

TAX FLASH NEWS

24 August 2022



New Overseas Investment framework under FEMA 1999 notified by Central Government and Reserve Bank of India

Background

In keeping with the spirit of liberalisation and to promote ease of doing business in India, and further to the draft framework released earlier for public comments, the Central Government and the Reserve Bank of India ('RBI') have enacted the new Overseas Investment ('OI') regime. On 22 August 2022, the Foreign Exchange Management (Overseas Investment) Rules, 2022 ('OI Rules') have been notified by the Central Government¹ and the Foreign Exchange Management (Overseas Investment) Regulations, 2022 ('OI Regulations') have been notified² by the RBI. They supersede the Foreign Exchange Management (Transfer or Issue of Any Foreign Security) Regulation 2004 ('FEMA 120') and the OI Rules subsume the Foreign Exchange Management (Acquisition and Transfer of Immovable Property Outside India) Regulations 2015 ['FEMA 7(R)']. Subsequently, RBI has also issued its Directions³ on the OI framework and also amended certain Master Directions to align with the new OI framework especially the one relating to the Liberalised Remittance Scheme.

In line with the earlier amendments to the Foreign Exchange Management Act 1999, the new OI regime gives power to the Central Government to enact and amend OI Rules for investment in Overseas Non-debt Instruments and Immovable Property, whereas the RBI continues to have the power to regulate other overseas investments and also has administrative powers for purposes of OI Rules. The provisions with respect to acquisition of immovable properties outside India by a person

resident in India (PRII) has been subsumed under OI Rules whereas those relating to debt / fund based and non-fund based facilities have been incorporated into OI Regulations.

This Flash News endeavors to highlight some of the key changes and new provisions in the OI Rules / Regulations.

Key Highlights

- i. Introduction of new definitions and enhanced clarity with respect to various Definitions**
- 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 them to ten percent or more of voting rights or in any other manner in the entity. The concept of control is primarily relevant for making ODI in listed foreign entity, granting of debt and giving of guarantee as part of financial commitment in the foreign entity.
- iii. Equity Capital:** The term Equity Capital is now defined and means 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.

¹ Notification No. G.S.R. 646(E) dated 22 August 2022

² Notification No. FEMA 400/2022-RB dated August 22, 2022

³ A.P. (Dir Series) Circular No. 12 dated 22 August 2022

- iii. **Foreign Entity:** The term Foreign Entity is now defined and means an entity formed or registered or incorporated outside India including IFSC that has limited liability. It is further clarified by the RBI that the restriction of limited liability shall not apply to an entity with core activity in a strategic sector.
- iv. **Indian Entity:** The term Indian Entity replaces erstwhile concept of India Party eligible to make ODI. It means companies incorporated under the Companies Act 2013, a body corporate incorporated by any law for the time being in force, a Limited Liability Partnership under the Limited Liability Partnership Act 2008 and a Partnership Firm registered under the Indian Partnership Act, 1932.
- v. **Listing Entity Criteria:** The terms Listed Indian entity or Listed Foreign entity are defined to mean only entities whose equity shares or any other full and compulsorily convertible instruments are listed on recognized stock exchanges in or outside India respectively. A recognised stock exchange in the IFSC is treated as a recognised stock exchange outside India.
- vi. **Net Worth:** The meaning of the term of net-worth for an Indian company to be 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.
- vii. **ODI:** ODI is defined to include investment by way of acquisition of any unlisted equity capital of foreign entity or subscription as a part of the memorandum of association 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. 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.
- viii. **Overseas Portfolio Investment (OPI):** The term OPI defined to mean investment, other than ODI, in foreign securities, on a recognized stock exchange outside India but not in any securities issued by a PRII (outside an IFSC). The investment shall continue to be treated as OPI even after delisting until any further investment is made in the

entity. Under the new framework, OPI is permitted to unlisted Indian company apart from listed Indian company and resident individual in certain stipulated situations.

- ix. **Overseas Investment:** The term overseas investment is defined to mean financial commitment (ODI, Debt and non-fund facilities extended) and OPI by PRII.
- x. **Subsidiary / Step Down Subsidiary (SDS):** The terms Subsidiary / SDS have been defined to mean an entity in which the foreign entity has control. The Subsidiary/SDS is subject to same compliance framework as applicable to the foreign entity.
- xi. **Strategic Sector:** The term strategic sector has been defined to include energy and natural resources sectors such as Oil, Gas, Coal, Mineral Ores, submarine cable system and start-ups and any other sector or sub-sector as deemed necessary by the Central Government.

Key highlights / features of OI Rules / Regulations are as under:-

(a) Enhanced clarity on distinction between ODI and OPI

The new definitions have provided for clarity for classifying overseas investments as ODI (unlisted and listed equity shares) or OPI (i.e. listed foreign securities). The extant FEMA 120 and LRS guidelines did not envisage a clear criteria to bifurcate between strategic investments and portfolio investments.

(b) NOC for Loan defaulters and those under Investigation

Any PRII who, has an account appearing as a non-performing asset; or classified as a willful defaulter; or is under investigation by a financial service regulator / investigative agencies as prescribed, is required to obtain a No-objection certificate from the respective lenders / authorities before undertaking any financial commitment or disinvestment of ODI. 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.

(c) ODI in start-ups by an Indian entity / resident individual

Any ODI in start-ups, recognised under the laws of host country, can be made by an Indian entity only from the internal accruals whether from the Indian entity or group or associate companies in India and in the case of resident individuals, from own funds of such an individual.

(d) Acquisition / Transfer under ODI by way of Deferred Payment

In respect of ODI in equity capital of a foreign entity by PRII (acquisition or issuance), the amount of consideration can be deferred as agreed between the parties subject to prescribed conditions. The part of the payment towards consideration deferred by the PRII shall be treated as non-fund based financial commitment by such person and to be reported accordingly.

(e) Introduction of arm's-length criteria

The issue and transfer of equity capital in foreign entity between PRII and PROI is subject to compliance with arm's-length pricing taking into consideration the valuation as per any internationally accepted pricing methodology for valuation. Further any lending by eligible PRII in debt / debt instrument of a foreign entity to be backed up by a loan agreement where rate of interest shall be charged at arm's-length basis.

(f) Liberalization of provisions surrounding write-off on account of disinvestment, liquidation and restructuring

The OI framework liberalizes the conditions surrounding write-off on account of ODI disinvestments subject only to arm's-length pricing / independent valuation criteria and also for realization of dues receivables at liquidation stage. Similarly, the provisions for write off capital / other receivables in a restructuring have been liberalized to the extent of accumulated losses in the foreign entity subject to stipulated conditions.

(g) Tightening of the reporting requirements for domestic entities opting for the ODI route and introduction of Late Submission Fee ('LSF')

The revised framework has tightened the reporting requirements for overseas investments by restricting any further overseas investment till any non-reporting or the delay in reporting is regularized. There is also an introduction of Late Submission Fee for delays in reporting (as stipulated) which should reduce the time taken to regularize such non-compliances vis-a-vis the traditional compounding route.

(h) Issuance of corporate guarantees to or on behalf of second or subsequent level step down subsidiary (SDS);

Under the new framework, an Indian entity is not permitted to lend directly to its overseas SDS but is permitted to issue guarantee (as stipulated) to any of its step down subsidiary in which it has acquired control through the foreign entity.

(i) Liberalisation of Round tripping structures

The financial commitment for ODI by a 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, resulting in a structure with more than two layers of subsidiaries is not permitted. No further layer of subsidiary or subsidiaries can be added to any structure existing with two or more layers of subsidiaries. In other words, ODI-FDI structure liberalized subject to these and other conditions in the framework.

(j) Liberalisation of ODI in Financial Services Sector

A foreign entity is considered to be engaged in the business of financial services activity if it undertakes an activity, which if carried out by an entity in India, requires registration with or is regulated by a financial sector regulator in India. The ODI investment criteria in FS sector has been relaxed for sectors other than banking and insurance and is now permissible to an Indian entity not engaged in financial services sector subject to three years profitability criterion and further, ODI in general and health insurance permitted in such cases if the insurance business is to support the core activities of the foreign company.

(k) Acquisition / transfer by way of gift or inheritance

- A resident individual ('RI') can acquire foreign securities by way of inheritance from a PRII or PROI subject to prescribed conditions.
- A RI can acquire foreign securities by way of gift –
 - from a PRII who is a relative of such RI; or
 - from a PROI in accordance with the provisions of the Foreign Contribution (Regulation) Act, 2010 and the rules / regulations prescribed thereunder.
- Further, RIs are not permitted to transfer any overseas investment by way of gift to a PROI.

(l) Overseas investments in IFSC

A PRII can make an investment in IFSC in the same manner as making overseas investment in a foreign entity. For such cases of ODI in IFSC, the time period available to financial services regulator of the Indian Entity to grant is approval stands reduced to forty-five days. Further, the three years profitability criteria for overseas investment in FS sector is not applicable to an Indian entity making ODI in IFSC.

A PRII, being an Indian entity or a resident individual, may make investment (including sponsor contribution) in the units of an investment fund or vehicle set up in an IFSC as OPI.

The Resident individuals can make ODI in a foreign entity in IFSC, including an entity engaged in financial services activity, (except in banking and insurance), if such entity does not have subsidiary or step-down subsidiary outside IFSC where the resident individual has control in the foreign entity.

The OI framework does not apply to any investment made outside India by a financial institution in an IFSC.

(m) ODI in Strategic Sector

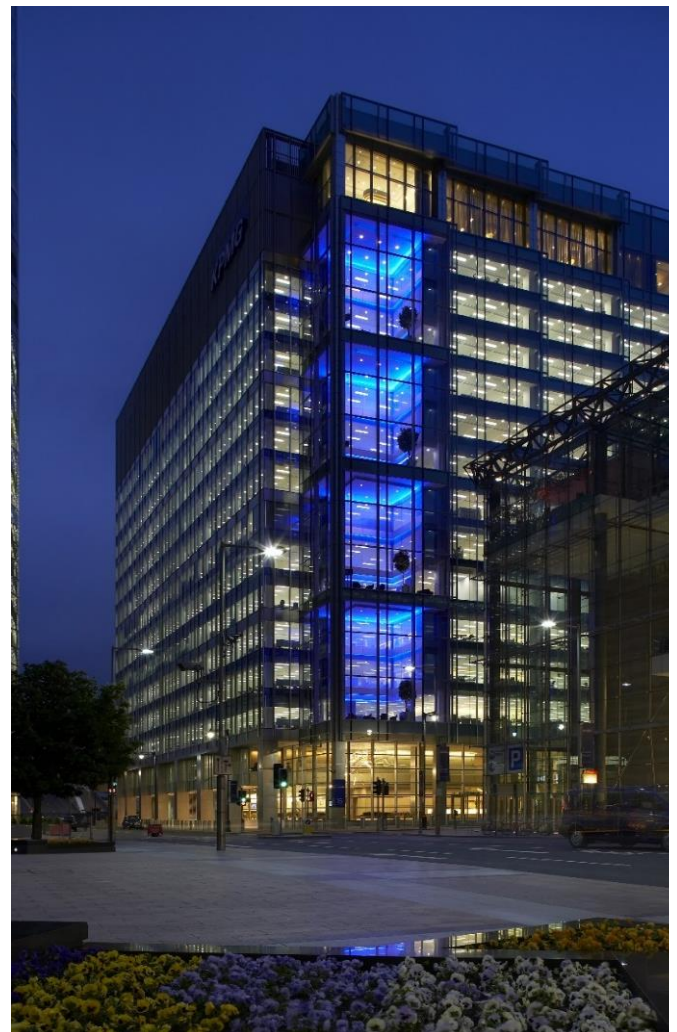
Under the new framework, the ODI in strategic sector will be subject to Indian entity obtaining necessary permission from the competent authority, wherever applicable. The restriction of limited liability structure of foreign entity does not apply for entities with core activity in any strategic sector. Accordingly, Overseas Direct Investment (ODI) can be made in such sectors in unincorporated entities as well. Further, an Indian entity is also permitted to participate in a consortium with other international operators to construct and maintain submarine cable systems on co-ownership basis.

Conclusion

In line with the past announcements and draft guidelines seeking public comments, the final Overseas Investment framework has ushered clarity and/or liberalization in several cases e.g. overseas portfolio investments, FS sector ODIs, ODIs under the approval route, NOCs in cases of banking defaulters and those under investigation, round-tripping, etc. The new aspects include the concept of control, arms-length criteria, deferred consideration, late submission fees for filing delays, etc.

Under the new framework, there is more clarity on classification of Overseas Direct Investment and Overseas Portfolio Investment. The overseas investments that were earlier under the approval route including round tripping / ODI-FDI structures are now liberalized for an Indian Entity subject to stipulated conditions.

Though the RBI has released its Directions on the framework, the RBI's FAQs on this topic are still awaited and once released they should assist in further clarifying various aspects of the OI framework.



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