FDI in India and repatriation of surplus: A how-to overview in the light of Union Budget 2020

Introduction

In light of economic uncertainties in Europe with Brexit befallen at last, the Indian economy, though slowed down, continues to show signs of significant growth. Over a period of time, India has come – in leaps and bounds – to increase its viability to attract foreign investments having jumped 23 ranks in 2018 and another 16 ranks in 2019, to be ranked 63rd among 190 nations in the World Bank's global Ease of Doing Business. Even though the overall ranking might not look very impressive to some pundits, given the size of India’s economy and distinct regional diversity, this is feasibly a tremendous breakthrough.

Any growing economy recognizes the importance of creating long lasting stable relationships, which are built upon international economic integration through cross-border investments. This very goal has led India to undertake notable initiatives and business reforms, including:

- relaxing the Foreign Direct Investment (FDI) norms with amended FDI policy;
- reforms leading to curbing and cascading of taxes through implementation of a Goods and Service Tax (GST) introduced in July 2017;
- enactment of Insolvency and Bankruptcy Code, 2016, which follows global standards for insolvency and bankruptcy issues;
- a digitization drive through e-governance and a much needed infrastructure push with increased budget spending.

There are mainly two routes for FDI in India:

- the automatic route, where no approval or authority is required by the foreign investor e.g. automobile, asset reconstruction companies, agriculture and animal husbandry, capital goods, e-commerce, medical devices, pharmaceuticals, railway infrastructure, renewable energy, tourism and hospitality etc.
- the government route where prior to investment an approval of the Government of India is required for e.g. in defence sector any investment more than 49 per cent requires government approval and similarly for the banking sector.

FDI coming through any route can either be in the form of direct investment by creating a new foreign entity called a Greenfield investment for e.g. establishing a new mill or a plant, or by investing in an existing firm through merger or an acquisition, called a Brownfield investment for e.g. an existing plant or a mill is taken over by the foreign firm.

Incidentally, India was the highest ranked country in attracting Greenfield FDI in 2015 and 2016, respectively, and has remained at a reputable position since then.
India was also among the top 10 recipients of FDI in 2019, attracting to the tune of USD 49 billion in inflows despite facing much weaker macroeconomic conditions compared to the previous years. Just a glimpse of some notable developments below demonstrates India’s credibility in its efforts to become a favorable foreign investment destination:

• In October 2019, French oil and gas giant Total S.A. acquired a 37.4 per cent stake in Adani Gas Ltd for USD 810 million;

• In August 2019, 100 per cent FDI was permitted under the automatic route in coal mining for open sale;

• In August 2019, one of India’s biggest FDI deals was announced where Saudi Aramco agreed to acquire a 20 per cent stake in Reliance’s oil-to-chemicals business at an enterprise value of USD 75 billion;

• In May 2018, Walmart acquired a 77 per cent stake in Flipkart for a consideration of USD 16 billion;

• In February 2018, IKEA announced its plans to invest up to USD 612 million in the Indian state of Maharashtra, to set up multi-format stores and experience centres;

• In Union Budget 2019-20, the government of India proposed opening of FDI in aviation, media (animation, AVGC) and insurance sectors in consultation with all stakeholders;

• In the latest Union Budget 2020-21, effective from April 1, 2020, the government of India has proposed the long awaited removal of the dreaded dividend distribution tax (DDT) payable on dividend pay-outs. The Union Budget 2020 also provides an exemption to file a return of income in India for foreign companies who earn income only in the form of dividend, royalty, interest and fees for technical services and withhold appropriate taxes as applicable on such income. However, where a foreign company choses for a tax rate under any treaty in respect of dividend income, it would be required to file its tax returns in India.

There is another big question that any foreign company intending to invest in India seeks an answer for- ‘How and when can we repatriate the funds?’ And rightly so, because the reasons for choosing the right method for repatriation will not only protect the company from running into any avoidable regulatory road-blocks but is also vital in safeguarding the revenue generated in India from any foreign exchange or tax risks. Moreover, Indian history testifies that not only has India allowed repatriation of profits freely subject to certain tax liabilities but also has never failed to provide requisite foreign exchange for repatriation.

Choosing a Corporate Vehicle

Before we venture on to the ways in which a foreign company can repatriate the funds, it is essential to recognize different corporate vehicles through which a foreign company can set-up its business in India:

• By remaining a foreign company, if it chooses to establish a liaison office, project office or a branch office. These are formed mainly for
carrying out project execution operations, export-import and market research; or

- as an Indian company by establishing either a wholly owned subsidiary, a joint venture with an Indian partner (equity participation) or a limited liability partnership (LLP).

In this overview, we primarily focus on foreign companies intending to operate in India through wholly owned subsidiaries. The reasons are simple. Not only does this structure provide a robust legal foundation for doing business in India but also offers an unlimited scope of permitted activities with no restriction per se when it comes to foreign investment. The wholly owned subsidiary could either be in the form of private limited company for ensuring a closely held shareholding or a public limited one with unlimited number of members. These are incorporated entities formed and registered under Companies Act, 2013.

Besides, more often than not, foreign entities are looking for long-term business objectives and hence are better-off in establishing their presence through incorporating an independent legal entity in the form of a wholly owned subsidiary of the foreign company. Such a subsidiary is treated as an Indian resident and an Indian company for the purpose of all Indian regulations.

Repatriation Options

Dividends- Often when a company makes sizeable profit it may declare dividends in favor of its shareholders, either annually or at such time intervals as the company resolves. This is a classic hassle free way to repatriate profits especially since the recent announcement in the Union Budget 2020 which no longer requires a 15 per cent dividend distribution tax (DDT) plus surcharge and education cess (20.56 per cent effectively) which was liable to be paid by the Indian entity on the dividend pay-outs.

Normally, an Indian subsidiary of the foreign company was subject to DDT on the dividend pay-outs, which were over and above the corporate tax (25 percent or 30 percent subject to the gross turnover) companies' pay on their taxable profit. The dividend prior to even reaching its home jurisdiction was already subjected to significant tax brunt of 20.56 per cent. Once the dividend was received by the foreign company it would be liable to be taxed yet again in its home jurisdiction. And, no tax credit could be claimed by the foreign company since DDT was paid by the Indian company and not the foreign company directly in India.

This proposal to abolish DDT has provided much needed relief to the foreign companies from this double whammy. Now, the dividend pay-out forms part of the taxable income of the shareholder and shall be taxed only in the hands of the recipient and not the Indian subsidiary, as per the applicable rate. And, the investors will be able to claim credit in their home countries for all the taxes paid in India.

The question how the dividends will be taxed in the recipients' home countries depends largely upon double tax avoidance agreements (DTAAs) with the respective country which generally may offer tax credit or an exemption for foreign-sourced income from taxation.

2. Share Buyback- Once a company is sitting on a pile of cash with no attractive investment in-sight, the share buyback is an appropriate mean to repatriate funds. The foreign company with equity holding in its Indian
subsidiary can return the shares it owns and get paid a pre-decided sum for such shares.

This pre-decided sum is valued as per fair market value and other internationally accepted pricing methodologies. The share buyback was a popular mechanism to avoid the DDT payable on dividend payouts, whether or not it remains so after scrapping of the DDT, is yet to be seen.

Still, a 20 per cent withholding tax is liable to be paid on the difference between the sum the Indian company was paid at the time of issue of shares and the sum received from buyback. This means a 20 per cent tax is levied on the distributed income. It should also be kept in mind that the sum payable under a share buyback is limited to 25 per cent of the total paid up capital plus free reserves per financial year, while ensuring that the debt to equity ratio of 2:1 is maintained post buyback.

In this case as well, DTAs also offer different measures for double tax avoidance depending upon the tenets of bilateral DTAA with the respective country in which the foreign entity is registered.

3. Reduction of Capital- Usually, when the amount of money to be repatriated exceeds the limitations under share buyback, the method of capital reduction may be used. The capital reduction entails that the Indian company may either reduce the face value or cancel some shares at a pre-determined price resulting in the foreign company reducing its holding in the Indian entity in lieu of return of capital.

A special resolution for reducing share capital must be passed, provided the articles of the company permit so, and unlike the share buyback the special resolution must be confirmed by the National Company Law Tribunal (NCLT), a quasi-judicial body in India that adjudicates issues relating to Indian companies.

4. Royalties- In this method, the Indian entity pays a royalty to the foreign company for use of any technology patented in the name of the foreign company. These payments could range from payments towards use of trademark, brand names, drawings, designs, technical expertise etc. The popularity of this method has particularly increased since 2009, when the previously applicable limitations were removed.

Though recent regulatory developments include the possible introduction of limits on royalty pay-outs to foreign parent companies, it is widely recognized such limitations can critically affect India’s attempt to build a favorable destination for foreign investment, which requires flexibility in capital outflows. Still, these payments made by the Indian entity are subject to withholding tax of 10 per cent plus any surcharge and cess.

5. Payment in lieu of services- It is often the case that the Indian subsidiary avails itself of services; whether in the form of consultancy or IT, from the foreign company against which Indian entity can make payment as a service fee subject to the transaction being on arms length basis. The taxes applicable to such payments largely depend on specific characteristics of the payments made.

Conclusion

In light of the current global economic ecosystem, flexibility is the key to uphold the vital essence of globalization. India is a vibrant growing economy with an estimate of reaching a 1 billion middle-class
population over the next decade, which is soon to bear fruits of a slew of measures taken to enable an investor-friendly business environment. Therefore, it cannot be stressed enough that a successful business plan should entail a definite gradual withdrawal of any surplus funds through seamless repatriation strategy, which can generally be implemented by way of dividends, share buybacks, reduction of capital, royalties and payments in lieu of services.

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