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Doing Business in India: Critical Legal Issues for U.S. Companies

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ISSUES RELEVANT FOR FOREIGN
COMPANIES DOING BUSINESS IN INDIA

Shishir Sharma

Dua Associates

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I. INTRODUCTION

In the year 1991, the Government of India ushered in reforms in the form of '*liberalisation*', which made it easier for Multinational companies (MNCs) to operate in India.

Since 1991, the Government of India has taken several initiatives and measures to encourage foreign investment inflows, particularly the flow of Foreign Direct Investment (FDI) into India, especially in specified 'thrust areas', which include infrastructure development, particularly energy, power, telecom and township development.

India has matured over the years from a closed economy to today being a fairly liberalized one and is now placed high on a list of favoured investment destinations. In fact, today not only are foreign investments on the rise but also domestic investments and mergers and acquisitions. It is the fourth largest economy in terms of purchase power parity and the tenth most industrialized country in the world. The World Bank has described India as an "Asian giant" which had risen from 12th to 10th in dollar terms between 2003 and 2004 with the GDP of India overtaking Korea and Mexico. India was then stated to be worth US\$ 692 billion. While services share in overall GDP is over 50% (52.4% share in GDP in 2004-05), the

share of manufacturing sector grew at 8.8% in 2004-05 (17.4% share in GDP in 2004-05). Merchandise exports grew by 25% in 2004-05, and now stood at US\$ 80 billion and the imports grew by 36% to be US\$ 106 billion. With over US\$ 14 billion in 2004-05 (FDI US\$ 5.5 billion, FII US\$ 8.9 billion), foreign exchange reserves of the country as on January 20, 2006 stood at US\$ 139 billion.

Ever since the liberalization and industrial reform process started in the 1990's, the licensing and investment restrictions in various sectors have gradually been done away with. The Industrial Policy resolution of 1956 and the statement on Industrial Policy of 1991 provides for the basic framework for the overall Industrial Policy of the Government of India. Foreign investment in India is regulated by the Foreign Exchange Management Act, 1999 ("FEMA"). Pursuant thereto, the Reserve Bank of India ("RBI") and the Government of India ("Central Government") issue Regulations governing investment into India.

This article highlights some of the key legal issues in foreign investment, competition, taxation and employment that would be of concern a foreign investor looking to invest into India. Depending on the nature of investment into India, a foreign investor would need to obtain appropriate advice on the specific legislations regulating the business both by the Central Government as well as the

Government of the State (“State Government”) where the proposed business activity is to be undertaken.

II. FOREIGN INVESTMENT

Foreign exchange transactions in India are regulated by the Foreign Exchange Management Act, 1999 and the Rules and Regulations framed under it.

(a) Foreign Investment into India

Foreign investment into India is regulated by the Foreign Exchange Management (Transfer or Issue of Security by a person Resident outside India) Regulations, 2000 read with the press releases issued by the Ministry of Industry and Commerce.

While the entry barriers for foreign investment into India have gradually reduced over the years, there are still industries where foreign investment is either completely prohibited (e.g. multi-brand retail) or the quantum of permissible foreign investment is regulated (e.g. telecom).

Foreign investment in India can either be through the “automatic route” or through the “approval route”.

(i) Automatic Route

The Foreign Exchange Management (Transfer or Issue of Security by a Person Resident outside India) Regulations, 2000 provide for FDI entry through the Automatic Route, wherein no prior permission needs to be sought from the RBI. Certain criteria must be adhered to when taking this specific route for investment:

1. The investment should not be in areas where foreign investment is prohibited such as retail trading (except Single Brand Product retailing), gambling/lottery business, atomic energy etc.;
2. The investment, if made in certain sectors, should be within the sectoral equity caps prescribed for those sectors;
3. The investment should be by way of issue of fresh equity and not by way of transfer of shares from existing shareholders;
4. The foreign investor concerned should not already have a previous tie-up or venture in India in the same or allied area of business in which the proposed investment is to be made;
5. The investment should not be in an activity/area which requires an industrial license.
6. The foreign investment, if made in companies in Small Scale Industries, shall not exceed 24 % of the equity of such companies.

While there are no prior permissions that need to be sought under the automatic route, compliance with filings and declarations with the RBI and other relevant government ministries are necessary to follow on receipt of monies from outside India.

(ii) Approval Route

1. Where provisions of Press Note 1 (2005 Series) are attracted;
2. Where more than 24% foreign equity is proposed to be inducted for manufacture

of items reserved for the Small Scale sector.

Special approval of the Foreign Investment Promotion Board ("FIPB") or the Cabinet Committee on Foreign Investment ("CCFI") is required for foreign investment which does not qualify for the automatic approval route. Such approval is granted on a case-by-case basis. This process usually takes about 30 days. The FIPB is under the domain of the Ministry of Commerce and Industry and it has the power to accept or reject proposals for investments up to INR 6 billion. The FIPB sends its recommendations to the Minister of Commerce and Industry for final approval.

While the Ministry of Commerce and Industry will decide each proposal on its merits, it primarily looks at the quantum of investment, employment generation, new technology, export commitment and other possible benefits to India as the main criteria for deciding foreign investment applications.

(b) Minimum Capitalisation

Under the Foreign Exchange Management (Transfer or Issue of Security by a person Resident outside India) Regulations, 2000, foreign investment in specified Non-Banking Financial Companies and permitted real estate projects need to comply with the specified "capitalization norms" (i.e. being the minimum amount with which the Indian company needs to be capitalized by the foreign investor). For non-fund based Non-Banking Financial activities, the Indian

company would need to be capitalised at least to the extent of USD 500,000.

(c) Requirement of a No Objection Certificate from an Indian Partner

In the initial phases of liberalization, 100% FDI was not permitted in India in most industries. This led to foreign investors investing in India in the form of joint ventures with an Indian partner or through franchisee or license arrangements.

In the year 1998, the Ministry of Industry announced Press Note 18 of 1998 inter alia stated that a foreign investor who has a previous joint venture or technology transfer/trade-mark agreement in the same or allied field in India, would inter alia not be able to avail of the benefits of the “automatic” route for the new investment and would also need to obtain a no objection certificate from the existing Indian partner.

The introduction of Press Note 18 of 1998, and the process of further liberalization of entry barriers required to establish wholly owned subsidiaries in India, led to several high profile disputes where the Indian Partner refused to give its consent to the foreign investor for the new venture. Joint ventures such as that of Dabur-Nestle, Modi-Walt Disney, TCL-Baron, Draeger-Usha Group, Graphite India-Amiantit and Kennametal-YK Birla have run into difficulties after the issuance of Press Note 18 of 1998.

In the year 2005, the Ministry of Industry and Commerce reviewed Press Note 18 of 1998

and watered down its effect by introducing Press Note 1 of 2005 and Press Note 3 of 2005. Now, a foreign investor would not be entitled to the benefit of the “automatic route” and require obtaining the no objection of the Indian Partner where it has “an existing” joint venture or technology transfer/trade-mark agreement in the same field in India.

(d) Representative Offices in India

The Foreign Exchange Management (Establishment in India of branch or office or other place of business) Regulations, 2000 regulate the establishment of other offices such as branch and liaison offices in India.

The prior approval of the RBI is required by any foreign company that proposes to establish a branch/liaison office in India. The activities that such an office can undertake in India are very restricted.

A branch office in India can undertake the following activities:

- Export/Import of goods
- Rendering professional or consultancy services.
- Carrying out research work, in which the parent company is engaged.
- Promoting technical or financial collaborations between Indian companies and parent/overseas group company.

- Representing the parent company in India and acting as buying/selling agent in India.
- Rendering services in information technology and development of software in India.
- Rendering technical support to the products supplied by parent/group companies.
- Foreign airline/shipping company.

A liaison office in India can undertake the following activities:

- Representing in India the parent company/group companies.
- Promoting export import from/to India.
- Promoting technical/financial collaborations between parent/group companies and companies in India.
- Acting as a communication channel between the parent company and Indian companies.

III. TAXATION

(a) *Investing in India Through Tax Havens*

Presently, in India there is a 10% short term capital gains tax on sales of shares (that is, if the income from securities transactions retained for less than one year) of an Indian company sold through a stock exchange and no long term capital gains tax on such sales of shares. Sales of shares in a private company, i.e., a company not listed on a stock exchange, are taxed at 20% for long term capital gains and at 30% for short term capital gains. The long-term capital gains tax earlier used to be 10 per cent, a rate of taxation that is now levied on short-term capital gains that used to earlier attract a tax rate that was twice as high.

The Indian Government, under Section 90 of the Income Tax Act 1961, has been authorised to enter into double tax avoidance agreements (“DTAA”) with other countries. One such tax treaty was signed with Mauritius in August 1982. The DTAA specified that capital gains made on the sale of shares of Indian companies by investors resident in Mauritius would be taxed only in Mauritius¹ and not in India. For about 10 years the DTAA existed only on paper since FIIs were not allowed to invest in the Indian stock markets. That changed in 1992 when FIIs were allowed into India. The same year, Mauritius passed the Offshore Business Activities Act 1992, which allowed foreign

¹ Mauritius Tax structure does not provide for any capital gains tax

companies to register in the island nation for investing abroad.

Thereafter, foreign investors willing to invest in India preferred to set up a subsidiary in Mauritius and route their investments through that country. By doing so, they would avoid paying capital-gains tax all together -- India won't tax because the company is based in Mauritius and Mauritius exempted investors from capital-gains tax. In addition, Mauritius also has low rates of dividend and income taxes.

As per Article 4 and 13 of the DTAA, gains realized by a Mauritius resident on the sales of an Indian company would be taxable in Mauritius wherein one is exempt from capital gains tax. It is estimated that India's revenue department loses between US\$100 million and \$500 million² annually through companies routing their investments via Mauritius in what is known as treaty shopping.

Certain requirements must be met in order to receive a Mauritius tax residency certificate for purposes of the DTAA including:

1. two local directors approved by the Mauritius Financial Services Commission;
2. a bank account in Mauritius; and
3. compliance with Mauritius corporate formalities.

A tax residency certificate is sufficient evidence for India tax authorities to accept the

² www.globalpolicy.com

status of residence as well as beneficial ownership³. However, the Mauritius structure does have some complexities for example funds to be invested in, or loaned to, the India subsidiary should be wired first to the Mauritius company prior to investment in India. The Board of Directors of the Mauritius company should then approve the investment and funds subsequently be wired to the Indian company from the Mauritius company.

The income of any non-Indian company is taxed in India if such non-Indian company has a “permanent establishment”⁴ in India. Having an India subsidiary is a necessary but not sufficient condition for a Mauritius company to avoid permanent establishment status. If a Mauritius company is deemed to have a permanent establishment in India because its activities are determined to be the business of investing/trading in securities within India, then the profits arising from the sale of such securities will be treated as business income in India (not as capital gains). Investment decisions must, however, be made outside of India. In addition, the effective management of a Mauritius company must not be from India. Whether the effective management of a company is in India or Mauritius or elsewhere is a question of fact. If there is no permanent establishment in India, income on the sale of the securities of India investments by a

³ Union of India vs. Azadi Bachao Andolan, 2003 SOL 619.

⁴ Defined by Article 5 of the DTAA

Mauritius company would not be taxable in India.

An investment therefore may be organized in Mauritius, with whom India has a favourable tax treaty and claim reduction of or exemption from tax in India. Similarly, Singapore has become a tax haven as well. The India - Singapore Comprehensive Economic Cooperation Agreement (“CECA”) is likely to exploit India’s cost effectiveness and large skill base and Singapore’s well-developed infrastructure, managerial and technical expertise. The CECA is likely to attract FDI Investments from Singapore to the tune of \$2 billion in the first year itself. Lower Tax rates, flexible wage system, skilled manpower, strong supply chain and world-class infrastructure are only some of the advantages that India can bank on while doing business with Singapore.

The India – Singapore DTAA also envisages zero capital gains tax treatment to Singapore-based companies by avoiding the double-taxation system. Indian software companies rendering services in Singapore will be major gainers of the improved DTAA. The effective tax liability of these companies will drop as India and Singapore have agreed to lower the withholding tax on royalties and fee for technical services from 15 per cent to 10 per cent in the revised Treaty. The benefit of a lower withholding tax rate will be broad-based. Software product companies that license technology to Singaporean companies will be among the major gainers. Tax planning may be legitimate provided it is within the framework of the law. It should also be based

on necessary substance and commercial rationale.

(b) Tax Benefits

The Government of India has extended income tax benefits in the form of tax holidays to certain thrust areas such as industries set up in “special economic zones” or information technology / information technology enabled services companies registered with the Software Technology Parks of India.

IV. DATA PROTECTION: THE INDIAN SCENARIO

(a) *An Overview*

There is no specific privacy or data protection law in India at present. The Constitution of India makes no specific mention of privacy, but the courts have read an implicit basic right of privacy in the Constitution of India. The protection to data at present is basically through contract law. Other laws which enhance protection are the Information Technology Act, 2000 (“IT Act”) the Copyright law, the Indian Penal Code and customs and practices developed with the passage of time.

Although India does not have a dedicated data protection law, it is one of the few countries where there is comprehensive legislation governing cyber and information technology.

India has often been criticized by western countries for not having sufficient data protection legislations in place. But the IT Act has several provisions relating to data protection. Hence the notion that India does not have any data protection laws is not entirely justified. In fact the IT Act not only recognizes any attack on data as an offence both for criminal, as well as civil penalties but also addresses the issues of technical facilitation of data protection and provides for a good system of grievance redressal.

(b) *Data protection as under the IT Act*

Section 2(o) of the IT Act defines the term ‘data’ as a representation of information, knowledge, facts, concepts or instructions which are being prepared or have been prepared in a formalized manner, and is intended to be processed, is being processed or has been processed in a computer system or computer network, and may be in any form (including computer printouts magnetic or optical storage media, punched cards, punched tapes) or stored internally in the memory of the computer. This definition is wide enough to cover under its ambit any sort of information that a company would receive from its clients and hence the same may fall under the provisions of the said legislation.

(c) *Future Trends*

The Government of India is finally taking note of the necessity for laws such as the IT Act. The Union Cabinet recently gave its approval for amendments to the IT Act, in order to strengthen the legislation pertaining to data protection and privacy in India. If the proposed amendment takes effect, then certain security practices and procedures would be imposed on body corporates and organizations. Some of the key amendments that have been proposed are given hereinbelow:

Secure Electronic Records

In order to promote secure electronic records, Section 16 of the IT Act is being amended, so as to empower the Central Government to prescribe certain security procedures for body

corporates in each particular industry. These security procedures are to be formulated by the Central Government keeping in view the commercial circumstances, nature of transactions and other related matters in regard to that particular industry. Any such security measure prescribed shall be binding on all body corporates falling under the purview of that particular industry. Further in order to develop highly specialized industry-wise security procedures the legislature intends to empower the Central Government to consult any self-regulatory bodies of a particular industry, if any. Thus the amended section would enable the Central Government to understand the exact needs of a particular industry and provide customized data protection measures for each industry.

Compensation Payable

The proposed amendment to the IT Act contemplates the insertion of the following clause into section 43 of the IT Act:

“If any body corporate, that owns or handles sensitive personal data or information in a computer resource that it owns or operates, is found to have been negligent in implementing and maintaining reasonable security practices and procedures, it shall be liable to pay damages by way of compensation not exceeding Rs. 1 crore⁵ to the person so affected.”

If the proposed amendment takes effect then the abovementioned clause would directly hold all the company liable for negligence if any information leak takes place and would be as effective as any exclusive data protection law. But another change which has been widely recommended is the revision of the cap on the compensation amount payable by a body corporate to a client from INR 1 crore to INR 5 crores.

It seems likely that either the amendment to the IT Act or a new data protection act would be put in place by the Central Government.

⁵ Rs. 1 crore is equivalent to INR 10 million

V. COMPETITION LAW

(a) Overview

In the sphere of competition policy, India is undergoing a major transition, whereby the earlier license Raj is being slowly phased out and a new regime envisaging a competitive market place is being ushered in. A new Competition Act was enacted in 2002 (“Competition Act”) and is now being implemented in phases. The Monopolies and Restrictive Trade Practices Act, 1969 (“MRTP”) was enacted based on the recommendations of the Monopoly Enquiry Commission in 1964. The MRTP Act was enacted in an era when regulating monopolies were the biggest concern but the Competition Act was enacted with the objective of promoting competition in the market place. Further the Competition Act seeks to repeal the MRTP Act and dismantle the MRTP Commission created thereunder. But as of now only the Competition Commission of India (“CCI”) has been set up, which is carrying on administrative activities and the MRTP Commission is still functioning normally. The objective of the Competition Act, as well as the CCI, was to prevent practices having an adverse effect on competition, to promote and sustain competition in market, to prevent abuse of dominance, to ensure quality of products and services, to protect the interest of consumers and to ensure freedom of trade carried on by other participants in the Indian market.

(b) Comparison of the Old Regime and the New Regime

Under the MRTP Act the main thrust was to prevent monopolistic and restrictive trade practices and the MRTP Commission was empowered suitably to achieve this goal. In this regard the MRTP Commission had the powers to (i) direct an errant undertaking to discontinue a trade practice and not to repeat it; (ii) grant temporary injunctions restraining an errant undertaking from continuing an alleged prohibited trade practice; (iii) award compensation for loss suffered on account of an restrictive trade practices, monopolistic trade practices, etc., and (iv) recommend to the Central Government division of undertakings, or severance of interconnections between undertakings, if their functioning was prejudicial to public interest or has led or is leading to restrictive trade practices, monopolistic trade practices.

The Competition Act empowers the CCI to (i) direct the parties to discontinue and not to re-enter any such agreement that has been declared void under the law; (ii) direct the parties to discontinue such practices which in its view may be construed as the abuse of dominant position; (iii) impose such penalty on each of the parties which shall not be more than ten per cent of the average of the turnover for the last three preceding financial years; (iii) award specified compensation to the parties; (iv) direct that the specified modifications be made to the agreements; and (v) recommend to the Central Government

for the division of an undertaking enjoying dominant position.

A comparison of the two regimes shows some remarkable differences. The major changes that can be viewed as an improvement over the old regime are:

- a. The registration requirement in regard to business agreements has been done away with;
- b. Four anti-competitive agreements, namely, price-fixing, output restriction, market allocation and bid rigging have been prohibited per se.
- c. Mergers and acquisitions have been brought within the ambit of the Competition Act but would be dealt with more liberally and shall only apply over a certain threshold.

(c) Salient features of the Competition Act

The three main objectives of the Competition Act are to check market abuse by anti-competitive agreements between parties; check abuse of a dominant position; and regulate the procedure relating to mergers and acquisitions.

Further, CCI is to function as a regulator, and like other regulators to give impetus to quality of products and services, competition, faster mergers and acquisitions of companies, regulation of mergers and acquisitions coming within the threshold limits, allowing dominance and prevention of abuse of dominance to give effect to second generation

economic reforms on the pattern of the global standards set by the United Kingdom, the U.S. and the European Commission. The Competition Act primarily takes measures to counter anti-competitive practices, particularly cartelisation, price-fixing and other abuses of market power and regulates mergers, etc.

(d) Investigation by CCI

In determining whether an agreement has an appreciable adverse impact on competition, the CCI shall have due regard to:

- a. Whether there is any barriers created to prevent new entrants in the market;
- b. Whether the agreement results in driving the existing competitors out of the market;
- c. Whether there is a foreclosure of competition by hindering entry into the market;
- d. Whether there is any effect on the accrual of benefits to consumers in the market;

Further in inquiring into the dominant position of a particular entity the CCI shall have due regard to:

- a. The market share of the entity;
- b. The size and resources of the entity;
- c. The size and importance of the competitors in the market;
- d. Economic power of the entity including commercial advantages over the competitors in the market;
- e. Vertical integration of the entity;
- f. If the entity is enjoying a monopoly or dominant position in the market;

- g. The market structure and the size of market;

If the enquiry by the commission finds that any agreement or action by an entity in a dominant position is in contravention of Section 3 or Section.4 of the Competition Act, then the CCI may pass all or any of the orders that it is empowered to do so, as mentioned hereinabove.

The Central Government on the recommendation of the CCI may direct division of an entity enjoying dominant position to ensure that such entity does not abuse its dominant position. In regard to this the Central Government may pass any of the following orders:

- a. the transfer or vesting of property, rights, liabilities, or obligations;
- b. the adjustment of contracts either by discharge or reduction of any liability or obligation or otherwise;
- c. the creation, allotment, surrender or cancellation of any shares, stock or securities;
- d. the payment of compensation to any person who suffered any loss due to dominant position of such enterprise;
- e. the formation or winding up of an enterprise or the amendment of memorandum of association or articles of association or any other instruments regulating the business of any enterprise;
- f. the extent to which and circumstances in which, provisions of the order affecting an

enterprise may be altered by the enterprise and the registration thereof;

- g. any other matter which may be necessary to give effect to the division of the enterprise.

The Competition Act signals a drastic shift in legislative thinking and is a contemporary act in relation to any other equivalent act in the world. The Competition Act may come into force, as early as 2007, which would then repeal the MRTP Act and would make the Indian market more competitive and consequently consumer friendly.

VI. EMPLOYMENT ISSUES

(a) Overview

Indian Labour Laws are pro workmen and aim to protect the interests of the workmen. The Central Government has from time to time indicated that it shall overhaul the labour legislations in India to ensure that the same are suitable for the changing business environment in India.

India has numerous labour laws which any foreign investor must be well aware of before doing business in India including the Contract Labour (Regulation & Abolition) Act, 1970, Employees Provident Funds and Miscellaneous Provisions Act, 1952, Employees State Insurance Act, 1948, Factories Act, 1948, Industrial Disputes Act, 1947, etc.

(b) Non-Compete

While it has been customary to include provisions of non-compete in employment contracts, Section 27 of the Indian Contract Act, 1872 states that every agreement by which anyone is restrained from exercising a lawful profession, trade or business of any kind, is to that extent void.

Indian Courts have from time to time held that non-compete clauses that extend beyond the term of a contract are unenforceable as the same are violative of Section 27 of the Indian Contract Act, 1872.

It is essential that care is taken to ensure employment contracts be structured such that they are in compliance with labour legislations framed by the Central Government as well as the concerned State Government.