

TAX FLASH NEWS

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Draft Rules and Regulations for rationalisation of Overseas Investment Regulations under FEMA, 1999

Background

Any overseas investments in foreign security and immovable property outside India by persons resident in India (PRII) is presently governed by the Foreign Exchange Management (Transfer or Issue of Any Foreign Security) Regulation 2004 (FEMA 120) and the Foreign Exchange Management (Acquisition and Transfer of Immovable Property Outside India) Regulations 2015 [FEMA 7(R)] respectively.

To liberalize and rationalize these existing overseas investment provisions, the Reserve Bank of India (RBI) on 9 August 2021 has placed on its website two documents for public comments i.e. (i) Draft Foreign Exchange Management (Non-debt Instruments - Overseas Investment) Rules, 2021 (NDIOI); and (ii) Draft Foreign Exchange Management (Overseas Investment) Regulations, 2021 (OI).

The RBI has invited comments/feedback from all stakeholders on the aforesaid draft documents on or before 23 August 2021.

Presently, both the current Regulations are notified by the RBI. In line with the earlier amendments to the Foreign Exchange Management Act 1999, the two documents give power to the Central Government to enact and amend NDIOI Rules governing overseas investment in Overseas Non-debt Instruments and Immovable Property whereas the RBI continues to have power to regulate other overseas investments under the OI regulations. The provisions with respect to acquisition of immovable properties outside India by PRII is proposed to be subsumed under NDIOI Rules whereas those relating to debt / fund based and non-fund based facilities are carved into OI Regulations.

This Flash News endeavors to highlight some of the key changes proposed in the draft Rules / Regulations as compared to the existing provisions.

Key Highlights

I. The draft NDIOI Rules

(A) The Following definitions have been introduced in the NDIOI Rules which will apply for all overseas investment purposes:

- i. **Exception:** The NDIOI Rules carve out unit set-up in an International Financial Service Centre (IFSC) from their applicability.
- ii. **Control:** The term 'control' is defined to mean the right to appoint the majority of the directors or to control the management or policy decisions exercisable by a person or persons acting individually or in concert, directly or indirectly, including by virtue of their shareholding or management rights or shareholders' agreements or voting agreements that entitle to ten percent or more of voting rights or in any other manner in the foreign entity.
- iii. **Equity Capital:** The term Equity Capital defined to mean equity shares or perpetual capital/instruments that are irredeemable or contribution to non-debt capital of a foreign entity in the nature of fully and compulsorily convertible instruments.
- iv. **Foreign Entity:** The term Foreign Entity in which ODI can be made is defined to mean an entity incorporated and registered outside India under the laws of the host country. The definition expanded to include unincorporated entity engaged in a strategic sector and formed under the laws of the host country.
- v. **Indian Entity:** The definition of Indian Entity eligible to make ODI, apart from companies incorporated under the Companies Act 2013, includes Limited Liability Partnership having perpetual succession under the Limited Liability Partnership Act 2008.

- vi. **Listing Entity Criteria:** The definition of Listed Indian entity or Foreign entity means only entities whose equity shares or any other full and compulsorily convertible instruments are listed on recognized stock exchanges in or outside India respectively. Further, any recognized stock exchange in IFSC is treated as a recognized stock exchange outside India.
- vii. **Net Worth:** The definition of net-worth of Indian company is streamlined as per the definition in Section 2(57) of the Companies Act, 2013. This explicitly allows inclusion of Securities Premium as part of net worth computation as compared to the current definition of net-worth (paid up capital and free reserves). In case of a Registered Partnership firm or LLP, the computation of net worth to take into account accumulated losses, deferred expenditure and miscellaneous expenditure not written off apart from partners' capital and undistributed profits.
- viii. **ODI:** ODI defined to mean investment by way of acquisition of equity capital of an unlisted foreign entity or subscription to the MoA of a foreign entity or investment in ten percent or more of the paid-up equity capital of a listed foreign entity, or where the PRII making such investment has or acquires control, directly or indirectly, in the foreign entity. The term ODI to include sponsor contribution by an Indian Party in AIF / Investment vehicle set-up outside India, participating rights in specified sectors, and engaging in agricultural operations as stipulated. Once an investment is classified as ODI, it will continue as ODI even if investment falls below threshold for listed overseas entity or control is lost (unlisted overseas entity).
- ix. **Overseas Portfolio Investment (OPI):** The term OPI defined to mean investment, other than ODI, in foreign securities, including units of Exchange-traded Funds and depository receipts, which are listed, unless stated otherwise, on a recognized stock exchange outside India but not in any securities issued by a PRII (outside an IFSC).
- x. **Overseas Investment:** The term overseas investment is defined to mean financial commitment (ODI, Debt and non-fund facilities extended) and OPI by PRII.
- xi. **Step Down Subsidiary (SDS):** A definition of SDS has been introduced to mean a subsidiary of a foreign entity having ODI and in a case where the Indian entity has control in the foreign entity at the time of the creation of SDS, the structure of such SDS shall comply with the requirements of a foreign entity as prescribed. A subsidiary of an SDS will also be an SDS.
- xii. **Write-off:** The term write-off is now defined to include shortfall in consideration received by PRII against full / proportionate amount of equity capital and debt at the time of full or partial disinvestment of ODI or the amount of diminution in the capital and other receivables on account of restructuring of the balance sheet of the foreign entity.
- (B) The other key features of NDIOI Rules in respect of Foreign Securities are as under:**
- i. **Automatic Route:** Subject to limits and conditions prescribed, any investment made by a person resident in India shall be made in a foreign entity engaged in a bona fide business activity, directly or through SDS, subject to the limits and the conditions prescribed in these rules and specified in the FEM (OI) regulations. The term bona fide business activity is explained to mean any business activity legally permissible both in India and host jurisdiction.
- ii. **Approval Route:** For ODI beyond permissible financial commitment, prior approval of the Central Government required for Indian Entities engaged in strategic sectors. For Indian Entities engaged in other sectors, such prior approval within limits fixed in consultation with the Central Government, to be granted by RBI.
- iii. **Investigation cases:** The Indian Entities proposing ODI which are Special Mention – Category 1 & 2 categorization, Non-Performing Assets or wilful defaulters or under investigations by any Regulatory Body or by Central Bureau of Investigation or Directorate of Enforcement or Income-tax Department or Serious Frauds Investigation Office or any other agency as advised by the Central Government, now obliged to seek and obtain No-objection certificate from the respective lenders / authorities before making the proposed ODI in compliance with the prescribed framework and handover to the AD-Bank. If these authorities do not give their NOC within sixty days from the date of receipt of such request, then it would be presumed that they have no such objection.
- iv. **Schedules for overseas investments:** The NDIOI Rules stipulated four separate schedules for overseas investment as below:
- Schedule I - Overseas Direct Investment by an Indian entity
 - Schedule II - Overseas Portfolio Investment by an Indian Entity
 - Schedule III - Overseas Investment by Resident Individuals
 - Schedule IV - Overseas Investment by a Person Resident in India other than an Indian Entity and an Individual.

- v. **Pricing:** The stipulated pricing guidelines with respect to issue or transfer of foreign securities are as under:
- Listed foreign securities: The price worked out in accordance with the concerned stock exchanges of the host country
 - Other than listed foreign securities: The price to be within 5 percent range of the fair value arrived on an arm's length basis as per any internationally accepted pricing methodology certified by a registered valuer as per the Companies Act 2013; or similar valuer registered with the regulatory authority in the host jurisdiction to the satisfaction of the AD bank.
 - The valuation certificate should not be older than six months as on the date of transaction.
- vi. **Merger / Demerger / Liquidation of Foreign Entity:** A PRII holding equity capital permitted to transfer such investment including on liquidation subject to pricing guidelines and other prescribed conditions. In case the transfer is on account of merger, amalgamation or demerger or on account of buyback of foreign securities or liquidation of the foreign entity, it should have the approval of the competent authority as per the laws in India and/or the host country. On disinvestment other than liquidation, the Indian entity to have no outstanding receivables from the foreign entity as an investor in equity and debt. Transferor to have invested for at least a year from the date of making ODI except in case of conversion of loans. Transferor not to lose control in foreign entity in case of any disinvestment by way of conversion of loan.
- vii. **Restructuring of Foreign Entity:** The Indian entity can permit restructuring of balance sheet by foreign entity incurring losses as evidenced by its last audited balance sheets for the previous two years subject to conditions and limits prescribed under the rules. The cases where diminution of original investment is more than USD 10 million or where it exceeds 10 percent of the total value of the outstanding dues towards the Indian entity, the diminution to be certified by registered valuers. Further, the total value of the outstanding dues towards the Indian entity including investment in equity and debt, after such restructuring cannot exceed the proportionate amount of the accumulated losses.
- viii. **Restricted activities for ODI:** Apart from Real estate activity as in the past, the proposed draft rules prohibits PRII from making ODI in a foreign entity engaged in Gambling in any form or offering financial products linked to Indian Rupee except for products offered in an IFSC.
- ix. **Foreign Direct Investment (FDI) below ODI structures:** The Financial Commitment by PRII in a foreign entity that has invested or invests into India, at the time of making such Financial Commitment or at any time thereafter, either directly or indirectly, which is designed for the purpose of tax evasion/ tax avoidance by such person is not permitted and any contravention in this regard to be considered as of a serious/sensitive nature. This rule to apply mutatis mutandis to SDS as well.
- (C) Key changes relating to acquisition of Immovable Property outside India by PRIIs.**
- i. In respect of acquisition of Immovable property outside India by PRII who is an individual under LRS, the remittances under the LRS can be consolidated in respect of relatives (as defined) who are PRII, are co-owners of the property acquired and individual family members complying with the terms and conditions of the LRS.
 - ii. If the original investment in immovable property was not permitted under the Act or the rules or regulations made thereunder, then transfer thereof in any manner will also be treated as a contravention.
- (D) Schedule I - Overseas Direct Investment by an Indian entity of NDIOI**
- i. **Modes of ODI:** The method of ODI / investment by an Indian entity explicitly include (i) Subscription to/Purchase of equity capital, listed or unlisted; (ii) Acquisition through bidding or tender procedure; (iii) Rights and Bonus Shares; (iv) Capitalisation of the dues from the Foreign Entity within the prescribed time; (iv) Swap of shares and with prior Central Government approval wherever required; and (v) Merger, Demerger, amalgamation or any scheme of arrangement.
 - ii. **ODI in Financial Services:** An Indian Entity which is engaged in financial services activity in India can make ODI in a Foreign Entity which is directly or indirectly engaged in financial services subject to conditions similar to existing Regulation 7 of FEMA 120. A foreign entity is considered to be engaged in the business of financial services if it undertakes an activity, which if carried out by an Indian entity will require registration with or is regulated by a financial sector regulator in India. Banks / Non-Banking Financial Institutions subject to conditions prescribed in this regard.
 - iii. **Portfolio investment by Listed Indian Company:** An Indian Entity listed on a recognized stock exchange in India and having a net worth of INR 500 crore as per latest audited balance sheet may make ODI including by way of contribution in an Overseas Technology Fund for the purpose of investing in overseas technology startups engaged in an activity which is in alignment with the core

business of such Indian entity. This ODI is subject to the such Entity having profits in last three preceding financial years and the investment being from their or group company's internal accrual and not borrowed from banks / financial institutions / regulated entities.

- iv. **Special cases of ODI:** The aggregate financial commitment ceiling of 400% of net-worth as per last audited balance sheet shall not apply to ODIs made by "Maharatna" PSUs or "Navratna" PSUs or subsidiaries of such PSUs in foreign entities outside India engaged in strategic sectors.
- v. **Limits:** Any utilisation of the proceeds from External Commercial Borrowings (ECB) for making financial commitment shall also be considered towards the limit of total financial commitment to the extent the corresponding pledge or creation of charge on assets to raise such ECB has already not been reckoned towards the above limit of the Indian entity.

(E) Schedule II - Overseas Portfolio Investment by an Indian Entity

- i. A listed Indian Company may make OPI including by way of reinvestment within the limit of 50 percent of its net-worth as on the date of its last audited balance sheet.
- ii. An Indian entity which is a software exporter, or any other Indian entity prescribed by Central Government may receive foreign securities up to 25 per cent of the value of exports made to a foreign company irrespective of whether such company is listed or not.

(F) Schedule III - Overseas Investment by Resident Individuals

- iii. **Scope:** A resident individual is allowed to make ODI and OPI (as defined) within the overall LRS ceiling at the time of investment which ceiling and restriction shall not apply when the investment (i) is out of RFC Account; or (ii) is out of Foreign Currency Deposits held outside India in case of persons not permanently resident in India (i.e. employment of specified duration irrespective of length thereof or for a specific job or duration which does not exceed three years).
- iv. **Categorization:** The Overseas Investment by a Resident Individual with the LRS ceiling to be categorized as ODI or OPI based on nature of investment acquired and categories of investment expanded to include merger, demerge, amalgamation, liquidation, rights / bonus issue, sweat equity shares, management qualification share, ESOP / Employee Benefit Scheme, etc.

- i. **Other modes of overseas investments:** The acquisition of equity capital under sweat equity shares, minimum qualification shares for management and Employee Benefit Scheme / ESOP shall be treated as 'Overseas Portfolio Investment' if the shares/interest so acquired by such person does not exceed 10 percent of the paid-up capital/stock of the foreign entity and they not leading to any control.
- ii. **ESOP / others schemes:** The remittance by resident individual to acquire shares / interest in ESOP / Employee Benefits Scheme and Sweat Equity Shares as stipulated within LRS ceiling subjected to the test of not acquiring control.

(G) Schedule IV - Overseas Investment by a Person Resident in India other than an Indian Entity and an Individual

- i. **ODI by Trust / Society:** A registered trust or a registered society engaged in the educational sector or which has set up hospital(s) in India permitted to make ODI in the same sector with prior approval of RBI in a foreign entity. The Indian Trust / Society to be in existence for at least three financial years before the year in which such investment is being made. Further, such ODI is subject to prior regulatory approval from Government / other authority as may be applicable.
- ii. **ODI by Funds:** Overseas investment by Mutual Funds, Venture Capital Funds and Alternative Investment Funds subject to terms and conditions prescribed by RBI and SEBI including the individual and overall limits. All their transactions of purchase and sales to be routed through a designated AD Bank.
- iii. **Other cases:** A domestic depository may acquire, hold and transfer foreign securities of a foreign entity, being the underlying security to issue Indian Depository Receipts (IDRs) in accordance with Foreign Exchange Management (Non-Debt Instruments) Rules, 2019, as amended from time to time, as may be authorised by such company or its overseas custodian bank and subject to the following conditions:
 - Indian entities/Indian mutual funds/AIFs may either sell or continue to hold the underlying shares in compliance with the conditions laid down in these rules;
 - In case of Indian Depository Receipts Resident individuals may hold the underlying shares only for sale within 90 days from the date of conversion of the IDRs into underlying shares.

- iv. **ODI / OPI by Banks:** The overseas branch of an Indian Bank regulated by RBI may acquire foreign securities and /or transfer them in terms of host country regulations/ laws in the normal course of its banking business outside India.

II. The draft OI Regulations

(A) Financial commitment by way of Debt and Guarantees

- i. **Mode:** An Indian Entity eligible and who has made ODI, can undertake financial commitment in modes other than equity capital, only after it has made investment in equity capital and has acquired control.
- ii. **Terms:** The Indian entity may lend or invest in any debt instruments issued by a foreign entity or extend non-fund based commitments to or on behalf of a foreign entity including its SDS within its permissible financial commitment limits. The money lent to foreign entity or invested in any of its debt instruments to be duly backed by a loan agreement and the rate of interest thereon to be charged on an arm's-length basis (transaction conducted as if they were unrelated so that there is no conflict of interest).
- iii. **Scope:** The financial commitment by way of guarantee can be issued on behalf of the foreign entity in which the Indian Entity has made ODI or its SDS in which it has acquired control through such foreign entity and can be corporate / performance guarantee by the Indian Entity, its Holding or Subsidiary Company (minimum 51% stake in both cases), promoter group company, personal guarantee of the resident individual promoter or bank guarantee of AD Bank basis counter-guarantee / collateral of the Indian entity.
- iv. **Computing financial commitment:** The guarantee extended by a group company, to be counted not towards the utilisation of financial commitment limit of the Indian entity but its own independently and any fund-based exposure to or from the Indian entity shall be deducted from the 'Net Worth' of the group company. Guarantees invoked will cease to be a part of the non-fund-based commitments but will be considered as debt. In case of guarantee(s) extended jointly by two or more Indian entities to a foreign entity, 100% of the amount of such guarantee to be reckoned towards the individual limits of each of such Indian entities.

(B) Pledge

The Indian entity will now be permitted to pledge / create a charge the equity capital of the foreign entity in which it has made ODI or of its SDS outside India in favour of a debenture trustee registered with SEBI in India for availing fund based facilities for itself.

(C) Acquisition / Transfer by way of Deferred Payment

In respect of ODI in equity capital of a foreign entity by PRII (acquisition or issuance), the amount of eligible consideration can be deferred for such period as agreed between the parties subject to the total foreign securities transferred upfront to the Buyer. If such full consideration is paid upfront, the buyer may be indemnified by the seller as agreed between the parties subject to such agreement complying with Foreign Exchange Management (Guarantee) Regulations, as amended from time to time.

(D) Obligations of the Person Resident in India

A PRII, through its designated AD bank, will be required to obtain a Unique Identification Number (UIN) from the RBI for the foreign entity in which the ODI is intended to be made before sending outward remittance or acquisition of equity capital in a foreign entity.

UIN should be generated before sending outward remittance or acquisition of equity capital in a foreign entity, whichever is earlier.

An Indian party's to be under an obligation to repatriate to India, all dues receivable from the foreign entity, like dividend, royalty, technical fees etc., and also the proceed of sale of such share / securities or from liquidation within 90 days of its falling due or date of its realization (as stipulated).

(E) Reporting

- i. Form FC – A new form to be released by RBI for reporting investment or disinvestment in a foreign entity under ODI route (currently Form ODI).
- ii. Form OPI – A new form to be released by RBI for reporting Overseas Portfolio Investment or transferring such investment by way of sale within 30 days from the end of the half-year in which such investment/ transfer is made as at September/March-end.

- iii. Form APR – The APR in terms of the foreign entity which is reckoned as ODI is to be submitted within 6 months from the end of accounting period of such foreign entity. No APR reporting required where financial commitment is made only in equity capital with only one person resident in India having invested in the foreign entity and such person neither exercises control nor holds 10 percent or more of the equity capital of such foreign entity.
- iv. Apart from Annual Return on FLA, a PRII holding equity capital in a foreign entity as ODI to report the setting up /winding up of an SDS or alteration in the shareholding pattern in the overseas entity as directed by RBI within 30 days thereof (as stipulated) and also include the same in the APR to be submitted annually.

(F) Late Submission Fees

The levy of Late Submission Fee (LSF) provided for delay in filing submissions or report under proposed regulations and also the existing Regulation 6(1) of FEMA 120 but it will not apply to those exceeding three years from the due date of such filing or submission as the case may be or three years from the date of notification of these regulations, whichever is later. Indian entity prohibited from making further any financial commitment (fund-based or non-fund-based), directly or indirectly, towards such foreign entity or transfer such investment until such delay in reporting is regularized.

III. Way forward

The draft OI regulations do liberalize, clarify, and address many aspects of the extant ODI regulations. However, there continues to be certain aspects that remained to be fully addressed e.g. round tripping whether now permitted for all cases which are not in nature of tax-evasion / tax-avoidance, multilayer investment structures, etc. Further, some of the provisions of the Rules / Regulations are not happily worded and need further clarifications. It would be interesting to wait and watch out for the public comments and the final guidelines to be issued by the RBI in this regard.



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