

Doing business in India

A Guest Article by Sarosh Zaiwalla
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An attractive destination

"Strength does not come from physical capacity. It comes from indomitable will," said Mahatma Gandhi, the founder of modern India. The Indian economy, freed in the early 90s from the shackles of the earlier socialist era, has now certainly begun to show that "indomitable will" to acquire strength in the global marketplace.

With a fast-growing middle class that currently stands at nearly 300 million, and a maturing genuine democracy, India today provides an attractive destination for international business players. This article aims to assist international business houses – large and small – to understand more easily the requirements for entry into the Indian market.

Basic facts about India

Strong growth

India has been rated by overseas financial houses, business houses and funds as one of the most attractive investment and offshoring destinations. India achieved a GDP growth rate of 9.4% in 2006-07, with a forecast GDP growth rate of 7% to 8% for the coming years.

A sound legal system

A judicial and quasi-judicial system exists in India. Courts in India are the judicial authorities, while regulatory bodies such as the Securities and Exchange Board of India (SEBI), the capital markets regulator, are quasi-judicial bodies.

The High Court is the highest court for each state in India, and appeals from the High Court lie with the Supreme Court of India, which is the apex judicial authority in India.

The Indian legal system is very well organised and is based on the British model.

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Business structures

Foreign companies wishing to carry on business in India may do so by setting up one of the following in the country:

- a liaison or representative office
- a branch office
- a wholly owned subsidiary.

The establishment of such entities is regulated by the Foreign Exchange Management Act, 1999. Foreign entities are required to obtain a licence from the Reserve Bank of India to establish a liaison, representative or branch office in India.

1. Representative office

A liaison or representative office can act as a channel of communication between the foreign entity's head office abroad and parties in India. It is not allowed to undertake any business activity in India and is not permitted to earn any income in India. All expenses of a liaison or representative office will have to be met by the foreign entity entirely through inward remittances of foreign exchange from its head office abroad.

Because such an office cannot earn any income in India, it will not be subject to tax in India.

2. Branch office

Foreign companies may set up branch offices in India for the purposes of representing the parent company or other foreign companies in various matters – for example, acting as buying or selling agents – as specified in the regulations.

After meeting its local expenses, a branch office is allowed to repatriate profits, subject to payment of taxes in India. The inclusive rate of income tax applicable to a branch office of a foreign company in India is 42.23%. A branch office would ordinarily constitute a permanent establishment of the foreign entity in India.

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3. Wholly owned subsidiary

A foreign entity can establish a wholly owned subsidiary in India as a private company or a public company.

A private company is required to have a minimum paid-up share capital of INR100,000. (The exchange rate at the time of writing is approximately £1 = INR75).

The Articles of Association of a private company must restrict the transferability of shares and the number of members to 50. They must prohibit the private company from making any invitation to the public to subscribe for shares or debentures, and any invitation or acceptance of deposits except from members, directors or their relatives.

The minimum number of members required in a private company is two. A private company has greater flexibility and less stringent rules than a public company.

Shares of a public company are freely transferable and there is no limit on the maximum number of members that a public company may have. However, the minimum number of members of a public company is seven, and the minimum paid-up share capital of a public company is INR500,000.

Taxation of wholly owned subsidiaries

A wholly owned subsidiary incorporated in India is a separate corporate entity. Its entire income will therefore be subject to tax in India at 33.99%. Thus from a tax perspective, it is preferable to incorporate a wholly owned subsidiary in India rather than carry on activities through a branch office, which would be taxed at 42.23%.

Under current tax laws in India, any dividend paid by the Indian company would be subject to dividend distribution tax at an inclusive rate of 16.995%, and such dividend would not be taxable in India in the hands of the shareholder.

The wholly owned subsidiary would be liable to pay service tax at the rate of 12.36% on the gross value of taxable services, if any, rendered by it. Although it is the primary obligation of the service provider to pay the service tax to the tax authorities in India, the incidence of service tax may be passed on by the wholly owned subsidiary and be recovered from the final consumer of services. Management consultancy, maintenance and repairs are a few of the numerous services in respect of which service tax is payable.

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A value added tax, at a maximum tax rate of 12.5%, is payable in respect of the sale of goods.

Tax incentives

Subject to fulfilment of certain conditions, the Indian tax laws provide for tax incentives by way of deductions of profits (100% of profits or up to a specified limit) for a specified time frame in respect of enterprises or undertakings that are:

- developing and operating infrastructure facilities
- providing telecommunication services
- developing industrial parks/special economic zones
- generating power
- commencing transmission or distribution of power
- undertaking substantial renovation and modernisation of existing transmission or distribution lines or lays and beginning to operate a cross-country natural gas distribution network.

Tax incentives by way of deductions of profits (100% of profits or up to a specified limit) are also available to newly established units in special economic zones that manufacture or produce articles or things or provide any services, and derive such profits from the export of such articles, things or services.

To be eligible for this tax incentive, the unit must undertake export activities and must realise export income. The transfer pricing regulations in India require any income arising from an international transaction with associated enterprises to be computed having regard to the arm's length price. The same applies to any income of the wholly owned subsidiary from transactions with its parent company.

Funding of a subsidiary

A wholly owned subsidiary can be funded in one of three ways:

- the issue of equity shares
- the issue of preference shares
- external commercial borrowings.

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Under Indian law, there are no end use restrictions of the proceeds from the issue of either equity or preference shares, with one exception: in the case of issue of shares at a premium, the premium may be utilised only for specific purposes.

The repayment or redemption of equity shares can take place at the time of liquidation of the company or through a buy-back of shares by the company. Buy-back of shares is subject to several conditions under the Companies Act, 1956.

Preference shares can be convertible to equity. Non-convertible preference shares are regarded as debt. Preference shares can be redeemed out of profits that would otherwise be available for dividend, or out of proceeds from fresh issue of shares of the company.

Preference shareholders have priority over equity shareholders in terms of receipt of dividend and repayment of capital on winding up of the company. The maximum fixed coupon rate for preference shares is State Bank of India PLR 2 plus 300 basis points, whereas in the case of equity shares there is no limit on payment of dividends. Dividends declared by the wholly owned subsidiary can be freely remitted to its shareholder after payment of tax in India.

The transfer of shares of an Indian company by residents to non-residents and by non-residents to residents has to comply with pricing guidelines.

External commercial borrowings (ECBs) can be raised by domestic companies. The Reserve Bank of India regulates such ECBs. Monies raised by way of ECBs are subject to certain end-use restrictions, and are not permitted for on-lending or investments in the capital market or real estate, working capital, general corporate purposes or repayment of existing rupee loans. ECB guidelines also prescribe certain restrictions on the term of repayment of ECBs and the limit of interest payments on ECBs.

Labour laws

In India, the rights and obligations of an organisation's managerial staff are regulated by the terms of their employment contract. However, the rights and obligations of workmen, the nature of whose work is not managerial, supervisory or administrative, and whose income falls below a specified financial threshold, are regulated by various labour welfare regulations.

Negotiating and reviewing employment contracts is an area that warrants considerable attention. Downloading precedents or using standard

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documentation is unlikely to give a business the level of protection it needs. Companies wishing to do business in India should therefore seek specific legal advice on these subjects.

Structuring the investment

Investments into India must be subject to careful tax planning to obtain maximum tax benefits and reduce tax liability. Mauritius and Singapore are favourable locations for inbound investments into India.

Investments from Mauritius

Currently, about 50% of the outbound investments from Mauritius come to India.

Under the present terms of the double taxation avoidance agreement between India and Mauritius, a transfer of shares of a company in India being held as a capital asset by a foreign investor resident in Mauritius will not be subject to capital gains tax in India.

The Government of India is considering a renegotiation of certain terms of the double taxation avoidance agreement between India and Mauritius to plug "treaty shopping" and "round tripping" of investments. However, the Mauritius authorities are opposing any amendment to the tax treaty.

Investments from Singapore

The double taxation avoidance agreement entered into by India and Singapore, as amended, specifies that capital gains derived by a resident of Singapore from the sale of shares will be taxable in Singapore.

However, the treaty specifies that the resident of Singapore will not be entitled to such benefit if its affairs are arranged with the primary purpose of taking advantage of such benefits of the treaty.

Further, the treaty specifies that a shell/conduit company that claims it is a resident of Singapore shall not be entitled to such benefits of the treaty. It defines a shell/conduit company as any legal entity falling within the definition of resident but with negligible or nil business operations or with no real and continuous business activities carried out in Singapore.

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A resident of Singapore is deemed to be a shell/conduit company if its total annual expenditure on operations in Singapore is less than S\$200,000 in the 24 month period immediately preceding the date the capital gains arise.

A resident of Singapore is deemed **not** to be a shell/conduit company if:

- it is listed on a recognised stock exchange of Singapore, or
- its total annual expenditure on operations in Singapore is equal to or more than S\$200,000 in the 24 month period immediately preceding the date the capital gains arise.

Licences and approvals

To conduct business in India, certain standard registrations need to be obtained. These include:

- income tax registration
- excise registration
- service tax registration
- licence under the Factories Act.

Certain industry-specific registrations and licences are also required.

The foreign direct investment policy of India permits foreign direct investment, up to the limits specified therein, through the automatic route (i.e. without the prior approval of the Foreign Investment Promotion Board or the Reserve Bank of India) or with the prior approval of the Foreign Investment Promotion Board, depending on the activities/sector where the proposed investment is to be made.

Prior approval of the Foreign Investment Promotion Board will be required for proposals in which the foreign investor has in India an existing venture, tie-up, or technology transfer or trademark agreement in the same field.

Conclusion

India remains a favourable investment destination for foreign investors. In 2006-2007, foreign direct investments were worth US\$19.5 billion. With a consistently increasing GDP growth rate and abundant highly skilled manpower resources, India is poised for further growth in the coming years.

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India has been growing at an average annual growth rate of about 8.6% per annum over the last three years. The Government of India has promised to keep India on the growth path and strengthen economic policies to maintain growth.

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If you would like more information on any of the points covered in this Guest Article, please contact **TCii** on **020 7099 2621**.