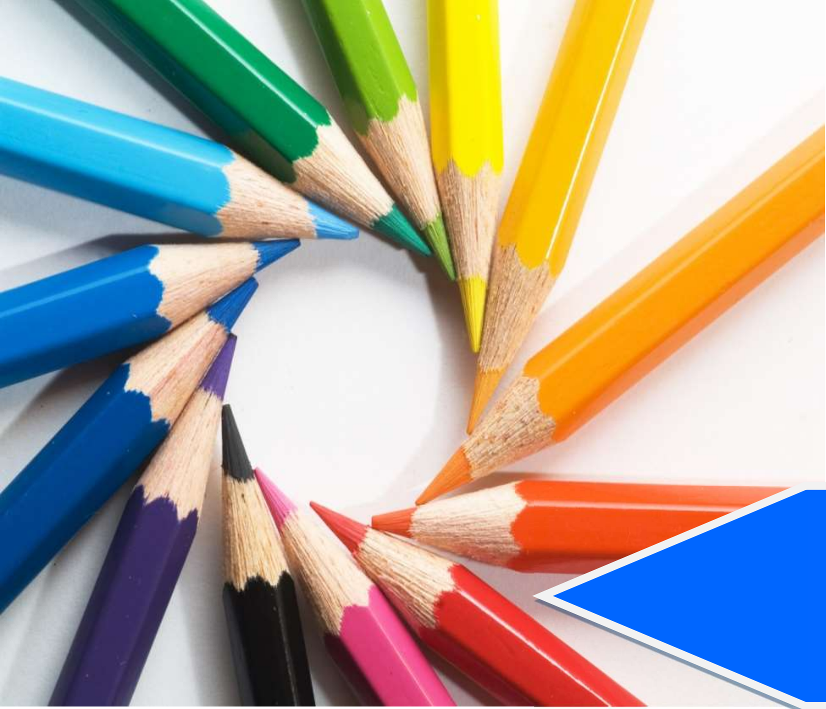

NEWSLETTER

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FEMA

THE LIBERALISED REMITTANCE SCHEME – LRS

The Tarapore committee which was constituted by The Reserve Bank of India (RBI) to suggest a roadmap on full convertibility of Rupee on Capital account transactions, submitted their report in May 1997 recommending liberalisation of controls on capital account transactions to be done in a phased manner. One of the recommendations was to allow an individual who is resident in India to invest in assets in financial markets overseas up to US $ 25,000 and gradually increase this amount in Phase II and Phase III, over a period of time.

Giving due regards to the recommendation of the committee, the RBI introduced the Liberalised Remittance Scheme (LRS) vide A.P. (Dir series) circular no. 64 dated 4th February 2004 which allowed a resident individual to remit outside India up to US $ 25,000 per calendar year **for permitted capital or current account transactions** or for combination of both.

Later on, the calendar year was changed to financial year and the limits were gradually raised over a period of time as depicted in the chart below. Currently, an individual who is resident in India is allowed to remit outside India up to **USD 250,000** in a **financial year** under the LRS.

The LRS							**Amounts in USD**
Date	4 Feb 2004	20 Dec 2006	8 Mar 2007	26 Sept 2007	14 Aug 2013	3 June 2014	26 May 2015
LRS limits	25,000	50,000	100,000	200,000	75,000	125,000	250,000

- **Who can avail benefit under this scheme?**

  The remittance can be made under the LRS by a **Resident Individual only**. An HUF, Partnership firm, Company, Trust, any Association of Persons, Body of Individuals or ant Artificial juridical person cannot avail benefit of remittance under this scheme.

- **Which are the permitted CAPITAL ACCOUNT transactions an individual can undertake?**

  It is our general understanding that all capital account transactions are prohibited to be undertaken unless they are specifically permitted by the RBI. An individual is specifically allowed to remit outside India the following nature of capital account transactions under the scheme:

  - ✓ Opening a **foreign currency account** abroad with a bank
  - ✓ Purchase of **property** abroad
  - ✓ Making **investment** abroad in equity shares, debt instruments, Mutual funds, Venture Capital funds etc.
  - ✓ Extending Loans to Non-Resident Indians who are **relatives** as defined under the Companies' Act.
  - ✓ Setting up Wholly Owned subsidiary **(WOS)** or a Joint Venture **(JV)** outside India for any bonafide business purpose subject to the rules framed under the Overseas Direct Investments (ODI) regulations.

  In my opinion, any capital account transaction which falls outside the purview of the above list is not permitted to be undertaken under this scheme.

- **Which are the permitted CURRENT ACCOUNT transactions an individual can undertake?**

It is the general understanding that all the current account transactions are permitted to be undertaken unless they are specifically prohibited by regulation. Therefore every ‘current account transaction’ is permitted to be undertaken, **within prescribed limit**, unless there is specific prohibition from undertaking the same. The limit of USD 250,000 in a financial year actually subsumes remittance for all the current account transactions under its ambit. Following are the nature of current account transactions that are subsumed under this scheme:

a) **Private visits abroad:**

An individual is allowed to obtain foreign exchange from an Authorised Dealer (AD) or an FFMC for his private visit abroad **except for visits to Nepal and Bhutan.** All the tour related expenses abroad like euro rail ticket, overseas hotel/lodging expenses shall all be subsumed under the LRS limit.

b) **Gift to Non-residents:**

An individual resident is allowed to remit gift to a person residing outside India. A resident, however, cannot gift to another resident in foreign currency, for the credit to latter’s foreign currency account held abroad under this LRS scheme.

An individual resident can also make a rupee gift to an NRI/PIO who is a ‘Relative’ of the resident individual. The amount should be credited to the NRO Account. The gift amount has to be within the overall limit of the LRS per Financial Year. It would be the responsibility of the resident donor to ensure that all the remittances made by the donor during the financial year including the gift amount have not exceeded the limit of USD 250,000 prescribed under the LRS. The term ‘relative’ will be as defined under the Companies’ Act 2013.

c) **Donation:**

An individual resident is allowed to remit donation **to an organisation outside India.**

d) **Employment:**

A resident individual going abroad for ‘Employment’ can draw foreign exchange up to USD 250,000 per financial year.

e) **Maintenance of close relative:**

An individual resident can remit up to USD 250,000 per financial year for maintenance of close relative abroad. The term ‘relative’ will be as defined under the Companies’ Act 2013.

f) **Business trip:**

A resident individual who needs to take up any business trip in connection with any conference, seminar, training can draw foreign exchange up to the LRS limit.

If an employee is deputed by his Company for any business trip for any of the above purposes and the expenses are borne by the company, the same shall not be regarded as foreign exchange used by the individual from his LRS limit. Such kind of expenses which are incurred by companies are regarded as residual current account transactions and are permitted without any limit.

g) Medical Treatment abroad:

A resident individual is allowed to draw foreign exchange up to the LRS limit for medical treatment abroad without submitting any estimate or supporting for the treatment. An Authorised Dealer can also allow remittances in excess of the LRS limit based on the estimate of medical expenses from a doctor in India or doctor/hospital abroad.

In addition to the above, the Authorised Dealer may further allow a sum up to USD 250,000 to a person for **accompanying as an attendant** to the patient going abroad for medical treatment.

h) Students going abroad:

Authorised Dealers are allowed to release foreign exchange up to the LRS limit to resident individual for studies abroad without any estimate or supporting from the foreign University. An Authorised Dealer can also allow remittances in excess of the LRS limit based on the estimate received from the Universities abroad.

- **Which are the transactions that are not permitted under this scheme?**

Following are some of the remittances which are mentioned under Schedule 1 of the Foreign Exchange Management (Current Account Transactions) Rules are **prohibited** and therefore not allowed even under the LRS:

- ✓ Out of lottery winnings;
- ✓ Income from racing and riding or other hobbies;
- ✓ Purchase of lottery tickets, banned magazines etc;

Remittance on capital account is also not permitted to be made under this scheme to countries identified by Financial Action Task Force (FATF) as non-cooperative countries notified by the RBI.

- **Repatriation of funds:**

An investor who has remitted funds under the scheme is **not required to repatriate funds or income** generated out of this investment made under the scheme back to India. He is in fact allowed to retain and reinvest the income earned on the investments abroad.

However, if Overseas Direct Investment (ODI) is made under this scheme in the equity shares or compulsory convertible debentures/preference shares, the guidelines and regulations as specified under the ODI regulation will need to be followed and complied with.

- **Some other important information:**

It is important to note that an individual is required to **designate a single branch of an AD** through which all the remittances under the scheme will have to be made.

The AD bank is required to ensure that the **'Know Your Customer'** guidelines and **'Anti Money laundering'** rules are complied with.

The remittance must be made by a resident individual out of his/her **own funds**.

The AD bank is not permitted to lend money to anyone for the purpose of making any remittance under this scheme.

It is mandatory for the resident individual to make full and proper **disclosure** of all the income generated out of the remittance made under this scheme as well as assets created and located abroad in his income tax return.

Under the Income Tax Act, section 206C(1G) has been recently introduced which is applicable from 1st October 2020. According to this section, if any remittance is made under LRS for an amount exceeding

Rs. 700,000/-, the AD bank is required to collect tax at source **(TCS) @ 5%** on the amount that **exceeds Rs. 700,000/-.** The resident individual will get a certificate of such tax payment and can claim this TCS against his personal tax liability.

It is further provided that if the amount of remittance by an individual under LRS represents payment our of the loan taken from a defined financial institution for the purpose of pursuing **any education** abroad, the rate of TCS shall stand reduced to **0.5%** (as against 5%) on the amount that exceeds Rs. 700,000/-.

As can be seen from above, there is substantial relaxation and flexibility given by the RBI to an Indian resident individual to remit funds abroad. By and large, for most of the purposes and reasons for which the funds are generally required to be remitted abroad are covered and permitted under this scheme. Further, the procedure of remittance of funds is also quite simple. An individual is only required to fill up Form **A2, a declaration form** and submitted some informative documents to make the remittance. **No further reporting** as regards the performance of the investment abroad is required to be done to the RBI.

Compiled by **CA Malay Damania Partner**, DNV & Co.

INTERNATIONAL TAX

THIN CAPITALISATION NORMS

DISALLOWANCE OF 'EXCESS INTEREST' ON ECB – SECTION 94B

History and Background:

With the continued efforts by the Indian policy makers on liberalisation and thrust on globalisation, India has remained one of the most attractive destination for foreign companies to set up their business establishments. There have been progressive reforms undertaken by the Indian Government in implementing One Nation One Tax - GST, Insolvency and Bankruptcy code (IBC), RERA to add to the famous campion of 'Ease of doing business' in India. India has inherent advantage of vast middle-class population, skilled and English-speaking resources, comparative low-cost labour which all adds up to India being a preferred destination for foreign companies to set up their businesses in.

The Foreign Direct Investment (FDI) Policy as framed by the Government of India and Foreign Exchange management Act (FEMA) as regulated by the RBI has put most of the business sectors under 'automatic route' which means that for most of these business sectors, the foreign companies can without obtaining any prior permission from any Government authority, set up their business establishment in India. They are only required to report to the RBI once the business is set up.

FDI vis-à-vis ECB:

These foreign companies (FCO) typically establish their subsidiary or associate company in India. They have principally two ways of infusing funds into them viz 1) By way of subscribing to the equity share capital in the company and 2) In addition to the capital, by way of lending to these companies. The lending by the foreign companies to the Indian subsidiary/associate companies are referred to as External Commercial Borrowings (ECB). Though the ECB generally comes under approval route, to encourage more funds to flow in India, the scope and allowability of ECB has been substantially relaxed in last couple of years.

Given an option between infusing funds by way of equity (FDI) and ECB, the foreign companies would almost always prefer ECB. This is due to the fact that they can charge interest from the Indian company and the funds can be easily returned back to the parent/group lending company on completion of the tenure of the ECB. On the other hand, while RBI has relaxed ECB norms to encourage more and free flow of funds into India, it is always in favour of receiving funds in the form of FDI. This is due too the fact that funds received in the form of FDI remains in the country for much longer duration. It has inherent characteristics of permanency in nature.

To strike a balance between receiving funds in the form of FDI and as ECB by the Indian subsidiary/associate company, RBI has provided the ECB from direct equity shareholder cannot exceed the limit of ECB debt liability to equity ratio of 7:1. The Indian company therefore can borrow ECB within these specified limits only, albeit this ratio of limitation applies only in case where the ECB is more than USD 5 million.

The Taxation angle:

Amidst this background, The Finance Act, 2017 inserted **Section 94B** which is applicable from Assessment year 2018 – 19 which largely impacts the subsidiaries/associates of the foreign companies (this includes a Permanent Establishment of a foreign Company in India) in India which has taken large ECB from their parent or group companies. The section seeks to discourage the Indian subsidiaries/associate companies of the foreign entities to borrow large amount of ECB but does not have enough profits to absorb it.

"Excess interest" would mean an amount of total interest cost **in excess of 30% of Earning before interest, taxes, depreciation and amortisation (EBIDTA)** of the borrowing Company in the previous year OR interest paid to the Associated Enterprise (foreign parent/group company) for that previous year, **whichever is LESS.**

Since the liberalisation of ECB regulations by RBI, it is practically seen that the foreign Companies that have set up their subsidiaries/associates in India, establish the Company with comparatively lower equity share capital and infuse funds by lending money through External Commercial Borrowing (ECB) route to meet the requirement of the fund flow of the Indian subsidiary/associate Company.

By this way, the foreign Company is able to 1) repatriate interest cost on the ECB to the parent/group company, every year and also 2) return the loan taken in the form of ECB as per the terms of the loan agreement. Very little capital is left in the Indian Company that represents foreign direct investment of the foreign Company.

Section 94B states that where an Indian Company borrows money from its non-resident associated enterprise (AE) and incurs any expenditure by way of interest or similar cost, such interest shall not be allowable as deduction from the total income of the Indian Company to the extent it is regarded as "Excess Interest".

This would effectively mean that if the Indian subsidiary/associated company has borrowed money under ECB and do not have sufficient net profit, as defined as excess interest under this section, to absorb the interest payment to the foreign parent/group company, the excess amount over the 30% of the EBIDTA will stand to be disallowed in the previous year in question.

This can be explained by way of following illustrative examples:

Description	Case 1	Case 2	Case 3
EBIDTA	**100**	**100**	**100**
Interest paid to outside (Non AE)	40	30	20
Interest paid to foreign AE	20	30	40
Total Interest cost	**60**	**60**	**60**
Disallowance of interest calculation:			
30% of EBIDTA	30	30	30
Total interest cost in excess of 30% of EBIDTA (Total – A)	30	30	30
Interest paid to AE (Total - B)	20	30	40
Excess Interest (Lower of Total (A or B))	**20**	**30**	**30**

It has been further provided that If Indian Company borrows from a lender who is not an AE but an AE has given an implicit or explicit **guarantee** to the lender, such borrowing shall also be regarded as borrowing from an AE and accordingly this section shall apply to them.

Where for any assessment year, the interest is not fully deductible, the excess interest so calculated, shall be carried forward to subsequent assessment year/s and it shall be deductible from against profits of any business carried on by the Company to the extent it falls within the maximum allowable interest as calculated above. No such excess interest can be carried forward for more than **8 assessment years** immediately succeeding the assessment year for which the excess interest was first computed.

The entire Section 94B on thin capitalisation will not apply to Indian subsidiary/associate Companies who have borrowed ECB but the interest or similar expenditure does not exceed **Rs. 1 crore** in a financial year. Therefore, relatively small and medium companies and the Companies which has relatively lower ECB exposure will not get impacted by the disallowance of expenditure under this section. It also does not apply to companies engaged in the business of banking or insurance.

It is clarified that ‘debt’ or borrowing would mean any loan, financial instrument, finance lease, financial derivative, or any arrangement that gives rise to interest, discounts or other finance charges.

Therefore, all the subsidiaries/associate companies of foreign entities who have borrowed funds under ECB, while preparing the computation of taxable income, will have to check whether they are exposed to any impact of disallowance of interest under this section.

Compiled by CA Malay Damania Partner, DNV & Co.
