INDIRECT FOREIGN INVESTMENT UNDER FEMA AND INCOME TAX ACT

Shubham Agarwal, St Xaviers University, Kolkata

ABSTRACT

Indirect Investment refers to investment made by a company in its subsidiaries or other businesses that are further down the supply chain. It typically involves investment in the companies that are involved in the distribution, marketing or sales of the products or services produced by the investing company. This type of investment allows the investing company to have greater control over the distribution and sales channel ensuring smooth operations and maximizing business profitability. It can be a strategic move to expand the business and capture a larger market share. Overseas direct investment can give various benefits in fostering economic growth, promoting international trade and facilitating knowledge transfer between countries. SEBI Category III AIFs include funds that provide complex trading strategies and higher risk profiles. Indirect transfers of foreign investment is possible in such circumstances when foreign investors sell their shares or ownership interests in a company that has substantial assets located in a different country. This can have an effect of tax compliance and regulatory compliance. Additionally, it is mandatory to comply with all the necessary rules and regulations including FEMA, tax obligations and reporting requirements. Foreign investors can invest in unlisted NCDs issued by Indian Companies as part of their foreign investment strategy. They offer a fixed rate of interest and have a specified maturity period. It is important to carefully assess the creditworthiness of the issuing company as unlisted NCDs carry a higher level of risk compared to listed NCDs. Government often encourages FDIs through policies and regulations that provide favorable conditions for foreign investors such as tax incentives, streamlined procedures and protection of intellectual property rights. The host country can gain access to capital, technology, managerial expertise and employment opportunities. Foreign Portfolio Investment can diversify their portfolios, access new investment opportunities and potentialy earn high returns compared to their domestic markets. Unlike FDI, which involves direct ownership stake in a business, FPI is more focused on the investment in financial assets to earn financial returns.

INTRODUCTION

It is important to note that several mechanisms exist for investment abroad or within India. One of the options is Foreign Direct Investment (FDI) i.e. Direct Investment by foreign investors in India and the other option is Indirect Investment which is also known as Downstream Investment. These investments help to diversify funds through acquisitions and operations through an entity set up in India. The Foreign Exchange and Management Act, 1999 states about the bureaucratic framework of the downstream investment as provided under Rule 23 of Foreign Exchange Management (Non-Debt Instrument) Rules, 2019[1]. Foreign Portfolio Investment as stated in Section 2t of FEM (Non-Debt Instrument) Rules, 2019 states that any investment made through equity instrument by a person resident outside India where such investment is less than 10% of the post-issued share capital on a fully diluted basis of a listed Indian Company or less than 10% of paid-up value of each series of equity instruments of a listed Indian Company. Earlier the NCDs were required to be mandatorily listed within 15 days of allotment, now the situation has been shifted and now the foreign portfolio investors can invest in unlisted NCDs which is to be read under SEBI (Foreign Portfolio Investors) Regulations, 2019 in consonance with Foreign Exchange Management (Debt Instrument) Regulations, 2019. ODI (Overseas Direct Investment)[2] refers to the process of acquiring unlisted equity capital of a foreign entity, by subscribing to the shares and the names are entered into the memorandum of a foreign entity, making an investment or holding 10% or more than 10% in any foreign listed entity, investment with control where the investor is holding less than 10% in the Listed Foreign entity. Earlier SEBI was restrained to only Mutual Funds, Collective Investment Schemes Venture Capital Funds (VCF), portfolio managers were well regulated till 2012. Now the situation has been changed and SEBI has successfully moved a big way forward to expand the scope of Indirect Foreign Investment by passing SEBI (Alternative Investment Funds) 2012[3]. An Alternative Investment Fund (AIF) is a type of pooling fund that collects money from an Indian or Foreign investor in conformity with a defined investment policy. AIF can be of various types such as Venture Capital Funds, PIPE funds, Hedge funds, Real Estate Fund, SME Fund. AIF can be formed as company, trust, LLP, body corporate. However a family trust, ESOP trust, Funds managed by Securitization Company under SARFAESI Act or

[1] NOTIFICATION NO. S.O. 3732(E) [F.NO.1/14/EM/2015], DATED 17-10-2019 (India)
[2] Mondaq, https://www.mondaq.com/india/financial-services/1286750/new-overseas-investment-regulations-and-rules [19.12.2023]
[3] SBS AND COMPANY LLP CHARTERED ACCOUNTANTS, https://www.sbsandco.com/blog/alternative-investment-funds-fema [19.12.2023]

any other funds regulated by any other regulator shall not be considered as AIF. As per Schedule 11 of the Foreign Exchange Management (Transfer of issue of security by a person resident outside India) A person not residing in India including REPI and NRI may invest in units of investment vehicle after satisfying the conditions laid down in this schedule:-

1) The payment shall be made by inward remittance through normal banking channels including by debit to FCNR account by a person registered/incorporated outside India.

2) A person not residing in India may purchase or sell or redeem any units of the schedule as per the directions/regulations by SEBI.

3) Downstream Investment shall be regarded as foreign investment if neither the sponsor nor the manager nor the investment manager is India-owned as per Regulation 14 of the Principal regulations.

4) Downstream Investment by Investment vehicle shall have to adhere to the sectoral caps conditions/restrictions as applicable to the company in which indirect investment is made as per FDI policy or Schedule 1 of the principal regulations.

5) Indirect Investment has to comply with the provisions of Schedule 9 of the regulations as well as extant FDI policy for investment in foreign LLPs.

6) An Alternative Investment Fund Category III shall have to be a registered portfolio investor to make portfolio investments under the principal regulations.

7) The Investment vehicle shall have to require to make report in such form as may be applicable from time to time or follow the directions of SEBI or RBI.

TAXATION OF INDIRECT TRANSFERS UNDER INCOME-TAX ACT

The idea of action for indirect transfer emerged from China. People usually tend to avoid paying Capital gain tax in their own country. Therefore the approach of China is incorporated as an Anti-avoidance measure. The Indirect transfer tax will apply only when it fails to fulfill the *"reasonable business purpose test"*[4]. The Indian Tax Authorities have taken into account

[4] *An offshore indirect transfer fails the 'reasonable business purpose test', if all of the following conditions are satisfied: (1) the foreign holding company is located in a jurisdiction where the effective tax rate is significantly low, or where offshore income is not taxed; (2) the asset directly transferred derives at least 75% (directly or indirectly) of its value from Chinese taxable property; (3) at least 90% of the total assets or income of the foreign holding company is based (directly or indirectly) on investment or income from China; (4) the overseas*

offshore indirect transfers under the provisions of the Income Tax Act of 1961 in the ***Vodafone***[5] case. The Revenue commenced high stake litigation on the premise that Vodafone had concealed taxes on the payments made to the selling Hutch entity for the transfer of shares in the Cayman Island entity which was a holding company through various levels of intermediary. The Supreme Court of India pronounced the decision in favor of Vodafone that the transactions were not subject to ITA and accordingly no Indian tax was required to be paid on the transfer of assets between two non-residents. Therefore after the S.C ruling the legislature introduced several laws to nullify the ruling. Significant amendments to the definitions of capital assets and transfer as well as an addition of Explanation 5 of Section 9 (I) (1) of ITA justifying that an offshore capital asset would have position in India if it is considerably deriving its value from India. India as a country follows residence based taxation which means income is taxable on the global income which is derived from source in India whereas Section 9 of the Income Tax Act, 1961[6] states about the income which is received or is deemed to be received in India and Income which accrues, arises or is deemed to accrue or arise in India. Also, Income arising from the transfer of capital assets is to be treated as Capital gain which is stated in Section 45 of the Income Tax Act, 1961[7].

CONCLUSION

Foreign Exchange Management Act (FEMA) and Income Tax Act (IT Act) play an important role in regulating indirect foreign investment in India. While FEMA focuses on foreign exchange transactions and regulations, the IT Act deals with taxation aspects of such investments. Together these Acts provide a framework for monitoring and regulating indirect foreign investment in the country. There are lot of strictness shown in the part of the Income Tax Act to cover offshore transactions or investments in a taxable limit.

enterprise does not undertake substantive functions and risks, and; (5) the tax consequences of the indirect transfer in the foreign country is lower than the Chinese tax payable, had the sale was made directly.

[5] Vodafone International Holdings B.V vs Union of India [2012] 341 ITR 1 (SC)

[6] Income Tax Act, 1961, Tax Laws & Rules > Acts > Income-tax Act, 1961 (incometaxindia.gov.in) [19.12.2023]

[7] Income Tax Act,1961, , Tax Laws & Rules > Acts > Income-tax Act, 1961 (incometaxindia.gov.in) [19.12.2023]