# DOING BUSINESS IN INDIA

By
**Ms. Shivangi & Mr. Rohit Kathuria under guidance of**
**Mr. Himanshu Srivastava Sr. Manager**

## 1. INTRODUCTION

As India moves to become the 3rd largest economy and 5th largest consumer market by 2025, more and more businesses are being set up in India. A proper understanding of the regulatory environment will facilitate better decision making by companies proposing to set up operations in India. It is best to keep a perspective that the Indian regulatory environment is dynamic and it is imperative to be in touch with the ever-evolving conditions. This article aims to provide potential investors a quick overview on the possible business structures and some typical regulatory issues which need attention. The information is validated as of November 2009.

## 2. INDIA AT A GLANCE

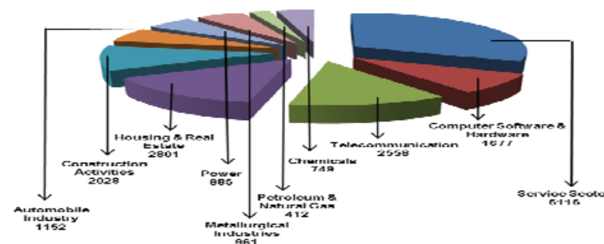
Constitution of India came into force on 26th January 1950. The President of India is the head of State. The Prime Minister heads the government and runs government with the support of council of members forming the cabinet. The parliament comprises of Lok Sabha (House of People) and Rajya Sabha (Council of State).

| India | Union of State, a Sovereign, Secular, Democratic Republic with Parliamentary system of Government |
|---|---|
| Demographic background | Literacy rate – 64.84 per cent *(2001 National Census)*<br>Population – 1155 Million – World's 2nd Largest |
| Independent judiciary | Supreme court- Highest Judicial authority<br>High Court – state Judicial authority |
| Language | Total 22 national languages and 844 dialects<br>State Official Language – Hindi<br>Preferred Business Language - English |
| Growth rate of economy | 6.70 per cent in 2008-09<br>9.00 per cent in 2007-08<br>9.70 per cent in 2006-07 |

## 3. INDUSTRIAL OUTLOOK

A significant feature of India's growth process has been the broad-based economy. Besides the traditional sectors like Steel, Engineering Goods, Ores and Minerals, Chemicals related products, Gems and Jewellery, new industries like Information Technology, Pharmaceuticals and Biotechnology have shown steady growth. India is now getting recognition as a global destination for Research and Development, Engineering Design and Prototype Development as well as manufacturing hub for high end technology products.

Amount (in USD Million)




Source: Department of Industrial Policy & Promotion, Ministry of Commerce and Industry Government of India.

The unprecedented global financial crisis during financial year 2008-09 impacted the robust growth rate of 9 per cent over past years, which closed at 6.7 per cent. However, the World Bank has projected a 8 per cent growth for India in 2010, which will make it the fastest-growing economy in which case, overtaking China's expected growth rate of 7.7 per cent.

## 4. INVESTING IN INDIA

Statement on Industrial Policy of 1991 was formulated with special focus to promote and encourage foreign investment. Since then, the Indian regulatory environment for foreign investment has been consistently eased to allow industrial freedom and flexibility, making it increasingly investor-friendly.

| S.No. | Country | 2006-07 | 2007-08 | 2008-09 | 2009-10 *(April-Sep. 2009)* | Cumulative *(April-Sep.2009)* |
|---|---|---|---|---|---|---|
| 1. | MAURITIUS | 6,363 | 11,096 | 11,208 | 6,520 | 43,385 |
| 2. | SINGAPORE | 578 | 3,073 | 3,454 | 1,187 | 8,998 |
| 3. | USA | 856 | 1,089 | 1,802 | 1,244 | 7,579 |
| 4. | UK | 1,878 | 1,176 | 864 | 282 | 5,508 |
| 5. | NETHERLANDS | 644 | 695 | 883 | 571 | 4,161 |
| 6. | JAPAN | 85 | 815 | 405 | 793 | 3,324 |
| 7. | CYPRUS | 58 | 834 | 1,287 | 794 | 3,067 |
| 8. | GERMANY | 120 | 514 | 629 | 375 | 2,548 |
| 9. | FRANCE | 117 | 145 | 467 | 185 | 1,412 |
| 10. | U.A.E. | 260 | 258 | 257 | 484 | 1,404 |
| | **Total** | **15,726** | **24,579** | **27,329** | **15,312** | **105,153** |

Source: Department of Industrial Policy & Promotion, Ministry of Commerce and Industry Government of India.

India has exchange controls, whereby investments to and from India are governed by the Reserve Bank of India (RBI), which is the federal bank and the apex exchange control authority in India. Foreign Direct Investment (FDI) under the current framework is permitted from all categories of investors and in all sectors except:

(i) Retail Trading (except single brand product retailing)
(ii) Atomic Energy
(iii) Lottery Business
(iv) Gambling and Betting
(v) Agriculture

For other sectors, there are two routes for investing in India:

(i) **Automatic Route** wherein the foreign investor does not require any prior approval from the RBI or Government of India.

(ii) **Prior government approval route** which applies in the following circumstances:

a) Activities which fall within the ambit of government licensing such as tobacco, distillation and brewing of alcoholic drinks, aerospace and defense equipment, industrial explosives, etc.
b) Proposal exceeding the sectoral cap as set out for certain industries E.g. foreign investment in insurance sector is capped at 26 per cent.

c) Where the foreign collaborator has an existing financial /technical collaboration in India in the same field in which he is proposing a new investment.

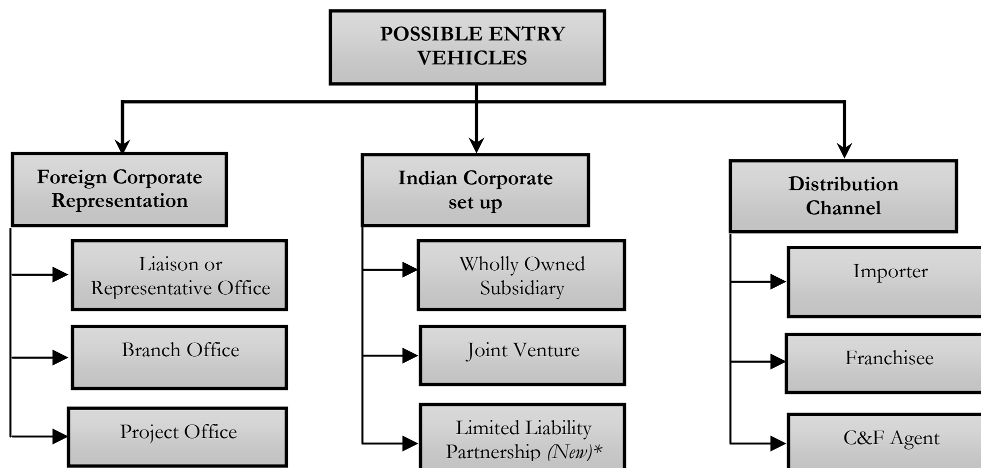
d) Where more than 24 per cent foreign equity is proposed to be inducted for manufacture of items reserved for the Small Scale sector.

e) Proposal for acquisition of shares of an Indian company in Financial Sector and where the transactions attract the provisions of SEBI. (Substantial Acquisition of Shares and Takeovers) Regulations, 1997.

## 5. ENTRY STRATEGY

In India, Sole Proprietorship, Partnership and Company (private or public) are the most common business entities. However, investment by non-Indians is not allowed as Partnership or Sole Proprietorship.

Foreign entities can set up its presence in India as foreign company in the form of Liaison Office/Representative Office (LO), Branch Office (BO) or Project Office (PO). It can also invest directly through a Wholly Owned Subsidiary (WOS), as a Joint Venture with Indian Partners or Limited Liability Partnership (LLP).




*Even though the newly introduced law defines simplified operational rules for Limited Liability Partnership yet issues pertaining to taxation of profits and foreign investment and repatriation issues are yet to be clarified.

### 5.1 Foreign Corporate

Foreign corporate can set up their operations in India as LO, BO or PO after obtaining approval from the RBI. On obtaining the approval, a registration needs to be made with the Registrar of Companies (ROC) for obtaining Certificate of Establishment of Place of Business in India. Such entities can undertake only activities as permitted through the approval.

#### *5.1.1 LO*

A Liaison Office, which is akin to a Representative Office, can explore India and understand the business environment, establish contacts and gather market intelligence to promote the

products or services of the parent company. It can not undertake any industrial, commercial or trading activity. The initial approval is normally granted for a period of 3 years and subsequent request for extension are approved on a case-to-case basis.

### *5.1.2 BO*

As a Branch Office in India, foreign companies can conduct full-fledged business in India. BO can carry the same or substantially the same trading activities as carried out by their parent or group companies. However, BO is not allowed to directly carry out manufacturing activities though it is permitted to sub-contract these services to an Indian manufacturer. As BO is regarded as a foreign company, their income is taxed at rate of 40 per cent, and can be thereafter remitted outside India, subject to procedural aspects under exchange control regulations.

### *5.1.3 PO*

Foreign Companies, having obtained specific project contracts in India, can set up temporary project office. If certain conditions are satisfied, the PO can be even set-up without any prior approval from the RBI. These offices can only undertake an activity related and incidental to execution of the specified project. After the completion of the project, the surplus funds can be repatriated back to the parent company. E.g. A Japanese Company gets an Erection, Procurement and Commissioning (EPC) contract for supply of gas turbine from an Indian Power company. The Japanese company, if it so chooses, can now set up a PO in respect of this contract.

## 5.2 Indian Corporate

Indian Companies Act, 1956 has been enacted to regulate companies in India. The Registrar of Companies (ROC), specific to each Indian state and operating under the Ministry of Corporate Affairs ensures compliance with the Act.

### *5.2.1 Wholly Owned Subsidiary (WOS)*

A foreign company, setting up an eligible business activity, may register a WOS in India. WOS is a preferred business vehicle for those who wish to have limited liability and prefer to keep total control over the business. A WOS can be set-up as a private limited or a public limited company. A public limited company is one which can freely transfer its shares, but not necessarily listed.

**Private Vs Public Company**

| | Private Company | Public Company |
|---|---|---|
| Minimum Paid up Capital | Rs. 100,000<br>*(approx USD 2,000)* | Rs. 500,000<br>*(approx USD 11,000)* |
| Minimum No. of Members | 2 | 7 |
| Maximum No. of Members | 50 | No restriction |
| Number of Directors | 2 | 3 |
| Transferability of Shares | Restricted | Transferable |
| Regulatory Compliances & Disclosures | Minimum | High |

Most Small and Medium Enterprise prefer to set up as a Private Limited Company.

### *5.2.2 Joint Venture*

Joint Venture (JV) refers to the formation of a new company where ownership is with two or more partners. Activities which are not open for exclusive ownership by foreign investors or where sectoral caps exist, can be accessed through JV structures. As in the case of WOS, a JV can be set-up either as a private limited or a public limited company.

Indian partner can bring value in respect of the following

(i) Will provide an operating infrastructure
(ii) Ready market access and distribution channel
(iii) Labor management, which is always a cause of concern
(iv) Dealings with government bodies, tenders and bids

**Overview – Alternate Entry Vehicles**

| | Corporate (CO) | Liaison Office (LO) | Project Office (PO) | Branch Office (BO) |
|---|---|---|---|---|
| **Characteristics** | Share capital owned by parent company | No commercial activities allowed | Temporary site office, specific projects | Commercial activities allowed |
| **Status** | Shareholders | Foreign Company | Foreign Company | Foreign Company |
| **Tax Rate** | 30% + | Non Taxable | 40% + | 40% + |
| **Control** | Board of Directors | Parent Company | Parent Company | Parent Company |
| **Set-up** | FIPB Approval / Automatic Route (4-6 weeks) | RBI approval (4 weeks) | RBI approval (4 weeks) | RBI approval (4 weeks) |
| **Closure** | ROC (6-9 months) | RBI (3 months) | RBI (3 months) | RBI (3 months) |

## 6. KEY REGULATORY MATTERS

Even as one plans an entity into India, it is worthwhile to grasp various regulatory matters which have immediate and future bearing. It will certainly be difficult, if not impossible, to understand all aspects of all regulatory laws. We present here some of these, which be given due consideration.

### 6.1 Taxation

In the last 10-15 years, Indian taxation system has undergone tremendous reforms. The tax rates have been rationalized and tax laws have been simplified.

### *6.1.1 Direct Tax*

Direct taxes are charge by the Central Government including Corporate Tax, Dividend Distribution Tax and Wealth Tax.

*6.1.1.1 Corporate Tax*

The Corporate Tax rate in India depends on the origin of the company. If a company is incorporated in India (private or public limited) it is treated as domestic company and profits are taxed at 30 per cent. Foreign companies including BO and PO are taxed at 40 per cent.

### *6.1.1.2 Dividend Distribution Tax*

Another component of direct tax is the Dividend Distribution Tax (DDT). This is levied on companies as a charge on the dividend payable to the shareholders. The dividend thereafter is not taxable in the hands of recipient. At present, dividend distribution tax is 15 per cent. It is worthwhile to note that DDT paid in India does not get tax credit benefit under income tax treaties India has with other countries.

### *6.1.1.3 Double Taxation Avoidance Agreements (DTAA)*

The Double Tax Avoidance Agreements (DTAA) are essentially bilateral agreements entered between two countries, with an objective that income taxed in one and not both jurisdiction. The Government of India has tax agreements with over ninety countries, including US, UK, most European countries, Mauritius, Japan, Singapore etc. While planning business structure for India, it would be advisable to verify tax treatment accorded in the specific DTAA as regards business earnings, royalty payments, salary to expatriate to be deputed, etc.

In all treaties there is a standard provision that if a foreign entity has not formed a resultant Permanent Establishment (PE) in India or does not have a fixed place of business, then it shall not be taxable in India.

### *6.1.1.4 Transfer Pricing*

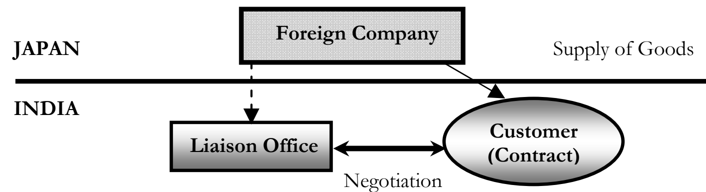
Businesses having cross border dealings with related concerns fall within ambit of Indian transfer pricing regulations. Primarily, this requires maintenance of documentation and certification by an Indian firm of chartered accountants confirming that dealings with related concern were at Arm's Length and the profit is appropriately reported by the Indian business entity.

Where two group companies are dealing with each other, transfer pricing will attempt to verify that the dealings have been done at Arm's Length Price (ALP). The purpose is to see whether independent person would have transacted at similar prices. In case transaction appears under / over valued, transfer pricing adjusts the prices of cross-border transactions as adopted by related parties.

### *6.1.1.5 Permanent Establishment (PE)*

PE is a fixed place of business through which the business of the enterprise is wholly or partly carried on. It includes a branch office, dependent agent. Normally a subsidiary in India or a Liaison Office will not be regarded as forming a PE. However, when the tax officer is able to prove existence of close business nexus between an Indian business entity and the parent body outside India, he can classify the Indian entity as a PE of the parent. This would cause taxability of incomes of the parent, as can be attributed to Indian operations. E.g. a Representative /Liaison office does not carry on business activity in India and, consequently, in normal circumstances, will not form a PE. However, it can be pulled into the ambit and said to form a PE if it is directly involved in the negotiations of a contract for its parent

company. Then, and as an effect, part or whole of the contract can be taxed by India. Above example can be explained through the following graphical representation




### 6.1.2 *Indirect* Taxes

Indirect taxes are charges levied on goods and services. Some of the significant indirect taxes are Value Added Tax, Service Tax, Excise and Custom Duty. These taxes are finally charged to the customers.

#### *6.1.2.1 Excise Duty*

Excise duty is charged on the manufacturing unit for the goods produced in India. The duty varies between products. A detailed stock record and accounts in respect of the duty payable is required to be maintained by the manufacturing unit.

#### *6.1.2.2 Service Tax*

Service tax levied on specific services. The responsibility to pay the tax is on the service provider and they are required to deposit the tax collected on a monthly basis and submit bi-annual returns with the authorities. Tax is to recovered from the service receiver and separately shown in the invoice.

#### *6.1.2.3 Value Added Tax (VAT)/ Central Sales Tax* (CST)

Since April 1, 2005, all states in India have progressively replaced local sales tax with VAT. VAT is not different from local sales tax regime, except that it considers tax on value addition at each level of the distribution network. The state VAT is essentially a tax on sale of goods and does not applies to services. There are 5 slab rates i.e. 0 per cent, 1 per cent, 4 per cent, 12.5 per cent and 20 per cent.

VAT is levied on sale of goods within the state. If the sale is outside the state of origin, CST is levied. The standard rate of CST is 2 per cent provided both the seller and buyer are registered dealers. Else, the rate is as per VAT, as applicable in the state of seller.

CST/VAT is neither imposed on import of goods into, nor export of goods out of India.

## 6.2 Accounting and Audit

All businesses in India need to maintain accounting records in accordance with the Indian Generally Accepted Accounting Policies (GAAP). Accounting year can be financial year or calendar but the income tax laws mandate to close the books of accounts on a financial year basis i.e. April 1st to March 31st.

| REGULATORY MATTER | DUE DATE |
|---|---|
| **Corporate Law** | |
| Board Meeting | Quarterly (calendar year basis) |
| Annual General Meeting (AGM) | Within 180 days of closing the accounts |
| Annual Return with ROC | Within 30 days of holding the AGM |
| **Income Tax** | |
| Corporate Tax Return | September 30th |
| Tax Audit Report | September 30th |
| Transfer Pricing Report | September 30th |
| TDS Returns | Quarterly |
| Employee Tax Return | July 31st |
| **Service Tax** | **October 25th & April 25th** |

## 6.3 Labour Issues

With a view to ensure job security and to prevent exploitation by the employers, several legislations have been made covering various aspects viz. Child Labour, Industrial Disputes, Bonus, Gratuity, working hours, minimum wages, contribution to Provident Fund, Insurance etc. It is advisable that when planning a manufacturing operation in India, labour issues are given a clear look. The impact of bonus payable, future gratuity etc, are considered in the financial feasibility study.

## 6.4 Technology Transfer

Exchange control norms of India permit foreign technology collaboration wherein payment of lump-sum fee of USD 2 million and recurring royalty of 5 per cent on domestic sales and 8 per cent on exports are freely allowed. Additionally, royalty upto 2 per cent on exports and 1 per cent on domestic sales is allowed under automatic route in respect of use of trademarks and brand names of the foreign collaborator. Beyond these limits, prior permission of the Government of India is required. While finalizing technology transfer agreements, it is advisable to ensure transfer of intellectual property rights and understand tax impact on such arrangements.

# 7. FORTHCOMING MAJOR REFORMS

## 7.1 Direct Tax Code

A new Direct Tax Code has been proposed by the government of India to overhaul the outdated and cumbersome tax system. This code is under public debate and is targeted to be implemented in respect of financial year 2011-12 onwards.

## 7.2 Goods and Service Tax (GST)

The GST regime, scheduled for implementation from April 1, 2010 proposes to integrate the central levies such as excise duty, service tax, additional excise duty and customs duty, countervailing duty, surcharges etc under one GST regime. Besides, state levies such as value added tax, entertainment tax, luxury tax, octroi, central sales tax, stamp duty, telecom would also be covered under GST umbrella.

## 7.3 Companies Bill 2009

The Companies Bill, 2009 which on enactment will replace the entire Companies Act, would allow the country to have a modern legislation for growth and regulation of the corporate sector in India. Amongst other measures, the Bill proposes to allow formation of one-person company, have a simpler compliance regime for companies, prohibit insider trading by company directors or key managerial personnel. This is expected in 2010 early.

## 7.4 International Financial Reporting Standards (IFRS)

Effective April 1, 2011 every listed company in India and those companies where turnover exceed USD 25 million (approx), would need to adopt IFRS. The Indian accounting standards are alongside being required to coverage with IFRS and will thereafter cover all Indian Companies.