Regulatory Hotline

November 13, 2015

FOREIGN INVESTMENT IN INDIA: REFORMS REFINED AND CONTINUE

- No approval to be required for eligible investments in Limited Liability Partnerships
- Special treatment applicable for investment by non-resident Indians on non-repatriation basis to be extended to investment made by them through companies, partnerships, trusts, etc.
- No approval to be required for foreign investment by way of share swap; New sectors to be opened up for foreign investment, including regional airlines, plantations, duty free shops and ownership in real estate for purposes of leasing
- Shareholding limits to be increased in certain sectors, including broadcasting and airline services
- Investment in certain sectors including defence, broadcasting and airline services, now under automatic route
- Full fungibility for portfolio and venture capital investment in defence and private banking sectors
- Conditions attached to FDI relaxed in certain sectors, including removal of restriction on e-commerce by entities engaged in single brand retail trading and removal of minimum land and capitalization requirement for construction development sector

The Government of India has, on the eve of Diwali festivities, announced reforms ("**Announcement**") relating to various aspects governing Foreign Direct Investment ("**FDI**") in India, which are expected to have a wide-ranging impact.

The key reforms include:

1. removal of requirement for approval for eligible foreign investment in Limited Liability Partnerships ("**LLPs**") and for foreign investment by way of share swap;
2. extending special treatment applicable for non-resident Indian ("**NRIs**") investment on non-repatriation basis to investment made by them through legal entities;
3. rationalizing certain existing regulations to sector-specific changes such as opening up FDI in certain sectors;
4. increasing FDI caps in certain sectors;
5. change of approval route to automatic route in certain sectors; and
6. relaxing conditions attached to FDI in certain sectors.

These changes have been announced with an aim to increase FDI inflow into India, to improve the ease of doing business in India and to factor in booming technological developments.

The changes announced are set out below, along with our analysis. The description below is based on the press note[1] issued by the Government. The fine print of the actual amendments (to be made to the Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2000 ("**TISPRO**"), which governs FDI in India) are still awaited. However, the Announcement provides a lot of details and has led to positive expectations in relation to reforms expected to be brought into effect soon.

ELIGIBLE FOREIGN INVESTMENT IN LLPS WOULD NOT REQUIRE APPROVAL – IMPORTANT FOR MANUFACTURING SECTOR AND BOOMING ENTERPRISES IN THE TECHNOLOGY SPACE

Foreign investment in LLPs is allowed, to start with, in sectors (a) in which 100% FDI is allowed under the automatic route; and (b) which are not subject to FDI-linked performance conditions (for example minimum capitalization norms, etc). Currently, such eligible foreign investment in LLPs is allowed only with prior Government/ Foreign Investment Promotion Board ("**FIPB**") approval and post approval, such LLPs are not allowed to make downstream investment in an Indian entity.

As per the Announcement, eligible foreign investment in LLPs would be allowed under the automatic route (i.e., without approval) and downstream investment can be made by such LLPs in a company or LLP operating in sectors in which foreign investment can be made in a LLP.

LLPs, since their introduction in 2008, has been looked upon as an attractive vehicle (to companies) for undertaking business. A LLP is a hybrid entity with characteristics similar to a company (especially, separate legal entity status and limited liability) and with the operational flexibilities of a partnership. Particularly, LLPs and their partners are not subject to restrictions and conditions applicable to companies in relation to related party transactions, directors'

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duties, restrictions on acceptance of deposits (a very widely defined term, with limited exclusions), corporate social responsibility, onerous liabilities on directors and other officers for routine non-compliances, prohibition on maintaining accounts on cash basis, etc.,. Further, compliances applicable in case of LLPs are not as high as compliances applicable to companies.

Income of a LLP, like a partnership, is taxed only once, i.e., at the corporate tax rate of 30%[2] in the hands of the LLP. There is no further taxation in India upon distribution of profits to its members. This becomes more important in comparison with taxation of companies, and more so, in a foreign investment context. The profits of a company are subject to corporate tax at 30% and thereafter, the profits of the company are subject to an additional dividend distribution tax ("**DDT**") at 20.36% on a grossed up basis at the time of distribution as dividends. DDT is a tax levied on the company and not the shareholder and therefore, it would be difficult to claim relief under tax treaties (which restricts taxation on dividends in India to limits ranging from 5% to 15%). Further, in relation to the tax liability of the shareholder in its country of residence, he / she / it may not be able to claim tax credit in relation to DDT paid in India, unless the applicable tax treaty mandates tax credit for corporate taxes paid in India.

The objective of the Announcement has been to bring investment in LLPs in line with that of companies. However, it is important to note that other existing restrictions for FDI in LLPs (which are not applicable in case of companies) may continue to apply. For example, debt investments (both convertible and non-convertible) are not allowed in a LLP; LLPs should have at least one designated partner who is a resident individual and who is: (i) a partner of the LLP or (ii) a nominee of an Indian company which is a partner of the LLP, etc. While companies are also required to have one resident director, all shareholders can be non-residents unless there are sector-specific caps.

NRIS INVESTING THROUGH COMPANIES/ TRUSTS / PARTNERSHIPS ON NON-REPATRIATION BASIS WOULD BE TREATED AS DOMESTIC INVESTMENT

NRIs include non-residents who are Indian citizens or are 'Overseas Citizen of India' cardholders.[3] Investments made by NRIs on non-repatriation basis (as per Schedule 4 of TISPRO) are currently are treated as domestic investment at par with investment made by residents. Further, for investments made by NRIs on repatriation basis, special treatment is allowed in some sectors - in construction development, FDI-linked conditions are not applicable and civil aviation, no caps are applicable. As per the Announcement, such treatment is to be extended to companies, trusts and partnership firms, which are incorporated outside India and are owned and controlled by NRIs.

Therefore, restrictions applicable as per Schedule 1 of TISPRO Regulations on investments by non-residents in general, especially sectoral caps, pricing guidelines, cap on coupon rate in case of Compulsorily Convertible Debentures ("**CCDs**") and Compulsorily Convertible Preference Shares or ("**CCPS**") and limitations on acquisition of right shares or bonus shares, acquisition of employee stock options, different modes of transfer of securities, pledge of securities, etc., would not be applicable in case of such entities of NRIs investing on non-repatriation basis under Schedule IV of TISPRO.

Further, in determining whether an Indian company is a foreign owned company (with 50% or more shareholding held by non-residents), investment by such entities of NRIs on non-repatriation basis should not be included. Therefore, from the perspective of downstream investment in companies engaged in sectors subject to sectoral caps or FDI-specific conditions / approval, existing limitations may not apply in case of Indian companies with investment by such entities.

The extension of special treatment applicable to NRIs would allow NRIs investing on non-repatriation basis to ring-fence their Indian investments (which may particularly be an important consideration while making large investments) and to have the flexibility for investing though different entity structures depending on commercial and strategic considerations, administrative convenience, tax efficiency, etc.

However, as discussed in our earlier hotline in relation to treatment of investment by NRIs, it is not clear whether investments other than investment in shares, CCDs and CCPS issued by Indian companies on non-repatriation basis, for example, investment in AIFs (which are typically set up as trusts and not as companies), investment in LLPs, etc., are also intended to be covered.

MANUFACTURERS COULD SELL THEIR PRODUCTS WITHOUT GOVERNMENT APPROVAL

As per the Announcement, Indian manufacturers with foreign investment would be allowed to sell their products through wholesale and/or retail formats, including through e-commerce platform without Government approval. For this purpose, the manufacturer is required to be the owner of the Indian brand and manufacture at least 70% of its products (in terms of value) in-house in India, and source at most 30% from Indian manufacturers.

Currently, several manufacturers with foreign investment appear to be selling their products, either to wholesale traders or to retail buyers, without government approval based on the understanding that they are allowed to do so. Therefore, to that extent, the Announcement appears to be in the nature of a clarification rather than a change, though the language of the Announcement suggests otherwise.

The 30% cap on sourcing from external sources is new and may be difficult to satisfy depending on the nature of business model involved. Particularly, businesses which earn profits from bulk manufacturing of standardized products (as opposed to customized products) for sale with lower margins may not be able to satisfy this rule as their raw material costs may be high. Further, it is not clear whether contract manufacturing arrangement would qualify as manufacture 'in house' and one needs to wait to see if the fine print of the amendments provides clarity on this aspect.

RELAXATION IN CONDITIONS FOR SINGLE BRAND RETAIL TRADING ("SBRT")

Currently, FDI policy on SBRT provides that products are required to be sold under the same brand internationally and that the foreign investor is required to be the brand owner or have the right to use the brand name under a legally tenable agreement with the brand owner. Further, in cases of FDI beyond 51%, 30% of the value of goods purchased are required to be sourced from India. Post foreign investment, this condition is required to be satisfied on an average basis for the first five period. Thereafter, it applies annually. Also, SBRT by means of e-commerce are not permissible.

As per the Announcement, entities with foreign investment in SBRT can sell products with an Indian brand name and in that case, the requirement of using the same brand name internationally and the foreign investor having right to use / ownership over the brand name does not apply. Instead, Indian brands are required to be owned and controlled by resident Indian citizens and/or companies, which are owned and controlled by resident Indian citizens.

Also, as per the Announcement, the 30% sourcing rule would be triggered only after the first store is set up (and not immediately post receipt of foreign investment). For 'state-of-art' and 'cutting-edge technology', sourcing norms may be relaxed with Government approval. Further, SBRT can now be undertaken through e-commerce platform.

There is no specific condition stating that SBRT can be undertaken through e-commerce platform only by players who also operate retail stores. However, a comprehensive reading of the provisions seem to suggest that such a business model is not contemplated.

The phase wise easing of Government policy on SBRT has been viewed positively by international single brand retailers. This is evident from the fact that this sector has witnessed huge flows of FDI in the last few years. Further, allowing single brand retailers within the overall policy to use e-commerce platform would improve the availability of such goods for the consumer.

EARNING RENT/ INCOME ON LEASING PROPERTY NOT TO QUALIFY AS REAL ESTATE BUSINESS

Currently, FDI and investment by NRIs on non-repatriation basis are not permitted in an entity which is engaged or proposes to engage in 'real estate' business. The Announcement states that earning of rent/ income on lease of the property, not amounting to transfer, will not amount to real estate business. Therefore, FDI and investment by NRIs on non-repatriation basis in such businesses should be permitted.

As the prohibition on investment in real estate business is a significant one, the Announcement has brought much-needed clarity with respect to lease rentals. Particularly, in case of NRIs, there has been a keen interest in investing in properties in India through corporate vehicles. Further, in industries where the immovable properties involved are sophisticated, prone to various risks and in businesses where excess capacity is sought to be rented to external parties for long-term or short-term (as and when there is excess capacity / during off-seasons), there may be a commercial preference to hold the property and the regular business in separate entities. This change is a major boost to investors in such industries / businesses.

RELAXATION IN ENTRY AND EXIT-RELATED CONDITIONS IN CONSTRUCTION DEVELOPMENT SECTOR AND COMPLETED PROJECTS

As per the Announcement, the existing minimum land requirement of 20,000 square metres and the existing minimum capitalization requirement of USD 5 million (to be invested within 6 months of commencement of business) in construction development projects are to be removed.

Secondly, from an exit perspective:

- Each phase of the construction development project would be considered as a separate project and consequently, a foreign investor will be permitted to exit and repatriate foreign investment, provided that a lock-in-period of 3 years, calculated with reference to each tranche of foreign investment, has been completed.
- The foreign investor may also exit and repatriate prior to the 3-year period if trunk infrastructure or the project has been completed.
- Transfer of stake from by a non-resident investor to another non-resident, without repatriation of investment would not be subject to any lock-in period nor to any Government approval. In addition to sale, transfer also includes extinguishment of rights in the property, compulsory acquisition under law, arrangements which have the effect of transferring or enabling the enjoyment of any immovable property, etc.
- The above lock-in period will not apply to hotels & tourist resorts, hospitals, Special Economic Zones (SEZs), educational institutions, old age homes and investment by NRIs.

In case of FDI in completed projects for operation and management of townships, malls/ shopping complexes and business centres, transfer of ownership and/or control of the investee company from residents to non-residents is permitted, subject to a lock-in-period of three years, calculated with reference to each tranche of FDI. During the lock-in-period, transfer of immovable property or part thereof is not permitted.

The above changes appear to be a logical extension of the changes announced a year back (our analysis of the earlier changes can be accessed here.)

OTHER LIBERALIZATION MEASURES (SECTOR-SPECIFIC):

a) Defence sector: Currently, foreign investment up to 49% is permitted under Government approval route and foreign investment beyond 49% is subject to approval of Cabinet Committee on Security ("**CCS**"). Portfolio investment and investment by FVCIs is restricted to 24%.

The following changes have been announced:

1. Foreign investment up to 49% will now be under automatic (not approval) route. Further, portfolio investment and investment by FVCIs will be allowed up to 49% under automatic rote. However, foreign investment resulting in change in the ownership pattern or transfer of stake by existing investor to new foreign investor will require Government approval even if such investment is within the permitted automatic route level.
2. Proposals for foreign investment in excess of 49% will be considered by the FIPB, not CCS.

While FDI up to 49% has been permitted under the automatic route, based on a comprehensive reading of the proposed changes, it appears that the Government is looking to monitor the profile of investors (given the sensitivity of the sector) and approval would not be required only in circumstances where existing investors are infusing additional capital in the same proportion.

b) Broadcasting sector: Revised sectoral caps and entry routes have been announced as follows:

Activity	Announced cap and route	Existing cap and route
Teleports(setting up of up-linking HUBs/Teleports); Direct to Home (DTH); Cable Networks (Multi System operators (MSOs) operating at National or State or District level and undertaking upgradation of networks towards digitalization and addressability) Mobile TV Headend-in-the Sky Broadcasting Service(HITS) Cable Networks (Other MSOs not undertaking upgradation of networks towards digitalization and addressability and Local Cable Operators (LCOs))	100% (Up to 49% - Automatic route; Beyond 49% - under Government approval route)	74% (Up to 49% - Automatic route; Beyond 49% and up to 74%- under Government approval route)
Terrestrial Broadcasting FM (FM Radio) Up-linking of 'News & Current Affairs' TV Channels	49% Government route	26% Government route
Up-linking of Non-'News & Current Affairs' TV Channels Down-linking of TV Channels	100% Automatic route	100% Government route

c) Full fungibility to be permitted in private banking sector: Government has decided to introduce full fungibility of foreign investment in Banking-Private sector. Accordingly, FIIs/FPIs/QFIs can now invest up to sectoral limit of 74%, provided that there is no change of control and management of the investee company. In contrast, currently, following are the restrictions that are applicable:

1. Individual FII/FPI holding is restricted to below 10% and aggregate limit for all FIIs/FPIs/QFIs to 24%, which can be raised to 49% by the banking company through a resolution by its board of directors followed by a special resolution to that effect by its shareholders.
2. In the case of NRIs, individual holding is restricted to 5% (both on repatriation and non- repatriation basis) and aggregate limit to 10%, which can be raised to 24% provided the banking company passes a special resolution to that effect in the shareholders.

There are many foreign investors (including FPIs/FIIs) who are interested to invest beyond 5% in private banks. However, under banking laws (which operate in addition to laws governing FDI), for an investment more than 5% in a banking company, the bank is required to obtain clearance from RBI, which is time-consuming. Government / RBI should either increase this limit to say 9.99% (limit permitted for a FII/FPI) or should simplify the process for obtaining clearance so as to cut down on the time taken for approval.

d) Same entity to be allowed to carry out both wholesale and single brand retail trading: Currently, in wholesale cash & carry activities, 100% foreign investment is permitted under the automatic route and a wholesale/cash & carry trader cannot open retail shops. As per the Announcement, a single entity will be permitted to undertake both wholesale and SBRT with conditions applicable on both activities having to be complied by both the business arms separately.

This change, coupled with the change that SBRT can be carried out by way of e-commerce, could be important for business that are looking to have their own in-house distribution networks and also make use of external distribution networks.

e) Regional Air Transport Service – 49%FDI allowed: Currently, foreign investment up to 49% is allowed under the automatic route in Scheduled Air Transport Service/ Domestic Scheduled Passenger Airline. As per the Announcement, similar treatment is to be extended to Regional Air Transport Service.

f) Non-scheduled air transport, ground handling services, satellites- establishment and operation and credit information companies: FDI caps to be increased from 74% to 100% and FDI entry route to be modified from approval route to automatic route (except in case of establishment and operation of satellites).

g) Duty free shops in customs bonded areas - 100% FDI to be allowed under automatic route.

h) Tea / Coffee / Rubber / Cardamom / Palm Oil & Olive Oil Plantations - 100% FDI to be allowed under automatic route. Currently, FDI is not allowed in either of the above (except tea plantation where FDI is allowed under the approval route).

i) Simplification of conditionalities: It has been announced that certain FDI-specific conditions on agriculture and animal husbandry, and mining and mineral separation of titanium bearing minerals and ores, its value addition and integrated activities have been simplified. The details regarding these changes are yet to be announced.

OTHER LIBERALIZATION MEASURES (NOT SECTOR-SPECIFIC):

a) Companies without operations not to require Government approval for FDI for undertaking automatic route sector activities: For infusion of foreign investment into an Indian company which does not have any operations or downstream investments, Government approval would not be required for undertaking activities which are under automatic route and without FDI-linked performance conditions, regardless of the amount or extent of foreign investment. Currently, such infusion of foreign investment requires approval.

This change may become important where Indian companies are set up by a resident with nominal capital and subsequently receive investment from a foreign investor. Such set up and subsequent investment may be done from a timeline perspective, particularly, where the foreign investor is a corporate entity, which is in the process of being set up, obtaining internal approvals prior to investment, etc.

b) Establishment and transfer of ownership and control of Indian companies: Currently, there is an ambiguity in relation to need of approval for establishment and transfer of ownership or control of an Indian company in sectors/activities with caps. As per the Announcement, requirement for approval will apply only if the company concerned is operating in sectors/ activities which are under Government approval route (rather than sectoral caps). This is a rationalization measure keeping in mind the distinction between investments which require approval and which are subject to caps.

c) Share swap: No Government approval would be required for investment in automatic route sectors by way of swap of shares. This is a major relief as various transactions (for example, those involving internal group re-structuring, etc.) can now be structured in an efficient manner.

d) Raising the threshold limit for investment approval by FIPB from INR 30 billion to 50 billion: Therefore, only investment above INR 30 billion are to be placed for consideration of Cabinet Committee on Economic Affairs. This would simplify the approval process for investment proposals up to INR 50 billion.

e) Consolidated Booklet: Department of Industrial Policy and Promotion has been advised by the Government to consolidate all FDI related instructions and prepare a booklet so that the investors do not have to refer to several documents of different timeframes.

CONCLUSION

Since last year, we have witnessed reforms and new initiatives being announced regularly by the Government. The continuous inflow of FDI in India, which is now allowed across several sectors, clearly shows the faith that overseas investors have in the economy. The changes outlined in the Announcement are in line with the changes that have been announced since last year and are in line with industry expectations. We now hope that the RBI expedites necessary amendments in the TISPRO, so that these changes become effective.

While there is a lot more to be done, the Announcement has given hope that more changes may be expected in due course of time, particularly in sectors where foreign investment could lead to transfer of technical know-how, generation of employment and economic growth.

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You can direct your queries or comments to the authors

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[1] Available at dipp.nic.in/English/policies/fdi_review_10112015.pdf

[2] All tax rates mentioned in this hotline are exclusive of surcharge and cess.

[3] You may refer to our earlier hotline explaining the scope of the recently amended definition of the term NRI.
