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The central government issues notifications on subsidiarisation of foreign banks in India, under section 115JG of Income-tax Act, 1961

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Background

- Traditionally, foreign banks have operated in India through a branch model.
- Following the global financial crisis of 2008, the Reserve Bank of India (RBI) in November 2013, issued its framework for setting-up of Wholly-Owned Subsidiaries (WOS) by foreign banks in India (hereinafter referred to as RBI Scheme).
- Keeping in mind the paramount objective of financial stability, the RBI Scheme was designed to make foreign banks operate as WOS in the country in order to insulate their local Indian operations from any difficulties that the parent company may encounter overseas. Consequently, the RBI Scheme advocated that the WOS model for foreign banks would involve local incorporation, a local board, and ring-fenced capital that would remain unaffected by global events on its parent.
- The RBI Scheme, *inter-alia*, stipulated that:
  - Foreign banks that have commenced banking business in India before August 2010 shall have the option to continue their banking business in India either through the branch mode or to convert those branches into WOS.
  - Foreign banks which have commenced or propose to commence banking business in India post August 2010, would be mandated entry into India only in the WOS mode, if any of the matters described in the RBI Scheme are applicable to them. These matters *inter alia* include banks with complex structures, banks which do not provide adequate disclosures in their home jurisdiction, banks which are not widely-held, banks from jurisdictions that have legislations giving preferential claim to depositors of home country in winding-up proceedings, etc.
- With a view to encouraging foreign banks to convert their existing Indian bank branches into WOS, the RBI Scheme provided incentives in the form of "Near National Treatment" to WOS of foreign banks, thereby affording a level playing field to foreign banks that operate in India, vis-à-vis the Indian banks. To further incentivize foreign banks and to facilitate conversion of Indian branch of a foreign bank, into a subsidiary company, section 115JG was introduced by the Finance Act, 2012 in the Income-tax Act, 1961 (the Act) which prescribes special provisions governing such conversions.
- Section 115JG of the Act, *inter alia,* provides that in case the conversion of the Indian branch of a foreign bank fulfills the conditions notified by the central government, the capital gains arising from such conversion shall not be chargeable to tax; and the provision relating to unabsorbed depreciation, set-off or carry forward and set-off of losses, tax credit in respect of tax paid on deemed income relating to certain companies and the computation of income in case of foreign company and Indian subsidiary, shall apply with such modification, exception and adaptations as may be specified in the notification. The section was introduced with effect from 1 April 2013.
- After four long years from the introduction of section 115JG in the Act, the central government finally issued a draft notification dated 17 November, 2017 (Draft Notification), laying out the conditions that the foreign banking group needs to comply with, in order to avail the benefits of section 115JG of the Act.
- Based on the feedback received from various stakeholders, the central government has now issued two final notifications on this subject.
  - Notification 1 ~ Notification No. 85 / 2018 dated 6 December 2018
  - Notification 2 ~ Notification No. 86 / 2018 dated 6 December 2018

Clarifications provided vide the Notifications

Notification 1 ~ Notification No. 85 / 2018 dated 6 December 2018

Notification 1 provides guidance on two aspects:

- **Part A**: Conditions to be met to avail capital gains tax exemption on conversion of the Indian branch of a foreign bank into an Indian subsidiary company.
- **Part B**: Exceptions, modifications and adaptations with regards to applicability of various provisions of the Act on conversion of the Indian branch of a foreign bank into an Indian subsidiary company.

Part A of the Notification 1 lays down the following five conditions that must be satisfied in order to avail the exemption from the capital gains tax arising from conversion of an Indian branch into a subsidiary company:

(i) The Indian branch(es) should amalgamate with the Indian subsidiary company in accordance with the scheme of amalgamation approved by the shareholders of the foreign company and the Indian subsidiary company, and should be sanctioned by the RBI in accordance with the RBI Scheme.

(ii) All the assets and liabilities of the Indian branch(es) should, immediately before conversion, become the assets and liabilities of the Indian subsidiary company.

(iii) The assets and liabilities of the Indian branch(es) should be transferred to the Indian subsidiary company at book value of the Indian branch(es) immediately before its conversion; however, change in the value of assets consequent to their revaluation shall be ignored.

(iv) The foreign bank or its nominee shall –

- Hold the whole of the share capital of the Indian subsidiary company during the period beginning from the date of conversion and ending on the last day of the previous year in which the conversion took place; and
- Continue to hold at least 51 per cent of the voting power in the Indian subsidiary company for a period of five years immediately succeeding the year of conversion.

(v) The foreign company should **not** receive any consideration or benefit, directly or indirectly, in any form or manner, other than by way of allotment of shares in the Indian subsidiary company.

The conditions listed above are largely similar to the conditions stipulated in the Draft Notification issued on this subject with the following exceptions:

- The Notification 1 additionally requires that the assets and liabilities of the Indian branch are transferred to the Indian subsidiary at book value of the Indian branch immediately before its conversion. No such prescription was provided in the Draft Notification.
- The flexibility has been provided to the foreign bank group to dilute its stake in the WOS in the manner described above as against the Draft Notification which required that the resultant subsidiary shall remain as the WOS of the foreign company at all times. This is a welcome relief.

Part B of Notification 1 lays down exceptions, modifications and adaptations with regards to applicability of various provisions of the Act on conversion of the Indian branch into an Indian subsidiary company. The clarifications are largely similar to the Draft Notification and have been summarized below.

Exceptions / Modifications / Adaptations same as the Draft Notification

- **Depreciation allowance**: The aggregate depreciation allowance in respect of the tangible and intangible assets allowable to the Indian branch and the Indian subsidiary company shall not exceed in any previous year the deduction calculated at the prescribed rates as if the conversion had not taken place; and such deduction shall be apportioned between the Indian branch and the Indian subsidiary company in the ratio of the number of days for which the assets were used by them.
- **Accumulated loss and Unabsorbed depreciation**: The accumulated loss (i.e. business loss excluding speculative business loss) and the unabsorbed depreciation of the Indian branch shall be deemed to be the loss or allowance for depreciation of the Indian subsidiary company for the previous year in which conversion was effected and the provisions relating to set-off and carry forward shall apply accordingly. For this purpose, the terms "accumulated loss" and "unabsorbed depreciation" are specifically defined in the Notification.
- **Actual cost of capital asset for the purpose of section 43(1) of the Act**: The written down value of the block of assets of the Indian branch as on the date of conversion shall be the actual cost of the block of assets for the Indian subsidiary company. Further, the actual cost of any capital asset on which deduction has been allowed or is allowable under section 35AD of the Act shall be taken as **Nil** by the Indian subsidiary company, if such capital asset was acquired as a result of conversion.
- **Cost of acquisition of capital assets other than those covered in point 3 above**: The cost of acquisition of the capital assets other than those covered in point 3 above, shall be the cost at which the Indian branch or the previous owner (if any) acquired it.
- **MAT credit under section 115JAA of the Act**: MAT credit of the Indian branch shall be deemed to be the tax credit available to the Indian subsidiary company from the date of conversion and the provisions of section 115JAA of the Act shall apply accordingly.
- **Provision for bad and doubtful debts**: The credit balance in the provision for bad and doubtful debts account of the Indian branch shall be deemed to be the provision for bad and doubtful debts for the Indian subsidiary company and the provisions of section 36 of the Act shall apply accordingly.

Additional Exceptions / Modifications / Adaptations that were not part of the Draft Notification

- **Voluntary Retirement Scheme (VRS) expenditure**: The provisions of section 35DDA of the Act dealing with deduction for VRS expenditure, shall apply to the Indian subsidiary company as they would have applied to the Indian branch if the conversion had not taken place.
- **Deemed gift tax provisions**: Section 56(2)(x) of the Act shall not apply to the transaction of receipt of shares in the Indian subsidiary company by the foreign company or its nominee in consequence of the conversion.

Notification 2 ~ Notification No. 86 / 2018 dated 6 December 2018

By way of Notification 2, the central government has introduced sub-rule (4) to Rule 8AA to the Income-tax Rules, 1962, which provides method for determination of period of holding of capital assets in certain cases. The new sub-rule (4) provides that the period of holding of the capital asset, which became the property of the Indian subsidiary company as a result of conversion of the Indian branch, shall include the period for which the asset was held by such Indian branch and by the previous owner (if any) who has acquired the capital asset by mode of acquisition referred to in section 49(1) or section 115JG(1) of the Act.

Conclusion

Prima facie, the notifications iron out the uncertainty surrounding the tax treatment of conversion of an Indian bank branch of a foreign bank into a subsidiary company.

- The tax certainties should help provide impetus to RBI's plan to incentivize foreign banks to open local units in India and attract interest from the foreign banks to convert their operations into a subsidiary model.
- The flexibility accorded by the notification enabling the foreign bank to dilute its stake in the WOS is much appreciated since this aspect was surprisingly absent in the Draft Notification. The relaxation is similar to the relaxation contained in the RBI Scheme which also permits the foreign company to dilute its stake in the WOS.
- Introduction of Rule 8AA(4) providing guidance on the period of holding of capital assets received pursuant to the conversion, should also help in avoiding unwarranted litigation.
- Relaxations in the form of: (a) extending tax deduction for expenses incurred on conversion while computing the taxable income of the Indian subsidiary; and (b) allowing the foreign banking group to replicate their capital structure that they use for their Indian bank branches (in terms of a combination of Tier I and Tier II Capital) as part of the conversion to the WOS form, would have been an additional sweetener to further increase the attractiveness of the Scheme from a tax standpoint.

While the aforesaid notifications do address the tax concerns of foreign banks planning to operate in India via the subsidiary route, RBI still needs to channel its efforts towards rationalizing the regulatory scheme, as non-tax matters still guide the plans of foreign banks.

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