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Outbound Investments from India – A Bouquet of Tax Considerations [Part I]

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Amit Dhadphale

CA Nikita Agrawal

CA Nikhil Shimpi

This article is a two-part series. In Part 1, the Authors touch upon various aspects of outbound investments from India including the tax considerations from the perspective of setting up of overseas presence (legal structure, jurisdiction) and nuances arising out of the financing aspect viz, financing via equity/debt or hybrid model. In Part2, we shall discuss certain additional tax considerations which are essential for Indian MNCs from operational perspective which need to be considered while setting up an overseas presence.

Background

The introduction of liberalisation, privatisation, and globalisation policy in India, brought significant changes in the Indian economy. Since then, the Indian economy flourished with overseas funding in various sectors in form of subscription to debt instruments, foreign direct investment, etc.

It wasn't just the beginning of a new era in inbound investment, but also a kick start to outbound investments, and since then a number of Indian promoter-based entities have established global presence, either in the form of Wholly-Owned Subsidiaries ('WOS'), Joint Ventures ('JV'), or branch offices. Big global acquisitions by Indian business houses such as acquisition of Jaguar Land Rover businesses by Tata Motors, investment in overseas entities by Serum Institute of India to manufacture and expand its vaccine business overseas and those by Tata Steel, Wipro, Tata Power, Reliance Industries, etc., are the testimonials to Indian Corporate houses focusing on growing their business overseas.

The Indian outbound trend has continued and is further multiplied by the booming start-up ecosystem in India. The monthly average statistics of Outward Foreign Direct Investment from India for the period January 2021 to October 2021 of more than USD 2,000 million[1] illustrates that the numbers are on a constant rise.

While the significant outbound investments by the India Inc. is a welcome aspect from the perspective of Indian economy, the Indian MNCs need to be mindful of important Tax and Transfer Pricing (TP) aspects for their outbound investments and dealings to avoid any surprises or tax controversies.

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Considering this, in the ensuing paras, the authors have outlined certain key tax parameters that could impact Indian MNCs aspiring to establish a presence globally.

Setting up overseas presence

First step while setting up overseas operations is deciding upon the legal entity structure and the overseas jurisdiction. While the business can be housed in various legal forms such as a Company, General Partnership, Limited Liability Partnership, Branch Office, etc, due considerations need to be given to the tax and regulatory parameters as well. For example: investment criteria and exchange control regulations for each entity type, financing criteria i.e permissibility of issuing various debt, equity or hybrid instruments, profit attribution requirements, dividend/ cash repatriation tax business model of the entity and the TP policies for the intercompany transactions, and other local regulations may also have a commercial bearing.

Along with the legal entity structure, the Group holding structure should also be evaluated and considered to optimise the operational tax cost and tax cost on cash repatriation as well as exit gains. This also involves analysis on whether to set-up operational Hold Companies ('Cos'), Regional Hold Cos, Industry Specific Hold Cos or Corporate Hold Cos, etc. Towards this, certain other tax considerations such as appropriate tax jurisdictions for overseas investment, ultimate beneficial ownership criteria and disclosure rules of the jurisdiction, operating substance requirements, etc shall also be examined. For example, say a particular treaty benefit may be available only if the overseas entity is ultimate beneficial owner of the income or is in substance situated in the jurisdiction with which treaty benefit is being considered. A branch structure may need an additional analysis from a profit attribution perspective.

Financial transactions

With the establishment of group entities globally, to satisfy the financial requirements of the group entities, MNCs enter into various kinds of financial transactions ranging from subscription to debt instruments, equity investments, issuance of corporate guarantee, etc. Funding continues to be an important element for any business and considering the continuing rise of the intragroup financial transactions, on 11th February 2020, Organisation for Organisation for Economic Co-operation and Development ('OECD') released its final report on Financial Transaction as part of BEPS Action Plan 4, 8-10, to address TP issues revolving around the financial transactions undertaken between group entities. Provided below are certain key aspects in respect of the financial transactions undertaken by MNCs headquartered in India.

Overseas debt subscription

Considering the commercial and economic feasibilities, generally, intra-group funding, in the form of External Commercial Borrowings, Convertible Debt Instruments, advance payment against imports, etc. are preferred sources by multiple MNCs. The key tax aspects to be considered for intra-group financing arrangement are outlined below:

- **Consideration from arm's length rate perspective**

The TP provisions would require evaluation of not only the remuneration in respect of the loans from an arm's length price ('ALP') perspective, but also if the terms of the transaction represent circumstances under which a third party would have been willing to source the funding requirements of respective group entity.

Generally, under intragroup funding arrangements, terms pertaining to interest moratorium exist, i.e., delay in payment of interest, without any loss of interest for the lender. Under such circumstances, it becomes necessary to compute the ALP of interest rate, which takes care of loss of interest on account of moratorium period. For the purpose of determination of arm's length rate of interest, mere reliance on lending rates charged/ offered by the Banks might not be appropriate since it might not be taking care of the loss of interest, on account of the moratorium. The interest rate on loan is a consequence of various factors, viz. the repayment period, existence of financial security in case of default, currency of loan, ability of recipient to obtain loan from independent parties, credit rating of the borrower, cost of loan for the lender, options realistically available for transacting parties, economic inflation, etc.

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In case of CCDs/ OCDs having interest moratorium clause, premature conversion/ redemption of the said instruments, would require evaluation of impact of loss of interest on account of said arrangement, thereby warranting computation of notional interest on account of premature conversions/ redemptions. Additionally, the arm's length rate for conversion of CCDs/ OCDs into equity, along with terms and conditions of instrument, need to be analysed.

In view of the above, in order to comply with TP regulations, it becomes essential to undertake benchmarking analysis, to validate the arm's length nature of debt instrument, both from lender and borrower perspective.

Along with tax and TP provisions, it is also essential to ensure due evaluation of the exchange control regulations of the respective jurisdictions to examine whether the loans advanced are within the permissible limit and the interest is charged on such loans as per the guidelines under exchange control regulations of both jurisdictions.

- **Deductibility of interest expense in hands of Indian parent**

On multiple instances, Indian parent companies borrow funds from banks at a certain interest rate and onward lend it to their foreign subsidiaries either at a lower interest rate or interest-free. From a corporate tax point of view, such an arrangement creates additional risk in hands of the Indian parent on the allowability of such excess interest paid (where funds are lent interest-free) or the interest gap (where funds are lent at a lower interest rate). Whether such funds borrowed by the Indian parent are utilised for the purpose of its business and hence whether the interest paid on the same should be an allowable business expenditure, has been a subject matter of judicial controversy.

Hon'ble Supreme Court in the case of S.A. Builders Ltd (288 ITR 1) (SC) held that when an Assessee borrows funds from the bank and lends some of it to its sister concern as an interest-free loan, interest deduction shall be allowed under section 36(1) (iii) of the Income-tax Act, 1961 ('Act') if the borrowed funds were advanced for the purpose of commercial expediency.[2]

Thus, in such intra-group lending cases, interpretation of the term 'commercial expediency' and factual aspect as to whether commercial expediency exists between the business of Indian parent and its overseas venture becomes important to be ironed out.

Also, it is pertinent to note that the risk of disallowance of interest rises where there is direct nexus between borrowed funds and interest-free overseas loans given or where there are no interest-free funds available with Indian parent. Ideally, in a situation where the Indian parent has a mix pool of interest-free funds and interest-bearing funds, an argument could be explored if interest free advances can be regarded as attributable to available interest free funds.

- **Thin Capitalization rules in overseas jurisdictions**

In a case where corporates prefer debt financing over equity financing, the concept of thin capitalization comes into the picture. To discourage debt financing by transferring funds from low tax jurisdictions to high tax jurisdictions for tax benefits, many countries have implemented thin capitalization rules which limit the amount of interest a company can claim as deduction for tax purposes. In India, the concept of thin capitalization is introduced by way of section 94B of the Act, wherein the amount of interest deduction is capped to 30% of EBITDA for the year.

Thus, in case of debt funding, there could be a situation where the foreign subsidiary is not able to claim full interest cost deduction because of thin capitalization rules and the Indian parent company pays tax on full interest income resulting in overall tax loss as a group – especially in the initial years when the profitability of the overseas subsidiary might be on a lower side and cases where there is no moratorium period for loans advanced. Thus, financing debt transactions should be carefully planned and analysed, and respective tax laws should be considered.

- **Deemed dividend exposure**

Subject to commercial considerations and availability of funds, there could be situations wherein

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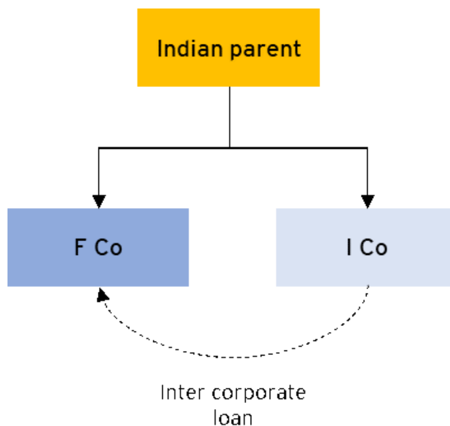
overseas debt is infused from a group entity other than the Indian parent especially another domestic subsidiary of the Indian parent.



In case of a closely held Indian group, such a funding arrangement could create additional tax exposures as subject to availability of accumulated profits, the amount of loan granted by the domestic subsidiary to the foreign subsidiary could be taxed in the hands of the Indian parent as deemed dividend under the provisions of section 2 (22) (e) of the Act.

In multi-level and complex group structures wherein, there are multiple Indian as well as foreign entities the provisions of section 2 (22) (e) should be importantly evaluated so as to minimize the risk of deemed dividend taxation.

Corporate guarantees (‘CG’)

As an alternative to intra group funding, MNCs rely on external sources of funding, where Banks insist for a CG from the Parent entity.

At the inception of introduction of TP provisions in India, the primary question of dispute was, whether the transaction of provision of CG is an international transaction, thereby subjected to TP provisions in India. Over a period of time, the said dispute sought attention of various Appellate authorities, to grant certainty regarding qualification of provision of CG as an international transaction. On identification of said transaction as an international transaction, computation of arm’s length remuneration for same.

For the purpose of ALP computation, the crucial aspect is to evaluate benefits derived on account of CG extended by the Indian parent, which can be in the form of excess credit period, reduced rate of interest, access to a larger amount of funds, etc. In this regard, while the Indian tax authorities, have generally been concluding on a fixed rate of principal amount (generally in the range of 0.5% - 1%) as ALP, the Safe Harbour Rules have notified 1% of the amount guaranteed, as ALP for CG. However, it might not be always beneficial for MNCs to consider fixed rate for the purpose of computation of guarantee fees and hence fact specific benchmarking analysis is to be undertaken to compute the ALP of the same. Additionally, reference can also be made to the globally prescribed basis for computation of same. The OECD guidelines prescribe application of various alternatives, viz. Comparable Uncontrolled Price approach, Yield approach, Cost approach, valuation of expected loss approach, capital support method, etc. to determine the ALP of provision of CG.

With regard to the CG fees received by the Indian parent from its overseas subsidiary, withholding tax implications per the local regulations in the overseas jurisdictions read with the applicable tax treaty with India become relevant. Basis the reading of applicable tax treaty, the corporate guarantee fees could either be categorised under the Interest Article or Other Income. Needless to mention that the said income shall be taxable in India in hands of the parent entity, and it can claim credit for foreign taxes paid (if applicable).

Further, irrespective of whether CG fees are paid or not, in case where the guarantee is invoked due to a

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default by the overseas subsidiary it shall be essential to examine whether the Indian parent company shall be allowed tax deduction of the loan and/or interest repayment made by it on behalf of its subsidiary and factor appropriate clauses in the intercompany loan agreement in advance.

BEPS – Action 9 (Aligning TP outcomes with value creation: risks and capital)

The OECD BEPS Action 9 provides that the assumption/ allocation of risks has a significant impact on transfer price and hence it is essential to evaluate actual conduct over the contractual conduct of transacting parties. In this regard, OECD guidelines have prescribed a six-step approach for analysing the risk, where one of the essential factors is whether the party assuming the risk has the financial capacity to assume the risk, in the absence of which, the resulting rewards pertaining to financial transactions, should be allocated to the entity exercising control and having financial capacity to assume the risk.

In the context of Indian outbound entities, it becomes essential to analyse the risks assumed by Indian parent entities, in respect of intra-group loans, even if the said entity is not a party to the transaction. Similarly, in respect of loans availed by group entities, it is essential to evaluate if it was for its own funding or to seek tax benefits for group. Under such circumstances, if it is concluded that the Indian entity is the real risk bearing entity, it could be entitled to rewards arising as a consequence of the said risks.

Equity subscription and dividends

Equity infusion is one of the primary means of overseas direct investment by Indian MNCs. The share in equity capital of an entity is one of the essential criteria to evaluate existence of relation of Associated Enterprises. Unlike the first-time subscription in the equity capital of group entity, subsequent subscriptions, would attract TP provisions in hands of Indian parent and hence documentation capturing fair market value of shares is to be prepared and maintained, to comply with TP regulations.

Further, Indian parent entities setting up WOS and JV overseas receive inter corporate dividend from such ventures once the businesses turn profitable.

In India, dividend received by the Indian parent from its foreign subsidiary/JV, in which such domestic company has 26% or more equity shareholding, is taxable at a rate of 15% (plus applicable surcharge and cess). Whereas the same is taxable at normal tax rate in an otherwise scenario. The dividend taxable in the hands of Indian parent would additionally warrant TP compliance as per the provisions of the Act.

It is important to note that subject to applicable local laws and per the provisions of applicable tax treaty, the dividend income could also be taxed in hands of the Indian parent in the overseas state. However, to be eligible to claim tax treaty benefits on such foreign taxes, Indian entity should ensure compliance with beneficial ownership and economic substance related conditions.

Further, where the dividend received by the Indian parent entity is onward distributed by it to its shareholders, same dividend income is being taxed twice (once in the hands of the Indian parent and then in hands of its shareholders).

Therefore, to remove the cascading effect, benefit of section 80M of the Act has been made available where the gross total income of a domestic company includes dividend received from any another domestic company or foreign company or business trust, and the same is onward distributed to its shareholders.

However, there are various nuances around the claim of deduction under section 80M of the Act and implications could vary based on facts. Further, issues arise in case the Indian parent receives dividend income from foreign subsidiary as well as Indian domestic subsidiary as section 80M of the Act does not distinguish/ prioritize distribution of dividend received from foreign Company/ Indian Company.

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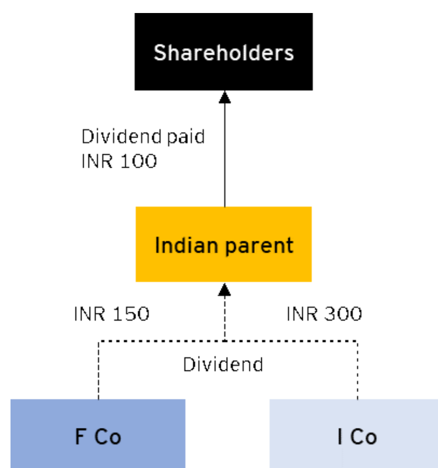

When the dividend onward distributed by the Indian parent is less than the total dividend income from foreign and domestic subsidiary, a view could be explored to take beneficial allocation as amount distributed can first be set off against, the Indian dividend income, and the balance can be subjected to tax as per the beneficial provisions of section 115BBD of the Act.

Further, appropriate claim for foreign tax credit should be evaluated by the Indian parent depending upon whether or not the entire dividend income included in the Gross Total Income is claimed as deduction under section 80M of the Act.

In addition to the above, similar to the case of debt financing, the risk of interest disallowance exists in case the Indian parent makes an equity infusion in the overseas subsidiary by borrowing interest bearing funds. However, in this case, the Indian entity could explore a claim for interest deduction against the dividend income earned from the overseas subsidiary.

Apart from debt and equity financing, in case hybrid financing instruments and embedded options, due considerations should be given to tax and TP aspects after considering the substance of the instruments and the Accounting treatment.

Concluding thoughts

Clearly, this is just a beginning. Outbound investments bring along new set of challenges for Indian business Groups. Please stay tuned in for the next part of the article for insights on some additional aspects viz. tax considerations for Indian MNCs earning income globally from intangibles, royalties, patents, trademarks and from intragroup services. The authors would also touch upon some important tax aspects like overseas PE exposure, POEM of foreign subsidiary, SEP provisions, exit tax, business restructuring, compliance, and reporting requirements, etc in the second part of the article.

The authors acknowledge the contribution of CA Jaishal Parmar in drafting this article.

The views and opinions expressed in this Article are those of the Authors.

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[1] Reserve Bank of India - Data on Overseas Investment (rbi.org.in)

[2] However, in case of Tulip Stars Hotels Ltd. (21 taxmann.com 97) (SC), larger bench of the SC has expressed a view in interim order that S.A. Builders ruling (which was 2 Judge bench ruling) requires re-consideration. The matter is currently pending for final hearing. Going by the settled rule of binding judicial precedent, the principle of S.A. Builders ruling shall be binding as law of the land unless overruled by larger bench of SC and/or by amendment in law.

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