Overseas Direct Investment by an Indian Party

In the recent years, Indian entities have been extensively considering overseas investment to have their presence in the global marketplace. Outbound investments have seen tremendous increase and spread in terms of geography as well as sectors. This article aims at explaining basic provisions of Overseas Direct Investment which is available to Indian entities whereby they can invest in foreign entities as per the prescribed rules and regulations under Foreign Exchange Management Act, 1999 (FEMA). It covers the key aspects such as who can invest, what is the limit on the quantum of investment, which are those instruments in which the investment can be made, what are the funding modes, what are the reporting compliances under FEMA etc.

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IMPORTANT DEFINITIONS

1. What is Direct Investment outside India by an Indian Party?

   'Direct investment outside India' means

   - investment by way of Contribution to the Capital of a foreign entity or
   - subscription to the Memorandum of Association of a foreign entity or
   - by way of purchase of existing shares of a foreign entity either by market purchase or private placement or through stock exchange,
   - but does not include Portfolio Investment.

2. Who is an Indian Party?

   'Indian party' means

   - a company incorporated in India or
   - a Partnership firm registered under the Indian Partnership Act, 1932,
   - Limited Liability Partnership registered under the Limited Liability Partnership Act, 2008 and
   - a body created under an Act of Parliament
   - Includes any other entity in India as may be notified by the RBI
   - A combination of more than one such company, body or entity
   - Registered Trusts and Societies engaged in manufacturing / educational / medical sector satisfying the eligibility criteria as prescribed ***need to obtain prior approval from RBI***
   - Proprietorship concerns and unregistered Partnership firms satisfying certain eligibility criteria ***also need to obtain prior approval from RBI.***

3. What is a Joint Venture?

   Joint Venture means a foreign entity formed, registered or incorporated in accordance with the laws and regulations of the host country in which the Indian party makes a direct investment.

4. What is a Wholly Owned Subsidiary?

   Wholly Owned Subsidiary means a foreign entity formed, registered or incorporated in accordance with the laws and regulations of the host country, whose entire capital is held by the Indian party.

GENERAL PROHIBITIONS

- An Indian party cannot make any direct investment in a foreign entity engaged in 'real estate business' or 'banking business' without prior approval of RBI.

  (Real Estate means meaning buying and selling of real estate or trading in Transferable Development Rights but does not include development of townships, construction of residential/commercial premises, roads or bridges.)

- An overseas entity, having direct or indirect equity participation by an Indian Party, cannot offer financial products linked to Indian Rupee.

MODES OF INVESTMENT

AUTOMATIC ROUTE:

Under the Automatic Route, an Indian Party can make investment in the Equity shares and CCPS of JV/WOS outside India without prior approval of the RBI subject to certain conditions and restrictions as follows:

- The entity abroad should be engaged in bonafide business activity.
- The **total financial commitment of the Indian Party in all entities abroad should not exceed 400% of the networth of the Indian Party** as on the date of last audited balance sheet. However, **any financial commitment exceeding USD 1 billion in a financial year would require prior approval of the RBI** even when the total financial commitment of the Indian Party is within the eligible limit under the automatic route. Indian company meeting threshold criteria can also utilize the networth of its Indian holding/subsidiary company.

  <u>For the purpose of Financial Commitment the following shall include</u>

  - contribution to equity shares or CCPS of the overseas JV/WOS
  - contribution to the JV/ WOS as preference shares (for reporting purpose to be treated as loan)
  - loans to the overseas JV / WOS
  - 100% of the amount of guarantees issued on behalf of its overseas JV/WOS
  - 50% of the amount of performance guarantee issued on behalf of its overseas JV/WOS.

  One should note that no guarantee is 'open ended' i.e. the amount and period of guarantee should be specified upfront.

- **An Indian Party may extend a loan or a guarantee to or for the JV/WOS abroad only if the Indian Party has made investment by way of contribution to the equity of the JV/WOS.**
- The Indian party should not be on the RBI's exporter caution list or list of defaulters to banking system or under investigation.
- **The Indian Party routes all the transactions relating to the overseas JV/WOS through only one branch of an AD Bank to be designated by the Indian Party.**
- The JV/WOS shall not be located in countries identified by the Financial Action Task Force as "non co-operative countries and territories".
- Investments in Nepal are permitted only in Indian Rupees whereas investments in Bhutan are permitted in Indian Rupees as well as in freely convertible currencies. Investments in Pakistan are permissible under the Approval route.
- For the purpose of making further investment, **the valuation of shares of the overseas JV/WOS shall be made by a Chartered Accountant or a Certified Public Accountant.** However, if the investment is more than USD 5 million, the valuation of the share shall be made by a Category I Merchant Banker registered with SEBI or an Investment Banker / Merchant Banker outside India registered with the appropriate regulatory authority in the host country.
- In addition to above conditions, Indian companies engaged in financial services sector can make investment in overseas JV/WOS only on satisfying certain prescribed conditions.

APPROVAL ROUTE

Proposals not satisfying above conditions will require prior approval of the RBI.

METHODS OF FUNDING

Investment in an overseas JV / WOS may be funded out of one or more of the following sources:

i. drawal of foreign exchange from an AD bank in India
ii. capitalization of exports and other dues
iii. swap of shares
iv. proceeds of ECBs/ FCCBs

v. in exchange of ADRs/GDRs issued in accordance with the Scheme for issue of Foreign Currency Convertible Bonds and Ordinary Shares (through Depository Receipt Mechanism) Scheme, 1993 and the guidelines issued thereunder from time to time by the Government of India

vi. balances held in EEFC account of the Indian party

vii. proceeds of foreign currency funds raised through ADR / GDR issues

Note:

- In case of funding by (vi) and (vii), the limit of financial commitment based on networth will not apply.
- Capitalisation of payments due includes towards exports, fees, royalties or any other dues from the overseas JV/WOS for supply of technical know-how, consultancy, managerial and other services within the ceilings applicable.
- Capitalisation of export proceeds remaining unrealised beyond the prescribed period of realisation will require the prior approval of the RBI.

REPORTING COMPLIANCES AND OBLIGATIONS ON INDIAN PARTY

ONE TIME

Form ODI has to be submitted to the AD Bank within 30 days of remittance duly supported by the documents listed as follows:

- Copy of the Board Resolution
- Statutory Auditor’s Certificate
- Valuation report
- Incorporation Certificate of the overseas entity along with its Memorandum of Association
- PAN and latest audited financials of the Indian entity
- Any other requirements of the AD bank
- Receive share certificates or any other documentary evidence of investment in the foreign entity as an evidence of investment and submit the same to the designated AD within 6 months from the remittance date.

RECURRING

- Submit Annual Return on Foreign Liabilities and Foreign Assets by 15th July

- Submit Annual Performance Report of overseas entity to the RBI through AD Bank by 31st December
- Report the details of the decisions taken by a JV/WOS regarding diversification of its activities /setting up of step down subsidiaries/alteration in its share holding pattern within 30 days of such alteration.

DUES

- Repatriate to India all dues viz. dividends, royalty, technical fees, etc. within 60 days of falling due.
- In case of disinvestment, sale proceeds shall be repatriated to India immediately on receipt thereof and in any case not later than 90 days from the date of sale and documentary evidence to this effect shall be submitted to the RBI through the AD bank. Such disinvestment can be made only after the overseas entity has been in operation for atleast one year.

CERTAIN IMPORTANT PROVISIONS OF INDIAN TAX LAW

- **Disclosure in Indian Income tax return**

  The Indian party should also disclose its investment/loan in the overseas entity in the "Foreign Assets Schedule" in the Income Tax Return.

- **Transfer Pricing**

  Transfer pricing regulations of India may become applicable if the Indian party has control and participation in the overseas JV/WOS. Therefore any transactions between the Indian party and overseas JV /WOS will be subject to transfer pricing regulations of India and adherence to the arms length principle and reporting obligations will be required.

- **Withholding Tax and DTAA Provisions**

  Certain incomes received by the overseas entity may also be taxable in India if the source country is India. However, the overseas entity would be able to claim the more beneficial provision of either Income Tax Act or DTAA. This concessional rate of tax can be claimed subject to availability of TRC. TRC is to be obtained on year on year basis for the overseas entity from the respective regulatory authority of the country where the overseas entity is incorporated.

- **Dividend**

  In certain structures, the dividend income from the overseas entity will be taxed in the hands of the Indian entity at concessional rates.

- **Place of Effective Management (POEM)**

  A company will be considered as a resident in India if POEM is determined to be in India. POEM as defined under the Act means a place where key management and commercial decisions that are necessary for the conduct of the business of the entity as a whole are, in substance, made. Further, POEM rules have also been laid down to determine the POEM.

GLOSSARY

AD	Authorised Dealer
ADR	American Depository Receipts
CCPS	Compulsorily Convertible Preference Shares
DTAA	Double Tax Avoidance Agreement
ECB	External Commercial Borrowings
EEFC	Exchange Earners Foreign Currency
FCCB	Foreign Currency Convertible Bonds
GDR	Global Depository Receipts
JV	Joint Venture
LLP	Limited Liability Partnership
ODI	Overseas Direct Investment
RBI	Reserve Bank of India
TRC	Tax Residency Certificate
WOS	Wholly Owned Subsidiary

20th February, 2020