

FDI in LLPs

As regards FDI in LLP, the current policy on FDI can be summarized as under:

As per Schedule 4 of the Inbound Regulations, investment by NRIs, including a company, a

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

trust and a partnership firm incorporated outside India and owned and controlled by non-resident Indians may contribute, on non-repatriation basis, to the capital of a LLP without any limit.

Thus, while NRIs (and entities owned by them) are allowed to invest without any limitation on non-repatriation basis, policy related to investment on repatriation basis or investment by persons other than NRIs is discussed below (As per Schedule 9 of Inbound Regulations & FDI Policy) –

a) Owner of LLP

LLP will be considered as owned by resident Indian citizens if

– More than 50% of the investment in such an LLP is contributed by resident Indian citizens and/or entities which are ultimately 'owned and controlled by resident Indian citizens' and

– Such resident Indian citizens and entities have majority of the profit share.

Further, for the purpose of LLP, control will mean right to appoint majority of the designated partners, where such designated partners, with specific exclusion to others, have control over all the policies of the LLP.

b) Entry Norms

Vide Press Note No.12 (2015) the Government has made substantial changes in the FDI policy pertaining to investments in LLPs.

In terms of the same, foreign investments can be made in LLPs under the automatic route where such LLPs are operating in sectors in which 100% FDI is permissible under automatic route and there are no FDI-linked performance conditions attached to such sector.

c) Eligible Investment

Contribution to the capital of a LLP would be an eligible investment subject to the compliance of the conditions of LLP Act, 2008."

d) Pricing

FDI in LLP either by way of capital contribution or by way of acquisition/transfer of 'profit shares" is to be valued at more than or equal to the fair price as worked out with any valuation norm which is internationally accepted/adopted as per market practice.

In case of transfer of capital contribution/profit share from a resident to a non-resident the consideration should be equal to or more than the fair price of capital contribution/profit share of an LLP. On the other hand when there is transfer of capital contribution/profit share from a non-resident to a resident the consideration should be less than or equal to the fair price of the capital contribution/profit share of an LLP.

A valuation certificate shall be obtained from a Chartered Accountant or practicing Cost Accountant or by an approved valuer from the panel maintained by the Central Government.

e) Downstream Investments

Indian Company or LLPs having foreign investment are now permitted to make downstream investments[2] in an Indian company or LLP engaged in sectors in which 100% FDI is allowed under automatic route, and where there are no FDI-linked performance conditions and sectoral caps.

However, such downstream investments are subject to the following conditions:

i. Such a Company/LLP has to notify Secretariat of Industrial Assistance, DIPP and FIPB of its downstream investment in the prescribed form within 30 days of such investment;

ii. Downstream investment by way of induction of foreign investment in an existing Indian company to be duly supported by a resolution of the Board of Directors as also a shareholders agreement, if any;

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

iii. Issue / transfer / pricing / valuation of capital shall be in accordance with applicable RBI guidelines;

iv. For the purpose of downstream investment, Indian companies/LLPs would have to bring in requisite funds from abroad and not leverage funds from the domestic market. The downstream companies/LLPs, can raise debt from the domestic market for their operations.

Downstream investment in LLP by an Investment Vehicle[3] that is reckoned as foreign investment has to conform to the principal FEMA Regulations as well as the extant FDI policy for foreign investment in LLPs.

Reporting requirements

LLPs shall report to the concerned Regional Office of the RBI, the details of receipt of the amount of consideration for capital contribution and profit shares in Form FDI-LLP(I). Further, the said form shall be accompanied with copies of the Foreign Inward Remittance Certificates evidencing the receipt of the remittance along with the KYC report on the non-resident investor as per the specified format and valuation certificate as regards pricing. The aforesaid form along with the documents is to be submitted not later than 30 days from the date of receipt of the amount of consideration.

Disinvestment / transfer of capital contribution or profit share between a resident and a non-resident (or vice versa) is to be reported within 60 days from the date of receipt of funds in Form FDI-LLP(II).

All LLPs which have received Foreign Direct Investment in the previous year(s) including the current year shall submit to the Reserve Bank of India, on or before the 15th day of July of each year, a report titled 'Annual Return on Foreign Liabilities and Assets' as specified by the Reserve Bank from time to time.

External Commercial Borrowings not permitted

Though the recent amendments in relation to FDI in LLPs have made the policy very similar to companies, one major difference is that the LLPs are not permitted to obtain overseas loans i.e. External Commercial Borrowings. This may be a hindrance since foreign borrowings are generally available at lower interest rates compared to the local borrowings from banks in India.

Conversion of Private Company into LLP

In the FDI policy 2015, there was a specific provision which stated that conversion of a private company to LLP was permissible under the approval route subject to the specified conditions being met.

However, post the release of Press Note No. 12 (2015), wherein FDI in LLPs have been allowed under automatic route, the point as regards conversion of private company to LLP requiring prior approval has been deleted. Although, it may be noted that the condition of obtaining prior approval continues to be there in Schedule 9 of Inbound Regulations. Thus, conversion of a company with FDI, into an LLP, will be allowed only if the above discussed stipulations (except the stipulation as regards mode of payment) are met and with the prior approval of FIPB/ Government

Key Considerations on Conversion

– <u>Remittance of current profits</u>

Currently, there are no restrictions on LLP as regards remittance of current profits outside India. Thus, profits can be remitted outside India even after conversion of company to LLP as current account transactions.

3. 'Investment Vehicle' shall mean an entity registered and regulated under relevant regulations framed by SEBI or any other authority designated for the purpose and shall include Real Estate Investment Trusts (REITs) governed by the SEBI (REITs) Regulations, 2014, Infrastructure Investment Trusts (InvIts) governed by the SEBI (InvIts) Regulations, 2014 and Alternative Investment Funds (AIFs) governed by the SEBI (AIFs) Regulations, 2012.

– *Accumulated profits on conversion*

No specific provisions under FEMA governing the distribution / repatriation of accumulated profits on conversion of company to LLP. Accumulated earnings represent amounts which should have been credited to partner's capital account. However, income tax aspects as discussed in below paragraphs need to be taken into account for distribution of accumulated profits.

As per RBIs guidelines on foreign investments in partnership firms, non-residents can repatriate funds outside India only after obtaining prior permission from RBI. In regard to FDI in LLPs, the policy is more akin to companies. One would therefore await some more clarity on the subject.

– *ECB*

Companies are permitted to obtain ECBs as per the FEMA guidelines. However, LLPs are restricted from obtaining ECB. Accordingly, before conversion of company to LLP, the said ECBs (if any) shall have to be repaid.

– *Tax Considerations*

One would also have to take into considerations the possible tax implications on conversion, since section 47(xiiib) of the Income Tax Act, 1961 provides exemption to conversion of private companies into LLPs subject to certain stipulations, few of which are relevant are stated below –

- Total sales / turnover / gross receipts in the business of the company in any of the three previous years preceding the year of conversion does not exceed sixty lakh rupees
- the total value of the assets in the books of the company in any of the three previous years preceding the year of conversion does not exceed five crore rupees; and
- No amount is paid, either directly or indirectly, to any partner out of balance of accumulated profit of the company on the date of conversion for a period of three years from the date of conversion.

If such stipulated conditions are not met, the conversion shall be taxable transfer as per the Income Tax Act

Ideal Corporate Vehicle

The recent liberalisation on the FDI policy on LLPs is a big boost for the LLPs as the new favoured corporate entity. As far as the tax laws are concerned, LLPs do have a distinct advantage as they do not have to pay the dividend distribution tax and have a much better Minimum Alternate Tax regime. In recent times, companies have a lot of regulations to comply with due to the amendments made in the Companies Act. On the other hand LLPs have less of regulatory compliance to be made. With the amendments made in the Foreign Exchange Management Act and liberalization of the FDI regime, LLPs are clearly a favoured corporate entity. India has attracted a lot of foreign investment in the entities providing shared services in the Knowledge Processing (KPO) and Business Processing (BPO) sector. A LLP would be an ideal entity to set up in all areas where there is a cost plus arrangement as it would enable repatriation of cash back to the parent without additional tax leakages.

CA Vijay K. Gupta

Portfolio Investments:

a. Foreign Investments under Portfolio Investment Scheme (PIS) by FIIs & FPIs (Schedules 2 & 2A), in other Securities (Schedule 5)

b. Foreign Investments under Portfolio Investment Scheme (PIS) by NRIs on repatriation basis (Schedule 3) and on non-repatriation basis (Schedule 4)

1. Introduction

1.1 As per June '14 Report of Dr. Arvind Mayaram Committee on rationalising FDI/FII Definition, 'Portfolio Investment' (by FIIs/FPIs and NRIs) is distinctive from Foreign Direct Investment because of nature of funds raised, largely anonymous relationship between issuers and holders, and degree of trading liquidity in instruments, and it covers, but is not limited to securities traded on organised or other financial markets. 'Portfolio Investment Scheme' ('PIS') is as referred to in Schedules 2 (FIIs), 2A (FPIs) & 3 (NRIs) of FEM (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2000 ('FEMA 20') – (reference to Schedule/regulation number is of FEMA 20).

1.2 As per First edition of Foreign Portfolio Investor Survey 2016-17 by PwC[1], 'Views gathered from over 200 participants from across globe suggest that India is one of the most attractive destinations for FPIs, with a favourable trade and settlement cycle, moderate tax rates and adequate investment limits.

1.3 As per August '16 Press Release by PRIME Database[2], based on analysis of shareholding patterns of 1,517 of total 1,532 companies listed at NSE for quarter ending June 2016, 'percentage holding of FIIs was 20.09% (` 20.13 lakh crore by value on back of net inflows of ` 14,671 crore). On overall basis, FII holding went up in 437 companies in last one year with average stock price return of these companies being a huge 37%. FII holding went down in 577 companies with average stock price return of these companies was 18.32%'.

1.4 On the whole Foreign Exchange regulations have been substantially amended/relaxed/simplified in recent past to attract much needed foreign exchange for the country and simultaneously making India an attractive destinations for foreign investment.

1.5 (a) PIS regime has been substituted *vide* amended Schedules 2A and 3 on March 19, 2014 and February 15, 2016 respectively.

1. http://www.pwc.in/assets/pdfs/trs/fpi/fpi-survey.pdf
2. http://www.primedatabasegroup.com/newsroom/PR-325.pdf

(b) Purchase of securities (other than shares or Convertible Debentures) by FPIs has been substituted *vide* amended Schedule 5 on March 19, 2014.

(c) Investment by FPIs and NRIs in Investment Vehicles has been introduced *vide* Schedule 11 on February 15, 2016.

(d) Acquisition by NRIs on non-repatriation basis has been substituted *vide* amended Schedule 4 on February 15, 2016.

1.6 With the liberalisation of investment under Schedule 4, a lot of opportunities/structuring options are now available to NRIs for making investments in India vis-a-vis investment under FDI.

1.7 Masala Bonds Scheme (Rupee denominated bonds) has been introduced under FEMA 3 as an alternative for raising overseas debt through listed NCDs to FPIs, and Foreign currency denominated borrowing/ECB.

1.8 Listed non-convertible debentures/bonds issued by an Indian company (including a private limited company) – through public issue or on private placement basis under SEBI (Issue and Listing of Debt Securities) Regulations, 2008, on Wholesale Debt Market segment of BSE, has been quite popular – with assured return, no sector restrictions, no ECB restrictions, Secured or Unsecured etc. as an alternative to investment under FDI, and borrowings under ECB regime.

2. New regime and definition of NRI/PIO

2.1 NRI means an individual resident outside India who is citizen of India or is an 'Overseas Citizen of India' ('OCI') cardholder within the meaning of section 7(A) of the Citizenship Act, 1955. An OCI Cardholder means:

(a) Any person of full age and capacity,(a major who is a citizen of another country),–

(i) But was a citizen of India at the time of, or at any time after the commencement of the Constitution; or

(ii) But was eligible to become a citizen of India at the time of the commencement of the Constitution or

(iii) But belonged to a territory that became part of India after the 15th day of August, 1947; or

(iv) Who is a child or a grandchild or a great grandchild of such a citizen; or

(b) A person, who is a minor child of a person mentioned in clause (a); or

(c) A person, who is a minor child, and whose both parents are citizens of India or one of the parents is a citizen of India; or

(d) Spouse of foreign origin of a citizen of India or spouse of foreign origin of an OCI Cardholder registered under section 7A and whose marriage has been registered and subsisted for a continuous period of not less than two years immediately preceding the presentation of the application under this section.

2.2 No person, who or either of whose parents or grandparents or great grandparents is or had been a citizen of Pakistan, Bangladesh or such other country as Central Government may prescribe, may be a OCI Cardholder.

2.3 Existing OCI Cardholders shall be deemed to be OCI Cardholders, which means persons registered as such under Notification Number 26011/4/98 F.I., dated 19th August, 2002 issued by Central Government.

2.4 The Central Government has specified following rights to which persons registered as OCI shall be entitled:

(a) Grant of multiple entry lifelong visa for visiting India for any purpose;

(b) Exemption from registration with Foreign Regional Registration Officer or Foreign Registration Officer for any length of stay in India; and

(c) Parity with NRIs in respect of all facilities available to them in economic, financial and educational fields except in matters relating to the acquisition of agricultural or plantation properties.

2.5 Prior to above amendment in Citizenship Act, 1955 w.e.f. June 28, 2005, from FEMA perspective, NRI meant a person resident outside India who is a citizen of India or is a Person of Indian Origin. 'Person of Indian Origin' meant a citizen of any country other than Bangladesh or Pakistan or Sri Lanka, if a) he at any time held Indian passport; or b) 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 the Citizenship Act, 1955; or c) the person is a spouse of an Indian citizen or a person referred to in sub-clause (a) or (b) as PIO. Now, definition of NRI under FEMA has been aligned to amended Citizenship Act.

3. PIS for FPIs under Schedule 2A on repatriation basis

3.1 With the enforcement of SEBI (Foreign Portfolio Investors) Regulations, 2014 from June 1, 2014, erstwhile SEBI (Foreign Institutional Investors) Regulations, 1995 has been repealed. Erstwhile FIIs, Sub-accounts (Schedule 2) and Qualified Foreign Investor (QFIs) (Schedule 8) regimes are merged into a new investor class FPIs under Schedule 2A. FIIs/SAs (deemed FPIs) may continue to purchase through offer both through primary as well as secondary market/ private placement, till the expiry of the block of three years of its registration as FII or SA, or until it obtains a Registration CoR as FPI, whichever is earlier.

3.2 Qualified Foreign Investor ('QFI') was permitted to purchase equity shares of Indian company as specified in Schedule 8. At present, QFI is not permitted, as a separate category for a period of one year from the date of commencement of FPI Regulations or until it obtains CoR as FPI, whichever is earlier. Erstwhile QFIs did not include FIIs/ SAs/FVCI. An NRI could not make investments simultaneously through the QFI route and PIS route.

3.3 All investments made by FIIs/SAs/QFIs prior to registration as FPI shall continue and taken into account for computation of aggregate limit under Schedule 2A.

3.4 NRI/PIO is not eligible to make investments as an FPI. However, a fund having NRIs as its investors is not prohibited from obtaining registration as FPI. A company which is majority owned by NRIs/PIOs shall not be allowed to make investments as FPI.

3.5 Eligible criteria for FPI, *inter alia*, includes being a person

(a) Not resident in India under Income-tax Act;

(b) Resident of country whose securities market regulator is signatory to International Organisation of Securities Commission's Multilateral Memorandum of Understanding (Appendix A Signatories) or a signatory to bilateral Memorandum of Understanding with the Board;

(c) Applicant being a bank, is a resident of a country whose central bank is a member of Bank for International Settlements;

(d) Not resident in a country identified in the public statement of Financial Action Task Force as:

(i) A jurisdiction having a strategic Anti Money Laundering or Combating the Financing of Terrorism deficiencies to which counter measures apply; or

(ii) A jurisdiction that has not made sufficient progress in addressing the deficiencies or has not committed to an action plan developed with the Financial Action Task Force to address the deficiencies;

(e) Not a non-resident Indian;

(f) Legally permitted to invest in securities outside the country of its incorporation or establishment or place of business;

(g) Applicant is authorised by its Memorandum of Association and Articles of Association or equivalent document(s) or agreement to invest on its own behalf or on behalf of its clients;

(h) Applicant has sufficient experience, good track record, is professionally competent, financially sound and has a generally good reputation of fairness and integrity;

(i) Grant of certificate to applicant is in interest of e development of securities market;

(j) Is a fit and proper person as per criteria specified in Schedule II of SEBI (Intermediaries) Regulations, 2008.

3.6 Categories of eligible FPIs:

Category I – Government and Government related investors such as Central Banks, Governmental agencies, sovereign wealth funds, international/multilateral organisations/agencies. ***Category II*** – Appropriately regulated broad based funds such as mutual funds, investment trusts, insurance/reinsurance companies, appropriately regulated persons such as banks, asset management companies, investment managers/advisors, portfolio managers, broad based funds that are not appropriately regulated whose investment manager is appropriately regulated, university funds and pension funds as well as university related endowments already registered with SEBI as FII/SA. ***Category III*** – All other FPIs not eligible under Categories I and II such as Endowments, Charitable Societies/Trust, Foundations, Corporate Bodies, Trusts, Individuals, Family Offices, etc.

3.7 No FPI may issue, subscribe to or otherwise deal in offshore derivative instruments/Participatory Notes ('ODI'), directly or indirectly, unless prescribed conditions are satisfied including transfer of ODIs. ODI means any instrument which is issued overseas by FPI against Indian securities as its underlying.

3.8 FPI may purchase shares or convertible debentures of an Indian company under FPI Scheme subject to terms and conditions specified in Schedule 2A. Total holding (acquired both through primary as well as secondary market, through offer/private placement) by each FPI and deemed FPI (erstwhile FIIs/SAs/QFI) shall be below 10% of total paid-up equity capital or 10% of paid-up value of each series of convertible debentures issued, and total holdings/aggregate limit of all FPIs put together shall not exceed 24% of such securities. Aggregate limit of 24% may be increased up to sectoral cap/statutory ceiling, as applicable, by Indian company concerned by passing resolution by its Board of Directors followed by passing of special resolution to that effect by its General Body and intimation to RBI.

3.9 Composite Portfolio Investment Cap: Portfolio investment, up to aggregate foreign investment level of 49% or sectoral/statutory cap, whichever is lower, will not be subject to either Government approval or compliance of sectoral conditions, as the case may be, if such investment does not result in transfer of ownership and/or control of Indian entities from resident Indian citizens to non-resident entities.

3.10 FPI shall be subject to FDI policy in respect of sectoral caps i.e. maximum amount which can be invested by foreign investors, under Schedule 1, in an entity, is composite and includes all types of foreign investments, direct and indirect, regardless of whether said investments have been made under Schedules 1(FDI), 2(FII), 2A(FPI), 3(NRI), 6(FVCI), 8(QFI), 9(LLPs) and 10(DRs).

3.11 An Indian company can also issue shares to FPI under the FDI Policy (Schedule 1). However, consolidated investment for individual FPI will not exceed 10%.

3.12 (a) In case of Public Offer, price is not less than price at which shares are issued to residents, and (b) in case of issue by private placement, price is not less than price arrived in terms of SEBI guidelines or not less than fair price worked out as per any internationally accepted pricing methodology for valuation of shares on arm's length basis, duly certified by SEBI registered Merchant Banker or Chartered Accountant.

3.13 FPI may, undertake short selling as well as lending and borrowing of securities subject to conditions stipulated by RBI and SEBI.

3.14 RBI monitors ceilings on FPI investments on daily basis, and the 'caution' and the 'stop purchase' communications are made public through press releases[3].

4. FPI for purchase of securities *other than shares or convertible debentures* under Schedule 5 *on repatriation basis*

4.1 FPI may purchase/sell/redeem, **on repatriation basis**, either directly from issuer of such securities or through registered stock broker on recognised stock exchange in India following securities, subject to terms and conditions as specified by SEBI and RBI:

(a) Dated Government securities/treasury bills;

(b) Listed NCDs/bonds issued by Indian company;

(c) Commercial papers issued by Indian company;

(d) Units of domestic mutual funds;

(e) Security Receipts issued by ARC – subject to prescribed ceiling;

(f) Perpetual Debt instruments eligible for inclusion as Tier I capital and Debt capital instruments as upper Tier II capital issued by banks in India subject to prescribed ceiling;

(g) Listed and unlisted NCDs/bonds issued by Indian company in infrastructure sector;

(h) NCDs/bonds issued by NBFCs categorized as IFCs;

(i) Rupee denominated bonds/units issued by Infrastructure Debt Funds;

(j) Primary issues of NCDs/bonds committed to be listed within 15 days of such investment; subject to sale/redemption/buy back if not listed;

(k) Credit enhanced bonds;

(l) Listed non-convertible/redeemable preference shares or debentures issued out of general reserves by way of distribution as bonus;

(m) Security receipts issued by securitisation companies.

5. Investment by FPI/NRI in Investment Vehicle under Schedule 11 *on repatriation basis*

5.1 FPI/NRI may invest in units of Investment Vehicles – SEBI registered REITs, InvIts, AIFs subject to Schedule 11. Downstream investment

3. https://www.rbi.org.in/scripts/bs_fiiuser.aspx

shall be regarded as foreign investment if either the Sponsor or the Manager or the Investment Manager is not Indian 'owned and controlled' as defined in Regulation 14. For sponsors or managers or investment managers organised in a form other than companies or LLPs, SEBI shall determine whether the sponsor or manager or investment manager is foreign owned and controlled.

5.2 Downstream investment has to conform to sectoral caps and conditions/restrictions, as applicable to company in which the downstream investment is made as per Schedule 1. Downstream investment in an LLP has to conform to Schedule 9.

6. Listed NCDs/Bonds *on repatriation basis*

6.1 FPI may purchase/subscribe to listed NCDs/bonds issued by Indian company - through public issue or on private placement basis under SEBI (Issue and Listing of Debt Securities) Regulations, 2008, with following terms/advantages:

(i) Compulsory listed on the Wholesale Debt Market segment of BSE Limited;

(ii) Assured Return possible; no cap on interest; coupon rate + additional yield on redemption linked to share price of listed share; earn out; cash flow; valuation; profits; IRR etc.;

(iii) No sector restrictions;

(iv) No ECB restrictions;

(v) Purchase from secondary market;

(vi) Open Pricing;

(vii) Exit: Redemption/sale;

(viii) Full Repatriation;

(ix) Credit rating;

(x) Secured or Unsecured;

(xi) With Put & Call options;

(xii) Face Value: minimum ` 10 lakhs per instrument;

(xiii) Even private limited companies can issue subject to additional compliances applicable for a listed company under Companies Act 2013[4];

(xiv) Only in dematerialised form;

(xv) Listed in 15-30 days;

(xvi) Only persons who are specifically addressed are eligible to apply.

7. Rupee denominated bonds overseas ('Masala Bonds') under FEMA 3 *on repatriation basis*

7.1 HDFC successfully listed first by an Indian company, Masala bond of INR 30 billion of three-years at an annualised yield of 8.33%, on London Stock Exchange on July 14, 2016. Masala Bonds are an alternative to raising overseas debt through Listed NCDs to FPIs, and Foreign currency denominated borrowing/ECB.

7.2 Form of borrowing: Any corporate (entity registered as a company under Companies Act, 1956/2013) or body corporate (created by Act of Parliament), or REITs or INVITs can issue plain vanilla Rupee denominated bonds issued overseas in FATF compliant financial centres. Bonds can be either placed privately or listed on exchanges as per host country regulations. LLPs and Partnership firms, etc. are not eligible.

7.3 Available routes and limits of borrowing: Automatic Route: Up to INR 50 billion per financial year; cases beyond this limit will require prior approval of RBI. Issuance of bonds will be within aggregate limit of INR 2443.23 billion for foreign investment in corporate debt.

7.4 Minimum Maturity: Three years with call and put option not prior to completion of minimum maturity.

4. http://www.bseindia.com/markets/debt/memorandum_data.aspx?expandable=3

7.5 All-in-Cost: Commensurate with prevailing market conditions and comparable with cost at which borrowing company is able to raise funds domestically.

7.6 End-use Prescriptions: All purposes except: i. Real estate activities other than development of integrated township/affordable housing projects; ii. Investing in capital market and using proceeds for equity investment domestically; iii. Activities prohibited as per FDI guidelines; iv. On-lending to other entities for any of above purposes; and v. Purchase of land.

7.7 ECB liability: Equity ratio, as applicable for raising ECB from foreign equity holder: Not applicable.

7.8 Exchange Rate for conversion: Market rate.

7.9 Hedging: Overseas investors are eligible to hedge their exposure in Rupee.

7.10 Other provisions: ECB framework - obtaining LRN, parking of proceeds, security/guarantee for borrowings, conversion into equity, corporates under investigation, etc. will be applicable. The Companies (Share Capital and Debenture) Rules, 2014 is not applicable.

8. Acquisition of Securities or Units by NRI on Stock Exchange in India *on Repatriation basis* under PIS under Schedule 3

8.1 NRI may purchase or sell shares, convertible preference shares, convertible debentures and warrants of Indian company or units of an investment vehicle (SEBI registered REITs, InvIts, AIFs), on repatriation basis, under PIS on a recognised stock exchange, subject to following conditions:

a. Through designated branch of AD;

b. The paid-up value of (i) shares, (ii) convertible preference shares or convertible debentures, and (iii) warrants of any series of Indian company purchased by any individual NRI should not exceed 5% of such instruments; and aggregate securities by all NRIs should not exceed 10% of paid-up value thereof. Provided that aggregate ceiling of 10% may be raised to 24% if special resolution to that effect is passed by General Body of Indian company concerned and intimation to RBI;

c. NRI investor should take delivery and give delivery; and

d. Investment shall be subject to FDI policy in respect of sectoral caps i.e. the maximum amount which can be invested by foreign investors, under schedule 1, in an entity, is composite and includes all types of foreign investments, direct and indirect, regardless of whether made under Schedule 1 (FDI), 2 (FII), 2A (FPI), 3 (NRI), 6 (FVCI), 8 (QFI), 9 (LLPs) and 10 (DRs).

8.2 Prior to February 15, 2016, acquisition of listed security issued by company by NRIs, on non-repatriation basis, was governed by Schedule 3. Now it is governed under Schedule 4. Limit of 5% for any individual NRI, both on repatriation and on non-repatriation basis, has been retained for repatriation basis. Under Schedule 4, NRI may acquire, on non-repatriation basis, any security issued by a company and units issued by an investment vehicle, without any limit, either on the stock exchange or outside it.

8.3 RBI monitors ceilings on NRI/PIO investments on daily basis, and the 'caution' and the 'stop purchase' communications are made public through press release.

9. Acquisition of Securities or units by NRI, *on non-repatriation basis* under Schedule 4

9.1 'Investment on non-repatriable basis' means investment, the sale proceeds of which, net of taxes, are not eligible to be repatriated out of India.

5. https://www.rbi.org.in/scripts/bs_fiiuser.aspx

9.2 NRI, including a company, a trust and a partnership firm incorporated outside India and owned and controlled by NRIs ('Overseas Entity'), may acquire and hold, on non-repatriation basis, without any limit, which will be deemed to be domestic investment at par with investment made by residents in India:

a. Acquire any security issued by a company either on the stock exchange or outside it.

b. Invest in units issued by an investment vehicle (SEBI registered REITs, InvIts, AIFs), either on the stock exchange or outside it.

c. Contribute to capital of a partnership firm, a proprietary firm or a limited liability partnership (under Limited Partnership Act, 2008).

9.3 Accordingly, now Overseas Entity will be eligible for investment under Schedule 4 and such investment will be deemed domestic investment at par with investment made by Residents. Similarly, under FDI policy/scheme under Schedule 1, Overseas Entity can invest in India with the special dispensation as available to NRIs, e.g., (a) Scheduled Air Transport Services/Domestic Scheduled Passenger Airlines, (b) Regional Air Transport Service, (c) Condition of lock-in period in Construction-development projects. This dispensation is not available for investment by NRIs under Schedules 3 and 11.

9.4 The concept of 'owned and controlled by NRIs' has not been defined under Schedule 4; but may be borrowed from Regulation 14. 'Control' shall include the right to appoint a majority of the directors or to control the management or policy decisions including by virtue of their shareholding or management rights or shareholders agreements or voting agreements. A company is considered as 'Owned' by NRIs if more than 50% of the capital in it is beneficially owned by NRIs. A Partnership Firm will be considered as owned by NRIs if more than 50% of the investment in such firm is contributed by NRIs and such NRIs have majority of the profit share.

9.5 Since investments made under Schedule 4 are deemed domestic investment restrictions on sectoral/statutory cap/conditionalities, pricing guidelines, caps on rate of dividend on preference shares/interest on CCDs, entry route, reporting requirement (e.g. Advance Remittance Form, FCGPR, FC-TRS, Form-ESOP, FDI-LLP (I), Form FDI-LLP (II), Annual Return on Foreign Liabilities and Assets, Downstream Investment Reporting), documentation, etc., which are applicable on investment made by non-residents under Schedule 1, shall not apply.

9.6 Investments under Schedule 4 are not counted for direct and indirect foreign investment. Sectoral caps are given in Annex B to Schedule 1 and in Chapter 5 of the Consolidated FDI Policy (Effective from June 7, 2016).

9.7 NRI shall not make any investment, under Schedule 4, in a Nidhi company or a company engaged in agricultural/plantation activities or real estate business or construction of farm houses or dealing in Transfer of Development Rights. Further, prohibition in certain sectors under FDI Scheme under Schedule 1 [i.e. (a) Lottery Business including Government/private lottery, online lotteries, etc. (b) Gambling and Betting including casinos etc. (c) Chit funds (g) Manufacturing of Cigars, cheroots, cigarillos and cigarettes, of tobacco or of tobacco substitutes (h) Activities/sectors not open to private sector investment e.g. (I) Atomic Energy and (II) Railway operations (other than specified permitted activities)] shall not apply to investments made under Schedule 4.

9.8 "Real estate business" means dealing in land and immovable property with a view to earning profit therefrom and does not include development of townships, construction of residential commercial premises, roads or bridges, educational institutions, recreational facilities, city and regional level infrastructure, townships. Further, earning of rent income on lease of the property, not amounting to transfer, will not amount to "real estate business". Investment in units of Real Estate Investment

Trusts (REITs) registered and regulated under the SEBI (REITs) Regulations 2014 shall also be excluded from definition of "real estate business".

9.9 Acquisition of Rights Shares/Bonus Shares/Shares after merger, demerger, amalgamation/ESOP/Pledge of shares: Limitations/restrictions contained in FEMA 20 may not apply to investments made under Schedule 4.

9.10 Sale/Maturity proceeds/Remittance: The limitations/restrictions contained in FEMA 20 regarding transfer of shares by NRI may not apply to investments made under Schedule 4. However, a person resident in India, who intends to transfer any security, by way of gift to a person resident outside India, has to obtain prior approval from RBI subject to prescribed conditions.

9.11 Transfer of shares from NRI to NR requires prior approval of RBI.

9.12 The sale/maturity proceeds (net of applicable taxes) of securities or units acquired under Schedule 4 shall be credited only to NRO account irrespective of type of account from which considerations for acquisition were paid. The amount invested under Schedule 4 and the capital appreciation thereon shall not be allowed to be repatriated abroad.

9.13 Under FEMA 13(R)/2016-RB dated April 1, 2016, a NRI or PIO (being an individual) may remit through an AD an amount, not exceeding US$ 1,000,000 per financial year (April to March) out of balances held in NRO accounts opened in terms of FEM (Deposit) Regulations, 2016 - subject to the applicable taxes paid in India. Funds can also be transferred to NRE account. It is not clear how a company, trust and partnership firm incorporated outside India and owned and controlled by non-resident Indians will be able to remit funds outside India.

10. NRI for purchase of securities, other than shares or convertible debentures under Schedule 5

10.1 NRI may, without limit, purchase/sell/ redeem ***on repatriation basis***

(i) Government dated securities (other than bearer securities) or treasury bills or units of domestic mutual funds;

(ii) Bonds issued by PSU;

(iii) Shares in PSE being disinvested by GOI;

(iv) Bonds/units issued by Infrastructure Debt Funds;

(v) Listed non-convertible/redeemable preference shares or debentures issued out of its general reserves by way of distribution as bonus;

(vi) National Pension System governed and administered by PFRDA. The annuity/ accumulated saving will be **repatriable**.

10.2 A NRI may purchase/sell/redeem ***on repatriation basis*** perpetual debt instruments eligible for inclusion as Tier I capital and Debt capital instruments as upper Tier II capital issued by banks in India subject to prescribed ceiling.

10.3 NRI may, without limit, purchase/sell/ redeem ***on non-repatriation basis***

(i) Dated Government securities (other than bearer securities), treasury bills, units of domestic mutual funds, units of Money Market Mutual Funds in India, or National Plan/Savings Certificates,

(ii) Listed non-convertible/redeemable preference shares or debentures issued out of its general reserves by way of distribution as bonus.

Conclusion

With liberalisation of Foreign Exchange regulations (substantially amended/ substituted/relaxed/ simplified) investment opportunities/structuring options are now available to foreign investors for making investments in India which makes India further an attractive destination for foreign investments.

CA Mayur B. Nayak

Transfer/Divestment of Shares & CCDs - Documentation and Reporting

1. Introduction

India is one of the most sought after destinations for Foreign Direct Investments (FDI) in world despite having regulated foreign exchange laws. FDI Policy and regulations are governed by the Department of Industrial Policy and Promotion (DIPP) and Reserve Bank of India (RBI) respectively. Restrictions with respect to sectors where FDI is allowed and up to what percentage, is laid down by the Finance Ministry through DIPP in its Annual Consolidated FDI Policy. Most of the reporting and compliances with respect to Investments, Disinvestments and Transfers are governed by the RBI through Authorized Dealers.

FEMA Notification No. 20/2000 Transfer or Issue of Security by a Person Resident outside India dated 3rd May 2000, amended from time-to-time by RBI governs FDI through its regulations. FDI in this write-up refers to Foreign Direct Investments into equity shares, compulsory convertible debentures and compulsory convertible preference shares. A reference to any one of these instruments would be equally applicable to others as well.

In this article, we shall discuss the documentation requirements pertaining to Investments, Disinvestments and Transfer of shares under FDI regime.

2. Documentation and Reporting of Investments under the Automatic Route

a) Intimation to RBI through AD for receipt of funds

An Indian Company receiving investment from outside India should report the details of the amount of consideration received towards issue of shares/compulsory convertible debentures/ warrants or any other instruments under FDI Scheme within 30 days from the date of receipt. The said reporting has to be made in Advance Reporting Form (ARF) on e-biz portal (www. ebiz.gov.in). Along with ARF, Indian company is also required to obtain Know Your Customer (KYC) report on the non-resident investor from the overseas bank remitting the amount. Copy of Foreign Inward Remittance Certificate (FIRC/s) is also required to be submitted as an evidence of receipt of remittance. Both KYC and FIRC have to be attached and uploaded with ARF. The ARF would be acknowledged by the Regional Office (of RBI) concerned, which will allot a Unique Identification Number (UIN) for the amount reported.

b) Filing of Form FCGPR (Foreign Currency Gross Provisional Return)

Indian Company has to issue shares/ convertible debentures/warrants towards

which the remittance is received within 180 days from the date of receipt of funds. After the issue of shares or any other instrument the same has to be reported to RBI through its authorised dealer within 30 days from the date of issue of shares. The said form FCGPR has to be digitally signed by the Managing Director/Director/Secretary of the Company and submitted online on e-biz portal. The following documents have to be attached/ uploaded along with Form FCGPR:

- Unique Identification Number from RBI received on reporting of Advanced Foreign Remittance.
- KYC report for the beneficiary if the beneficiary and remitter are different entities.
- A certificate from the Company Secretary of the company certifying that:
  - i) All the requirements of the Companies Act, 2013 have been complied with;
  - ii) Terms and conditions of the Government's approval, if any, have been complied with;
  - iii) The company is eligible to issue shares under these Regulations; and
  - iv) The company has all original certificates issued by AD banks in India evidencing the receipt of amount of consideration.
- Certificate from SEBI registered Merchant Banker/Chartered Accountant indicating the manner of arriving at the price of the shares issued to the persons resident outside India
- Disclaimer Certificate
- Statutory Auditor's Certificate
- Board Resolution
- LRN (Loan Registration Number) allotted in case of conversion from ECB to equity
- Copy of FIPB (Foreign Investment Promotional Board) approval (if required)
- Details of Transfer of shares, if any
- No objection certificate from the remitter for the shares being allotted to the third party mentioning their relationship, if applicable
- Letter from the foreign investor explaining the reason for making subscription to shares by the remitter on his behalf, if applicable.
- Copy of agreement/Board resolution from the investee company for issue and allotment of shares to the foreign investor, other than the remitter, if applicable.
- Reason for delay in submission (if required)

c) Filing of Annual Return on Foreign Assets and Liabilities

All Indian entities which have received FDI and/or made overseas investment in the previous year(s), should send by e-mail to fla@rbi.org.in the annual return on Foreign Liabilities and Assets (FLA) in the Excel based soft form to the Reserve Bank, Department of Statistics and Information Management, Mumbai by July 15 every year, in respect of investments made in the preceding Financial Year (from 1st April to 31st March). The form FLA is to be sent by e-mail to fla@rbi.org.in. Below are the few important queries replied by RBI in its FAQ's Section:—

- If a company has received only share application money and does not have any foreign direct investment or overseas direct investment outstanding as on 31st March of the reporting year, then that company is not required to fill up FLA return.
- Also if the company has not 'received any fresh FDI and/or ODI (overseas

direct investment)' in the latest year but the company has outstanding FDI and/or ODI, then that company is required to submit the FLA Return every year by July 15.

- If all non-resident shareholders of a company have transferred their shares to the residents during the reporting period and the company does not have any outstanding investment in respect of FDI as on March of the reporting year, then the company need not submit the FLA Return.
- Shares issued by reporting company to non-resident on Non-repatriable basis should not be considered as foreign investment; therefore, companies which have issued the shares to non-resident only on non-repatriable basis, is not required to submit the FLA Return.
- After sending the Excel based FLA return to e-mail, you will receive an acknowledgement. Ensure that you have received a successful processing acknowledgement. If some error is mentioned in the acknowledgement rather than successful processing statement, then you have to resubmit the form by rectifying the mentioned error.

3. Reporting of conversion of External Commercial Borrowings (ECB) into equity

Details of issue of shares against conversion of ECB have to be reported to the Regional Office concerned of the Reserve Bank, as indicated below:

(i) In case of full conversion of ECB into equity, the company should report the conversion in Form FCGPR to the Regional Office concerned of the Reserve Bank as well as in Form ECB-2 to the Department of Statistics and Information Management (DSIM), Reserve Bank of India, Bandra Kurla Complex, Mumbai-400 051, within seven working days from the close of month to which it relates. The said FCGPR has to be filed on e-biz portal. The words *"ECB wholly converted to equity"* should be clearly indicated on top of the Form ECB-2. Once reported, filing of Form ECB-2 in the subsequent months is not necessary.

(ii) In case of partial conversion of ECB, the company is required to report the converted portion in Form FCGPR to the Regional Office concerned as well as in Form ECB-2 clearly differentiating the converted portion from the non-converted portion. The words *"ECB partially converted to equity"* should be indicated on top of the Form ECB-2. In the subsequent months, the outstanding balance of ECB shall be reported in Form ECB-2 to DSIM.

4. Reporting of ESOPs for allotment of Equity Shares

An Indian company issuing ESOPs to its non-resident employees is required to report the details of issuance of ESOPs to the Regional Office concerned of the Reserve Bank. The said reporting has to be made in Form ESOP within 30 days from the date of issue of ESOPs. Further, at the time of conversion of ESOPs into shares the Indian company has to ensure reporting to the Regional Office concerned of the Reserve Bank in form FCGPR, within 30 days of allotment of such shares.

5. Reporting of FII investments under FDI and Portfolio Investment Scheme (PIS)

The Indian Company which has issued shares to FIIs under the FDI Scheme (for which the payment has been received directly into company's account) and the Portfolio Investment Scheme (for which the payment has been received from FIIs' account

maintained with an AD Category-I bank in India) should report these figures separately under item No. 5 of Form FC-GPR (Post-issue pattern of shareholding) so that the details could be suitably reconciled for statistical/ monitoring purposes.

6. Reporting of Transfer of shares

a) Transfer by sale from non-resident to Non-Resident

There is no specific reporting requirement to RBI/GOI in case of transfer of shares by sale from a Non-resident, other than NRI, to another Non-resident. However, the same should be reported to the company by the seller so as to enable them to transfer the title to the new shareholder.

b) Transfer by sale from non-resident Indian to non-Resident

Transfer of shares from a Non-resident Indian (NRI) to a Non-resident (non NRI i.e. absolute foreigner or a foreign company/entity) requires prior approval of RBI. Once the approval is received, the same would have to be reported to the company by the seller so as to enable them to transfer the title to the new shareholder.

c) Transfer by sale from non-resident on stock exchanges in India is freely permitted and in such a case no documentation is required to be filed.

d) Transfer by sale from Non-resident to Resident or from Resident to Non-resident

Reporting of transfer of shares/convertible debentures and partly paid shares and warrants to the extent the equity shares are called upon between residents and non-residents and vice- versa is to be made in Form FC-TRS. The Form FC-TRS should be submitted online on e-biz portal within 60 days from the date of receipt of the amount of consideration. The onus of submission of the Form FC-TRS within the given timeframe would be on the transferor/transferee, resident in India. However, the onus of reporting the purchase of shares by non-residents/NRIs on the recognized stock exchanges in accordance with SEBI (Substantial Acquisition of Shares and Takeover) Regulations shall be on the investee company.

The sale consideration in respect of equity instruments purchased by a person resident outside India, remitted to India through a normal banking channel, shall be subjected to a KYC check by the remittance receiving AD Category-I bank at the time of receipt of funds. In case, the remittance receiving AD Category-I bank is different from the AD Category-I bank handling the transfer transaction, the KYC check should be carried out by the remittance receiving bank and the KYC report be submitted by the customer to the AD Category-I bank carrying out the transaction along with the Form FC-TRS.

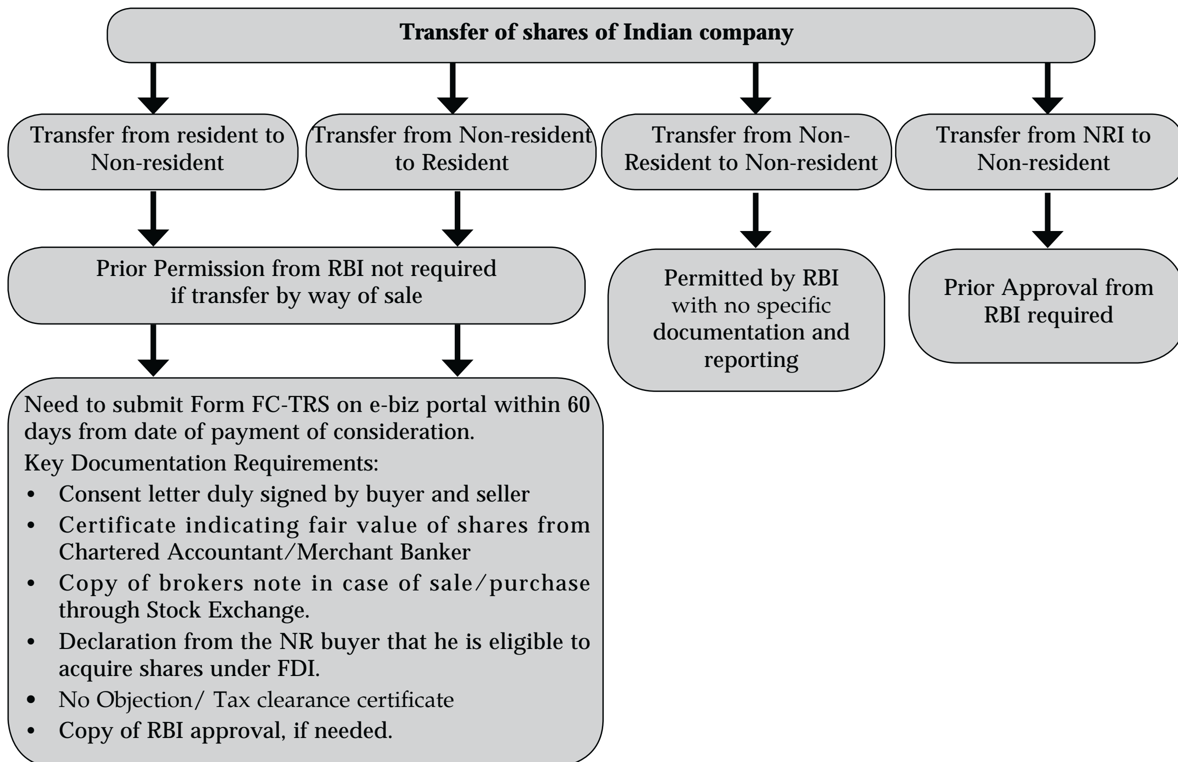
Documents to be obtained before filing of Form FC-TRS are as follows:-

- Certificate indicating fair value of shares from a Chartered Accountant/SEBI registered Category-I Merchant Banker.
- Copy of Broker's note if sale/purchase is made on Stock Exchange.
- Declaration from the NR buyer to the effect that he is eligible to acquire shares/ compulsorily and mandatorily convertible preference shares/debentures/others under FDI policy and the existing sectoral limits and conditionality (such as minimum capitalisation norms, etc.) and Pricing Guidelines have been complied with.
- Declaration from the FII/sub-account to the effect that the individual FII/Sub-account ceiling as prescribed has not been breached.

- Extracts of Share Purchase Agreement (SPA) containing:
  - o Name of the buyer and seller
  - o Name of the investee company
  - o No. of shares to be transferred
  - o Price at which they are transferred
  - o Mode of transfer
  - o Date of transfer
  - o Any other relevant information
- If the sellers are NRIs/erstwhile OCBs, the copies of RBI approvals, if applicable, evidencing the shares held by them on repatriation/non-repatriation basis.
- No Objection/Tax Clearance Certificate from Income Tax Authority/Chartered Accountant.
- Approval letter from RBI/FIPB, if applicable.
- Power of attorney (if signatory is agent)

The transferee/his duly appointed agent should approach the investee company to record the transfer in their books along with the certificate in the Form FC-TRS from the AD branch that the remittances have been received by the transferor or the payment has been made by the transferee. On receipt of the certificate from the AD, the company may record the transfer in its books. On receipt of statements from the AD bank, the Reserve Bank may call for such additional details or give such directions as required from the transferor/transferee or their agents, if need be.

DIAGRAMATICAL ANALYSIS OF THE LAW



e) A person resident in India who intends to transfer any security, by way of gift to a person resident outside India, has to obtain prior approval from the Reserve Bank. While forwarding the application to the Reserve Bank for approval for transfer of shares by way of gift, the documents mentioned below should be enclosed.

Documents to be enclosed with the application are:—

- Name and address of the transferor (donor) and the transferee (donee).
- Relationship between the transferor and the transferee.
- Reasons for making the gift.
- In case of Government dated securities and treasury bills and bonds, a certificate issued by a Chartered Accountant on the market value of such security.
- In case of units of domestic mutual funds and units of Money Market Mutual Funds, a certificate from the issuer on the Net Asset Value of such security.
- In case of shares and convertible debentures, a certificate from a Chartered Accountant on the value of such securities according to the guidelines issued by Securities & Exchange Board of India or fair value worked out as per any internationally accepted pricing methodology for valuation of shares for listed companies and unlisted companies, respectively.
- Certificate from the concerned Indian company certifying that the proposed transfer of shares/convertible debentures by way of gift from resident to the non-resident shall not breach the applicable sectoral cap/FDI limit in the company and that the proposed number of shares/convertible debentures to be held by the non-resident transferee shall not exceed 5 per cent of the paid-up capital of the company.
- An undertaking from the resident transferor that the value of security to be transferred together with any security already transferred by the transferor, as gift, to any person residing outside India does not exceed the prescribed limit of US D 50,000 or its rupee equivalent, during a financial year.

Apart from the above documentation, Reserve Bank considers the following factors while processing such applications:

- The proposed transferee is eligible to hold such security under Schedules 1, 4 and 5 of Notification No. FEMA 20/2000-RB dated May 3, 2000, as amended from time-to-time.
- The gift does not exceed 5 per cent of the paid-up capital of the Indian company/each series of debentures/each mutual fund scheme.
- The applicable sectoral cap limit in the Indian company is not breached.
- The transferor (donor) and the proposed transferee (donee) are close relatives as defined in Section 6 of the Companies Act, 2013, as amended from time-to-time.
- The value of security to be transferred together with any security already transferred by the transferor, as gift, to any person residing outside India does not exceed the rupee equivalent of US D 50,000 per financial year.
- Such other conditions as stipulated by the Reserve Bank in public interest from time-to-time.

iv) A person resident outside India can transfer any security to person resident in India by way of gift without any specific documentation or reporting to RBI. However, the transferor of securities has to follow the general documentation as required by the statutory bodies other than RBI (e.g. SEBI).

7. Documentation and Reporting of FDI in LLP

A Limited Liability Partnership (LLP) receiving amount of consideration for capital contribution and acquisition of profit shares is required to submit a report in Form Foreign Direct Investment-LLP (I). The same has to be reported through its Authorised Dealer Category-I bank, to the Regional Office of the Reserve Bank under whose jurisdiction the Registered Office of the Limited Liability Partnership making the declaration is situated. The reporting has to be made within 30 days from the date of receipt of the amount of consideration. The form should be accompanied by:

(a) Copy/ies of the FIRC/s evidencing the receipt of the remittance

(b) KYC report in respect of the foreign investor from the overseas bank remitting the amount, in the format specified.

The report would be acknowledged by the Regional Office concerned, which would allot a Unique Identification Number (UIN) for the amount reported.

Disinvestment/Transfer in LLP: LLPs should report disinvestment/transfer of capital contribution or profit share between a resident and a non-resident (or vice versa) within 60 days from the date of receipt of funds in Form Foreign Direct Investment LLP (II).

All LLPs in India which have received FDI and/or made FDI abroad should send by e-mail, the annual return on Foreign Liabilities and Assets (FLA) in the Excel based soft form to the Reserve Bank, Department of Statistics and Information Management, Mumbai by July 15 every year. Since LLPs do not have 21-Digit CIN (Corporate Identity Number), they are advised to enter 'A99999AA9999LLP999999' against CIN in the FLA Return.

8. Reporting of foreign investment by way of issue/transfer of 'participating interest/ right' in oil fields

Foreign investment by way of issue/transfer of 'participating interest/right' in oil fields by Indian companies to a non-resident would be treated as an FDI transaction. Accordingly, transfer of 'participating interest/rights' will be reported as 'other' category under Para 7 of Form FC-TRS (Annex IV) and issuance of 'participating interest/ rights' will be reported as 'other' category of instruments under Para 4 of Form FC-GPR.

9. Approval Route

The following cases require prior approval of RBI/Government as the case may be :

(i) Transfer of capital instruments from resident to non-residents by way of sale where:

(a) Transfer is at a price which falls outside the pricing guidelines specified by the Reserve Bank from time-to-time and the transaction does not fall under general permission.

(b) Transfer of capital instruments by the non-resident acquirer involving deferment of payment of the amount of consideration. Further, in case approval is granted by RBI for a transaction, the same should be reported in Form FC-TRS, to an AD Category-I bank for necessary due diligence, within 60 days from the

date of receipt of the full and final amount of consideration.

(ii) Transfer of any capital instrument, by way of gift by a person resident in India to a person resident outside India. While forwarding applications to Reserve Bank for approval for transfer of capital instruments by way of gift, the documents mentioned above should be enclosed.

(iii) Transfer of shares with Government approval from NRI to non-resident (other than NRI)

(iv) Government approval is required in case of Transfer of control or ownership of the companies where sectoral cap is specified owned and controlled by Resident Indian Citizens or owned and controlled by companies which are owned and controlled by Resident Indian Citizens.

(v) Transfer of equity instruments to non-residents where sectoral caps are specified and the resultant ownership by non-residents is in excess of the specified cap where Government approval is not required.

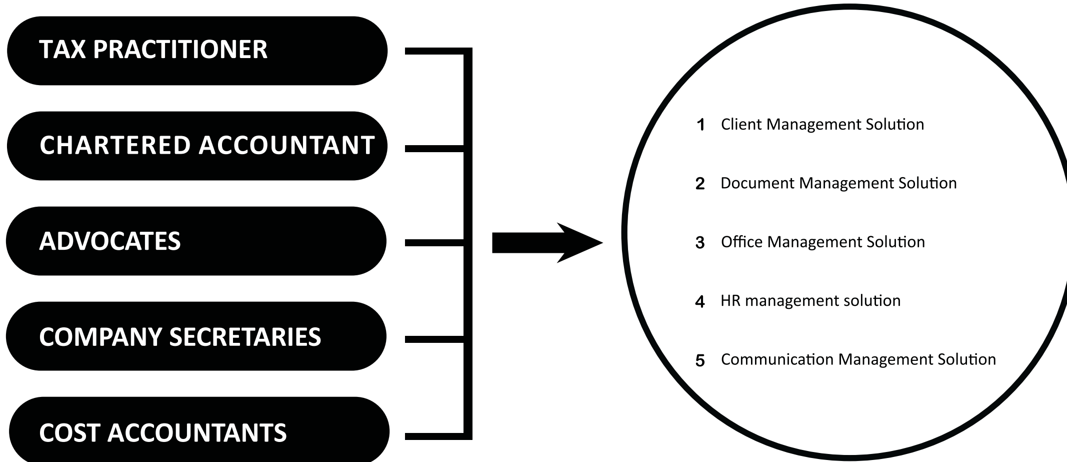
Summation

FDI in India may be through automatic route or approval route. However, in both cases reporting of investments is required at various stages. The delay in reporting may attract compounding penalties. Some of the reporting is to be routed through authorised dealer (Bank) and therefore it is imperative that proper follow-up is being made with the bank to ensure onward submission of documents to RBI. Fortunately, of late, many such reporting requirements are required to be complied with electronically. FDI being a dynamic subject the reader is well advised to keep track of the latest developments in this area.

Overview of the Reporting of FDI

Purpose/Transaction	Form	Time Limit	Where to submit
Remittance received by the Indian Company from non-resident as FDI	Advance Reporting Form (ARF) along with KYC of the investor as per RBI format	Within 30 days from the date of receipt of funds	Electronically on e-biz portal
Issue of shares towards FDI by an Indian Company	Form FCGPR	Within 30 days from the date of allotment of shares	Electronically on e-biz portal
Annual Reporting of FDI received by an Indian Company/ LLP	Annual Return on Foreign Assets and Liabilities (FLA)	By 15th July for year ended on preceding 31st March	E-mail in the soft copy to fla@rbi.org.in
Reporting of conversion of ECB into Equity	Form FCGPR and Form ECB 2	Within 30 days from the date of allotment of shares towards conversion of ECB. Form ECB-2 has to be filed within seven days from the end of the month in which the conversion takes place	Form FCGPR has to be filed online on e-biz portal and form ECB-2 has to be filed with Department of Statistics and Information Management (DSIM), RBI through Authorized Dealer

Purpose/Transaction	Form	Time Limit	Where to submit
Reporting of ESOPs for allotment of Equity Shares	Form ESOP	Within 30 days from the date of issue of ESOPs	File through Authorized dealer with Regional Office of RBI
Reporting of Transfer of Shares from Non-resident to Resident/ Resident to Non-resident	Form FCTRS	Within 60 days from the date of receipt of the amount of consideration	Online on e-biz portal
Reporting of FDI in LLP	Form FDI LLP (I)	Within 30 days from the date of receipt of the amount of consideration	File with RBI through Authorised Dealer
Disinvestment/ Transfer in LLP	Form FDI LLP (II)	Within 60 days from the date of receipt of funds	Submit to RBI through Authorised Dealer



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CA Chandresh Bhimani, CA Harshal Kamdar
& CA Jigar Mehta

Remittance of sale proceeds and on winding up/liquidation of companies

As they say, the proof of the pudding is in the eating. Similarly, in the context of foreign investments, though investments are being progressively liberalised, it becomes important to be cognizant of the conditions applicable to the remittance of sale proceeds.

Regulation 11 of the Foreign Exchange Management (Transfer or Issue of Security by A Person Resident Outside India) Regulations, 2000 ('the Inbound Regulations' or 'FEMA 20') outlines the conditions for remittance of sale proceeds of securities acquired under the Inbound Regulations.

While Regulation 11 provides that the remittance of sale proceeds would be governed by respective Schedule of FEMA 20 under which the investment may have been made (i.e., respective investment route permitted under the Inbound Regulations), it specifically lays down the following prerequisites for allowing remittances to foreign investors:

(a) Remittance should be net of all applicable taxes in India;

(b) The security sold should have been held by the seller on repatriation basis;

(c) In case of listed securities, the same have been sold on a recognised stock exchange in India through a stock broker at the ruling market price as determined on the floor of the exchange. In other cases, RBI's approval has been obtained for sale of security and remittance of sale proceeds thereof; and

(d) No objection/tax clearance certificate is obtained from Indian income-tax authorities.

Generally, in the context of remittances, the RBI has clarified[1] that it would not issue any instructions under FEMA clarifying tax issues. It would be mandatory on the part of Authorised Dealer banks ('AD banks') to comply with the requirement of tax laws, as applicable.

- Sale by Non-Resident to Non-Resident: Sale of securities by a non-resident (other than a NRI/OCB) to another non-resident is permissible in terms of Regulation 9 of FEMA 20, subject to compliance with conditions under the FDI Scheme – in case of NRIs, the sale is permissible only to another NRI or a resident person.
- Sale by Non-Resident to Resident: Regulation 10(B)(2) of FEMA 20 permits non-resident investors to transfer the securities to a resident person without any prior approval of the RBI, subject to compliance with applicable pricing guidelines, documentation and reporting.

While the requirement of obtaining RBI approval is mentioned under Regulation 11, the same would be subject to the provisions under the respective Schedule of FEMA 20. Requirements under relevant

1. A.P. (DIR Series) Circular No. 151 dated June 30, 2014

Schedules of FEMA 20 are separately discussed hereinafter:

Schedule 1 – Foreign Direct Investment ('FDI') Scheme

Under the FDI scheme, a non-resident is allowed to invest in equity shares (including partly paid shares), compulsorily convertible preference shares/ debentures and warrants, subject to prescribed sectoral conditionalities and caps.

In case of sale of above instruments to a resident, the sale price would be subject to prescribed pricing guidelines. Further, the transferee resident in India is required to submit Form FC-TRS to the AD bank while requesting remittance of sale proceeds along with other requisite documents such as consent letters, valuation certificate, etc. The AD bank may peruse the documents and issue certificate in Form FC-TRS permitting transfer of shares if the same are found to be satisfactory and also remit the sale proceeds. The investee company would record the transfer on receipt of the aforesaid certificate from AD bank.

Further, the sale consideration in respect of shares or convertible debentures or warrants is to be remitted through normal banking channels. In case the seller is a NRI, it would be permissible for him to have the sale proceeds credited to his bank in India, such as Non-Resident External ('NRE') account and Foreign Currency Non-Resident ('FCNR') account. It is also possible for NRI to credit the sale proceeds to his Non-Resident Ordinary ('NRO') account – however, in such a case, the funds may get characterised as 'non-repatriable' and subject to conditions applicable to NRO account.

Similar conditions would be applicable in case of remittance of sale proceeds on transfer of capital contribution / profit share in LLP from a non-resident to a resident.

Escrow arrangement

In case of sale by non-resident investors, it is permissible for resident buyers of shares to have an Escrow arrangement for facilitating purchase of shares from non-resident sellers and subsequent remittance of sale proceeds to the non-resident seller. The escrow account is permitted for a maximum period of six months only (except in case of payment of consideration on deferred basis). Once the transaction goes through, the consideration is paid directly into the bank account of the beneficiary. In case of non-materialisation of the transaction, the amount is refunded back to the depositor (i.e., proposed buyer).

Optionality clauses

It is permissible to have in-built put/call options in the share purchase agreement under the FDI Policy vis-à-vis equity shares and compulsorily and mandatorily convertible preference shares / debentures. The optionality clause enables the investor to exit and obliges the buyback of securities from the investor. The provision of optionality clause can be inserted subject to the following conditions:

(a) The non-resident investor should not be guaranteed any assured return/exit price at the time of making the investment or entering into share purchase agreement.

(b) There should be a minimum lock-in period of one year or such period as prescribed under FDI Policy, whichever is higher.

(c) After the lock-in period, as applicable above, the non-resident investor exercising the option may exit at prescribed pricing guidelines:

   (i) In case of a listed company, the exit price is the market price prevailing at the recognised stock exchange.

   (ii) In case of unlisted company, the exit price should be determined as per any internationally accepted pricing methodology on arm's length basis, duly certified by a CA or a SEBI-registered Merchant Banker.

Deferred payment of sale consideration

The RBI has recently permitted transfer of shares where sale consideration is payable on a deferred basis (including through escrow/indemnity

bond arrangements), subject to compliance with following conditions:

(a) Maximum 25% of the total consideration is payable by the buyer on a deferred basis

(b) If the total consideration is paid, the seller can furnish an indemnity for the amount of consideration payable on deferred basis

(c) The consideration payable on deferred basis should be paid within a period of 18 months from date of transfer agreement. Also, the escrow arrangement/period of indemnity (if any) cannot exceed 18 months

(d) The total consideration paid for shares must be compliant with applicable pricing guidelines

The above conditions need to be complied with for transfer of shares between a resident buyer and a non-resident seller as well as vice versa.

Thus, in case of sale of securities by non-resident investor to a resident, the resident buyer would be required to discharge at least 75% of the total consideration upfront. Further, the balance 25% would need to be remitted within a maximum period of 18 months as discussed above. Prior to the above amendment, while deferment of payment of consideration require prior RBI approval in case of resident seller and non-resident buyer, there was no express direction regarding deferment of consideration in case of purchase by a resident buyer from a non-resident seller.

It would also be interesting to see whether pursuant to the above amendment, the RBI would permit arrangements where the sale price is compliant with applicable pricing guidelines but not entirely fixed upfront, say, up to 25% is contingent upon happening of certain event (profitability/sales by the investee company).

Schedule 2/2A/5 – Foreign Portfolio Investment ('FPI') Scheme by FPIs

Under the FPI scheme, a registered foreign portfolio investor ('RFPI') is allowed to invest in listed equity shares (including partly paid shares), preference shares/convertible preference shares, convertible debentures and warrants (under Schedule 2/21 of FEMA 20). Besides the above, under Schedule 5 of FEMA 20, RFPIs are also allowed to invest in other securities such as dated Government securities/ treasury bills, listed NCDs/bonds, Commercial Papers, units of domestic mutual funds, security receipts issued by Asset Reconstruction Companies and securitisation companies, perpetual debt instruments.

A RFPI may open a Foreign Currency Account and/or a Special Non-Resident Rupee Account with an AD bank for routing the receipts and payments concerning purchase and sale of above securities, subject to the following conditions:

(a) The Account is funded by inward remittance through normal banking channels or by credit of sale proceeds of permissible securities on stock exchange in India

(b) The funds in the account should be utilised for purchase of permissible securities or for remittance outside India

(c) The Foreign Currency Account and the Special Non-Resident Rupee account of the RFPI are non-interest-bearing account(s).

RFPI is permitted to transfer funds between its Foreign Currency Account and its Special Non-Resident Rupee account.

In case of sale of securities, the AD banker is permitted to allow remittance of sale proceeds/ maturity proceeds (after payment of applicable taxes) to RFPI's bank account outside India. Alternatively, at the option of RFPI, the said proceeds may be credited to RFPI's Foreign Currency Account or its Special Non-Resident Rupee Account.

Portfolio Investment by NRI – Schedules 3, 4 and 5

A NRI may invest in India under two investment routes – investment on repatriation basis (under Schedules 1, 3 and 5 of FEMA 20) or on non-repatriation basis (under Schedule 4 of FEMA 20).

We have already discussed the implications under Schedule 1 to FEMA 20 above.

Investment under Schedule 3 – on Repatriation Basis

Under Schedule 3, a NRI may invest in listed equity shares, convertible preference shares/debentures, warrants and units of investment vehicle (as defined under FEMA 20) on a recognised stock exchange in India under the Portfolio Investment Scheme ('PIS') on repatriation basis.

Under the PIS, the NRI may open a designated NRE (PIS) account with an AD bank for routing the receipt and payment for transactions concerning sale and purchase of listed securities.

The sale proceeds of the above securities may be credited to NRE (PIS) account after payment of applicable taxes in India. The AD bank is bound to ensure that only the sale proceeds pertaining to listed securities purchased on repatriation basis are credited to the NRE (PIS) account and that there is no intermingling of sale proceeds of other securities that may have been held by the NRI.

Investment under Schedule 4 – on Non-Repatriation Basis

Under Schedule 4 of FEMA 20, NRIs and foreign companies/trusts/partnership firms owned and controlled by NRIs are permitted to invest on non-repatriation basis in equity shares (including partly paid shares), convertible preference shares/debentures, capital of LLP/partnership firms/proprietary concern or units of investment vehicle, subject to prescribed sectoral restrictions. Investments made under this route are deemed to be domestic investment and treated at par with investments by residents.

Investment under Schedule 5 – on Repatriation / Non-Repatriation Basis

Further, under Schedule 5 of FEMA 20, NRIs are permitted to invest, without limit, on repatriation basis in securities such as Government dated securities (other than bearer securities), treasury bills, units of domestic mutual funds, bonds issued by a Public Sector Undertaking (PSU), shares in Public Sector Enterprises being disinvested by the Government of India, bonds/units issued by Infrastructure Debt Funds, etc. Also, the NRIs are permitted to invest, without limit, on non-repatriation basis in dated Government securities (other than bearer securities), treasury bills, units of domestic mutual funds and Money Market mutual funds or National Plan/Savings Certificates.

Remittance conditions

In case of investment on repatriation basis, it is permissible to remit the sale proceeds to NRI's bank account outside India or credit to his NRE / FCNR/NRO account in India. Further remittance from the aforesaid accounts will be subject to the conditions applicable under the respective schemes.

In case of investment on non-repatriation basis, the sale/maturity proceeds (net of applicable taxes) of the securities or units would be credited only to NRO account of the NRI irrespective of the type of account (NRO/NRE/FCNR/bank account outside India) from which the purchase price may have been paid. In case of investment on non-repatriation basis, the principal and capital appreciation thereon are not allowed to be repatriated abroad without RBI approval. Nonetheless, in terms of Regulation 4(2) of FEMA 13(R) Foreign Exchange Management (Remittance of Assets) Regulations, 2016, the NRO account scheme permits NRIs to remit the sale proceeds of assets out of balances held in NRO account. The remittance permissible is up to USD 1 million.

Schedule 6 – Foreign Venture Capital Investment Scheme

A Foreign Venture Capital Investor ('FVCI') registered with SEBI is permitted to acquire equity or equity linked instruments, debt instruments of unlisted companies in prescribed sectors or of startups in any sector and units of VCF, Cat-1 AIF. FVCIs are permitted to sell above securities to eligible non-residents or resident buyers.

A registered FVCI is allowed to open a Foreign Currency Account as well as a Rupee account with an AD bank in India. The aforesaid account(s) could be used only and exclusively for transactions under FVCI route and not otherwise. The sale proceeds on sale of securities under FVCI route

may be credited to aforesaid account(s) or remitted directly outside India.

Remittance on winding up/liquidation of Companies

In case of remittance on winding up/liquidation of companies having foreign investment, the winding up proceeds are permitted to be remitted outside India subject to payment of applicable taxes and liquidation being undertaken subject to the order of the competent court or as per the official liquidator in case of voluntary winding up under the Companies Act. The following documents are required to be submitted in connection with remittance of winding up proceeds:

(a) No objection or tax clearance certificate from Income Tax Department

(b) Auditor's certificate confirming that all liabilities in India have been either fully paid or adequately provided for

(c) Auditor's certificate to the effect that the winding up is in accordance with the provisions of the Companies Act, as applicable

(d) In case of winding up otherwise than by a court, an auditor's certificate to the effect that there are no legal proceeding spending in any court in India against the applicant or the company under liquidation and there is no legal impediment in permitting the remittance.

Remittance on closure/winding up of Branch Office ('BO') / Liaison Office ('LO')

Similarly, in case of remittance on closure of BO/LO, the remittance to head office is permitted without prior approval of RBI subject to submission of following documents:

(a) A copy of the Reserve Bank's permission for establishing the branch/office in India, wherever applicable;

(b) Auditor's certificate:

   (i) Indicating the manner in which the remittable amount has been arrived and supported by a statement of assets and liabilities of the applicant, and indicating the manner of disposal of assets;

   (ii) Confirming that all liabilities in India including arrears of gratuity and other benefits to the employees etc., of the branch/office have been either fully met or adequately provided for;

   (iii) Confirming that no income accruing from sources outside India (including proceeds of exports) has remained un-repatriated to India; and

   (iv) Confirming that the branch/office has complied with all regulatory requirements stipulated by the Reserve Bank of India from time-to-time regarding functioning of such offices in India.

(c) A confirmation from the applicant that no legal proceedings are pending in any Court in India and there is no legal impediment to the remittance; and

(d) A report from the Registrar of Companies regarding compliance with the provisions of the Companies Act, 2013, in case of winding up of the office in India.

Thus, the remittance on liquidation/closure of companies/offices in India is generally permissible without requirement of prior RBI approval, subject to compliance with prescribed formalities in the past and availability of prescribed documentation.

To summarise, as in case of foreign investments, the regulatory authorities have been mindful of facilitating remittance of sale proceeds of investments in India while building in checks and balances to safeguard interest of Indian economy. A lot of onus has been placed on AD banks in effectively implementing the policy on remittances and facilitating and guiding foreign investors in walking through the last mile of the investment cycle.

CA Hinesh R. Doshi, CA Shital H. Desai &
CA Ashish J. Mehta

Liaison, Branch, Project Office of the Non-Residents

1. Introduction

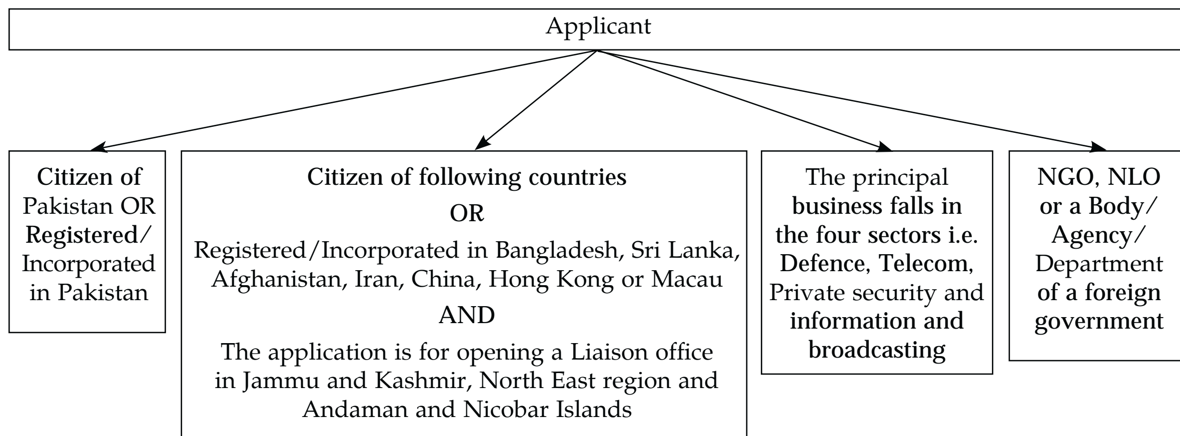
The Liaison Office (referred to as **"LO"**) can undertake only liaison activities, i.e. it can act as a channel of communication between Head Office abroad and parties in India, which does not undertake any commercial/trading/industrial activity in India. Expenses of such offices are to be met entirely through inward remittances of foreign exchange from the Head Office outside India.

Branch Offices (referred to as **"BO"**) in relation to a company; means any establishment described as such by the company. A branch can be opened for specific purposes; it should be engaged in the same activities as the parent company. It can undertake activity like Export/Import of goods, rendering professional or consultancy services, rendering technical support to the products supplied by parent/group companies.

Foreign Companies planning to execute EPC/turnkey projects in India can set up temporary project/site offices (referred to as **"PO"**) in India. Project office is a place of business to represent the interest of the foreign company executing a project in India. Site office means a sub-office of the Project office established at the site of a project where major work like construction, installation, erection, supervision and commissioning is to be carried out.

2. Prior Approval of RBI

A body corporate incorporated outside India, desirous of opening a Liaison Office (LO)/Branch Offices (BO)/Project Offices (PO) in India shall require prior approval of RBI in following cases:



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

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

Foreign banks can establish Branch/Liaison Offices in India only after obtaining approval from the Department of Banking Regulation (DBR), RBI.

3. Application Procedure

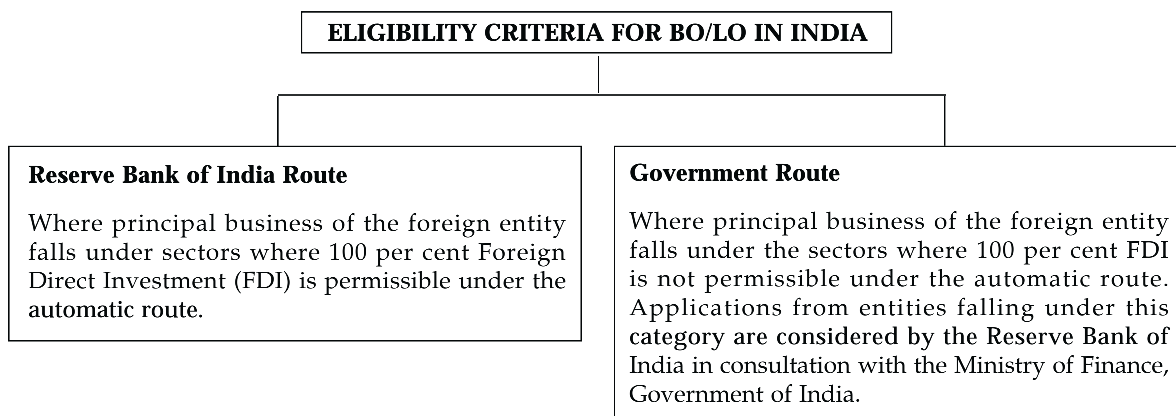
The application for establishing BO/LO/PO in India is to be submitted by the non-resident entity in **Form FNC** to a designated AD bank along with the prescribed documents. The AD bank shall after exercising due diligence in respect of the applicant's background and satisfying itself as regards adherence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

Registration with State Police Authorities by BO/PO

Applicants from Bangladesh, Sri Lanka, Afghanistan, Iran, China, Hong Kong or Macau opening a Liaison/Project offices in India shall have to register with the concerned State Police Authorities. Copy of approval letter shall be marked by the AD bank to the Ministry of Home Affairs, Internal Security Division-I, Government of India, New Delhi.

4. Eligibility Criteria

The applications from Branch/Liaison offices in Form FNC will be considered by AD Bank under two routes:



Additional Criteria

The following additional criteria are also considered by the AD Bank while sanctioning Branch/Liaison Offices of foreign entities:

I. **Track Record of Profits**

Branch Office should have a profit making track record during the immediately preceding five financial years in the home country. A Liaison office should have a profit making track record during the immediately preceding three financial years in the home country.

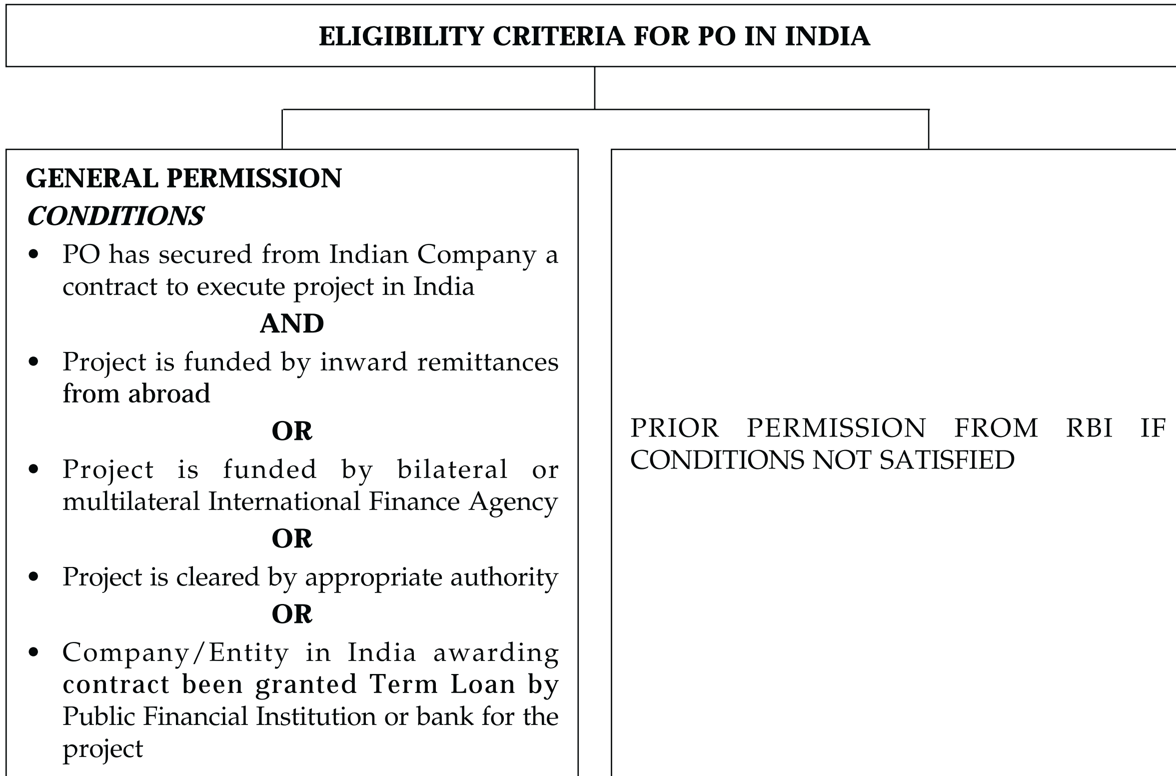
II. **Net Worth**

For Branch Office Net worth should not be less than US D 100,000 or its equivalent.

For Liaison Office Net worth should not be less than US D 50,000 or its equivalent.

Project offices

1. Regulation 4f(I) of Notification No. FEMA 22(R)/RB-2016 grants General Permission to a foreign company to set up Project Office in India, subject to specified conditions.
2. If the specified conditions are not met, the foreign entity has to approach RBI for approval.



5. Other Conditions related to approval

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

6. Branch Office in Special Economic Zones (SEZs)

6.1 Reserve Bank has given general permission to foreign companies for establishing branch/unit in Special Economic Zones (SEZs) to undertake manufacturing and service activities. The general permission is subject to the following conditions:

6.1.1 Such units are functioning in those sectors where 100 per cent FDI is permitted;

6.1.2 Such units comply with Part XI of the Companies Act, 2013;

6.1.3 Such units function on a stand alone basis.

6.2 In the event of winding-up of business and for remittance of winding-up proceeds, the branch shall approach an AD Category–I bank with the documents as mentioned under "Closure of Liaison/Branch Office" except the copy of the letter granting approval by the Reserve Bank.

7. Procedures post approval

7.1 Once it establishes a place of business in India, a BO/LO/PO or any other place of business by whatever name called is required to register with the Registrar of Companies (ROCs) if such registration is required under the Companies Act, 2013.

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

8. Activities permitted for Branch/ Liaison Office

8.1 Liaison Offices

8.1.1 Representing in India the parent company/group companies.

8.1.2 Promoting export/import from/to India.

8.1.3 Promoting technical/financial collaborations between parent/group companies and companies in India.

8.1.4 Acting as a communication channel between the parent company and Indian companies.

8.2 Branch Offices

Normally, the Branch Office should be engaged in the activity in which the parent company is engaged.

8.2.1 Export / Import of goods.

8.2.2 Rendering professional or consultancy services.

8.2.3 Carrying out research work, in areas in which the parent company is engaged.

8.2.4 Promoting technical or financial collaborations between Indian companies and parent or overseas group company.

8.2.5 Representing the parent company in India and acting as buying/selling agent in India.

8.2.6 Rendering services in information technology and development of software in India.

8.2.7 Rendering technical support to the products supplied by parent/group companies.

8.2.8 Foreign airline/shipping company.

Activities not permitted for Branch office:

8.2.9 Retail trading activities of any nature is not allowed for a Branch Office in India.

8.2.10 A Branch Office is not allowed to carry out manufacturing or processing activities in India, directly or indirectly

8.3 Project Office

8.3.1 To execute a contract/project in India secured from an Indian company and activities related to execution of the project.

8.3.2 To render service during the warranty period and after sales service as per the Contract terms.

9. Opening of Bank Account

Liaison offices

LO may open an account with the designated AD category-I Bank in India for receiving remittances from its Head Office outside India. It may be noted that LO shall not maintain more than one bank account at any

given time without the prior permission of Reserve Bank of India. The permitted Credits and Debits to the account shall be:

9.1 Credits

9.1.1 Funds received from Head Office through normal banking channels for meeting the expenses of the office.

9.1.2 Refund of security deposits paid from LO's account or paid directly by the Head Office through normal banking channels.

9.1.3 Refund of taxes, duties etc., paid from LO's bank account.

9.1.4 Sale proceeds of assets of the LO.

9.2 Debits

9.2.1 Only for meeting the local expenses of the office.

Branch offices

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

Project offices

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

9.4 AD bank can open non-interest bearing Foreign Currency Account for PO in India subject to the following:

9.4.1 The PO has been established in India, with General/Specific permission of RBI, having the requisite approval from the concerned Project Sanctioning Authority.

9.4.2 The contract governing the project specifically provides for payment in foreign currency.

9.4.3 Each PO can open 2 Foreign Currency Accounts – usually one denominated in USD and the other one in home currency provided both are maintained with the same AD bank.

9.4.4 The permissible debits to the account shall be payment of project related expenditure and credits shall be foreign currency receipts from the Project Sanctioning Authority and remittances from parent company/group Company abroad or bilateral/multilateral international financing agency.

9.4.5 AD bank shall ensure that only approved debits and credits are allowed in the foreign currency account. Further, the accounts shall be subject to 100 per cent scrutiny by the Concurrent Auditor of the respective Bank.

9.4.6 The foreign currency accounts have to be closed at the completion of the Project.

9.4.7 Each PO is required to transact through one designated AD bank only who shall be responsible for the due diligence and KYC norms of the PO. PO, present in multiple locations, is required to transact through their designated AD.

10. Term deposit account by Branch/Liaison/Project Office

AD Category-I bank can allow term deposit account for a period not exceeding 6 months in favour of a BO/LO/PO provided the bank is satisfied that the term deposit is out of temporary surplus funds and the BO/LO/PO furnishes an undertaking that

the maturity proceeds of the term deposit will be utilised for their business in India within 3 months of maturity. However, such facility may not be extended to shipping/ airline companies.

11. Validity & extension

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

The validity period of the project office is for tenure of the project.

There is no such validity period for Branch offices.

12. Intermittent Remittances by Project Office

12.1 AD bank can permit intermittent remittances by Project Offices pending winding up/completion of the project provided they are satisfied with the bona fides of the transaction, subject to the following:

12.1.1 The Project Office submits an Auditors'/Chartered Accountants' Certificate to the effect that sufficient provisions have been made to meet the liabilities in India including Income Tax, etc.

12.1.2 An undertaking from the Project Office that the remittance will not, in any way, affect the completion of the Project in India and that any shortfall of funds for meeting any liability in India will be met by inward remittance from abroad.

12.2 Inter-Project transfer of funds requires prior permission of RBI under whose jurisdiction the PO is situated.

13. Reporting Requirements

13.1 Reporting to AD Category – I Bank

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

a. In case of a sole BO/ LO, by the BO/ LO concerned;

b. In case of multiple BOs/LOs, a combined AAC in respect of all the offices in India by the nodal office of the BOs/LOs.

c. Project offices – Showing Project Status and certifying that the accounts of the Project Office have been audited and the activities undertaken are in conformity with the General/Specific permission by RBI

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

13.2 Reporting to Director General of Police (DGP)

13.2.1 As per A.P. (DIR Series) Circular No. 35 dated 25th September, 2012, BO/LO/PO shall submit a report containing information as per Annex within five working days of the BO/LO/PO becoming functional to the DGP of the state concerned in which BO/LO/PO has established its office; if there are more

than one office of such a foreign entity, in such cases to each of the DGP concerned of the State where it has established office in India;

13.2.2 A copy of the report with the DGP concerned on an annual basis along with a copy of the AAC/Annual Report submitted to the AD bank.

13.2.3 A copy of report thus filed as above shall also be filed with AD bank by BO/LO/PO concerned.

13.3 Annual Compliances under the Companies Act, 2013

13.3.1 The Company has to file, within a period of sixty days from the last day of its financial year, annual return in Form FC-4.

13.3.2 Similarly, the financial statements along with list of places of business in India and global reports have to be filed in Form FC-3.

13.4 Filing of Form 49C with Income Tax Department

13.4.1 As per Section 285 of Income-tax Act, 1961 read with rule 114DA every liaison office in India shall, file a statement in Form 49C within sixty days from the end of financial year.

13.5 Income tax return filing

13.5.1 LO/BO/PO is required to furnish return of its income on or before 30th September each year.

14. Acquisition and Transfer of Immovable Property

14.1 As per Master Direction No. 12/2015-16 dated January 1, 2016 which governs Acquisition and transfer of Immovable property under FEMA Act, 1999, PO can acquire any immovable property in India for their own use only for permitted/incidental activities subject to filing of declaration in Form IPI within 90 days from the date of such acquisition.

14.2 As per Section 6(3) (h) of the FEMA Act, 1999, all POs have general permission to carry out permitted/incidental activities from lease property subject to lease period not exceeding five years.

14.3 Prior approval of RBI is required by PO for acquisition of immovable property in any other mode, other than one mentioned above.

14.4 Prior RBI permission is required for entities of Pakistan, Bangladesh, Sri Lanka, Afghanistan, China, Iran, Nepal, Bhutan Hong Kong and Macau whether resident in/outside India, to acquire/transfer immovable property in India. Such restriction is not applicable where immovable property taken on lease for period not exceeding 5 years.

14.5 Such acquired property can be transferred by way of mortgage to an AD bank as a security for any borrowings.

14.6 Sale/transfer of property by PO requires prior approval of the Central Office of the Foreign Exchange Department, RBI.

14.7 Subject to certain other conditions, remittance of funds on sale/transfer of property is allowed after paying all applicable taxes in India.

15. Other general conditions for Branch Office

15.1 Branch Offices of a foreign entity are permitted to acquire immovable property by way of purchase for their own use and to carry out permitted/incidental activities.

However, entities from Pakistan, Bangladesh, Sri Lanka, Afghanistan, Iran, Hong Kong, Macau, Nepal, Bhutan or China are not allowed to acquire immovable property in

India for a Branch Office without prior RBI approval.

15.2 Branch Offices are permitted to remit outside India profit of the branch net of applicable Indian taxes, on production of the following documents to the satisfaction of the Authorised Dealer through whom the remittance is effected.

15.2.1 A Certified copy of the audited Balance Sheet and Profit and Loss account for the relevant year

15.2.2 A Chartered Accountant's certificate certifying:

a. The manner of arriving at the remittable profit

b. That the entire remittable profit has been earned by undertaking the permitted activities

c. That the profit does not include any profit on revaluation of the assets of the branch.

16. Winding up/Closure of Branch/ Liaison/Project Offices

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

16.1 Copy of the RBI approval for establishing the BO/LO/PO.

16.2 Auditor's certificate :

16.2.1 Indicating the manner in which the remittable amount has been arrived at and supported by a statement of assets and liabilities of the applicant and indicating the manner of disposal of assets;

16.2.2 Confirming that all liabilities in India including arrears of gratuity and other benefits to employees, etc. of the office have been either fully met or adequately provided for; and

16.2.3 Confirming that no income accruing from sources outside India (including proceeds of exports) has remained un repatriated to India.

16.3 Confirmation from the applicant/ parent company that no legal proceedings in any Court in India are pending and there is no legal impediment to the remittance.

16.4 A report from the Registrar of Companies regarding compliance with the provisions of the Companies Act, 2013, in case of winding up of the Office in India.

16.5 Any other documents, specified by RBI/AD Category-I bank while granting approval.

> "The great secret of true success, of true happiness, is this: the man or woman who asks for no return, the perfectly unselfish person, is the most successful."
>
> **• Swami Vivekananda**

CA Nirav Panchmia

Investments by FVCI and Investments in AIF & REITs by Foreign Investors under FEMA

1. Regulatory overview

1.1 Foreign investment in Indian securities is regulated by the FEMA through which, the Government of India exercises its policy with respect to foreign investment in India and all dealings by residents of India with non-residents and with foreign currency.

1.2 As per section 6(3)(b) of FEMA, the RBI has been given the authority to prohibit, restrict or regulate the transfer or issue of any Indian security by a person outside India. Accordingly, the RBI has prescribed the Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2000 (Notification No. FEMA 20/2000-RB dated 3rd May, 2000) pursuant to which no person resident outside India and no company that is not incorporated in India (other than a banking company) can purchase the shares of any company carrying on any trading, commercial or industrial activity in India without the general or special permission of the RBI. Various Schedules to FEMA 20 permit foreign investments through different routes based on the nature and extent of the foreign investment and the category of foreign investor.

1.3 The Government has been pro-active in making various policy reforms focusing on ease of doing business in India and increase in a flow of the foreign investment in India. The regulatory regime is being streamlined with relaxation of pricing norms for foreign investment in India, rationalisation of foreign portfolio investment policy, liberalisation of investments caps and conditions, proposal to allow investment in different kinds of Investment Vehicles under automatic route, etc. The scope of this article is to discuss the regulatory framework under FEMA that is applicable to foreign investments in the Investment Funds industry in India.

2. Background to the Venture and Alternative Funds Industry

2.1 Before the emergence of the Venture Fund industry in India, entrepreneurs largely depended on private & family sources, public issues and lending by financial institutions for raising capital. However, these were not optimal means of raising funds. The economic liberalization of the economy from the 1990s led to the awareness and introduction of international practices of Venture Capital and Private Equity funds as an attractive source of capital.

2.2 Following the introduction of the Securities and Exchange Board of India (Venture Capital Funds) Regulations ("VCF Regulations") in 1996 and the SEBI (Foreign Venture Capital Investors) Regulations in 2000, ("FVCI Regulations"), the Venture Fund industry got a formal structure and recognition which enabled it to successfully fill the gap between capital requirements of fast-growing companies and funding available from traditional sources such as banks, IPOs, etc.

2.3 Subsequently, in 2012, SEBI took steps to completely overhaul the regulatory framework

for domestic funds in India and introduced the Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012 ("AIF Regulations"). Among the main reasons cited by SEBI to highlight its rationale behind introducing the AIF Regulations are to recognise AIFs as a distinct asset class; promote start-ups and early stage companies; to permit fund investment strategies in the secondary markets; and to tie concessions and incentives to investment restrictions.

2.4 The AIF Regulations recognises the needs of every type of private pooling vehicle so that such funds are channelled in the desired space in a regulated manner without posing a systemic risk. AIF Regulations replaced the VCF Regulations. Funds registered under the VCF Regulations shall continue to be regulated by the said regulations till the existing fund or scheme is wound up.

2.5 AIF means any fund established in India in the form of a trust, company, limited liability partnership or a body corporate which:

(i) is a privately pooled investment vehicle that collects funds from investors, whether Indian or foreign, for investing it in accordance with a defined investment policy for the benefit of its investors; and

(ii) is not covered under the SEBI (Mutual Funds) Regulations, 1996, SEBI (Collective Investment Schemes) Regulations, 1999 or any other regulations of SEBI, which aims to regulate fund management activities.

3. Different kinds of Investment Funds

3.1 SEBI has classified AIF into the following broad categories into which investors, both domestic and foreign, may invest:

Category I AIF: Funds which invest in start-ups, early stage ventures, social ventures, infrastructure or other sectors which the Government or regulators consider as socially or economically desirable will qualify as Category I AIFs. These funds are generally perceived to have positive spillover effects on the economy and for which the SEBI or the Government might consider providing incentives or concessions. This category includes Venture capital funds, SME funds, social venture funds, infrastructure funds and such other AIFs as may be prescribed.

Category II AIF: These are Funds which cannot be categorized as Category I or Category III AIF. These funds do not undertake leverage or borrowing other than to meet the permitted day-to-day operational requirement s. Private Equity Funds or Debt Funds for which no specific incentives or concessions are given by the Government of India or any other regulator are included in the Category II AIF classification.

Category III AIF: Funds that employ diverse or complex trading strategies and may employ leverage including through investment in listed or unlisted derivatives are included in this category. Hedge Funds or funds which trade with a view to make short-term returns are included in the Category III AIF classification.

3.2 Investment conditions and restrictions for investment in all categories of AIFs:

AIF can raise funds through private placement by the issue of placement Memorandum. AIF will be required to state its investment purpose, investment strategy and its investment methodology in its placement Memorandum to the investors. Any material change in the fund strategy shall require consent of at least two-thirds of unit holders by value.

General conditions and restrictions for investment in all categories of AIF:

- The AIF may raise funds from any investor whether Indian, foreign or non-resident Indians by way of issue of units;
- Each scheme of the Alternative Investment Fund shall have corpus of at least twenty crore rupees;
- The minimum investment by each investor shall be one crore rupees.
- The Manager or Sponsor shall have a continuing interest in the Alternative Investment Fund of not less than two and half per cent of the corpus or five crore rupees, whichever is lower, in the form of investment in the Alternative Investment Fund and such interest shall not be through the waiver of management fees. For Category III AIF, the continuing interest shall be not

less than five per cent of the corpus or ten crore rupees, whichever is lower.

- Any scheme of AIF shall not have more than 1,000 investors.

3.3 The comparison between Categories I, II and III AIFs is given in table below:

Particulars	Category I AIF	Category II AIF	Category III AIF
Concept	Funds which invest in start-ups, early stage ventures, Social Ventures, SMEs, infrastructure or other sectors which the Government or regulators consider as socially or economically desirable sectors	Funds that do not fall in Categories I and III AIF	Funds that employ diverse or complex trading strategies and may employ leverage including through investment in listed or unlisted derivatives
Types of funds	Venture capital funds, SME funds, social venture funds, infrastructure funds and such other AIFs as may be prescribed	Private Equity Funds, Debt funds	Hedge Funds or Funds which trade with a view to make short-term returns
Tenure	Can only be close ended fund with a minimum tenure of 3 years. Extension of tenure permitted up to 2 years subject to approval of 2/3rd of the unit holders of value	Same as Category I	Can be open ended or close ended
Investee entity	Shall invest in investee companies or venture capital undertakings or in special purpose vehicles or in limited liability partnerships or in units of other AIFs specified in the Regulations	Shall invest primarily in unlisted investee companies or in units of other AIFs as may be specified in the placement memorandum	Shall invest in securities of listed or unlisted investee companies or derivatives or complex or structured products
Investment in other AIFs	• May invest in units of Category I AIF of same sub-category • Investment in Fund of funds not permitted	• May invest in units of Category I or II AIF • Investment in Fund of Funds not permitted	• May invest in units of Category I or II AIF • Investment in Fund of funds not permitted
Leverage	Cannot borrow or leverage directly or indirectly except for meeting temporary funding requirements for: • Maximum 30 days • Maximum 4 occasions in a year • Maximum 10% of investible funds	Cannot borrow or leverage directly or indirectly except for meeting temporary funding requirements for: • Maximum 30 days • Maximum 4 occasions in a year • Maximum 10% of investible funds	Can borrow or leverage subject to consent from investors and limit specified by SEBI
Key investment restrictions	Cannot invest more than 25% of the investible funds in one investee company	Same as Category I	Cannot invest more than 10% of the investible funds in one investee company

3.4 Infrastructure Investment Trusts ('InvITs')

InvIT means a trust registered under the SEBI (InvIT) Regulations, 2014 which may raise capital through units issued inter alia under private placement and/or initial/follow on offer. The InvIT shall invest in infrastructure projects, either directly or through a Special Purpose Vehicle (SPV), in accordance with stipulated conditions in the said SEBI Regulations.

3.5 Real Estate Investment Trust ('REIT'):

REIT means a trust registered under the SEBI (REIT) Regulations, 2014 which owns and manages income generating developed properties and offers its unit to public investors. REITs typically offer regular yields coupled with capital appreciation and typically caters to the retail investors. The REIT shall invest in Real Estate assets in accordance with stipulated conditions in the said SEBI Regulations.

4. Regulatory framework for inbound foreign investments

4.1 Inbound foreign investment is regulated under Notification FEMA 20. The prominent investment routes for the offshore fund / investor are as follows:

i. Foreign Direct Investments (FDI); (Regulation 5(1) and Schedule 1 of FEMA 20)

ii. Foreign Portfolio Investment route for SEBI registered Foreign Portfolio Investors (FPI); (Regulation 5(2A) and Schedule 2A of FEMA 20)

iii. Foreign Venture Capital Investment route for SEBI registered Foreign Venture Capital Investors (FVCI); (Regulation 5(5) and Schedule 6 of FEMA 20)

iv. Investment by Persons Resident Outside India ("PROI") in an Investment Vehicle (Regulation 5(10) and Schedule 11 of FEMA 20)

The inbound regulations under FEMA 20 are framed and regulated by the Reserve Bank of India ('RBI') and the Department of Industrial Policy and Promotion ("DIPP"). In addition to this, it is also important to keep in view the regulations framed by the SEBI for FVCI and FPI.

5. Key aspects of the inbound regulations under FEMA 20 and the SEBI Regulations under each of the above investment routes

5.1 FDI Route under Schedule I of FEMA 20 and the FDI Policy

As per the FDI Policy, Investments can be made by non-residents in the equity shares/ fully, compulsorily and mandatorily convertible debentures/fully, compulsorily and mandatorily convertible preference shares of an Indian company, through the Automatic Route or the Government Route. Under the Automatic Route, the non-resident investor or the Indian company does not require any approval from Government of India for the investment. Under the Government Route, prior approval of the Government of India is required.

Investments can be made by non-residents in the capital of a resident entity only to the extent of the percentage of the total capital as specified in the FDI policy. The caps in various sector(s) as well as the entry route are detailed in Chapter 6 of the Consolidated FDI Policy. In sectors/activities not listed therein, FDI is permitted up to 100% under the automatic route, subject to applicable laws/ regulations, security and other conditionalities.

The detailed stipulations under FDI route have been covered elsewhere in this Publication. Therefore, we shall limit our discussions in this Article to the key considerations relating to foreign investment by offshore funds in Investment funds/ vehicles which have an important bearing on the suitability of investments in AIFs under FDI route i.e. under Schedule I of FEMA 20.

5.1.1 Important issues to be kept in view are as under:

i. Most of the domestic pooling structures (AIF) is evolved in the form of Trust due to the operational flexibility. Under the FDI regime, foreign investment into trust is subject to the FIPB approval. In the past, FIPB has granted approval for such investment that qualify with the condition of compliance with downstream conditions as applicable under FDI regime, irrespective of whether AIF being owned and controlled by Indian resident.

ii. Further, the repatriation of investment proceeds from AIF to the Offshore Fund/investor may also require the RBI approval.

iii. Foreign investment into LLP is not permitted to FVCI, RFPI, FII, etc. Therefore, foreign investment by such entities into domestic fund which is formed as LLP may not be workable option.

iv. Foreign investment into an Indian company, engaged only in the activity of investing in the capital of other Indian companies also require prior FIPB approval.

v. There is an ambiguity whether the investment management activities undertaken by an AIF manager are the asset management activities (which are subject to higher minimum capitalisation norms) or it should qualify as Investment Advisory Services which is non-fund based activity and accordingly, should require the minimum capitalisation of USD 0.5 mn only.

vi. Assured return and creation of securities is not permissible under FDI route.

   a. In case of Tata Docomo, the RBI rejected Docomo exit at pre-agreed price which was higher than the fair market value as on date.

   b. In case of Hubtown Ltd. the Bombay High court has made an observation that the transaction of routing the FDI through a newly interposed company was a colourable device and was structured to secure repayment of FDI amount and return thereon.

In view of the above, given the customisation requirements of investments in alternative funds and stringent rules regulating the relationship between the investee company and the foreign investor, the FDI route may not work out as an optimal method.

5.2 Foreign Portfolio Investor ('FPI') route

On January 7, 2014, SEBI introduced the SEBI (Foreign Portfolio Investment) Regulation, 2014 ("FPI Regulations"). Under the FPI regime, SEBI has merged foreign institutional investors ("FIIs"), sub-accounts and qualified foreign investors ("QFIs") regimes into a single investor class – foreign portfolio investors ("FPIs"). SEBI approved Designated Depository Participants ('DDPs') shall register Foreign Portfolio Investor ('FPI') on behalf of SEBI subject to compliance with know your client ('KYC') requirements.

5.2.2 FPIs have been classified under three categories as below:

i. "Category I FPI" which shall include Government and Government related foreign investors etc.;

ii. "Category II FPI" which shall include appropriately regulated broad based funds, appropriately regulated entities, broad-based funds whose investment manager is appropriately regulated, university funds, university related endowments, pension funds etc.; and

iii. "Category III FPI" which shall include all others not eligible under Categories I and II FPI such as individuals other than NRIs, corporates, etc. However, NRIs can be registered as investment manager or sponsor if it is not investing proprietary funds in Indian markets.

The FPI regulations provide that investment in the issued capital of a single company by a single FPI or an investor group shall be below 10% of the total issued capital and of the company. As per investment conditions under the SEBI FPI regulations, FPI can make investment in shares, debentures and warrants of companies, listed or to be listed on a recognized stock exchange in India.

5.2.3 Key considerations in the Offshore fund context:

i. Depending on the facts of the case, the Offshore Fund qualifies for registration as Category II or III FPI. As per the SEBI FPI Regulations and the FAQs issued by SEBI, FPI can invest only in listed or to be listed shares or debentures of the companies. Accordingly, investment in unlisted shares and debenture (other than debenture issued by Infrastructure Company) would not be permissible.

ii. The Offshore Fund may choose to invest under the FPI route where the investment is in listed company for stake up to 10% and there are regulatory hurdles for investment under the FDI route such as sectorial

restriction e.g. Retail trading where conditionalities of local sourcing apply; Construction activities where lock-in conditions of three years apply; NBFCs where conditions of minimum capitalization apply, etc. Further, any income earned by FPIs from purchase and sale of securities is considered as capital gains. So there is no risk of characterization of income earned by FPIs being treated as business income.

iii. The FDI route does not permit investment in debt instruments of Indian companies. The offshore fund may use the FPI route to make investment in Indian company by way of listed debt where there are regulatory hurdles for investment under FDI route such as sectorial restriction, pricing norms, etc. if debt instrument in the form of CCDs or other quasi equity instruments are considered.

iv. While AIFs are essentially formed as Indian entities, FPIs are always foreign entities registered with SEBI investing in Indian operating ventures or AIFs.

5.3 Foreign Venture Capital Investment ('FVCI') route ('FVCI') route:

SEBI (Foreign Venture Capital Investors) Regulations, 2000 makes it mandatory for an offshore fund to register itself with SEBI. The SEBI in turn seeks the RBI approval for granting the FVCI registration. FVCIs can invest directly into eligible Indian portfolio companies subject to compliance with certain investment conditions and restrictions as stipulated under the FVCI Regulations and the Indian exchange controls.

The term "VCU" has been defined to mean a domestic company whose shares are not listed in India at the time of making investment and which is engaged in a business for providing services, production or manufacture of article or things which do not include certain specified activities or sectors such as NBFCs, etc.

5.3.1 The investment conditions and restrictions as laid down under the SEBI FVCI Regulations are summarized herein below:

i. An FVCI is required to designate its investible funds for investment into India at the time of seeking registration. Accordingly, the investment conditions and restrictions would be applicable with respect to such investible funds.

ii. The investment restrictions on FVCI are required to be achieved by the end of its life cycle.

iii. An FVCI is required to invest at least 66.67% of its investible funds in unlisted equity shares or equity linked instruments (i.e. instruments convertible into equity shares or share warrants, preference shares, debentures compulsorily or optionally convertible into equity) of a VCU.

iv. An FVCI may invest up to 33.33% of its investible funds:

- by way of subscription to an initial public offering ("IPO") of a VCU whose shares are proposed to be listed on a recognized stock exchange;
- in debt/debt instruments of a VCU in which the FVCI has already made an investment by way of equity;
- preferential allotment of equity shares of a listed company subject to lock in period of one year;
- the equity shares or equity linked instruments of a financially weak company (i.e. a company which has at the end of the previous financial year accumulated losses, which has resulted in erosion of more than 50% but less than 100% of its net worth as at the beginning of the previous financial year) or a

sick industrial company whose shares are listed; and

- special purpose vehicles which are created by a FVCI for the purposes of facilitating or promoting investment in accordance with the FVCI Regulations.

5.3.2 Recently, *vide* Ntf. No. 363 dated 28-4-2016, RBI has made amendments to FEMA 20 relating to investments in startups and replaced Schedule 6 of FEMA 20 relating to investments by a registered FVCI to align the provisions with the new impetus being given to startups. These amendments have introduced the definition of "start-up" and allowed FVCIs to invest in such startups irrespective of the sector in which such start-up operates. Further, these amendments have done away with the requirement earlier imposed on FVCIs to take prior approval from RBI for making FVCI investments and opening a foreign currency account and / or a rupee account with an authorised dealer bank. The amended regulations also contain an explicit provision on transfer of investments by FVCIs to residents or non-residents.

5.3.3 As specified in Schedule 6 to FEMA 20, a Foreign Venture Capital Investor (FVCI) registered under the SEBI (FVCI) Regulations, 2000, may purchase:

(a) equity or equity linked instruments or debt instruments, issued by an Indian company engaged in any sector mentioned at Annex to the Schedule and whose shares are not listed on a recognised stock exchange at the time of issue of the said securities / instruments;

(b) equity or equity linked instruments or debt instruments issued by a startup, irrespective of the sector in which it is engaged;

(c) units of a Venture Capital Fund (VCF) or of a Category I Alternative Investment Fund (Cat-I AIF) or units of a scheme or of a fund set up by a VCF or by a Cat-I AIF;

subject to the terms and conditions as may be laid down by the Reserve Bank.

A registered FVCI may purchase the securities / instruments mentioned above either from the issuer of these securities / instruments or from any person holding these securities / instruments or on a recognized stock exchange.

The FVCI may acquire, by purchase or otherwise, from, or transfer, by sale or otherwise, to, any person resident or non-resident, any security / instrument it is allowed to invest in, at a price that is mutually acceptable to the buyer and the seller/ issuer. The FVCI may also receive the proceeds of the liquidation of VCFs or of Cat-I AIFs or of schemes/funds set up by the VCFs or Cat-I AIFs.

List of sectors in which a Foreign Venture Capital Investor is allowed to invest:

1. Biotechnology
2. IT related to hardware and software development
3. Nanotechnology
4. Seed research and development
5. Research and development of new chemical entities in pharmaceutical sector
6. Dairy industry
7. Poultry industry
8. Production of bio-fuels
9. Hotel-cum-convention centres with seating capacity of more than three thousand.
10. Infrastructure sector. (This will include activities included within the scope of the definition of infrastructure under the External Commercial Borrowing guidelines/ policies notified under the extant FEMA Regulations as amended from time to time)

It should be noted that RBI in the past has generally given its consent for FVCI investments only in the aforesaid incentivised industries. For investments in other industries, the FDI route under Schedule I or through AIFs under Schedule 11 of FEMA 20 is available.

5.3.4 FVCIs enjoy certain regulatory advantage over FDI route as mentioned below:

- The pricing norms applicable to FDI route do not apply to FVCIs. Accordingly, FVCI can subscribe, purchase or sell securities at any price subject to other applicable law.
- Apart from investment into Equity, CCPS and CCD, FVCI can also invest into optionally convertible redeemable preference shares (OCRPS) and optionally convertible debentures (OCDs).
- Possible to invest in debt securities such as non-convertible debentures. ECB norms should not apply for investment in debt/optionally convertible instruments
- One year lock-in applicable to shares (under the SEBI ICDS Regulations) do not apply to shares held by FVCI if shares are held for at least one year before IPO. This enables FVCI to exit immediately post listing.
- The transfer of listed shares from FVCIs to promoters is exempt from public offer provisions under the SEBI takeover regulations.

5.4 Investment by PROI in Investment Vehicle:

5.4.1 RBI has made amendments to FEMA 20 *vide* Ntf. No. 355 dated 16-11-2015 relating to investments by PROI in Investment Vehicle and has introduced new Schedule 11 relating to such investments.

5.4.2 According to these amendments, FPIs and NRIs can also invest in the units of an investment vehicle under the automatic route; where -

"Investment vehicle" shall mean an entity registered and regulated under the relevant regulations framed by SEBI or any other authority designated for the purpose and shall include Real Estate Investment Trusts ("REIT") governed by the SEBI (REITs) Regulations, 2014, Infrastructure Investment Trusts ("InvIts") governed by the SEBI (InvIts) Regulations, 2014 and Alternative Investment Funds governed by the SEBI (AIFs) Regulations, 2012; and

"Unit" shall mean beneficial interest of an investor in the investment vehicle (as defined above) and shall include shares or partnership interests.

5.4.3 The above notification classifies downstream investment by an AIF as foreign investment if neither the Sponsor nor the Manager nor the Investment Manager is Indian 'owned and controlled' as defined in Regulation 14 of the principal Regulations. Prior to the amendment, foreign investments in AIFs required a specific approval from the FIPB and the downstream investments by such AIFs were also governed by the FDI Policy.

Downstream investment by an Investment Vehicle that is reckoned as foreign investment shall have to conform to the sectoral caps and conditions / restrictions, if any, as applicable to the company in which the downstream investment is made as per the FDI Policy or Schedule 1 of the principal Regulations.

However, these amendments seemed to prohibit LLPs from acting as the sponsor or manager to an AIF. Subsequently, by another Notification No. 362 dated 15-2-2016 ("February Notification") 12, RBI has clarified the position by permitting LLPs to act as the sponsor or manager of an AIF if they are Indian "owned and controlled". As per the new notification, an LLP shall be considered to be Indian "owned and controlled" if:-

a. More than 50% of the investment in such an LLP is contributed by resident Indian citizens and/or entities which are ultimately "owned and controlled" by resident Indian citizens; and

b. Such residents have a majority of the profit share. Further, the new notification also states that for the purposes of an LLP, "control" shall mean the right to appoint majority of designated partners, where such designated partners, with specific exclusion to others, have control over all the policies of the LLP.

5.4.5 The significance of new Schedule 11 is that it introduces a framework to permit FPIs & NRIs to invest in AIFs which they were unable to do under Schedule 2/2A and Schedule 3 respectively.

6. Comparative routes and conclusion:

6.1 From the above discussions, one can conclude that a foreign offshore fund has a number of alternatives available to it when seeking to invest in India. Its eligibility under a particular route and the benefits or restrictions depends on a number of factors such as the nature of the investor (whether FPI Category I, II or III), the nature of the investment (listed / unlisted or in AIF), the legal structure of the investee (company, trust, LLP), instrument used for entry (equity, CCDs, NCD, Units of AIF), etc.

It may be noted that now with new Schedule 11 on Investment Vehicles, NRIs have more than one route to invest into listed equity and debt instruments namely Schedule 3 for listed equity and Schedule 11 for both the instruments except indirectly through mutual funds under Schedule 5. It should also be noted that it is not possible for any of the categories of FPI to register NRIs as overseas client including as OCBs.

The following summary is aimed at bringing clarity to the matter and assist in choosing the appropriate route for entry by an offshore fund.

6.2 Comparison between FDI, FVCI and FPI routes of investment:

Parameters	FDI	FPI	FVCI
Investment in unlisted shares & debentures	Permissible	Not Permissible (except debenture of infrastructure company)	Permissible
Investment in listed securities	Can be acquired on private placement basis Secondary acquisition can be only through an off-market deal	Permissible to acquire on market	Permissible to acquire on market
Investment in debt instruments	Possible to invest in CCDs	Can invest in debt instruments with minimum residual maturity of three years	Can invest in debt instruments such as OCDs and NCDs
Foreign investment limits	Possible to acquire up to 100% stake in an investee company, subject to sectoral caps, if any	Investment in the issued capital of a single company by a single FPI or an investor group shall be below 10% of the total issued capital of the company	Possible to acquire up to 100% stake in an investee company, subject to sector restriction for FVCI and applicable Investment guidelines
Pricing	Pricing guidelines need to be adhered, while making investment and also on transfer of shares of investee companies	Pricing guidelines do not apply	Pricing guidelines do not apply
Pre-IPO lock-in exemption under SEBI ICDS regulation	Not available	Not available	Pre-IPO shares not subject to 1 year lock-in if shares held by FVCI for at least 1 year before IPO
Investment vehicle in India	Company and LLP	No investment vehicle required in India unless FPI invests through AIF which could be a company, trust, LLP	No investment vehicle required in India. FVCI can directly invest in VCU i.e. operating company
NRIs or PIO as investor	Available	Not available except registration as Asset Manager or Investment Manager or Advisor without investment	Available
Downstream investment guidelines	Apply	Apply if investing into investment vehicle	Not applicable

This article has useful contributions from CA Bhavin Shah and CA Paresh P. Shah

C. B. Thakar, *Advocate*

HOT SPOT

Applicability of MVAT on works contract transactions involving barter with special thrust on MSTT decision in the case of M/s Sumer Corporation vs State of Maharashtra

Introduction

Under Sales Tax Laws, the transactions of 'sale' are liable to tax. The transaction of 'sale' is to be understood as per Sale of Goods Act, as held by Hon'ble Supreme Court in case of **Gannon Dunkerley & Co. (9 STC 353)(SC)**. In this case Hon'ble Supreme Court has interpreted the term 'sale' and has held that the transaction to be a sale, it should fulfil the minimum criteria as laid down in Sale of Goods Act. In fact, Hon'ble Supreme Court has observed as under in relation to transaction of sale.

"We then come to the Indian Sale of Goods Act, 1930, which repealed Ch. VII of the Indian Contract Act relating to sale of goods, and S. 4 thereof is practically in the same terms as S. 1 of the English Act. ***Thus, according to the law both of England and of India, in order to constitute a sale it is necessary that there should be an agreement between the parties for the purpose of transferring title to goods which of course presupposes capacity to contract, that it must be supported by money consideration, and that as a result of the transaction property must actually pass in the goods. Unless all these elements are present, there can be no sale.*** *Thus, if merely titles to the goods passes but not as a result of any contract between the parties, express or implied, there is no sale. So also if the consideration for the transfer was not money but other valuable consideration, it may then be exchange or barter but not a sale. And if under the contract of sale, title to the goods has not passed, then there is an agreement to sell and not a completed sale."*

From above passage it is clear that to be a 'sale' following criteria should be fulfilled.

(i) There should be two parties to contract i.e. seller/purchaser,

(ii) The subject matter of sale is movable goods,

(iii) There must be money consideration and

(iv) Transfer of property i.e. transfer of ownership from seller to purchaser.

Deemed sale by way of works contract

By 46th Amendment to the Constitution, the deemed sales were introduced which can be taxed under Sales Tax laws. One of the deemed sales is 'works contract' which has been introduced by Article 366(29A)(b) in the Constitution.

A question arose as to whether the whole works contract price is liable to tax or only value relating to the goods. While analysing the taxability of

above deemed sale category of works contract, Hon'ble Supreme Court in case of **Builders Association of India (73 STC 370)(SC)** stated as under.

*"It is true that in the **State of Madras vs. Gannon Dunkerley & Co. (Madras) Ltd. [1959] 1 SCR 379 (supra)** this Court held that a works contract was an indivisible contract and the turnover of the goods used in the execution of the works contract could not, therefore, become exigible to sales-tax. It was in order to overcome the effect of the said decision Parliament amended Article 366 by introducing sub-clause (b) of Clause (29-A). Sub-clause (b) of clause (29-A) states that "tax on the sale or purchase of goods" includes among other things a tax on the transfer of property in the goods (whether as goods or in some other form) involved in the execution of a works contract. It does not say that a tax on the sale or purchase of goods included a tax on the amount paid for the execution of a works contract. It refers to a tax on the transfer of property in goods (whether as goods or in some other form) involved in the execution of a works contract. The emphasis is on the transfer of property in goods (whether as goods or in some other form). The latter part of clause (29-A) of Article 366 of the Constitution makes the position very clear. While referring to the transfer, delivery or supply of any goods that takes place as per sub-clauses (a) to (f) of clause (29-A,) the latter part of clause (29-A) says that "such transfer, delivery or supply of any goods" shall be deemed to be a sale of those goods by the person making the transfer, deliver or supply and a purchase of those goods by the person to whom such transfer, delivery or supply is made. Hence, a transfer of property in goods under sub-clause (b) of clause (29-A) is deemed to be a sale of the goods involved in the execution of a works contract by the person making the transfer and a purchase of those goods by the person to whom such transfer is made. The object of the new definition introduced in clause (29-A) of Article 366 of the Constitution is, therefore, to enlarge the scope of "tax on the sale or purchase of goods" wherever it occurs in the Constitution so that it may include within its scope the transfer, delivery or supply of goods that may take place under any of the transactions referred to in sub-clauses (a) to (f) thereof wherever such transfer, delivery or supply becomes subject to levy of sales tax. So construed the expression "tax on the sale or purchase of goods" in entry 54 of the State List, therefore, includes a tax on the transfer of property in goods (whether as goods or in some other form) involved in the execution of a works contract also. The tax leviable by virtue of sub-clause (b) of clause (29-A) of Article 366 of the Constitution thus becomes subject to the same discipline to which any levy under entry 54 of the State List is made subject to under the Constitution.."*

It can be seen that works contract is nothing but composite transaction for supply of goods and for supply of services. By constitutional amendment the composite transaction is notionally divided between goods and services.

It is also clear that to the extent of supply of goods the nature and character of supply is at par with normal sale of goods. In other words, all the criteria as applicable to normal sale i.e. as discussed above in **Gannon Dunkerley & Co. (73 STC 370)(SC)** are equally applicable to this deemed sale under works contract.

Therefore, even under works contract also the transaction should be against money consideration and if it is against any other consideration in form of goods or property etc., it cannot be taxable transaction under Sales Tax laws, as it will not fall in the category of sale but in the category of barter or exchange.

Definition of 'sale' under MVAT Act, 2002

The definition of 'sale' in section 2(24) of MVAT Act, 2002 is as under:

"(24) "sale" means a sale of goods made within the State for cash or deferred payment or other valuable consideration but does not include a mortgage, hypothecation, charge or pledge; and the words "sell", "buy" and "purchase", with all their grammatical variations and cognate expressions, shall be construed accordingly;

Explanation,— For the purposes of this clause,—

(a) A sale within the State includes a sale determined to be inside the State in accordance with the principles formulated

in section 4 of the Central Sales Tax Act, 1956;

(b) (i) The transfer of property in any goods, otherwise than in pursuance of a contract, for cash, deferred payment or other valuable consideration;

(ii) The transfer of property in goods (whether as goods or in some other form) involved in the execution of a works contract including, an agreement for carrying out **for cash, deferred payment or other valuable consideration**, the building, construction, manufacture, processing, fabrication, erection, installation, fitting out, improvement, modification, repair or commissioning of any movable or immovable property...."

(emphasis given)

It can be seen that even under MVAT Act, 2002 the works contract transaction should be against cash/ deferred payment or other valuable consideration.

'Other valuable consideration'

The terminology/phrase/expression cash, *deferred payment or other valuable consideration* used in the aforesaid provisions have been dealt by the Hon'ble Supreme Court in the case of *M/s. Devi Dass Gopal Krishnan and Ors. vs. State of Punjab & Ors. (22 STC 430)(SC) ["Devi Dass"*]. In this case, the Hon'ble Apex Court was faced with the issue as to whether the term *'other valuable consideration'* will include consideration other than money. The Court held as follows:

"Bearing that in mind let us look at clause (ff) in section 2 of the principal Act in which the said clause was inserted. The ingredients of the definition of 'purchase' are as follows: (i) there shall be acquisitions of goods; (ii) the acquisition shall be for cash or deferred payment or other valuable consideration; (iii) the said valuable consideration shall not be other than under a mortgage, hypothecation, charge or pledge. Clause (h) of section 2 defines 'sale' thus:

'sale' means any transfer of property in goods other than goods specified in Schedule C for cash or deferred payment or other valuable consideration but does not include a mortgage, hypothecation, charge or pledge.

If we turn to the Sale of Goods Act, section 4 thereof defines a contract of sale of goods. It reads:

"A contract of sale of goods is a contract whereby the seller transfers or agrees to transfer the property in goods to the buyer for a price…."

The essential requisites of sale are (i) there shall be a transfer of property or agreement to transfer property by one party to another; and (ii) it shall be for consideration of money payment or promise thereof by the buyer. …

Now, coming to the expression 'price', it is no doubt defined in the Sale of Goods as 'money consideration'. Cash or deferred payment in clause (ff) of section 2 of the Act satisfies the said definition. The expression 'valuable consideration' has a wider connotation, but the said expression is also used in the same collocation in the definition of 'sale' in section 2(h) of the Act. The said expression must bear the same meaning in clause (ff) and clause (h) of section 2 of the Act. It may also be noticed that in most of the Sales Tax Acts the same three expressions are used. ***It has never be argued or decided that the said expression means other than monetary consideration. This consistent legislative practices cannot be ignored. The expression 'valuable consideration' takes colour from the preceding expression 'cash or deferred payment'****. If so, it can only mean some other monetary payment in the nature of cash or deferred payment. We, therefore, hold that clause (ff) of section 2 of the Act is not void for legislative incompetence."*

The above term 'other valuable consideration' in relation to Sales Tax laws is also considered by Kerala High Court in case of *M. Jaihind vs. State of Kerala (111 STC 374)(Ker)*. It is observed as under:

"The essence of a sale lies in the transfer of property "for cash or for deferred payment or for other valuable consideration". The definition of "sale" contained in the Kerala General Sales Tax Act, 1963 cannot be construed to include within its ambit those transactions which do not fall within

the definition of "sale" as contained in the Sale of Goods Act, 1930 and the definition in the Kerala General Sales Tax Act, must therefore be construed accordingly. Section 4 of the Sale of Goods Act defines "sale" as a transaction whereby there is transfer of property in goods to the buyer for a price. Section 2(10) of the Sale of Goods Act defines "price as money consideration for a sale of goods". Thus in order that a transaction may amount to a sale in accordance with the Sale of Goods Act, the consideration has to be money. The expression "cash or deferred payment or other valuable consideration" used in the definition of "sale" in section 2(xxi) of the Kerala General Sales Tax Act has to be construed to mean cash or some other monetary payment. The words "other valuable consideration", which occur in section 2(xxi) of the Act can be interpreted by rules of *ejusdem generis*, as the payment by cheque, bills of exchange or other negotiable instruments. The words "deferred payment or other valuable consideration" used in section 2(xxi) of the Kerala General Sales Tax Act merely enlarge the ambit of the consideration beyond cash, but do not carry it outside the scope of the term "money". If, the consideration is not money, but for other valuable consideration, it cannot then be a sale."

Thus, the other valuable consideration should also be in money terms like Bill of Exchange or Cheque etc..

Judgment in case of M/s Sumer Corporation (VAT SA No. 335 of 2015 dated 3-5-2016)

Hon'ble MST Tribunal had an occasion to decide one of the important issues in relation to alleged works contract transaction *vide* above judgment. In this case, the facts noted by the Tribunal are as under:

"2. Appellant contends that he is engaged in the business of construction of buildings and tenements for Slum Rehabilitation Authority (SRA). He was assessed by the Assistant Commissioner of Sales Tax, (INV-7), Investigation-A, Mumbai for the period 2006-07 under MVAT Act *vide* order dated 12-5-2014. It is alleged that in the said assessment, assessing authority levied tax on a transaction which is not a sale within the meaning of MVAT Act.

Appellant states that he has constructed buildings for SRA for which he did not receive any money consideration. No contract value in terms of money was fixed. According to him, as per agreement, he has received TDR (Transferable Development Rights), which he has sold and realised money out of that. He claims that the transaction was barter and cannot be taxed under MVAT Act.

He states that assessing authority assessed him as unregistered dealer (URD). He contends that the assessing authority has committed illegality by holding the sale value of TDR and proposed value of TDR as turnover and tax is calculated on the same. He states that TDR itself is not taxable under the MVAT Act. Hence, he contended that appeal be allowed."

Before Tribunal various arguments were made like:

a) The transaction is not against any agreed money consideration, therefore it cannot be within the definition of 'sale'.

b) The assessing authority has levied tax on the money amount received against the sale of TDR which were issued by SRA against transfer of land and constructed tenements. It was argued that TDR is immovable property or even if goods, they are intangible goods. It was further argued that the transaction will be barter, as against the construction material, appellant has received other goods in form of TDR.

c) It was also argued that as per settled law in case of *TISCO General Office Recreation Club vs. State of Bihar and Others (126 STC 547) (SC)*, sale price is required to be received from buyer and not from third party. The only situation in which the transaction would have become taxable had the money been received by the Petitioner from SRA. Since the tax is levied on the amount received from buyers of TDR, tax cannot be levied on the transaction with SRA.

d) It was also argued that even if on barter transaction, tax is to be levied, there is no method provided in the law to convert the goods received in money terms. Therefore, percentage prescribed for levy of tax cannot be applied. Judgment of Hon'ble Supreme Court in case of *Commissioner, Central Excise & Customs, Kerala vs. Larsen and Toubro Ltd. (84 VST 403)(SC)*, wherein Supreme Court has held that without mechanism to compute tax, no tax can be levied. Existence of such machinery (valuation rules) under Service Tax was also pointed out to Tribunal.

e) In addition, various analogous arguments were made including for interest and penalty.

On behalf of department, the main argument was that the judgments cited regarding barter are prior to Constitutional amendment and hence not applicable to works contract, which has come into effect by 46th amendment to Constitution in 1982.

Further, it was stated that after judgment of Supreme Court in case of *Larsen & Toubro (65 VST 1)* the builders and developers are also liable.

Hon'ble Tribunal came to conclusion as under:

"19. Taking into consideration the definition of sale under the MVAT Act as defined in section 2(24) the words 'other valuable consideration' would include anything that would directly or indirectly fetch some element of money or any other consideration. In the present case, TDR which is mentioned as Transfer Development Rights can be converted into money and in the present case already appellant has encashed some TDR and obtained considerable amount therein and therefore TDR would be a valuable consideration. Under these circumstances, the contention of the appellant that the transaction is barter or free of cost or without consideration cannot be accepted."

Thus Tribunal has departed from settled position that there should be consideration in money terms from the buyer itself. Hon. Tribunal has expanded the meaning of 'other valuable consideration' in relation to contracts observing that the earlier judgments are now not relevant after 46th Amendment.

Hon. Tribunal has also not appreciated that there is no procedure laid down for conversion of TDR into money terms to compute tax. Hon. Tribunal has applied its own theory and held that the monetary value can be ascertained as market value by reference to ready reckoner for stamp duty at the relevant time of agreement. In fact, there was no argument from either side about levying tax on market value read with ready reckoner. Thus, Tribunal has given above verdict about market price, without any hearing opportunity and accordingly, such holding is against principles of natural justice. With respect, it can also be noted that Tribunal has no such power to prescribe method of tax when there is no such scheme provided in the Act.

Thus, Hon. Tribunal has arrived at conclusion that transaction is taxable but changed the mode of computation. Lower authorities have levied tax on amount received against sale of TDR, whereas Tribunal has shifted it to market value on the date of agreement. The tax computation is left to the lower authorities. Penalty is directed to be waived.

Conclusion

With due respect, the judgment cannot be said to be laying down correct law. There will be also impact on the various other transactions which are in the nature of exchange like land owner granting rights of construction to the developer against allotment of certain flats. The issue will get decided at the higher forum in Appeals etc.

INTERNATIONAL TAXATION CONFERENCE - 2016

OUR FIRST JOINT CONFERENCE IN CO-OPERATION BETWEEN FOUNDATION FOR INTERNATIONAL TAXATION (FIT) INDIA AND INTERNATIONAL BUREAU OF FISCAL DOCUMENTATION (IBFD) AMSTERDAM

DECEMBER 1-3, 2016, ITC MARATHA HOTEL, MUMBAI

(As at August 10, 2016)

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BEPS AND BEYOND BEPS - A YEAR LATER

Our 21st Annual Conference is a special event: It is our first conference jointly held with IBFD, Amsterdam. IBFD is the sister organization of International Fiscal Association. It was set us as its publications, research and training arm in 1938. Set up as a charity, it is the largest institution of its kind in the world - FIT as a charity runs the leading conference annually on International taxation in India since 1995. We welcome them to our conference.

The conference theme is BEPS AND BEYOND BEPS: A YEAR LATER. Our first speaker will be Porus Kaka from India, President of International Fiscal Association - Worldwide. Our keynote ("Klaus Vogel") speaker is Pascal Saint - Amans, Director of the OECD's Center for Tax Policy, Paris. He also heads the BEPS Project since its inception at the OECD and reports regularly to the G20 Finance Ministers. The theme of our Plenary session on Day One is Action 15 on Multilateral Instrument (MLI) which is needed to comply with the recommendations of the BEPS Reports without making bilateral treaty changes. The speakers will make presentations, followed by panel discussions, to clarify some of the key issues underlying MLI.

On Day Two morning, we have a half-day session on BEPS and Indian Tax Policy, Practice and Compliance. Our speakers include Anita Kapur, former CBDT Chairman, Professor Parthasarathi Shome (former advisor to previous Finance Minister) and Akhilesh Ranjan, Chief Commissioner of Income Tax (International) in India. These presentations are followed by a panel discussion to review the Impact of BEPS on Indian Tax policy, Practice and Compliance with some of the leading Indian experts as panelists.

The rest of the conference covers panel discussion by global experts on a wide range of issues and recommendations under BEPS Action Points with twelve selected issues. We have also included several Revenue speakers to give their views; we trust their involvement will assist in achieving a more balanced tax view. As in previous years, these discussions should help better understanding of these issues and hopefully their resolution by expert speakers.

We look forward to your participation at our 21st Conference, held jointly with IBFD this year. The full programme is given overleaf.

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B.V. Jhaveri, *Advocate*

DIRECT TAXES
Supreme Court

SLP dismissed against High Court's ruling that where assessee's liability to pay excise duty relating to earlier years was adjudicated during relevant assessment year, assessee could claim deduction of amount so paid in assessment year in question even though books of account were maintained on mercantile system of accounting.

CIT vs. ITC Ltd. Special Leave Petition No. 31244 of 2014 dated 15th July, 2016. [(2016) 72 taxmann.com 120 (SC)]

1. The assessee incurred liability to pay the excise duty of ` 85.71 lakhs. The assessee disputed the valuation and the matter went to the adjudicatory authority. Once the demand was adjudicated, the assessee paid the amount adjudicated and claimed deduction thereof. The assessee made the payment after adjudication and not during the relevant year. The Tribunal held that the liability of earlier assessment years could not be allowed as a deduction out of the profit of the relevant assessment year 1984-85 in terms of section 43B of the Income-tax Act, 1961. For arriving at the total income of the previous year, only the expenditure pertaining to that previous year to be deducted. It was not open to the assessee to deduct the expenses of earlier years or subsequent years for arriving at the total income of that previous year. On appeal:

2. Allowing the appeal of the assessee the High Court held as under:

"8. In the case of *CIT vs. Orient Supply Syndicate (134 ITR 12)*, the Division Bench took the view that the question whether the liability of the earlier years discharged subsequently can be allowed to be deducted is a question which would depend on the facts and circumstances of the case and the statutory provisions. Our attention was not drawn to any statutory provisions on the basis of which the appellant before us incurred the liability to pay the excise duty in question or in violation whereof the appellant refused to pay. On the contrary, it appears that the claim was made on the basis of a valuation which the assessee disputed and that is how the matter went to the adjudicatory authority. It is in those circumstances that the payment was made after adjudication and not during the relevant year. We are of the opinion that even before the introduction of section 43B, it could not have been said that in all cases the assessee, maintaining books of account in a mercantile system, could not be permitted to deduct the amount paid in respect of liability which was incurred in the earlier years. We are, in any event, bound by the judgment in the case of *CIT vs. Orient Supply Syndicate and are not in a position to take a different view. ….* "

3. Dismissing the Special Leave Petition of the department the Supreme Court held as under:

"2. We do not find any legal and valid ground for interference. The Special Leave Petition is dismissed."

SLP dismissed against High Court's ruling that proceedings concluded by High Court could not be revived due to amendment to section 201 extending the period.

DCIT vs. Oracle India (P.) Ltd. Special Leave Petition No. 12701 of 2016 dated 22nd July, 2016.[(2016) 72 taxmann.com 138 (SC)]

1. The Deputy Commissioner issued a notice to the assessee on February 17, 2014, under section 201 of the I.T. Act, 1961, in respect of the financial year 2007-08 and thereafter the order was passed pursuant to the notice. On a writ petition the assessee contended that under the proviso to section 201(3) introduced with effect from April 1, 2010, an order can be passed at any time on or before March 31, 2011 and that the notice issued was barred by limitation. The court allowed the writ petition to that extent holding that the notice dated February 17, 2014, was barred in view of the provisions of section 201(3) as it then existed. Thereafter, another notice was issued on January 20, 2015, to take advantage of the amended section 201(3) which was brought into effect by the Finance (No. 2) Act, 2014 from October 1, 2014, whereby the period of limitation had been extended to seven years.

2. Allowing the Writ Petition the Delhi High Court (376 ITR 411) held as under:

"4. …. However, we need not go into that aspect of the matter inasmuch as, in the present case, no new information has come and the impugned notice that was issued on January 20, 2015, was on the basis of the same information in respect of which the notice dated February 17, 2014, had been issued. Thus, those proceedings which had ended and attained finality with the passing of the order dated December 5, 2014, of this court in W. P. (C.) 2061 of 2014 cannot now be sought to be revived through this methodology adopted by the Assessing Officer. Even otherwise, in so far as the financial year 2007-08 is concerned, the period for completing the assessment under Sections 201(1)/201(1A) has expired on March 31, 2015.

"5. Therefore, looked at from any point of view, in so far as the facts of the present case are concerned, the impugned notice dated January 20, 2015, and subsequent order dated March 17, 2015, cannot be sustained. The same are set aside. The writ petition is allowed."

3. Dismissing the Special Leave Petition the Supreme Court held as under:

"2. We do not find any merit in this Petition. The special leave petition is, accordingly, dismissed."

SLP dismissed against High Court's ruling that adverse inference against assessee for failing to cross-examine a witness in quantum proceedings would equally apply to penalty proceedings and there was no necessity to again offer assessee a further opportunity of cross-examining in penalty proceeding.

SLP dismissed against High Court's ruling that where evidence of one of two witnesses was by itself sufficient to draw adverse inference against assessee that commission payments made by it were fictitious, refusal by assessee to cross-examine said witness must follow that assessee had accepted said witness and commission payments were rightly disallowed.

Roger Enterprises P. Ltd. vs. CIT, Special Leave to Appeal Nos. 18759 & 18761 of 2016, dated 22nd July, 2016. [(2016) 72 taxmann.com 167 (SC)]

1. The assessee company represented customers for supply of equipment required by various Governments and semi-Government Departments and undertakings. It engaged sub-agents to render certain services like bringing proposals for tenders, follow up with customers, obtaining business information, transportation, clearing and handling of goods based on the nature of the contract and paid the agreed commission out of the commission received from the principals. The assessee claimed and was allowed deduction of these payments.

Subsequently, a search was conducted on the entities to whom the commission was claimed to have been paid by the assessee, in the course of which, M, the managing director of the payee companies admitted in a statement that the transactions with the assessee were hawala entries. Notice was issued for reassessment for the three assessment years. In a later statement, M stated that commission of one per cent was to be paid only after completion of transaction for ` 1 crore and no payment was received. M also stated that the receipt of commission was neither accounted for in the books of account nor declared to the income tax authorities. Though opportunity was given, the assessee expressed inability to cross-examine M at short notice. Reassessment was completed adding back the commission. On appeal the Commissioner (Appeals) held that the assessee should have been granted more time for cross examination and restored the matter to the file of the Assessing Officer. On being called upon by the Assessing Officer pursuant to the remand, the assessee refused to cross-examine AKJ and J (persons who had also given statements adverse to the assessee) without cross-examining M first on the ground that they were strangers to the transactions. Summons to M were received back unserved. Despite all the efforts by the Assessing Officer M could not be traced for cross-examination. The Assessing Officer proceeded with the reassessment. For a second time the Commissioner (Appeals) dismissed the appeals and the Tribunal affirmed this. Penalty was also levied on the assessee which the appellate authority affirmed but the Tribunal set aside the penalty. On appeals by the assessee and the Department:

2. Dismissing the appeals of the assessee the Delhi High Court held as under:

"28. The Court is satisfied that as far as making Mr. Meattle available for his cross-examination is concerned, every effort was made by the Department to locate him. It could not be said that the failure to produce Mr. Meattle for cross-examination was deliberate. That does not appear to be any wilful disobedience of the order passed by the ITAT in that regard.

"29. While there may be merit in the contention of Mr. Vohra that Section 33 of ITA may not strictly apply in the facts and circumstances of the present case, nevertheless the fact remains that Mr. Jhunjhunwala was an important witness. He had made incriminating statements against the assessee and the assessee chose not to counter it. Despite opportunities, the Assessee declined to cross-examine Mr. Jhunjhunwala. There have to be consequences as a result of the failure by the Assessee to avail of the above opportunities. In AEG Carapiet vs. A.Y. Derderian AIR 1961 Cal. 359, *it was held that "wherever the opponent has declined to avail himself of the opportunity to put his essential and material case in cross-examination, it must follow that he believed that the testimony given could not be disputed at all." Here, the AO proceeded to draw an adverse inference and considered the statement made by Mr. Jhunjhunwala as substantive evidence against the assessee. The above conclusion of the AO cannot be faulted.*

"30. While the wisdom of applying Section 33 of the ITA to the evidence of Mr. Meattle may be doubtful, the Court is of the view that de hors *the evidence of Mr. Meattle, the evidence of Mr. Jhunjhunwala was by itself sufficient to draw an adverse inference against the assessee that the payments of commission were fictitious. The Court is not persuaded to hold that Mr. Jhunjhunwala had made contradictory and inconsistent statements particularly since he was never confronted with those inconsistencies and contradictions by the assessee. If, as is urged by the assessee, Mr. Meattle's statements are to be entirely kept aside, then Mr. Jhunjhunwala's statements can be examined for their intrinsic worth. The assessee took a calculated risk in declining to cross-examine Mr. Jhunjhunwala on the understanding that it had to be preceded by the cross-examination of Mr. Meattle.*

"31. Two conclusions that could be drawn from the above narration are that there is no violation of principles of natural justice as far as the assessee is concerned, and the uncontroverted statements of Mr. Jhunjhunwala were sufficient to substantiate the case of the Revenue against the assessee.

"32. Consequently, the Court is unable to find any error having been committed by the ITAT in upholding the concurrent findings of the AO and the CIT(A)

regarding disallowance of the commission payments claimed by the assessee."

"41. The Court first notes that on merits, the finding of the ITAT that no material was placed on record by the assessee to demonstrate the nature of service rendered by the three companies to whom the commission was paid has been concurrently upheld by this Court. The assessee indeed failed to discharge onus on proving the genuineness of those payments. The conclusion that the payment of commission was bogus has been concurrently held by the CIT(A), by the ITAT and this Court.

"42. Consequently, the essential conditions for attracting the penalty under Section 271(1)(c) of the Act stand fulfilled in the present case. Further observed in Dharamendra Textile Processors (supra), the findings in the assessment (quantum) proceedings would be relevant and admissible in the penalty proceedings. The adverse inference against the assessee for failing to cross-examine Mr. Jhunjhunwala would equally apply to the penalty proceedings. There was no necessity to again offer the assessee a further opportunity of cross-examining Mr. Meattle and Mr. Jhunjhunwala in the penalty proceedings.

"43. As already noted, the CIT(A) erred in proceeding to delete the penalty on the ground that the assessee had been denied an opportunity of cross-examining both Mr. Meattle and Mr. Jhunjhunwala. The ITAT erred in concluding that the mere pendency of the assessee's quantum appeal made the issue a debatable one.

"44. The Court rejects the plea of the assessee that the matter should be remanded to the AO for arriving at a satisfaction de novo *regarding initiation of penalty proceedings. In the facts of the present case, where the disallowance of the commission payment has been upheld by this Court, on account of the assessee failing to furnish the true and correct particulars, the initiation of the penalty proceedings against the assessee under Section 271(1)(c) of the Act is perfectly justified.*

"45. The decision in CIT vs. Reliance Petroproduts (P.) Ltd. [2010] 322 ITR 158/189 Taxman 322 (SC) *proceeded on the basis that no information given in the return was found to be incorrect or inaccurate. It was in that context that it was observed that the mere making of an incorrect claim would not tantamount to furnishing inaccurate particulars. Here the question is not mere making of a wrong claim but in making a claim that is demonstrably false. With the assessee failing to establish the genuineness to the commission payments the essential conditions for attracting penalty under Section 271(1)(c) of the Act stood fulfilled.*

3. Dismissing the appeals of the assessee the Supreme Court held as under:

"1. We find no reason to entertain these Special Leave Petitions, which are accordingly dismissed."

Where assessee company was having house property and its business was to lease out its property and to earn rent, income so earned as rent should be treated as 'business income', and not as 'income from house property'

Rayala Corporation (P). Ltd. vs. ACIT, Civil Appeal Nos. 6437 to 6441 of 2016 dated 11th August, 2016. [(2016) 72 taxmann.com 149 (SC)]

1. The appellant-assessee, a private limited company, is having house property, which has been rented and the assessee is receiving income from the said property by way of rent. The main issue in all these appeals is whether the income so received should be taxed under the head "Income from House Property" or "Profit and gains of business or profession". The reason for which the aforestated issue has arisen is that though the assessee is having the house property and is receiving income by way of rent, the case of the assessee is that the assessee company is in business of renting its properties and is receiving rent as its business income, the said income should be taxed under the head "Profits and gains of business or profession" whereas the case of the Revenue is that as the income is arising from House Property, the said income must be taxed under the head "Income from House Property".

2. The Supreme Court held as under:

"9. Upon hearing the learned counsel and going through the judgments cited by the counsel, we are of the view that the law laid down by this Court in the case of Chennai Properties (supra) shows the correct position of law and looking at the facts of the case in

question, the case on hand is squarely covered by the said judgment.

"10. ….. It is an admitted fact in the instant case that the assessee company has only one business and that is of leasing its property and earning rent therefrom. Thus, even on the factual aspect, we do not find any substance in what has been submitted by the learned counsel appearing for the Revenue.

"11. The judgment relied upon by the learned counsel appearing for the assessee squarely covers the facts of the case involved in the appeals. The business of the company is to lease its property and to earn rent and therefore, the income so earned should be treated as its business income."

Penalty proceedings for contravention of Sections 269SS & 269T are not related to the assessment proceeding but are independent of it. Therefore, the completion of appellate proceedings arising out of the assessment proceedings has no relevance. Consequently, the limitation prescribed by s. 275(1)(a) does not apply. The limitation period prescribed in s. 275(1)(c) applies to such penalty proceedings.

CIT vs. Hissaria Brothers Civil Appeal No. 5254 of 2008, dated 22nd August, 2016

The assessee was a firm doing the business of Kachcha Arhatiya acting as agent for its farmers constituent, who used to bring their crops to the assessee for sale and the assessee in this relationship used to sell their crops and retain sales proceeds of the crops so as to be adjusted against their withdrawal from time-to-time and for buying the goods. While completing the assessments for A.Ys. 1993-94 to 1995-96, the AO invoked the provisions of sections 269SS and 269T and accordingly initiated penalty proceedings u/s. 271D and u/s. 271E respectively.

The Tribunal found on the question of limitation that the order of penalty should have been passed within six months from the end of the month in which the assessment was completed. As the orders levying penalty were passed beyond the period of six months, the same were held to be barred by limitation. The Tribunal also held in favour of the assessee on merits. Accordingly, the orders of the penalty were cancelled.

Dismissing the appeal of the Revenue, the High Court upheld the order of the Tribunal on merits. Upholding the order on the ground of limitation, their Lordships held as under:

"38. We are, therefore, of the opinion that since penalty proceedings for default in not having transactions through the bank, as required under sections 269SS and 269T, are not related to the assessment proceedings but are independent of it, therefor, the completion of appellate proceedings arising out of the assessment proceedings or the other proceedings during which the penalty proceedings under sections 271D and 271E may have been initiated has no relevance for sustaining or not sustaining the penalty proceedings and, therefore, clause (a) of section 275(1) cannot be attracted to such proceedings. If that were not so, clause (c) of section 275(1) would be redundant, because otherwise, as a matter of fact, every penalty proceeding is usually initiated when during some proceedings such default is noticed, though the final fact finding in this proceeding may not have any bearing on the issues relating to establishing default, e.g., penalty for not deducting tax at source while making payment to employees, or contractor, or for that matter not making payment through cheque or demand draft where it is so required to be made. Either of the contingencies does not affect the computation of taxable income and levy of correct tax on chargeable income; if clause (a) was to be invoked, no necessity of clause (c) would arise."

Dismissing the appeal of the Revenue the Supreme Court held as under:

"On perusing the judgment of the High Court, it is found that penalty imposed on the respondent herein was also set aside on the ground that the provisions of Section 271-D and 271-E of the Income-tax Act were invoked after six months of limitation and, therefore, such penalty could not have been imposed. Since the outcome of the judgment of the High Court can be sustained on this aspect alone, it is not even necessary to go into other aspects. Leaving the other questions of law open, the appeal is dismissed. There shall be no order as to costs."

Jitendra Singh & Sameer Dalal
Advocates

DIGEST OF CASE LAWS
Tribunal

Reported

1. **Income – Section 2(24) of the Income-tax Act, 1961 – Compensation received from developer towards hardship caused on redevelopment of the building premises – Not to be taxed as revenue receipt. A.Y.: 2007-08**

Jitendra Kumar Soneja vs. ITO [2016] 72 taxmann.com 318 (Mumbai - Trib.)

The assessee before the Hon'ble Appellate Tribunal is an Individual. The assessee during the previous year relevant to the impugned assessment year received an amount of ` 22 lakhs as corpus fund from the developer apart from ` 8.55 lakhs towards rent. The Learned A.O. while passing the assessment order made addition of ` 30,55,800/-, consisting of a sum of ` 22 lakhs as corpus fund received by assessee and also rental income of ` 8,55,800/- appearing as credited to his bank account, for which assessee failed to explain the reasons for non-disclosure in his return of income. On appeal the Learned CIT(A) upheld the order of the Learned A.O. The assessee being aggrieved by the above order preferred an appeal before the Hon'ble Mumbai Appellate Tribunal. The Appellate Tribunal was pleased to allow the appeal of the assessee by observing that compensation received by assessee, a member of co-operative housing society from developer, received towards hardship caused to assessee on redevelopment was outside ambit of income under section 2(24) and thus not taxable as a revenue receipt

2. **Income from Other Sources – section 56 of the Income Tax Act, 1961 – share premium money has not been used in day-to-day business – share premium could not be treated as business receipt. A.Y.: 2010-11**

Credit Suisse Business Analysis (India) (P.) Ltd. vs. ACIT [2016] 72 taxmann.com 131 (Mumbai - Trib.)

The assessee before the Hon'ble Appellate Tribunal was engaged in the business of providing various business support and information technology enabled services to its group companies as well as infrastructure support services. The assessee during the previous year relevant to the impugned assessment year issued 40 lakh equity shares of face value of ` 10/- each out of which 10 lakh shares had been issued at par, that the premium received by the assessee was credited to Securities Premium under the head reserves and surplus in the balance

sheet. The A.O. observed that the value of shares was not readily ascertainable due to various constraints and that the value could be taken only at ` 10 per share and the receipt of premium of ` 187 per share was a device to avoid tax. The A.O. further observed that share premium collected was used for day-to-day business activities, which was a clear violation of section 78 of the Companies Act. Thus, the share premium lost its character and was characterised as a trading receipt. The A.O. after making the above observation passed the assessment order holding that as per section 56, assessee had received ` 56.10 crores in the guise of share premium and that the same had to be taxed under the head income from Other Sources. On appeal the Learned CIT(A) upheld the view of the A.O. The assessee being aggrieved by the above order preferred an appeal before the Hon'ble Mumbai Appellate Tribunal. The Appellate Tribunal was pleased to allow the appeal of the assessee by observing that the assessee had proved that opening and closing balance of share premium money account was same for year under consideration and neither A.O. nor Learned CIT(A) proved that share premium money was utilised by assessee for running its day-to-day business. Hence, share premium could not have been treated as business receipt.

Unreported

3. Revisions – Section 263 of the Income-tax Act, 1961 – orders erroneous as well as prejudicial to the interest of revenue – Commissioner of Income Tax passing the order under section 263 without any reasons – bad in law. A.Y.: 2007-08

Achiles Knitwear Pvt. Ltd. vs. Commissioner of Income Tax [ITA No. 2242/Mum/2012 order dated 27-7-2016]

The assessee before the Hon'ble Appellate Tribunal is engaged in the business of job work and trading of knitted hosiery fabrics. The assessment order under section 143(3) was passed after detailed scrutiny. The Learned CIT issued show cause notice under section 263 of the Act to the assessee on the ground that there was a claim of prior period expenses of ` 4,39,573/- in the profit and loss account which was not added back by the assessee in the computation of income nor by the A.O. in the assessment order. The assessee filed detailed reply to the above show cause notice and also contended that the prior period expenses has wrongly been mentioned in the Profit & Loss Account and the impugned expenditure has actually been incurred during the previous year relevant to the impugned assessment year. The Learned CIT, however, without considering the submissions made by the assessee passed the order under section 263 of the Act and set aside the assessment order treating the same as erroneous as well as prejudicial to the interest of revenue. The assessee being aggrieved by the above assessment order preferred an appeal before the Hon’ble Mumbai Appellate Tribunal. The Appellate Tribunal was pleased to quash the order passed by Learned CIT and allowed the appeal of the assessee by observing that Perusal of the above order reveals that CIT reproduced observations of Hon’ble Supreme Court and Hon’ble Kerala High Court and thereafter without discussing the facts of this case and without giving any proper reasoning, he abruptly reached on the conclusion that assessment order passed u/s. 143(3) dated 21-12-2009 is erroneous and prejudicial to the interest of revenue and therefore same was set aside to the file of the A.O. for *de novo* assessment. No analysis or reasoning has been given by Learned CIT. Nothing has been mentioned that how prior period items were not allowable. On

the other hand, assessee had explained that impugned expenses pertain to the year under consideration. The CIT did not meet or controvert the explanation and justification given by the assessee. Actually, we find the order passed under section 263 itself, to be erroneous as per law and facts. The impugned revision order has been passed in highly unfair and unjustified manner.

4. Income from other sources – section 56(2)(v) of the Income Tax Act, 1961 – Gift received by Karta from HUF – HUF is nothing but group of relatives – Gift not taxable. A.Y.: 2006-07

ACIT vs. Shri Rakesh Kumar Garodia [ITA No. 4528/Mum/2013 order dated 20-7-2016]

The assessee before the Hon'ble Appellate Tribunal is a Karta of Rakesh Kumar Garodia HUF. During the impugned assessment year the assessee has received gift amounting to ` 82 lakhs. The assessee filed his return of income for A.Y. 2006-07 on 24-7-2006. The Learned A.O. after detailed examination of return of the assessee passed the scrutiny assessment under section 143(3) of the Act accepting the returned income. The Learned A.O. issued notice under section 148 of the Act to treat the gift received from the HUF by the assessee as 'Income from Other Sources' invoking the provisions of section 56(2)(v) of the Act. The assessee duly replied to the above notice and contended that the notice issued under section 148 of the Act is merely on change of opinion as the issue of gift received from the HUF is already examined during the course of original assessment proceedings. The Learned A.O. however without appreciating the facts and circumstances of the case passed the assessment order under section 143(3) r.w.s. 147 of the Act and treated the gift received by the assessee from the HUF as 'Income from Other Sources' under section 56(2)(v) of the Act. On appeal the Learned CIT(A) quashed the reassessment proceedings on the ground the same is based on change of opinion. The Learned CIT(A) further held that the gift received by the assessee from HUF is not taxable within the meaning of section 56(2)(v) of the Act. The department being aggrieved by the order passed by Learned CIT(A) preferred an appeal before the Hon'ble Mumbai Appellate Tribunal. The Appellate Tribunal was pleased to dismiss the appeal filed by the department on the ground that during the original assessment proceeding, the A.O. seek the clarification with regard to the gift received from the HUF the same was furnished before the A.O., A.O. passed the order after considering the material available before him, thus keeping in view the decision of Bombay High Court in German Remedies Ltd. (supra), the re-opening was based on mere change of opinion and thus in our considered opinion, the same is invalid. Now coming to the merit of the case, the Co-ordinate Bench of Hyderabad Tribunal in the case of Dr. M. Shobha Ravhuveera (supra) and Ahmadabad Tribunal in Harshabhai Dahyalal Vaidhya (HUF) (supra) held that HUF is nothing but a group of relatives. The status as "HUF", does not lose their identity as the relatives as provided in the explanation attached to Clause-5 of sub-section 2 of section 56 of Income-tax Act, thus respectfully following the decision of Coordinate Bench we confirm the findings of Ld CIT(A).

CA Tarunkumar Singhal & Sunil Moti Lala, *Advocate*

INTERNATIONAL TAXATION

Case Law Update

A. HIGH COURT JUDGMENTS

1. Transfer pricing provisions would not apply where it resulted in the reduction of income chargeable to tax. Adjustment on Technical consultancy fee could not be made without conducting any exercise to determine the value of services received or where the TPO did not carry out the transfer pricing exercise in accordance with the methods prescribed under the Income-tax Act, 1961

CIT vs. M/s. Merck Ltd. – TS-608-HC-2016 (Bom.) - TP

Facts

1. The assessee had undertaken two sets of international transactions with its AE – import of pigments and payment of technical know-how / consultancy fee (of ` 1.57 crore) in pursuance of a technical consultancy agreement.

2. With respect to the import of pigments, the Tribunal held that since price paid by the assessee to its AE for the import of pigments was less than the normal consideration paid / payable which was evidenced by the imposition of anti-dumping duty on the said import under the Customs Tariff Act, 1975, the transaction was at ALP.

3. As per the agreement between the assessee and its AE, the technical consultancy fee was being paid for consultancy in 12 fields. The TPO, observing that the assessee had availed of 3 technical services out of the 12, held that the ALP of the payment was ` 40 lakh and made an addition of ` 1.17 crore. On further appeal, the Tribunal held that there was no obligation on the assessee to avail technical services in all 12 fields and that it was for the availability of assistance in all 12 areas that the consideration was paid. It further recorded that no method under section 92C had been applied to determine ALP and that no transfer pricing exercise was done by the AO/TPO to determine the value of services received by the assessee and that the ` 40 lakh was an arbitrary amount arrived at. Accordingly, it deleted the addition made by the TPO.

4. Aggrieved, the Revenue filed an appeal before the Hon'ble High Court contending that a) as regards the import of pigment, an e-mail of the assessee stating that it was deliberately following a predatory pricing policy in India to combat local competition established that the import was at a price lesser than ALP and therefore the issue was to be considered and b) as regards the technical consultancy fee, services were received in only three areas and therefore the consideration paid was to be attributed only to the services received.

Judgment

1. The Court held that if the contention of the Revenue was to be accepted it would increase the import price of the pigments resulting in a reduction of income chargeable to tax, which was contrary to the provisions of Section 92(3) of the Income-tax Act, 1961 which provides that Transfer pricing provisions would not apply where it resulted in the reduction of income chargeable to tax. Accordingly, it upheld the order of the Tribunal as the question urged by the Revenue did not give rise to any substantial question of law.

2. As regards the Technical consultancy fee, the Court upheld the finding of the Tribunal that no method under section 92C was applied to determine the ALP in respect of such fee and that no exercise was undertaken to benchmark the value of services received by the assessee. It held that the agreement was similar to a retainer agreement and accordingly the finding of the AO attributing Nil value to nine of the services listed in the agreement for which services were not availed of was unjustified. It also upheld the finding of the Tribunal that the fee of ` 1.57 crore was in respect of the assessee's right to avail and the AE's obligation to provide technical assistance in any of the 12 services enlisted in the agreement. Accordingly, since the question urged by the Revenue was not a substantial question of law, the Court dismissed the same.

2. Where the assessee received a host services from its AE via a consolidated agreement which were all intrinsically linked to the manufacturing activity of the assessee, the TPO was not justified in splitting up the agreement to determine the ALP of certain services separately while accepting the price of the other services.

Pr CIT vs. Avery Dennison (India) Pvt. Ltd. – TS-527-HC-2016 (Del.) – TP

Facts

1. The assessee, a subsidiary of Avery Dennison Corporation, USA was predominantly engaged in the manufacturing and trading of pressure sensitive adhesive material, self-adhesive paper, self-adhesive films in India. It entered into international transactions with its AEs for purchase of raw material, sale of finished goods, payment of service fee etc. for which it used TNMM as the most appropriate method for benchmarking its international transactions. The TPO applied the CUP method and proceeded to make a TP adjustment by splitting up the transactions entered into. The TPO also held that the services for which the payment was made did not result in any benefit and that no independent party would have made such payment.

2. Aggrieved, the assessee filed an appeal before the Tribunal wherein the Tribunal held that the agreement between the AE and the assessee was a composite one and could not be split up to hold that some of the services were at ALP while the others were not. It noted that the assessee was predominantly a manufacturer and that services received by it from its AEs were intrinsically linked to the core business operations. Further, the Tribunal also held that the observation of the TPO that the services availed by the assessee did not lead to any benefit to the assessee was not backed by any material and therefore did not hold good.

3. Aggrieved, the Revenue filed an appeal before the Hon'ble High Court.

Judgment

1. The Court upheld the order of the Tribunal and held that the conclusions reached in its order i.e. that the agreement being intrinsic could not be split and that the TPO was not empowered to determine the benefit of services availed. Accordingly, the Court dismissed the appeal filed by the Revenue.

3. Companies having fluctuating profit margins could not be considered as comparable. Companies could not be excluded on the ground of non-

availability of segments without verifying the actual activities carried on by it.

Pr CIT vs. Allscripts (India) Pvt. Ltd. – TS-552-HC-2016 (Guj.) - TP

Facts

1. The assessee was engaged in providing captive software development services to its AE on a cost plus remuneration basis and adopted TNMM as the most appropriate method. The DRP had arrived at 12 companies as comparable pursuant to which the assessee filed an appeal before the Tribunal contending the exclusion of certain comparable companies.

2. As regards Bodhtree Consulting Ltd., selected by the DRP, the Tribunal directed for its exclusion since its Operating Profit to Total Cost ratio fluctuated widely from -11.53 per cent to 80.15 per cent in a span of 7 years and that the ratio fluctuated on a year to year basis as well and therefore it would be unsafe to assess the ALP based on TNMM by taking this company into consideration. The Tribunal also directed for the exclusion of E-Infochip Bangalore Ltd., selected by the DRP, on the ground that the company was engaged both in software development services as well as in IT enabled services and had only one reportable segment whereas the assessee was only engaged in providing software development services.

3. Aggrieved, the Revenue filed an appeal before the Hon'ble High Court.

Judgment

1. The Court upheld the decision of the Tribunal with respect to the exclusion of Bodhtree Consulting on account of the company's fluctuating profit margins.

2. As regards E-Infochip Bangalore Ltd., the Court noted that during the TP proceedings, the TPO had examined the functionality of the said comparable and observed that it was engaged in providing software development services alone, which had not been considered by the Tribunal in passing its judgment. It therefore held that that the very question whether E-Infochip Bangalore Ltd. was engaged in any services other than software development services remained unanswered and it was only when such question was answered in the affirmative, could the question of availability or non-availability of segmental information arise. Accordingly, it reversed the ITAT ruling in this respect and restored the issue back to the Tribunal for re-consideration.

4. Companies initially included by the assessee in its TP study can be subsequently excluded based on supporting evidence

CIT vs. Haworth (India) Pvt. Ltd. – TS-534-HC-2016 (Bom.) – TP

Facts

1. The assessee was engaged in the business of providing marketing support services to its AE situated in Singapore and justified its international transactions to be at ALP using TNMM. In its TP study, it had considered ICRA Online as one of the external comparable companies.

2. The TPO directed the assessee to carry out a fresh search directing the computation of margins based on the current year's data, in the course of which, the assessee came across the Directors Report of ICRA Online Ltd. and excluded the company as comparable on the ground that the same was not functionally comparable owing to it having income from sale of products. The exclusion of ICRA Online Ltd. was not accepted by the TPO which led to non-acceptance of the margin arrived at by the assessee consequent to which the AO passed a Draft assessment order.

3. The Assessee filed objections before the DRP wherein the DRP upheld the order of the AO.

4. Aggrieved, the assessee filed an appeal before the Tribunal, wherein the Tribunal observed that ICRA Online Ltd. had significant income on account of sale of products and noted that the said

information was not available with the assessee at the time when the transfer pricing study was prepared by the assessee at first. Relying on the decision of the Special Bench in *DCIT vs. Quark Systems P. Ltd.*, it held that merely because a comparable was included by the assessee earlier, it would not be estopped from contending that the same was not functionally comparable on the basis of supporting evidence. Accordingly, the Tribunal directed the AO to exclude ICRA Online Ltd as a comparable.

5. Aggrieved, the Revenue filed an appeal before the Hon'ble High Court.

Judgment

1. The Court held that the contention of the revenue that the once a comparable was selected by the assessee in its Transfer Pricing study, then subsequent event/information could not be relied upon to discard it, was invalid since the exclusion sought by the assessee was in compliance with the provisions of Rule 10D(4) of the Rules. It noted that 10D(4) of the Rules, provides for a cut-off date for the use of information/documents to support inclusion/exclusion of a comparable for a particular AY i.e. November 30 of the AY and held that since the assessee relied on the Directors report of ICRA Online which was dated May 12, 2007, the exclusion sought by it was valid since it was prior to November 30, 2007. Accordingly, it held that no substantial question of law arose from the appeal of the department.

5. Where the Tribunal failed to determine the central issue viz. the existence of international transaction on account of AMP expenses, the Tribunal was incorrect in remanding the matter for determination of ALP.

Daikin Airconditioning India Pvt. Ltd. vs. ACIT – TS-533-HC-2016 (Del.) – TP

Facts

1. The assessee had filed an appeal before the ITAT in respect of the determination of ALP on AMP expenses incurred by the assessee since the TPO proposed adjustments of ` 8.89 crore holding the AMP expenses to be an international transaction under section 92B of the Act. During the pendency of appeal, the Court in the case of Sony Ericsson Mobile Communication held that the Bright Line Test was not a valid basis for determining the existence of an international transaction in relation to AMP expenses. The ITAT following the said decision remitted the matter to the TPO for a fresh determination of ALP.

2. The assessee filed an appeal before the Hon'ble High Court contending that the ITAT had abdicated its responsibility of determining the central issue that arose in the matter viz. whether there existed an international transaction between the assessee and its AE involving AMP expenses.

Judgment

1. The Court observed that the Tribunal had not rendered any categorical finding on the central issue and therefore remitted the matter to the Tribunal and held that if the Tribunal ruled that there was no international transaction between the assessee and its AE, no other question survived. Considering the contention of the assessee, it also held that since all the necessary factual information for such determination was placed before the Tribunal, there was no occasion for the Tribunal to remand the determination of the aforesaid question to the lower authorities.

2. As regard the other contention of the assessee viz., the power of the TPO to determine the existence of an international transaction when it was not reported by an assessee in its 3CEB, the Court held that if the Tribunal determined the non-existence of an international transaction then this contention would be irrelevant. However, it held that in event the same was decided against the assessee, it would be open to the assessee to urge this point before the Court.

6. BPO service providers could not be compared to a company engaged in KPO activities. Further other KPO service

providers providing marketing and sales services could not be compared to KPO service providers providing capital and financial services.

Pr CIT vs. Actis Global Services Pvt. Ltd. – TS-535-HC-2016 (Del.) – TP

Facts

1. The assessee engaged in providing Knowledge Process Outsourcing services had rendered KPO services to its AE during the year under review. The lower authorities included 2 companies viz. Infosys BPO and Eclerx Services Ltd. as comparable for determining the ALP of the international transactions.

2. Aggrieved, the assessee filed an appeal before the Tribunal wherein both the comparables were excluded on the ground of functionality.

3. Consequently, the Revenue preferred an appeal before the Hon'ble High Court.

Judgment

1. As regards Infosys BPO, the Court held that exclusion did not call for any interference since the said company was a BPO and the assessee was engaged in KPO activities and therefore could not be compared.

2. In relation to Eclerx Services, the Court held that the ITAT was incorrect in excluding the same as comparable in spite of the fact that the company was a KPO since the functional profile of the two companies were different as the assessee catered to the capital and financial services markets whereas Eclerx Services worked in the area of sales, marketing and supporting financial services and therefore could not be compared.

7. Reference by AO to TPO and consequent notice issued by TPO was without jurisdiction as the assessee was a co-operative society, not covered under the definition of person under section 40A(2)(b) and therefore not subject to the provisions of section 92AB.

Satpuda Tapi Parisar Sahakari Sakhar Karkhana Ltd. vs. DCIT – TS-517-HC-2016 (Bom.) – TP

Facts

1. The Petitioner, in the given case, filed a Writ Petition before the Hon'ble High Court challenging the notice issued by the AO to TPO making reference under section 92CA(1) of the Act as well as the notice issued by the TPO under section 92CA(2), which were issued on the basis that the amount paid by the assessee to cane growers was an expenditure covered under section 92BA of the Act i.e. specified domestic transactions.

2. The assessee, being a co-operative society contended that it was not a person referred to in Section 40A(2)(b) of the Act and therefore would not be covered under Section 92BA.

3. The AO rejected the assessee's contention on the ground that the Apex Court in the assessee's own case had set aside the order of the Bombay High Court which held that the transaction with cane growers was not covered within the meaning of specified domestic transaction.

Judgment

1. The Court prima *facie held* that the order of the Apex Court restored the issue to the CIT(A) to examine whether or not the payments made to cane growers after the close of the financial year would constitute expenditure under section 37 and observed that the Apex Court had given a finding that the applicability of Section 40A of the Act would only arise for consideration once the issue of Section 37 of the Act.

2. Accordingly, the Court held that the notice issued by the AO to the TPO and also the TPO's consequent notice was without jurisdiction as any expenditure incurred by co-operative societies would not be a specified domestic transaction as it was not mentioned amongst the entities referred to in section 40A(2)(b) of the Act.

8. Wherein prior years the Tribunal had accepted that the assessee was not into core research activities, there was no cogent reason for arriving at a contrary conclusion without any supporting.

Honda R&D (India) Pvt. Ltd. vs. ACIT- TS-525-HC-2016 (Del.) – TP

Facts

1. The assessee, a 100 per cent subsidiary of Honda R&D Company Ltd, Japan performed certain services for its AE in the nature of market research on Indian markets and testing of products already launched in the market as well as certain auxiliary administrative services, pursuant to a Research and Service Agreement.

2. During the TP proceedings, the TPO proposed an adjustment of ` 80.99 lakhs, pursuant to which the assessee filed an appeal before the CIT(A) and contended that the Cost Plus Method should be considered as the Most Appropriate Method for benchmarking the international transaction between the assessee and the AE since it was compensated at a cost plus markup of 3 per cent which was the practice of the Group and proposed its own comparables. The TPO rejected the claim of the assessee and held that TNMM was the most appropriate method, pursuant to which he included his own comparable companies. The TPO rejected 3 comparables selected by the assessee. The assessee filed an appeal before the CIT(A) wherein the CIT(A) selected 3 comparables accepted by the TPO and aslo added one company viz. ITDC, on the basis of directions given by the DRP for AY 2007-08. On the basis of these 4 companies, the CIT(A) held that no addition was called for and accordingly deleted the addition.

3. On appeal by the Revenue, the Tribunal concluded that the assessee had undertaken core R&D activitie and therefore ITDC could not be considered as comparable as it was engaged in marketing services. It also noted that the CIT(A) failed to consider the inclusion of 3 other comparables and therefore remitted the matter to the CIT(A).

4. Aggrieved, the assessee preferred an appeal before the Hon'ble High Court.

Judgment

1. The Court noted that the Tribunal in the assessee's own case for AY 2004-05 accepted the plea of the assessee that it was not into core R&D activities which was also accepted by the AO in its remand report for the relevant year and by the DRP in AY 2007-08. The Court also referred to the directions of the DRP for AY 2007-08 wherein ITDC was held as comparable and noted that the said directions had attained finality since the revenue had not challenged the said directions.

2. Accordingly, it held that the Tribunal's approach in concluding that the assessee had undertaken core R&D activities appeared to be contrary to the view taken in the past and was not supported by any other findings. The Court noted that the Tribunal had rejected ITDC as a comparable by taking up all the functions of the ITDC whereas only the market research segment was offered by the assessee for comparison. Accordingly, it held that the rejection of ITDC by the Tribunal was erroneous.

3. As regards the 3 comparable companies remanded to the CIT(A), the Court noted that the said companies had been rejected by the TPO in its remand report and the CIT(A) had also rejected the comparables on cogent reasons. Further, noting that the Tribunal itself, for the prior assessment year, relied upon the remand report of the TPO for the current year, it held that the Tribunal was merely adding to the confusion.

9. For AY 2010-11, the Revenue was not empowered to file cross objections against the order of the DRP

Pr CIT vs. Trend Micro India Pvt. Ltd. – TS-515-HC-2016 (Del.) – TP

Facts

1. The assessee, was engaged in providing pre sales and post sales services, marketing and

other technical services to clients on behalf of its AE, Trend Taiwan. It also imported certain services from its AE. For the year under review i.e. AY 2010-11, the assessee adopted the cost plus method as the most appropriate method which was rejected by the TPO who adopted TNMM and arrived at a set of 9 comparable companies and made an upward adjustment of ` 1.80 crores.

2. The DRP allowed partial relief pursuant to which the AO passed the final assessment order. On further appeal to the ITAT, the ITAT excluded 3 comparable companies selected by the TPO.

3. Aggrieved, the Revenue preferred an appeal before the Hon'ble High Court contending that if 3 out of 9 comparables were to be excluded, then the Tribunal ought to have *suo motu* required the TP adjustment exercise to be undertaken afresh by the TPO.

Judgment

1. The Court held that for the year under review, there was no provision in the Act permitting the Revenue to appeal against the inclusion or exclusion of a comparable which was affirmed by the DRP as the statutory scheme at the relevant time did not envisage so. The Revenue was not permitted to file cross objections for AY 2010-11. Accordingly, it dismissed the appeal filed by the Revenue.

10. The Most Favoured Nation clause could be used to import benefit for either lower rate of tax or for restrictive scope while taxing fees for technical services.

Steria (India) Ltd. vs. CIT – TS-416-HC-2016 (Del.)

Facts

1. The assessee, Steria (India) Limited ("SIL / Taxpayer"), a public limited company registered and resident in India primarily engaged in providing IT driven services had entered into a Management Services Agreement ("MSA") with Steria France, one of Steria's group entities and a limited liability partnership. The services rendered by Steria France to SIL included corporate communication services, group marketing services, development services, information system and services, legal services, human relation services, etc. These services were provided by Steria France through telephone, fax, e-mail, etc. and no personnel of Steria France visited India to provide such services.

2. The assessee made an application before the Authority for Advance Ruling (AAR) to determine the taxability of these payments in the hands of Steria France and withholding tax liability of SIL for these payments and contended that the services rendered by Steria France did not 'make available' any technical knowledge, experience, know-how or process to SIL and hence, they were not taxable as FTS under Article 13 of India France DTAA. In making this contention, it imported the restrictive definition of FTS as stated under the India-UK DTAA which contains the 'make available clause'. The basis for SIL importing the restrictive definition of FTS according to the India-UK DTAA, was Clause 7 of the India-France DTAA Protocol which provides that if any DTAA or Protocol is signed between India and an OECD member state after 1st September, 1989 which limits its taxation at source to FTS, to a rate lower or a scope more restricted than the rate or scope provided in the India-France DTAA then the same rate or scope as provided in the other DTAA would apply

3. The AAR held that the payment made by SIL for the management services to Steria France will be taxable as Fees for Technical Services according to Article 13 of the India-France DTAA and denied the benefit of Clause 7 of the Protocol to the DTAA and also observed that it would be inappropriate to import words, phrases/clauses which were not a part of the treaty between two States on the basis of treaties with other sovereign States.

4. Aggrieved, the assessee filed an appeal before the Hon'ble High Court.

Judgment

1. The Court, disagreeing with the AARs contention of restrictive interpretation placed on

Clause 7 of the Protocol, observed that the words "a rate lower or a scope more restricted" occurring therein envisaged that the benefit could either be on account of lower rate or more restricted scope and that the wordings "if under any convention, agreement or Protocol signed between India and a third State which is a member of OECD" in Clause 7 of the Protocol, indicated that the most beneficial of the provisions that may be available in other Convention between India and the OECD member country can be availed automatically by virtue of the Protocol.

2. Once the DTAA has been notified and contains the Protocol thereof, there was no need for the Protocol itself to be separately notified or for the beneficial provisions in other Conventions between India and another OECD country to be separately notified.

3. Since the definition of fees for technical services in Article 13 of the India-UK DTAA excludes 'managerial services' from its ambit, the payment made by SIL for rendered management services by Steria France shall not be liable to tax in India.

4. Accordingly, the services provided by Steria France did not have to be further examined to understand whether they were "made available" or not.

B) Tribunal Decisions

11. Taxability of Export commission paid to non-resident abroad – Whether taxable under section 9(1)(i) of Income-tax Act – Held: No, in favour of the assessee

ITO vs. Excel Chemicals India Ltd. TS-417-ITAT-2016(Ahd.) – Assessment Year: 2012-13

Facts

(i) The assessee was a resident company engaged in the business of trading in chemicals. During the assessment year 2012-13, the assessee paid commission on sales in respect of services rendered abroad by non-resident entities.

(ii) The assessee did not withhold tax from the commission paid, on the ground that no operations of the non-resident agent had been carried out in India, and accordingly, no income accrued or arose or was deemed to accrue or arise in India under section 9(1)(i) of the Act. Since no portion of the payment was income taxable in India, there could not be any requirement to withhold taxes.

(iii) The Tax Officer disallowed the commission paid under section 40(a)(i) of the Act for non-deduction of withholding tax on the commission paid.

(iv) In his appellate order, the Commissioner of Income Tax (Appeal) [CIT(A)] concurred with the assessee, holding that the income was not taxable in India as no operations were carried out in India. As no income was taxable in India, there was no occasion to withhold tax from the remittances in question. The Revenue appealed before the Tribunal.

(v) Before the Tribunal, the assessee contended that:

- Commission on sale was paid in respect of services rendered abroad, and as such, no tax was to be withheld. Since there was no requirement to withhold tax, there was no occasion to invoke disallowance under section 40(a)(i) of the Act.
- The assessee also cited certain judicial precedents in support of the proposition that unless the recipient of commission was carrying on business in India through a permanent establishment, the sales commission paid to non-resident entities was not taxable in India.
- The assessee also placed reliance on the certificate issued by a chartered accountant, certifying that no withholding tax was warranted from the remittances of commission.

(vi) The revenue contended that:

- The Revenue cited a ruling of *SKF Boilers and Driers Pvt. Ltd., [(2012) 343 ITR 385 (AAR)]* in support of the proposition that

the commission remitted abroad to a non-resident agent rendering services abroad was income accruing or arising in India, and the fact that the non-resident agent rendered services abroad was wholly irrelevant for the purpose of determining the *situs* of its income.

- Since the orders were executed in India, it was implied that the right to commission arose in India.
- The Revenue rejected the reliance on the CA's certificate by placing reliance on the Mumbai Tribunal decision in *DCIT vs. Rediff.com India Limited [(2011) 47 SOT 310 (Mumbai)]* stating that a certificate could not conclusively determine taxability in the recipient's hands.
- The Revenue rejected the assessee's claim, relying on Explanation 4 to section 9(1)(i) of the Act, introduced by the Finance Act 2012 w.r.e.f. 1st April, 1962, to contend that the expression, 'through' included, (and would always be deemed to have included) "by means of", "in consequence of" and "by reason of". Thus, by virtue of execution of contracts in India, the commission income became taxable in India.

Decision

The Tribunal held in favour of the asssessee as under:

(i) The Tribunal observed that the Revenue had overlooked the impact of Explanation 1 to S ection 9 (1)(i) of the Act, which states,

"For the purpose of this clause, … in case of a business, of which all the operations are not carried out in India, the income of the business deemed under this clause to accrue or arise in India shall be only such part of the income as is reasonably attributable to the operations carried out in India".

(ii) It further held that even if the deeming fiction under Section 9(1)(i) of the Act was triggered on the facts of this case on account of the commission agent's business connection in India, it had no impact on taxability in the hands of the commission agent, because no business operations had admittedly been carried out in India, thereby making Explanation 1 to Section 9(1)(i) relevant.

(iii) The Tribunal rejected the reliance on the ruling in SKF Boilers and Driers Pvt. Ltd., *In Re* 2 that followed the ruling of *Rajiv Malhotra, In Re* [(2006) 284 ITR 564 (Delhi)]

(iv) It did not agree with the approach adopted by the AAR, since the impact of Explanation 1 to Section 9(1)(i) had not been handled appropriately in these rulings.

(v) It concluded that the point of time when the commission agent's right to receive the commission fructified was irrelevant to determining the scope of Explanation 1 to Section 9(1)(i) of the Act.

(vi) It upheld the CIT(A)'s order, holding that non-resident commission agents were not taxable in India in respect of their commission earnings from orders procured abroad.

(vii) The Tribunal separately held that if the payment to a non-resident did not have an element of income, tax was not required to be withheld under section 195 of the Act, following the SC ruling in *GE India Technology Centre Pvt. Ltd.* [(2010) 327 ITR 436]

12. India-USA DTAA – Article 12 vs. Article 15 – Taxability of software development services rendered by an individual – Whether covered by IPS Article or FIS Article under the India-USA tax treaty – Held : Not taxable under Article 15, in favour of the assessee

ITO vs. SUSANTO PURNAMO 2016-TII-196-ITAT-AHM-INTL Assessment Year: 2011-12

Facts

(i) The Assessee, an individual resident in the US, carried on his business as a sole proprietor.

(ii) During the relevant year, the Assessee rendered certain software development services to an Indian company (ICo). As part of the software development services, the assessee was required to design, build and maintain a complete video streaming website for ICo.

(iii) The assessee contended that the income from software development services was in the nature of business income and in the absence of a PE or a fixed base in India, such income is not taxable in India under Article 7, as well as Article 15, of the DTAA. Furthermore, even if one were to contend that the services are in the nature of technical services, as such services do not make available any technical knowledge or skill, they would not be covered by the FIS Article.

(iv) The Tax Authority rejected the assessee's contention on the ground that services rendered by the assessee were not in the nature of IPS, but in the nature of FIS. Furthermore, it was contended that the services satisfy the "make available" condition and arise in India as the payer is in India. Hence, income from software development services is taxable in India.

(v) On appeal, the CIT (Appeals) held that software development services are covered by the IPS Article. Furthermore, due to the presence of a specific carve-out in the FIS Article, services covered by the IPS Article would fall outside the ambit of FIS. Since the assessee did not have a fixed base in India nor did his presence in India exceed 90 days, the income from such services is not taxable in India.

Decision

The Tribunal held in favour of the assessee as under:

(i) On a conjoint reading of Article 12 and Article 15 of the DTAA, it is clear that once an amount is found to be of such a nature as it can be covered by the IPS Article, the same shall stand excluded from the ambit of the FIS Article.

(ii) The applicability of Article 15 is substantially influenced by the status of the recipient, whether the recipient is an individual or a corporate entity. Thus, although there may be an overlap in the scope of services covered by Article 12 and Article 15, but, as long as the services are rendered by an individual or a group of individuals, rendition of such services is covered by Article 15. This view was also upheld by the Mumbai Tribunal in the case of ***Linklaters LLP [(2011) 9 ITR (Trib.) 271]*** in the context of the India–UK DTAA. In the context of the India-US DTAA, this is specifically exemplified by way of a specific carve-out in Article 12.

(iii) The definition of "professional services" in Article 15 is only illustrative and not exhaustive. The emphasis is on the nature of services.

(iv) Software development services, which essentially require predominant intellectual skill and are dependent on the individual characteristics of the person pursuing software development and are based on specialised and advanced education and expertise, qualify as "professional services" under Article 15. Reliance in this regard was placed on the Kolkata Tribunal decision in the case of *Graphite India Ltd. [(2002) 86 ITD 384].*

(v) It is not in dispute that the assessee does not have a fixed base in India, nor does his presence in India exceed 90 days in the relevant year. Thus, although the services are in the nature of IPS, in the absence of satisfaction of the conditions of Article 15, income from software development services is not taxable in India.

(vi) In light of the above observations, the issue of whether the services satisfy the "make available" clause under the FIS Article is wholly academic and infructuous.

13. Whether an arm's length price (ALP) adjustment was required to be made in respect of interest – free loan granted by the assessee, a non-resident company, to its wholly owned subsidiary in India – Held: Yes – In favour of the Revenue

Instrumentarium Corporation Ltd., Finland vs. ADIT 2016-TII-372-ITAT-KOL-TP-SB – Assessment years: 2003-04 and 2004-05

Facts

(i) The assessee, a non-resident engaged in the business of manufacturing and selling medical equipment, had a wholly owned subsidiary in India (the India Sub), which acted as the assessee's marketing arm for its products in India. The assessee advanced an interest-free loan to the India Subsidiary.

(ii) The Assessing Officer (AO) held that an AL interest on this loan was required, and the same had to be taxed in the assessee's hands. The AO computed notional interest and brought to tax such an amount in the assessee's hands, which was upheld by the Commissioner of Income-Tax (Appeals) [CIT(A)]. This was the crux of the dispute.

(iii) The assessee preferred an appeal before the Tribunal. An SB of the Tribunal was constituted to decide on the matter and answer the following question:

"Whether, on the facts and in the circumstances of the case, an arm's length price (ALP) adjustment was required to be made in respect of interest-free loan granted by the assessee, a non-resident company, to its wholly owned subsidiary in India?"

(iv) Apart from the assessee (being the appellant), another entity similar, and have therefore not been segregated. They have been presented as "Key contentions of the assessee". Similarly, the key contentions put forth by the Revenue in the intervener's case were quite also played the intervener before the SB.

(v) The Assessee contended that:

a) Computing an AL charge for the transaction would result in erosion of tax base, and consequent loss of tax revenue in India, which was not the intent of the Indian Transfer Pricing (TP) Regulations. Therefore, applying the provisions of section 92(3) of the Act, and CBDT circulars No. 12 and 14 of 2001, the TP provisions should not apply to the transaction in dispute. In support, reliance was placed on judicial precedents as per which CBDT circulars were binding on all field officers, and also on other judicial precedents as per which a statute should be interpreted to achieve and advance the legislative intent.

b) Section 92(3) of the Act cannot be given such a restrictive meaning so as to examine the impact of taxability only in the assessee's hands, rather than of all its associated enterprises (AE) put together.

c) Reliance was placed on "Taxation Ruling No. 2007/1" issued by the Australian Tax Office (ATO), as per which ALP adjustments were not required for interest-free loan advanced by a non-resident entity to a domestic company even if it was making losses.

d) An effort to increase losses (capable of being carried forward) had always been similarly viewed under the law as an effort to decrease profits. The expression, 'income' always included 'losses'. Thus, notional computation of tax should be taken into account for computing base erosion.

e) The second proviso to Section 92C(4) of the Act comes into play only when ALP is paid to the AE, as is evident from the language of the proviso. This was not so in the instant case, as no payment was made by the India Subsidiry.

(vi) The assessee's other contentions were with regard to : (a) grant of interest-free loan was in the nature of a shareholder service; (b) commercial expediency of the interest-free loan could not be disregarded; (c) interest-free loan being treated as interest-bearing amounted to re-characterisation, which was not permissible;

and (d) legally binding agreements between parties could not be disregarded.

(vii) The Revenue contended that:

a) The 'base erosion' argument was unsustainable in law as the Indian Subsidiry had been a loss-making company right from the beginning, and thus payment of interest by it would only enhance the losses; the loss of revenue would be merely notional. In fact, the non-application of the AL principle would result in a real loss for the Indian Revenue, and not the other way round. Loss to the Revenue for the purposes of Section 92(3) had to be real loss, and not hypothetical loss. Further, the time value of money could not be ignored, i.e., a rupee in tax, say five years from now, could not be treated as equivalent to a rupee in tax today.

b) Section 92(3) of the Act comes into play only when the income of an assessee, in whose hands income from an international transaction is to be computed, stands reduced, or the loss in his hands stands increased (and this was not so in the instant case).

c) The assessee was earlier charging interest on loans given to the India Subsidiary, but when the India Subsidiary suffered losses, the assessee stopped charging the interest.

d) The Indian AEs were not entitled to get any deductions in respect of adjustments made in the hands of the non-resident AEs. The second proviso to Section 92C(4) of the Act had thus been misinterpreted.

Decision

The SB rejected the 'base erosion' argument on account of the following:

(i) Re: Section 92(3)

a) Section 92(3) of the Act, essentially refers to computation of income in the hands of the assessee in respect of whom income is being computed under Section 92(1) of the Act.

b) Section 92(3) does not contemplate taking of a holistic view, considering lowering of overall profits/increasing overall losses, i.e., not only for the assessee but in respect of all AEs (taxable in India) taken as a whole.

c) A plain reading of Section 92(3) of the Act indicates that what is to be seen is impact on profits or losses for the year in consideration itself, rather than taking into account the impact on taxes for the subsequent years. The tax shield available to the Indian AEs as a result of accumulated losses, if any, could only affect income of the subsequent years, which were not relevant for the purpose of Section 92(3) of the Act. Thus, if the transaction in the instant case was accepted without an ALP adjustment, then it would result in base erosion to the extent of taxability of interest in the hands of the non-resident assessee, as the India Sub had incurred a loss.

d) To what extent this tax revenue could have been offset by the increase in the India Subsidirys loss was wholly academic, as there was no way to ascertain, at least at the assessment stage, as to whether this loss would be actually set off against future profits of the India Subsidiry. The tax administration could not be expected to predict whether or not the India Subsidiry would actually make sufficient profits in the next eight assessment years to subsume the losses. Further, time value of money could also not be ignored.

e) Even if the plea that TP provisions were not to be invoked when overall profitability is reduced was accepted, it would have no impact on the present fact situation, as the benefit of loss was not real – it was contingent upon an uncertain

event, i.e., profits being made in the future so as to subsume the losses. What was therefore known only with the benefit of hindsight today could not have been known at the time of assessment.

(ii) Re: Second proviso to Section 92C(4)

a) If an ALP adjustment was made in the hands of a non-resident assessee (for example, a recipient of interest income), the Indian AE would not be entitled to get any additional deduction in respect of such an adjustment, as there was no provision in the law enabling such an additional deduction. Accordingly, there would be no base erosion.

b) Further, this position did not change, irrespective of whether an altogether new income was brought to tax in the non-resident AE's hands, or there was an enhancement of income.

c) The reference to the second proviso of Section 92C(4) of the Act was thus unwarranted, as it applies to situations distinct from those prevailing in the instant case. This proviso constitutes a bar against lowering of the non-resident AE's income as a result of lowering the deduction in the Indian AE's hands, rather than as enabling a higher deduction in the Indian AE's hands as a result of increasing the non-resident AE's income.

(iii) Re: Reliance on Australian law

a) The assessee's reliance on Australian law was rejected as, unlike the Australian law, the Indian TP regulations did not give any discretion to the tax administration for application of ALP when computing profits arising from international transactions.

b) Further, in Australian law, as a result of ALP adjustments, consequential adjustments were permissible – no such adjustments were permissible in the Indian law.

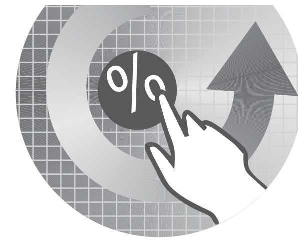
c) Since the relevant legal provisions were materially different, the clarifications issued by the ATO were also not relevant.

(iv) Re: CBDT circular

a) CBDT's circular No. 14 of 2001 is not an 'order, instruction or direction' of the CBDT (as referred to in section 119 of the Act) which bound the field authorities.

b) The role of 'intent of legislature' at best comes into play only when there is ambiguity in the words of the statute sought to be interpreted (which was not so in the instant case).

c) In addition to the above, the SB also rejected the 'commercial expediency', 'shareholder service' and re-characterisation arguments of the assessee. Specifically, it held that commercial expediency of a loan to a subsidiary was wholly irrelevant in ascertaining the AL interest on a loan which is an international transaction between AEs. The loan would thus be covered by Section 92 of the Act which mandated income from such transaction to be computed on the basis of ALP. Further, the question of re-characterisation arose only when the very nature of the transaction was altered, which was not so in the instant case, as the transaction under consideration continued to be a loan transaction. Finally, the SB directed the Division Bench to quantify the ALP Adjustment.



CA. Hasmukh Kamdar

INDIRECT TAXES
Central Excise and Customs – Case Law Update

Happy Hours vs. Commissioner of Customs Export
[W.P. (C) No. 5243 of 2016 and CM No. 21823 of 2016, decided on 30-5-2016, 2016 (338) E.L.T 559 (Del.)]

Freezing of Bank Account
Facts in this writ petition were as follows:

The Petitioner had exported 57 consignments of readymade garments between October, 2006 and July, 2007 and had availed the benefit of the Central Excise portion of the drawback incentives. The Department alleged fraud in availing such benefit and the petitioner's bank account No. 404700CA00019719 with the Punjab National Bank having a sum of ` 57,01,072/- was frozen in 2007, pending investigation.

A show cause notice was issued in October 2008 which was adjudicated and in May 2013 an Order in Original was passed by the Commissioner of Customs (Export) confirming the demand. Petitioner succeeded in its appeal before the Customs, Excise & Service Tax Appellate Tribunal (CESTAT) by Order passed in January, 2016.

The petitioner thereafter approached the respondent for defreezing of its account but did not get any response.

The Department's contention is that they are still in the process of taking a decision on filing an appeal against the order 2016 passed by the CESTAT in January 2016.

After hearing both the sides the Court observed that the respondent is not justified in continuing to keep the petitioner's account frozen for nearly five months after the petitioner succeeded before the CESTAT. If the respondent was keen that the petitioner's account should continue to remain frozen, it should have taken immediate steps to file an appeal.

In the circumstances, the Court directed that the petitioner's account No. 404700CA00019719 with the Punjab National Bank shall be defrozen forthwith. The petitioner was permitted to approach the Manager of the concerned branch of the Punjab National Bank, with a certified copy of the Court's order, and the Manager will proceed to forthwith defreeze the said account.

The writ petition was disposed of in the above terms.

Spentex Industries Ltd. vs. Commissioner of C.Ex. & S.T., Indore
[2016(338) E.L.T. 614 (Tri. – Del.)]

Reversal of CENVAT Credit
The facts in this case were as follows:

The appellants were engaged in the manufacture of cotton and synthetic yarn liable to Central Excise duty. They were availing CENVAT credit on inputs, input services and capital goods in terms of CENVAT Credit Rules, 2004. They were clearing a part of the finished goods without payment of duty in terms of Notification No. 30/2004-C.E., dated 9-7-2004. In respect of this exempted goods, the appellants were paying an amount equal to 6% of the value in terms of Rule 6(3)(i) of the said Rules.

The Revenue was of the view that as the appellants have availed credit on all inputs (used for duty paid as well as exempted final products) they are barred from availing the exemption under Notification No. 30/2004-C.E., dated 9-7-2004 which stipulates that nothing contained in the said notification shall apply to the goods in respect of which credit of duty on inputs has been taken under the provisions of CENVAT Credit Rules, 2004. The appellant's contention was that payment of 6% of value of exempted goods will make them entitled for above said exemption. For this, they rely on sub-rule (3D) of Rule 6 of CENVAT Credit Rules, 2004, which states as under:

"(3D) Payment of an amount under sub-rule (3) shall be deemed to be Cenvat Credit not taken for the purpose of an exemption notification where in any exemption is granted on the condition that no CENVAT credit of inputs and input services shall be taken".

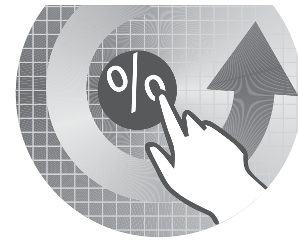
On behalf of the Appellants it was submitted that that exemption availing under the above-mentioned notification has been rightly claimed by the appellants. The findings of the original authority based on the Explanation (3) of Rule 3 are misconceived. The deeming provision under Rule 6(3D) covers the present situation. Even without this sub-rule when the assessee follows the procedure under Rule 6(3)(i) they are entitled for exemption. Reliance was placed on the decision of the Tribunal in Life Long Appliances Ltd. 2000 (123) E.L.T. 1110 (Tri. –Del.) and in Sita Singh & sons (P) Ltd. – 2015 (327) E.L.T. 281 (Tri. – Del.)

The Hon. Tribunal observed that the short point for decision is the eligibility of the appellant for exemption under Notification No. 30/2004 – C.E. when Appellants have reversed (paid?) 6% of the value of exempted goods in terms of Rule 6(3)(i). It was noted that the appellants claim on the applicability of sub-rule (3D) of Rule 6 is legally sustainable. The said sub rule provides for a deeming provision to the effect that payment of amount under sub-rule (3) should be considered as credit not taken for the purpose of such exemption notification. It was further noted that the appellant's case is covered by the said provision even before the introduction of the said sub-rule in 2011.

The Hon'ble Tribunal held that payment of amount under sub-rule (3)(i) of Rule 6 will make the assessee eligible for claiming such exemption as the present one. The case laws relied on by the appellants clearly supports their contention. The decisions of the Tribunal in Life Long Appliances Ltd. (supra), was affirmed by the Hon'ble Supreme Court reported at 2006 (196) E.L.T. A144 (S.C.).

It was further noted that the original authority had fallen in error in not considering the said sub-rule (3D) and relying on Explanation (3) of Rule 3. We find the said explanation has no relevance to the facts of the present case in view of the specific provision of sub-rule (3D) of Rule 6.

In view of above analysis and findings, the impugned order in appeal was held as unsustainable, and was accordingly, set aside. The appeal was allowed.



Nikita Badheka, *Advocate & Notary*

INDIRECT TAXES
VAT Update

A. Intimation about new automation returns

1. **By Circular No. 22 T of 2016 dated 26-8-2016,** the Commissioner has given detailed information about the returns to be filed under the new automation system. This circular also has answer to the few of the FAQs including the website help for filing the new returns. Each and every instruction given under this detailed circular running into 14 pages needs to be understood properly before one starts filing the new returns.

   One more corrigendum is issued to this circular on 30st August, 2016. This is a corrigendum to some of the paragraphs in the circular dated 26-8-2016. It is specifically made clear that blank CST returns will have to be filed by the dealers registered under the CST Act, although they have Nil turnover in the CST Act. The return templates are now available in the website and therefore following schedule dates are given.

Monthly returns

Month	Start Date	Extended date for uploading
April 2016	29-8-2016	26-9-2016
May 2016	6-9-2016	5-10-2016
June 2016	12-9-2016	11-10-2016
July 2016	16-9-2016	15-10-2016
August 2016	20-9-2016	20-10-2016
September 2016	26-9-2016*	25-10-2016*
***By a Corrigendum dates are revised to**	**1-10-2016**	**31-10-2016**

Quarterly returns

Month	Start Date	Last date for uploading
April-June 2016	26-10-2016	30-11-2016
July-Sept. 2016	26-11-2016	31-12-2016

It is specifically clarified by the Commissioner that the dealers who fail to upload the returns as per these circulars would be liable for payment of late fee.

2. **Circular 23T of 2016 dated 2-9-2016 & 25T of 2016 dated 7-9-2016**

   By this circular the Commissioner has intimated the dealers about the e-seva Kendra for the dealers who may not be able to apply online for registration being new dealers and helpdesk for new returns submissions, the Commissioner has given details about e-seva Kendra

who will be assisting the e-dealers for filing e-registration. The list of e-seva Kendra is available on the website of Mahaonline.

Similar assistance would be provided for new automated returns by the helpdesk. The Commissioner has clarified that applications submitted through e-seva Kendra would be treated as application submitted by the applicant and it would be responsibility of the applicant to check the correctness of the application before submitting the same online. The charges for e-seva Kendra will have to be borne by the dealer separately. The list of nodal help desk available at locations is on the website of the department. These officers shall work as help desk for e-returns.

By the next circular 25T of 2016, the earlier instructions stated above are withdrawn. However, it is provided that the applicants who wish to avail of the facility may approach any e-seva Kendra along with all details, documents required for registration or relevant details for availing the services of return, e-payment and e-CST declaration. The manual for application is available on website

3. Circular 24T of 2016 dated 3-9-2016

Clarifications about SAD Act, 2016.

The instructions for three issues are modified by this circular.

i) Condition of Stay

The condition about valid stay till date of withdrawal of appeal was causing impediment for SAD benefits. To mitigate this issue the modified instructions are given that the applicant can submit any kind of Stay which may be valid till the date of withdrawal of appeal order or not.

ii) Proof of withdrawal of appeal

The previous instructions about withdrawal order are revised. The applicant can simply submit the proof of submission of request letter to withdraw the appeal. Acknowledged copy of the receipt of this letter would be sufficient proof for withdrawal of appeal.

Appropriate directions are given to the Appellate Authority. In case the withdrawal is rejected the Appellate Authority should send the order to the Nodal Officer. The Nodal officer in turn can accept the application on mere acknowledgement. He should co-ordinate with the Appellate Authority about withdrawal of appeal and only after receipt of withdrawal order the settlement order will be passed.

iii) There were queries about penalty under section 61(2). It is clarified by the Commissioner that if the audit report is filed on or before 31st October, 2016, then the applicant would be entitled to full waiver.

4 Circular 26T of 2016 dated 9-9-2016:

Grant of Administrative relief to developers

By this circular the Commissioner has clarified that builders/developers who have complied with the conditions as per the previous circulars dated 6-8-2012, 25-9-2012 and 24-3-2015 would be considered for grant of administrative relief.

B. Notifications under the MVAT Act

1. Notifications regarding Amendment to Rules

Notification No. VAT-1516/CR 86/ Taxation-1 dated 6-8-2016

In Rule 17A, sub-rule 1(B) is inserted. This rule is regarding electronic filing. By new rule 17A(1B) the Commissioner is empowered to notify the date after which order, certificate, notice, intimation or any other document as specified in the Notification would be issued in the electronic form, with or without digital signature, as may be specified and in the manner laid down in the Notification.

2. Rule 21(1A) is inserted: The intimation under 23(5A) shall be in Form 604(B). Section 23(5A) is inserted by Maharashtra Act 15 of 2015 with effect from 23-4-2016. This new section refers to the intimation of the observation of the tax liability. This intimation should be in form 604(B) as per the new sub-rule.

3. New Rule 21(A) Rule 21 refers to form of notice for assessment. The new Rule 21(A) which shall be deemed to be inserted with effect from 1st April, 2011 is regarding fair market price. It is provided that the fair market price as per section 28A inserted as per Maharashtra Act, 2016 dated 26-4-2016 (with effect from 1-4-2011). As per this section if the Commissioner is of the opinion that the transaction by any dealer is below the prescribed fair market price for commodity for a prescribed class of dealer, to reduce the liability of tax, then the Commissioner would determine the fair market price. The new rule now inserted prescribes the manner to determine the fair market price. The table attached to this rule provides fair market price for various kinds of foreign liquor, country liquor, wines etc. The fair market price is prescribed for the prescribed class of dealer namely manufacturer and importer. This fair market price is to be determined at 50% of the MRP.

4. Rule 23 : This rule is substituted and Form 303 is prescribed. The proviso to this rule is about dealer liable to file more than one form of return for such dealers separate orders pertaining to different form of return are required to be issued.

C. VAT 1516/CR-85/Taxation-1 dated 6th August, 2016

By this notification rule 52A is amended. The proviso to rule 52A is amended. The marginal note is substituted. This rule is regarding mega-units The marginal note (title to the rule) shall now read: "set off in respect to goods manufactured by certain dealers covered under various package of incentives". Sub-rule 1 of this rule is amended. If the claimant dealer has purchased goods (other than declared goods), which are originally manufactured by

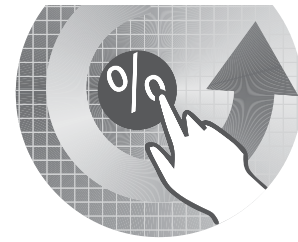
(i) Mega unit or Ultra mega unit – holding valid ID certificates or

(ii) Very large unit or mega unit holding certificate of entitlement by way of deferment under PSI, 1983.

Such claimant dealer shall be entitled to claim the set off only to the extent of aggregate of

Tax paid or payable under the CST Act on inter-State resale of corresponding goods and taxes paid on purchase of the goods if resold locally under the Act.

Rule 83A is substituted. The declaration provided for the purpose of section 89 is substituted. The declaration to be given by immediate purchaser or subsequent purchaser is also substituted.



CA Rajkamal Shah & CA Naresh Sheth

INDIRECT TAXES
Service Tax – Statute Update

1. Service tax on freight forwarders on transportation of goods from India:

Board received many representations regarding service tax on freight forwarders on transportation of goods from India. It has clarified position as to place of provision of such services and its taxability. The clarifications are broadly summarised as under:

Nature of transaction	Applicable Rule of Place of Provision of Service Rules ('POPSR')
Freight forwarders merely acting as a booking agent ('intermediary') where: • Freight forwarders have no responsibility for the actual transportation • Legal proceedings, if any, can be instituted against airline/ocean carrier and not against freight forwarder	Rule 9 of POPSR: Place of provision of service would be location of service provider (freight forwarder).
Freight forwarders acting as principal who provides service of transportation of goods where freight forwarders: • Negotiate terms of freight with airline carrier /ocean liner • Raises invoice on the exporter • Bears all the risk and responsibility of transportation of goods	Rule 10 of POPSR: Place of provision of service would be the place of destination of goods. If destination of goods is outside India, place of provision of service would be outside India. Consequently, freight forwarders are not liable to service tax.

[Circular No.197/07/2016-ST, dated 12-8-2016]

2. Service tax on hiring of goods without transfer of the right to use goods

There was a confusion at field level as to taxability of hiring, leasing or licensing of goods especially hiring of goods without transfer of right to use the goods. Board has clarified the position as under:

- Transactions involving transfer of right to use goods in terms of Article 366(29A) are liable to VAT/Sales Tax.
- Transfer of right to use goods involving hiring, leasing or licensing or in any such manner not involving transfer of right to use goods is liable to service tax in terms of section 66E(f) of the Finance Act, 1994.
- In cases involving hiring, leasing or licensing of goods it is essential to determine whether in terms of contract there is transfer of the right to use the goods.
- Criteria laid down by Honourable Supreme Court in the case of Bharat Sanchar Nigam Limited vs UOI [2006 (2) STR 161 SC] to be invariably followed and applied in cases involving hiring, leasing or licensing of goods.
- Circular cites many other cases which officers need to refer while determining the taxability of hiring, leasing or licensing transactions. However, said case laws are not to be applied mechanically. Terms of contract and facts of the case should be examined carefully considering the diverse nature of transactions such as difference between operating lease and finance lease or between dry lease and wet lease in case of aircraft industry.

[Circular No. 198/08/2016-ST, dated 17-8-2016]

3. Services provided to the Government, local authority or a Governmental authority with regard to water supply

It was reported to Board that in case of some contractors providing services of construction of tube wells for Government were made liable to service tax on such services. Board has now clarified the position as under:

- Entries 12(e) and 25(a) of Notification No. 25/2012-ST dated 20-6-2012 provides exemption in respect of specified services provided to Government or local authority or Governmental Authority in relation to water supply.
- Above entries cover wide range of activities and these exemption entries are to be interpreted and understood with reference to a context.

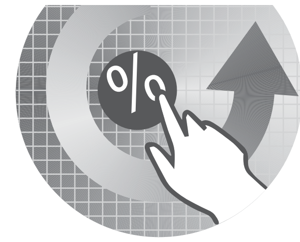
Phrase 'water supply' is a general phrase and will involve not only service of providing users access to a source of water but also activities like drilling, laying of pipes, valves, gauges, etc. eventually resulting in the supply of water.

The source of water may be natural or artificial like tanks, wells, tube wells, etc., whereas a 'plant' for water supply need not necessarily involve a huge assembly of machinery or apparatus.

[Circular No. 199/09/2016-ST, dated 22-8-2016]

4. Presently transport of passengers, with or without accompanied belongings, by air is allowed 60% of abatement with the condition that CENVAT credit on input service shall be allowed. Now transport of passengers, with or without accompanied belongings, by air, embarking from or terminating in a Regional Connectivity Scheme Airport shall be allowed 90% of abatement, with the condition that no CENVAT credit shall be allowed. Further, it has been provided that such enhanced abatement shall not be allowed on or after the expiry of a period of one year from the date of commencement of operations of the Regional Connectivity Scheme Airport as notified by the Ministry of Civil Aviation.

[Notification No. 38/2016-ST dtd. 30-8-2016]



CA. Bharat Shemlani

INDIRECT TAXES
Service Tax – Case Law Update

1. Services

Admission and access to Entertainment events and amusement facilities

1.1 Kanjirappilly Amusement Park & Hotels Pvt. Ltd. vs. UOI 2016 (43) STR 323 (Ker.)

The issue before the High Court was whether levy of service tax on 'admission and access to entertainment event and amusement facilities' in view of removal from section 66D(j) of FA, 1994 is valid. It is held that, Parliament did not trench on exclusive field assigned to State under Entry 62 of List II of VII Schedule of Constitution of India. The object of taxation and measures employed cannot be mixed up, which at times may provide indication as to nature of tax but never determine it. Further the enacted legislation cannot decide field of taxation, as power to tax is to be sourced from Article 245 of Constitution. Amusements are covered by Entry 62 of List II but aspect of 'service' when facilities for amusement is offered for price can be taxed under Union Parliament's power to levy it by appropriate enactment.

Erection, Commissioning and Installation Service

1.2 CCE, Jaipur-I vs. Sanjay Engineering Industries 2016 (43) STR 354 (Raj.)

The High Court in this case held that benefit of Notification No. 1/2006-ST is available even if the earlier credit taken has been reversed subsequently along with interest after clearance of goods as the same amounts to situation where no credit was taken.

Business Support Service

1.3 Reliance Ada Group Pvt. Ltd. vs. CST, Mumbai-IV 2016 (43) STR 372 (Tri.-Mumbai)

The appellant in this case engaged in activity of promoting, managing, administering, counselling or otherwise assisting in growth and operation of Group companies by way of entering into a cost sharing agreement with participating Group companies. The Tribunal observed that, service were provided by third parties and appellant is appointed as a trustee or manager to obtain, hold and manage resources required for jointly carrying out activities. The appellant entitled for only fixed remuneration for acting as manager and no common services are provided but only procured from other service providers. It is held that, cost therefore shared by recipient participating Group companies by making reimbursement to appellant cannot be regarded as consideration flowing to appellant towards taxable service. Further, no additional fees or profits or consideration for pure agent services is received by appellant and they satisfy condition of a 'pure agent' as set out in rule 5(2) of Valuation Rules.

1.4 Emrald System Engg. Ltd. vs. CST, Mumbai - II 2016 (43) STR 545 (Tri.-Mumbai)

The Tribunal in this case held that, the activity of arranging of entire transportation, dispatching of the goods, supervising the loading and unloading

of goods is covered under BSS and not under BAS. It is further held that, activity of organizing orders from various stockiest, distribution of goods and collecting them from stockiest is liable under BAS.

Business Auxiliary Service

1.5 CCE&ST LTU, Delhi vs. Honda Siel Cars India Ltd. 2016 (43) STR 390 (Tri.-Del.)

The department sought to demand tax on consideration received for extended warranty scheme offered for cars under BAS. The Tribunal held that, there is no enhancement of business or increase arising from extended warranty scheme and such enhancement arises from defects in cars and replacement of defectives are not happy anticipations. Such warranty scheme does not of itself render it a service and not a taxable service under BAS. Service will be provided only when defects exist in a car and mere coverage by extended warranty scheme does not of itself create an intention to use service of dealer.

1.6 Mahesh Auto vs. CCE, Aurangabad 2016 (43) STR 437 (Tri.-Mumbai)

The appellant received commission from Financial Institutions and paid service tax under BSS, however claimed refund on the ground that said commission is not taxable under BSS according to Tribunal decision but under BAS. The Tribunal held that, Tribunal in the said decision categorically held that, aforesaid commission is taxable *per se* and appellant having himself classified services under BSS as per their understanding and discharged service tax accordingly cannot now dispute their liability and claim refund.

1.7 Sourav Ganguly vs. UOI 2016 (43) STR 482 (Cal.)

The High Court in this case held that, following activities are not liable to tax under BAS:

- Writing articles for newspapers, sports magazines or for any other form of media
- Anchoring of TV shows
- Brand promotion as the same is made taxable w.e.f. 1-7-2010
- Playing of IPL matches

Tour Operator's Service

1.8 SVR Tours and Travels vs. CCE&ST, Hyderabad-II 2016 (43) STR 405 (Tri.-Hyd.)

The appellant engaged in plying of contract carriage vehicles to various places as both intra-State and inter-State and department sought to demand the tax as tour operator. The Tribunal held that, appellant operating buses not under tourist permit but under contract carriage permit. Buses of appellant do not conform to specification of tourist vehicle and therefore not covered under tour operator service for the relevant period.

Management, Maintenance or Repair Service

1.9 CST, Mumbai-II vs. Global SS Construction Pvt. Ltd. 2016 (43) STR 433 (Tri.-Mumbai)

The appellant in this case engaged in activity of operating plants such as cooling water system, compressed air system, boilers etc. The adjudicating authority dropped demand on the ground that in absence of any specific clause in contract for providing management, maintenance or repair mere operating of plant is not covered under this service. It was also held that operation of plant etc. on behalf of other got covered under BSS at much later date. The Tribunal held that, there being nothing in appeal averments to counter aforesaid findings of facts and law by adjudicating authority, revenue's appeal is liable to be rejected.

1.10 D. P. Jain & Co. Infrastructure Pvt. Ltd. vs. UOI 2016 (43) STR 507 (Mom.)

The High Court in this case held that repair of road and airports excluded from construction services does not mean that it cannot form part of other taxable service. The Legislature thought it fit to bring it within management, maintenance or repair service. It is further held that, retrospective exemption to activity of management, maintenance or repair of road w.e.f. 16-6-2005 does not include runways in airport which are specifically prepared along which aircraft takes off and lands. It is not how it is made and surfaced but what it is utilised for which is relevant. Hence road cannot be said to be genus of which runway is specie.

Banking & Other Financial Service

1.11 Citibank NA vs. CST, Chennai 2016 (43) STR 445 (Tri.-Chennai)

The Tribunal in this case held that, mark up charges for cards used abroad are being charged only on foreign currency transaction as a part of cost of goods/services purchased abroad by cardholder and not as a consideration for extending credit facility. Further, the Tribunal decision in *SBI Cards* and *Payment Services Pvt. Ltd. 2016 (41) STR 846 (Tri.-Del.)* holding that mark-up charges attributable to conversion of currency, is also squarely applicable to the present case. The decision about mark-up charges on credit card is also applicable to mark-up charges on debit card also.

2. Interest/Penalties/Others

2.1 G. B. Engineers vs. UOI 2016 (43) STR 345 (Jhar.)

The appellant in this case claimed refund of service tax paid for the period prior to date on which ECI services made taxable. The High Court held that, service tax paid by the appellant being erroneous and without authority of law and cannot be retained by Government. For refund of such erroneous levy, statutory provisions prescribing limitations are not applicable.

2.2 Renfro India Pvt. Ltd. vs. CCE, Pune-III 2016 (43) STR 385 (Tri.-Mumbai)

In the present case, appellant availed refund of accumulated credit availed during the years 2004, 2005 and 2006 under Notification No. 5/2006 CE (NT) in the year 2006. The Tribunal held that, while one to one co-relation of inputs with manufactured product may not be possible for a particular quarter, a nexus of use of inputs/input services in manufactured product is required to be established. Since nexus of inputs and output is not established the refund is not admissible.

2.3 CCE, Indore vs. Kriti Industries (I) Ltd. 2016 (43) STR 443 (Tri.-Del.)

The Tribunal in this case held that, appellant having borne service tax under Technical Testing and Analysis Service on activities of supervision of weighment, sampling, container, stuffing analysis etc. cannot be denied refund of service tax when such activities used in export of goods. It is further held that, even if these activities may appear classifiable under any other heading, since no objection raised on payment of service tax under impugned service, refund is admissible.

2.4 Usha International Ltd. vs. CST, New Delhi 2016 (43) STR 552 (Tri.-Del.)

The appellant company amalgamated on the basis of High Court's order dated 26-5-2008 w.e.f. 1-4-2007. They have claimed refund of service tax paid on royalty paid to transferor company during the period 1-4-2007 to 26-5-2008. The Tribunal held that the date of amalgamation held to be 1-4-2007 and services rendered during the impugned period became service to self and therefore appellant eligible for refund. Further it is held that, since services were rendered to self, service tax burden can only be passed on to self and passing of burden to self is not tantamount to passing it to any other person.

2.5 Cognizant Technology Solutions vs. CCE&ST(LTU) Chennai 2016 (43) STR 576 (Tri.-Chennai)

The department in this case denied refund of accumulated CENVAT credit on export of software to SEZ on the ground that, export of software services was not taxable prior to 16-5-2008. The Tribunal observed that, the appellant has been granted registration for activity of developing software for export as well as for domestic clearance under management, maintenance or repair service. They are also paying service tax in cash as well as CENVAT credit on domestic services under said service. It is held that, department cannot have two standards one for accepting payment of service tax and second for grant of accumulated credit. Even otherwise aforesaid activity is taxable under MMRS in terms of decision of Tribunal in *KPIT Cummins Infosystems Ltd. 2013 (32) STR 356 (Tri.-Mum.)*. Further in view of decision in *Tata Consultancy*

Services Ltd. 2013 (29) STR 393 (Tri.-Mum.) refund of accumulated credit on account of export of services to SEZ is permissible.

2.6 Benzy Tours & Travels Pvt. Ltd. vs. CST, Mumbai-I 2016 (43) STR 625 (Tri.-Mumbai)

The appellant in this case claimed refund of service tax paid erroneously on BAS on the ground that limitation period cannot be made applicable in such cases as tax cannot be retained without authority of law. The Tribunal held that, if the contention of appellant is accepted than statutory provisions prescribing limitation period would become redundant. Every case of refund is for duty/tax paid but not payable. There being no other provision of refund, time limit prescribed under section 11B of CEA, 1944 has to be mandatorily followed. The Tribunal functioning under CEA/CA and cannot go beyond the statute and relax time limitation prescribed as per law.

2.7 Lufthansa German Airlines vs. CST, (Adjn), New Delhi 2016 (43) STR 636 (Tri.-Del.)

The Tribunal in this case held that, passenger service fees collected by assessee on behalf of Airport Authority of India and paid to said Authority is not includible in value of services.

3. CENVAT Credit

3.1 CCE, Bangalore vs. Sanmar Speciality Chemicals Ltd. 2016 (43) STR 347 (Kar.)

The High Court in this case allowed CENVAT credit of service tax paid for services procured for infusing finance in manufacturing company is undoubtedly related to manufacturing activity and therefore CENVAT credit thereon is admissible. It is further held that, tax credit claimed duly reflected in return hence it cannot be said that there is suppression of facts.

3.2 Sanmar Foundaries Ltd. vs. CCE, Trichy 2016 (43) STR 362 (Tri.-Chennai.)

The Tribunal in this case allowed CENVAT credit on the following services:

- Helicopers used for transportation of Directors and Chairman.
- Rent-a-cab and contract bus services used exclusively for transportation of officers and in case there is recovery of cost, proportionate credit to be reversed.
- Management Consultancy services without elaborating the reasons for disallowance in SCN.

3.3 Aster Pvt. Ltd. vs CC&CE, Hyderabad-III 2016 (43) STR 411 (Tri.-Hyd.)

The appellant in this case reversed proportionate credit used for manufacturing exempt goods under rule 6(3), however failed to intimate the option to the department. The department demanded 10%/5% of sale price of exempted goods. The Tribunal held that, rule 6(3A) simply contemplating procedure for application of rule 6(3) and does not provide that on failure to intimate in writing for availing option, manufacturer/service provider to lose his choice to avail option under rule 6(3)(ii) for reversing proportionate credit. Procedure and condition in said rule are intended to make rule 6(3) workable and not to take away option exercisable under it. Rule 6(3)(i) does not become automatically applicable on failure to intimate in writing about option availed.

3.4 Sitel India Ltd. vs. CCE, Mumbai-II 2016 (43) STR 424 (Tri-Mumbai)

The Tribunal in this case allowed CENVAT credit on following:

- Employees of BPO are to perform duties on 24*7 basis which adversely affect health of employees which directly affects performance of services, hence health and fitness service is essential factor in order to run function of a BPO.
- Transport services used for transportation of goods.
- Service tax levied on electricity charges which is consumed by the appellant for business operations.

3.5 Xilink India Technology Services vs. CCCE&ST, Hyderabad-IV 2016 (43) STR 438 (Tri.-Hyd.)

The department in this case rejected service tax paid on various input services used in software services exported by EOU on the ground that, no nexus with output service. The Tribunal held that prior to 1-4-2011 when definition of Input Service had wider ambit and included activities 'relating to business' besides services used, directly or indirectly in or in relation to manufacture of final product refund is admissible.

It is further held that, there is no requirement that input credit claimed as refund should correspond to months in which exports have taken place.

3.6 Sundaram Fastners Ltd. vs. CCE, Chennai-II 2016 (43) STR 454 (Tri.-Chennai)

The Tribunal in this case allowed CENVAT credit of service tax paid on insurance premium for employee's welfare and compensation in case of hazard and pest control services used for business protection.

3.7 Bajaj Hindustan Ltd. vs. CCE, Meerut 2016 (43) STR 461 (Tri.-Del.)

The Tribunal in this case allowed CENVAT credit of service tax paid on construction of dormitory within factory premises for technicians/engineers as the stay of those peoples required in factory located in remote area for maintenance of plant and machinery.

3.8 CCE, Delhi-III vs. Exide Industries Limited 2016 (43) STR 463 (Tri.-Del.)

The Tribunal in this case held as follows;

- Admissibility of credit of construction of factory for the period prior to 1-4-2011 cannot be disputed
- Repair and maintenance of building/plant/road is input service as the definition of input service specifically includes services used in relation to modernisation, renovation, repair of factory. The amendment in 2011 excludes only construction service from this definition and not services relating to repair or renovation.

3.9 Pithampur Tools Pvt. Ltd. vs. CCE, Indore 2016 (43) STR 465 (Tri.-Del.)

In the present case, the Tribunal held that, in absence of any restriction under statutory provision not to avail credit of input services prior to taking registration under Central Excise, credit not deniable for services used for construction of factory.

3.10 JCT Ltd. vs. CCE, Ludhiana 2016 (43) STR 467 (Tri.-Chan.)

The supplier of service has charged service tax on 67% of value of service provided instead of 33% and appellant being service recipient taking credit of tax actually paid. The Tribunal held that, CENVAT credit is not deniable to appellant.

3.11 Amara Raja Electronics Ltd. vs. CCE, Tirupathi 2016 (43) STR 601 (Tri.-Hyd.)

The Tribunal in this case held that since objection at the end of service provider has not been raised and tax paid by them is accepted by the department then credit cannot be denied to service recipient alleging that no services were rendered.

3.12 Grindwell Norton Ltd. vs. CCE, Tirupati 2016 (43) STR 614 (Tri.-Hyd.)

The Tribunal in this case held as under:

- Rubber hoses and air receivers are Capital Goods and integral to manufacturing process of Silicon Carbide.
- Payroll processing of employees is part of maintaining proper accounts and C Form collection is necessary for upkeep of tax accounting therefore credit on these input services admissible.

Janak C. Pandya, Company Secretary

CORPORATE LAWS
Company Law Update

Case Law No. 1

[2016] 197 Comp Cas 386 (Raj.)
[In the Rajasthan High Court – Jaipur Bench]
Uma Enterprises P. Ltd., In re

A demerger scheme cannot be unlawful or invalid merely on suspicion of alleged avoidance of tax and stamp duty. However, if sanctioned, it would tantamount to a sanction being sought contrary to public interest if the same is adopted solely with the intent to avoid tax and without any evidence that the same is for the benefit of the shareholders and for efficiency of the restructured business.

Brief Case

This petition has been filed by the petitioner company for the sanction of the Scheme of Demerger ("Scheme"). The Scheme envisages transfer of a certain land to nine resultant companies to enable them to pursue the business of real estate. The Scheme was necessitated due to family arrangement between the shareholders who are all related. The demerger will facilitate each branch of family to have an independent right to operate the resultant company. This will facilitate cordial relations amongst them. Further, it was submitted that the Scheme is in compliance of all applicable laws. The court has only supervisory jurisdiction and to ensure that Scheme is fair, reasonable, just and not contrary to public interest while sanctioning the same.

Based on the Court order, the necessary procedural compliances with respect to obtaining the approval of the shareholders and unsecured creditors were completed. The necessary advertisements were also published in English and vernacular language newspapers. The notice thereof was also served upon the Regional Director ("RD").

The RD in its reply, by filing four affidavits, objected the Scheme on following grounds:

1. The company is engaged only in manufacturing and sale of vanaspati and edible oils.
2. Since its incorporation, the company has not generated any income from its real estate business.
3. In its balance sheet, the land is shown under "fixed assets" category and not under "current assets", thus showcasing that the company does not carry any real estate business.
4. Under the colour of demerger, the land having a market price of ` 260 crores is being transferred at a face value of ` 1.61 lakhs only.
5. The Scheme is also *mala fide* as it is based upon incorrect statement of facts

as to the existence of real estate division as an ongoing concern/undertaking/division. At no point of time, real estate business was being carried out by the company.

6. The Scheme is evidently a sham and mere ruse to convey the company's land to third parties.

7. The Scheme will lead to circumventing the capital gains liabilities under the Income-tax Act, 1961.

8. It also circumvents the payment of stamp duty under the Rajasthan Stamp Act, 1998.

9. The Scheme does not fall within the ambit of Section 2 (19AA) of the Income-tax Act, 1961.

10. It is for advancement of private interest of the promoters and shareholders.

11. If sanctioned, the Scheme will cause huge loss to the public exchequer and thus it is against public interest.

12. The capital expenditure on account of alleged levelling of land cannot be taken as a commencement of real estate business or creation of real estate division.

13. The shareholders of the company will get the non-cumulative compulsorily redeemable preference shares and not equity shares, thus, separating them from ownership/interest in the resultant companies. This shows it is more of sale of assets under a device to circumvent tax liability.

The petitioner submitted the following:

1. The Scheme is in compliance with all operative laws and within the legal framework of the Companies Act, 1956 ("Act").

2. Any taxation issue pertaining to the Scheme will take its own course under the Income-tax Act, 1961 or the Act of 1998.

3. As per the Supreme Court, mere suspicion of alleged avoidance of tax cannot be ground for not sanctioning the Scheme, which is otherwise lawful and valid. The judgment in case of *CIT vs. Calcutta Discount Co. Ltd. [1973] 91 ITR 8 (SC); [1974] 3 SCC 260* was referred.

4. The argument of RD is not correct when the capital expenditure incurred on land is certified by the statutory auditor and also accepted by the Income Tax Department.

5. For the commencement of business, mere intention to do so suffices and that RD has not cited any rule, regulation or law applicable to a private limited company.

6. The shareholders have approved the resolution in their EGM to pursue the business of real estate as mentioned in clauses 9, 10 and 11 of Part C of the other objects of the company's memorandum of association.

7. Issue of compulsorily redeemable preference shares in lieu of equity shares in a case of demerger of a company is a matter of practice and does not render the Scheme illegal or fraudulent.

Judgment and reasoning

The Court rejected the petition and held that the Scheme is only a device for avoidance of obligation towards capital gains tax and stamp duty. It is falls foul of explanation to section 2 (19AA) of the Income-tax Act, 1961.

The reasoning is as under:

1. While the Scheme under Sections 391 to 394 of the Act is fundamentally a commercial document based on the commercial wisdom of the shareholders and creditors of the company, the sanction is not to be mechanically granted.
2. However, the court while sanctioning the Scheme has to ensure that it is not prejudicial to public interest and does not violate any provision of law rendering it contrary to public interest and is not a device to evade tax.
3. As per available records, since incorporation, the company is only in the business of manufacturing and sale of edible and vanaspati oil.
4. The company did not carry out any real estate activity as neither was such activity reflected in its even tax audit report or its books of account by way of turnover, income and profit therefrom.
5. A mere intent to commence the business of real estate does not bring it within the scope of Section 2(19AA) of the Income-tax Act, 1961.
6. Issuance of compulsorily redeemable preference shares in lieu of equity shares is also indicative of the arrangement/demerger being a plain transfer of land.
7. Reliance was placed in the Apex Court judgment in *McDowell and Co. Ltd. vs. CTO [1985] 154 ITR 148 (SC); [1985] 59 STC 277 (SC); [1985] 3 SCC 230.* In the said case, it was held that though tax planning may be legitimate within the framework of law, yet colourable device cannot be part of tax planning and it is wrong to encourage or entertain the belief that it is honourable to avoid the payment of tax through dubious methods.
8. In a *Gujarat High Court judgment of Wood Polymer Ltd., in re [1977] 109 ITR 177 (Guj.),* it is said that if the object of a Scheme of amalgamation and by extension demerger, is just to defeat tax provisions, it would be against public interest.
9. The company court before sanctioning a Scheme should ensure that the arrangement is not violative of law or is not contrary to public policy/interest. The judgment of Apex Court in in *Hindustan Lever vs. State of Maharashtra [2003] 117 Comp Cas 758 (SC); [2004] 9 SCC 438 reiterated the judgment of Miheer H. Mafatlal vs. Mafatlal Industries Ltd. [1996] 87 Comp Cas 792 (SC); [1997] 1 SCC 579.*

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OTHER LAWS
FEMA Update

In this article, we have discussed recent amendments to FEMA issued by Press Release by Press Information Bureau.

1. Cabinet approves simplification and liberalisation of the Foreign Direct Investment Policy, 2016 in various sectors

The Union Cabinet chaired by the PM Narendra Modi has given its *ex-post-facto* approval for the FDI policy amendments announced by the Government on 20th June, 2016.

Background of the amendment: In last two years, GOI has brought major FDI policy reforms in a number of sectors. Measures undertaken by GOI have resulted in increased FDI inflows at US$ 55.46 billion in financial year 2015-16, as against US$ 36.04 billion during the financial year 2013-14. This is the highest ever FDI inflow for a particular financial year. However, it was felt by GOI that the country has potential to attract far more foreign investment which can be achieved by further liberalising and simplifying the FDI regime.

Accordingly, Union Government radically liberalised the FDI regime on **20th June, 2016** with the objective of providing major impetus to employment and job creation in India. Changes introduced in the policy include increase in sectoral caps, bringing more activities under automatic route and easing of conditionalities for foreign investment. The amendments are aimed at further simplifying the regulations governing FDI in India and make India an attractive destination for foreign investors.

The details of the press release are as follows:

a) Radical Changes for promoting Food Products manufactured/produced in India

It has now been provided that 100% FDI under Government route for trading, including through e-commerce, is permitted in respect of food products manufactured and/or produced in India.

(No Change in comparison to Press Note 5 dated 26th June 2016 issued by DIPP)

b) Foreign Investment in Defence Sector up to 100%

Earlier FDI regime permitted 49% FDI participation in the equity of a company under automatic route. FDI above 49% was permitted through Government approval on case-to-case basis, wherever it is likely to

result in access to modern and 'state-of-art' technology in the country. In this regard, the following changes have *inter-alia* been brought in the FDI policy on this sector:

i. Foreign investment beyond 49% has now been permitted through Government approval route wherever it is likely to result in access to modern technology or for other reasons to be recorded.

ii. FDI limit for defence sector has also been made applicable to manufacturing of Small Arms and Ammunitions covered under Arms Act 1959.

(No Change in comparison to Press Note 5 dated 26th June 2016 issued by DIPP)

c) Review of Entry Routes in Broadcasting Carriage Services

FDI policy on Broadcasting carriage services has also been amended. New sectoral caps and entry routes are as under:

Sector/Activity	*New Cap and Route*
5.2.7.1.1 (1) **Teleports** (setting up of up-linking HUBs/Teleports)	100% Automatic
(2) **Direct to Home** (DTH)	
(3) **Cable Networks** (Multi System operators (MSOs) operating at National or State or District level and undertaking upgradation of networks towards digitalisation and addressability)	
(4) **Mobile TV**	
(5) **Headend-in-the Sky Broadcasting Service** (HITS)	

Sector/Activity	*New Cap and Route*
5.2.7.1.2 Cable Networks (Other MSOs not undertaking upgradation of networks towards digitalization and addressability and Local Cable Operators (LCOs))	
Infusion of fresh foreign investment, beyond 49% in a company not seeking licence/ permission from sectoral Ministry, resulting in change in the ownership pattern or transfer of stake by existing investor to new foreign investor, will require FIPB approval	

(Difference in comparison to Press Note 5 dated 26th June 2016 issued by DIPP: In place of Government, specific approval of FIPB has been provided.)

d) Pharmaceutical

The earlier FDI policy on pharmaceutical sector provides for 100% FDI under automatic route in greenfield pharma and FDI up to 100% under Government approval in brownfield pharma. With the objective of promoting the development of this sector, 74% FDI under automatic route has been permitted in brownfield pharmaceuticals. FDI beyond 74% would be permitted through Government approval route

(No Change in comparison to Press Note 5 dated 26th June 2016 issued by DIPP)

e) Civil Aviation Sector

(i) The earlier FDI policy on Airports permitted 100% FDI under automatic route in Greenfield Projects and 74% FDI in Brownfield Projects under automatic route. FDI beyond 74% for Brownfield Projects is under Government route.

(ii) With a view to aid in modernisation of the existing airports to establish a high

standard and help ease the pressure on the existing airports, 100% FDI under automatic route has now been permitted in Brownfield Airport projects.

(iii) As per the earlier FDI policy, foreign investment up to 49% was allowed under automatic route in Scheduled Air Transport Service/ Domestic Scheduled Passenger Airline and regional Air Transport Service. This limit has now been raised to 100%, with FDI up to 49% permitted under automatic route and FDI beyond 49% through Government approval. For NRIs, 100% FDI will continue to be allowed under automatic route. Foreign airlines would continue to be allowed to invest in capital of Indian companies operating scheduled and non-scheduled air-transport services up to the limit of 49% of their paid up capital.

(No Change in comparison to Press Note 5 dated 26th June 2016 issued by DIPP)

f) Private Security Agencies

The earlier policy permitted 49% FDI under Government approval route in Private Security Agencies. Since Private Security Agencies are already required to get license under PSAR Act 2005, the requirement of putting them through another line of Government approvals through FIPB has now been done away with for FDI up to 49%. Accordingly, FDI up to 49% is now permitted under automatic route in this sector. FDI beyond 49% and up to 74% is permitted through Government approval route.

(No Change in comparison to Press Note 5 dated 26th June 2016 issued by DIPP)

g) Establishment of branch office, liaison office or project office

For establishment of branch office, liaison office or project office or any other place of business in India if the principal business of the applicant is Defence, Telecom, Private Security or Information and Broadcasting, it has provided that approval of Reserve Bank of India would not be required in cases where FIPB approval or licence/permission by the concerned Ministry/Regulator has already been granted.

(No Change in comparison to Press Note 5 dated 26th June 2016 issued by DIPP)

h) Animal Husbandry

As per FDI Policy 2016, FDI in Animal Husbandry (including breeding of dogs), Pisciculture, Aquaculture and Apiculture is allowed 100% under Automatic Route under controlled conditions. The requirement of 'controlled conditions' for FDI in these activities has now been done away with.

(Difference in comparison to Press Note 5 dated 26th June 2016 issued by DIPP: It has been explicitly mentioned that the requirement of 'controlled conditions' for FDI in these activities has now been done away with.)

i) Single Brand Retail Trading

Local sourcing norms have been relaxed up to three years, with prior Government approval, for entities undertaking Single Brand Retail Trading of products having 'state-of-art' and 'cutting edge' technology. For such entities, sourcing norms will not be applicable up to three years from commencement of the business i.e. opening of the first store for entities undertaking single brand retail trading of products having 'state-of-art' and 'cutting-edge' technology and where local sourcing is not possible. Thereafter, sourcing norms would be applicable.

(Difference in comparison to Press Note 5 dated 26th June 2016 issued by DIPP: The wordings of this press release make it clear that non- applicability of sourcing norms shall be available only with prior government approval.*)*

(PIB Press Release bearing Release ID 149381 dated 31st August, 2016)

2. Cabinet approves foreign investment in other Financial Services sector

In the last budget speech, the FM had announced that "FDI will be allowed beyond the 18 specified NBFC activities in the automatic route in other activities which are regulated by financial sector regulators". Currently, the regulations on "Non-Banking Finance Companies" stipulates that FDI would be allowed on automatic route for only 18 specified NBFC activities after fulfilling prescribed minimum capitalisation norms mentioned therein.

The Union Cabinet chaired by the PM Narendra Modi has given its approval to amend regulation for foreign investment in the Non-Banking Finance Companies (NBFCs).

The amendment in the existing Foreign Exchange Management (Transfer or Issue of Security by the Person Resident Outside India) regulations on Non-Banking Finance Companies (NBFCs) will enable inflow of foreign investment in "Other Financial Services" under automatic route provided such services are regulated by any financial sector regulators (RBI, SEBI, PFRDA etc.)/ Government Agencies. Foreign investment in "Other Financial Services", which are not regulated by any regulators/Government Agency, can be made on approval route.

Further, minimum capitalisation norms as mandated under FDI policy have been eliminated as most of the regulators have already fixed minimum capitalisation norms. This will induce FDI and spurt economic activities. It will cover whole India and is not limited to any State/Districts.

(Comments: Cabinet approval of Foreign Invest in Financial Services sector will boost the country's economy further. Allowing investment in financial services other than the 18 NBFC activities listed in the FDI Policy will open up FDI permissibility into financial services such as commodity broking, asset finance companies, depository participants and infrastructure debt funds, etc. 100% FDI under the automatic route in such services will however be allowed only if they are regulated by any financial services regulator. This would ensure that they are lawfully regulated. Further, an exemption from capitalisation norms under FDI policy has been provided to these companies as they would already have explicit capitalization norms provided by their regulators and thereby avoid compliance with multiple cap norms.)

3. Cabinet Approves Grant of Permanent Residency Status to Foreign Investors

The Union Cabinet under the Chairmanship of PM Narendra Modi has approved the scheme for grant of Permanent Residency Status (PRS) to foreign investors subject to the relevant conditions as specified in the FDI Policy notified by the Government from time-to-time.

The scheme is expected to encourage foreign investment in India and facilitate Make in India Programme. Under the Scheme, suitable provisions will be incorporated in the Visa Manual to provide for the grant of PRS to foreign investors.

The PRS will be granted for a period of 10 years with multiple entry. This can be reviewed for another 10 years if the PRS holder has not come to adverse notice. The scheme will be applicable only to foreign investors fulfilling the prescribed eligibility

conditions, his/her spouse and dependents. In order to avail this scheme, the foreign investor will have to invest a minimum of ` 10 crores to be brought within 18 months or ` 25 crores to be brought within 36 months. Further, the foreign investment should result in generating employment to at least 20 resident Indians every financial year.

Permanent Residency Status will be granted for a period of 10 years initially with multiple entry facility, which can be renewed for another 10 years. PRS will serve as a multiple entry visa without any stay stipulation and PRS holders will be exempted from the registration requirements. PRS holders will be allowed to purchase one residential property for dwelling purpose. The spouse/dependents of the PRS holder will be allowed to take up employment in private sector (in relaxation to salary stipulations for Employment Visa) and undertake studies in India.

(PIB Press Release bearing Release ID 149376 dated 31st August, 2016)

(Comments: The scheme for grant of Permanent Residency Status is an attractive scheme for non-resident high net worth individuals. GOI hopes to boost its Make in India campaign as well as attract developing countries into India due to India's increasing economic presence in South East Asian nations such as Cambodia, Laos, Myanmar and Vietnam since these countries have a unique position in the regional value chains and offer a gateway for market access to China/EU and other markets due to various trade agreements. The investment under this scheme shall be subject to relevant conditions as specified in the FDI Policy notified by the Government from time to time. The scheme also provides benefits to the spouse and dependents of the foreign investors fulfilling the prescribed eligibility conditions. The spouse/dependents of the PRS holder will be allowed to take up employment in private sector and undertake studies in India and would therefore not be required to undergo the process of applying for Employment Visa/Student Visa which have various conditions and salary stipulations/requirements. PRS will serve as a multiple entry visa without any minimum stay requirements. Currently, all foreigners (including those of Indian origin) visiting on a long-term (more than 180 days) student visa, medical visa, research visa or employment visa are required to register with the Foreigners Registration Office concerned, having jurisdiction over the place **the person intends to stay, within 14 days of arrival and in fact Pakistani nationals have to register within 24 hours of arrival. Gratefully, PRS holders will be exempted from such registration requirements. PRS holders will be allowed to purchase one residential property for dwelling purpose. Apart from inflow into India, the scheme also creates employment opportunities since one of the conditions require that the foreign investment should result in generating employment to at least 20 resident Indians every financial year.)**

Ajay Singh, *Advocate &* CA Namrata Bhandarkar

BEST OF THE REST

1. HUF Property – Claim for share in property it is necessary for existence of an HUF and its properties – Concept of HUF is an exception to the main provision contained in sub-sections (1) and (2) of section 4 of the Benami Act: Hindu Succession Act, Ss. 6, 8 & Benami Transaction (Prohibition) Act, 1988

The defendants filed an application for dismissal of the suit on the ground that the suit plaint did not show existence of the legal cause of action as the plaintiff is only a grandson of late Jage Ram and thus not a class I legal heir and since there were already the sons of late Jage Ram who were alive, plaintiff could not lay any claim to the said properties. It was further averred by the defendants that the properties of late Jage Ram were not Hindu Undivided Family(HUF) properties/joint Hindu family properties but were individual properties of late Jage Ram. The plaintiff in the plaint has made a specific averment that the properties of late Jage Ram, grandfather, remained joint Hindu family properties and have continued to be even after his death between his legal heirs. It is his further claim that once the suit properties are joint family properties the issue with respect to the plaintiff not being class I legal heir is immaterial because plaintiff claims right in the suit properties as a co-parcener of a joint Hindu family/HUF.

The Hon'ble Delhi High Court observed that in the plaint it is claimed that ownership of properties by late Jage Ram in his name was as joint Hindu family properties. Such a bald averment in itself cannot create an HUF unless it was pleaded that late Jage Ram inherited the properties from his paternal ancestors prior to 1956 or that late Jage Ram created an HUF by throwing his own properties into a common hotchpotch. These essential averments were completely missing in the plaint and therefore a casual statement of existence of an HUF does not mean the necessary factual cause of action, as required in law, is pleaded in the plaint of existence of an HUF and of its properties.

The Delhi High Court further noted that the requirement of pleading should be in a clear cut manner as to how the HUF and its properties exist i.e., whether because of pre-1956 position or because of the post, 1956 position on account of throwing of properties into a common hotchpotch, needs to be now mentioned especially after passing of the Benami Transaction (Prohibition) Act, 1988 and which Act states that property in the name of an individual has to be taken as owned by that individual and no claim to such property is maintainable as per Section 4(1) of the Benami Act on the ground that monies have come from the person who claims right in the property though title deeds person. An exception is created with respect to provision of Section 4 of the Benami Act by its sub-section(3) which allows existence of the concept of HUF. Once existence of the concept of HUF is an exception to the main provision

contained in sub-sections (1) and (2) of Section 4 of the Benami Act, then, to take the case outside sub-sections (1) and (2) of Section 4 of the Benami Act it has to be specifically pleaded as to how and in what manner an HUF and each specific property claimed as being an HUF property has come into existence as an HUF property. If such specific facts are not pleaded, this Court in fact would be negating the mandate of the language contained in sub-sections (1) and (2) of Section 4 of the Benami Act.

The Court therefore allowed application of the defendants and dismissed the suit as there was no cause of action which is found to exist with respect to existence of an HUF and its properties.

Surendra Kumar vs. Dhani Ram and others AIR 2016 Delhi 120

2. Recovery of Debt – Enforcement of security interest – Nature of property at time of creation of security interest – Security interest created in agricultural land is exempt from provisions of SARFAESI Act – Therefore security interest in agricultural land cannot be enforced: SARFAESI Act, 2002

The petitioner bank had given loan to partners of Yelagiri Dairy farm to set up a dairy farm mortgaging land in the said village. The said dairy farm failed to make repayment and suit was filed before the Debts Recovery Tribunal. The Tribunal passed the order to make payment along with interest at the earliest and in case of default of payment to sell the assets mortgaged and directed to prepare a recovery certificate. Against this order the partnership firm preferred an appeal which was still pending. The petitioner bank issued a fresh demand notice under SARFAESI Act demanding the sum outstanding. During the pendency of the appeal as aforestated a notice of sale was issued and on auction the successful bidder was given sale certificate. Thereafter an appeal was filed claiming that the secured asset is an agricultural land and as such the provisions of the SARFAESI Act would not be applicable.

The Hon'ble Madras High Court observed that on a bare perusal of the object read with the relevant provisions, it is luculent that the nature of the property at the time of creation of security interest is the relevant consideration for the purpose of application of the provisions of the SARFAESI Act.

The object of the Act is to ensure expeditious recovery by enforcement of security interest created in the property. However, the security interest created in agricultural land is exempt from the provisions of the SARFAESI Act. There is no ambiguity, incompatibility and incongruity to give any other meaning or to substitute the word by supplying the other word.

Therefore, the High Court held that security interest in agricultural land cannot be enforced.

A. Akthar Hussain vs. K. Pappireddiyar and others. AIR 2016 Madras 114

3. Stridhan – Appellant wife claiming stridhan entrusted to husband – Appellant wife claiming stridhan 2 years after decree of judicial separation, held, maintainable – Protection of Women from Domestic Violence Act, 2005

The appellant wife married the respondent husband on 27-11-2005. Thereafter, the wife file a criminal case against her husband and in-laws for demanding dowry. The matter was settled out of court. Thereafter, the husband obtained a decree of judicial separation in the year 2008. After that on 22-5-2010, the wife filed an application under Section 12, Protection of Women from Domestic Violence Act, 2005 for seizure of stridhan articles from the possession of the husband. The main issue of the appeal was whether the wife can make a claim of stridhan under Section 12, Protection of Women from Domestic Violence Act, 2005 after a decree of separation.

The Hon'ble Apex Court observed that in the application preferred by the wife, she was claiming

to get back her stridhan. Stridhan has been described as saudayika by Sir Gooroodas Banerjee in "Hindu Law of Marriage and Stridhan" which is as follows :— "First, take the case of property obtained by gift. Gifts of affectionate kindred, which are known by the name of saudayika stridhan, constitute a woman's absolute property, which she has at all times independent power to alienate, and over which her husband has only a qualified right, namely, the right of use in times of distress." The said passage, be it noted, has been quoted ***Pratibha Rani vs. Suraj Kumar and Another (1985) 2 SSC 370.*** The Apex Court in that decision after analysing the classical texts opined that:– "It is, therefore, manifest that the position of stridhan of a Hindu married woman's property during coverture is absolutely clear and unambiguous; she is the absolute owner of such property and can deal with it in any manner she likes — she may spend the whole of it or give it away at her own pleasure by gift or will without any reference to her husband. Ordinarily, the husband has no right or interest in it with the sole exception that in times of extreme distress, as in famine, illness or the like, the husband can utilise it but he is morally bound to restore it or its value when he is able to do so. It may be further noted that this right is purely personal to the husband and the property so received by him in marriage cannot be proceeded against even in execution of a decree for debt." The Apex Court further ruled:– "... a pure and simple entrustment of stridhan without creating any rights in the husband excepting putting the articles in his possession does not entitle him to use the same to the detriment of his wife without her consent. The husband has no justification for not returning the said articles as and when demanded by the wife nor can he burden her with losses of business by using the said property which was never intended by her while entrusting possession of stridhan. On the allegations in the complaint, the husband is no more and no less than a pure and simple custodian acting on behalf of his wife and if he diverts the entrusted property elsewhere or for different purposes he takes a clear risk of prosecution under Section 406 of the IPC. On a parity of reasoning, it is manifest that the husband, being only a custodian of the stridhan of his wife, cannot be said to be in joint possession thereof and thus acquire a joint interest in the property."

The Supreme Court in this case, further referred to the decision rendered by the three-Judge Bench ***Rashmi Kumar (Smt.) vs. Mahesh Kumar Bhada (1997) 2 SSC 397*** wherein while considering the issue in the said case, the court ruled that "A woman's power of disposal, independent of her husband's control, is not confined to saudayika but extends to other properties as well. Devala says: "A woman's maintenance (vritti), ornaments, perquisites (sulka), gains (labha), are her stridhana. She herself has the exclusive right to enjoy it. Her husband has no right to use it except in distress…." In N. R. Raghavachariar's Hindu Law — Principles and Precedents, (8th Edn.) edited by Prof. S. Venkataraman, one of the renowned Professors of Hindu Law para 468 deals with "Definition of Stridhana". In para 469 dealing with "Sources of acquisition" it is stated that the sources of acquisition of property in a woman's possession are: gifts before marriage, wedding gifts, gifts subsequent to marriage etc. Para 470 deals with "Gifts to a maiden". Para 471 deals with "Wedding gifts" and it is stated therein that properties gifted at the time of marriage to the bride, whether by relations or strangers, either Adhiyagni or Adhyavahanika, are the bride's stridhana. In para 481 at page 426, it is stated that ornaments presented to the bride by her husband or father constitute her stridhana property. In para 487 dealing with "powers during coverture" it is stated that saudayika meaning the gift of affectionate kindred, includes both Yautaka or gifts received at the time of marriage as well as its negative Ayautaka. In respect of such property, whether given by gift or will she is the absolute owner and can deal with it in any way she likes. She may spend, sell or give it away at her own pleasure. It is thus clear that the properties gifted to her before the marriage, at the time of marriage or at the time of giving farewell or thereafter are her stridhana properties. It is her absolute property with all rights to dispose at her own pleasure. He has no

control over her stridhana property. Husband may use it during the time of his distress but nonetheless he has a moral obligation to restore the same or its value to his wife. Therefore, stridhana property does not become a joint property of the wife and the husband and the husband has no title or independent dominion over the property as owner thereof."

In view of the above, the Apex Court proceeded to rule that stridhana property is the exclusive property of the wife on proof that she entrusted the property or dominion over the stridhana property to her husband or any other member of the family, there is no need to establish any further special agreement to establish that the property was given to the husband or other members of the family.

Krishna Bhattacharjee vs. Sarathi Choudhary and another (2016) 2 SCC 705.

4. Suit for possession by person wrongfully dispossessed – Plaintiffs entitled to restoration of possession –Even otherwise, if dispossession is by illegal means then plaintiff is bound to get benefit of section 6 of the Act irrespective of time of six months of dispossession: Specific Relief Act.

Two portions of plot of land were sold by the defendants nameless Gordham Singh and Veer Singh by two separate registered sale deeds on 25-10-1988 to the plaintiffs namely Kanhaiyalal and Ratanlal respectively. Suit was filed by the plaintiffs in the trial court with the averments that after the sale in the year 1988, since the plaintiffs remained out of town in connection with their business, the defendants taking advantage of their absence had taken back the forcible possession of the plots of land three months before the date of filing of suit and the plaintiffs being the owners and in actual possession of plot in question were entitled to seek possession under Section 6 of the Specific Relief Act, 1963. The suit was contested by the defendants but the trial court passed the judgment in favour of plaintiffs.

The Hon'ble Rajasthan High Court observed that on a close perusal of section 6 of the Act of 1963 it would clearly show that dispossession of plaintiff has to be established to be 'otherwise than in due course of law'. The plaintiffs in the present case are admittedly the registered owners of the suit land and thus the burden was upon the defendants to show that they were in possession of the suit land in question by adopting due process of law and not otherwise because they denied the registered sale-deeds and claimed to be in long possession of the suit land. The point time of dispossession within six months prior to the date of filing of the suit was also amply proved by the plaintiffs in the present case. Even if a deviation by any witness that the defendants dispossessed them soon after the sale was there that also does not dislodge the claim of the plaintiffs to claim back the possession of the suit land without any due process of law adopted by them. In the present case, not only the plaintiffs averments but the examinations and cross-examination of the plaintiffs witnesses have proved that they were dispossessed forcibly without any due process of law adopted by defendants within six months prior to filing of the suit.

The defendants/petitioners thus failed to dislodge the claim and evidence of the plaintiffs that they were in legal and peaceful possession of plots of land in question and the defendants without any due process of law adopted by them dispossessed the plaintiffs and thus section 6 of the Act of 1963 was clearly attracted in the present case. The plaintiffs have amply proved their case of illegal and forcible dispossession from their own purchased plots by the sellers themselves within six months prior to filing of the suit in 2002.

The Court therefore held that the plaintiffs are entitled to succeed and the decree passed by the learned court below in their favour was upheld.

Gordhan Singh & Anr. vs. Kanhaiyalal AIR 2016 Rajasthan 112

5. Family Arrangement –Admissibility in evidence – Panchayat resolution reduced in writing – Explaining settlement arrived at between parties – Could be taken as family arrangements/ settlements –Though not registered, can be used as piece of evidence. Registration Act, 1908 Ss. 49, 17

Disputed properties are the joint family property of Late Narayana. The defendant and respondents are the sons of Late Narayana. Respondents were working in the army and were sending money to get joint family and the joint family affairs were run by the defendant. The respondents retired from the army in the years 1988 and 1989. A house was constructed in the year 1980 out of the joint family income and the contribution made by the respondents. Late Narayana was in possession of the suit property and had converted the same from forest land to a wet land and the same was further developed out of the joint family income and contribution. Respondents averred that taking advantage of absence of the respondents, defendant filed an application to the Tahsildar for grant of patta. Alleging that the defendant is attempting to grab the suit properties, respondents filed for suit for partition claiming 1/5th share to each of the property. In the written statement, defendant claimed that the respondents have sold their share to the defendant and the respondents have no right to claim partition in items Nos. 1 and 2 (i.e. Patta). It was further averred that there was a panchayat in the village wherein the defendants and respondents participated and it was agreed that the defendant will give ` 50,000/- to respondent and defendant will have all rights over items Nos. 1 and 2. On appeal before Trial Court, upon consideration of evidence, trial court held that there can be no relinquishment by virtue of resolution of Panchayat without any registered documents. Being aggrieved, the defendant preferred an appeal before the High Court. The High Court held that in the absence of any conveyance deed it cannot be held that the items Nos. 1 and 2 was transferred to the defendant. Further appeal was filed before the Hon'ble Apex Court.

The Hon'ble Supreme Court observed that resolution is signed by the respondents and also by the panchayatdars. The trial court as well as High Court was not right in brushing aside the oral and documentary evidence adduced by the defendant to prove that respondents have relinquished their rights of certain items of suit schedule property.

Even though recitals is to the effect of rights in items no.1 and 2, it could be taken as family arrangements/settlements. There is no provision of law requiring family settlements to be reduced to writing and registered, though when reduced to writing the question of registration may arise. Binding family arrangements dealing with immovable property worth more than rupees hundred can be made orally and when so made no question if registration arises. If, however, it is reduced to the form of writing with the purpose that the terms should be evidenced by it, it required registration and without registration it is inadmissible; but the said family arrangement can be used as corroborative piece of evidence for showing or explaining the conduct of the parties. In the present case, panchayat resolution reduced into writing, though not registered can be used as a piece of evidence explaining the settlement arrived at and the conduct of the parties in receiving the money from the defendant in lieu of relinquishing their interest in item Nos. 1 and 2. Therefore, it was held that courts below erred in ignoring the oral and documentary evidence adduced by the defendant and the order was accordingly reversed.

Subraya M. N. vs. Vittala M.N & others AIR 2016 Supreme Court 3236

Ninad Karpe

FAT Tax? What next?

Just when you thought that the country has run out of ideas to tax its citizens, the Kerala Government has come up with an innovative idea to raise tax revenues – Fat tax!

In Kerala, 14.5 per cent fat tax will be levied on burgers, pizzas and other junk food served in branded restaurants.

The natural question that arises is – are burgers and pizzas the only food, which can be categorised as "fat"? What about samosas and pakoras? And why tax only branded restaurants? Is the tax meant to discourage eating of "junk food" or another means of raising revenue? With an avowed aim of curbing eating of unhealthy food, it has targeted specific food items.

We shouldn't complain about such inequities. The organised cigarette industry has been complaining for decades that they are taxed heavily and 'bidis' are not. They also claim that "bidis" cause more harm than cigarettes and yet do not bear the brunt of taxation.

Hopefully, this fat tax will eventually get subsumed in GST. But till that happens, we should expect some more imaginative forms of taxation.

What next? Here are some ideas:

- Thin Tax on slimming products
- Fairness Tax on products offering to lighten the complexion
- Hair Tax on products offering to cure baldness
- Noise Tax on purchase of loudspeakers

The list is endless. Fat tax is just the beginning of many more innovative taxes to follow – let's wait and watch!

> Our duty is to encourage every one in his struggle to live up to his own highest idea, and strive at the same time to make the ideal as near as possible to the Truth.
>
> — *Swami Vivekananda*

CA Hinesh R. Doshi, CA Haresh P. Kenia
Hon. Jt. Secretaries

The Chamber News

Important events and happenings that took place between 8th August, 2016 to 8th September, 2016 are being reported as under.

I. Admission of New Members

1) The following new members were admitted in the Managing Council Meeting held on 2nd September, 2016.

Life Members

1	Mr. Tanna Rasik Amritlal (Ord. to Life Mem.)	CA	Mumbai
2	Mr. Pettiwala Abdulla Yusuf	CA	Mumbai
3	Mr. Goenka Sanjay Nathmal	CA	Mumbai

Ordinary Members

1	Mr. Bhatt Fenil Amit	CA	Mumbai
2	Mr. Agrawal Vipul Ashok	CA	Mumbai
3	Mr. Bansal Vikas Jai Bhagwan	CA	Mumbai
4	Mr. Chauhan Kuldip Singh Sh. V. N.	Advocate	Shimla
5	Mr. Rao Ramnath Devdas	CA	Mumbai
6	Mr. Sastakar Sachin Shashikant	CA	Pune
7	Mr. Jain Yash Kantilal	CA	Mumbai
8	Mr. Rambhia Chintan Tarun	CA	Mumbai
9	Mr. Lasrado Irwin Fredrick	CA	Mumbai

Student Members

1	Mr. Shah Saurabh Vipul	CA Student	Mumbai
2	Ms. Jain Prachi Prakash	CA Student	Mumbai
3	Mr. Biyani Anuj Rajendra Prasad	CA Student	Mumbai

II. Past Programmes

1. MEMBERSHIP & PUBLIC RELATIONS COMMITTEE

The **Full Day Seminar on "Companies Law and Direct Tax Law Focus on Practical and Upcoming Issues"** jointly with Solapur WIRC Branch of ICAI and Solapur Tax Practitioners' Association was held on 20th August, 2016 at Balaji Sarovar Hotel, Hotgi Road, Solapur 413 003.

2. STUDENT & IT CONNECT COMMITTEE

The **"3rd Football Cup"** jointly with Membership & Public Relations Committee was held on 27th August, 2016 at Indian Football School, Cooperage Football Ground – Mini Ground, Colaba, Churchgate, Mumbai.

The winner of 3rd Football Cup – (1) BDO India LLP, (2) 1st Runner Up – GMJ & Co and (3) 2nd Runner Up – CNK Associates LLP.

3. LAW & REPRESENTATION COMMITTEE

REPRESENTATIONS BEFORE :

A) Hon'ble Shri Rajiv Jalota, Commissioner of VAT, Maharashtra – 4th September, 2016

Representation for Automation and Settlement of Disputes Scheme

B) Hon'ble Ms. Rani Singh Nair, The Chairperson, CBDT, New Delhi

i) Representation on Scrutiny

ii) Representation before the CBDT suggestion on draft rules for prescribing manner of determination of amount received by company in respect of buy back of shares taxable u/s 115 QA of the Income-tax Act, 1961.

C) Hon'ble Finance Minister, New Delhi

i) Representation on Model GST Law

ii) GST Representation on Exemptions and Rates.

4. DELHI CHAPTER

The Full Day Seminar on **"Insolvency and Bankruptcy Law – Emerging Issues, Challenges and Professional Opportunities"** held on 27th August, 2016 at Indian International Centre, New Delhi.

(For details and Study Material of the Past Programme, kindly visit www.ctconline.org)

III. Future Programmes

(For details of the future programmes, kindly visit www.ctconline.org or refer The CTC News of September, 2016)

1. ALLIED LAWS COMMITTEE

The **Certificate Training Course in IND-AS (40 HRS.) (With Knowledge Assessment)** jointly with **Corporate Members Committe**e will be held on 12th, 19th, 26th November, 2016 & 3rd, 10th, 17th December, 2016 at Babubhai Chinai Hall, IMC.

2. CORPORATE MEMBERS COMMITTEE

The committee is pleased to unveil its forthcoming programmes:

i) The **Listed Company Saga** will be held on 11th November, 2016.

ii) The **CSR Story – Culture, Challenges and Compliances** will be held on 16th December, 2016.

iii) The two days programmes on **Mergers & Acquisitions Journey** will be held on 20th & 21st January, 2017.

The other details will be announced in next News Letter.

3. DIRECT TAXES COMMITTEE

The **Full Day Seminar on Surveys under Income – Tax & TDS Surveys** will be held on 19th November, 2016. Venue will be intimated in due course.

4. INDIRECT TAXES COMMITTEE

A) The **Orientation Course on GST Model Law** will be held on 16th, 21st, 22nd & 23rd September, 2016 at Jai Hind College.

B) The **5th Residential Refresher Course on Service Tax** will be held from 26th to 28th January, 2017 at Bogmallo Beach Resort, Goa.

5. INTERNATIONAL TAXATION COMMITTEE

A. The **Basic Intensive Study Course on FEMA** will be held on 14th, 15th, 21st and 22nd October, 2016 at M. C. Ghia Hall.

B. The Publication on Transfer Pricing an Industry & Technical Perspective (Reprint July 2014 Edition) on Special price for members only ` 950/- [Book MRP – ` 1,995].

6. RESIDENTIAL REFRESHER COURSE & SKILL DEVELOPMENT COMMITTEE

A) The **40th Residential Refresher Course** will be held from 16th to 19th February, 2017 at The Golden Palms Hotel and SPA Resort, Bengaluru.

7. DELHI CHAPTER

The **Full Day Seminar on "M & A and Corporate Restructuring – Legal, Tax & Practical Aspects"** will be held on 17th September, 2016 at India International Centre, New Delhi.

STUDY CIRCLE & STUDY GROUP COMMITTEE

Study Circle Meeting on "Income Declaration Scheme" held on 11th August, 2016 at Babubhai Chinai Committee Room, IMC

CA. Kishor Karia chairing the session

CA. Reepal Tralshawala addressing the members

Study Circle on International Taxation Meeting on "Recent Developments in International Taxation" held on 12th August, 2016 & 24th August, 2016 at Kilachand Hall, IMC

CA. Naresh Ajwani addressing the members

Study Circle Meeting on "Issues in Limited Scrutiny Assessments & E-Assessments" held on 9th September, 2016 at Babubhai Chinai Committee Room, IMC

CA. Ashok Mehta addressing the members

ALLIED LAWS COMMITTEE

Study Circle Meeting on the subject "Cheque Bouncing" held on 2nd September, 2016 at Babubhai Chinai Committee Room, IMC

Mr. Subhash Jha, Advocate, Bombay High Court addressing the members

MEMBERSHIP & PUBLIC RELATIONS COMMITTEE

Full Day Seminar on "Company Law and Direct Tax Law Focus on Practical and Upcoming Issues" jointly with Solapur WIRC Branch of ICAI and Solapur Tax Practitioners' Association held on 20th August, 2016 at Solapur

CA Hitesh R. Shah, President, CTC delivering opening speech

CA Hemant Parab, Chairman, Membership & Public Relations Committee, CTC welcoming the speakers

Faculties

CA Heneel K. Patel

CA Devendra Jain

CA Amit A. Purohit

Self Awareness Series on the subject "Stress Management through Breathing Techniques" held on 23rd August, 2016 at CTC Office

CA Rahul Sutar addressing the members

INDIRECT TAXES COMMITTEE

Study Circle Meeting on "Issues in Reverse Change on Government Services" held on 22nd August, 2016 at Babubhai Chinai Committee Room, IMC

Mr. Naresh Thacker Advocate chairing the session

CA Rajiv Luthia addressing the members

CTC OFFICE BEARERS FELICITATING MEMBERS OF NATIONAL COMPANY LAW TRIBUNAL (NCLT), MUMBAI ON 9TH AUGUST, 2016

CA Hitesh R. Shah, President, Shri Ajay Singh Vice President and CA Haresh Kenia, Hon. Jt. Secretary offering flower bouquet to Shri Mukul Shrawant, Member of NCLT.

Seen from L to R : CA Haresh Kenia, Hon. Jt. Secretary, Shri Mahesh Kuwadia, Shri Ajay R. Singh, Vice President, Shri N. Nallahsenapati, Shri Mukul Shrawat and Shri B. S. V. Prakash Kumar, Members of NCLT and CA Hitesh R. Shah, President.

HOLINESS SRI SRI RAVISHANKAR SHOWERED HIS BLESSINGS ON TEAM CHAMBER ON 21ST AUGUST, 2016 AT HIS ASHRAM AT BANGLORE

Shri Hitesh R. Shah, President & Shri Kishor Vanjara, Past President offering shawl to Sri Sri Ravishankar.

Seen from L to R : S/Shri Venkatraman, CA Charu Ved, Vice Chairperson and CA Shailesh Bandi, Chairman, RRC & PR Committee, Sri Sri Ravishankar, Shri Ajay Singh, Vice President, Shri Kishor Vanjara, Past President and Shri Hitesh R. Shah, President.

CTC OFFICE – SHREE SATYANARAYAN PUJA HELD ON 24TH AUGUST, 2016

MEMBERSHIP & PUBLIC RELATIONS COMMITTEE STUDENT & IT CONNECT COMMITTEE

3rd Football Cup held on 27th August, 2016 at Indian Football School, Cooperage Football Ground – Mini Ground, Colaba

Shri Y. P. Trivedi, Chief Guest & Past President addressing the players. Seen from L to R : S/Shri CA Parimal Parikh, Chairman, Student & IT Connect and Shri Kishor Vanjara, Past President and CA Hitesh R. Shah, President.

CA Hitesh R. Shah, President alongwith Shri Kishor Vanjara, Past President inaugurating the 3rd Football Cup.

CA Hitesh R. Shah, President scoring goal at 3rd Football Cup.

Participant singing National Anthem at the opening ceremony at the 3rd Football Cup

3rd Football Cup held on 27th August, 2016 at Indian Football School, Cooperage Football Ground – Mini Ground, Colaba

Shri Y. P. Trivedi, Chief Guest & Past President handing over the Trophy to the Winner Team, BDO India LLP

Shri Y. P. Trivedi, Chief Guest & Past President handing over the Trophy to the 1st Runner Up Team, GMJ & Co.

Shri Kishor Vanjara, Past President handing over the Trophy to the 2nd Runner Up Team, CNK Associates LLP

Players playing football

Shri Hitesh R. Shah, President handing over the Golden Boot Trophy to Mr. Karsh Sarvaiya, CNK Associates, LLP

Shri Ajay Singh, Vice President handing over Golden Gloves Trophy to Mr. Mihir Singhania, GMJ & Co.

Shri Parimal Parikh, Chairman, Student & IT Connect Committee handing over Golden Ball Trophy to Mr. Sameer Bhatia, BDO India LLP

Shri Hemant Parab, Chairman, Membership & Public Relations Committee handing over the consolation Trophy to team.

Shri Kishor Vanjara, Past President handing over the Perfect Kick Trophy to Ms. Shweta Bhatnate.

Shri Y. P. Trivedi, Chief Guest & Past President handing over the Perfect Kick Trophy to Ms. Himani Mehta.

DELHI CHAPTER

Full day seminar on "Insolvency and Bankruptcy Law – Emerging Issues, Challenges and Professional Opportunities" held on 27th August, 2016 at India International Centre, New Delhi

Seen from L to R: S/Shri G. S. Ahuja, Member, Atul Sharma, Faculty, K. A. Najmi, Faculty, V. P. Verma, Advisor and Vijay Gupta, Hon. Jt. Secretary

Faculties

Mr. Vinod Kothari

Mr. Atul Sharma

Mr. K. A. Najmi

Seen from L to R: S/Shri R. P. Garg, Chairman, Vinod Kothari, Faculty, V. P. Verma, Advisor and Harish Kumar, Hon. Treasurer

DIRECT TAXES COMMITTEE

Lecture Meeting on "Income Declaration Scheme, 2016 — Provisions and Issues" held on 5th August, 2016 At IMC

CA Hitesh R. Shah, President delivering opening speech. Seen from L to R : S/Shri CA Ganesh Rajgopalan, Vice Chairman, K. Gopal, Advocate, Session Chairman, CA Sanjeev Lalan, Faculty, CA Atul Suraiya, Faculty and CA Ashok Mehta, Convenor

Section of members

Faculties

Shri K. Gopal, Advocate chairing the session

CA Sanjeev Lalan addressing the members

CA Atul Suraiya addressing the members

Intensive Study Group on Direct Tax Meeting on "Recent Important Decisions under Direct Taxes" held on 29th August, 2016 at CTC Office

Mr. Rahul Hakani, Advocate addressing the members

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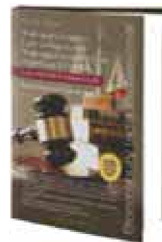

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