

GIFTS AND LOANS — BY AND TO NON-RESIDENT INDIANS - II

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Editor's Note:

This is the second part of the Article on Gifts And Loans — By and to Non-Resident Indians. The first part of this Article dealt with Gifts by and to NRIs, and this part deals with Loans by and to NRIs. Along with the FEMA aspects of “Loans by and to NRIs”, the authors have also discussed Income-tax implications including Transfer Pricing Provisions. The article deals with loans in Indian Rupees as well as Foreign Currency, thereby making for interesting reading.

B. LOANS BY AND TO NRIs

FEMA Aspects of Loans by and to NRIs

Currently, the regulatory framework governing borrowing and lending transactions between a Person Resident in India ('PRI') and a Person Resident Outside India ('PROI') is legislated through the Foreign Exchange Management (Borrowing and Lending) Regulations, 2018 ('ECB Regulations') as notified under FEMA 3(R)/2018-RB on 17th December, 2018.

PRIs are generally prohibited from engaging in borrowing or lending in foreign exchange with other PROIs unless specifically permitted by RBI. Similarly, borrowing or lending in Indian rupees to PROIs is also prohibited unless specifically permitted. Notwithstanding the above, the Reserve Bank of India has permitted PRIs to borrow or lend in foreign exchange from or to PROIs, as well as permitted PRIs to borrow or lend in Indian rupees to PROIs.

With this background, let us delve into the key provisions regarding borrowing / lending in foreign exchange / Indian rupees:

B.1 Borrowing in Foreign Exchange by PRI from NRIs

❖ Borrowing by Indian Companies from NRIs

- According to paragraph 4(B)(i) of the ECB Regulation, eligible resident entities in India can raise External Commercial Borrowings (ECB) from foreign sources. This borrowing must comply with the provisions in Schedule I of the regulations and is required to be in accordance with the FED Master Direction No. 5/2018–19 — Master Direction-External Commercial Borrowings, Trade Credits, and Structured Obligations ('ECB Directions').
- Schedule I details various ECB parameters, including eligible borrowers, recognised lenders, minimum average maturity, end-use restrictions, and all-in-cost ceilings.
- The key end-use restrictions in this regard are real estate activities, investment in capital markets, equity investment, etc.
- Real estate activities have been defined to mean any real estate activity involving owned or leased property for buying, selling, and renting of commercial and residential properties or land and also includes activities either on a fee or contract basis assigning real estate agents for intermediating in buying, selling, letting or managing real estate. However, this would not include (i) construction/development of industrial parks/integrated townships/SEZ, (ii) purchase / long-term leasing of industrial land as part of new project / modernisation of expansion of existing units and (iii) any activity under 'infrastructure sector' definition.

- It is important to note that, according to the above definition, the construction and development of residential premises (unless included under the integrated township category) will be classified as real estate activities. Therefore, ECB cannot be availed for this purpose.

- To assess whether NRIs can lend to Indian companies, we must consider the ECB parameters related to recognised lenders. Recognised lenders are defined as residents of countries compliant with FATF or IOSCO. The regulations specify that individuals can qualify as lenders only if they are foreign equity holders. The ECB Directions in paragraph 1.11 define a foreign equity holder as a recognized lender meeting certain criteria: (i) a direct foreign equity holder with at least 25 per cent direct equity ownership in the borrowing entity, (ii) an indirect equity holder with at least 51 per cent indirect equity ownership, or (iii) a group company with a common overseas parent.

- In summary, lenders who meet these criteria qualify to become recognized lenders. Consequently, NRIs who are foreign equity holders can lend to Indian corporates in foreign exchange, provided they comply with other specified ECB parameters.

❖ **Borrowing by Resident Individual from NRIs**

- An individual resident in India is permitted to borrow from his / her **relatives** outside India a sum not exceeding USD 2,50,000 or its equivalent, subject to **terms and conditions** as may be specified by RBI in consultation with the Government of India ('GOI').

- For these regulations, the term 'relative' is defined in accordance with Section 2(77) of the Companies Act, 2013. This definition ensures clarity regarding who qualifies as a relative, which typically includes family members such as parents, siblings, spouses, and children, among others. This clarification is crucial for determining eligibility for borrowing from relatives abroad.

- Additionally, Individual residents in India studying abroad are also permitted to raise loans outside India for payment of education fees abroad and maintenance, not exceeding USD 250,000 or its equivalent, subject to **terms and conditions** as may be specified by RBI in consultation with GOI.

- It is also noteworthy that although the External Commercial Borrowings (ECB) regulations were officially introduced in 2018, no specific terms and conditions

necessary for implementing these borrowing provisions have been prescribed by the RBI. The absence of detailed guidelines indicates that, although a framework is in place for individuals to borrow from relatives or obtain loans for educational purposes, potential borrowers may experience uncertainty about the specific requirements they need to adhere to.

B.2 Borrowing in Indian Rupees by PRI from NRIs

❖ **Borrowing by Indian Companies from NRIs**

- Similar to borrowings in foreign exchange, Indian companies are also permitted to borrow in Indian rupees (INR-denominated ECB) from NRIs who are foreign equity holders subject to the satisfaction of other ECB parameters.

- Unlike the FDI regulations, RBI has not specified any mode of payment regulations for the ECB. The definition of ECB, as provided in ECB regulations, states that **ECB means borrowing by an eligible resident entity from outside India** in accordance with the framework decided by the Reserve Bank in consultation with the Government of India. Further, even Schedule I of the ECB Regulation states that **eligible entities may raise ECB from outside India** in accordance with the provisions contained in this Schedule. Hence, based on these provisions, it is to be noted that the source of funds for the INR-denominated ECB should be outside of India.

- **Hence, the source of funds should be outside of India, irrespective of whether it is a foreign currency-denominated ECB or INR-denominated ECB.**

❖ **Borrowing by Resident Individuals from NRIs**

- PRI (other than Indian company) are permitted to borrow in Indian Rupees from NRI / OCI relatives subject to **terms and conditions** as may be specified by RBI in consultation with GOI. For these regulations, the term 'relative' is defined in accordance with Section 2(77) of the Companies Act, 2013. It is also noteworthy that although the External Commercial Borrowings (ECB) regulations were officially introduced in 2018, the specific **terms and conditions** necessary for implementing these borrowing provisions have yet to be prescribed by the RBI.

- Additionally, it is to be noted that the borrowers are not

permitted to and utilise the borrowed funds for restricted *end-uses*.

- According to regulation 2(xiv) of the ECB Regulations, "Restricted End Uses" shall mean end uses where borrowed funds cannot be deployed and shall include the following:

1. In the business of chit fund or Nidhi Company;
2. Investment in the capital market, including margin trading and derivatives;
3. Agricultural or plantation activities;
4. Real estate activity or construction of farm-houses; and
5. Trading in Transferrable Development Rights (TDR), where TDR shall have the meaning as assigned to it in the Foreign Exchange Management (Permissible Capital Account Transactions) Regulations, 2015.

B.3 Lending in Foreign Exchange by PRI to NRIs

- ❖ Branches outside India of AD banks are permitted to extend foreign exchange loans against the security of funds held in NRE / FCNR deposit accounts or any other account as specified by RBI from time to time and maintained in accordance with the Foreign Exchange Management (Deposit) Regulations, 2016, notified vide Notification No. FEMA 5(R)/2016-RB dated 1st April, 2016, as amended from time to time.

- ❖ Additionally, Indian companies are permitted to grant loans in foreign exchange to the employees of their branches outside India for personal purposes provided that the loan shall be granted for personal purposes in accordance with the lender's Staff Welfare Scheme / Loan Rules and other terms and conditions as applicable to its staff resident in India and abroad.

- ❖ Apart from the above, the current External Commercial Borrowing (ECB) regulations do not include specific provisions that allow Non-Resident Indians (NRIs) to obtain foreign exchange loans for non-trade purposes, either from individuals or entities residing in India. For example, lending in foreign exchange by PRI to their close relatives living abroad is not permitted under FEMA.

B.4 Lending in Indian Rupees by PRI to NRIs

❖ Lending by Authorised Dealers (AD)

- AD in India is permitted to grant a loan to an NRI/ OCI Cardholder for meeting the borrower's personal requirements / own business purposes / acquisition of a residential accommodation in India / acquisition of a motor vehicle in India/ or for any purpose as per the loan policy laid down by the Board of Directors of the AD and in compliance with prudential guidelines of Reserve Bank of India.

- However, it is to be noted that the borrowers are not permitted to utilise the borrowed funds for restricted end-uses. The list of restricted end-use has already been provided in paragraph B.4 of this article.

❖ Other Lending Transactions

- A registered non-banking financial company in India, a registered housing finance institution in India, or any other financial institution, as may be specified by the RBI permitted to provide housing loans or vehicle loans, as the case may be, to an NRI / OCI Cardholder subject to such terms and conditions as prescribed by the Reserve Bank from time to time. The borrower should ensure that the borrowed funds are not used for restricted end uses. The list of restricted end-use has already been provided in paragraph B.4 of this article.

- Further, an Indian entity may grant a loan in Indian Rupees to its employee who is an NRI / OCI Cardholder in accordance with the Staff Welfare Scheme subject to such terms and conditions as prescribed by the Reserve Bank from time to time. The borrower should ensure that the borrowed funds are not used for restricted end uses.

- Additionally, a resident individual is permitted to grant a rupee loan to an NRI / OCI Cardholder relative within the overall limit under the Liberalised Remittance Scheme subject to such terms and conditions as prescribed by the Reserve Bank from time to time. The borrower should ensure that the borrowed funds are not used for restricted end uses.

- Furthermore, it's important to note that even the revised Master Direction on the Liberalized Remittance Scheme (LRS) still outlines the terms and conditions for NRIs to obtain rupee loans from PRI. The decision to retain these terms and conditions in the LRS Master Direction may indicate a deliberate stance by the RBI, especially since the RBI has

not yet specified the terms and conditions mentioned in various parts of the ECB regulations.

- Specifically, Master Direction LRS states that a resident individual is permitted to lend in rupees to an NRI/Person of Indian Origin (PIO) relative ['relative' as defined in Section 2(77) of the Companies Act, 2013] by way of crossed cheque / electronic transfer subject to the following conditions:

i. The loan is free of interest, and the minimum maturity of the loan is one year;

ii. The loan amount should be within the overall limit under the Liberalised Remittance Scheme of USD 2,50,000 per financial year available for a resident individual. It would be the responsibility of the resident individual to ensure that the amount of loan granted by him is within the LRS limit and that all the remittances made by the resident individual during a given financial year, including the loan together, have not exceeded the limit prescribed under LRS;

iii. the loan shall be utilised for meeting the borrower's personal requirements or for his own business purposes in India;

iv. the loan shall not be utilised, either singly or in association with other people, for any of the activities in which investment by persons resident outside India is prohibited, namely:

- The business of chit fund, or
- Nidhi Company, or
- Agricultural or plantation activities or in the real estate business, or construction of farm-houses, or
- Trading in Transferable Development Rights (TDRs).

Explanation: For item (c) above, real estate business shall not include the development of townships, construction of residential/ commercial premises, roads, or bridges;

v. the loan amount should be credited to the NRO a/c of the NRI / PIO. The credit of such loan amount may be treated as an eligible credit to NRO a/c;

vi. the loan amount shall not be remitted outside India; and

vii. repayment of loan shall be made by way of inward remittances through normal banking channels or by debit to the Non-resident Ordinary (NRO) / Non-resident External (NRE) / Foreign Currency Non-resident (FCNR) account of the borrower or out of the sale proceeds of the shares or securities or immovable property against which such loan was granted.

B.5 Borrowing and Lending Transactions between NRIs

❖ ECB Regulations do not cover any situation of borrowing and lending in India between two NRIs.

❖ However, in line with our view discussed in paragraph A.3.f, NRI may grant a sum of money as a loan to another NRI from their NRO bank account to the NRO bank account of another NRI, as transfers between NRO accounts are considered permissible debits and credits. The expression transfer, as defined under section 2(ze) of FEMA, includes in its purview even a loan transaction. Similarly, granting a sum of money as a loan from an NRE account to another NRE account belonging to another NRI is also allowed without restrictions.

❖ However, a loan from an NRO account to the NRE account of another NRI, or vice versa, may not be allowed in our view, as the regulations concerning permissible debits and credits for NRE and NRO accounts do not specifically address such loan transactions.

B.6 Effect of Change of Residential Status on Repayment of Loan

❖ As per Schedule I of ECB Regulations, repayment of loans is permitted as long as the borrower complies with ECB parameters of maintaining the minimum average maturity period. Additionally, borrowers can convert their ECB loans into equity under specific circumstances, provided they adhere to both ECB guidelines and regulations governing such conversions, such as compliance with NDI Rules, pricing guidelines, and reporting compliances under ECB regulations as well as NDI Rules.

❖ Additionally, there may be situations where, after a loan has been granted, the residential status of either the lender or the borrower changes. Such situations are envisaged in the Regulation 8 of ECB Regulations. The following table outlines how the loan can be serviced in those situations of changes in residential status:

Residential Status of Lender at the time of Loan	Residential Status of Borrower at the time of Loan	Whose Residential Status Changed?	Impact
AD Bank - Resident	Resident	Borrower became non-resident	Permitted subject to such terms and conditions as specified by the Reserve Bank from time to time. The RBI has not yet specified the terms and conditions.
Resident	Resident	Lender became non-resident	Repayment of the loan by the resident borrower should be made by credit to the NRO account or any other account of the lender maintained with a bank in India as specified by the Reserve Bank from time to time, at the option of the lender.
Non-resident	Resident	Lender became resident	Repayment of the loan permitted.
Non-resident	Non-resident	Borrower became resident	Permitted to service loans subject to terms and conditions and limits as specified by the Reserve Bank from time to time. The RBI has not yet specified the terms and conditions.

❖ Furthermore, it is to be noted here that not all cases of residential status have been envisaged under ECB Regulations such as those given below and, therefore, may require prior RBI permission in the absence of clarity.

Residential Status of Lender at the time of Loan	Residential Status of Borrower at the time of Loan	Whose Residential Status Changed?
Resident	Resident	Borrower became non-resident
Non-resident	Non-resident	Lender became resident

INCOME TAX ASPECT OF LOAN

B.7 Applicability of Transfer Pricing Provisions under the Income Tax Act, 1961

Section 92B(1), which deals with the meaning of international transactions includes lending or borrowing of money. Further, explanation (i)(c) of Section 92B states as follows: capital financing, including any type of long-term or short-term borrowing, lending or guarantee, purchase or sale of marketable securities or any type of advance, payments or deferred payment or receivable or any other debt arising during the course of business.

As per Section 92A of the Income Tax Act, NRI can become associated enterprises in cases such as (i) NRI holds, directly or indirectly, shares carrying not less than 26 per cent of the voting power in the other enterprise; (ii) more than half of the board of directors or members of the governing board, or one or more executive directors or executive members of the governing board of one enterprise, are appointed by NRI; (iii) a loan advanced by NRI to the other enterprise constitutes not less than fifty-

one per cent of the book value of the total assets of the other enterprise, etc.

Hence, the borrowing or lending transaction between associated enterprises is construed as an international transaction and is required to comply with the transfer pricing provisions. Section 92(1) states that any income arising from an international transaction shall be computed having regard to the arm's length principle. Consequently, financing transactions will be subjected to the arm's length principle and are required to be benchmarked based on certain factors such as the nature and purpose of the loan, contractual terms, credit rating, geographical location, default risk, payment terms, availability of finance, currency, tenure of loan, need benefit test of loan, etc.

For benchmarking Income-tax Act does not prescribe any particular method to determine the arm's length price with respect to borrowing/ lending transactions. However, the Comparable Uncontrolled Price ('CUP') method is often applied to test the arm's length nature of borrowing/ lending transactions. The CUP method compares the price charged or paid in related party transactions to the price charged or paid in unrelated party transactions. Further, it has been held by various judicial precedents¹ that the rate of interest prevailing in the jurisdiction of the borrower has to be adopted and currency would be that in which transaction has taken place. In this case, it would be the international benchmark rate.

To simplify certain aspects, Safe Harbour Rules ('SHR') are also in place, which now cover the advancement of loans denominated in INR as well as foreign currency. The

¹ Tata Autocomp Systems Limited [2015] 56 taxmann.com 206 (Bombay); Aurionpro Solutions Limited [2018] 95 taxmann.com 657 (Bombay)

SHR specifies certain profit margins and transfer pricing methodologies that taxpayers can adopt for various types of transactions. The SHR is updated and periodically extended for application to the international transactions of advancing of loans.

B.8 Applicability of Section 94B of the Income Tax Act, 1961

Further, to address the aspect of base erosion, India has also introduced section 94B to limit the interest expense deduction based on EBITDA. Section 94B applies to Indian companies and permanent establishments of foreign companies that have raised debt from a foreign-associated enterprise. The section imposes a limit on the deduction of interest expenses. The deduction is restricted to 30 per cent of the earnings before interest, tax, depreciation, and amortization (EBITDA). This provision may apply when NRI, being an AE, advances a loan to an Indian entity over and above the application of transfer pricing.

B.9 Applicability of Section 40A(2) of the Income Tax Act, 1961

Section 40A(2) of the Income Tax Act deals with the disallowance of certain expenses that are deemed excessive or unreasonable when incurred in transactions with related parties. When transfer pricing regulations are applicable for transactions with associated enterprises, the provisions of Section 40A(2) are not applicable.

As a result, in scenarios where transfer pricing provisions apply (for instance, when shareholding exceeds 26 per cent), both transfer pricing regulations and Section 94B will come into effect. In such cases, Section 40A(2) will not apply. Conversely, in situations where transfer pricing provisions do not apply (for example, when shareholding is 25 per cent, which is the minimum percentage required under ECB Regulations to be considered a foreign equity holder eligible for granting a loan), Section 40A(2) will be applicable, and the provisions of transfer pricing and Section 94B will not become applicable.

B.10 Applicability of Section 68 of the Income Tax Act, 1961

Same as discussed in the gift portion in paragraph A.8 of this article. Additionally, the resident borrower also needs to

explain the source of source for loan availed by NRIs.

B.11 Applicability of Section 2(22)(e) of the Income Tax Act, 1961

In a case where the loan is granted by the Indian company in foreign exchange to the employees of their branches outside India (who are also the shareholders of the company) for personal purposes as permitted under ECB Regulations, implications of Section 2(22)(e) need to be examined.

C. Deposits from NRIs — FEMA Aspects

Acceptance of deposits from NRIs has been dealt with in Notification No. FEMA 5(R)/2016-RB - Foreign Exchange Management (Deposit) Regulations, 2016, as amended from time to time.

According to this, a company registered under the Companies Act, 2013 or a body corporate, proprietary concern, or a firm in India may accept deposits from a non-resident Indian or a person of Indian origin on a **non-repatriation basis**, subject to the terms and conditions as tabled below:

Particulars	Deposit on non-repatriation basis
Who can accept the deposit?	Proprietorship concern, firm, Indian company (including NBFC)
Mode	A private arrangement or public deposit scheme
Credit rating	If NBFC, then it should be registered with RBI, and credit rating is required
Maturity	< 3 years
Interest	As prescribed under RBI guidelines for NBFC / Companies (Acceptance of Deposits) Rules, 2014. In both cases, it is 12.5% p.a. presently.
Investment	Debit to NRO Account only. Inward remittance and transfer from NRE/FCNR(B) Account prohibited.
End-use restriction	The amount cannot be used for re-lending (not applicable to NBFC), carrying on agricultural/ plantation activities or, investment in real estate, or investment in any other entity engaged in the above.
Repatriability of loan o/s India	Not allowed

It may be noted that the firm may not include LLP for the above purpose.

CONCLUSION

FEMA, being a dynamic subject, one needs to verify the regulations at the time of entering into various transactions. An attempt has been made to cover

various issues concerning gifts and loan transactions between NRIs and Residents as well as amongst NRIs. However, they may not be comprehensive, and every situation cannot be envisaged and covered in an article. Moreover, there are some issues where provisions

are not clear and/or are open to more than one interpretation, and hence, one may take appropriate advice from experts/authorized dealers or write to RBI. It is always better to take a conservative view and fall on the right side of the law in case of doubt. ■