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What India's New Dematerialization Rules Mean for Global Investors

by Anshu Khanna

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In this article, Khanna explains the need to dematerialize shares held in India and the rules and procedures that accompany the obligation. She also addresses the concerns of some global investors regarding the necessity of obtaining a tax registration number in India.

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The Indian market has recently witnessed a surge in interest from investors seeking both short-term gains and long-term opportunities. Traditionally, Indian companies issued paper share certificates, which were susceptible to forgery, loss, and transfer delays. To enhance corporate governance and protect the interests of both domestic and foreign investors, Indian regulators have implemented significant measures. The latest of these is the mandatory dematerialization of shares — converting physical shares into electronic form. This initiative aims to eliminate illicit transfer practices and foster a more transparent and secure investment landscape.

Dematerialization, as mandated under section 29 of the Companies Act, 2013, represents a pivotal stride toward modernizing corporate governance practices in India. The provision establishes the legal framework for issuing and trading shares electronically, replacing traditional paper-based certificates. The Ministry of Corporate Affairs reinforced this transition with the introduction of Rule 9B, requiring private companies to dematerialize their shares by September 30.

This article explains dematerialization's requirements in detail, its key features, its applicability to global companies with subsidiaries in India, timelines, noncompliance penalties, and challenges or concerns for the global investors. The article also explores the challenges and concerns faced by global investors, particularly the interplay with the permanent account number (PAN), an Indian tax registration number, which is often a contentious issue for international companies.

Key Features

Section 29 of the Indian Companies Act, 2013, and Rule 9B of the Companies (Prospectus and Allotment of Securities) Rules, 2014, play crucial roles in the recent amendment concerning the dematerialization of shares. Here's an overview of their roles and the context of the amendment.

Section 29

Section 29 deals with the issue of securities in dematerialized form. Initially, section 29 mandated that every public company should issue its securities only in dematerialized form. Rule 9A requires every unlisted public company to issue its securities only in dematerialized form; facilitate dematerialization of all its existing securities by making necessary application to a depository; secure an International Security Identification Number for each type of security; and inform all its existing security holders about such a facility. Rule 9A took effect October 2, 2018.

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For other investors, converting physical securities into dematerialized form is optional. Companies and their investors are required to comply with the provisions of the Depository Act, 1996, addressing the maintenance and transfer of securities in dematerialized form.

The recent amendments extend the requirement of dematerialization to include some private companies. This broadens the scope of section 29 to enhance transparency, reduce fraud, and streamline the process of transfer and management of shares.

Rule 9B

Rule 9B was introduced to operationalize the provisions of section 29 and provide detailed guidelines for the dematerialization of securities. Key aspects of rule 9B include:

- **Applicability:** This specifies which types of companies must dematerialize their shares. The recent amendment mandates that unlisted public companies and specific classes of private companies (such as large private companies or those planning to raise funds through private placements) must issue and maintain their shares in dematerialized form.
- **The Dematerialization Process:** This outlines the process that companies need to follow to convert their physical shares into dematerialized form, including the role of depositories, registered depository participants, and compliance requirements.
- **Compliance and Reporting:** This requires companies to ensure that all securities are dematerialized and that records are maintained accordingly. Companies are also required to submit periodic compliance reports to regulatory authorities.

Amendments to section 29 and Rule 9B aim to:

- **Enhance Transparency:** Dematerialization eliminates the risk of fraudulent practices associated with paper-based securities, promoting transparency and investor confidence.
- **Protect Investors:** Dematerialization safeguards investors' interests by ensuring accurate record-keeping and preventing unauthorized transfer of securities.
- **Integrate Globally:** Aligning with international standards, dematerialization enhances India's attractiveness to foreign investors and promotes capital inflows.

Global Companies, Foreign Subsidiaries

In a typical scenario, investors from the United States or other countries opt to invest in or expand their business operations in India by establishing wholly owned subsidiaries or using their foreign entities to remit funds through foreign direct investment channels. Wholly owned subsidiaries of foreign entities are typically structured as private limited companies in India. Further, in accordance with the most recent notification issued by the Ministry of Corporate Affairs, all private companies, excluding small companies, are mandated to dematerialize their shares.

Rule 9A states that unlisted public companies must issue securities only in dematerialized form; existing securities must be converted into dematerialized form; the transfer of securities in physical form is restricted; and only dematerialized securities can be transferred.

Wholly owned subsidiaries of foreign companies are therefore classified as unlisted public companies, and are subject to rule 9A.

Exceptions for Small Companies

The term "small company" is defined in section 2(85) of the Companies Act, 2013. However, small-company status is typically associated with private companies, not public. The definition includes criteria based on paid-up share capital and turnover, which, if exceeded, means the company cannot be classified as a small company.

According to section 2(85), a small company is defined as a company, other than a public company, with:

- A paid-up share capital not exceeding INR 40 million (about $479,000) (or a higher amount as prescribed but not more than INR 100 million).
- A turnover not exceeding INR 40 million (or such higher amount as prescribed but not more than INR 1 billion) in the previous financial year.

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Summary of Company Type and Applicability of Dematerialization Rules

Nature of Wholly Owned Subsidiary	Nature of Holding Company	Applicability of Dematerialization Provisions
Public Company	Public Company	Exempt under rule 9A(11).
Public Company	Private Company	Exempt under rule 9A(11).
Private Company	Private Company	Covered under rule 9B.
Private Company	Public Company	Because this is a deemed public company, it is unclear if rule 9A or rule 9B applies. If considered a private company — covered under rule 9B; if considered a public company — exempt in terms of rule 9A(11).

Public Company Exclusion

Public companies, by definition, cannot be classified as small companies. Thus, an unlisted public company, even if wholly owned by a foreign parent, would not qualify for exemptions granted to small companies.

In other words, wholly owned subsidiaries of foreign companies in India that are unlisted public companies must comply with rule 9A, irrespective of their size, the small company exemption is not available. The table summarizes.

Required Actions

Private companies subject to mandatory dematerialization provisions must:

- issue all securities exclusively in dematerialized form;
- facilitate dematerialization of existing securities upon request;
- ensure promoters, directors, and key management personnel hold securities solely in dematerialized form before any issuance or buyback;
- submit applications to depositories for dematerialization and obtain international securities identification numbers;
- inform existing security holders about dematerialization;
- ensure timely payment and maintenance of security deposits;
- comply with relevant regulations, directives, and guidelines;
- notify depositories of any disparities in issued capital; and
- address security holder grievances through the Investor Education and Protection Fund Authority.

Filing Form PAS-6 for reconciliation of issued capital is also required. This e-form, prescribed under rule 9A, tracks mismatches between shares in dematerialized mode and those in physical form. Form PAS-6 must be submitted to the Ministry of Corporate Affairs semiannually within 60 days of the half-year end, certified by a company secretary or chartered accountant in full-time practice.

Timeline for Completion of Dematerialization

Under rule 9B, every company must dematerialize securities within 18 months from the date of closure of the financial year ending on or after March 31, 2023. Hence, in the case of a company's financial year ending March 31, 2023 (standard financial year), the due date is September 30, 2024.

Penalties for Noncompliance

If companies or security holders do not comply with the dematerialization requirement by September 30, the following penalties will apply:

- the company will not be able to issue or allot any type of securities;
- the security holder will not be able to transfer or subscribe for any type of security;
- monetary penalties will be levied on company and every officer in default as detailed below;
- the penalty on the company is about $135 for each day the violation continues with a cap of $2,400; and
- the penalty for every officer of the company who is in default is also about $135 for each day the violation continues with a cap of $600.

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Challenges During the Dematerialization — PAN

Compulsory dematerialization mandates that all foreign investors holding securities in Indian companies must establish demat accounts with Indian depositories. This entails fulfilling specific procedural prerequisites, which include but are not restricted to:

- acquiring a PAN;
- adhering to know your customer regulations;
- potentially incurring financial fees; and
- authenticating certain documents for foreign nationals, such as passports and proof of address.

To facilitate the holding of securities, nonresident investors must engage a custodian to manage their demat account and oversee trade settlements. The custodian serves as a proxy for executing trades and holds shares on behalf of the nonresident investor. This arrangement streamlines processes, ensuring regulatory compliance and facilitating seamless transactions.

In light of the above, nonresident investors are mandated to open a demat account, for which obtaining a PAN is essential. A PAN is a unique identification number that facilitates the income tax system and ensures compliance with tax laws. To fulfil the PAN requirement, nonresident investors or their authorized representatives (in the case of foreign entities) must obtain a digital signature certificate, which entails one-time password verification via designated contact numbers and email addresses, along with video verification of the individual. The process of applying for a PAN is not complex but must be done carefully to avoid delays and further questions.

Foreign Investors' PAN Concerns

Nonresident Shareholder Tax Return Filing Rules

Global companies are required to comply with dematerialization rules. There is general concern about the requirement of having a PAN to enable compliance with these new rules. Companies that do not have any business or income in India often ask if they need to file a tax return in India because they have a PAN and, if they don't, will they be subjected to questions from Indian tax authorities.

Position on Return Filing in India

In compliance with section 139 of the Income Tax Act, 1961, foreign nationals meeting the section 6 residency criteria are required to submit an income tax return in India for any income earned or received within the nation's territorial jurisdiction, subject to relevant exemptions, deductions, and provisions. Below is an excerpt from section 139 stipulating the requirement for filing income tax returns:

> Section 139 of Income Tax Act, 1961:
>
> (1) Every person, —
>
> (a) being a company or a firm; or
>
> (b) being a person other than a company or a firm, if his total income or the total income of any other person in respect of which he is assessable under this Act during the previous year exceeded the maximum amount which is not chargeable to income-tax, shall, on or before the due date, furnish a return of his income or the income of such other person during the previous year, in the prescribed form and verified in the prescribed manner and setting forth such other particulars as may be prescribed.

The obligation to file arises only if the individual meets the specified conditions outlined in the act. Merely possessing a PAN as a foreign national doesn't automatically necessitate the filing of an income tax return.

Under section 139(1)(a), every company, including foreign companies, are compulsorily required to file an income return. However, exemptions are granted to foreign companies in scenarios in which the act exempts the income in question.

Under section 115A, any foreign company whose income consists exclusively of specific incomes listed in the section are not required to file an income tax return in India. A few examples are dividends, royalties, fees for technical services, and interest received from an Indian

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company. There are certain other conditions attached like paying withholding tax and not making use of a tax treaty benefit.

Essentially, if a foreign company doesn't generate any income within India, there's no purpose in mandating it to file an income tax return. Even if legislation imposed this obligation on a foreign company with no connection to India, noncompliance wouldn't matter. Unlike other cases, in which filing may be contingent upon meeting certain conditions, such as a "nil" tax slab, this isn't applicable to companies with exempt income. Hence, when a foreign company's income isn't subject to taxation in India, there's no obligation for it to file an income tax return. Compliance with procedural provisions is more of a formality when there's no tax liability.

Also, some provisions of the Indian domestic income tax laws offer specific exemptions from filing a return. The sections related to the exemption (for example, sections 115A, 194LC, etc.) list conditions under which tax is not due. However, it is important to note that enterprises earning income sourced from India and benefiting from preferential tax rates under a tax treaty are required to file an income tax return.

To summarize, taxability depends on income generated, exemptions claimed, treaty benefits, and the facts and circumstances of each case. Holding a PAN never itself creates an obligation to file a tax return in India.

My Take on PAN

Holding a PAN in India offers significant advantages to foreign companies and nonresidents, particularly when they engage in securities investment through a demat account with an Indian custodian. Here's how PAN can mitigate potential issues and provide some other benefits in terms of tax compliance and credibility:

1. **Reduced Withholding Tax Rates:** Foreign companies and nonresidents with a PAN may enjoy reduced withholding tax rates on various types of income earned in India. This includes dividends, interest, royalties, and other payments received from Indian sources. A PAN facilitates eligibility for lower tax rates as per bilateral tax treaties, thereby optimizing tax liabilities.
2. **Tax Benefits and Optimization:** PAN enables foreign companies and nonresidents to access tax benefits available under Indian tax laws. This includes claiming deductions, exemptions, and credits for taxes paid in India. By leveraging PAN, companies can optimize tax liabilities and enhance financial efficiency.
3. **Relief From Double Taxation:** Holding a PAN is essential for claiming relief from double taxation under tax treaties between India and other countries. Nonresidents can use their PAN to establish tax residency status and prevent taxation on the same income in both India and their home country. This ensures fair and equitable taxation and avoids unnecessary financial burdens.
4. **Enhanced Credibility and Trust:** Possessing a PAN enhances the credibility and trustworthiness of foreign companies and nonresidents in the Indian market. It signifies a commitment to transparency, compliance with Indian tax regulations, and responsible engagement with Indian authorities, banks, customers, and business partners. This, in turn, fosters positive relationships and facilitates smoother business operations.
5. **General Aid in Transactions:** PAN helps generally in several situations when dealing with India. For instance, PAN is required to be mentioned while entering into the transactions prescribed under rule 114B of the Income Tax Rules, 1962, while making payment for acquiring debentures or bonds (in case the same exceeds INR 50,000, approximately $600), or for sale or purchase of shares of an unlisted company (in case the same exceeds INR 1,00,000, approximately $1,200).

Conclusion

Private companies under rule 9B must dematerialize shares by September 30, including wholly owned foreign subsidiaries, ensuring universal compliance. PAN compliance is

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essential for appointing custodians and enhancing transaction efficiency and transparency. Holding a PAN itself doesn't mandate filing of an income tax return for foreign companies without Indian income — a facts and circumstances analysis is necessary. Initial compliance for dematerialized shares and PAN regulations promises long-term benefits including investor protection and market transparency. This reinforces India's appeal for global investment and financial ecosystem growth. ■

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