India's Investment Environment – August 2009

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I. Introduction

The environment for doing business in India is set to become easier, more convenient and investor friendly with the government initiative in e-business which will enable budding entrepreneurs to obtain central, state and even municipal clearances, licenses and permits online. When completed in 2019, the portal will include all state and central government departments covering more than 205 government-to-business services, including the issue of licenses and permits needed during the course of a company's business cycle.

Though the initiative would not reduce procedures, it would ensure minimum physical interface of potential entrepreneurs and investors with the government. Moreover, it would enable the setting of time bound targets for the issue of permits and other licenses. It is expected that when the project is complete, India will be part of a select group of countries in which a business can be started in three days. At present, it takes at least 30 days to set up a new business in India.

II. Expected changes in FDI rules:-

The following changes in FDI rules are expected in the near future:

(i) No more changes to Press Notes 2 and 4
In sharp divergence from its opposition to Press Notes 2 and 4 that relaxed FDI in February 2009, the government is not going to make further changes to the guidelines. According to these press notes, the FDI routed through an Indian company owned and controlled by resident Indians will not be taken into account while calculating sectoral limits.

The Department of Economic Affairs (DEA) and RBI have raised questions over the application of these guidelines. RBI was of the opinion that investors could be encouraged to set up companies in which non resident entities hold 49 percent of equity. In this event, downstream investments by such companies might cause them to breach sectoral FDI limits or undertake direct investments in companies in which FDI was prohibited.
http://www.business-standard.com/india/storypage.php?autono=368338

(ii) RBI opens FDI door for entry in new areas
The RBI has allowed investment of Foreign Venture Capital Funds (FVCFs) beyond the select investment options that were being offered in recent times. According to new guidelines, barring a few sensitive sectors, a FVCF registered in India is free to invest in almost any business in the country.

This move will allow the venture capital and private equity fund owners to undertake FDI without establishing a stand alone entity in India. The preferred sectors of FVCFs such as telecom, media and entertainment and BPO's are most likely to be benefited. However, for buying into firms which are outside the ten sectors identified for tax benefits to VCs, the FVCFs will need to either obtain the Foreign Investment Promotion Board (FIPB) approval or invest directly only where FDI is permitted automatically.

However, certain regulatory benefits under SEBI and FEMA regulations, such as exit and entry, pricing and lock-in relaxations will not be available for investments under FDI route.
http://epaper.timesofindia.com/Repository/ml.asp?Ref=RVRELzIwMDkvMDgvMjgjQXIwMDYwMA==&Mode=HTML&Locale=english-skin-custom

(iii) FDI in nuclear power plants may not be allowed
Atomic Energy Commission (AEC) of India has ruled out FDI in nuclear power plants. However, AEC is of the opinion that there should be no restrictions on manufacture and construction of nuclear equipment by private players. The AEC reasons that India is well poised to solely design as well as build Fast Breeder Reactors (FBR).

The AEC's views came close on the heels of the economic survey making a pitch for greater private participation even in the sensitive sectors of nuclear power generation. The survey called for allowing up to 49 percent FDI in the sector.
http://timesofindia.indiatimes.com/news/india/Kakodkar-rules-out-FDI-in-nuclear-plants/articleshow/4909421.cms

(iv) FDI in sensitive sectors may face lifelong tracking
The Indian National Security Council (NSC) has proposed that foreign companies willing to invest in sensitive sectors such as telecom, shipping, oil & gas, pharmaceuticals and defence and having exposure to countries such as China, Pakistan and Bangladesh should be screened not just at the time of approval but during their entire period of operation in India. The NSC is also of the view that FDI coming from entities with presence in countries such as Bangladesh, China, Pakistan, North Korea, Macau, Hong Kong and Taiwan should be subject to scrutiny.

The NSC notes that the existing system is flawed and does not possess a mechanism for examining fund inflows into/from sectors/countries identified as sensitive by the government. The exhaustive list corresponding to the automatic route allows these to escape even the most basic checking procedure.
http://www.financialexpress.com/news/security-concern-on-fdi-in-sensitive-sectors-resurfaces/502272/

(v) The tax liability of MNCs operating in India may go up
According to the draft Direct Taxes Code which is expected to come into force from 1st April 2011, multinational companies (MNCs) operating in India could see a substantial increase in their tax liability in the country. The Code proposes that a foreign company "will be treated as a resident of India if, at any time in the financial year, the control and management of its affairs is situated wholly of partly in India". In contrast, the present Income Tax Act deems a foreign company as residential during a fiscal year only if the control and management of its affairs is wholly in India.

Additionally, MNCs shall now be expected to pay a dividend distribution tax in the country and would be eligible for the benefits of double-tax avoidance agreement (DTAA) signed with its country of origin.
http://www.financialexpress.com/news/tax-liability-of-resident-foreign-firms-to-go-up/501847/

(vi) Change in DTAA with Mauritius likely

The government is negotiating amendments in the DTAA with Mauritius to check the entry of slush funds in the country through this route. The government is conscious of the potential for misuse of the double taxation treaty. However, the government is not considering a ban on Participatory Notes as SEBI and stock exchanges have been exercising sufficient caution to look out for any suspicious entry into the market.
http://lite.epaper.timesofindia.com/mobile.aspx?article=yes&pageid=4&edlabel=ETD&mydateHid=11-8-2009&pubname=Economic+Times+-+Delhi+-+Front+Page&edname=&articleid=Ar00402&format=&publabel=ET

(vii) US asks India to go easy on screening of its FDI

India and United States have started talks on a bilateral investment treaty that is aimed at easing capital flows to each other's shores. But fundamental differences in regard to the nature of the desired pact could delay its implementation.

The U.S. government has urged India to give pre-establishment national treatment status for investments by its companies. This would imply exemption to US companies from screening process carried out by the government agencies like FIPB. US also expects that that India should take responsibility for losses suffered by an American investor in carrying out pre-investment activity in the country such as market research. Such treatment has not been granted exemption through any of the 62 Bilateral Investment Promotion and Protection Agreements (BIPA) signed so far.

Notably, U.S. is the third largest foreign investor in India after Mauritius and Singapore. India has always been opposing inclusion of investment norms in the multilateral trade talks under the Doha Round.
http://www.financialexpress.com/news/us-wants-screening-exemption-for-investments-by-its-firms-in-india/501336/

(viii) Single law on foreign investment likely

The government is planning to introduce a new legislation for removing distinctions among various categories of foreign investments such as foreign portfolio investment, venture capital, private equity and direct investments. This will ensure stability in the policy and help Indian firms attract long term capital.

The existing rules make a distinction between portfolio investment and FDI. The norms prescribe a cap on portfolio flows and FDI, leading to confusion and lack of clarity.

(ix) Promoters of insurance entities to face five year lock-in period

The Insurance Regulatory and Development Authority of India (IRDA) has prescribed a minimum lock-in period of five years for promoters of insurance entities from the date of certificate of commencement of business of an insurer. Within this duration transfer of promoter's shares shall not be permitted. According to the Act, it will be mandatory to obtain

IRDA's nod for registration/transfer of shares which are above the ceiling of 1% and/or which involve holding of share capital, after such transfer, in excess of 5% of the paid-up capital of the company (2.5 percent for banking or Investment Company). The newly prescribed norms also inculcate corporate governance issues viz. external audit and hiring statutory auditors.
http://www.financialexpress.com/news/irda-seeks-5yr-lockin-period-for-insurance-co-promoters/498465/

(x) Telecom companies may be asked to fill senior positions with Indians
The government is considering a requirement that telecom companies fill senior management positions, including chief operating officer, with resident Indians. The proposal comes after state security agencies raised concerns over non-Indian managers having the ability to monitor and intercept calls.

The telecom companies are describing the proposal as retrograde as it would restrict the freedom of companies to make use of foreign expertise. It is also expected to complicate corporate mergers and acquisition activity such as Bharti Airtel's merger plan with MTN.
http://www.ft.com/cms/s/0/edc98e9a-86d6-11de-9e8e-00144feabdc0.html

(xi) Simpler mining laws to boost investment
The Government is in the process of amending the fifty year old Mines & Minerals (Development & Regulation) Act to make it easier to promote investment in the sector. At present, procedural matters related to mining are a big bottleneck discouraging foreign investors.
http://www.financialexpress.com/news/simpler-mining-laws-to-boost-investment/503666/

III. News & Views

(i) Regulators ask SBI's insurance partner to avoid Mauritius route
The government and financial regulators have asked Insurance Australia Group (IAG) to route its investment in the general insurance venture with State Bank of India (SBI) through Singapore instead of the original proposal to bring the money through a Mauritian subsidiary.

This decision has been taken to ensure transparency in these transactions which involve the country's largest bank, which is also in the public sector. Although the tax benefits under Comprehensive Economic Cooperation Agreement (CECA) are the same as those offered by the DTAA with Mauritius, the Indian government had ensured that companies do not use the Singapore route merely to avail fiscal incentives. As a result, a clause has been inserted in the CECA which consider companies eligible for tax benefits only after their presence for a specified number of years and investment exceeding a certain sum of money.
www.business-standard.com/.../regulators-ask-sbi%5Cs-insurance-partner-to-avoid-mauritius-route/367431/

(ii) Freeway to FDI in road sector
The government is planning to award contracts for building longer stretches of highways – 500 kilometres per contract as against an average of 200 kilometres now. This will involve vastly bigger sums of money. It is felt that this decision would not only bring FDI but also upgrade technology, management, work practice and speed in execution.

It is also argued that certain obstacles such as land acquisition, conflict of interest clause, and termination clause need to be addressed before foreigners begin to invest in road building in India.
http://www.thehindubusinessline.com/2009/08/22/stories/2009082250100800.htm

(iii) New direct tax code will be cause of worry for foreign investors
The new direct tax code seeks to revamp the tax regime for non-residents doing business in India. It is being argued that the Code's thrust on clarity, certainty, and effective dispute resolution is salutary and should go a long way in boosting India's image as a friendly investment destination. However, there are many areas such as tax residency, transfer pricing, royalty/ fees for technical services (FTS) taxation, which would be of great concern for foreign investors.

Whether implementation of this Code will prompt companies to show control and management as residing outside India is another issue for debate. Moreover, contrary to the objectives of the Code to simplify tax laws and reduce disputes, the provision is likely to expand scope for litigation as it would be up to the assessing officer to decide if a foreign company is indeed a resident one.
http://www.livemint.com/2009/08/23233840/New-code-will-be-cause-of-worr.html

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