

**Chamber of Income Tax Consultants  
NRI - FEMA v/s Tax**

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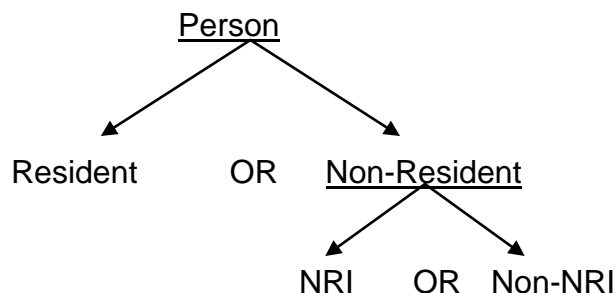
1. Two laws which most NRIs are concerned with, are Tax and FEMA. Even after so many years, there is a lot of confusion concerning the similarity or differences between the two laws. Generally there is a tendency to mix up the concepts of the two laws which leads to several difficulties. In this article, the focus will be:
  - i) To understand the differences regarding basic concepts between FEMA and Tax laws.
  - ii) To understand basic investment options. (This being a vast topic, it will be covered briefly).
  - iii) In case of return to India, what provisions apply for retention of assets abroad

In this article, I have primarily concentrated on issues which would apply to NRIs – i.e. issues which would apply to persons who are NRIs, or issues regarding NRIs who are planning to come back to India. The article does not cover issues relating to persons who intend to become NRIs (except as passing references).

**2. Basic differences between Income Tax and FEMA law**

**2.1 Residential Status**

The first and foremost difference is in the meaning of residential status as per Income Tax Act, and as per FEMA. It should be noted that as far as residential status is concerned, a person is a resident or a non-resident. The phrase “Non Resident Indian (NRI)” is different. First it should be determined whether a person is a resident or a non-resident. If a person is a non-resident, then one has to see whether a person is an NRI or not. Again persons confuse by stating that “although I am in India, I am a NRI”. Once you are a resident, he cannot be a NRI. Graphically, the position can be explained as under (for both Income Tax and FEMA laws).



- 2.1.1 As per the income tax act – section 6(1), it is the number of days which determine the residential status. A person is considered as a non-resident for the previous year (hereinafter referred to as relevant previous year), if he is in India for a period of less than 181 days in the year.
- 2.1.2 However there is another condition. If the person has been in India in the four preceding years (preceding the relevant previous year for which residential status has to be determined) for 365 days or more, then he should in India for less than 60 days. **For NRIs however, the number of days for which he be in India and still be a non-resident, is less than 182 days (instead of less than 60 days)**. Thus they can be for almost six months in a year and continue to be non-residents. Thus the condition of 60 days is redundant in case of NRIs. There is however one condition to be fulfilled. The relief of allowing to be in India for upto 181 days and still continuing to be a non-resident is available if the NRI comes to India for a visit. What is a visit is not explained. Generally if he comes to India (for any purpose), and goes back, it should be considered as a visit to India. This can have an impact in the year in which a person returns to India.

### Example 1

Consider a case of Mr. Singh who frequently comes to India. During the four years 1999-00 to 2002-03, he has been in India for more than 365 days. In the Financial Year 2003-04, if he returns to India for settling down, how many days should he be in India? Normally he can be in India for upto 181 days. However in the year 2003-04, he comes on 1<sup>st</sup> December 03 for the first time, and does not go back for the remaining year, he will be in India for 121 days (less than 181, but more than 60 days). When he has come to India on 1<sup>st</sup> December, can we say that he is in India for a visit? Probably not. He has come to India for good, and not for a visit. To avoid such a situation, one should make a trip to India for a few days, and then come back again for good. One trip to India will qualify as a visit to India, and he can get the benefit of 181 days.

- 2.1.3 Thus it is the physical presence in India, which determines the residential status for Income Tax purpose. One issue which comes up is regarding the day of arrival and departure. Should such days be considered as “in India” or “outside India”. In the Advance Ruling No. 7 of 1995 (223 IT 462), it has been held that both the days – arrival and departure – will be considered as in India. One should keep the same in mind when counting the number of days in India.

There is a contrary view given in an old Tribunal decision of Jaipur bench (No. 1230 of 1985 dated 22.8.1986 (ITO Vs. Dr. R. K. Sharma) which has held that the day of assessee’s arrival has to be excluded for the purpose of counting the number of days in India. Normally a day should mean a day of 24 hours and a part of a day should be excluded.

This was keeping in line with section 6 of General Clauses Act. However for practical purposes and to avoid undue controversy, one may plan on a conservative basis.

- 2.1.4 Under FEMA, the determination of residential status has different criteria. The understanding of the purpose of both laws will help to understand the issues better.

For Income Tax purposes, the issue is of taxability of income. The income is determined for the full year. If a person is a resident, his global income will be taxable in India. If a person is a non-resident, only his Indian income will be taxable. Income earned and received outside India is not taxable in India. For earning income, no approval is required under the Income tax act.

Under FEMA there are regulations for undertaking transactions themselves. For example, if a person wants to keep deposits in NRE/FCNR accounts in India, NRIs can keep the deposits. Indian residents cannot keep the deposits. Or if a person wants to borrow from a bank in USA, there are several restrictions on residents. Whereas the NRIs being non-residents of India, can borrow freely. Hence it is necessary to know the status at the time of doing the transaction. One cannot wait for the year to complete and then know whether he can do a transaction or not. If that were the situation, then there will be several difficulties.

### **Example 2**

For example, a person comes to India for taking a job on 1<sup>st</sup> May 2003. Under FEMA he becomes a resident from the day he comes to India. As a resident he can do several transactions. But a non-resident, there will be restrictions. If such a person had to wait till 31<sup>st</sup> March 2004 to know whether he is a resident, there will be difficulties.

**Therefore under FEMA, a person is a resident or a non-resident from the day he comes in, or leaves India. This a fundamental difference between residential status as per Income Tax Act and FEMA. There is no link otherwise**

- 2.1.5 With this background, let us see understand the concept of residential status under FEMA.

Under section 2(v)(i) of FEMA, a person is considered as an Indian resident if has been in India in the preceding financial year for more than 182 days. However this condition is almost redundant. As we have seen in the earlier para, the purpose of Income Tax and FEMA law is different. If one has to wait till the end of the year to know the status, things will become difficult. For practical purposes, two clauses (A) and (B) will apply. As per the clauses, a person is a resident if comes to India :

- for taking up employment in India; or
- for carrying on any business in India; or
- for any purpose which indicates his intention to stay in India for an uncertain period.

Conversely if a person goes abroad for any of the above purposes, then he becomes a non-resident.

Thus under FEMA, it is the purpose of staying in or outside India which determines residential status.

At this stage it may not be out of place to mention that several NRIs are of the view that the intention determines the residential status under FEMA. People would like to stay in India for 8 to 10 months, but state their "intention" is to go back. Hence they claim s status of NRI. This is my submission is not correct. Merely intention does not determine anything. If a person has come for employment or doing business in India, he is a resident. There is no question of intention. It is only if he comes in India under circumstances to stay in India for an uncertain period, that the intention comes into picture. Here also it is the facts which should indicate his intention to go back. If he stays in India for more than six months every year, then the person does not remain an NRI.

#### 2.1.5 Different residential status under FEMA and Income Tax

Due to different definitions under Income Tax and FEMA, there could be situations, where a person could be a resident under Income tax Act, and non-resident under FEMA, or vice-versa. Some examples are given below:

##### **Example 3**

A person who is an Indian resident, takes up a job in the USA in November 03. From Nov. 03, he will become a non-resident under FEMA. He will be free from FEMA as far as transactions abroad are concerned. However under Income Tax Act, the person will be a resident. His US Salary from Nov. 03 to March 04, will be liable to tax in India – subject to DTA relief.

##### **Example 4**

An NRI has FCNR / NRE fixed deposits. He returns to India for good in Nov. 03. Under FEMA he becomes a resident from Nov. 03. However under Income Tax Act, such a person will be a non-resident for FY 03-04. Under FEMA, such a person can continue his FCNR / NRE fixed deposits until maturity. Is such interest which he earns after returning to India taxable? While he can continue the deposits until maturity, for income tax relief, section 10(4)(ii) states that the person should be a

non-resident under FERA (now FEMA). As the NRI becomes resident under FEMA, he will lose the primary benefit of exemption from tax. (Other provisions like S. 10(15)(iv)(fa), and chapter XII-A will have to be looked at independently).

Thus this difference in the status as per both laws becomes relevant especially in the year of arrival or departure.

- 2.1.6 An interesting issue arises in case of persons who are employed on ships. A person who is employed on ships which keep traveling to different ports around the world including India.

Under the Income tax Act (explanation a to S. 6(1)), if an Indian citizen leaves India in any year as a member of crew of an Indian ship, then instead of 60 days, even if he is in India for upto 181 days, he can be a non-resident. CBDT circular no. 572 dated 3.8.1990 has further clarified that crew members who are already employed on the Indian ship (and does not leave India), will also be considered as a non-resident if he is in India for upto 181 days. CBDT circular no. 586 dated 28.11.1990 has further clarified that Indian ships operating beyond Indian territorial waters, will not be considered as operating in India. Thus a person on an Indian ship which is operating outside the territorial waters of India, will be considered as outside India. (Indian territorial waters means a distance of upto 12 nautical miles from the nearest point of appropriate baseline).

Under FEMA the situation is different. There is a decision reported 45 Taxman 94 in the case of Paul H Rodrigues Vs. Director of Enforcement. In the decision it has been held that a ship flying an Indian flag is a floating Indian island. Therefore Mr. Paul was an Indian resident. Thus there could be a situation for Indian crew on ships, where the person is considered as “outside India” under income tax act, and “in India” under FEMA.

Such a person can have foreign income which may be tax free as he will be a non-resident. However as he will be a resident under FEMA. Hence he will have to bring all his income in India; he may not be able to open NRE accounts and in general not enjoy facilities available to NRIs.

There is a caveat. The case of Mr. Paul discussed above has considered the fact that Mr. Paul had not set up any residence outside India. This was not the most crucial issue in the case. However if Mr. Paul has a residence abroad, then what could be the situation, will have to be considered.

#### 2.1.7 **Persons in Nepal**

Several persons go to Nepal and claim the status of a non-resident. Essentially there is no legal difficulty. If a person is outside India, he will

be a non-resident under Income Tax Act and FEMA (subject to other criteria being fulfilled as discussed above). However there is a practical difficulty. How does one prove that he has been to Nepal. The border between India and Nepal is porous. Further there is no requirement of any passport or visa for traveling to Nepal. (Therefore under FEMA there are special provisions for persons of Nepal and Bhutan.) It will be useful to make a reference to the decision of Raj Kumar Dhanuka in 252 ITR 205. Though the decision was mainly on the matter of search and seizure, an observation has been made by the Honorable High Court that *“Only because there is an open border between India and Nepal and a passport is not required to ... .., it cannot be presumed that anyone who claims to be an Indian national residing in Nepal, is a non-resident India. Simply because it is difficult to prove in such a case whether a person was residing for a particular period in Nepal or India, it does not mean that the claim of a person who claims to be residing in Nepal that he is a non-resident Indian, has to be accepted by the authorities.”*

The observations show that the facts have to be proved that a person was staying in Nepal. Preferably the passport should be carried and stamping done. Further there should be utility bills, house tax receipts, receipts for visiting places in Nepal, etc.

#### **2.1.8 Intermediate Residential Status**

Normally a person is either a resident or a non-resident. However under Income Tax Act, a person can be a “Resident but Not Ordinary Resident”. Under FEMA also, a person can be “Not Permanently Resident”. These concepts are discussed more in details below in para 4 which deals returning Indians.

#### **2.2 Meaning of Non-resident Indian (NRI)**

The other major area where there is a difference under Income Tax Act and FEMA is the meaning of NRI. As NRIs are offered specific reliefs under Income Tax Act and FEMA, a specific meaning has been given to the term NRI. Indian citizens resident outside India are NRIs. For foreign citizens who can be considered as NRIs, there are differences.

2.2.1 Under the income tax act, the term NRI is used under chapter XII-A. Under chapter XII-A, NRIs are given preferential treatment. These have been discussed in a separate article. The meaning of NRI has been given in section 115C(e).

As per the section, an NRI means a person who is:

- i) a non-resident, and
- ii) an Indian citizen; or  
a Person of Indian Origin (PIO).

PIO means a person who himself, or either of his parents, or either of his grandparents, were born in undivided India.

There is no reference to spouse of a person.

2.2.2 Under FEMA, the term NRI is defined in three different manners – for different purposes.

#### **A. For NRE, FCNR, Investments shares, FDI in India, etc.**

Under the Deposit Regulations, the NRIs can open NRO, NRE and FCNR accounts. They can also place deposits with Indian residents. Regulation 2(vi) of “Deposit” Regulations states that an NRI means a person who is:

- i) a non-resident, and
- ii) an Indian citizen; or  
a Person of Indian Origin (PIO).

PIO means a person who:

- held an Indian passport, or
- himself, or either of his parents, or either of his grandparents, was a citizen of India by virtue of the Constitution of India or the Citizenship Act, 1955;
- is a spouse of an Indian citizen or a person a spouse of a PIO as discussed above.

Citizens of Bangladesh and Pakistan are not considered as NRIs.

This definition applies to most of the transactions which NRIs are permitted to do.

#### **Example 5**

Mr. Amit Shah is a NRI staying in USA for several years. He marries Ms. Jane – a person of US origin. She will be entitled to keep funds in NRE, FCNR accounts (as spouses of NRIs are considered as NRIs). However she will not be entitled to benefits under chapter XII-A (as spouses of Non-Indian origin are not considered as NRIs under Income Tax Act.)

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#### **B. Investment in a partnership firm and a proprietary firm**

S. 2(iv) and 2(vi) of “Investment in Firm or Proprietary Concern in India” Regulations state that an NRI means a person who is:

- i) a non-resident, and
- ii) an Indian citizen; or  
a Person of Indian Origin (PIO).

PIO means a person who:

- held an Indian passport, or
- himself, or either of his parents, or either of his grandparents, was a citizen of India by virtue of the Constitution of India or the Citizenship Act, 1955;
- is a spouse of an Indian citizen or a person a spouse of a PIO as discussed above.

Citizens of Bangladesh, Pakistan and Sri Lanka are not considered as NRIs. This is keeping in line with the general policy on investments by foreigners where citizens of above 3 countries are not permitted to invest in India on automatic basis.

Compared to the definition in clause A above, the only difference is that citizens of Sri Lanka are excluded from the meaning of NRI.

### **C. Immovable Properties in India**

S. 2(c) of “Acquisition and Transfer of Immovable Property in India” Regulations define the meaning of PIO. Indian citizens resident outside India are NRIs. PIO means a person who:

- held an Indian passport, or
- himself, or either of his father or grandfather, was a citizen of India by virtue of the Constitution of India or the Citizenship Act, 1955;

Citizens of Bangladesh, Pakistan, Sri Lanka, Afghanistan, China, Iran, Nepal and Bhutan are not considered as PIOs.

For immovable properties, the meaning is restricted. Spouses are not included. Only father’s and grandfather’s citizenship is considered. Further citizens of 8 countries are not included.

### **Example 6**

In the example 5 above, Ms. Jane will not be able to buy immovable property in India.

Thus one should keep the differences and nuances in mind when considering whether an NRI can do different transactions.



### **3. Investment options for NRIs**

Under FEMA, NRIs have several investment options. While this area is very broad, here it is covered in brief. Incomes arising out Indian investments and operations have tax implications. Tax implications have been dealt with in different articles. The para explains different investment and business operations which can give tax implications.

It may be pointed out that NRIs could invest through Overseas Corporate Bodies (OCBs). However that category of investor is abolished with effect from 16.9.2003. Now NRIs can invest through their companies just as any other foreign company.

Investment can be made on repatriable basis and non-repatriable basis. In case of investment on non-repatriable basis, principal is non-repatriable. But incomes can be repatriated as the same are current account transactions. This principle applies for all investments and incomes.

#### **3.1 Bank deposits**

NRIs can invest in NRO, NRE and FCNR deposits. NRE and FCNR deposits are repatriable. NRO deposits are non-repatriable.

#### **3.2 Giving loans to Indian residents**

NRIs can give loans to Indian residents. Interest can be charged on the loans. The loans are subject to guidelines.

NRIs can also invest in Non convertible debentures of a company on repatriable basis.

Generally loans to companies can be on repatriable basis. Loans to non-companies can be non-repatriable basis.

Loans can also be given to close relatives from NRE account on repatriable basis. However no interest can be charged on the loan.

#### **3.3 Investment in shares of Indian companies**

Under the FDI policy, NRIs can invest in shares and convertible debentures of Indian companies. Investment can be made on repatriable and non-repatriable basis.

NRIs can provide technology and earn royalties and fees for technical services.

#### **3.4 Portfolio Investment**

Investments can be made in shares and convertible debentures through stock exchanges. Investments can be made on repatriable and non-repatriable basis. Recently RBI has allowed them to invest in exchange traded derivative contracts.

### **3.5 Immovable properties**

NRIs can invest in immovable properties. They can give the properties on rent also. Investment in agricultural/plantation properties is not permitted. Investment can be on repatriable basis.

### **3.6 Proprietary and partnership firms**

Investment can be made in proprietary and partnerships on non-repatriable basis. Profits earned can be repatriated as the same are current account transactions.

### **3.7 Mutual funds. Government securities, etc.**

Investments can also be made in units, government securities, treasury bills, bonds of PSUs.

Recently however NRIs have been prohibited from investing in Post Office Savings schemes, NSCs, Kisan Vikas Patras and PPF.

### **3.8 Branches**

With approval from RBI, branches can be opened in India for specified purposes. The purposes for which branches can be opened are export and import of goods, IT related services, etc.

### **3.9 Services, employment, etc.**

NRIs can become directors on the board of Indian companies and earn board fees. They can also render services just as any other non-residents. NRIs can of course take up employment in which case they will become Indian residents.

## **4. Returning Indians**

There are several NRIs who plan to return to India. They need to take care of some FEMA and Tax issues. While tax issues are covered in respective articles, here some FEMA issues are considered. To become a resident, no approvals are required. However some simple steps may be required to be taken depending on the assets held by the NRI.

### **4.1 Foreign assets**

NRIs can continue to hold assets outside India – section 6(4) of FEMA. Thus immovable properties outside India, shares, mutual funds, securities and other investments can be held without any approval from RBI. There is no need to declare the assets to anyone. The only condition necessary is that the assets were acquired when he was a resident outside India.

At this stage it should be clarified that the drafting of FEMA is not very happy. Hence there are legal difficulties. For example on a strict reading of the law, any income earned on foreign assets is required to be brought back to India. It cannot be retained abroad. Further if the assets are sold, the proceeds cannot be reinvested. He can bring the sale proceeds in India and deposit in RFC A/c (discussed below). Then he can remit back the funds for investments. However retaining the sale proceeds abroad and reinvesting the same again, are very strictly not covered. Under FERA, both these issues were specifically permitted. However practically, the position is what has been mentioned above. In this respect, reference can be made to a very important circular issued under FERA - ADMA 51 dated 1992. This circular states the law and the intention for returning NRIs.

#### **4.2 Business Outside India**

A person could be having his proprietary business, or he could be a partner in a firm. The intention as per ADMA circular 51 referred to above is to allow business interests to continue, though there is no clear wording in law. However one must take care that as soon as the person earns income, he must bring it back to India. Usually however people have companies through which the business is conducted. The person holds shares in the company. As mentioned above, the returning NRI can continue to hold shares in such a company without any approvals from RBI.

#### **4.3 Liabilities abroad**

Liabilities abroad become a borrowing for the country. Hence if the NRI has any borrowings, approval will be required from RBI to continue the same.

##### **Example 7**

If the NRI has a house property abroad which is on mortgage, then the loan cannot be continued without approval from RBI. Though holding of property can be continued. Approval for the loan is at the discretion of RBI.

#### **4.4 Indian assets**

Normally, an NRI may have Indian assets like bank deposits, shares, etc. For such assets, simple procedures are required to be carried out.

The returning NRI must inform the bank to designate all his bank accounts (savings, fixed deposits, etc.) as resident accounts. Here the RBI has given options to the returning NRIs. Foreign currency deposits (FCNR) can be continued till maturity on same rates of interest. On maturity the balance including interest can be transferred to Resident Foreign Currency Account (RFC A/c) – discussed later. NRE deposits (repatriable) can also be continued till maturity on same rates. However on maturity, the deposits will have to be converted into ordinary resident accounts. If the NRI desires that the funds should be transferred to RFC A/c, then the deposits will have to be prematurely encashed and deposited in RFC A/c. This would result in loss of interest. Any other account would have to be designated as an ordinary resident account.

For shares, debentures and other securities, the companies and other relevant entities must be informed about the change in residential status. If he is a partner in an Indian firm, or has given loans or taken loans, then the persons concerned must also be informed accordingly.

#### **4.5 RFC A/c**

A returning NRI can open RFC account. FCNR / NRE funds can be deposited in this account as mentioned above. Further even foreign funds can be deposited in RFC account. RFC accounts can be maintained in any convertible currency. Funds can be held as savings or deposits. The benefit of this account is that it is free from operations. Normally an Indian resident cannot invest abroad freely. There are regulations for incurring expenses in foreign currency. With RFC account, the NRI can incur expenses abroad freely. For example, he may have holiday plans for which there is a restriction on the amount of foreign exchange he can draw. With RFC A/c, there is no limit. Similarly if wishes to buy foreign shares, subscribe to rights, mutual funds, etc., he can do so.

There is a further tax advantage with an RFC A/c. As long as a person is a NOR, interest on RFC accounts are tax free.

#### **4.6 Not Permanently Resident - Holding of foreign currency etc.**

For a very limited purpose, there is a concept of “Not Permanently Resident” (NPR). Under Regulation 4 of Possession and Retention of Foreign Currency, a resident can hold foreign currency without any limit if the same was acquired while the person was a non-resident.

NPR means persons who have come to India for employment of a specified duration (irrespective of the period), or for a specific job or assignment not exceeding 3 years.

#### **4.7 Not Ordinarily Resident (NOR)**

With effect from AY 04-05, the meaning of the term NOR has been amended and relief has been curtailed drastically. A detailed discussion is there in a previous issue of the Chamber, here the issue is dealt with briefly.

If a person is a non-resident for 9 years, he can be a NOR for 1 year. If a person is a non-resident for 10 years or more, he can be a NOR for 2 years. Further even within the past 7 years if his stay in India is for less than 730 days, he will be a NOR (practically he can be for NOR for 3 years). As a NOR, foreign income which is received outside India, is exempt from tax. Once the NOR status period expires, his foreign income will be taxable in India. Even some other benefits like tax exemption on foreign currency deposits will be available till a person is a NOR.

The NOR status has become a sore point with returning NRIs. Earlier the benefit of NOR status could be available for as much as 9 years. With effect from 1.4.03, this benefit has been reduced.

With the reduction of benefit, tax planning which was resorted to earlier may gain momentum. Persons resort to various kinds of planning including setting up offshore companies and offshore discretionary trusts. However it should be pointed out that this planning is very complicated and cannot be achieved by simply setting up foreign companies and trusts. Infact all may not be able to avail of this benefit. But then this issue is beyond the scope of this article.

## 5. **Conclusion**

This article deals with some issues. With tax rates being moderate and government trying to curb extra reliefs for NRIs, one may have to plan the affairs well in advance so as not to fall into avoidable difficulties.