RESEARCH NOTE

Strategies to Maximize Your Philanthropic Capital

A Summary of Indian Regulations Related to Social Investment into India

A research note by Deloitte Touche Tohmatsu India Private Limited and Talwar Thakore & Associates for Mission Investors Exchange

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INTRODUCTION

Environment for social entrepreneurship in India

India has a large number of non-governmental organisations ("NGOs") involved in various areas of development such as education, health care and such other welfare activities. These agencies are mainly funded by private individuals or institutions and also receive governmental aid. The Government of India (the "Central Government") has in recent months taken active measures to increase awareness among private corporations regarding corporate social responsibility.

This research note discusses the possible routes for investment in social welfare organisations in India. Readers will notice from this research note that whilst social investment into India is constrained in the current regulatory environment there are opportunities to structure investments in a manner that meet the objective of the investor within this regulatory framework. This research note does not seek to describe any particular structure(s) in any detail (as those will be bespoke based on the circumstances of each investor and the beneficiary) and is intended as a discussion of the tax and regulatory framework relevant to such investments.

This research note was written by Deloitte Touche Tohmatsu India Private Limited and Talwar Thakore & Associates for Mission Investors Exchange (www.missioninvestors.org).

EXECUTIVE SUMMARY

1 Forms of social investment

1.1 Investments into the social sector in India can be either by way of return-based investments or charitable contributions. Return-based investments include equity, foreign currency loans, guarantees and investments in funds with a focus on the social sector.

1.2 Equity or foreign direct investment ("FDI") into India is regulated by the Ministry of Finance, Government of India through the Foreign Investment Promotion Board and the Reserve Bank of India ("RBI") (www.rbi.org.in). The RBI is the central bank of India and is primarily responsible for implementing and enforcing foreign exchange regulations. The consolidated FDI policy ("FDI Policy")[1] issued every year sets out the nature of permissible capital investments into India. The main legislation regulating exchange control issues is the Foreign Exchange Management Act, 1999 ("FEMA")[2] and regulations issued thereunder.

1.3 Foreign currency loans or external commercial borrowings ("ECB") are regulated the RBI. The RBI has imposed strict regulations on such foreign currency borrowing by Indian entities by means of regulations on ECBs, known as the ECB Regulations[3]. The ECB Regulations impose various restrictions in relation to ECBs such as regulating who can receive and who can extend ECBs, limiting the return payable and imposing end-use requirements.

1.4 While guarantees extended by non-residents for or on behalf of residents do not attract the provisions of FEMA unless invoked, payments under such guarantees are regulated by the RBI through the ECB Regulations as the guarantor will effectively step into the shoes of the ECB lender upon a payment under the guarantee.

1.5 Guarantees by non-residents of rupee loans by resident creditors are also permitted subject to certain conditions. The ECB Regulations and other RBI

1 Government of India, Ministry of Commerce & Industry, Department of Industrial Policy & Promotion, (FC Section), Circular 1 of 2012 (http://dipp.nic.in/English/Policies/FDI_Circular_01_2012.pdf)

2 http://www.rbi.org.in/scripts/Fema.aspx

3 The ECB Regulations consist of the Foreign Exchange Management (Borrowing and Lending in Foreign Currency) Regulations, 2000 and various notifications and circulars issued by the RBI from time to time in relation to ECBs, including the Master Circular on ECBs and Trade Credits dated 1 July 2011 (the "ECB Master Circular") (http://rbi.org.in/scripts/BS_ViewMasCirculardetails.aspx?id=6950)

regulations[4] regulate the repayment of amounts by the resident debtor to the non-resident guarantor.

1.6 Charitable contributions to Indian entities are regulated by the Foreign Contribution Regulation Act, 2010 ("FCRA")[5].

1.7 Entities such as foreign endowments, foundations or charitable trusts or societies can make institutional investments in India as foreign institutional investors ("FIIs") registered with the Indian securities regulator, Securities and Exchange Board of India ("SEBI") (www.sebi.gov.in).

1.8 SEBI has recently introduced the regulatory regime governing alternative investment funds ("AIFs")[6] which are privately pooled investment vehicles with certain defined investment objectives. A social venture fund ("SVF") is a category of AIF which invests in social ventures or small and medium enterprises or in such other sectors. Foundations looking to make social investments in India can consider routing such investments through an SVF.

2 Indian tax regime

2.1 Broadly speaking, the Indian tax regime levies tax on non-residents on: (a) income accruing or arising in India; and (b) income deemed to accrue or arise in India.

2.2 The withholding tax provisions under the Indian tax regime are all-encompassing; tax is required to be withheld from all overseas payments (including interest, guarantee fees, etc.) if such payments are liable to tax in India. Generally speaking, the withholding tax is equal to the final tax liability, unless the overseas entity has a permanent establishment in India.

2.3 India has entered into a large number of tax treaties, including with the US. The tax treaties can be invoked to reduce the Indian tax liability, including the withholding tax. This report considers the provisions of the India-US tax treaty[7].

2.4 An overseas entity receiving income from India is required to register with the Indian tax authorities, failing which a higher withholding tax will apply. Overseas entities are also required to comply with various reporting requirements, including filing of tax returns in India.

4 RBI Notification No. FEMA 29/2000-RB dated 26 Sep 2000
5 Full text of the FCRA is available here: (http://lawmin.nic.in/ld/regionallanguages/THE%20FOREIGN%20CONTRIBUTION%20(REGULATION)%20ACT,2010.%20(42%20OF%202010).pdf)
6 SEBI (AIF) Regulations, 2012 http://www.sebi.gov.in/cms/sebi_data/attachdocs/1337601524196.pdf
7 Full text of the India-US tax treaty is available at: (http://law.incometaxindia.gov.in/DIT/File_opener.aspx?fn=http://law.incometaxindia.gov.in/Directtaxlaws/cbdt/dta/A1_USA.htm)

2.5 Every Indian company is required to pay dividend distribution tax @ 16.22% on distribution of dividend. Correspondingly, the dividend is exempt from tax in the hands of the shareholder. As the dividend is exempt from tax, there is no withholding tax on dividends.

2.6 Indian levies tax on disposal of shares of an Indian company; such tax is generally required to be withheld from the sale consideration.

2.7 A separate regime exists for taxation of charitable organisations in India that have been granted approvals for tax exemption. Broadly speaking, the income of the charitable organisation is considered as per the books of account. To the extent such income is applied for charitable purposes or accumulated for future use (subject to limits), the income is exempt from tax.

SUMMARY OF INDIAN REGULATIONS THAT IMPACT SOCIAL INVESTMENT INTO INDIA

3 Social Entrepreneurs in India

3.1 Form of Entities Commonly Used

3.1.1 Trusts

(i) Trusts are commonly used structures for social entrepreneurs in India. A trust can be either private or public depending on the purpose for which it has been established and the source of funds constituting the corpus of the trust.

(ii) Private trusts are generally established for the benefit of a specified person or a group of persons and are generally not involved in the social sector. The Indian Trusts Act, 1882 (the "Trust Act")[8] is the main legislation regulating private trusts.

(iii) Public trusts on the other hand are established for the benefit of an uncertain or fluctuating body of persons and are generally engaged in activities in the social sector. While there is no central legislation governing public trusts, a few states in India have enacted special legislations in this regard. One such example is the Bombay Public Trusts Act, 1950 (the "BPTA")[9] which applies to public trusts established in the state of Maharashtra (including Mumbai). While a trust may be registered in one state, it can extend its operations to other states.

(iv) In terms of the BPTA, public trusts are required to be registered with the local charity commissioner and to submit annual financial returns and are subject to other compliance related requirements.

(v) Foreign nationals, even if resident in India, are not permitted to be appointed as trustees under the BPTA.

8 http://indiacode.nic.in/
9 http://mahacharity.gov.in/static_pages/pdf/B.P.T.Act,1950.pdf

3.1.2 Societies

(i) Societies are membership organisations that can be formed for not-for-profit purposes. Societies are regulated by the Societies Registration Act, 1860 (the "SRA")[10] which has been adapted by various states in India. Societies have to be established for an identified purpose and are usually managed by a governing council or a managing committee.

(ii) The categories of societies that can be registered under the SRA include the following:

(a) charitable societies;

(b) societies established for the promotion of science, literature, education, or the fine arts; and

(c) public art museums and galleries, and certain other types of museums.

3.1.3 Section 25 Companies

(i) Another structure under which social organisations operate are companies registered under Section 25 of the Companies Act, 1956 (the "Companies Act")[11], ("Section 25 Companies"). Such companies are incorporated with a definite cultural, economic, educational, social or religious purpose.

(ii) Section 25 Companies are not-for-profit entities and are regulated by the Registrar of Companies of the state in which they are incorporated.

(iii) A Section 25 company may be formed for "promoting commerce, art, science, religion, charity or any other useful object" and must apply its profits, if any, or other income to the promotion of its objects. Such companies are not permitted to pay any dividend to shareholders.

3.1.4 Micro-finance companies

(i) A profit earning structure for social entrepreneurship is a micro-finance company registered under the Companies Act. These companies provide finance to borrowers in rural areas to undertake self-employment activities or to establish small businesses without dependence on

10 http://www.mca.gov.in/Ministry/actsbills/pdf/Societies_Registration_Act_1860.pdf
11 http://mca.gov.in/Ministry/pdf/Companies_Act_1956_13jun2011.pdf

traditional money-lenders who demand exorbitant rates of interest. These borrowers do not have access to regular bank loans either because of geographical reach, demographic (they do not fit the credit profile required by banks or cannot provide the collateral that banks typically require) or quantum of finance required.

(ii) Micro-finance activities in India are generally undertaken by banks, non-banking financial companies, trusts, societies and Section 25 Companies. MFIs in India can also operate as co-operative societies (or multi-state co-operative societies with operations in more than one state of India), mutual benefit societies or mutually aided societies. Such societies can be registered under separate state legislations or the federal Multi-state Co-operative Societies Act, 2002 ("MCS Act").

(iii) In terms of the RBI Act, 1934 every non-banking financial company ("NBFC") is required to be registered with RBI to commence or carry on any non-banking business as defined under the said act. However, this requirement does not apply to Section 25 Companies and NBFCs engaged in micro financing activities, providing credit not exceeding INR 50,000 for a business enterprise and INR 125,000 for a housing loan.

(iv) The RBI has recently issued regulations (the "MFI Regulations")[12] governing NBFCs engaged in micro-finance activities ("NBFC-MFIs"). The MFI Regulations prescribe the eligibility criteria for NBFC-MFIs and the prudential norms in relation to capital adequacy requirements and asset classification to be followed by NBFC-MFIs.

(v) The MFI Regulations also prescribe the nature of loans that can be extended by NBFC-MFIs including conditions on the maximum amount to be lent to an individual household, tenure of the loans, prohibiting collateral and on periodicity of repayment of loans. The MFI Regulations prescribe certain "fair lending practices" which each NBFC-MFI must adhere to.

3.1.5 Producer Companies[13]

A producer company ("Producer Company") is a separate category of companies under the Companies Act[14], incorporated by individuals or institutions such as co-operative societies, for the mutual benefit and welfare of its members. Membership of a Producer Company is restricted to persons who are engaged in an activity connected with, or related to, primary

12 RBI circular dated 2 December 2011 (DNBS.CC.PD.No. 250/03.10.01/2011-12) (http://rbi.org.in/scripts/NotificationUser.aspx?Id=6857&Mode=0)
13 Section 581A of Companies Act
14 Section 581A to 581ZT of the Companies Act

produce. Primary produce has been defined as the produce of farmers arising from agriculture including animal husbandry, horticulture, floriculture, pisciculture, viticulture, forestry, forest products, re-vegetation, bee raising and farming plantation products; produce of persons engaged in handloom, handicraft and other cottage industries; by-products of such products; and products arising out of ancillary industries.

A Producer Company can be formed by ten or more individuals (who are producers) or two or more producer institutions, or a combination of the two and can only conduct the activities for which it has been incorporated. A co-operative society such as a multi-state co-operative society established under the MCS Act can be converted into a Producer Company. Producers such as farmers cultivating the same crop often come together to form a Producer Company to work for their collective benefit.

3.1.6 Alternative Investment Funds

(i) An AIF is a fund established or incorporated in India as a trust, a company, a limited liability partnership or a body corporate which is a privately pooled investment vehicle with clearly defined investment objectives. AIFs include private equity funds and social venture funds.

(ii) An SVF is defined in the SEBI (Alternative Investment Funds) Regulations, 2012 (the "AIF Regulations")[15] as an AIF that invests primarily in the securities or units of social ventures that meet the social performance norms prescribed by the fund and whose investors may agree to receive restricted or muted returns.

(iii) A social venture is an entity (such as a trust, society or company) formed to promote social welfare or to solve social problems or to provide social benefits and includes:

- (a) registered public charitable trusts;
- (b) societies registered for charitable purposes or for promotion of science, literature, or fine arts;
- (c) Section 25 Companies; and
- (d) MFIs.

(iv) SVFs have to be registered with SEBI as Category I AIFs which invest in start-up or early stage ventures or social ventures or small and medium enterprises or infrastructure or other sectors or areas which the government or regulators consider as socially or economically desirable.

15 http://www.sebi.gov.in/cms/sebi_data/attachdocs/1337601524196.pdf

(v) Investments by AIFs

(a) The AIF Regulations prescribe certain investment conditions for category I AIFs, such as an SVF. An SVF cannot borrow or leverage funds, directly or indirectly except to meet temporary requirements. A category I AIF cannot invest more than 25 per cent. of its corpus in one company

(b) Additional conditions applicable to investments by an SVF are:

(I) at least 75 per cent. of the fund corpus has to be invested in unlisted securities or partnership interest of social ventures;
(II) an SVF can give grants to social ventures provided it makes a disclosure to this effect while raising funds; and
(III) an SVF can accept returns on investments that are lower than prevalent returns on other similar investments.

(vi) An SVF can invest in public charitable trusts (such as those registered under the BPTA) and societies registered under the SRA. SVFs can also invest in units or securities issued by Section 25 Companies or Producer Companies and MFIs. However, as the AIF Regulations have been recently notified, there is no clarity about the scope and nature of grants that an SVF can give or receive.

(vii) Investments in AIFs / SVFs

(a) AIFs can raise funds by issuing units to resident or non-resident investors. Each scheme of an AIF must have a corpus of at least INR250 million with a minimum investment of INR10 million by each investor. An AIF cannot solicit or collect funds except by private placement.

(b) SVFs can accept grants provided that the proceeds are invested in unlisted securities or partnership interests of social ventures (as discussed in paragraph 3.1.6(v)(b)(I) above).

(viii) Tax treatment

In its Press Release dated 2 April 2012, SEBI has indicated that it will take up with government to extend the pass through status to AIFs.

3.2 Investments in trusts or societies

3.2.1 Charitable Contributions or Donations

(i) Trusts and societies can receive contributions from non-residents by way of charitable contributions or donations in accordance with the FCRA. (See paragraph 4.4 below.)

(ii) As trusts and societies do not have share capital, equity investments by way of FDI are not permitted.

3.2.2 ECB

Trusts and societies are permitted to avail foreign currency loans or ECB only if they are NGOs engaged in micro-finance activities. (See paragraphs 4.1.4 and 4.1.5 below.)

3.3 Investments in Section 25 Companies

3.3.1 Equity and Donations

(i) Section 25 Companies can receive investments by way of FDI against issue of equity or preference shares subject to compliance with the FDI Policy and FEMA (described in paragraph 4.3 below). As discussed in paragraph 3.1.3 above, Section 25 Companies are not permitted to declare dividends and have to reinvest their income towards their stated objectives.

(ii) Section 25 Companies can also receive contributions in the form of donations or gifts subject to compliance with FCRA (described in paragraph 4.4 below).

3.3.2 Conditions for ECB

A Section 25 Company is not permitted to avail ECBs unless it is involved in micro-finance activities. (See paragraph 3.1.4 above.)

3.4 Investments in micro-finance companies

3.4.1 Equity investments

Micro-finance companies are eligible to receive FDI up to 100% of their share capital. FDI Policy classifies such companies as NBFCs and prescribes minimum capitalisation norms. NBFCs involved in fund-based activities such as micro-finance and treasury services are subject to minimum capitalisation norms based on the extent of foreign shareholding. The minimum amount of FDI that can be made in an NBFC is

USD500,000 for shareholding up to 51% and the minimum foreign investment required for FDI up to 100% is USD50 million. Minimum foreign investment in NBFCs involved in non-fund based activities, such as investment advisory and financial consultancy is USD500,000 irrespective of the extent of foreign shareholding in the company.

3.4.2 Conditions for ECB

Section 25 Companies involved in micro-finance activities and NBFC-MFIs are permitted to avail of ECBs. (See paragraph 4.1.4 below).

3.5 Investments in Producer Companies

Investments in producer companies can be made in the form of ECB or equity investments in the manner described below. (See paragraphs 4.1 to 4.3 below).

4 Forms of Investment

4.1 Foreign currency loans

4.1.1 Regime on ECB

(i) The main objective of the ECB policy is to provide flexibility in borrowings by Indian corporates while maintaining prudent limits for total external borrowings. The guiding principles for the ECB policy are to keep the maturity of relevant commercial loans long, costs low, and encourage infrastructure and export sector financing, all of which are crucial for overall growth of the Indian economy.

(ii) The ECB policy focuses on three aspects of each ECB:

- (a) eligibility criteria for accessing external markets;
- (b) the total volume of borrowings to be raised, their maturity structure and cost; and
- (c) end use of the funds raised.

(iii) A company can raise ECBs in the form of bank loans, buyers' credit, suppliers' credit and securitised instruments (such as floating rate notes and fixed rate bonds, non-convertible, optionally convertible or partially convertible preference shares) from non-resident lenders with a minimum average maturity of three years. ECBs can be accessed under the 'automatic route' or the 'approval route'.

4.1.2 Automatic Route

(i) Term and Amount: To qualify for the Automatic Route, the term of a loan must be for a specified minimum average maturity (three years for loans up to USD20 million (or its equivalent) or five years for loans above USD20 million and up to USD750 million (or its equivalent)).

(ii) Eligible Borrowers: There are restrictions on the types of entities that are eligible to raise ECBs under the Automatic Route. Companies registered under the Indian Companies Act, 1956 and infrastructure finance companies are eligible, but individuals, trusts, non-profit organisations (except as discussed in paragraph 4.1.4 below) and financial intermediaries such as banks, financial institutions, housing finance companies and NBFCs (other than infrastructure finance companies) are not eligible.

(iii) Recognised Lenders: Only certain categories of sources are permitted to extend ECBs to Indian companies. Foreign collaborators[16] and foreign equity holders, among others, are permitted lenders. For an ECB of more than USD5 million from a foreign equity holder, the lender must directly hold at least 25 per cent of the paid up equity capital of the Indian borrower and the proposed ECB from the shareholder should not exceed four times the direct foreign equity holding. Other eligible lenders include international banks, multilateral financial institutions, government owned development financial institutions and export credit agencies.

(iv) All-In-Cost Ceiling: The All-In-Cost of an ECB is capped at the following levels (but is subject to review and change from time to time):

AVERAGE MATURITY	ALL-IN-COST
3 years and up to 5 years	6 month LIBOR for the respective currency of borrowing or applicable benchmark + 350 basis points
More than 5 years	6 month LIBOR for the respective currency of borrowing or applicable benchmark + 500 basis points

16 The term foreign collaborators is not defined in any RBI regulations but is generally construed as referring to providers of technology or licensors of intellectual property.

All-in-cost includes interest, other fees and expenses payable in foreign currency but excludes commitment fees, pre-payment fees, fees payable in Indian Rupees and withholding tax paid in Indian Rupees.

(v) Permissible End-Use: ECBs can be raised to finance the import of capital goods, new projects, modernisation or expansion of existing production units in the industrial sector and the infrastructure sector, among others. Permissible end uses also include lending to self-help groups or for bona fide micro-finance activity including capacity building by NGOs engaged in micro-finance activities.

Borrowers can either keep the ECB proceeds outside India by investing them in specified liquid assets or remit these funds to India for credit to the borrower's Rupee accounts in India, in each case pending utilisation for permissible end uses. However, ECBs raised for Rupee expenditure in India such as on-lending to self help groups or for micro-credit have to be repatriated immediately to India.

(vi) End-Use Restrictions: ECBs cannot be used for on-lending (other than for micro-finance as discussed in paragraph (v) above), investment in the capital markets, acquiring shares in a company in India (other than for disinvestments by the government in public sector undertakings), real estate, working capital, general corporate purposes or for refinancing existing Rupee loans.

4.1.3 Approval Route

Under the Approval Route, the RBI will consider permitting loans which do not comply with the minimum maturity period or maximum amounts required under the Automatic Route. The Approval Route contemplates additional flexibility in several areas including (i) eligible borrowers, (ii) the amount of ECBs, (iii) additional end-uses and application towards Rupee expenditure, and (iv) provision of guarantees, stand-by letters of credit etc. by banks, financial institutions and non-banking finance companies in respect of ECBs. In our experience, obtaining RBI approval for an ECB under the Approval Route is a complicated and time consuming process and there is no assurance that such approval will be granted. Moreover, conditions imposed while granting the approval may also lead to difficulties in implementing the proposal.

4.1.4 ECBs to NGOs and MFIs

(i) The following entities engaged in micro-finance activities can avail of ECBs,

(a) societies registered under the SRA;

(b) private trusts registered under the Trusts Act;

(c) MFIs registered as co-operative societies under legislations such as the MCS Act or state legislations governing co-operative or mutually aided co-operative societies (except co-operative banks);

(d) NBFC-MFIs that are compliant with the MFI Regulations; and

(e) companies registered under Section 25 of the Companies Act, 1956 involved in micro-finance activity.

(ii) To avail of ECBs an NGO / MFI should (a) have a satisfactory borrowing relationship for at least three years with a scheduled commercial bank registered as an authorised dealer in foreign exchange with the RBI ("AD"); and (ii) obtain a certificate of due diligence on the 'fit and proper' status of the board of directors or committee of management of the borrower from the AD bank.

(iii) Eligible lenders:

(a) NGOs engaged in micro-finance activities can avail of ECBs from (a) international banks, (b) multilateral financial institutions, (c) export credit agencies (d) overseas organisations and (e) individuals. NGOs engaged in microfinance activities can avail of ECBs denominated in INR, from overseas organisations and individuals.

(b) NBFC-MFIs can avail of ECBs from multilateral institutions, such as IFC, ADB, regional financial institutions, international banks, foreign equity holders and overseas organisations;

(c) Companies registered under Section 25 of the Companies Act and engaged in micro-finance can avail of ECBs from international banks, multilateral financial institutions, export credit agencies, foreign equity holders, overseas organizations and individuals; and

(d) Other MFIs can avail of ECBs from international banks, multilateral financial institutions, export credit agencies, overseas organizations and individuals.

(iv) Overseas organisations complying with the following conditions are permitted to provide ECB to NGOs engaged in micro-finance activities and MFIs:

(a) Overseas organisations proposing to lend ECB are required to furnish to the AD bank of the borrower a certificate of due diligence from an overseas bank, which in turn is subject to the regulations of the host-country regulator and adheres to the FATF guidelines.

(b) The certificate of due diligence should state that (i) the lender has maintained an account with the bank for at least a period of two years; (ii) the lender is organised as per the local laws and held in good esteem by the business/local community; and (iii) that there is no criminal action pending against it.

4.1.5 Other ECB Parameters

NGOs engaged in micro-finance activities and MFIs can avail of ECBs up to USD10 million (or its equivalent) under the Automatic Route[17]. The borrowing entity will have to hedge its foreign currency exposure at the time of drawing down the ECB. All other ECB parameters such as minimum average maturity, all-in-cost ceilings, restrictions on issuance of guarantee, choice of security, parking of ECB proceeds, prepayment, refinancing of ECB, reporting arrangements under the Automatic Route are applicable to MFIs/NGOs availing ECBs.

4.1.6 Tax Implications

(i) Withholding tax on interest payment

(a) Tax rate

In accordance with section 115A of the Income-tax Act, 1961 ("ITA")[18], interest arising to a non-resident / foreign company on moneys borrowed or debt incurred by an Indian concern in foreign currency is generally liable to tax @ 20% (plus applicable surcharge and cess) of the gross amount of interest. A concessional tax rate of 5% (plus applicable surcharge and cess) is available during 1 July 2012 and 1 July 2015 under an agreement specifically approved by the Central Government in this regard, subject to prescribed conditions.

In accordance with the provisions of the ITA, a taxpayer is given an option to be governed by the provisions of the ITA or the tax treaty, whichever is more beneficial to the taxpayer.

17 RBI/2011-12/304 A.P. (DIR Series) Circular No. 59 ECB for MFIs and NGOs engaged in micro-finance activities under Automatic Route dated 19 December 2011 (http://www.rbi.org.in/scripts/NotificationUser.aspx?Id=6876&Mode=0)
18 Income-tax Act, 1961 (http://law.incometaxindia.gov.in/DIT/Income-tax-acts.aspx)

India has entered into a tax treaty with the US. In accordance with article 11 of the tax treaty, interest arising in India received by a resident of the US who is the beneficial owner of the interest is liable to tax in India @ 15% of the gross amount.

To avail of this concessional rate, the US organisation should be a tax resident of the US in terms of the India-US tax treaty, should not have a permanent establishment in India and should have a tax residency certificate issued by the US tax authorities, containing the prescribed particulars, indicating its eligibility to claim benefits of the tax treaty. It may be noted that the tax residency certificate is a necessary but not sufficient condition for availing the treaty benefits. It may be noted that the Indian tax authorities have challenged the eligibility of exempt organisations to claim tax treaty benefits in the past – this issue needs to be addressed based on the specific facts of each US organisation.

(b) Withholding tax

In accordance with section 195, any person paying interest to a non-resident / foreign company is required to withhold tax at the time of credit of such income to the account of the payee or at the time of payment thereof, whichever is earlier. In case the benefits of the tax treaty are available, the withholding tax would be at the rate specified in the tax treaty.

The ITA further provides that any person entitled to receive any sum which attracts withholding tax is required to furnish its Permanent Account Number ("PAN"), i.e. tax identification number in India, to the person responsible for withholding tax. In the absence of furnishing the PAN, broadly speaking, the withholding tax would be the higher of the following amounts:

- rate specified under the ITA / tax treaty;
- rate of 20%.

In other words, in case the US organisation does not have a PAN in India, the beneficial tax rate of 15% under the India-US tax treaty would not be available. To avoid additional tax liability in India, it may be advisable for the US organisation to obtain a PAN.

It may be noted that generally speaking the payer of income is required to obtain a certificate from the income-tax authorities or from a Chartered Accountant certifying the rate at which tax is required to be withheld.

(ii) Compliance obligations for recipient of interest i.e. the US organisation

(a) Income-tax return

In accordance with the provisions of the ITA, the US organisation will have to file a return of income in India for the interest earned. The Indian tax year is 1 April to 31 March. The return is generally required to be filed by the following 31 July in the case of non-corporate taxpayers and 30 September in the case of corporate taxpayers. The due date gets extended to 30 November in the case the transfer pricing provisions apply.

In accordance with the provisions of section 115A, if the total income of the taxpayer consists only of specified interest income and the tax on the said income is appropriately withheld, the taxpayer is not liable to file a return of income in India. In other words, if the only income of the US organisation is interest income governed by the provisions of section 115A and tax has been appropriately withheld, there is no requirement for the US organisation to file a return. It may however be noted that this exemption will not apply when the benefit of the India-US tax treaty is availed.

(b) Transfer pricing

In case the transfer pricing provisions are applicable (please see (iv) below), the US organisation will be required to: (a) obtain a Chartered Accountant's certificate in relation to transfer pricing and file it before the due date of filing the income-tax return; and (b) maintain documentation to support that the transaction is at arm's length.

(c) Tax audit report

The Indian tax law requires a taxpayer to obtain a tax audit report from a Chartered Accountant on or before 30 September or 30 November as the case may be, in case the turnover from business exceeds INR10 million. This report essentially contains details of disallowances in the computation of taxable income. It can be argued that this provision does not apply to the US organisation as: (a) the interest income is taxable on gross basis; and (b) the income is not derived from a 'business' of the US organisation. In case the income-tax authorities dispute this position, the matter may have to be litigated in appeal.

(iii) Deductibility of interest paid on loan in the hands of the payer

Generally speaking, interest paid in respect of capital borrowed for business purposes is tax deductible under the ITA. An exception to this rule is interest paid on borrowings for acquisition of an asset, in which case the interest relatable to the period prior to when it is put to use is capitalised as part of the asset cost and is not treated as revenue expenditure (interest on borrowings after the asset is put to use is tax deductible). It may also be noted that the deductibility of the interest may be subject to other conditions, including withholding of appropriate tax on the interest; moreover, interest paid to earn exempt income is not deductible.

A separate regime exists for taxation of charitable organisations in India that have been granted approvals for tax exemption. Broadly speaking, the income of the charitable organisation is considered as per the books of account. To the extent such income is applied for charitable purposes or accumulated for future use (subject to limits), the income is exempt from tax.

Broadly speaking, the income of a trust or institution carrying on any object of general public utility (other than relief of the poor, education, medical relief, preservation of environment and preservation of monuments / places / objects of artistic or historic interest) will not be exempt if its object involves the carrying on of: (1) any activity in the nature of trade, commerce or business; (2) any activity of rendering of any service in relation to any trade, commerce or business, fees or consideration for which exceeds INR2.5 million.

The Central Board of Direct Taxes, the body governing direct taxes in India, issued a circular in 1973 which states that where a trust incurs a debt for the purposes of the trust, repayment of the loan originally taken to fulfil one of the objects of the trust will amount to an application of income for charitable purposes. Indian Courts have also held that in case money is borrowed for construction of a building that augments the income of the trust, the repayment of debt amounts to application of income.

The above are generic guidelines in relation to broad tax implications and the facts and circumstances of each charitable organisation need to be examined in detail to determine tax deductibility.

(iv) Transfer pricing regulations

The transfer pricing regulations essentially provide that any income arising from an international transaction between associated enterprises shall be computed having regard to the arm's length price.

Broadly speaking, the criteria for an enterprise to be regarded as an associated enterprise of another are management or control or capital. In simple terms, enterprises of the same group are considered as associated enterprises.

There is a special provision under the ITA which provides that two enterprises shall be deemed to be associated enterprises, if at any time during the financial year (1 April to 31 March), a loan advanced by one enterprise (say, US organisation) to the other enterprise (say, Indian organisation) constitutes not less than 51% of the book value of the total assets of the other enterprise (i.e. Indian organisation). Accordingly, if this threshold is breached, the US and Indian organisations shall be deemed to be associated enterprises and the transfer pricing regulations will be triggered.

4.2 Overseas credit support for domestic loans

4.2.1 Guarantees for "plain vanilla" loans

(i) Non-resident entities can extend guarantees on behalf of Indian entities in relation to domestic rupee denominated loans availed by such Indian entities. The provisions of FEMA will not apply to such guarantees until the guarantee is invoked and the non-resident guarantor is required to make payments to the domestic lender. The resident borrower can reimburse the non-resident guarantor for payments made by it under the guarantee provided that such reimbursement is capped at the rupee equivalent of the amount paid by the non-resident guarantor. The exchange rate risk and accruing interest and expenses therefore cannot be claimed by the guarantor. The non-resident guarantor can make the payment under the guarantee by (a) payment out of rupee balances a non-resident account of the guarantor maintained in India; (b) by remitting funds into India; or (c) by debit to a foreign currency account of the guarantor maintained with an AD bank in India.

(ii) The guarantor will be permitted to repatriate amounts recovered from the Indian borrower if the guarantee has been discharged through an inward remittance from the guarantor to the Indian lenders or by debiting its foreign currency accounts in India. However, if the liability is discharged by payment out of rupee balances the amount recovered can only be credited to the non-resident account of the guarantor maintained in India.

4.2.2 Structured obligations — credit enhancement

(i) The ECB Regulations permit credit enhancement by way of guarantees extended by non-resident entities in relation to domestic loans availed by companies engaged exclusively in the infrastructure sector and infrastructure finance companies, meeting certain conditions. The guarantees can be provided by multi-lateral or regional financial institutions, government owned development financial institutions or non-resident shareholders.

(ii) Applicable conditions under the automatic route include a minimum average maturity of seven years for the underlying debt and a cap of 2 per cent of the principal amount on the guarantee fee and other costs for the credit enhancement.

(iii) The debt has to be raised through capital market instruments such as debentures and bonds and cannot be prepaid or have put options for the average maturity period of seven years.

(iv) The resident borrower can repay the guarantor in foreign currency for payments made under the guarantee and the all in cost ceiling described in paragraph 4.1.2 (iv) will be applicable.

4.2.3 Other forms of permitted credit support

Overseas suppliers, banks and financial institutions are permitted to extend trade credits to Indian entities for imports into India. Such credit facilities are not factored towards the ECBs of the Indian entity if the maturity period is less than three years. AD banks can approve trade credits for imports into India up to USD20 million per import transaction for imports permitted within the foreign trade policy of India. The all-in-cost ceiling for such facilities is 200 basis points over the six-month LIBOR.

4.2.4 Tax implications

We are proceeding on the assumption that a guarantee fee shall be charged by the US organisation to provide credit support overseas to enable the Indian charitable organisation to obtain a domestic loan.

(i) Withholding tax on guarantee fees

(a) Tax rate

The term ‘interest’ is defined under the ITA to mean interest payable in any manner in respect of any moneys borrowed or debt incurred and includes any service fee or other charge in respect of the moneys borrowed or debt incurred or in respect of any credit facility which has not been utilised. The definition of interest is very wide under the ITA and guarantee fees would come within the purview of this definition.

Section 115A of the ITA contains a special regime for interest arising to a non-resident / foreign company on moneys borrowed or debt incurred by an Indian concern in foreign currency. In the present case, as the borrowings would be in Indian currency, the provisions of section 115A will not apply. The tax in this scenario would be on the net amount of interest i.e. on the profits. The applicable tax rate would be 40% (plus applicable surcharge and cess) in case of a corporate entity and 30% (plus applicable surcharge and cess) in case of a non-corporate entity.

In accordance with the provisions of the ITA, a taxpayer is given an option to be governed by the provisions of the ITA or the tax treaty, whichever is more beneficial to the taxpayer.

The definition of 'interest' under the India-US tax treaty is narrow and effectively covers only income from debt claims of every kind. The guarantee fees are unlikely to be covered by this definition. Depending on the nature of the US organisation, the income could either be classified as 'business income' (article 7) or 'other income' (article 23). In case the guarantee fees are characterised as 'business income', the US organisation will not be liable to tax in India provided it does not have a permanent establishment in India. On the other hand, if the guarantee fees are characterised as 'other income', it is liable to tax in India if it arises in India. There are no guidelines for determining the place where income has arisen – this is to be determined on all the facts of the case, including the location of the borrower, the location of the party issuing the guarantee, the location of the party in whose favour the guarantee is issued, the place where the guarantee agreement is signed, etc. If the agreement is signed outside India, it may be possible to take a position that the income accrues outside India, although in the present case this position appears difficult to sustain since the borrower is an Indian organisation and the lender would be an Indian entity. In our view, if the guarantee fees are characterised as 'other income', the fees would arise in India and would be liable to tax in India 40% / 30% (plus applicable surcharge and cess) of the net amount of interest.

To avail of the concessional treatment in case the guarantee fees are characterised as 'business income', the US organisation should be a tax resident of the US in terms of the India-US tax treaty and should have a tax residency certificate issued by the US tax authorities, containing the prescribed particulars, indicating its eligibility to claim benefits of the tax treaty. It may be noted that the tax residency certificate is a necessary but not sufficient condition for availing the treaty benefits. It may be noted that the Indian tax authorities have challenged the eligibility of exempt organisations to claim tax treaty benefits in the past – this issue needs to be addressed based on the specific facts of each US organisation.

The summary of the tax position under various scenarios is indicated in the table below.

SCENARIO	TAX RATE
Benefits of India-US tax treaty are not available	40% / 30% (plus applicable surcharge and cess) of the net amount of interest
Benefits of India-US tax treaty are available:	
• Income is characterised as 'business income'	Nil (in the absence of PE)
• Income is characterised as 'other income'	40% / 30% (plus applicable surcharge and cess) of the net amount of interest

(b) Withholding tax

In accordance with section 195, any person paying interest to a non-resident / foreign company is required to withhold tax at the time of credit of such income to the account of the payee or at the time of payment thereof, whichever is earlier. In case the benefits of the tax treaty are available, the withholding tax would be at the rate specified in the tax treaty.

The ITA further provides that any person entitled to receive any sum which attracts withholding tax is required to furnish its PAN to the person responsible for withholding tax. In the absence of furnishing the PAN, broadly speaking, the withholding tax would be the higher of the following amounts:

- rate specified under the ITA / tax treaty;
- rate of 20%.

In other words, in case the US organisation does not have a PAN in India, the beneficial tax treatment under the India-US tax treaty would not be available. To avoid additional tax liability in India, it may be advisable for the US organisation to obtain a PAN where the treaty benefits are claimed.

It may be noted that generally speaking the payer of income is required to obtain a certificate from the income-tax authorities or from a Chartered Accountant certifying the rate at which tax is required to be withheld.

In the present case, as the income is taxable on 'net' basis, the certificate will have to be obtained from the income-tax authorities. In the absence of a certificate, the withholding tax would be @ 40% / 30% (plus applicable surcharge and cess) on the gross amount of interest.

(ii) Compliance obligations for recipient of guarantee fees i.e. the US organisation

(a) Income-tax return

In accordance with the provisions of the ITA, the US organisation will have to file a return of income in India for the guarantee fees earned. The Indian tax year is 1 April to 31 March. The return is generally required to be filed by the following 31 July in the case of non-corporate taxpayers and 30 September in the case of corporate taxpayers. The due date gets extended to 30 November in the case the transfer pricing provisions apply.

(b) Transfer pricing

In case the transfer pricing provisions are applicable (please see (iv) below), the US organisation will be required to: (a) obtain a Chartered Accountant's certificate in relation to transfer pricing and file it before the due date of filing the income-tax return; and (b) maintain documentation to support that the transaction is at arm's length.

(c) Tax audit report

The Indian tax law requires a taxpayer to obtain a tax audit report from a Chartered Accountant on or before 30 September or 30 November as the case may be, in case the turnover from business exceeds INR10 million. This report essentially contains details of disallowances in the computation of taxable income.

(iii) Deductibility of guarantee fees in the hands of the payer

Generally speaking, guarantee fees are tax deductible under the ITA. This may be subject to other conditions, including withholding of appropriate tax on the fees.

A separate regime exists for taxation of charitable organisations in India that have been granted approvals for tax exemption. Broadly speaking, the income of the charitable organisation is considered as per the books of account. To the extent such income is applied for charitable purposes or accumulated for future use (subject to limits), the income is exempt from tax.

Broadly speaking, the income of a trust or institution carrying on any object of general public utility (other than relief of the poor, education, medical relief, preservation of environment and preservation of monuments / places / objects of artistic or historic interest) will not be exempt if its object involves the carrying on of: (1) any activity in the nature of trade, commerce or business; (2) any activity of rendering of any service in relation to any trade, commerce or business, fees or consideration for which exceeds INR2.5 million.

The above are generic guidelines in relation to broad tax implications and the facts and circumstances of each charitable organisation need to be examined in detail to determine tax deductibility.

(iv) Transfer pricing regulations

The transfer pricing regulations essentially provide that any income arising from an international transaction between associated enterprises shall be computed having regard to the arm's length price.

Broadly speaking, the criteria for an enterprise to be regarded as an associated enterprise of another are management or control or capital. In simple terms, enterprises of the same group are considered as associated enterprises.

There is a special provision under the ITA which provides that two enterprises shall be deemed to be associated enterprises, if one enterprise (say, US organisation) guarantees not less than 10% of the total borrowings of the other enterprise (say, Indian organisation). Accordingly, if this threshold is breached, the US and Indian organisations shall be deemed to be associated enterprises and the transfer pricing regulations will be triggered.

4.3 Equity Investments

4.3.1 Regulatory regime

(i) FDI in India is made by way of subscription to and/or purchase of securities of, an Indian company by a non-resident investor. As discussed in paragraph 1.2 above, foreign investments in India are governed by the FDI Policy and FEMA.

(ii) As with ECBs, the FDI Policy provides for two routes for FDI, the 'automatic route' and the 'approval route'. An investment falls under the automatic route if the FDI is within the limits indicated by the Central Government for that particular sector (expressed as a percentage of foreign shareholding in a company in the specified sector). In case of investment under the automatic route a non-resident investor does not have to obtain any formal consent prior to making an investment but is required to file a declaration setting out the details of the investment with the RBI within 30 days of making the investment.

(iii) The proposal must be approved by the Foreign Investment Promotion Board established under the Ministry of Finance, Government of India if the FDI proposal is outside the sector specific limits prescribed by the Central Government for the automatic route and/or if the investment proposal fails to satisfy any conditions set out in the FDI Policy.

(iv) Entities into which FDI is permitted are companies incorporated under the Companies Act (such as Section 25 Companies and NBFC-MFIs incorporated as companies) and limited liability partnerships formed under the Limited Liability Partnership Act, 2008, subject to the compliance with certain conditions. Foreign investors are also permitted to establish liaison offices, branch offices and project offices for specific purposes.

4.3.2 Investment limits

The FDI Policy permits 100% foreign shareholding in most business sectors including micro-finance institutions. Investment in certain sectors such as telecom, aviation, insurance and banking is subject to sectoral caps. FDI in the manufacture of certain items which have been reserved for micro and small enterprises is also subject to limits. FDI is permitted only in equity and preference shares or debentures that are mandatorily and fully convertible into equity shares.

4.3.3 Pricing of shares

(i) The RBI regulates the pricing of shares of Indian companies:

(a) issued to non-residents;

(b) transferred by a resident to a non-resident; and

(c) transferred by a non-resident to a resident.

(ii) Pricing of shares of unlisted companies has to be based on the fair value of the shares as determined by a registered merchant banker or a Chartered Accountant.

(iii) Pricing of shares of a listed company has to be in accordance with the guidelines issued by Securities and Exchange Board of India, the securities regulator.

4.3.4 Returns on investment

(i) Non-resident investors are permitted to freely repatriate dividends earned on their shares in Indian companies (other than Section 25 Companies) subject to applicable taxes.

(ii) Similarly, proceeds of sale of shares of an Indian company can also be repatriated, subject to applicable taxes.

(iii) Dividend and interest on convertible debentures paid to non-residents are repatriable subject to applicable taxes

4.3.5 Tax implications

(i) Dividend regime in India

In terms of the provisions of the ITA, every Indian company is required to pay dividend distribution tax @ 16.22% on distribution of dividend.

Correspondingly, the dividend is exempt from tax in the hands of the shareholder i.e. the US organisation. It may be noted that as the dividend is exempt from tax, there is no withholding tax on dividends.

(ii) Treatment of interest on convertible debentures

(a) Tax rate

In accordance with section 115A of the ITA, interest arising to a non-resident / foreign company on moneys borrowed or debt incurred by an Indian concern in foreign currency is generally liable to tax @ 20% (plus applicable surcharge and cess) of the gross amount of interest. It may be noted that the debentures will be denominated in Indian rupees and accordingly the provisions of section 115A may not apply. In this scenario, the interest will be taxed on net basis @ 40% (plus applicable surcharge and cess) in case of a corporate entity and 30% (plus applicable surcharge and cess) in case of a non-corporate entity.

In accordance with the provisions of the ITA, a taxpayer is given an option to be governed by the provisions of the ITA or the tax treaty, whichever is more beneficial to the taxpayer.

India has entered into a tax treaty with the US. In accordance with article 11 of the tax treaty, interest arising in India received by a resident of the (US, who is the beneficial owner of the interest is liable to tax in India @ 15% of the gross amount.

To avail of this concessional rate, the US organisation should be a tax resident of the US in terms of the India-US tax treaty, should not have a permanent establishment in India and should have a tax residency certificate issued by the US tax authorities, containing the prescribed particulars, indicating its eligibility to claim benefits of the tax treaty. It may be noted that the tax residency certificate is a necessary but not sufficient condition for availing the treaty benefits. It may be noted that the Indian tax authorities have challenged the eligibility of exempt organisations to claim tax treaty benefits in the past – this issue needs to be addressed based on the specific facts of each US organisation.

Post conversion of the debentures into equity shares, the Indian company is required to pay dividend distribution tax @ 16.22%. Correspondingly, the dividend is exempt from tax in the hands of the shareholder i.e. the US organisation and there will not be any withholding tax.

(b) Withholding tax

In accordance with section 195, any person paying interest to a non-resident / foreign company is required to withhold tax at the time of credit of such income to the account of the payee or at the time of payment thereof, whichever is earlier. In case the benefits of the tax treaty are available, the withholding tax would be at the rate specified in the tax treaty.

The ITA further provides that any person entitled to receive any sum which attracts withholding tax is required to furnish its PAN to the person responsible for withholding tax. In the absence of furnishing the PAN, broadly speaking, the withholding tax would be the higher of the following amounts:

- rate specified under the ITA / tax treaty;
- rate of 20%.

In other words, in case the US organisation does not have a PAN in India, the beneficial tax rate of 15% under the India-US tax treaty would not be available. To avoid additional tax liability in India, it may be advisable for the US organisation to obtain a PAN.

It may be noted that generally speaking the payer of income is required to obtain a certificate from the income-tax authorities or from a Chartered Accountant certifying the rate at which tax is required to be withheld.

(c) Deductibility of interest in the hands of the Indian company

Generally speaking, interest paid in respect of capital borrowed for business purposes is tax deductible under the ITA. An exception to this rule is interest paid on borrowings for acquisition of an asset, in which case the interest relatable to the period prior to when it is put to use is capitalised as part of the asset cost and is not treated as revenue expenditure (interest on borrowings after the asset is put to use is tax deductible). It may also be noted that the deductibility of the interest may be subject to other conditions, including withholding of appropriate tax on the interest; moreover, interest paid to earn exempt income is not deductible.

It may be noted that as the debentures are compulsorily convertible into equity shares, the income-tax authorities may attempt to take a position that the interest on such debentures is not in the nature of 'interest' but is 'dividend' which is not deductible. In this scenario, the matter may have to be litigated in appeal.

(iii) Tax implications on sale of shares, including withholding tax

(a) Tax liability, computation and rate

Under the Indian tax law, a non-resident / foreign company is liable to tax in India on sale of shares of an Indian company. Article 13 of the India-US tax treaty provides that each Contracting State may tax capital gains in accordance with the provisions of its domestic law. Accordingly, the sale of shares of an Indian company by a US organisation will be liable to tax in India.

The capital gains on sale of shares shall be computed as under:

Sales consideration	XXX
Less: Cost of acquisition	XXX
Expenditure incurred wholly and exclusively in connection with transfer	XXX
	XXX
Capital gains	XXX

The computation of capital gains is to be made in foreign currency and thereafter the capital gains are to be converted in Indian Rupees.

The rate of tax on sale of unlisted shares is presently as under:

- Long-term capital gains (shares held for more than 12 months):
- Sale of unlisted securities – 10% (plus applicable surcharge and cess); capital gains are to be computed in Indian Rupees
- Other cases – 20% (plus applicable surcharge and cess)
- Short-term capital gains (shares held for 12 months or lesser):
- Seller is a corporate entity – 40% (plus applicable surcharge and cess)
- Seller is a non-corporate entity – 30% (plus applicable surcharge and cess)

(b) Withholding tax

The buyer of the shares is required to withhold the appropriate amount of tax and deposit the tax with the Indian government; the payment to the US organisation will be net of tax. The withholding tax provisions apply even if the buyer of shares is a non-resident / foreign company from the Indian income-tax perspective. For this purpose, the buyer of shares will be required to register with the tax authorities, make arrangements for payment of tax, issue a withholding tax certificate to the US organisation, file a withholding tax return, etc.

(iv) Compliance obligation for seller of shares i.e. US organisation

(a) Income-tax return

In accordance with the provisions of the ITA, the US organisation will have to file a return of income in India for the interest earned. The Indian tax year is 1 April to 31 March. The return is generally required to be filed by the following 31 July in the case of non-corporate taxpayers and 30 September in the case of corporate taxpayers. The due date gets extended to 30 November in the case the transfer pricing provisions apply.

It may be noted that in case the foreign buyer of shares has not withheld tax for any reason, the US organisation is required to *suo moto* pay the tax (along with interest, if any) before filing the return of income.

(b) Transfer pricing

In case the transfer pricing provisions are applicable (please see (vi) below), the US organisation will be required to: (a) obtain a Chartered Accountant's certificate in relation to transfer pricing and file it before the due date of filing the income-tax return; and (b) maintain documentation to support that the transaction is at arm's length.

(v) Intermediary holding company structures

Many companies use holding company structures for investment into India. The advantage of using an appropriate holding company structure is that it is tax efficient.

It may however be noted that the Indian tax authorities have been challenging such structures, especially in the recent past. Moreover, a general anti-avoidance rule is being introduced from 1 April 2013. The 'indirect' transfer of an Indian company will also attract capital gains tax liability in India.

The possibility of using an intermediary holding company structure needs to be examined by each US organisation based on its particular facts, taking into account the tax position in India at that point in time.

(vi) Transfer pricing regulations

The transfer pricing regulations essentially provide that any income arising from an international transaction between associated enterprises shall be computed having regard to the arm's length price.

Broadly speaking, the criteria for an enterprise to be regarded as an associated enterprise of another are management or control or capital. In simple terms, enterprises of the same group are considered as associated enterprises.

Accordingly, if the US organisation and the buyer are associated enterprises, the transfer pricing regulations will be triggered.

4.4 Foreign Contributions

4.4.1 Regulatory framework

(i) The FCRA regulates the acceptance and utilisation of foreign contributions by certain individuals, trusts, societies and Section 25 companies in India.

(ii) Foreign contributions include donations, delivery or transfer of foreign currency or security from a foreign source, whether direct or indirect. Charitable contributions from foreign sources will also be regulated by the FCRA.

(iii) The FCRA does not apply to investments in equity or foreign currency loans.

4.4.2 Eligible recipients

(i) Trusts, societies and Section 25 Companies are permitted to receive foreign contributions under the FCRA. Political organisations or parties or officer bearers thereof, government employees and persons involved in news media are not permitted to receive foreign contributions.

(ii) All eligible recipients "having a definite cultural, economic, educational, religious or social programme" are required to obtain a certificate of registration under the FCRA to receive foreign contributions. If an entity which has not obtained such registration proposes to receive foreign contributions, it will have to obtain prior approval from the Central Government to receive the contribution.

(iii) To be eligible for registration, an applicant must (a) be a registered society, trust or Section 25 Company; (b) have been in existence for at least three years at the time of applying for registration and have undertaken "reasonable activity in its chosen field for the benefit of society for which the foreign contribution is proposed to be utilised"; and (c) have spent at least INR 600,000 over the three year period on its activities, excluding administrative expenses.

4.4.3 Recognised contributors

(i) Foreign sources under the FCRA include the following:

(a) the government of or government agencies of a foreign country or territory;

(b) foreign companies or corporations;

(c) foreign trusts, foreign foundations, or such trust or foundation mainly financed by a foreign country or territory; and

(d) a society, club or other association of individuals formed or registered outside India.

(ii) Use of contributions for specified purposes

Foreign contributions are permitted to be used only for the stated purpose for which they have been received. Foreign contributions or income earned on such amounts cannot be used for speculative purposes such as investments in stocks. Recipients are permitted to utilise up to 50% of the amount of contributions received in a financial year towards administrative expenses. This cap may be exceeded with the prior approval of the Central Government. Recipients are required to make regular filings in relation to contributions received and to maintain books of accounts.

4.4.4 Appointment of foreign nationals

Organisations having foreign nationals as members of their executive committees or governing bodies are generally not permitted to receive foreign contribution. As an exception, a foreign national can be appointed as a member of the executive committee, after obtaining prior permission of the Central Government, if:

(i) the foreign national is married to an Indian citizen;

(ii) the foreign national has been living and working in India for at least five years;

(iii) the foreign national has made available his/her specialized knowledge, especially in the medical and health related fields on a voluntary basis in India, in the past;

(iv) the foreign national is part of the board of trustees/executive committee in an inter-governmental agreement; or

(v) the foreign national is part of the board of trustee/executive committee, in an ex-officio capacity representing a multilateral body which is exempted from the definition of foreign source. The need for such an appointment should, however, be adequately justified.

4.4.5 Tax implications for the recipient of contribution

A separate regime exists for taxation of charitable organisations in India that have been granted approvals for tax exemption. Broadly speaking, the income of the charitable organisation is considered as per the books of account. To the extent such income is applied for charitable purposes or accumulated for future use (subject to limits), the income is exempt from tax. Voluntary contributions, made with a specific direction that they shall form part of the corpus of the trust or institution, are also exempt from tax.

Broadly speaking, the income of a trust or institution carrying on any object of general public utility (other than relief of the poor, education, medical relief, preservation of environment and preservation of monuments / places / objects of artistic or historic interest) will not be exempt if its object involves the carrying on of: (1) any activity in the nature of trade, commerce or business; (2) any activity of rendering of any service in relation to any trade, commerce or business, fees or consideration for which exceeds INR2.5 million.

The above are generic guidelines in relation to broad tax implications and the facts and circumstances of each charitable organisation need to be examined in detail to determine the taxability of the contribution.

4.5 Foreign Institutional Investors

FIIs are institutions established outside India such as pension funds, collective investment schemes, investment funds, international or multilateral organizations, trusts, university funds, endowments, foundations or charitable trusts or charitable societies and are registered with the Indian securities regulator, SEBI in accordance with the SEBI (Foreign Institutional Investors) Regulations, 1995 (“FII Regulations”).

FIIs are permitted to invest in Government securities or treasury bills, non-convertible bonds or bonds issued by Indian companies, units of domestic mutual funds including corporate debt and infrastructure debt securities[19]. The investment limit in such securities is periodically reviewed by the Government and allocated to FIIs through a bidding process in accordance with SEBI regulations. FIIs can invest in corporate debt securities which are listed or will be listed within a few days after being issued, such as non-convertible debentures.

FIIs can also invest in unlisted bonds issued by companies engaged in the infrastructure sector subject to a lock-in on the investment.

4.5.1 Tax Implications

(i) Withholding tax on interest payment

(a) Tax rate

In accordance with section 115AD of the ITA, interest arising to an FII is liable to tax @ 20% (plus applicable surcharge and cess) of the gross amount of interest.

In accordance with the provisions of the ITA, a taxpayer is given an option to be governed by the provisions of the ITA or the tax treaty, whichever is more beneficial to the taxpayer.

India has entered into a tax treaty with the US. In accordance with article 11 of the tax treaty, interest arising in a Contracting State (India) received by a resident of the other Contracting State (US), who is the beneficial owner of the interest, is liable to tax in India @ 15% of the gross amount.

To avail of this concessional rate, the US FII should be a tax resident of the US in terms of the India-US tax treaty, should not have a permanent establishment in India and should have a tax residency certificate issued by the US tax authorities, containing the prescribed particulars, indicating its eligibility to claim benefits of the tax treaty. It may be noted that the tax residency certificate is a necessary but not sufficient condition for availing the treaty benefits. It may be noted that the Indian tax authorities have challenged the eligibility of exempt organisations to claim tax treaty benefits in the past – this issue needs

19 The ECB Master Circular defines infrastructure sector is defined as (i) power (ii) telecommunication (iii) railways (iv) roads including bridges (v) sea port and airport (vi) industrial parks (vii) urban infrastructure (water supply, sanitation and sewage projects) (viii) mining, exploration and refining and (ix) cold storage or cold room facility, including for farm level pre-cooling, for preservation or storage of agricultural and allied produce, marine products and meat.

to be addressed based on the specific facts of each US FII.

(b) Withholding tax

In accordance with section 195, any person paying interest to a non-resident / foreign company is required to withhold tax at the time of credit of such income to the account of the payee or at the time of payment thereof, whichever is earlier. In case the benefits of the tax treaty are available, the withholding tax would be at the rate specified in the tax treaty.

The ITA further provides that any person entitled to receive any sum which attracts withholding tax is required to furnish its PAN to the person responsible for withholding tax. In the absence of furnishing the PAN, broadly speaking, the withholding tax would be the higher of the following amounts:

- rate specified under the ITA / tax treaty;
- rate of 20%.

In other words, in case the US FII does not have a PAN in India, the beneficial tax rate of 15% under the India-US tax treaty would not be available. FIIs are required to obtain a PAN prior to commencing trading on the Indian market and accordingly it is unlikely that an FII will not have a PAN.

It may be noted that generally speaking the payer of income is required to obtain a certificate from the income-tax authorities or from a Chartered Accountant certifying the rate at which tax is required to be withheld.

(ii) Compliance obligations for recipient of interest i.e. the US FII

(a) Income-tax return

In accordance with the provisions of the ITA, the US-based FII will have to file a return of income in India for the interest earned. The Indian tax year is 1 April to 31 March. The return is generally required to be filed by the following 31 July in the case of non-corporate taxpayers and 30 September in the case of corporate taxpayers. The due date gets extended to 30 November in the case the transfer pricing provisions apply.

(b) Transfer pricing

In case the transfer pricing provisions are applicable (please see (iii) below), the US organisation will be required to: (I) obtain a Chartered Accountant's certificate in relation to transfer pricing and file it before the due date of filing the income-tax return; and (II) maintain documentation to support that the transaction is at arm's length.

(c) Tax audit report

The Indian tax law requires a taxpayer to obtain a tax audit report from a Chartered Accountant on or before 30 September or 30 November as the case may be, in case the turnover from business exceeds INR10 million. This report essentially contains details of disallowances in the computation of taxable income. Generally speaking, FIIs take a position that this provisions do not apply to them.

(iii) Transfer pricing regulations

The transfer pricing regulations essentially provide that any income arising from an international transaction between associated enterprises shall be computed having regard to the arm's length price.

Broadly speaking, the criteria for an enterprise to be regarded as an associated enterprise of another are management or control or capital. In simple terms, enterprises of the same group are considered as associated enterprises.

Acronyms / Definitions

- "AIF" mean alternative investment funds
- "AIF Regulations" means SEBI (Alternative Investment Funds) Regulations, 2012
- "AD" means a scheduled commercial bank registered as an authorised dealer in foreign exchange with the RBI
- "BPTA" means Bombay Public Trusts Act, 1950 which applies to public trusts established in the state of Maharashtra (including Mumbai)
- "Central Government" means the Government of India
- "Companies Act" means the Companies Act, 1956
- "Debt Security Regulations" means SEBI (Issue and Listing of Debt Securities) Regulations 2008
- "ECB" means External commercial borrowings
- "ECB Master Circular" means the Foreign Exchange Management (Borrowing and Lending in Foreign Currency) Regulations, 2000 and various notifications and circulars issued by the RBI from time to time in relation to ECBs, including the Master Circular on ECBs and Trade Credits dated 1 July 2011
- "FATF" means Financial Action Task Force
- "FCRA" means Foreign Contribution Regulation Act, 2010 that regulates charitable contributions to Indian entities
- "FDI" means Foreign Direct Investment
- "FDI Policy" means a consolidated policy on FDI in India issued by the Department of Industrial Policy and Promotion, Government of India
- "FEM Security Regulations" means the Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2000
- "FEMA" means the Foreign Exchange Management Act, 1999
- "FII" means Foreign Institutional Investors
- "FII Regulations" means the SEBI (Foreign Institutional Investors) Regulations, 1995
- "ITA" means the Income-tax Act, 1961

- "MCS Act" means the Multi-state Co-operative Societies Act, 2002
- "MFI" means a micro-finance institution
- "MFI Regulations" means the circular dated 2 December 2011 issued by RBI title "Introduction of New Category of NBFCs - 'Non Banking Financial Company-Micro Finance Institutions' (NBFC-MFIs) – Directions"
- "NBFC" means non-banking financial companies
- "NBFC-MFIs" means NBFCs engaged in micro-finance activities
- "NGOs" means a non-governmental organisation
- "PAN" means Permanent Account Number
- "RBI" means the Reserve Bank of India
- "SEBI" means the Securities and Exchange Board of India
- "Section 25 Companies" — Companies that are incorporated under the Companies Act with a definite cultural, economic, educational, social or religious purpose.
- "SRA" means the Societies Registration Act, 1860
- "SVF" means social venture funds as defined by the AIF Regulations
- "Trust Act" means the Indian Trusts Act, 1882

FRONT COVER PHOTO A boy plays in a salt pan near Bhavnagar, in the western Indian state of Gujarat. REUTERS / Arko Datta

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