

Private Client Wrap

April 01, 2014

PRIVATE CLIENT WRAP: QUARTER 1, 2014 IN REVIEW

- New Foreign Portfolio Investor regime denies benefit of higher investment limits to NRIs
- Succession plans in top management a must for boards of Indian listed companies
- No tax payable on pro-rata rights issuance rules Mumbai Tribunal - some flexibility, some difficulty for family held companies
- Rules implementing mandatory corporate social responsibility policy for certain companies notified
- Delhi High Court dispenses with requirement for Hindu couples abroad to be personally present for registering their marriage in New Delhi
- Muslim couples allowed status of adoptive parents under Juvenile Justice Act, 2000 rather than mere guardians under customary law or Guardians and Wards Act, 1890

Dear Reader,

The United Nations has declared 2014 as the International Year of Crystallography, a science that studies how miniscule particles combine to make a solid whole. It seems easy to draw parallels between this and what is set to happen in India in just a few weeks i.e. the coming together of hundreds of thousands of Indians (including several first timers, as per reports), who will piece together single votes to elect a Government for the largest democracy in the world. The idea of it is daunting, for sure, and yet there is an atmosphere of cautious optimism for the changes this exercise promises to bring about.

Meanwhile, Q1 has largely been a wait-and-watch period. The interim Budget (presented in mid-February) had little of note. While the current government seems to have been startled into action in the past few months, it is the next two quarters that will bring in key policy and budget changes, once the new Government takes office later this year. For now, here's a wrap up of key events so far.

NEW FOREIGN PORTFOLIO INVESTOR REGIME

Until recently, non-residents looking to invest into India were faced with the choice of a variety of investor categories. They were required to decide if they were eligible to come in as: (i) Foreign Venture Capital Investors (FVCIs); (ii) Foreign Institutional Investors (FIIs) and Sub-Accounts; (iii) Qualified Foreign Investors (QFIs); or (iv) Non-Resident Indian investors (including Persons of Indian Origin) (NRIs), each category involving specified restrictions and benefits.

In June 2013, the Chandrashekhar Committee Report¹ recommended certain measures to do away with some of this complexity, which led to the SEBI² ushering in the (Foreign Portfolio Investments) Regulations, 2014 ("FPI Regulations")³ on 7 January 2014. The FPI Regulations which are to commence from 1 June 2014, repeal the SEBI (Foreign Institutional Investors) Regulations, 1995; club FIIs, Sub-Accounts, and QFIs (except NRIs) into a single investor class titled foreign portfolio investors (FPIs)⁴; and introduce a risk-based classification with progressively stringent KYC norms.⁵

Category I FPIs include the Government and Government-related investors and Category II FPIs include regulated entities, university/pension funds and university endowments registered as sub-accounts. Category III FPIs (perceived to have the highest risk profile) include endowments, charitable societies, charitable trusts, foundations, corporate bodies, trusts, individuals and family offices. Basically, the entities in Category III are the same investor categories that were allowed to participate under the erstwhile QFI regime with one notable exception: NRIs.

As a consequence of the above measures:

- NRIs lose out on the benefit granted to erstwhile QFIs under the FPI Regulations, i.e., expanded scope of investments, greater investment limits and simplified operational framework. An FPI's investment must be below 10% of the issued capital of a company. To that extent and subject to necessary amendments in the exchange control laws, the investment bandwidth for an FPI is now almost 100% more than that of an NRI under the previous regime.
- Family offices, corporate bodies and trusts that manage NRI money will be able to access the benefits of greater investment limits as Category III FPIs but (unlike other FPIs) they are prohibited from issuing or dealing with Offshore Derivative Instruments.

At this point it is unclear whether the omission of NRIs from Category III was intended. While the restriction may be inapplicable if the individual invests through a corporate vehicle instead of directly, the income may then not be eligible for the beneficial income tax rates available to NRIs, which would be a deterrent in today's "substance focussed" international tax regime. There also doesn't appear to be a clear regulatory rationale for the exclusion,

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even leaving aside the fact that it would be logical for NRIs to be permitted to invest more into India considering the current Indian economic situation and the vast and wealthy network of Indian diaspora.

PRO RATA ISSUE OF SHARES AT BELOW FAIR MARKET VALUE NOT TAXABLE

The Mumbai bench of the Income Tax Appellate Tribunal (“**Tribunal**”) has recently ruled that⁶ no income tax is payable by a shareholder (an individual or a Hindu Undivided Family (“**HUF**”)) if there is a pro-rata allotment of shares to existing shareholders. On the other hand, if the allotment of shares results in change in the percentage of holding, there may be tax consequences.

The background to the ruling is, that Section 56(2)(vii)(c) of the Income Tax Act, 1961 seeks to tax any individual or HUF on the notional income arising on receipt of any property (except immovable property), if it is received without consideration or for lower than the fair market value. Introduced as an anti-avoidance measure, there have been attempts to apply it to a wide variety of arrangements including distributions by a trust to its beneficiaries (even though the trust may have paid tax), rights issuance of shares etc.

In this case, an HUF (“**Taxpayer**”), held 4.98% of the shares in Dorf Ketel Chemicals Pvt. Ltd. (“**DKCLP**”), with almost the whole capital in DKCLP held by family members of the Taxpayer’s karta (manager of HUF) family. Upon a rights issuance, the Taxpayer subscribed to some shares and renounced some, as a consequence of which its holding reduced to 3.17%. The Revenue brought to tax the notional income on price paid for the subscribed shares (INR 100) and the FMV of the company (INR 1,538) under the above Section 56.

The Tribunal rejected the Revenue’s arguments and held that a proportionate issue of shares by a company to its existing shareholders was merely an apportionment of the value of their existing shareholding over a larger number of shares and no additional property was transferred to them. The Tribunal also examined the difference between the “transfer” of a property and the “receipt” of property, and held that a transfer in its ordinary sense was not required for the purpose of Section 56.

It is unclear from the ruling whether there was any impact in the hands of the other shareholders, whose shareholding increased by virtue of the rights issuance. Based on this judgment, this may well be the case. The irony here is that section 56 excludes certain intra-family transfers from the purview of the notional tax – therefore, there would have been no consequence if eligible members gifted shares to their relatives to achieve the desired percentage, after which the rights issuance took place on a pro-rata basis. The anomaly that also arises here is that a family member who is otherwise not taxable on subscription to a rights issuance, may become taxable merely because another member chooses to refuse the rights issue, on account of an increase in shareholding. As if family dynamics weren’t complex enough, without having to compel ones relatives not to renounce!

CORPORATE SOCIAL RESPONSIBILITY POLICY RULES NOTIFIED

The Companies Act, 2013 changed the character of corporate social responsibility (CSR) in India from being a voluntary step to a legal obligation for certain companies under a ‘comply or explain’ model. It specified that the CSR provision will be applicable to companies with an annual turnover of INR 10 billion and more, or a net worth of INR 5 billion and more, or a net profit of INR 0.05 billion or more during any year. Such companies must spend at least 2% of their average net profits made during the three immediately preceding financial years on CSR activities and/or report the reason for non-expenditure. However, the Companies Act provided only the basic framework and the implementing Rules were much awaited to see the shape in which this mandate would have to be carried out.

On 27 February 2014, the Ministry of Company Affairs notified Schedule VII of the Companies Act (which lists the CSR activity areas or themes) and the Companies (Corporate Social Responsibility Policy) Rules, 2014 (“**CSR Rules**”). They will take effect from 1 April 2014. With only about a month’s time to prepare for this compliance, companies and their Boards have had to check if they meet the threshold requirements (or are excluded as per provisions of Section 135 of the Companies Act) and gear up to comply with the requirements of establishing a CSR Committee, a CSR policy and other requirements under the CSR Rules.

The scope of activities under Schedule VII includes preventive healthcare, sanitation, providing safe drinking water, protection of national heritage, rural development projects, measures to benefit armed forces veterans, rural development projects and the like. New spectrum of activities have been added such as promoting rural sports, nationally recognized sports, setting up homes and hostels for women, orphans and senior citizens, reducing inequalities in socially and economically backward groups and support to technology incubators in academic institutions. Upto 5% of the total annual CSR expenditure may also be spent by companies on building CSR capacities of their own personnel or their implementing agencies. However, notable absentees from Schedule VII are ‘social business projects’ and the residual clause giving power to the government to prescribe other matters on CSR-related activities.

It will also be important to see whether CSR Rules would allow convergence with the Foreign Contributions Regulation Act, 2010 (“**FCRA**”) as many HNIs with OCI/PJO card holder status may be treated as a ‘foreign source’ for the purposes of making CSR contributions in India. Thus, the regulatory fault-line between foreign contribution laws and CSR regime vis-a-vis HNI participation may require further attention.

With the CSR regime now formally in force, more proactive efforts are expected to be witnessed in the philanthropy space by industry leaders and other high-net individuals (HNIs). HNIs will also be uniquely positioned to play a more critical role in spurring development innovations through increased participation in philanthropic activities in India. Through CSR, private philanthropy by HNIs (which has played a vital role in development issues so far ignored or underfunded by public investment) can be linked to their strategic requirements through localized intervention within such areas where they operate either independently or through their companies. Under the CSR Rules, companies are encouraged to undertake CSR activities in localities surrounding their area of operation. Thus, providing CSR support in untapped areas where a sizeable population lives, often far from schooling, health or other civic facilities may provide further market and economic opportunities. Since CSR is aimed at bringing about inclusion and responsive engagement with the masses, the philanthropy landscape does provide a wider platform for HNIs to participate in charitable giving while bringing such beneficiaries closer to market-led institutions.

MANDATORY BUSINESS SUCCESSION PLANNING FOR LISTED COMPANIES

It is always a happy moment for us when succession planning becomes a buzz word of sorts, as it did after the SEBI Board meeting on 13 February 2014. SEBI has decided to amend the Listing Agreement in order to mandate that Boards of listed companies must “*satisfy themselves that plans are in place for orderly succession for appointments*

to the Board and senior management'.⁷ This requirement will be applicable to all listed companies from 1 October 2014 and is likely to have been triggered by some of the very public succession issues faced by India Inc. in the recent past.

Separation of ownership and management is a sensitive topic for family-run businesses in India; and one most likely not discussed at length due to the tacit acceptance that the successor will be someone from the family. This assumes significance for stakeholders in such businesses in light of statistics that half the companies in the NIFTY index are family-owned and almost 75% of the top 500 companies are family-run.⁸

Indian corporate culture has been criticised as being generally weak and myopic⁹ leading to the risk that the proposed amendment may become implemented more in form than in substance. However, considering that neither the old Companies Act, 1956 nor the new Companies Act, 2013 provide for succession planning, such regulatory initiative is essential to further the incorporation of global best practices in the running of Indian businesses.

REGISTRATION OF MARRIAGE VIA VIDEO CONFERENCE

Quite a few Indian State Governments have permitted Indian couples to apply online for registering their marriage. However, they are still required to be physically present for the actual registration before the Registrar. This has posed hardship, especially to those who have relocated abroad post-marriage.

On a petition by the father of one such bride who relocated to Canada, the Delhi High Court¹⁰ has directed the Registrar to accept the application for registration of marriage of a Hindu couple located abroad submitted through their powers of attorney holders in India and process the application using video conference. The Registrar had refused to accept the application insisting that the married couple appear before him and stressing that one of the conditions for registration¹¹ required that the applicants must reside within the jurisdiction of the Registry for at least a period of thirty days.

The Delhi High Court followed its earlier decision in *Charanjit Kaur Nagi v. NCT of Delhi and Others*.¹² It held that the statutory language in Section 8 of the Hindu Marriage Act, 1955 directed State Governments to frame rules to "*facilitate the proof of Hindu marriages*" and the registration rules (framed in 1956) must be interpreted in the light of changing times. The High Court held that since modern technology enabled real-time communication across borders and secure transmission of documents virtually, it would be appropriate to substitute personal physical presence of the parties with video conference.

In *Charanjit Kaur*, the High Court gave detailed instructions on how the US-based husband could comply with the registration procedure. However, in this case, the High Court merely directed that the Registrar must use video conferencing to satisfy himself about the legality and validity of the power of attorney and of the legality and validity of the marriage before processing the application. Further, the High Court directed that the video conferencing facility must be provided by the powers of attorney holders at their own risk and cost.

Although in both cases, the Delhi High Court has mentioned that the decision is restricted to the particular facts of the case due to the hardship faced by the parties, the rationale behind the judgment would come as a relief to many Hindu couples who reside abroad. Previously, the Jharkhand High Court¹³ had granted relief on similar grounds to a Hindu couple residing in the UK. Seeing that this is a common concern, it would be helpful if State Governments took pro-active measures to facilitate such an implementation of the marriage registration rules rather than waiting to be directed by the courts to do so.

MUSLIM COUPLES PERMITTED TO ADOPT

Indian society has many religious communities, each of which is governed by their personal laws (which may be wholly codified or partly codified and partly customary). This complexity has led to efforts to introduce a Uniform Civil Code in India which have not been successful due to the difficulty in balancing competing interests. When it comes to personal laws, courts are usually reluctant to impose a public law standard to adjudge personal law matters. This attitude is well-reflected in a judge's observation in a case challenging the constitutional validity of divorce provisions under the Hindu Marriage Act 1955 when he said: "*Introduction of constitutional law in the home is most inappropriate. It is like introducing a bull in a china shop*".¹⁴

Against this backdrop, the decision of the Supreme Court in *Shabnam Hashmi v Union of India*,¹⁵ assumes great significance. The Supreme Court has addressed the issue of the right to adopt a child under Islamic law in the context of the right to adopt under the Juvenile Justice (Care and Protection of Children) Act, 2000, a secular legislation (the "**JJ Act**").¹⁶

The petitioner had approached the Court to be recognised as the parent of her adoptive daughter instead of being a 'guardian' to her 'ward'. This is because non-Hindus 'adopt' under the Guardians and Wards Act, 1890 while Hindus can adopt under the Hindu Adoption and Maintenance Act, 1956.

The All India Muslim Personal Law Board (AIMPLB) which was permitted to intervene in the proceeding objected to the Court's view that under the JJ Act, any person regardless of religion could adopt a child who would have the same status as a biological child.¹⁷ The AIMPLB contended that since customary Islamic law does not recognise an adopted child to be at par with a biological child, the adoption route under the JJ Act would not be applicable to a Muslim child. Instead, the other routes specifically recognised under the JJ Act, i.e. foster care or sponsorship would be appropriate as per the Kafala¹⁸ system recognised in Islamic law. Therefore, Child Welfare Committees under the JJ Act must be directed to follow this principle in case of a Muslim child.

The Supreme Court held that the JJ Act was an enabling legislation which offered prospective parents the option to adopt a child by following the procedures and rules prescribed under that Act. Since it did not mandate any compulsory action, any prospective parent is free to opt for such a provision or follow the rules of the personal law applicable to him.

The impact of this judgement is that Muslims who adopt under the JJ Act will be able to enjoy all consequences of a complete legal adoption. The AIMPLB has said that it may consider filing a petition to review the judgement on the basis that it violates the fundamental rights of minorities under the Constitution.¹⁹

We had discussed the Marriage Laws (Amendment Bill) 2010 in the previous edition of this wrap.²⁰ February saw protests against the further passage of this Bill by men's rights activists who say this Bill is unconstitutional, anti-men and runs the risk of being misused by women like the anti-dowry law. On the other hand, many believe that this Bill will help women get out of a bad marriage rather than be misused for personal financial gain. We would need to wait and see whether this Bill will be a priority for the new Government, particularly considering some of the other legislations on standby.

While presenting the Interim Budget, the Finance Minister appealed to all parties to come together and ensure the passage of two crucial legislations: the Direct Taxes Code and the Goods and Services Tax in 2014-15. Possible re-introduction of estate tax has cropped up whenever discussions touch on rising economic inequality but no concrete proposal or framework has emerged yet. From a private wealth perspective, it is quite likely that these will form some of headlines next quarter.

The Private Client practice,

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¹ The formal title is 'Report of the Committee on 'Rationalisation of Investment Routes and Monitoring of Foreign Portfolio Investments'. This report is available on http://www.sebi.gov.in/cms/sebi_data/attachdocs/1372854491698.pdf

² The Securities and Exchange Board of India, India's capital markets regulator.

³ Please click on our [hotline](#) for further details of this Regulation.

⁴ The 2009 Working Group on Foreign Investment in India had recommended that all existing investor classes for portfolio investments be clubbed into a single class.

⁵ SEBI has not notified new KYC norms and will continue to apply the requirements contained in its Circular of September 2013 specifying KYC norms for portfolio investors under the previous regime; http://www.sebi.gov.in/cms/sebi_data/attachdocs/1378989676484.pdf

⁶ Sudhir Menon HUF v. Asst. CIT (ITA No. 4887/Mum/2013)

⁷ SEBI Press Release No. 12/2014, available on http://www.sebi.gov.in/cms/sebi_data/pdfdocs/27383_t.pdf

⁸ <http://businesstoday.intoday.in/story/study-on-indian-family-businesses-personal-ties/1/203774.html>

⁹ See http://articles.economictimes.indiatimes.com/2011-11-29/news/30454677_1_global-study-family-owned-businesses-long-term; http://articles.economictimes.indiatimes.com/2014-02-16/news/47379664_1_succession-planning-sap-india-india-inc.

¹⁰ Ravinder Chadha v. Govt. of NCT of Delhi; W.P.(C) 306/2014

¹¹ This condition was contained in the application form provided under the rules for registration of marriage framed by the Delhi Government. While the Hindu Marriage Act, 1955 is a central legislation, the power to frame rules to register the marriage is delegated to the State Governments under Section 8 of this Act.

¹² 1 (2008) DMC 45

¹³ Upasana Bali v State of Jharkhand, 2013 (1) AJR 741

¹⁴ Harvinder Kaur v. Hamander Singh Choudhry, AIR 1984 Delhi 66. The difficulty faced in harmonising succession laws and constitutional directives on uniform personal laws is demonstrated by the decision of the Supreme Court in Mohd Ahmed Khan v. Shah Bano Begum, 1985 SCR (3) 844, pertaining to a Muslim woman's right to maintenance. The Court's expansive reading of this right (otherwise limited under Muslim personal law) was later overturned by the enactment of a specific legislation restoring the position as it stood under personal law.

¹⁵ Writ Petition (Civil) no. 470 of 2005.

¹⁶ The Supreme Court addressed this query in the context of a writ petition before it to recognise the right to adopt and to be adopted as a fundamental right guaranteed under the Constitution.

¹⁷ The JJ Act defines adoption to be "*the process through which the adopted child is permanently separated from his biological parents and becomes the legitimate child of his adoptive parents with all the rights, privileges and responsibilities that are attached to the relationship.*"

¹⁸ The AIMPLB submitted to the Court that under the Kafala system, a person is legally allowed to provide financial support and look after the well-being of the child. But the child remains the true descendant of his biological parents.

¹⁹ <http://muslimmirror.com/eng/sc-ruling-on-child-adoption-muslim-organizations-differ-with-aimplb-stand/>

²⁰ The Upper House of Parliament has passed the Bill. This Bill is controversial for introducing 'irretrievable breakdown of marriage' as a ground for divorce and for enabling the court to consider the inherited property of the husband to decide the quantum of compensation on a divorce petition by the wife.

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