CTC – New Delhi

ODI & Outbound Investments

FEMA & Tax Aspects

March 23, 2018

CA. Amithraj AN

+ 91 98861 20086

amithraj123@gmail.com

Contents

Contents

- FEMA Regulations
- Investment by Non Corporates
- Round Tripping Issues
- Overview of Indian Tax Concepts
- Overview of Some International Tax Concepts
- Options for Investing

Section 1

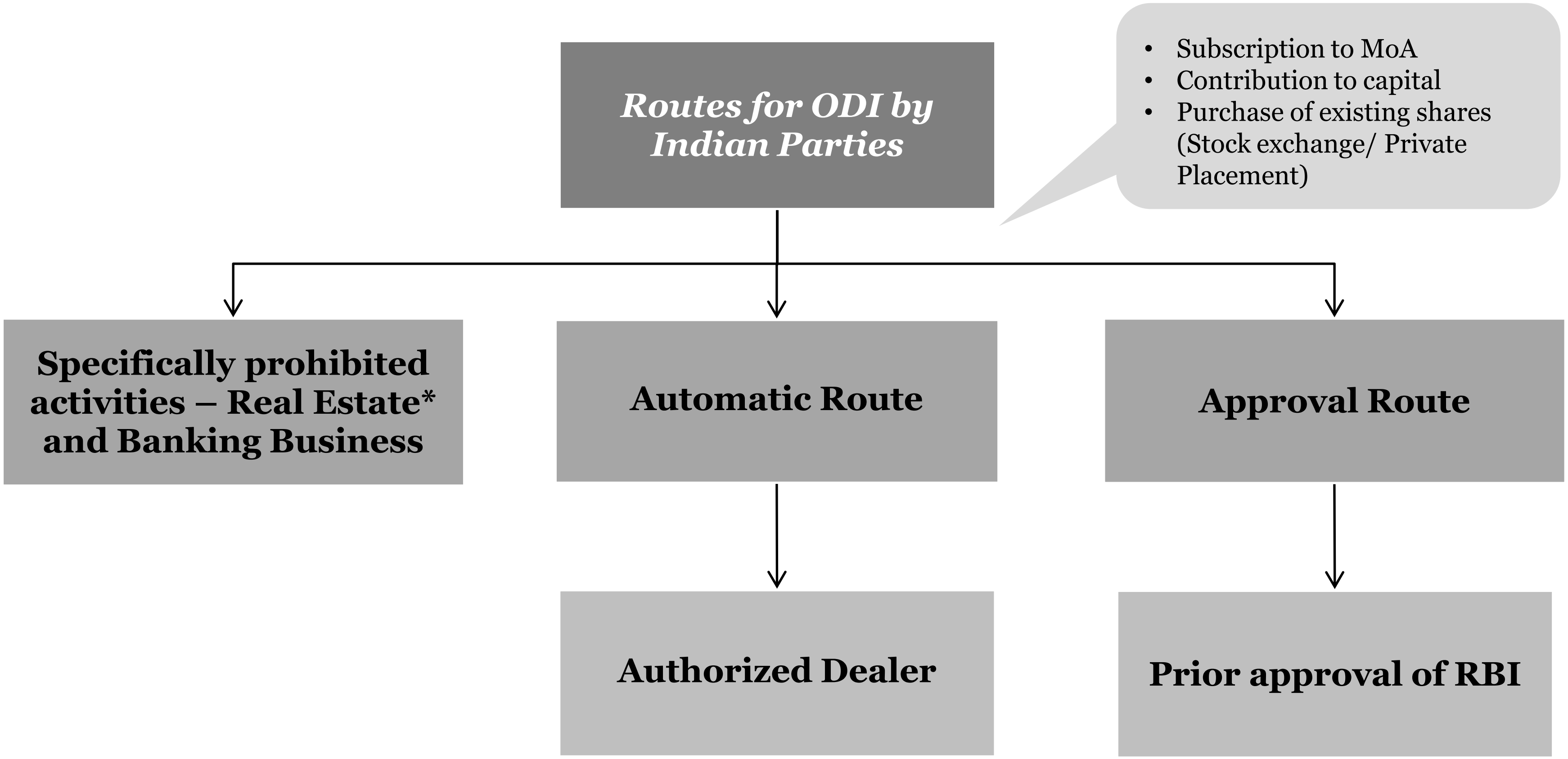
FEMA Regulations

Governing Regulations

Foreign Exchange Management (Transfer or Issue of Any Foreign Security) Regulations, 2004 [Notification No. FEMA 120/RB-2004 dated July 7, 2004]

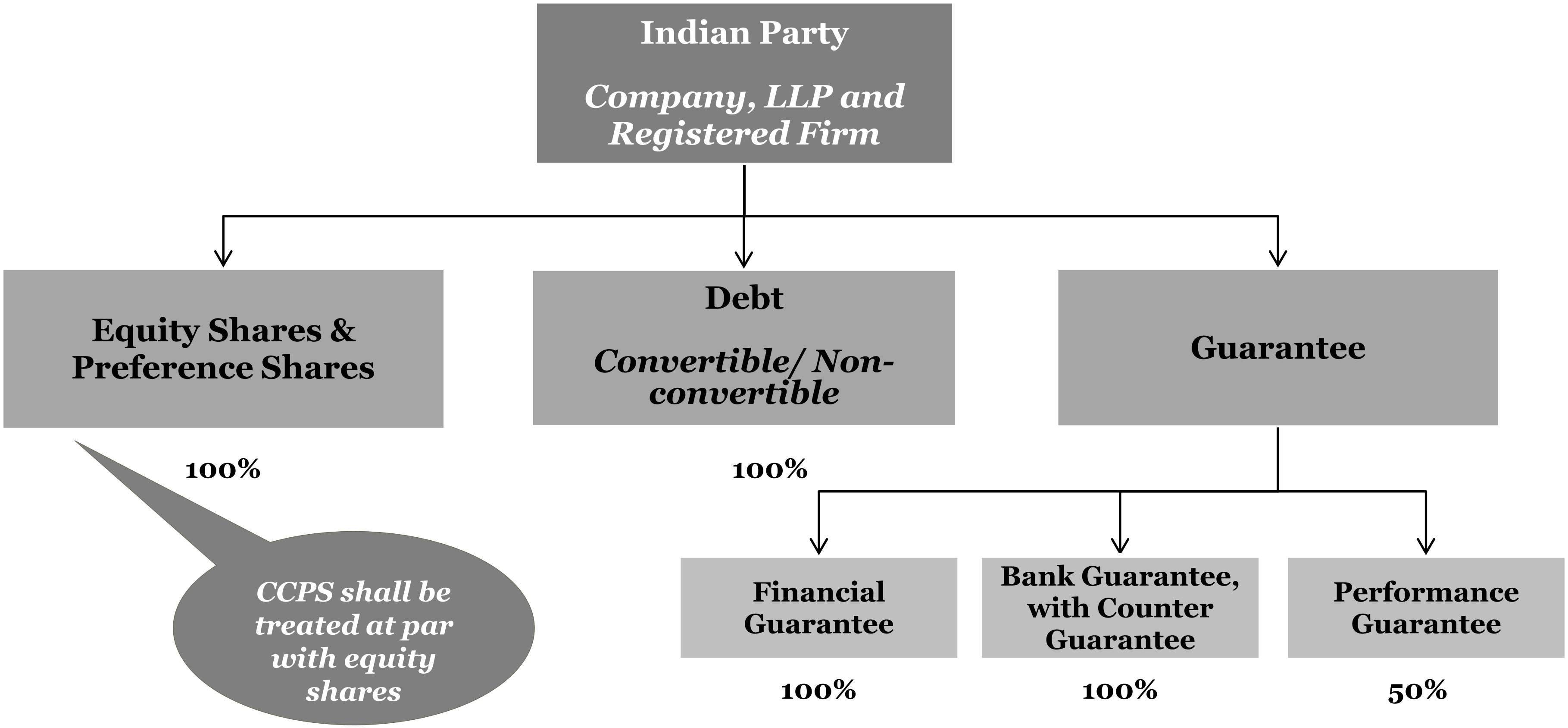
Master Directions on Direct Investments by Residents in JV/WOS abroad

Routes for ODI



*** Real Estate Business means buying and selling of real estate or trading in Transferable Development Rights but does not include development of townships, construction of residential/ commercial premises, roads or bridges**

ODI Overview, including Financial Commitment



No Distinction Between Equity, Preference & Debt for ODI purposes

ODI Regulations for Automatic Route

Total Financial commitment

- Total financial commitment not to exceed 400% of the net worth
- Investment can be made by way of equity or equity and debt/ guarantee
- Equity includes CCPS
- Only debt without equity participation not permitted (under Automatic Route)
- Energy & Natural Resources sector – investment exceeding specified limits permitted with RBI approval

Conditions

- All Indian entities are prohibited from investing in real estate and banking business under automatic route
- Must be engaged in bonafide business activity
- Investment in un-incorporated entities – not permitted (except Oil & Gas sector)

ODI Regulations for Automatic Route

Valuation

- Investment in shares of existing company – mandatory valuation requirements
  - > USD 5 mn: SEBI regd. Category I Merchant Banker/ Investment Banker/ Merchant Banker registered in host country
  - < USD 5 mn: Valuation by CA/ CPA
- Investment by way of swap of shares
  - SEBI regd. Category I Merchant Banker/ Investment Banker/ Merchant Banker regd. in host country
  - ADR/ GDR Swap: Valuation by Investment Banker
  - Automatic route

Calculation of Financial Commitment (400% of NW)

- Net-worth as on last audited Balance Sheet date
  - Net worth means paid up capital and free reserves
  - Securities premium ?
- Position of newly incorporated companies/ firms
- Last audited Balance Sheet – Should it be mandatorily March 31?
- Net-worth of holding co (holding at least 51% stake) or subsidiary co (in which at least 51% stake is held) includible if not availed of by such holding or subsidiary co
- Entire amount of guarantees (50% in case performance guarantee) to be considered
- RBI approval required for remittance on breach of performance guarantee > 400% net-worth
- Ceiling not applicable for investments out of EEFC or funds raised through ADRs/ GDRs

Maximum limit would be:

400% of net worth (including guarantees) + ***Balance in EEFC A/ c*** + ***ADR/ GDR proceeds***

Total Financial Commitment – Some Issues

ABC Ltd

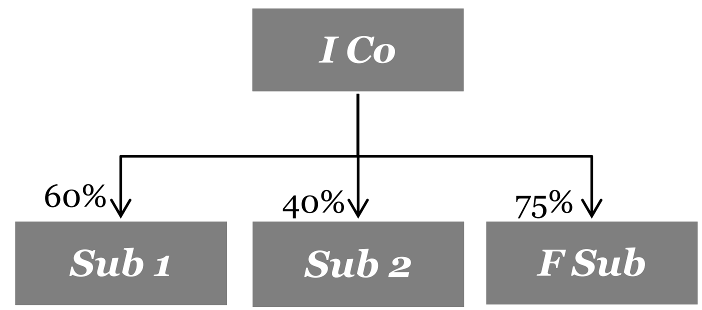
Particulars	Amount
Equity Share Capital	100
Redeemable Preference Share Capital	220
General reserves	40
Securities Premium Account	180
Capital reserves	200
Revaluation Reserves	140
IndAS Reserves	20
Total	**900**

What is the net worth of ABC Ltd for ODI Regulations

Which reserves would form part of free reserves?

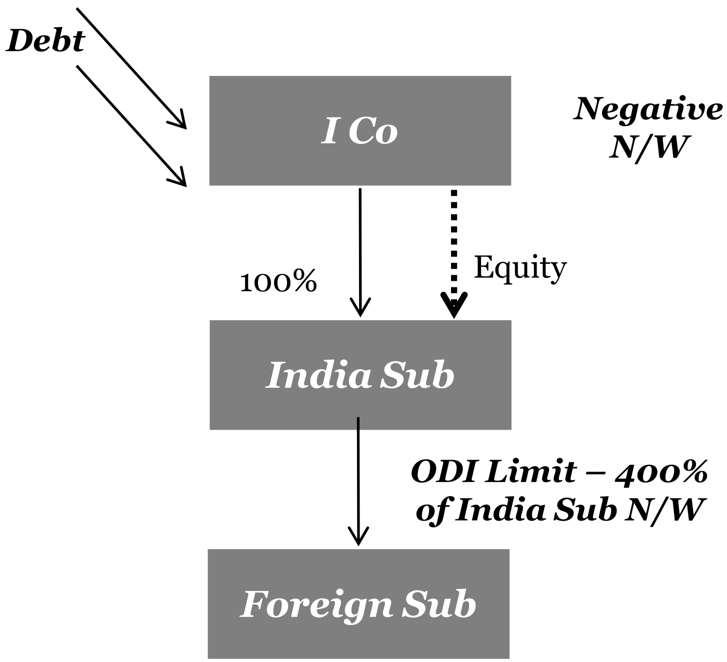
Total Financial Commitment – Some Issues

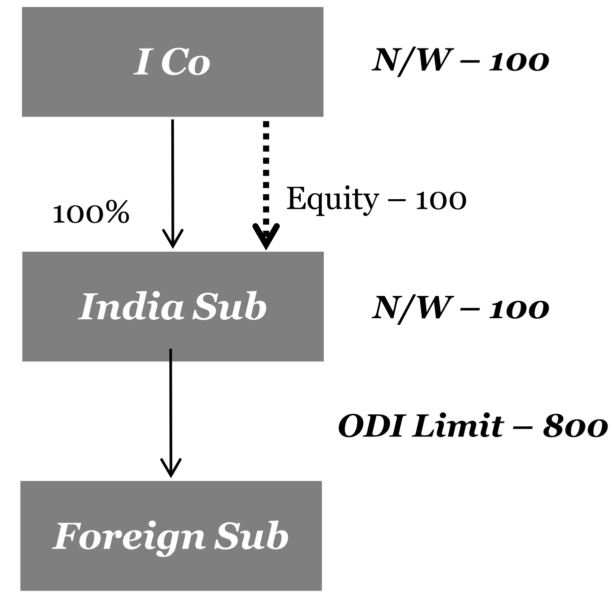
Particulars	I Co	Sub1 *(60%)*	Sub2 *(40%)*	F Sub *(75%)*
Equity Share Capital	50	10	30	100
Preference Share Capital	10	2	6	20
General reserves	20	4	12	40
Securities Premium Account	90	18	54	-
Capital reserves	100	20	60	-
IndAS Reserves	80	16	48	-
Total	**350**	**70**	**210**	**160**



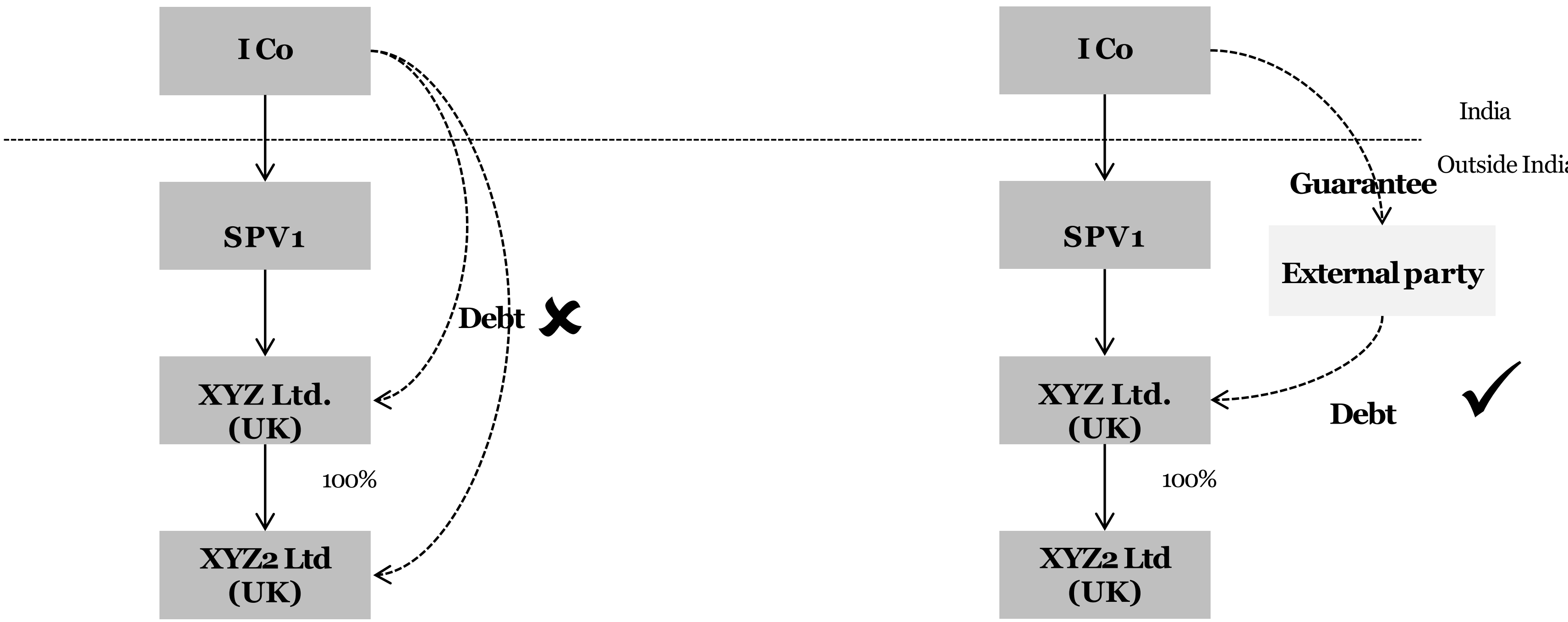
What is the net worth of I Co (including the net worth subsidiaries) as per ODI Regulations

Total Financial Commitment – Some Issues

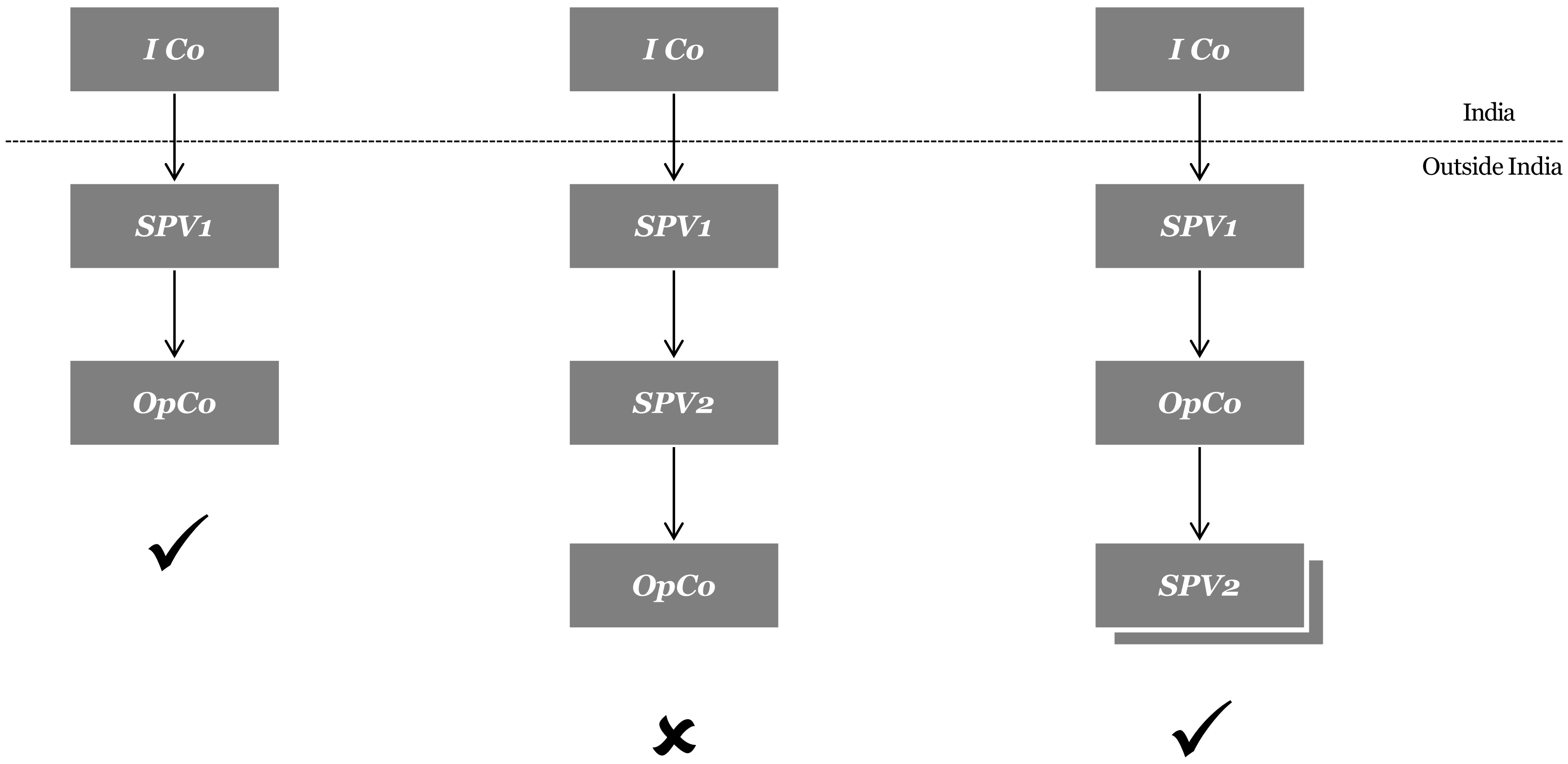




Total Financial Commitment – Some Issues



Investment through SPV



Guarantee

- No guarantee can be open ended – amount and period
- Corporate guarantee on behalf of fist level step down operating JV/ WOS is permitted
  - Direct subsidiary can be an operating or a SPV
- Corporate guarantee on behalf of second/ subsequent level step down operating subsidiary is permitted under approval route
  - Indian Party, indirectly, holds at-least 51% stake
- Renewal/Rollover of an existing guarantee shall not be treated as a fresh financial commitment:
  - No change in the end use of guarantee
  - No change in terms, conditions & amount except validity period of guarantee
  - Fresh reporting is done in Form ODI
- ODI compliance required for guarantee by a bank/ FI in India, backed by guarantee or collateral of Indian party
- Status of SBLC between two branches of same bank ?

ODI Steps

Step 1
- Board Resolution for investment in overseas entity

Step 2
- Valuation of shares – acquisition & further investment

Step 3
- Reporting in Form ODI within 30 days from the date of remittance

Step 4
- RBI will allot UIN for investment in entity

Step 5
- Filing of share certificates with the AD within 6 months

Other
- Post investment changes needs to be reported within 30 days

ODI Reporting

- All transactions relating to investment in WOS to be routed through one AD Bank branch

ODI comprises of four parts:

- Part I – includes the following:
  - Section A – Details of Indian Party
  - Section B – Details of Investment in New Project
  - Section C – Details of Investment in Existing Project
  - Section D – Funding for WOS
  - Section E – Declaration by Indian Party
  - Section F – Certificate by the Statutory Auditors of the Indian Party
- Part II – Reporting of Remittances
- Part III – Annual Performance Report (APR)
- Part IV – Report on Closure/ Disinvestment/ Voluntary Liquidation/ Winding up of WOS

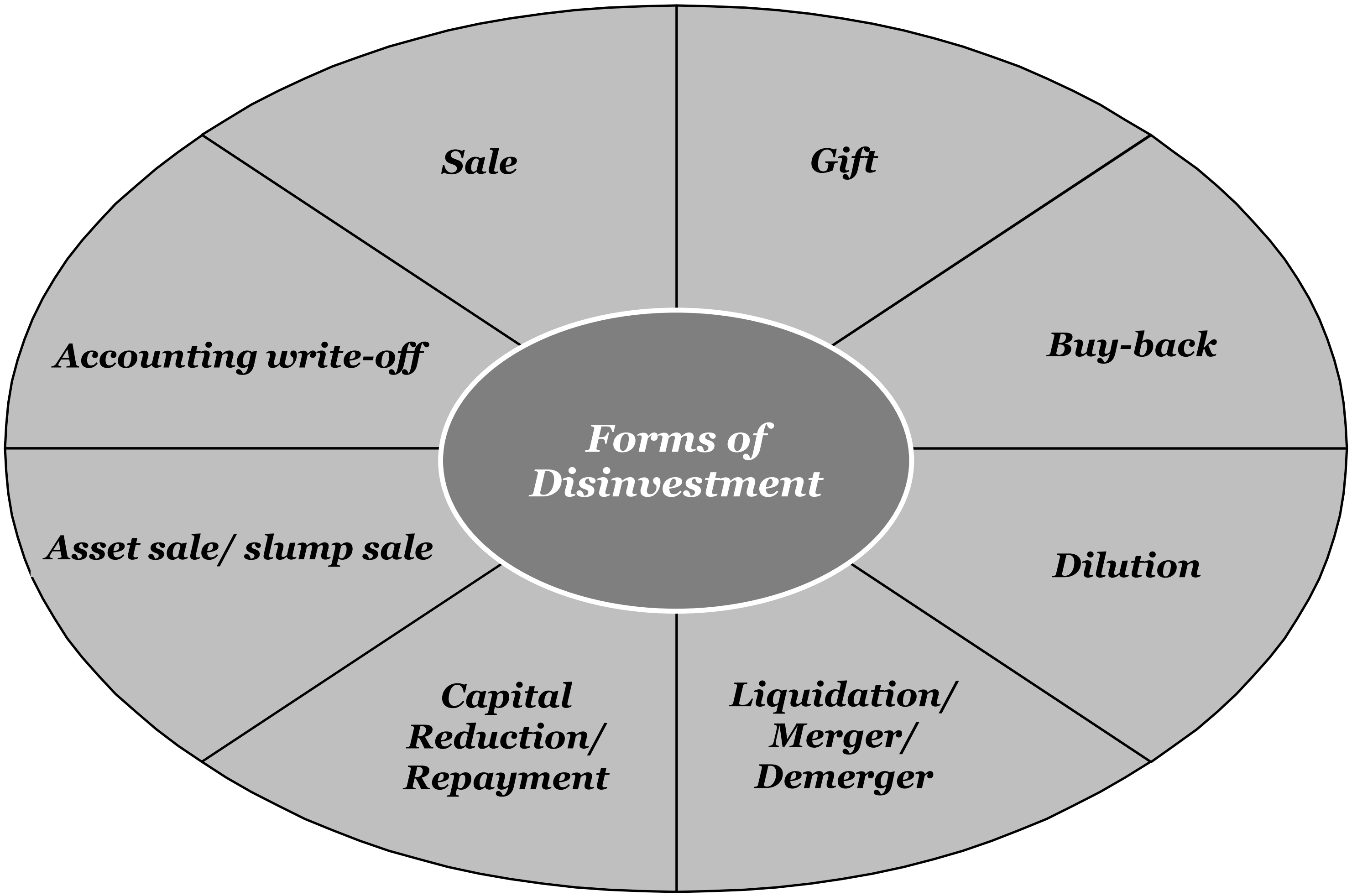
ODI Reporting – Key Aspects

- Second remittance not to be made pending allotment of UIN
- UIN should be received for the first investment in a company, before proceeding with set-up and remittance of funds to another company
- Changes in equity shareholding of JV/ WOS to be reported within 30 days
- Downstream investment by JV/ WOS to be reported within 30 days
    - How many levels of subsidiaries covered within this reporting requirement?

ODI under Approval Route

- Cases not covered under Automatic route
- Specific application to RBI with necessary documents in Form ODI through the AD (Category I Bank)
- RBI would inter alia consider the following factors:
    - Prima facie viability of JV/ WOS outside India
    - Contribution to external trade and other benefits which will accrue to India through such investment
    - Financial position and business track record of the Indian party and foreign entity
    - Expertise and experience of the Indian party in the same or related line of activity of the JV/ WOS outside India Part II - Reporting of Remittances

Disinvestment in JV/ WOS



Disinvestment in JV/ WOS

- Disinvestment when transferee is another Resident
  - Compliance of Regulation 6(2) by transferee
- Disinvestment to PROI (Non-resident), as long as there is not write-off of investment
- Disinvestment involving write-off of investment permitted subject to:
  - Overseas company is a listed company
  - Listed Indian Party with 100 Cr. Net worth
  - Unlisted Indian Party with total investment not over US$ 10mn
  - Listed Indian Party with less than 100 Cr. Net-worth but also investment is less than US$ 10mn

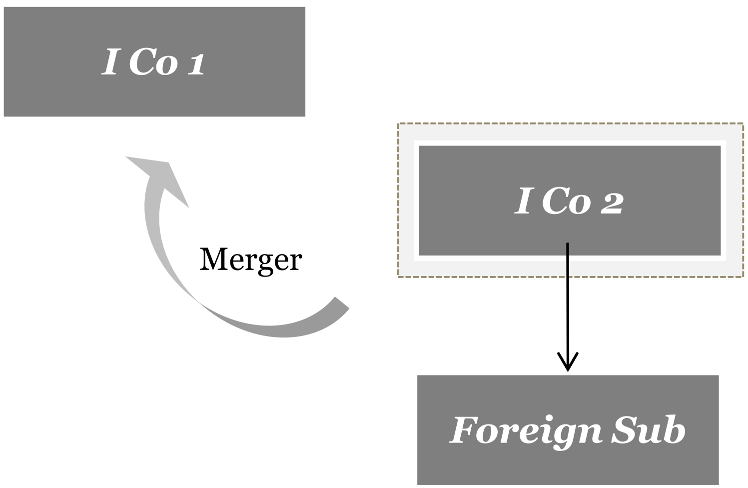
Disinvestment – Conditions

- Sale is effected through stock exchange
- Valued by CA/ CPA if sold through a private arrangement – linked to latest audited balance sheet
- Overseas concern in operation for at least full year
- All APR & Accounts are filed with the ADs
- Indian Party is not in adverse notice of Regulatory Authorities in India
- Amount is repatriated not later than 90 days from date of sale

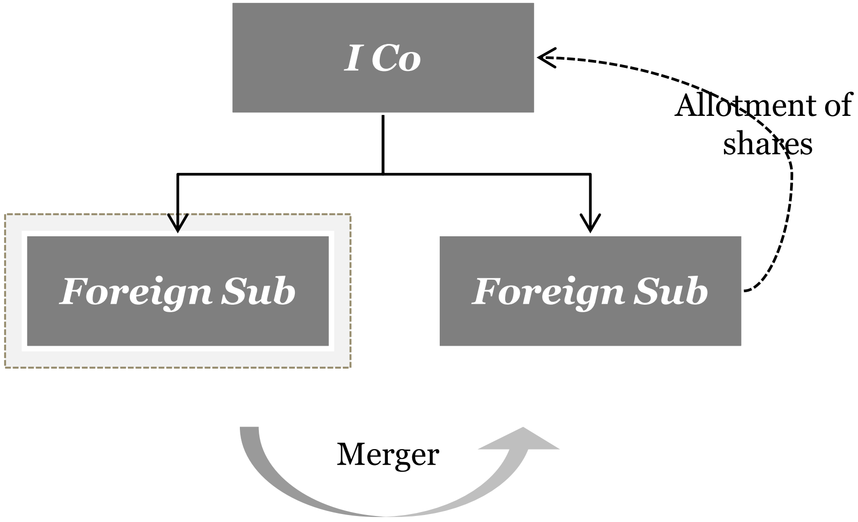
Disinvestment – Write Off

- Indian Promoter holding at least 51% capital of the Overseas Venture
  - Listed Indian company can write-off Capital and repatriable entitlements up to 25% of Equity investment in the JV/ WOS
  - Unlisted company can do so with prior approval
  - Report write-off within 30 days of write-off with copy of Balance Sheet of the overseas JV/ WOS and projections for next 5 years indicating benefit of write-off

Divestment – Few Illustrations



RBI Approval ?



RBI Approval ?

Key ODI Circulars

<u>Creation of charge on shares </u>of JV/ WOS/ Step Down Subsidiary in favour of domestic/ overseas lender

- Charge permitted to be created across all levels
- Financial commitment of 400% to be complied with – Position where there is no further overseas investment?
- Funds raised by overseas JV/ WOS/ SDS should be used for core business activities and not for investing back in India in any manner whatsoever
    - Permissibility of current account transactions
- Statutory auditors' certificate that funds have not been utilized for direct or indirect investments in India to be obtained by the designated AD
- Setting-up/ acquiring the multi-layered structure of overseas entities is under examination by the RBI
- Round tripping briefly touched upon

Key ODI Circulars

<u>Creation of charge on the domestic assets</u> in favour of overseas lenders to the JV / WOS / step down subsidiary

- Financial commitment of 400% to be complied with – Position where there is no further overseas investment?
- The domestic assets, on which charge is being created, are not securitized
- Funds raised by overseas JV/ WOS/ SDS should be used for core business activities and not for investing back in India in any manner whatsoever
    - Permissibility of current account transactions
- Statutory auditors' certificate that funds have not been utilized for direct or indirect investments in India to be obtained by the designated AD
- The overseas lender undertakes that, in the event of enforcement of charge, they shall transfer the domestic assets by way of sale to a resident only
- Wherever creation of charge involves pledge of shares of an Indian company, the pledge shall also be governed by the extant FEMA provisions
- Setting-up/ acquiring the multi-layered structure of overseas entities is under examination by the RBI

Key ODI Circulars

Creation of charge on overseas assets in favour of domestic lender

- Charge permitted to be created across all levels
- Financial commitment of 400% to be complied with – Position where there is no further overseas investment?
- The domestic assets, on which charge is being created, are not securitized
- Funds raised by overseas JV/ WOS/ SDS should be used for core business activities and not for investing back in India in any manner whatsoever
  - Permissibility of current account transactions
- Statutory auditors' certificate that funds have not been utilized for direct or indirect investments in India to be obtained by the designated AD
- The invocation of charge resulting into the domestic lender acquiring the overseas assets shall require prior approval of the Reserve Bank
- Wherever creation of charge involves pledge of shares of an Indian company, the pledge shall also be governed by the extant FEMA provisions
- Setting-up/ acquiring the multi-layered structure of overseas entities is under examination by the RBI

Section 2

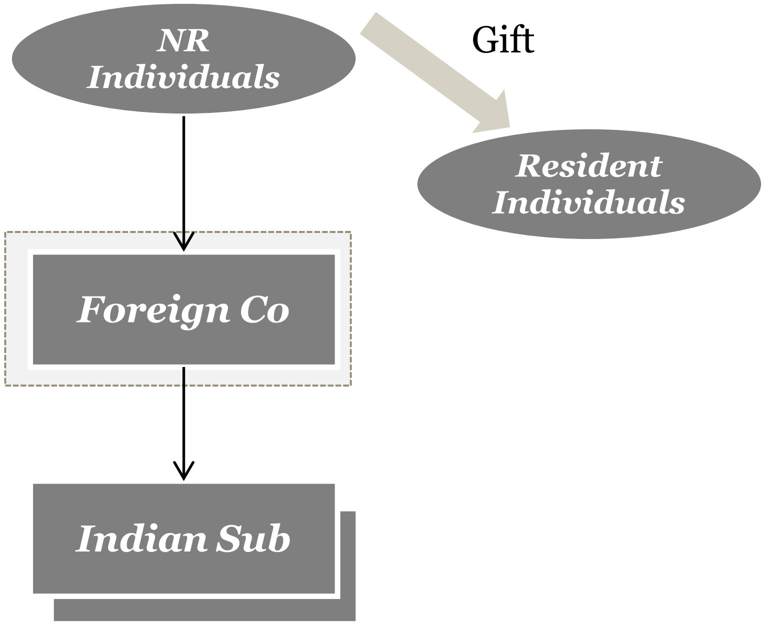
Investment by Non Corporates

Overseas Investments by Various Entities

- Individuals
  - Investment in unlisted companies covered under ODI Regulations
  - Limit under LRS up to USD 250,000 per annum/ per person
  - ***Resident individuals cannot invest in foreign companies having downstream subsidiaries***
    - Position of existing investments by resident individuals – can such companies set-up downstream subsidiaries
  - Acquisition of shares under ESOP scheme (see next slide)
- Proprietorship concerns/ Unregistered Partnership Firms
  - Permitted only to recognized Star Export House with a proven track record and satisfying the certain criteria (schedule II of the Notification, FEMA 120/ 2004 RB)

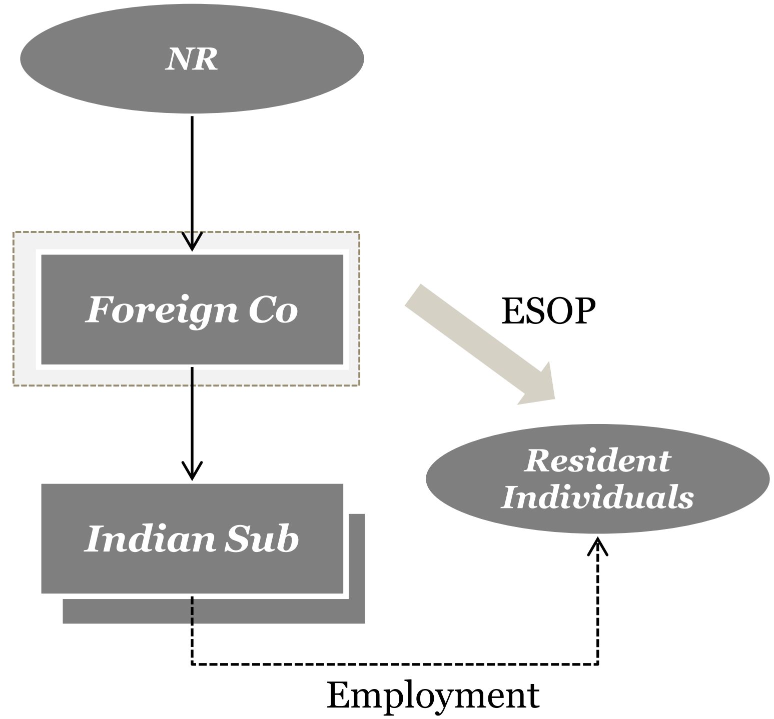
Overseas Investments by Individuals – Options

Option 1 – Gift Route



Possibility of further investing under Rights Issue route?

Option 2 – ESOP Route

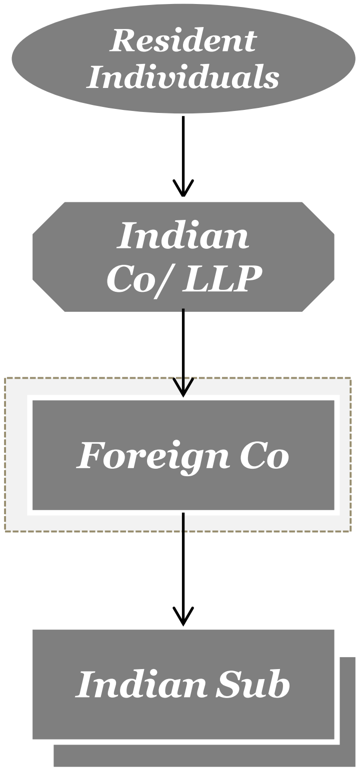


Can ESOP of say 80% be granted

Tax issues – Perquisite

Overseas Investments by Individuals – Options

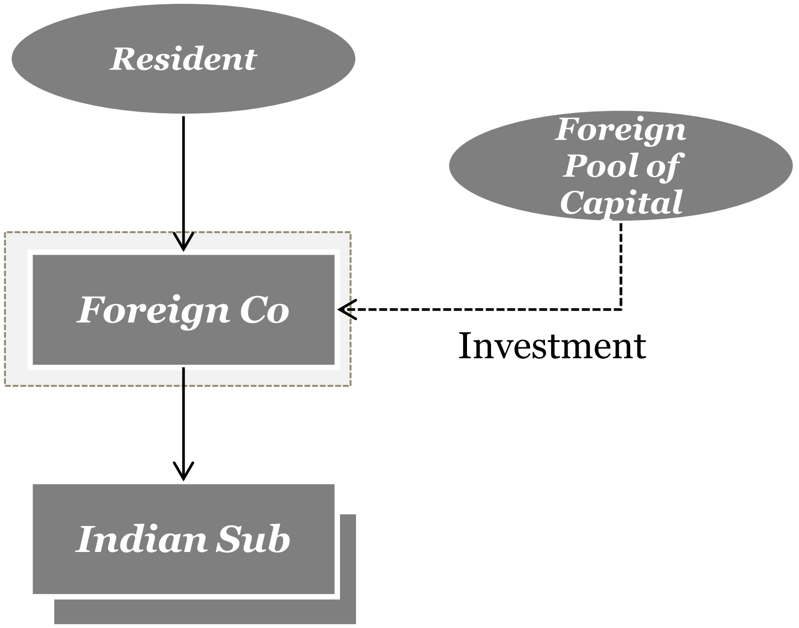
Option 3 – ODI Route for Corporates



Round Tripping?

Investors' preference

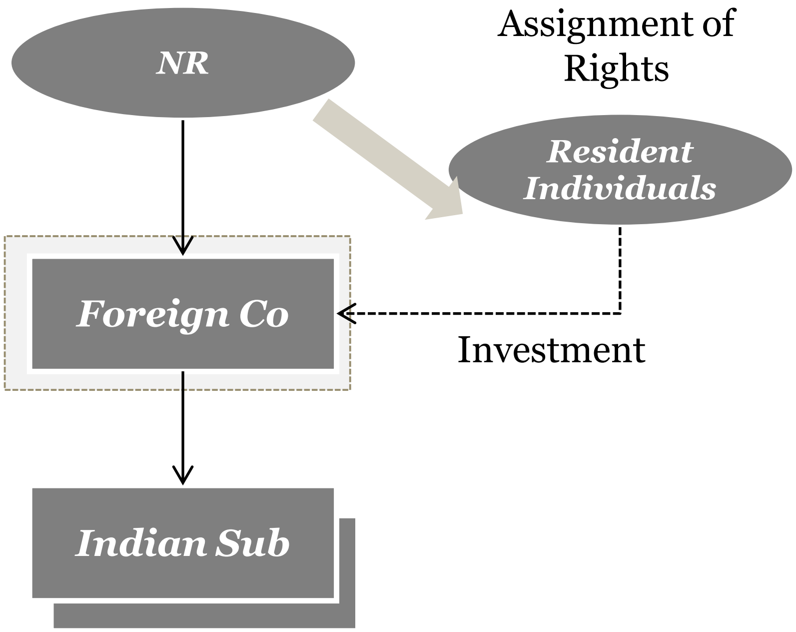
Option 4 – Overseas Capital Pool



Resident is not permanently resident in India

Overseas Investments by Individuals – Options

Option 5 – Rights Issue Route



Justifiable Argument??

Not recommended

ESOPs to Indian Residents

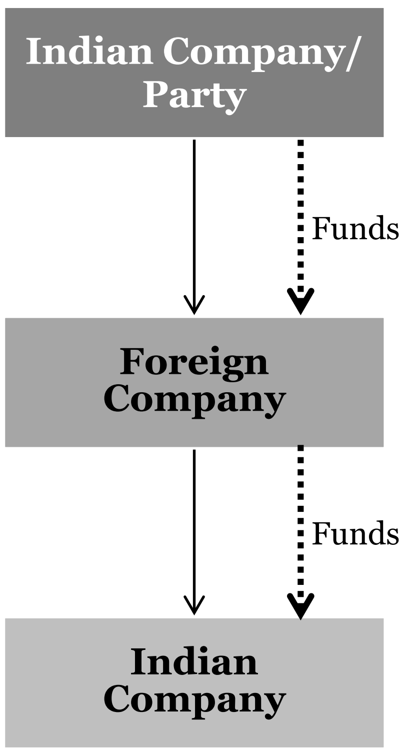
- No permission required for cashless ESOS; no remittance
- AD may allow remittance for acquiring equity shares of Foreign Co
  - Foreign Co can issue shares to employee/ directors of Indian office/ branch/ sub/ Indian Company in which foreign holding at least 51% of equity
  - Shares offered under ESOP offered by F Co globally on uniform basis
- Foreign Co to repatriate dividends/ sales proceeds within specified time frame
- Foreign Co can repurchase ESOP shares provided:
  - Shares issued in accordance with FEMA Rules and Regulations
  - Repurchase in terms of initial offer document
  - Annual return submitted by I Co

Section 3

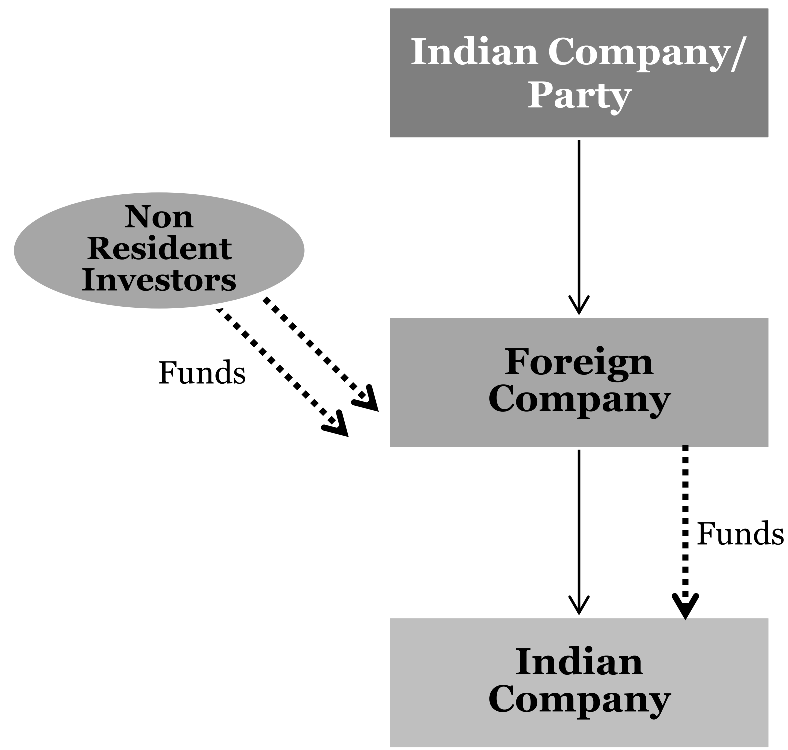
Round Tripping Issues

Round Tripping – Meaning

View I – Round Tripping of Funds



View II – Round Tripping of Structure



Round Tripping – Likely Challenges

ODI Regulations

- ODI for bonafide business activities
- Financial services not permitted
- APR form amended to include details of FDI

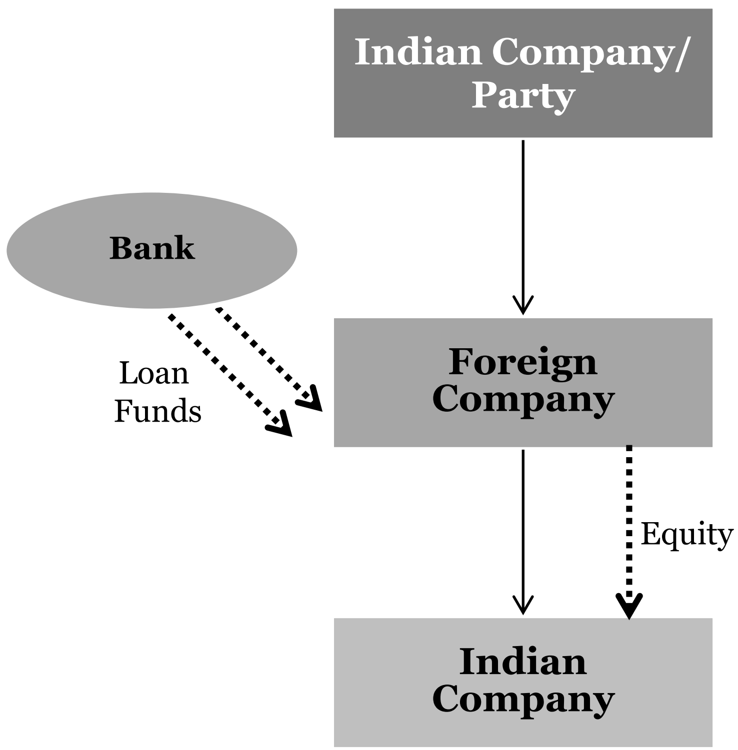
ECB Regulations

- Leveraging overseas for investment into India could amount to Deemed ECB
- End-use restrictions can be violated

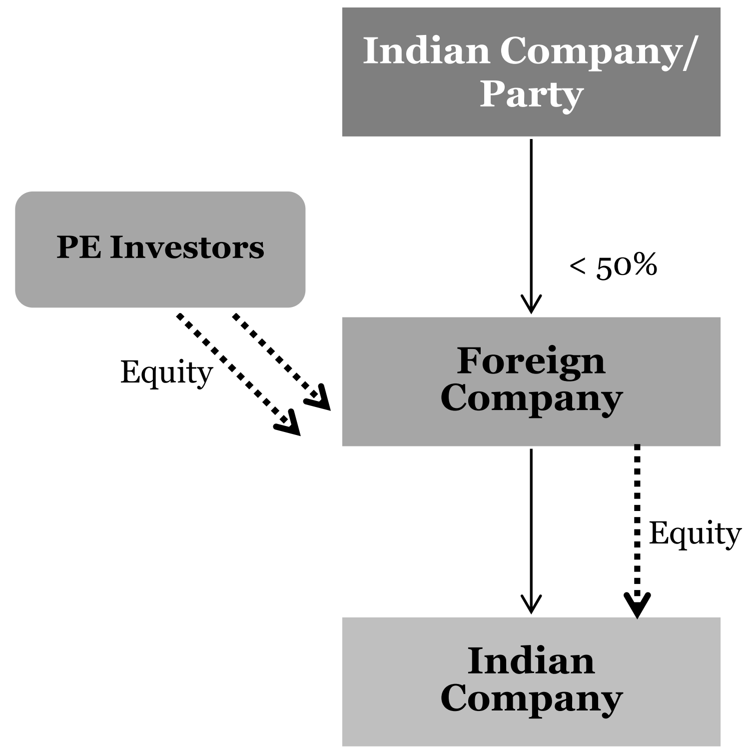
FDI Regulations

- Not genuine foreign investor
- Debt funds could be rerouted into India

Round Tripping – Illustrations

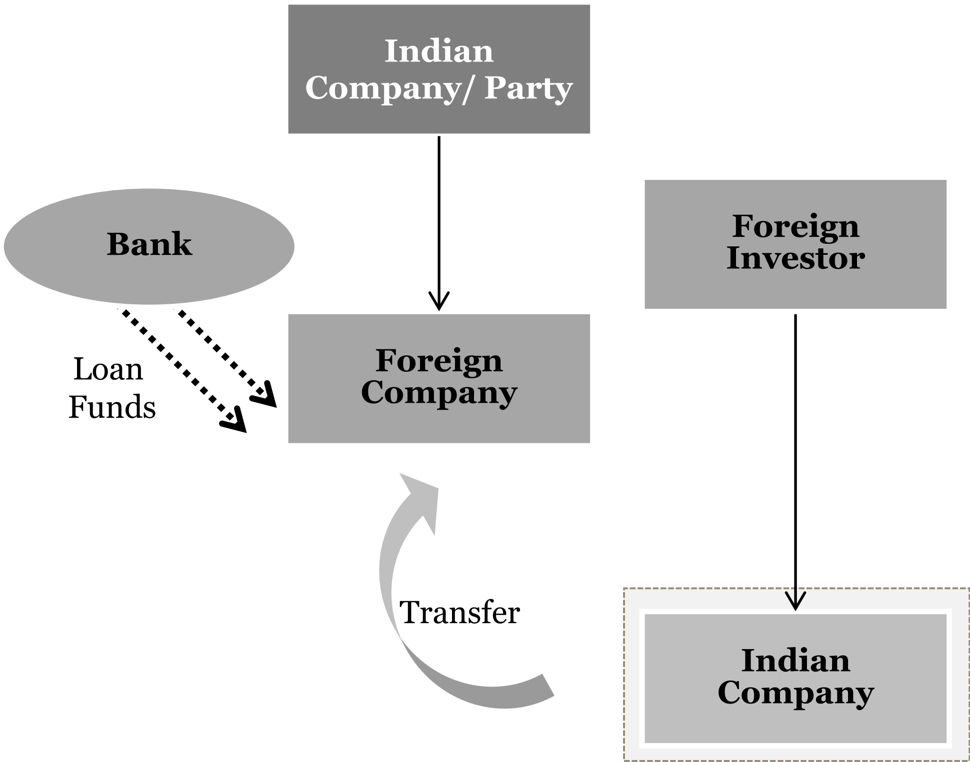


Risk	**High**



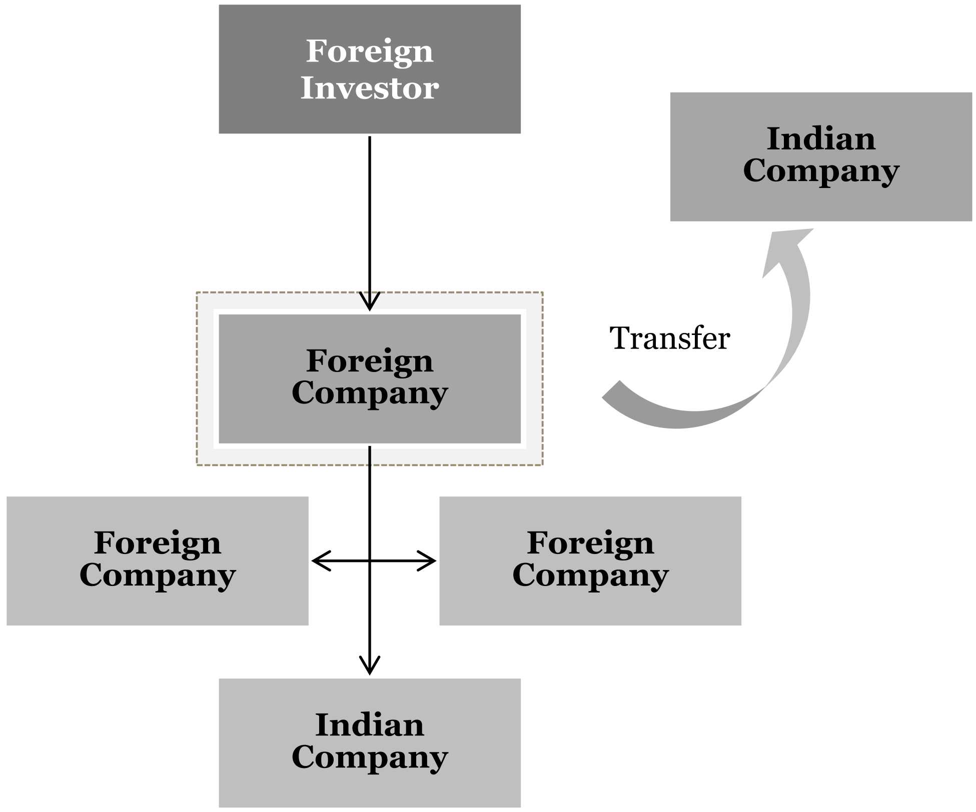
Risk	**Moderate**

Round Tripping – Illustrations



Risk	Moderate

Round Tripping – Illustrations



Risk	**Moderate**

Section 4

Overview of Indian Tax Concepts

India Tax Implications

Taxation of Dividend from Overseas Investments

- Dividends received from an overseas company is liable to tax at 16.995%
- ***Expenses incurred for earning such dividend income are not deductible***
  - Any expenses incurred (including interest) shall be disallowed
  - In case the Indian entity has operating income and debt funded – incremental tax cost on disallowance of interest
  - Can Section 14A principle be applied ??
- At least 26% in the ‘equity’ of foreign company for triggering 115BBD
- Implications of spreading shareholding over different entities

Taxation of Interest Income from Overseas Investments

- Interest received from an overseas company is liable to tax at 30%++
- Rate of interest to comply with Indian transfer pricing regulations
- Interest on debt borrowed and used for on-lending overseas – allowable as deduction

Modes of Funding

Equity Shares

- Lower rate of tax on foreign dividend – 15%++
- No transfer pricing implications on rate of dividend
- ***Portion of expenses incurred towards investment are disallowed as per Section 115BBD of the IT Act***

Convertible Preference Shares (CPS)

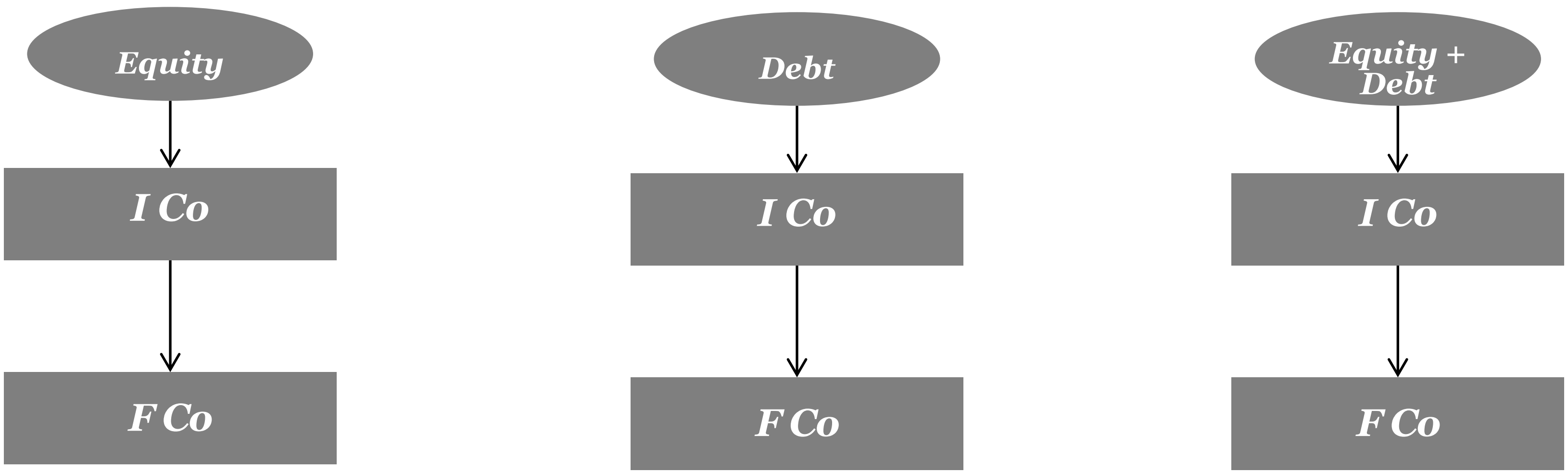
- Lower rate of tax on dividend – 15%++
- Rate of dividend to comply with Indian transfer pricing implications
- Tax payable on declaration of dividend
- Other implications are similar to equity investment

Debt/ Convertible Debentures (CD)

- Higher rate of tax on interest – 30%++
- Rate of interest to comply with Indian transfer pricing regulations
- Tax break on interest in SPV – may not be available in the absence of income chargeable to tax

India Tax Implications

Broad Framework for Investing



Equity/ Debt ?	**Equity/ Debt ?**	**Equity/ Debt ?**
Equity	**Debt**	**Equity + Debt**

POEM

OECD 2014 – An entity may have <u>more than one place of management</u>, but it can have <u>only one place of effective management</u>

OECD 2014

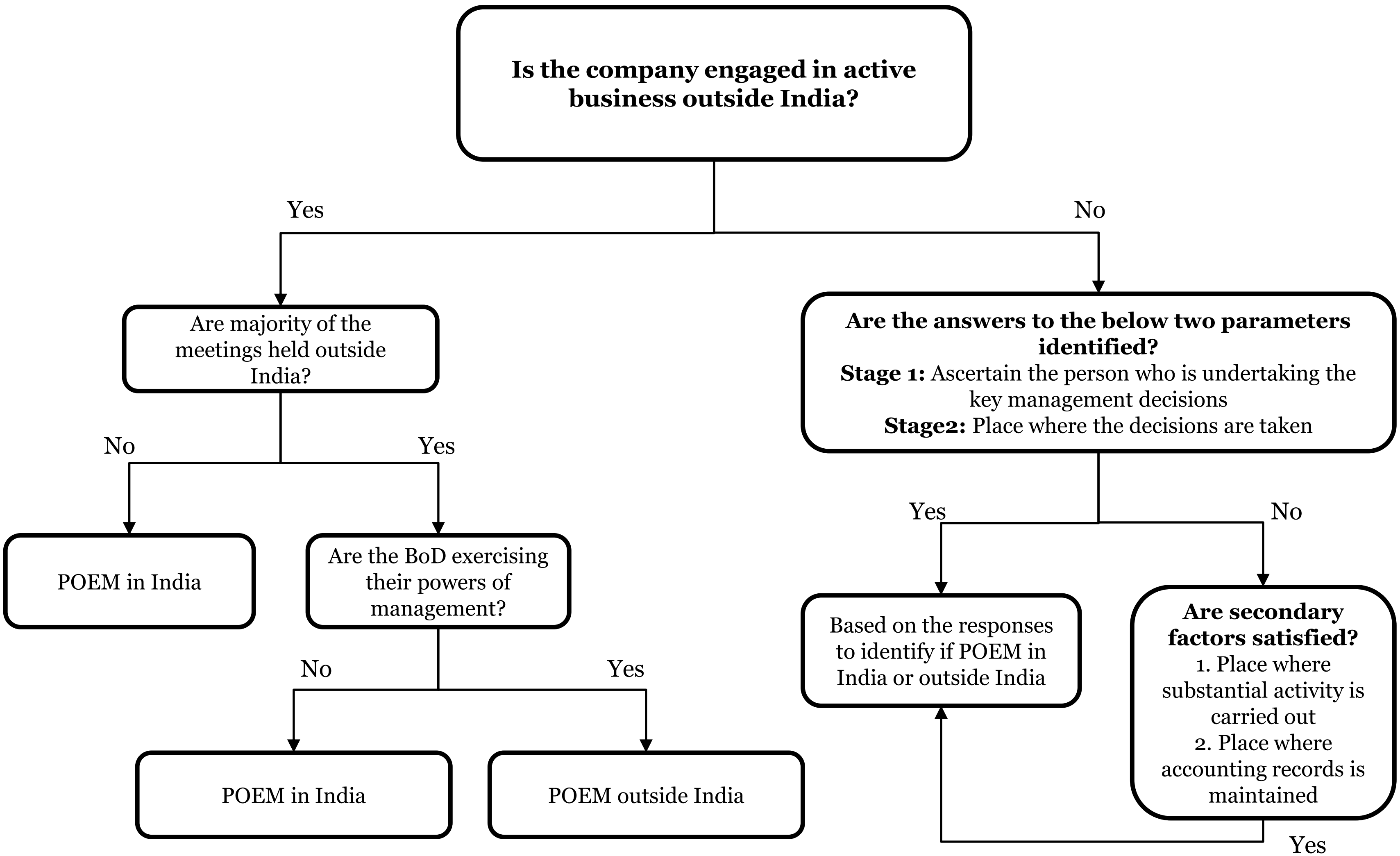
"The place of effective management is the place where key management and commercial decisions that are necessary for the conduct of the entity's business as a whole are in substance made"

PoEM Guidelines issued by CBDT

Finance Act, 2015

"Place of effective management means a place where key management and commercial decisions that are necessary for the conduct of the business of an entity as a whole are, in substance made"

POEM



Is the company engaged in active business outside India?
Yes
No
Are majority of the meetings held outside India?
No
Yes
POEM in India
Are the BoD exercising their powers of management?
No
Yes
POEM in India
POEM outside India
Are the answers to the below two parameters identified?
Stage 1: Ascertain the person who is undertaking the key management decisions
Stage2: Place where the decisions are taken
Yes
No
Based on the responses to identify if POEM in India or outside India
Are secondary factors satisfied?
1. Place where substantial activity is carried out
2. Place where accounting records is maintained
Yes

Section 5

Overview of Some International Tax Concepts

Thin Capitalization Rules

Benefits of debt funding

- Interest is deductible, dividends are not
- No capital taxes on debt financing (such as stamp duty)
- No economic double taxation of interest

Meaning

- Rules designed to discourage excessive debt funding from abroad leading to an unacceptable erosion of revenue base

Purpose

- Thin Cap rules are aimed at limiting interest deduction on excess debt funding from abroad
- Preservation of tax base

Approaches to Thin Cap rules

- Fixed debt-equity ratio approach
  - Interest not deductible; or
  - Interest treated as dividends
- Excess Interest Approach (e.g. Germany)
- General anti-abuse approach

Some countries having Thin Cap rules - Germany, Denmark, UK, France, Spain, Belgium, Netherlands, Switzerland	***Some countries not having Thin Cap rules – BVI, Mauritius, UAE, Singapore***

Participation Exemption

Meaning

- Tax relief accorded to a company in respect of distributions it receives from, or (in some cases) capital gains it realizes on certain shareholdings in another company

Purpose

- Avoiding the economic double taxation of the profits

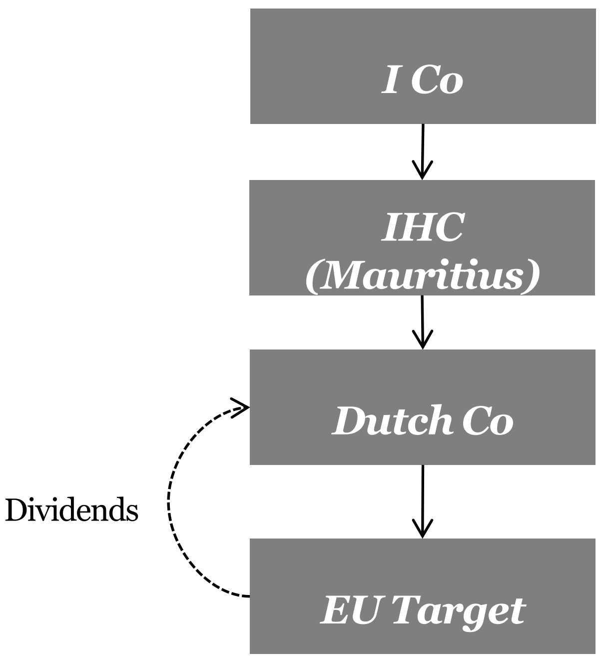
General Conditions

- Certain minimum % of shareholding or acquisition cost
- Certain minimum holding period may also be required
- Tax rate test or active income test (e.g. Netherlands)

Form of tax benefit

- The relief generally takes the form of:
  - Exemption from tax or
  - Deduction from taxable income equal in amount to the benefited income
- In some cases a small proportion of the income remains in effect taxable (e.g. Germany)

Participation Exemption – Planning Idea

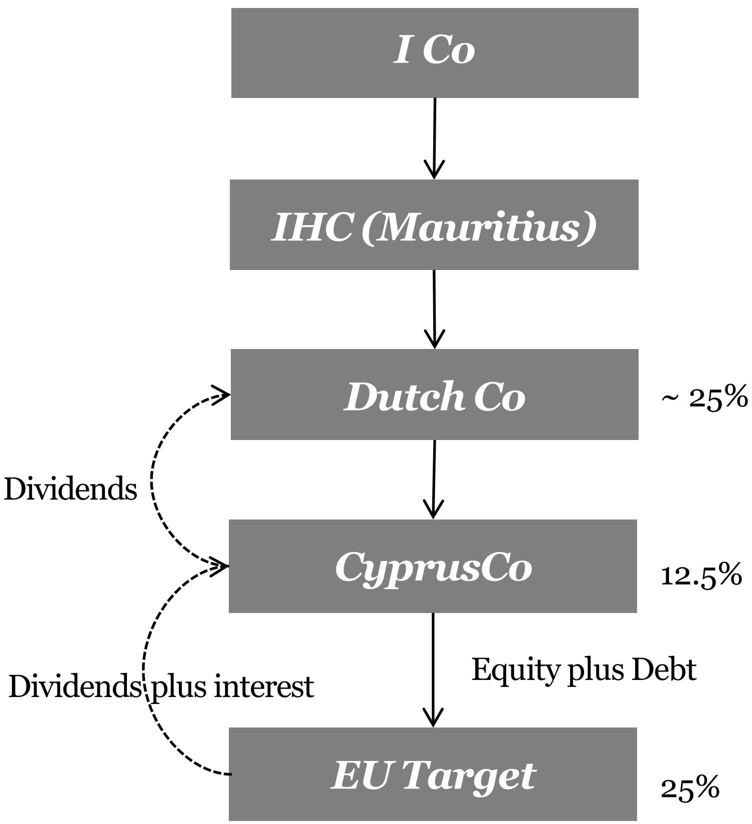


- EU Target pays dividends of EURO 100 mn.
- Corporate tax rate of EU Target is 25%

Tax implications:

- No WHT on dividends by EU Target
- Dividends received by Dutch Coop not taxable in the Netherlands
- No WHT on up-streaming of dividends Dutch Co
- Dividend not taxable in IHC
- No Indian taxation, in the absence of CFC

Participation Exemption – Planning Idea



- EU Target pays dividend of Euro 20 mn and interest of 80 mn.
- Corporate Tax rate of EU target is 25%

Tax implications

- No WHT on dividends
- No tax in Cyprus on dividends received by Cyprus SPV
- Deduction for interest cost of 80 mn for EU Target (tax saving of 20 mn)
- Tax payable on Interest in Cyprus – 10 mn
- Tax arbitrage on movement of income from EU Target to Cyprus
  - 25% vs. 12.5%

Underlying Tax Credit

Meaning

- An indirect credit granted for the tax levied on the profits of the company out of which the dividends have been paid

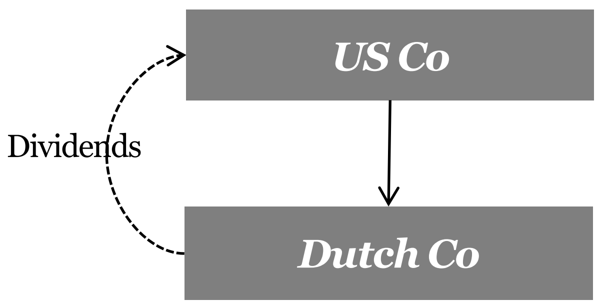
Purpose

- Avoidance of economic double taxation of profit distributions

General Approach

- Where dividends pass through a chain of companies, the credit may also be given for the tax levied on the profits of each company in the chain (e.g. Mauritius)
- In some cases this is limited to a number of levels, or “tiers”.
- Such relief may be given either under a tax treaty or in accordance with unilateral provisions

Underlying Tax Credit – Example



Particulars	Amount
Dutch Co's taxable income	100.00
Tax payable in Netherlands	25.50
Balance amount distributed as dividends	74.50
WHT on Dividends	Nil
Dividends received in US	74.50
Grossed up dividends (74.5 * 100/ 74.5%)	100.00
Tax Payable in US (at 35%)	35.00
Underlying tax credit available in US (lower of tax paid by Dutch BV or US tax)	**25.50**
Net tax payable in US	***9.50***

Limitation on Benefits (LoB) Clause

Meaning

- Provision which may be included in a tax treaty to prevent treaty shopping, e.g. through the use of a conduit company

Purpose

- Prevention of treaty shopping and misuse of treaty benefits

General Approach

- Look through approach
- Exclusion approach
- Subject to tax approach
- Channel approach / base erosion rule

- ***Most of the US tax treaties provide for detailed LoB article***
- ***Amongst others, India's tax treaty with Singapore, UAE, Namibia, Iceland, Armenia and USA also include LoB article***

- ***If there is no LoB provision in the tax treaty, Revenue Authorities cannot imply the one – Supreme Court in Azadi Bachao Andolan***

EU Directives

Objectives

- Harmonization of national tax legislation for functioning of ‘proper market’ in EU and single market implementation
- Free movement of People, Capital, Goods and Services

EU Directives – Meaning

- A legislative act of the EU which requires member states to achieve a particular result without dictating the means of achieving that result
- Only binding on member states to whom they are addressed
- Provides freedom of choice of ways of achieving underlying objectives
- Taxpayers see effects of a directive through their national legislation
- Specifies a date by which the Directives have to be put into effect by member states
- EC can initiate legal action in the European Court of Justice (ECJ) against member states for failure to comply with EU Directives

EU Member Countries – 28 (Switzerland is not part of EU)

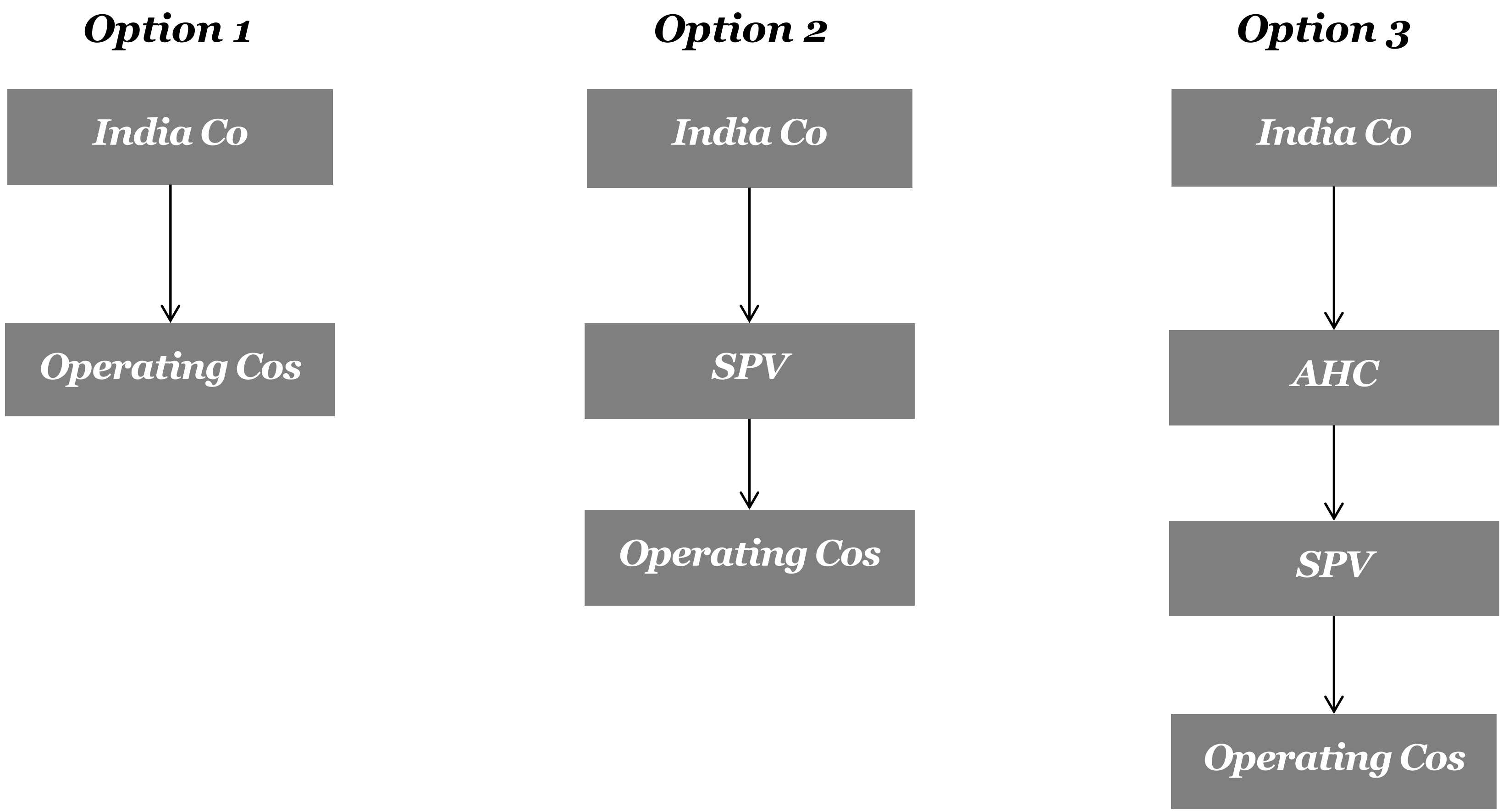
Key EU Directives

- Parent Subsidiary Directive – 90/435/EEC
- Merger Directive – 90/434/EEC
- Interest & Royalties Directive – 2003/49/EC

Section 6

Options for Investing

Options for Investing



Options for Investing

Particulars	*Tax Efficiency*	*Ease of Compliance with FEMA*	*Flexibility*	*Ease of implementation*
Option 1 – Direct Investments	Double taxation of income, i.e. in source country as well as India	Need to comply for each investment	No	Simple structure, easy to implement and less administrative costs
Option 2 – Investment through Special Purpose Vehicle	Double taxation of income at the time of repatriation from SPV to India - No single jurisdiction which gives an effective structuring	Yes	Less Flexible	More complex than option 1, require more time for implementation, administrative costs would also be more than option 1
Option 3 – Investment through International Hold Co and Special Purpose Vehicle	Most tax efficient	Yes	Yes	Need to manage higher number of entities. More complexities and higher administrative costs.

Thank You

CA. Amithraj AN

+ 91 98861 20086

amithraj123@gmail.com

Views expressed in the presentation are personal