Challenges of doing business in India

India is going through a period of unprecedented economic liberation, opening its vast consumer base to international firms. However, it is a notoriously difficult place to do business, and having local help on board is the key to unlocking the country's vast economic potential.

Per the latest report published by World Bank, India is ranked 130th, in terms of 'ease of doing business' and a gloomy and not encouraging at all 155th in terms of 'starting up new businesses'. It is evident hence that it is a lot more difficult to start a new business in India than it is to remain engaged in doing an existing one.

The gaps in the rankings essentially means that having gone through the ordeal of maneuvering through the regulatory environment to overcome the ignition aka start-up challenges, the organization then is relatively better-equipped to manage the business prospectively, as the hurdles are less, and hence a better ranking for "ease of doing business".

India imbibes a regime which is extremely administrative, heavy and cumbersome and it can be a daunting task to manage the compliances, timelines and efficacy, even for the relatively seasoned and established enterprises, leave alone those that wish to start afresh at the Indian soils.

SETTING UP BUSINESS IN INDIA AND RELATED PROCEDURES; REGSISTERING PROPERTY

The cost of starting a business in India is astronomical, and the procedures involved can be daunting without local knowledge. There are 12 procedures to complete in the initial set up of a business costing substantial effort, time and cost. Registering a property requires quite a bit of legwork and can also incur substantial charges. Stamp duty and other ancillary charges, could pinch too.

THE CENTRE STATE ECO SYSTEM

One of the hardest challenges that stare at most multinational companies is the unique architecture of the Indian governance framework, which is badly intertwined between the Centre and States.

The reasons aren't difficult to comprehend. State laws and incentives are structured to attract investments which local leadership see as critical to driving economic growth, and hence are sort of at the mercy of ruling parties and albeit their vested interests, which often compound the misery of the common man as it subordinates national interest to personal stakes. It is not uncommon for neighboring State Governments to have vastly differing legislations on labor, land acquisition, commercial taxes, and intrastate movement of goods.

These come into play in a substantial way when planning investments in India. It has been witnessed a number of times that what seems an attractive and a lucrative start and hence triggers a green field project; could turn out to be costly and resource heavy later and therefore doesn't translate to improved returns on capital employed.

REGULATORY FRAMEWORK

The ambiguity around regulations and the saga of having interpretations suit the exchequer have hit many a MNC's that have wanted to establish presence in India. Let's take an example of the Hutch-Vodafone deal that took place a decade ago and which involved the transfer of shares of a foreign company outside India, which indirectly held the shares of an Indian company; to a foreign company also outside India.

The demand for tax in the Vodafone case was essentially a result of failing to understand the difference between the sale of shares in a company and the sale of assets of that company. It is an elementary principle of company law that ownership of shares in a company does not mean ownership of the assets of the company. Thus, an individual who owns 45 per cent or 85 per cent of the share capital does not own 45 per cent or 85 per cent of that company's assets. The assets belong to that company which is a separate legal entity.

This is also exactly how several international transactions are concluded. Vodafone was not the first case where transfer of shares between non-resident overseas company resulted in a change in control of an Indian company. But controlling interest is not a capital asset; it is the consequence of the transfer of shares. The demand made by the Income Tax Department in the Vodafone case was thus contrary to elementary principles of company and tax law. In January 2012, the Indian Supreme Court passed the judgement in favour of Vodafone, saying that the Indian Income tax department had "no jurisdiction" to levy tax on overseas transaction between companies incorporated outside India. However, Indian government thought otherwise. It believed that if an Indian company, Hutchison India Ltd., conducts a financial transaction, government should get its tax out of it. Therefore, in 2012, India changed its Income Tax Act retroactively and made sure that any company, in similar circumstances, is not able to avoid tax by operating out of tax-havens like Cayman Islands or Lichtenstein. In May 2012, Indian authorities confirmed that they were going to charge Vodafone about ₹20,000 crore (US $3.3 billion) in tax and fines.

Another case in point would be the Cairn Energy India saga: UK-based Cairn Energy plc was the promoter of Cairn India, and sold its majority stake in Cairn India to Vedanta group. Cairn Energy plc is now a minority shareholder in Cairn India. Cairn India has received an order from the I-T department for its alleged failure to deduct withholding tax on capital gains arising during 2006-07 in the hands of Cairn UK Holdings Ltd, its erstwhile parent company and a subsidiary of Cairn Energy Plc. A demand of INR 20,495 crore, equally divided between Tax and Interest stares at the Indian Company. That it's a retrospective taxation staring at them a decade later only compounds the severity of the challenge at hand.

However, the clouds do allow for a silver lining. A recent McKinsey study showed that the nine market leaders by category in India enjoyed a ROCE (Return on Capital Employed) of 48 per cent, and even the next 26 enjoyed a ROCE of 36 per cent. Implicit in the return is the reward for managing the regulatory risk. Interesting inclusions in the list are Korean white-goods-maker LG and automobile giant Hyundai, and Japanese automotive giant Suzuki. Surprisingly, these companies don't enjoy market leadership in their very own home countries, which score far higher than India in terms of 'ease of doing business' or 'starting up anew'. The one common theme visible across these companies is their willingness to remain engaged with the regulatory environment and manage the concomitant uncertainties. Their ability to win includes, in large measure, their capacity to allow scale to subsume the vagaries of an uncertain political and regulatory environment.

JOINT VENTURES

The coming decade will be a decade of momentous change, as India integrates better with the global economy, focuses on driving greater competitiveness, and draws up a policy framework to enable a more transparent governance structure. Those MNCs that participate in this process are likely to position themselves more strongly to succeed, compared to those that rely on local Indian partners or JVs. The reason isn't difficult to fathom. Indian JV partners would be mostly family-owned or state PSUs, and, in most cases, diversified. Consequently, they may often have competing priorities in leveraging their relationship with the Government, and hence deferring to them for insights is fraught with inherent risks.

In fact, many a times these conflicting interests can make the task of setting up a new business in India appear a lot more difficult than it might actually be. This brings us back to essentially the same fundamental principle that a key driver of success would be the ability to understand the regulatory environment and use them to your advantage.

TAXATION

This goes for anyone who wants to enter the Indian territories; that he must acknowledge and take in to stride the fact that the tax liabilities in Indian soil are heavy and can erode incomes in a big way. From a direct taxation stand point, there is Corporate Income Tax, Withholding Tax and in the indirect realms, there is the newly introduced Goods & Services Tax. Corporate Tax Rates have been reduced to 25% which provides some relief for domestic companies.

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Nationwide, GST was meant to unify the $2-trillion economy and make it easier for companies to transact across state borders. Upon doing a reality check, nearly a quarter since implementation and many are finding that doing business is more complicated than ever.

Ambiguous rules under the new, multi-rate sales tax that went into effect on July 1 have left firms confused on how to price their products. The tax's complex structure — four main rates ranging from 5 to 28 per cent — has hurt sales and risks denting economic growth and government revenues in the months ahead. Let's pick up Airlines for example, there is ambiguity around the tax on premium economy seats and whether these would be charged as an economy or business class as the rates differ, these are 5 percent or 12 per cent, respectively. Let's look at another example, under GST, desktops and laptops are taxed at 18 percent, while multi-function printers and monitors attract a 28 per cent charge. Monitors, CPUs and other parts of a computer are imported as a single unit resulting in ambiguity on the rate to be charged — 18 or 28 per cent.

Billed as the country's biggest tax reform since independence in 1947, GST replaced more than a dozen federal and state levies and was meant to unify the country into a single market.

While teething troubles were expected, the ensuing chaos has some officials worrying about the repercussions for Asia's third-largest economy. Annual growth slowed in the January-March quarter to 6.1 per cent, its weakest pace in more than two years.

If growth slows further, federal finances would face pressure. A recent survey by tax software provider Tally Solutions indicated that more than 40 per cent of small businesses were still not up to speed on how the GST works. Hence, it must be emphasized that GST, until it becomes stable which is half a decade away, can cause immense challenges from an infrastructure and administration perspective and more so, along with it comes ambiguity which is a double-edged sword, often sharper at the end which belongs to the exchequer and has the potential to charge significant liabilities in lieu of the ambiguity. The amount of tax entrepreneurs have to shell out and the ease with which a country's tax system enables it is an important component in the ease of doing business. The transition is going to be anything but smooth — history has evidenced the same too. The mystery would take some time to convert to statistics and the positive or negative impact of India switching to GST will not show up until 2019 at the earliest. India's overall rank in Doing Business 2017 was 130 out of 190, which is bad enough. Among the 11 indicators based on which the report evaluates nations, No. 7 is paying taxes. This indicator tracks, "payments, time and total tax rate for a firm to comply with all tax regulations as well as post-filing processes" and the picture looks quite bleak with the infrastructural challenges revolving around the central tax.

If you have an Indian Subsidiary declaring dividends, there is a Dividend Distribution Tax too, which is charged at 15%. However, it may be prudent to note that the 15% charge translates to a little over 17% owing to Grossing up the Net Dividend and that could be a tad bit too costly too!

Another regulation which does require some evaluation is the GAAR (General Anti Avoidance Rules); which specify that any arrangement where the "main purpose" is to obtain a tax benefit, would be considered as an impermissible avoidance arrangement. The GAAR orders would be subject to review by an Approving Panel whose decision would be binding on the taxpayer and tax authorities.

INSOLVENCY

The Insolvency and Bankruptcy Code 2016 Code is a major step taken in the right direction to provide umbrella legislation for the laws relating to bankruptcy, liquidation and insolvency resolution, concerning both individuals/firms and corporate entities. The intent is quite logical, that is to boost foreign direct investment in India by improving India's score and ranking in the Ease of Doing Business Index. The difficulty with the Code however is this that it seems to be over ambitious. On one hand, this Code is aiming to cause major amendments in over 11 statutes and consolidate them to reduce administrative bottlenecks, compliance hassles and enable business ease; yet on the other hand it aims to establish institutions in the likes of the NCLT, NCLAT, DRT & DRAT, and this amidst the infrastructure chaos and crisis is nothing short of being ambitious. The Code cannot and in fact does not disturb the constitutional powers vested in the High Courts and the power of the Supreme Court to allow a special leave petition, thus, there is a likelihood that, orders of DRT and NCLT can be challenged in the High Courts and the Supreme Court in some cases of peculiar urgency despite the availability of alternative remedy of appeal to DRAT and NCLAT respectively. Further, Supreme Court will witness appeals coming to it from both ends, that is, from DRAT and NCLAT too. Thus, in sum and substance the docket explosion is here to stay along with an unimaginable burden on the legislative wing of the State to cause amendments to all the enactments which the 2016 Code touches upon by virtue of the 11 schedules annexed to it, which by all means is a daunting task and fraught with implementation challenges at the outset.

ENFORCEMENT OF CONTRACTS

Enforcing contracts in India has been an age-old epidemic that has continued to cripple the economic efficiency and shows marginal progress if not further deterioration. There is an urgency to focus on improving the business environment and arrest the decline in relative performance against various determinants of investment attractiveness. This poses a great challenge for India to show case it’s credentials of being a host country for the foreign investors and is therefore detrimental to the interests of an economy growing so rapidly as India.

On this one parameter India ranks a measly 172 out of the 190 countries and this is bothering! In India, it takes on an average, 1,420 days (~4 years!) to get a judgment on a contractual disagreement. Compared to that, its only 538 days (<1.5 yrs.) in OECD countries. China, at an overall rank of 84, scores a 7th rank on Enforcing Contracts. Success of China as a business destination probably indicates the criticality of the factor in the overall scheme of things.

The implications of this factor could have far reaching repercussions. One, the longer it takes to resolve disputes, lower is the implied value of the contracts. This fosters an environment of mistrust amongst parties, which is in no way conducive to the business environment a developing country would like to nurture. Second, lower contract enforceability also means greater cost to dispute resolution. Hence, most businesses build-in this higher cost into their cost structure, thereby making it more expensive to do business in India. And finally, the biggest cost to this is that it restricts respectable businesses from operating in a fair and just environment. For example, number of large, global companies shy away from operating in the real estate and infrastructure contracts space in India. One of the key reasons is the week enforceability of contracts in India. The nature of work typically leads to Contractual disputes, which can linger on for years and generations in the worst-case scenarios and phenomenally increase the cost of doing business for these companies. As a result, it leads the companies to either make money by cost efficiency at the unavoidable cost of doing away with quality or increase the contract price. An increase in price will automatically make them uncompetitive in the bidding process and hence most projects are only left with contractors cutting corners and that’s worse! The story repeats itself in all sectors conceptually.

THIN CAPITALISATION

Thin capitalisation refers to hidden equity capitalisation by borrowing higher level of debt as compared to equity and leveraging capital structure, which leads to reducing taxable profits to the extent of interest paid on debt borrowings. Multinational groups strategize their financing arrangements to create tax-efficient mixture of debt and equity in borrowing jurisdictions wherein interest expense can be claimed as deduction in computation of tax profits and lending jurisdictions that either exempts interest income from tax or interest taxed at lower rates.

Further, enterprises in developed countries borrow funds at lower interest rates and lend the same to their associated enterprises in other tax jurisdictions at higher interest rates to take advantage of interest arbitrage opportunities. Since India is a developing country, the rates of tax are higher than the developed countries. Thereby, there is motive for multinational groups to infuse funds in form of debt instead of equity. The period of repayment of debt is often extended by the MNCs after seeking requisite approvals from RBI. Such elongation of repayment period does, in substance, convert debt into funds available for long term benefit, equity under the mask of debt. Therefore, capital structure plays major role in reporting profits and tax payments by companies across the world.

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Keeping up with the trend and in line with Organisation for Economic Cooperation and Development (OECD) recommendation in its Base Erosion and Profit Shifting (BEPS) project- India has also announced Thin Capitalisation Rules by way of limiting interest deduction, also known as 'Earnings Stripping Approach'. It is proposed to introduce new section 94B to restrict interest deduction claimed by Indian company or permanent establishment of foreign company in India in respect of debt issued by non-resident associated enterprise exceeding 30% of earnings before interest, taxes, depreciation and amortisation (EBITDA) of borrower enterprise. The provisions are not applicable in case where interest expenses are less than or equal to Rs. 1 crore in respect of debt issued by non-resident associated enterprise in a financial year. Further, it is proposed to expand the scope of the section to include interest on debt issued by unrelated lender having underlying implicit or explicit guarantee by an associated enterprise to such lender or having corresponding or matching amount of funds deposited with such lender. The interest expense which is not wholly deducted against income shall be allowed to be carried forward and allowed as deduction against profits and gains of any business or profession carried on up to eight assessment years to the extent of maximum allowable interest expenditure as computed by the aforesaid provisions.

India is trying to recover from demonetisation and the government is encouraging fresh inflow of funds from abroad in order to sustain the growth, however, this proposal may adversely affect the investment avenues given by the government to encourage inflow of funds.

THE VALUE PROPOSITION

As all countries emerge from their current crises, there will be increased regulation, and business leaders need to build a deep understanding of the regulatory environment and governance frameworks, to deliver improved returns for their enterprise.

The ambiguity allows for phenomenal success as long as the Organization has the ability to thrive in "grey". Simultaneously, it leaves enough on the table to help enhance returns by carefully understanding the policy regimen. Once you master the nuances of the regulatory regime and are able to manoeuvre through the intertwined possibilities to enhance your success, you will truly be in that space in blue marble, where the potential is humungous. Localization is the key to succeeding in India and it is essential to have a diligent, world class compliance support system to partner and provide you hassle free services so that businesses can focus on their competencies and the regulatory, compliance and ancillary needs are professionally managed so that the venture in India is profitable. You may not always get it all right, but if you do, then your fastest growing market could well be your most profitable one too. We hand hold you through the entire process to make sure your transition in to Indian territories is seamless.