Destination India: Welcome Retail

Legal, Tax & Regulatory Primer with Industry insight

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Contents

1. Introduction

I. The Indian Retail Story

The current momentum in the Indian retail sector, which has been growing at an annual compounded rate of 5.9 percent since 1998[1], with a market size of USD 450 billion in 2012 with expectation to reach USD 574 billion by 2015[2], has caught the world's attention. Despite sociopolitical challenges and restrictions on foreign direct investment (**"FDI"**) in retail trading, the Indian retail sector has grown too large to ignore. Along with India's strong growth fundamentals, increased urbanization and consumerism provides immense scope for retail expansion both for domestic and foreign players.[3]

The Indian retail sector is just emerging with unorganized players predominantly controlling the market. However, with 97 percent of the business coming from the unorganized sector such as the traditional family run stores and corner stores, the Indian retail sector offers large potential for growth in the organized sector. The revenue generated from organized retail which continues to grow on impressive scales also shows the potential of the untapped sector. (From USD 290 billion in 2010[4], USD 395.96 billion in 2011, to a projected USD 200 billion by 2020[5])

In 2012-2016 organised retail is expected to grow at 24 percent or three times the pace of traditional retail (which is expected to expand at 8 percent).[6]

II. Global Positioning of the Indian Retail Sector

India has been an attractive destination for investment as it has been one of the least competitive and saturated economies in the world.[7]

III. High Growth Potential of the Sector Attracts Investors

There is a paradigm shift in global investors' destination choices: from being 'efficiency seeking'[8] to 'market seeking.' Also, there is a shift from sectors like

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1. IBEF, Retail: March 2013, available at http://www.ibef.org/download/Retail-March-220313.pdf
2. Ibid
3. IBEF, Retail: Jan 2012, January 16, 2012 available at: http://www.ibef.org/artdisplay.aspx?cat_id=377&art_id=30832
4. Global Retail Report, available at: http://www.researchandmarkets.com/reportinfo.asp?report_id=1580321&tracker=related.
5. Federation of Indian Chamber of Commerce and Industry, Retail Sector Profile, available at:http://www.ficci.com/sector/33/Project_docs/Sector-prof
6. See AT Kearney, The 2006 Global Retail Development Index, available at: www.atkearney.de/content/misc/wrapper.php/name/file_grdi_2006%5B1%5D_1147072562a95e.pdf
7. AT Kearney, 2012 Global Retail Development Index, available at: http://www.atkearney.com/consumer-products-retail/global-retail-development-index
8 AT Kearney, 2011 Global Retail Development Index, available at: http://www.atkearney.com/index.php/Publications/global-retail-development-index.html

natural resources, manufacturing and infrastructure, which are export-driven and are conducive to tariff avoidance, to more varied industries including retail, education, banking, tourism etc.[9] International retailers are now focusing on the portfolio of countries – with different levels of risk, at different stages of maturity and with distinct consumer profiles to balance short term and long term opportunities.[10]

Governments across the globe have begun to take notice of the corresponding benefits in development, export boost and supply chain improvements that FDI in retail can yield. FDI in retail has been a key driver of productivity growth in Brazil, Poland and Thailand, resulting in lower prices and higher consumption.

Large-scale foreign retailers also lead the path of improvements in the productivity chain, for wholesalers and food processors. As a result, since its opening up to foreign investment in 1994, traditional small retailers in Brazil managed to increase their market share by 27 percent. They can also channelize exports at a significant scale.

Governments across the globe have begun to take cognizance of the corresponding benefits in development, export boost and supply chain improvements that FDI in retail can yield

For example: Tesco in Thailand and Wal-Mart in Brazil increasingly depend on local products to feed their global supply chains. Retail also happens to be a pillar of the tourism industry.

More specifically in India's context, opening up the retail sector for FDI has been placed in the context of moderating inflation. The idea is that organized storage and transport chains will help cut nearly 40 percent transport and distribution losses in the present supply chains, one of the factors pushing up food prices to high and unsustainable levels.[11]

Governments across the globe have begun to take notice of the corresponding benefits in development, export boost and supply chain improvements that FDI in retail can yield. Thus, it can be said that this liberalization of investment in the retail sector could change the face of Indian retail by offering quality goods at lower prices to the consumers.

In addition, due to availability of cheap raw material and work force, global retailers would also utilize Indian goods for their

9. Vincent Palmade and Andrea Anayiotas, FDI Trends, Public Policy for Private Sector, World Bank, available at: http://rru.worldbank.org/documents/publicpolicyjournal/273palmade_anayiotas.pdf
10. Ibid.
11. Retail global expansion: A portfolio of opportunities - A.T. Kearney, available at: http://www.atkearney.com/images/global/pdf/Retail_Global_Expansion-GRDI_2011.pdf

international outlets leading to an increase in Indian exports and improving the balance of payment position.

2. Industry Analysis

I. The Concept of Retail

A perfect business model for retail in India is still at the evolutionary stage. AT Kearney terms retail expansion as a portfolio game where an optimal mix of countries, formats and operating models is the key to success. In this section, we analyze certain formats and models alongside thriving segments. However, the traditional unorganized formats like 'mom and pop' shops, hawkers, grocers etc., continue to co-exist with the modern formats of retailing.

Taking a step back, the very definition of 'retail' / 'retailer' has changed. In 2004, the High Court of Delhi defined the term 'retail' as a sale for final consumption in contrast to a sale for further sale or processing (i.e. wholesale).[12]

However, the traditional definition of a retail shop is referred to business premises where goods are sold to the public, or services are provided to the public, or to which the public is invited to negotiate for the supply of services. Due to the emergence of e-commerce and m-commerce, the physical / territorial component of the definition no longer holds true.

Such retailers manage to surpass the barrier of direct personal contact and reach out to the public via alternative media. While customers place orders online, the delivery takes place elsewhere, most likely at their doorsteps. Interestingly, judicial decisions on 'retail' always provided scope for such broad construction, indicating that delivery and sale need not be simultaneous or occurring at the same place.

Retail expansion is a portfolio game where an optimal mix of countries, formats and operating models is the key to success.

The emphasis on the business-to-consumer format remains, which must be differentiated from the business-to-business dealings i.e. wholesale.

Further, it is important to distinguish between the terms 'retailing' and 'retail trading' which are often used interchangeably. Retail trading is a subset of retailing (which is a far broader term), and foresees the buying and selling of goods to retail consumers. The FDI Policy contains conditions on foreign investment in retail trading and not retailing. Entities selling goods to retail consumers by undertaking manufacturing / contract manufacturing or under franchise and license agreements are said to be engaged in retailing and not retail trading. Examples of entities engaged in retailing in

12. Association of Traders of Maharashtra v. Union of India, 2005 (79) DRJ 426

India include Hindustan Unilever Limited and McDonalds.

II. Formats

In modern retail, a key strategic choice is the format; retailers are coming up with various innovative formats to provide an edge to their products and services. Retailers experiment with a variety of formats, from discount stores to supermarkets to hypermarkets to specialty chains etc.

The table below explains some popular formats used in the retail sector:

Popular Formats	Meaning
Big box stores	Large stand-alone store with varying market niches.
Category killer	A large retail chain store that is dominant in its product category. The store generally offers an extensive selection of merchandise at prices so low that smaller stores cannot compete.
Chain store	One of a number of retail stores under the same ownership and dealing in the same merchandise.
Co-operative	Any organization that is owned and operated by all of its members for their mutual benefit.
Hardline	A departmental store or product line primarily consisting of merchandise such as hardware, housewares, automotive, electronics,sports goods, health and beauty aids or toys.
Softline	A departmental store or product line primarily consisting of merchandise such as clothing, footwear, linens and towels.

i. Hypermarkets, supermarkets and malls

Hypermarket / supermarkets are large self-servicing outlets offering products from a variety of categories. In 2001, Pantaloon Retail launched the country's first hypermarket: 'Big Bazaar'. Hypermarkets turn out to be the most recommended format for the Indian retail sector, according to various reports. Hypermarkets would be the largest retail segment, accounting for 21 percent of the total retail space by 2013–14.[13] Malls are the biggest form of organized retail in India, which offer customers a mix of all types of products and services including entertainment and food under one roof. There are approximately 350 malls that have spread across the country.[14]

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13. Retail Update March 2013, available at: http://www.ibef.org/download/Retail-March-220313.pdf
14. 120 million square feet mall space by Q1, 2011: Malls of India report, available at: http://www.indiaretailing.com/news.aspx?topic=1&Id=4155

ii. Specialty Stores and Category Killers

Specialty stores are retail chains dealing in specific categories and provide a large variety. Mumbai's Crossword Book Store and RPG's Music World are two examples. Category killers are specialty stores that offer a variety of product categories. They are known as 'category killers' since they focus on specific categories, such as electronics and sporting goods. They are also known as Multi Brand Outlets or MBO's.

iii. Other Formats

Traditionally, India has been familiar with department stores and discount stores. However, with increased urbanization and use of technology, several new formats have evolved over time. For example:

1. Gas stations are providing amenities in the form of convenience stores, automated teller machine (ATM), food courts and pharmacies appearing in many outlets. However, convenience stores which are located in residential areas with slightly higher priced goods are yet to include these services.

2. Vending machines, almost always identified with Japan's retail formats, are a relatively new entrant to India.

3. Along with the modern retail formats, the non-store retailing channels are also witnessing movement. For example: (i) Local Banya.com, a direct to home service and (ii) Ek Stop.com, another home delivery e-commerce retail service.

4. Other formats through the use of internet and mobile technology have also been popular in the recent years.

iv. E–commerce

Electronic commerce commonly known as E-commerce is a more convenient way for buying and selling of products or services through the electronic medium which is growing in popularity. This is most preferred since it provides a click and buy method. Also the e-retailers provide facilities such as e-payment, home delivery and gift option. Many companies find e-commerce more profitable than resorting to traditional forms of advertising. Global and local e-commerce retailers have launched websites that offer Indian consumers a wide range of products such as apparel, electronics, baby products, etc.

v. M–commerce

Mobile commerce is a subset of E-commerce. The selling and buying of goods and services through mobile devices and smart phones is referred as m-commerce. The advantage of m-commerce is its personalization, flexibility, and distribution. It also promises exceptional business market potential, greater efficiency and higher productivity. With the initiation of mobile internet services the retail industry is also relieved as it provides easy mobile payment options. But as a security concern, there are certain banking regulations which are deterring the growth of m-commerce in India.

Examples of various formats

Format	Retailer
Supermarket	Shoppers' Stop, Westside, Big Bazaar, Reliance Trends
Corner shops	Crossword
E-commerce	Flipkart, Fashionandyou, yebhi.com
Hypermarket	Pantaloon, Star Bazaar, Hypercity, Spencer, More
Small fashion stores	Fabindia
Cash and carry	Metro, Bharti Walmart, Carrefour
Discount store	S Kumar's
Specialty store	Titan Industries, Landmark
Large Electronic Store	Croma, Vijay Sales

III. Segment–Wise Activity

i. Food and Grocery Retail

India accounts for 1.6 percent of international food trade,[15] which is expected to rise to 3 percent as per Vision 2015 for Ministry of Food Processing Industries Government of India. Available Market studies indicate that most of the giant food specific retail giants are concentrated in a given region. Some point out that this indicates a strategic pattern, which is to completely saturate the markets where they have established market presence, and then to utilize their efficiency and experience to spread into other areas. An example would be Food-World, an alliance between the RPG Group in India with Dairy Farm International of the Jardine Matheson Group.[16] Mass grocery retail (MGR) sales in India are expected to undergo enormous growth as a consequence of India's dramatic, rapid shift from small independent retailers to large, modern outlets.[17] According to Technopack the organized food and grocery retail market in India was estimated at USD 9 billion in 2011 and is expected to grow to USD 34 billion by 2016 at a CAGR of 30 percent.[18] Further, the Eleventh Five Year Plan has set a target of 30 Mega Food Parks. During 2011-12, approval has being given to set up 15 more Mega Food Parks. Foreign retailers might use this opportunity.

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15. Agro & Food Processing data available at: http://investingintamilnadu.com/tamilnadu/opportunities/agro_foodprocessing.php

16. Vijay Anand and Vikram Nambiar, Indian Food Retail Sector in the Global Scenario, available at: www.sathguru.com/Note_on_Retail_Industry.pdf
17. Emerging Trends in Indian Retail and Consumer 2011 available at: http://www.technopak.com/resources/retail/Emerging%20Trends%20in%20Indian%20Retail%20and%20Consumer-2011.pdf
18. Standing against each other Safal, Spencer's and Reliance Fresh adding dynamism to F&G segment, available at: http://www.indianretailer.com/article/sectorwatch/food-and-grocery/Standing-against-each-other-1489/

Leading brands

Indian	International
Food Bazaar, Nature's Basket, Reliance Fresh	Carrefour, Metro

ii. Apparel and Footwear Retail

This sector has been aligning itself with global trends in recent years with retailing companies like Shoppers' Stop and Crossroads entering the sector. While China is ranked at the top for growth opportunities in this segment, India figures as one among the top ten.[19] Spending on clothing and footwear is expected to reach USD 225 billion by 2020.[20] This sector also witnessed increasing activity in terms of joint ventures. For example, Future Ventures India Ltd and Clarks Future Footwear Ltd, UK, formed a joint venture. There have been target specific ventures as well. Mothercare, UK and DLF brands pulled out to venture into maternity garments, baby clothes and equipment segment. Further, Indian conglomerates like Tata and Reliance have also forayed into these segments.

Leading brands

Indian	International
Provogue, Wills Lifestyle, Reliance Footprint, Woodland	Zara, Mango, Marks & Spencer, Charles & Keith, Hush Puppies

iii. Pharma Retail

The rise in health care spending, from USD 49 billion in 2010 to an expected USD183 billion in 2020, will be fueled by a growing emphasis on wellness and nutrition and the rise in "lifestyle" diseases.[21] A few corporates who have already entered this segment include Dr. Morepen (with Lifespring and Tango), Medicine Shoppe, Apollo Pharmacies, 98.4 from Global Healthline Private Ltd. and CRS Health.

iv. Book and Music Retail

The "gifting" gesture in India is becoming more common and with books enjoying a significant share, thus pushing this sector to grow by 15 percent annually.[22] The size of the Indian music industry, as per this Images-KSA Study, is estimated at INR 11 billion of which about 36 percent is consumed by the pirated market and organized music retailing constitutes about 14 percent, equivalent to INR 1.5 billion.

Leading brands

Indian	International
Crosswords, Reliance Timeout	Oxford Bookstore

iv. Consumer Durables Retail

The consumer durables market can be

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19. Supra note 4.
20. Boston Consulting Group Report –'The Tiger Soars -Capturing India's explosive Growth in Consumer Spending' dated February 16, 2012
21. Ibid
22. Ernst & Young, The Great Indian Retail Story, 2006

segmented into consumer electronics comprising of TV sets, audio systems, VCD players and others; and appliances like washing machines, microwave ovens and air conditioners. There are various domestic and foreign players who have entered this segment in the last couple of years.

Leading brands

Indian	International
Croma, e-zone	Samsung, Sony

For the purpose of this paper, we have summarized the factors and the challenges that affect the demand and supply of the retail sector.

IV. Factors that Shape the Demand

As per the Boston Consulting Group Report of February 2012,[23] India is the second fastest growing major consumer market in the world. In the past few years the whole concept of shopping has been altered in terms of format and consumer buying behavior. With the increasing urbanization, the Indian consumer is emerging as more trend and brand conscious. There has also been a shift from price considerations to designs and quality as there is a greater focus on looking and feeling good (apparel as well as fitness). At the same time, the Indian consumer is not beguiled by retail products which are high on price but commensurately low on value or functionality.

The Indian consumer is also witnessing some changes in its demographics with a large working population being in the age group of 24-35 years. During the past few years, there has been an increase in the number of nuclear families, an increase in working women and emerging opportunities in the service sector which has been the key growth driver of the organized retail sector in India. Overall consumer spending is likely to expand 3.6 times from USD 991 billion in 2010 to USD 3.6 trillion by 2020 at a 14 percent annual growth rate, or 8 percent in real terms.

By 2020, India will constitute 5.8 percent of the world's total consumer spending significantly higher than the 2.7 percent it represents now.[24]

In addition to the above, use of digital and social media is revolutionizing the ways people interact and communicate with each other.

V. Opportunities & Challenges

i. Workforce

The retail sector in India is the second largest employer after agriculture. Retail trade employs approximately 8 percent of total workers.[25] Although, one challenge for an aspiring foreign retailer, is to re-train

23. *Supra Note 22*

24. *Supra Note 22*

25. *Supra Note 7*

the workforce according to international standards and practices that are being brought in.

ii. Infrastructure & Supply Chain

Lack of adequate infrastructure with respect to roads, electricity, cold chains and ports has further led to the impediment of a pan-India network of suppliers. Long intermediation chains would increase the costs by 15 percent. The various initiatives that retailers have started to optimize regarding their entire supply chain include workforce optimization, inventory planning and revamping of technological infrastructure.[26]

A study commissioned by the World Bank indicates how the weak storage chain does irreparable damage to India's exports.[27]

iii. Real Estate

Availability of real estate at the right prices and at the right location remains to be the key concern for growth of the retail sector. Further, lack of clear ownership titles and high stamp duty has resulted in a disorganized nature of transactions.

iv. Managing Shrinkage

In India, shrinkage is the highest in the world, ranging around 2.9 percent of the total sales.[28] Therefore, dealing with shrinkage and shoplifters continues to trouble foreign players aspiring to enter India.

v. Funding

The retail sector does not have 'industry' status yet, making it difficult for retailers to raise finance from banks to fund their expansion plans. Further, Indian companies cannot raise debt from overseas due to existing restrictions under the external commercial borrowing regulations.

vi. Regulatory Challenges

Government restrictions on FDI lead to an absence of foreign players resulting into limited exposure to best practices, an aspect that has been discussed in detail below, under "Regulatory Regime". Separately, even though the government is attempting to implement uniform goods and service tax across the nation, delay in its rollout and implementation is leading to increased costs and complexities in establishing an effective distribution network.

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26. Issues Monitor, July 2011
27. Mattoo, A. D.Mishra and A. Narain, *From competition at home to competing abroad: A case study of India's horticulture, 2007*
28. Issues Monitor, December 2010.

3. Regulatory Regime

From the very wide range of retail segments that we have taken a look at, evidently, the retail sector cuts across various industries and business models. As a consequence, there is a higher possibility of regulatory overlap. While general corporate, tax, commercial laws and laws related to intellectual property, trade and employment laws remain applicable to the retail industry, as in the case of any other industry, some regulatory aspects might get triggered on account of the format or business model that the investor chooses to adopt, m-commerce, for instance.

I. Regulatory Patterns Across the Globe

As we shall see, there have been proposals for setting up a National Retail Authority, which are yet to attain any momentum in the industry space. With respect to unorganized retail, the Ministry of Housing and Urban Poverty Alleviation has formulated a National Policy for Urban Street Vendors. However, at the moment, there is no single regulatory authority that governs the organized retail sector; nor is there any umbrella legislation. Under List I of Seventh Schedule of the Constitution of India, Inter-State trade and commerce is a subject for the Parliament, the Central legislative body, to enact upon. Under List II, however, trade and commerce within a State is a State subject. A regulatory framework to govern retail sector, consequently, might need the approval of the individual States under the Constitution. However, this position might undergo substantial changes if the Government pays heed to the stakeholders who demand 'industry' status for retail. This is hoped to entail developing a Ministry responsible and accountable for the growth and interests of the sector, a single-window clearance system to streamline license processes associated with establishing retail stores, tax and investment incentives, among other things.[29]

While countries like Spain, Denmark and Bhutan have experimented with a national legislation to regulate retail trading, the general trend has been to defer the regulation of retail trading to provincial / regional authorities, as has been done in the UK and Australia.

One can draw a pattern of retail regulation from most jurisdictions including India: retail outlets have been brought within the purview of other generic legislations that deal with taxes, pricing, weights and measures, shopping hours, marketing / advertising practices, licensing, employment etc. Given the complexity of retail structures and the diversity of its segments, this approach makes the most sense. Also,

29. D. Murali , Assign industry status to the retail sector, February 15, 2010 available at: http://www.thehindu.com/business/Industry/article106925.ece

one might note that legislations that cater to the needs of one country cannot be replicated in another. For example, some countries have 'blue laws', i.e. laws that deal with religious observances, which might be entirely inapplicable in the context of other countries.

Interestingly, retail trading also provides some scope for 'private regulations' where a powerful retailer might want manufacturers or service providers to comply with in terms of quality, carbon footprint etc. before their products can be sold through that retail chain. The antitrust and trade implications of such private norms enforced solely through the market forces, is an intriguing legal issue.

II. Foreign Direct Investment Regime

FDI in India is regulated under Foreign Exchange Management Act, 1999 ("**FEMA**"). The Department of Industrial Policy and Promotion ("**DIPP**"), Ministry of Commerce and Industry, Government of India makes policy pronouncements on FDI through Press Notes / Press Releases which are notified by the Reserve Bank of India ("**RBI**") as amendments to Foreign Exchange Management (Transfer or Issue of Security by Persons Resident Outside India) Regulations, 2000.

Paragraph 3.6.1 of consolidated FDI policy[30] ("**FDI Policy**") lays down two entry routes for investment: the automatic route and the government / approval route. Under the latter, prior approval of the Government of India through Foreign Investment Promotion Board ('FIPB') 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 (sectoral caps) as provided in the FDI Policy.

Accordingly, DIPP in press notes 4 and 5 (2012 Series) inserted / modified paragraphs 6.2.16.4 and 6.2.16.5 of the FDI Policy allowing FDI in single brand product retail trading (100 percent) and multi brand retail trading (51 percent) respectively with prior approval of FIPB subject to compliance of certain conditions. Further, paragraph 6.2 of the FDI Policy states FDI into cash and carry wholesale trading is allowed up to 100 percent under automatic route provided that certain conditions are satisfied. Additionally, Paragraph 6.2.16.2.1 of FDI Policy states that companies who engage in the activity of buying and selling by a company through the e-commerce platform would engage only in Business to Business (B2B) e-commerce and not in retail trading. However, provision of services by e-commerce companies to retail consumers is not covered under this restriction.

FDI Policy specifies eligible investors. A non-resident entity can invest in India subject to the FDI Policy. A citizen of Bangladesh or an entity incorporated in Bangladesh can invest only under the Govern-

30. Consolidated FDI Policy 2012 issued vide circular 1 of 2013 which came into effect from April 5, 2013.

ment route. Further, a citizen of Pakistan or an entity incorporated in Pakistan can invest, only under the Government route, in sectors / activities other than defence, space and atomic energy. FDI Policy also details the types of instruments through which an investor can invest into India. Issue of shares, fully, compulsorily and mandatorily convertible debentures and preference shares are counted as FDI. The inward remittance received by an Indian company by way of issuance of depository receipts and foreign currency convertible bonds is also counted as FDI. Subject to FDI sectoral policy, non-resident investors can also invest in Indian companies by purchasing / acquiring existing shares from Indian shareholders or from other non resident shareholders. However, if the activity of the Indian company falls outside the automatic route (i.e. in cases where a prior approval from the Government agencies or RBI is required) as single brand retail trading and multi brand retail trading does, such transfer requires RBI approval.

A general permission is granted for issue of equity shares / preference shares against lump sum technical knowhow fee, royalty, subject to entry route, sectoral cap and pricing guidelines and compliance with applicable tax laws.

As far as the entities into which FDI can be made, nonresident investors enjoy a choice from among companies, partnership firms / proprietory concerns/ limited liability partnership and Venture Capital Funds (VCFs) subject to the adherence to conditions of FDI Policy. There are guidelines laid down in FDI Policy on the calculation of total foreign investment i.e. direct and indirect foreign investment in India.

i. FDI in Retail Sector

India entered into the World Trade Organisation's General Agreement on Trade in Services (GATS), in January 1995 pursuant to the Uruguay Round negotiations. Each WTO Member is required to have a schedule of specific commitments. It is a document which identifies the service sectors, sub-sectors or activities which are subject to market access and national treatment obligations and any limitations attached to them.[31] One of the standard services to the GATS includes distribution services (i.e. commission agent, wholesale trade services, retailing services and franchising), As per India's Revised Offer at WTO on August 24, 2005, India has offered to undertake extensive commitments in a number of new sectors/sub-sectors such as distribution services in the areas of commission agents and wholesale trade services.[32] As a backdrop, India is gradually opening up the retail trade sector to foreign investment. Traditionally, the retail sector in India was considered to be a sensitive sector especially due to factors, such as (i) the employment it generates and (ii) being in its early

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31. Frequently asked question on General Agreement on Trade in Services available at: http://commerce.nic.in/trade/faqs_gats.pdf
32. India's Revised Offer dated August 24, 2005 available at: http://commerce.nic.in/trade/faqs_gats.pdf

and undeveloped stage (particularly the domestic organized retail segment) it is not in a position to compete with large players. As a result, the Government policy has largely been to protect agriculturist and small retailers and therefore has discouraged entry of larger retailers in the market. Thus, participation of foreign investors in the retail sector was prohibited.

However, the Government has liberalized its policy in a phased manner as reflected in the diagram below:

1997 - FDI in cash and carry (wholesale) with 100 per cent ownership was allowed under the Government approval route

2006 - FDI in cash and carry (wholesale) with 100 per cent brought under the automatic route

2006 - FDI upto 51 per cent in single brand product trading under Government approval route allowed

2010 - Discussion paper on FDI in multi-brand retail trading introduced by Government

2012 - FDI upto 100 per cent allowed in single brand product trading under the Government approval route subject to certain conditions

2012 - FDI upto 51 per cent allowed in multibrand retail trading under the Government approval route subject to certain condition's

2013 - FDI upto 49 percent in single brand product retail trading allowed under automatic route approved

ii. Wholesale Cash and Carry

According to the FDI Policy, whether a transaction is wholesale or retail would depend on the type of customers to whom the sale is made and not the size and volume of sales. Wholesale trading would mean the sale of goods to retailers, industrial, commercial, other professional business users or to other wholesalers, but not for personal consumption.

The consolidated FDI policy released for the first time in 2009 introduced guidelines that mandate relevant permits and licenses to be obtained.

It also lists a number of 'valid business customers' with whom wholesale transactions can be entered into (besides the Government). These entities should be; a) holders of sales tax / VAT registration / service tax /

excise duty registration; b) holders of trade licenses under Shops and Establishment Act, issued by the relevant governmental authority, indicating that the purchaser is engaged in a business involving commercial activity; c) holders of permits/licenses for undertaking retail trade (like tehbazari and similar license for hawkers) from the relevant authority; or d) institutions having a certificate of incorporation or registration as a society or registration as a public trust for their self-consumption.

Full records indicating all the details of such sales like the name of the entity, kind of entity, registration / license / permit etc. number, amount of sale etc. should be maintained on a day to day basis. It is expressly clarified that a wholesale trader cannot open retail outlets, whereby sales will be made to the customer directly.

Under the existing FDI Policy, wholesale deals would be permitted among companies of the same group. However, such wholesale trade to group companies taken together could not exceed 25 percent of the total turnover of the wholesale venture. For the purposes of the above, a group company as defined under the DIPP Press Note (2 of 2013) dated 3 June, 2013 means- two or more enterprises, which directly or indirectly are in a position to exercise 26 percent or more voting rights in the other enterprise,or can appoint more than 50 percent of members of the board of directors in the other enterprise.

iii. Single-Brand Product Retail Trading (SBPRT)

FDI up to 100 percent is permitted in SBPRT subject to fulfillment of certain criteria as recently introduced. In the meeting of the Ministry of Commerce & Industry held on July 16, 2013, the proposal to allow FDI up to 49 percent in SBPRT under automatic route was approved and the same has been notified by way of Press Note 6 of 2013.[33] Accordingly, 100 percent FDI in SBPRT is allowed, no Government approval shall be required for FDI up to 49 percent in SBPRT. and any investment beyond 49 percent in SBPRT shall require prior Government approval.

Knowing the objectives the government had in mind while allowing foreign investment in SBPRT will be helpful for prospective investors at the stage of formulating their FDI proposals. The objectives were:

a) attracting investments in production and marketing;

b) improving the availability of such goods for the consumer;

c) encouraging increased sourcing of goods from India;

d) enhancing competitiveness of Indian enterprises through access to global designs, technologies and management practices.

33. http://dipp.nic.in/English/acts_rules/Press_Notes/pn6_2013.pdf

It is subject to further conditions that relate to the following:

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

b) Products should be sold under the same brand internationally i.e. products should be sold under the same brand in one or more countries other than India.

c) Single Brand' product-retailing would cover only products which are branded during manufacturing.

   Any non-resident entity / entities can undertake SBPRT in the country for a specific brand directly or through legally tenable agreement with the brand owner.

   Under the FDI Policy issued by the DIPP on September 30, 2011. only the owner of the brand was permitted to invest in SBPRT This condition was seen to be restrictive as it ignored the IP holding structures prevalent globally. The condition was then modified to permit only one foreign investor whether owner of the brand directly or a licensee / franchisee / sub-licensee to invest in SBPRT in the country, for the specific brand for which approval is being sought through a legally tenable agreement, with the brand owner.

   The onus for ensuring compliance with this condition rested with the Indian entity carrying out SBPRT in India.

   This condition was still seen as restrictive and with the recent change, the requirement has been significantly diluted by allowing one or more non-resident entities to undertake SBPRT of a specific brand provided they are owner of the brand or they have some agreement with the brand owner for the specific brand. This will be helpful for structures where for example, more than one foreign entity has been provided with a license for a territory or where the owner and a licensee both invest.

d) In respect of proposals involving FDI beyond 51 percent, mandatory sourcing of at least 30 percent of the value of goods purchased, will have to be done from India, preferably from MSMEs,[34] village and cottage industries, artisans and craftsmen, in all sectors. The local procurement requirement would have to be met as an average of five years' total value of the goods purchased, beginning April 1 of the year during which the first tranche of FDI is received. Thereafter, this requirement is to be complied on an annual basis.

   The Press Note 1 of 2012 dated January 10, 2012, permitted FDI, up to 100 percent, in SBPRT and provided that in respect of proposals involving FDI beyond 51 percent, mandatory sourcing

34. The word MSMEs is not defined for this purpose. The definition of MSMEs can be borrowed from Micro, Small and Medium Enterprises Development Act 2006.

of at least 30 percent of the value of products sold would have to be done from Indian 'small industries / village and cottage industries, artisans and craftsmen'. Certain foreign investors had expressed their concern with respect to this condition, pursuant to which the condition has been modified vide Press Note 4 (2012 Series).

The modification of the local sourcing requirement stretched over a five year period is in line with the proposal made by many prospective investors who had emphasized the aforesaid condition shall be computed for a cumulative period from the date of approval instead of being required to comply on day 1 or soon thereafter. This condition will have to be followed fulfilled by the company incorporated in India carrying out SBPRT and recipient of FDI.

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

Applications seeking permission from the Government for FDI exceeding 49 percent in retail trade of 'single brand' products should be made to the Secretariat for Industrial Assistance (SIA) in the DIPP. The application shall specifically indicate the product / product categories which are proposed to be sold under a 'single brand'. Any addition to the product / product categories to be sold under 'single brand' would require a new approval of the Government. Applications would be processed by the DIPP, to determine whether the investment satisfies the noted guidelines, before being considered by the FIPB for Government approval. In case of FDI up to 49 percent the product/ product categories proposed to be sold except food products would be provided to the RBI.

After the opening up of the SBPRT market in January 2012, a number of investors , including big names in the retail industry had applied for approval.[35]

Till now (June 9, 2013), the government has approved 63 proposals of foreign companies to invest in single brand retail trade. Most recent entrant into this sector has been IKEA, Swedish furniture retailer which proposes to invest INR 10,500 crore in India. Proposals made by sporting goods company Decathlon, French fashion brand Promod, crockery maker Le Creuset and footwear company Pavers England, and luxury clothing retailer Brooks Brothers among others have been cleared by the FIPB in the recent past.

iv. Multi – Brand Product Retail Trading (MBRT)

DIPP vide Press Note 5 (2012 Series) dated September 20, 2012 has amended the FDI Policy permitting 51 percent FDI in MBRT

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35. http://www.ibef.org/artdisplay.aspx?tdy=1&cat_id=60&art_id=34949&utm_source=newsalert_08_2013&utm_medium=email&utm_campaign=IBEF_21

under the Government route i.e. with the prior approval of the DIPP and the FIPB subject to the compliance of certain conditions. The current FDI Policy does not define the term 'multi brand'. MBRT generally implies the sale of multiple brands to retail customers for personal consumption.

The proposal to allow FDI in MBRT dates back to July 2010, when DIPP first introduced its discussion paper (**"Discussion paper on FDI in retail"**) on allowing FDI in MBRT. The proposal of allowing FDI in MBRT was approved by the Cabinet in November 2011. However, due to adverse political backlash, the proposal was kept on hold.

There was tremendous international pressure on the government to open up the multi-brand retail sector for FDI, as well as pressure domestically to end the stalemate of policy inaction. The Government has risen from its state of policy inaction and tried to establish a reformist image by allowing FDI in MBRT.

As a result, the DIPP vide Press Note 5 (2012 Series) allowed 51 percent FDI in MBRT under the Government approval route subject to the following conditions:

- Retail sales outlets may be set up in those States which have agreed or agree in future to allow FDI in MBRT

Under List II of the Seventh Schedule of the Constitution of India, trade and commerce within a State is a State subject. A regulatory framework governing retail sector, consequently, needs the approval of States under the Constitution. As of now, only State Governments of Assam, Andhra Pradesh, Delhi, Haryana, Himachal Pradesh, Jammu and Kashmir, Karnataka, Maharashtra, Manipur, Rajasthan, Uttarakhand, and the Union Territories of Daman & Diu and Dadra & Nagar Haveli have agreed to allow MBRT.

Further, it has been recently clarified by DIPP that if the foreign investor approaches a State Government not included in the list of states supporting FDI in MBRT, consent from the State Government would be sufficient, and a suitable amendment to the policy will be issued by the Central Government.

Accordingly, it would be the prerogative of the State Governments to decide whether and where a multi-brand retailer, with FDI, is permitted to establish its sales outlets within the State. The establishment of the retail sales outlets will have to be in compliance with applicable State laws / regulations, such as the Shops and Establishments Act etc. Additionally, the companies engaged in MBRT will also have to comply with local zoning regulations, warehousing requirements, access, traffic, parking and other logistics as prescribed by State Governments from time to time.

With this restriction, each investor will have to comply with policy on FDI at both Centre and State levels. Depending on State policy on MBRT, the investors may or may not be permitted to invest in those States. Interestingly this seems to be the first time that discretion on whether to permit FDI in a sector or not has been left to the States.

- Retail sales locations may be set up only in certain cities

The reach of retail sales outlets of foreign multi brand retail trader will be limited to only those cities with a population of more than 10 lakh as per the 2011 Census or any other cities as per the decision of the respective State Governments (including an area of 10 kilometers around the municipal / urban agglomeration limits of such cities). Previously, the FDI Policy provided that retail outlets could only be set up in cities with a minimum population of 10 lakhs, however this condition was recently amended by way of Press Note 5 (2013 Series).[36]

While the previous restriction to Tier 1 and Tier 2 cities seemed reasonable given the sensitivity around the sector and prevalent undeveloped / unorganised retail segment in small towns/ villages which would be unable to compete with large players, the recent change to allow State Governments to determine the cities in which retail outlets can be set up will also ensure that every State Government has the discretion to choose the cities in which multi-brand retail outlets are set up and provide a sense of uniformity amongst the States.

- Minimum amount to be brought in, as FDI, by the foreign investor, would be USD 100 million

The foreign investor has to bring in a minimum investment of USD 100 million in an entity engaged in MBRT.

Retail sector being a capital intensive sector, the requirement for minimum capitalisation appears logical. This will attract serious investors and allow the government to study the benefit such investment will have on the Indian economy.

- 50 percent of the total FDI brought in to be invested in 'backend infrastructure' within three years

Considering the need for investment in back-end infrastructure, at least 50 percent the USD 100 million i.e. total FDI brought in in the first tranche[37] in shall be invested in 'back-end infrastructure' within three years. Any subsequent investment in backend infrastructure would be made by the MBRT retailer as needed, depending upon his business requirements. Investment in 'back-end infrastructure' will include capital expenditure on all activities such as investment made towards processing, manufacturing, distribution, design improvement, quality control, packaging,

36. http://dipp.nic.in/English/acts_rules/Press_Notes/pn5_2013.pdf

37. As clarified by Press Note 5 (2013 series), available at http://dipp.nic.in/English/acts_rules/Press_Notes/pn5_2013.pdf

logistics, storage, warehouse, agriculture market, produce, infrastructure etc. Expenditure incurred on front-end units, land cost and rentals will not be reckoned for the purposes of backend investment.

The Indian retail sector is lacking adequate infrastructure and immersed in increased cost and wastage due to disrupted supply chains and middlemen. To address this problem, the requirement for investment in back end infrastructure within a three year timeframe has been introduced.

- 30 percent mandatory local sourcing requirement

Similar to the requirement of mandatory local sourcing as applicable in SBPRT (prior to press note 4 of 2012), at least 30 percent of the value of procurement of manufactured / processed products purchased shall be sourced locally. Such sourcing was earlier limited to 'small industries' which have a total investment in plant and machinery not exceeding USD 1 million. This requirement has now been amended via Press Note 5 (2013 Series)[38] and investors are permitted to source such products from micro, small and medium industries which have a total investment in plant and machinery not exceeding USD 2 million. The amendment further clarifies that such 'small industry' status is only considered at the time of first engagement and that such industry will continue to qualify as a 'small industry' for this purpose even if it outgrows the said investment of USD 2 million. Compliance with this condition will have to be self-certified by the company and then cross-checked as and when required.

This 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 April 1 of the year during which the first tranche of FDI is received. Thereafter, it would have to be met on an annual basis.

In case of MBRT, the 30 percent sourcing requirement is to be calculated on the purchase of manufactured and processed products and sourcing from agricultural co-operatives and farmers co-operatives would also be considered. The mandatory local sourcing requirement in case of MBRT is aimed to provide a boost to small industries. It may be easier for multi brand retailers to meet this condition since they have a large spectrum of goods to offer.

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

A company which is the recipient of FDI has to ensure compliance of the conditions relating to minimum USD 100 million investment, investment in back-end infrastructure and mandatory local procurement requirement which could be verified, as and when required. Further, the inves-

38. http://dipp.nic.in/English/acts_rules/Press_Notes/pn5_2013.pdf

tors shall maintain accounts, duly certified by statutory auditors.

Applications for MBRT would have to be made to DIPP. DIPP will determine whether the proposed investment satisfies the notified guidelines and after being satisfied will forward the application to be considered by the FIPB for approval.

Further, DIPP came out with certain clarifications on queries raised by prospective investors with respect to the precision on MBRT under the FDI Policy You can refer to our analysis on these clarification in our hotline titled "Clarification on FDI in Multi Brand Retail Trading: As Restrictive as it may get".[39]

v. Challenges Moving Forward

While the policy framework in relation to FDI in MBRT is now put in place, the implementation of this policy framework is bound to have certain challenges. Some of which include:

A. Implementation at State level

It is the first time that FDI policy is introduced as an enabling policy and implementation is left to the discretion of the State Governments / Union Territories and draws support from the fact that 'trade and commerce within the State' is a State subject under the Constitution of India. Such a policy may give unrestricted powers to the State Government / Union Territories to impose conditions in addition to those prescribed by the DIPP. State level regulations could also lead to an inconsistent policy framework which will need to be carefully understood and followed by potential investors. There is also the risk of a State Government changing its policy on MBRT and reversing earlier decisions, especially in the event of a change in political power as this scenario has not been construed by the DIPP in the relevant press note.

In effect, a foreign investor will have to be mindful of the local rules and regulations of each State before finalizing the transaction structure / business model, especially when the investor intends to set up outlets in all the States. Further, for the existing entities operating across India, it would be difficult to get FDI into an entity without a restructuring of its operations.

B. India's commitments under international investment agreements / treaties

India is a signatory to various international trade agreements / treaties like the General Agreement on Trade in Services, Trade Related Investment Measures, bilateral investment protection agreements,[40] and comprehensive economic cooperation agreements

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39. Hotline titled "Clarification on FDI in Multi Brand Retail Trading: As Restrictive as it may get", available at: http://www.nishithdesai.com/1/?item=Research+and+Articales/NDA+Hotline/Gorpsec+Hotline&article=1822

40. India has signed bilateral investment protection agreements with 82 countries, out of which 72 are already in force and the rest are yet to be entered into force.

in the field of trade and economic affairs signed to promote investment inflow. While the Government in its press release[41] has categorically concluded that the policy framework does not violate any commitments or obligations arising out of India's international agreements, the introduction of FDI in SBPRT and MBRT with conditions such as domestic sourcing and state wise implementation has raised a few questions with respect to India's commitments under these treaties and agreements.

C. Options available with investors if the Government retroactively changes its policy in the future

While the Government has the right to enact, modify or repeal a law / policy at its own discretion in its sovereign capacity a foreign investor expects the host country to act in a consistent manner, so that it may know, beforehand any and all rules and regulations that will govern its investments and to be able to plan its investment and comply with such regulations accordingly.

The foreign investor also expects the host country to act consistently, without arbitrarily revoking any preexisting decisions or permits issued by the country that were relied upon by the investor to assume its commitments as well as plan and launch its commercial and business activities.

41. Press release of Ministry of Commerce and Industry on "FDI Policy on Multi Brand Retail Trading and India's Commitments under International Investment Agreements" dated September 18, 2012.40. To be increased to INR 10,000,000 w.e.f. April 1, 2013

Stability and predictability of legal and business framework is an essential element to ensure fair and equitable treatment towards the foreign investor. Evisceration of regulations in the future with regards to foreign investment in multi-brand retail by Government, in reliance upon which the foreign investor invests into India could be regarded as a breach of international obligations taken up by Indian under bilateral investment protection agreements and may also attract scrutiny as to the constitutional validity of such actions.

D. Regulatory overlap and dealing with multiple authorities

The retail sector cuts across various industries and business models. As a consequence, there is higher scope for regulatory overlap. While general corporate, tax, commercial laws and laws related to intellectual property, trade and employment laws are uniform across industries, state level laws and regulations like the Agricultural Produce Market Committee Act, local zoning regulations differ from each other and foreign investors will have to deal with multiple regulations and authorities.

vi. E-commerce

Currently, 100 percent FDI is allowed under automatic route (no approval required) in companies engaged in Business to Business (B2B) e-commerce and erstwhile restrictions on FDI in domestic trading were also applicable to e-commerce as well. The DIPP

Press Notes 4 and 5 (2012 Series) categorically state that retail trading, in any form, by means of e-commerce, would not be permissible, for companies with FDI, engaged in SBPRT or MBRT.

With the opening of FDI in SBPRT and MBRT, the restriction of FDI in domestic trading through e-commerce was also expected to be relaxed. However, such an express restriction will certainly impact global and local e-commerce retailers intending to offer Indian consumers wide range of products via e-commerce. One of the reasons for such an express restriction being imposed could be the difficulty in monitoring the trading via e-commerce in the States who have not allowed MBRT. Also, a similar restriction in SBPRT has now been categorically put in place to bring it in parity with policy on MBRT. Interestingly, e-commerce has not been defined and one will need to ascertain whether it will be construed broadly or narrowly. For instance: would any form of interaction (such as information sharing or advance booking) with a brick and mortar store, via its website, be considered e-commerce? Further, whether any trading (i.e. buying or selling of products) through any mobile phone application or through tele-booking mode would be considered as e-commerce?

III Other Corporate Laws

i. Investment Vehicles

Investments can be made either into unincorporated entities such as liaison office, branch office, project office, limited liability partnership, partnership, trust or into incorporated entities such as a public limited or private limited company. However, this is subject to the restrictions placed by FDI regulations discussed above. For example, FDI is not allowed in trusts.

ii. Instruments

FDI can be made into a number of instruments including equity shares, compulsorily convertible preference shares and compulsorily convertible debentures. Prospective investors may be mindful of the fact that any optionality (puts, calls etc.) built into an FDI instrument is viewed with suspicion by the RBI, even though the law itself does not prohibit it. When an FDI instrument does not ensure lasting interest of the investor in the target company, the authorities take the view that the investment lacks the very character of investment, and therefore treat them as coming under the external commercial borrowing (ECB) route, to which a different set of regulations apply.

Earnings out of India can be repatriated as dividends. Dividends are paid usually as a percentage of the nominal or face value of the share. For a foreign investor holding an equity interest, payment of dividend on equity shares is a straightforward way of extracting earnings. However, the dividend distribution tax borne by the company while distributing such dividend may not necessarily qualify as a tax credit against any direct tax payable by the foreign investor who receives such dividend in its home jurisdiction.

Additionally, in case a company issues compulsorily convertible debentures to non-resident investors, any interest paid by the Indian company shall be subject to withholding tax reduced to the rate of tax under the relevant treaty. For example: when the interest is paid by an Indian company to a U.S. corporation, the otherwise applicable Indian withholding tax, reduced to 15 percent under the India-U.S. income tax treaty.

IV. Tax laws

The levy of taxes in India is a constitutional power granted to the Union Government and the State Governments. Each tax levied or collected has to be backed by an accompanying law, passed either by the Parliament or the State Legislature.

V. Direct Taxes

i. Income Tax

Income tax in India is levied under the Income Tax Act, 1961 (“**Income Tax Act**”). India, in terms of direct taxes (Income tax) follows a system of progressive taxation wherein the rate of taxation increases as the income bracket increases. India follows a blend of source and residence bases of taxing income. In broad terms, under Section 44AF of Income Tax Act[42] for a person engaged in retail trade in any goods or merchandise, a sum equal to five percent of the total turnover in the previous year on account of such business would have been deemed to be the profits and gains of such business chargeable to tax under the head “Profits and gains of business or profession.” However, the section ceases to have any application for assessment years beginning on or after the 1st day of April, 2011. Hence, the income from profits and gains from retail trade will be calculated in the same way the calculation is undertaken for any other trade.

However, small business carried by an individual, Hindu undivided family and partnership who is a resident and whose total turnover or gross receipts does not exceed INR 6, 000, 000[43] have the option of being presumptively taxed at a rate of 8 percent of total turnover or gross receipts under section 44AD of the Income Tax Act.

Domestic companies in India are taxed at 30 percent (excluding surcharge and cess)[44] while foreign companies are taxed at 40 percent (excluding surcharge and cess),[45] both with a disallowance of expenses. Under Section 115-O of the Income Tax Act, an Indian company is required to pay dividend distribution tax (“**DDT**”) at the rate of 15

42. Inserted by Finance Act, 1977 wef April 1, 1998

43. To be increased to INR 10,000,000 w.e.f. April 1, 2013
44. Surcharge is applicable @ 5% if the total income is in excess of INR 10,000,000 and education cess is applicable @ 3% on income tax (inclusive of surcharge, if any).
45. Surcharge is applicable @ 2%if the total income is in ex[6]cess of INR 10,000,000 and education cess is applicable @ 3% on income tax (inclusive of surcharge, if any).

percent (excluding surcharge and cess) on dividends that are declared, distributed or paid by a domestic company. However, no further taxes are payable in India on such dividend income distributed to the shareholders once DDT is paid by the company.

When exiting or restructuring, capital gains tax is payable at a rate of up to 40 percent (excluding surcharge and cess) contingent on whether the capital gains are long term or short term. Certain types of payments in India require the payer to withhold tax as 'tax deducted at source'. However, there remain many nagging issues with respect to these taxes. Minimum alternate tax ("**MAT**") (payable if a company's book profits are less than the company's income due to exemptions etc.) is payable at 18.5 percent applicable to all persons.

ii. Proposed Direct Taxes Code ("**DTC**")

A new Direct Taxes Code is in the offing. It was released as a discussion draft some years ago and is currently pending for consideration by the Indian Parliament. This new legislation could bring about substantial change to the Indian tax regime by introduction of controlled foreign corporation rules, revised residency criteria etc. Further, there has been an increased focus on transparency, disclosure and substance requirements in India in the recent past, as well as the introduction of wide ranging source rules. While these rules are intended to target avoidance transactions, they can have an impact on legitimate arrangements, and it is important to consult with a qualified tax advisor on the impact of these developments on your proposed business.

iii. General Anti-Avoidance Rules ("**GAAR**")

Originally, the DTC had proposed a new regime for GAAR. However, since the implementation of DTC was postponed, the Finance Bill 2012 proposed to introduce comprehensive GAAR provisions in the Income Tax Act.

GAAR seeks to provide wide powers to the revenue authorities in taxing 'impermissible avoidance arrangements' including the power to disregard entities in a structure, reallocate income and expenditure between parties to the arrangement, alter the tax residence of such entities and the legal situs of assets involved, treat debt as equity and vice versa, and the like. Such wide discretionary powers give much room for misuse and the use of ambiguous expressions in relation to defining an 'impermissible avoidance arrangement', such as misuse, abuse, bona fide purpose, substantial purpose and commercial substance result in subjective interpretation and implementation of the law. Thus, there arose two main concerns - lack of clarity in applicability of these provisions and wide discretionary power conferred on the revenue authorities.

However, in response to the grievances expressed by investors when GAAR was incorporated in the Finance Bill 2012 (for implementation from April 1, 2013), an expert committee was constituted by the Prime Minister to provide recommendations for formulating the rules and guidelines for implementation of GAAR.

The expert committee vide its recent draft report of September 2012 has recommended that GAAR should be deferred for 3 years. It has also recommended that GAAR shall be restricted to only abusive, artificial and contrived arrangements. Based on these recommendations, it is now for the Government to decide its policy with respect to formulation / implementation of GAAR provisions. Subsequent to this recommendation, the Finance Minister, in a statement to the Press on January 14, 2013, announced that the major recommendations of the expert committee have been accepted and that the GAAR provisions will come into force with effect from April 1, 2016.

iv. Transfer Pricing Framework

A. International Transfer Pricing

Commercial transactions between related entities of multinational corporations increasingly dominate the sphere of world trade. The pricing of these transactions between related parties, which is known as 'transfer pricing', may differ from those that take place between unrelated parties. In India, the transfer pricing regulations ("**Regulations**") are contained in sections 92 to 92F of the Income Tax Act. The Regulations provide for a transfer pricing mechanism based on computation of income arising out of cross-border transactions having regard to the arm's length price ("**ALP**"). The ALP as codified in the Regulations has its roots in the Organization for Economic Co-operation and Development ("**OECD**") Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations. The "ALP" is defined to mean a price, at which transactions between persons other than associated enterprises, in uncontrolled circumstances are carried out.

It is important to note that the Finance Act, 2012 has introduced a regime relating to Advanced Pricing Agreements ("**APA**").

An APA would be valid for a period of maximum of 5 years and the APA would be binding only on the taxpayer and the concerned commissioner and his subordinates. If however there is a change in law or a fact post the execution of the APA, the APA shall cease to be valid from the date of such change. Further, the Central Board of Direct Taxes is empowered to declare any APA as invalid (void ab initio) if it finds that the APA has been obtained by fraud or misrepresentation of facts.

B. Domestic Transfer Pricing

If the domestic transactions between two related persons or two units of the same entity exceed INR 50 million (USD 1 million), then in order to determine the correctness of (i) the income from domestic related party transactions; and (ii) the domestic related party expenditure of the parties, the transfer pricing regulations (including procedural and penal provisions) would be extended to such domestic transactions as well.

While the rationale for the move is understandable, it shall no doubt increase the compliance burden of many a corporate tax payer. One significant issue that will remain is that while APA regime has been introduced with respect to international transactions, the same benefit has not been extended in cases of domestic transactions.

VI. Indirect Taxes

i. Service Tax

Service Tax is an indirect tax imposed on specific services. With the intention of gradually transitioning towards the Goods and Service Tax regime, the Finance Act, 2012 prescribed that the Service Tax law will henceforth follow the 'Negative List approach'. Under this approach, all services, except those specified in the negative list and those specifically exempted, would be chargeable to service tax. In this regard, it is important to note that 'trading of goods' is specifically included in the Negative List of Services. However, services provided by commission agent or a clearing and forwarding agent are not in the nature of trading of goods as these are auxiliary for trading of goods and therefore shall be subject to Service Tax.

'Service' has been widely defined as "any activity carried out by a person for another for consideration ..." thereby bringing any "activity" whatsoever, regardless of whether it is a service, under the service tax net. To add to the uncertainty, the new law does not differentiate between a service and a sale of goods, and hence a situation can arise where a taxpayer would be charged service tax and value added tax / sales tax in respect of the same 'activity'.

Further, by virtue of the Finance Act, 2012, a Service Tax of 12 percent is now leviable on services except those mentioned in the negative list. For example: an activity of renting immovable property for commercial purpose shall be subject to a Service Tax at the rate of 12 percent.

ii. Other Indirect Taxes

The following multiple indirect taxes applicable on manufacture, purchase, sale or movement of goods in their respective jurisdictions may become applicable to companies in the retail sector. It is important to note that some of these are either levied by Central Government or by the State Government. Further, the rates of taxes are amended almost every year by both Central and State government.

Type of tax*	Description
Customs duty	Duty on import of goods into India. Custom duties are levied by the

	Central Government under the Customs Act, 1962 and the Customs Tariff Act, 1975
Central Value Added Tax (CENVAT)	Tax imposed on manufacture or production of goods in India is imposed. This is also referred to as excise duty.[46]
Central Sales Tax	Tax on inter-state sales or purchases of goods is imposed by the origi nating state
States Value Added Tax	Tax on intra-state sales of or purchases of goods is imposed by the states
Entry Tax	Tax imposed on entry of goods into the state is imposed by the states

*Note: These are in addition to the octroi or local area taxes that may be levied by local authorities.

Indian taxation laws recognize the difference between contract for sale of goods, contract for rendition of services and a composite contract. Therefore, depending on the facts of each transaction, it will be taxed only once – either as sale of goods, rendition of service or a composite transaction.

iii. Proposed Goods and Service Tax

The introduction of Goods and Service Tax (**"GST"**) is part of the Government's reforms process to integrate the State economies and boost overall growth. GST which is a central legislation will abolish indirect state taxes with an aim to create a single and unified indirect tax system. Previously, GST was to be implemented w.e.f. April 2013, however, the same has now been postponed. For the retail sector, the implementation of GST will reduce tax incidence and complexities of doing business in India.

VII. Competition Laws

In this section, we highlight certain issues arising from the competition regime with possible implications for the retail sector. One may note that under Section 32 of the Competition Act, 2002 (**"Competition Act"**), extra territorial application is conferred on its provisions. This is a valid exercise of legislative power under the Constitution of India. This implies that even if an agreement is entered into outside India, it can still be brought under the scrutiny of the Competition Commission of India (**"CCI"**), if it can be shown that such agreement has an appreciable adverse effect on competition in India. Competition Act in its approach, leans more towards the EU competition jurisprudence, as against the antitrust laws of the US.

i. Anti competitive Agreements

Anti-competitive agreements can be vertical or horizontal. A version of the 'per se' rule is applicable for horizontal agreements

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46. 'Manufacture' includes activities such as repackaging and labeling. Under excise and service tax laws, a tax payer can claim credit in respect of taxes paid to the tax payers suppliers.

in India, where certain agreements are presumed to have an appreciable adverse effect on competition in India. On the other hand, verticals agreements are governed by 'rule of reason' where the onus lies with the antitrust regulator to prove an arrangement to have an appreciable adverse effect on competition. Though horizontal agreements like cartel are rendered a stricter treatment under the competition law regime, vertical arrangements involving tie-in arrangement, exclusive supply agreement, exclusive distribution agreement, resale price maintenance and exclusive dealings can also be found to have an 'appreciable adverse effect' on competition within the territory of India under Competition Act.

Therefore, retailers will have to be mindful of the competition law implications while entering into agreements which may be held violative of the above principles.

Retail by e-commerce is treated at par with other models in India; competition law and policy, thus, may extend to dealings on a virtual platform as well.

ii. Abuse of Dominance

In order to determine whether an enterprise is in a dominant position, there are no arithmetic parameters or particular share of the market size as was the case in the MRTP Act, 1969. The dominance of an enterprise is measured by its power to operate independent of its competitors and to affect its competitors and consumers in its favor,[47] apart from other criterions such as size of the enterprise, entry barriers, economic power etc.

Additionally, predatory pricing if engaged by giant retailers can be regarded as abuse of a dominant position and therefore violative of the provisions of Competition Act.

iii. Combinations

On March 4, 2011, the Government of India through the Ministry of Corporate Affairs notified the provisions of the Competition Act relating to "combinations" namely Sections 5 and 6. Although notified as of March 4, 2011, these provisions came into effect from June 1, 2011. The said provisions requires every acquirer undertaking combinations (defined in section 5) above a prescribed threshold limit in India or overseas (with an India connection), to notify the CCI of a combination unless specifically exempted and seek its approval prior to effectuating the same in the manner set out in Section 6 of the Competition Act and regulations governing combination.

iv. Important Points

The triggers of the Competition Act relating to combinations are linked to the value of the turnover / asset of parties (the acquirer and the target) or the group[48] to which

47. Abuse of dominance in the Indian competition law, available at:http://www.competition-commission india.nic.in/speeches_articles_presentations/Abuse%20of%20Dominant.pdf
48. Under the Competition Act, as modified by the

the target will belong post-acquisition or the target and not the transaction value. In terms of Section 5 of the Act, a 'combination' includes:

1. the acquisition[49] of control, shares or voting rights or assets by a person;

2. the acquisition of control of an enterprise where the acquirer already has direct or indirect control of another engaged in identical business; and

3. a merger or amalgamation between or among enterprises;

that crosses the prescribed financial thresholds for the joint assets / turnover.

So consolidation activity in the retail sector will have to be mindful of the thresholds prescribed under the competition laws of India.

VIII. International Trade Law

The industry contends that as per the extant foreign trade policy (**"FTP"**), retailers are eligible to get license from Directorate General of Foreign Trade (**"DGFT"**) under Served From India Scheme (**"SFIS"**). However, the same has so far been denied to retailers. Such ambiguity in the policy should be clarified and the SFIS license should be given to retailers who are generating foreign exchange inflows. Any sales using foreign currency / international credit cards must be counted against this and duty credit entitlements must be credited for retailers.

i. Trade Related Investment Measures

One of the questions raised by the Discussion Paper on FDI in retail was whether the restrictions placed on FDI with respect to local content requirements are compatible with India's TRIMs (defined hereinafter) obligations.

The Agreement on Trade-Related Investment Measures (**"TRIMs Agreement"**), negotiated during the Uruguay Round, applies only to measures that affect trade in goods.[50] Recognizing that certain investment measures can have trade restrictive and distorting effects, it states that no Member shall apply a measure that is prohibited by the provisions of General Agreement on Tariff and Trade (**"GATT"**) Article III (national treatment)[51] or Article XI (quantitative restrictions).[52] Examples of

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notification dated March 4, 2011, "group" is defined to mean two or more enterprises which, directly or indirectly are in a position to:

a. exercise 50% or more of the voting rights in the other enterprise; or
b. appoint more than 50% of the members of the board of directors in other enterprise; or
c. control the management or affairs of the other enterprise.

49. As per section 2(a) of the Competition Act "acquisi⁶tion" means, directly or indirectly, acquiring or agreeing to acquire -(i) shares, voting rights or assets of any enterprise; or (ii) control over management or control over assets of any enterprise;

50. Also see India and TRIMS, available at: http://commerce.nic.in/wtotrims.htm
51. That a member State should treat imported goods and domestically produced goods at par with each other.
52. Restrictions that limit the quantum of imported goods by way of a quota, for example, as opposed to imposition of non-quantitative restrictions like a customs duty or otherwise.

inconsistent measures, as spelled out in the Annex's Illustrative List, include measures which require particular levels of local procurement by an enterprise (local content requirements) or which restrict the volume or value of imports that an enterprise can purchase or use to an amount related to the level of products it exports (trade balancing requirements). The local content requirements that the discussion paper raised as one among the issues for deliberation will fall within the definition of these prohibited measures under TRIMs Agreement.

In this regard, it is interesting to note that the Panel of WTO's Dispute Resolution Body also observed in a dispute more widely known as Indonesia-Autos that: "We recall in this context that internal tax advantages or subsidies are only one of many types of advantages which may be tied to a local content requirement which is a principal focus of the TRIMs Agreement. The TRIMs Agreement is not concerned with subsidies and internal taxes as such but rather with local content requirements, compliance with which may be encouraged through providing any type of advantage. Nor, in any case, do we see why an internal measure would necessarily not govern the treatment of foreign investment."[53]

The significance of this decision, thus, is twofold. The local content requirements do not necessarily have to be in the nature of a restriction or a prohibition. It can also be an advantage or incentive, available to only those who fulfill specified local content requirements. Second, the decision also clarifies the relationship between TRIMs Agreement and the Agreement on Subsidies and Countervailing Measures.

ii. Antidumping and Subsidies and Countervailing Measures

GATT (Article 6) allows countries to take action against dumping. The Anti-Dumping Agreement clarifies and expands Article 6, and the two operate together. They allow countries to act in a way that would normally break the GATT principles of binding a tariff and not discriminating between trading partners — typically anti-dumping action means charging extra import duty on the particular product from the particular exporting country in order to bring its price closer to the "normal value" or to remove the injury to domestic industry in the importing country.[54]

It provides three methods to calculate a product's "normal value". The main one is based on the price in the exporter's domestic market. When this cannot be used, two alternatives are available — the price charged by the exporter in another country, or a calculation based on the combination of the exporter's production costs, other expenses and normal profit margins. The agreement

53. Panel Report on Indonesia — Autos, para. 14.73, available at: http://www.wto.org/english/res_e/booksp_e/analytic_index_e/trims_01_e.htm#fnt1

54. UNDERSTANDING THE WTO: THE AGREEMENTS : Anti-dumping, subsidies, safeguards: contingen[6]cies, etc, available at: http://www.wto.org/english/ thewto_e/whatis_e/tif_e/agrm8_e.htm

also specifies how a fair comparison can be made between the export price and what would be a normal price.[55]

One reason why restriction on FDI in retail are imposed is the potential for dumping that it brings about. Generally speaking, anti-dumping duty investigations are carried out under Sections 9A of the Customs Tariff Act, 1975 read with Section 9B ibid and the rules made thereunder. Antidumping duties are expected to overcome only the problem of dumping. To deal with the problem of direct and indirect Government subsidies there is provision for countervailing duties. In both cases injury and casual link must necessarily be proved. These investigations are carried out under the amended provisions of the Customs Tariff Act, 1975, and the rules made thereunder.

In the same vein, care should also be exercised while promulgating export-related initiatives for the goods that are exported out of India.[56] When certain conditions are satisfied, such export incentives can also be termed a subsidy, depending on whether there is export target requirements attached to any incentive or advantage that a person can obtain.

IX. Intellectual Property Regime

Under the 9th edition of International Classification of Goods (Nice Classification) retail services are afforded separate trademark protection under category 35. E-tailing, or e-retailing, is also classified under the same category. Interestingly, the issue of whether the activity of retail trading in goods in general or specifically the services rendered in connection with retail selling constitute services for which protection by means of trade mark registration should be granted has long been debated both across the globe.

Care should be taken on dealing with issues of trademarks, copyrights, designs, patents, labeling, packaging, on-pack promotions and retail price promotions, and ancillary intellectual property rights including the negotiation of licences, efficient from a tax and regulatory perspective.

Internet retailers who wish to take advantage of an offshore base for fulfillment will need to be aware of the tax implications of the transfer of assets abroad legislation. Assets such as domain names, brand names, trademarks, customer databases and other similar assets will be utilised by the overseas fulfillment operations and therefore tax-efficient strategies should be employed to minimise potential tax liabilities such as royalties, fees for technical services, or income tax.
A recent development of particular interest to retail franchisors is intellectual property securitization that allows companies to account for intangible assets such as intellectual property, royalty and brands and realize their full value. In recent years, a number of large restaurant franchisors

55. *Ibid*
56. Raj Bhala and Kevin Kennedy, WORLD TRADE LAW, (Lexis Law Publishing, Virginia, 1998)

have securitized their brands to raise funds, including Dunkin Donuts and Domino's Pizza (Domino's).[57]

X. Employment Laws

As discussed above, the retail sector in India is the second largest employer after agriculture. India ranks 6th in the Retail Talent Index and the retail sector employ approximately 8 percent of India's population,[58] with demand for skilled workers expected to rise. Therefore, in the context of retail, training and retaining work force is one of the biggest challenges that this sector faces. Further, stringent Indian labor laws govern the number of hours worked and minimum wages to be paid leading to limited flexibility of operations and employment of part-time employees. Additionally, multiple local clearances are required by the same company for opening new outlets / stores, adding to the time and costs incurred to expand presence in the country.

Additionally, due to a shortage of talented professionals, especially at the middle-management level, foreign players who wish to depute employees to India will have to comply with employment related Indian immigration laws.

With retail featuring as one of the top five sectors increasingly hiring women work force, it is important to note that recently law on prevention of sexual harassment against female employees at the work place has been enacted. The Sexual Harassment of Women at Work Place (Prevention, Prohibition and Redressal) Act, 2013 ("**Sexual Harassment Act**") has been made effective on April 23, 2013 by way of notification in the official gazette of India

XI. Telecom and Information Technology Laws

There are a couple of regulations that retailers that resort to e-commerce and m-commerce should be aware of. Telecom Regulatory Authority of India ("**TRAI**") had issued the Telecom Commercial Communications Customer Preference Regulations, 2010 with the objective of providing an effective mechanism for curbing unsolicited commercial communications ("**UCCs**"). The National Consumer Preference Registry is established with this end in view, which is a database of telephone numbers of subscribers who do not want to receive UCCs.

The concept known as invertising or invited-advertising, which seeks to prohibit spam, is also becoming increasingly popular.

XII. Payment and Settlement Laws

In India, the payment and settlement systems are regulated by the Payment and Settlement Systems Act, 2007 ("**PSS Act**") which was legislated in December

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57. Nisar, T. M. (2011) Intellectual property securitization and growth capital in retail franchising. Journal of Retailing
58. Supra Note 7

2007. The PSS Act as well as the Payment and Settlement System Regulations, 2008 framed thereunder came into effect from August 12, 2008. In terms of Section 4 of the PSS Act, no person other than the RBI can commence or operate a payment system in India unless authorized by the RBI. The RBI has since authorised payment system operators of pre-paid payment instruments, card schemes, cross-border in-bound money transfers, ATM networks and centralised clearing arrangements. E-commerce companies that encourage online payments for goods and services are required to be compliant of the PSS Act and regulations issued in this regard.

XIII. Miscellaneous

Multiple laws and regulations are in force at the central, state and local levels for governing the retail sector. There are various laws such as the Consumer Protection Act, Essential Commodities Act, the Cold Storage Order, the Weights & Measures Act, the Shops Establishments Acts, code of advertising, local labor laws that may become applicable to retail sector depending on the kind of business the entity is engaged in.

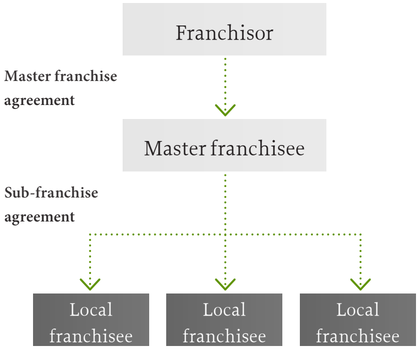
4. Permissible Models for Entry of Foreign Players

While there is no proven model for India as yet, in addition to direct foreign investment in companies engaged in retail trading in compliance with the sectoral cap and condition that may be applicable, the following are some permissible models for entry into the Indian retail sector.

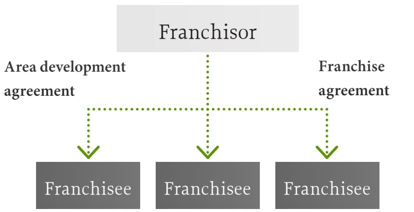
I. Franchise Agreements

Franchising is the easiest and most widely used route by international retailers to enter India. While, Indian law does not define franchising, it simply means a method of distributing products or services. The *Blacks Law Dictionary* defines a franchise as a license from the owner of a trademark or trade name permitting another to sell a product or service under that name or mark.[59] Though there is no specific law pertaining to franchising in India, franchising as a business deals with various general commercial laws and industry specific laws. It would be important to understand how these different laws can affect a franchising business in India and what issues could arise. There are various forms of entering into franchising arrangements. Some of the popular franchise models are reproduced below:

Structure 1



Structure 2



Under the master franchise structure, a multinational company i.e. franchisor will typically enter into a master franchise agreement for a particular territory with the counterpart in effect allowing the master franchisee to sub-franchise the rights to the local franchisee in that particular jurisdiction.

Under the second structure, the franchisor directly enters into franchise agreement

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59. black's law dictionary (6th edition) centennial edition (1891-1991) at p.658

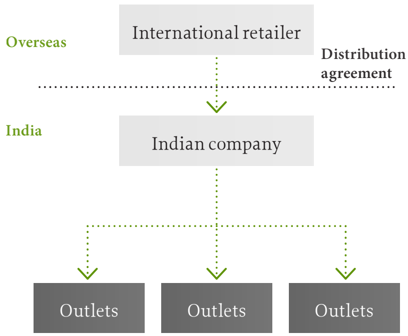
with the local area franchisee unlike the master franchise structure.

While the concept of franchising seems simple, there are several issues that must be dealt with before entering into a franchising arrangement. For example: in a franchising arrangement, the issues with respect to enforceability of franchise agreement, protection of intellectual property rights of the franchisor / owner, constitution of agency and issues under applicable anti-trust laws must be kept in mind.

Further, from an exchange control perspective, in an international franchise arrangement between an Indian resident and a non-resident, remittance for purchase / use of trademark / franchise is freely permitted.[60] Further, withdrawal of foreign exchange by persons for payment of royalty and lump-sum payment under technical collaboration agreements can be made without the approval of the Ministry of Commerce and Industry, Government of India.[61]

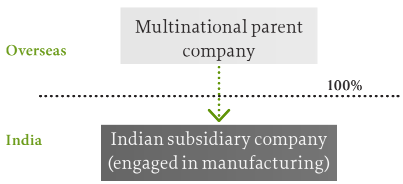
II. Strategic Licensing Agreements

Under the strategic licensing arrangement, an international retailer licenses distribution rights to Indian companies. Through these rights, Indian companies can either sell it through their own stores, or enter into shop-in-shop arrangements or distribute the brands to franchisees. The diagrammatic representation of the structure is given below:



III. Manufacturing and Wholly Owned Subsidiaries

From an exchange control perspective, conditionalities in retail trading are applicable to companies engaged in trading (whether SBPRT or MBRT or wholesale cash and carry). Therefore, international brands that have set up wholly-owned subsidiaries engaged in manufacturing of products are allowed to do retail trading. Further, these manufacturing companies can sell their products in India under franchising, distribution arrangements or through their own outlets. The diagrammatic representation of the structure is given below:

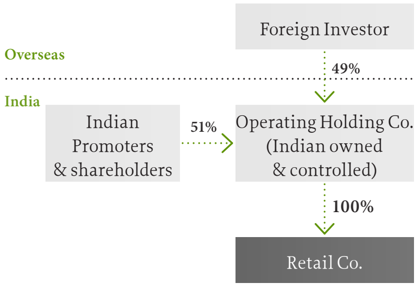


60. Vide Press Note No. 8 (2009 Series), dated December 16, 2009
61. Vide RBI/2009-10/465 A. P. (DIR Series) Circular No. 52 dated May 13, 2010

IV. Investment into an Indian Owned and Controlled Company

According to the FDI Policy, an Indian company which is owned and controlled[62] by an Indian resident directly or through Indian companies, will be considered as an Indian company. Thus, any downstream investments made by such a company (which has foreign investment of less than 50 percent) would not be taken as having any indirect foreign investment. However, this methodology for computation of foreign investment will not apply to sectors that are governed specifically by separate statutes, such as the insurance sector.

In light of the above and based on the interpretation of the provisions of the FDI Policy, if an Indian operating and holding company is owned and controlled by Indian promoters / shareholders, the downstream investment in a company (carrying on retail trading) should not be regarded as FDI even though there is foreign investment in an Indian operating and holding company, provided the investment of foreign investor in Indian operating and holding company is below 50 percent and the foreign investor does not exercise control in an Indian operating and holding company. The diagrammatic representation of the structure is given below:



However, it is possible, that the regulator may take a different view on this structure. This is because the downstream investment is in a subsidiary that is engaged in business falling in a restricted sector and the regulator may view the proposed structure as not aligned with the sectoral caps on retail trading. One must keep this in mind when discussing investment structures.

V. Investment Through the Nonconvertible Debenture Structure

Investment in a retail Indian company can be structured by the issuance of non-convertible debentures (NCDs) proposed to be listed on the wholesale debt market segment of the stock exchange as per the debt listing agreement and the SEBI (Issue of Debt Instruments) Regulations, 2009.

However, investment in debt securities will be purely financial investment as it may not confer control rights on the debenture holder.

62. The definition of 'control' was recently amended by way of Press Note 4 (2013 Series) and now reads as follows: "'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." (http://dipp.nic.in/English/acts_rules/Press_Notes/pn4_2013.pdf)

VI. Investment in back end Structure

Investment in the retail sector can be made in wholesale trading company (“**WTC**” or “**back end company**”) in which 100 percent FDI is permissible under the automatic route also engaged in back-end activities. Such a WTC can undertake transactions with a front end company (“**Retail Co.**”) engaged in retail trading. However, such wholesale trade made to Retail Co. of a group company cannot exceed 25 percent of the total turnover of WTC.

Further, WTC may enter into a licensing agreement for use of brands as well as a services agreement whereby WTC may provide certain services to Retail Co.

Given the sensitivity surrounding the retail sector in India, any transaction structure that is proposed must be mindful of the overall policy perspective of the Government and to that extent may be exposed to a degree of regulatory scrutiny.

5. Conclusion

The Indian retail sector has matured over the years but is still highly unorganized. The country's estimated annual retail opportunity of USD 500 billion is a great opportunity for both domestic and international retailers.

The country needs more investment in the retail and allied sectors such as cold chains, warehousing and logistics. The reforms in FDI in both SBPRT (relaxing of certain conditions), MBRT and further investments by joint ventures with domestic retail players will give the industry a boost and have a trickle-down effect on the agricultural and food sector in India.

– Retail Team

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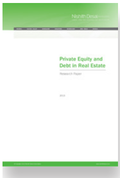

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