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Foreign Exchange Regulations - Some significant aspects relating to Outbound Investment by Residents

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FOREIGN EXCHANGE REGULATIONS – Some significant aspects relating to Outbound Investment by Residents

1.0 INTRODUCTION

During the recent years many Indian business houses have made significant investments in takeover of companies / businesses, joint ventures etc in various parts of the world so as to consolidate their international business interests and tap the world markets. Government of India has over the last few years, liberalized its policy and made it very easy for an Indian entity to setup business or invest in businesses outside India in any part of the world. In the following paragraphs we have discussed Foreign Exchange Regulations relating to Outbound Investment. We have also discussed general methodologies of making investment outside India.

Under Foreign Exchange Management Act, 1999 (FEMA), Reserve Bank of India (RBI) has given certain general permissions to residents of India either to set up a branch outside India or to setup a subsidiary outside India. Under certain circumstances prior permission of RBI may also required to be obtained.

In the following paragraphs, we have given the **FAQ's**, which will clarify many issues relating to investment outside India and will be of immense use to those who are contemplating investing in overseas countries.

1.1 Who is eligible to make investment in overseas Joint Venture (JV) or wholly owned subsidiaries (WOS)?

Under FEMA regulations, following entities can make direct investment outside India:

- Ø Resident corporate entities and partnership firms registered under Indian Partnership Act, 1932 can invest outside India under automatic route.
- Ø A Proprietary concern may accept shares of a company outside India in lieu of fees due to it for professional services rendered to the said company, with prior permission of RBI.
- Ø A Resident individual may apply to the Reserve Bank for permission to acquire shares in a foreign entity offered as consideration for professional services rendered to the foreign entity.
- Ø Proprietorship / unregistered partnership exporter firms subject to fulfillment of following conditions, with prior permission of RBI can invest outside India.

- ✓ The Partnership / Proprietorship firm is a DGFT recognized Star Export House (export exceeding Rs.15 crore) per annum.
- ✓ The Authorised Dealer bank is satisfied that the exporter is KYC (Know Your Customer) compliant, is engaged in the proposed business and has turnover as indicated.
- ✓ Exporter has proven track record i.e. export outstanding does not exceed 10 per cent of the average export realization of preceding three years.
- ✓ The exporter has not come under adverse notice of any Government agency like Enforcement Directorate, CBI and does not appear in the exporters' caution list of the Reserve Bank or in the list of defaulters to the banking system in India.
- ✓ The amount of investment outside India does not exceed 10 per cent of the average of three year export realization or 200 per cent of the net owned funds of the firm, whichever is lower.

1.2 What is the meaning of Direct Investment Outside India?

Direct investment outside India means investment by way of contribution to the capital or subscription to the Memorandum of Association of a foreign entity, signifying a long term interest (setting up a Joint Venture (JV) or a Wholly Owned Subsidiary (WOS)) in the overseas entity and thus does not include portfolio investment.

1.3 Can overseas direct investment be made in any activity?

An Indian Party can make overseas direct investment in any bonafide activity except those that are specifically prohibited such as real estate business and banking business.

1.4 What are the criteria for direct investment and how much investment can be made under automatic route?

The criteria for direct investment under the Automatic Route are as under:

- Ø The total 'financial commitment' of the Indian Party in JVs/WOSs in any country other than Pakistan is up to 200% of its net worth and the investment is in a lawful activity permitted by the host country;
- Ø The Indian Party is not on the Reserve Bank's exporters caution list / list of defaulters to the banking system published/ circulated by the Credit Information Bureau of India Ltd. (CIBIL)/RBI or under investigation by the Enforcement Directorate or any investigative agency or regulatory authority;

"Financial commitment" means the amount of direct investment by way of contribution to equity and loan and 50 per cent of the amount of guarantees issued by an Indian party to or on behalf of its overseas Joint Venture Company or Wholly Owned Subsidiary.

1.5 **Can an Indian party make investment in a JV/WOS abroad in the financial services sector?**

Only an Indian Party engaged in financial sector activities can make investment in the financial services sector provided it fulfills the following additional norms:

- (i) It has earned net profit during the preceding three financial years from the financial services activities;
- (ii) It is registered with the appropriate regulatory authority in India for conducting financial services activities;
- (iii) It has obtained approval for undertaking such activities from the concerned regulatory authorities both in India and abroad before venturing into such activity;
- (iv) It has fulfilled the prudential norms relating to capital adequacy as prescribed by the concerned regulatory authority in India.

1.6 **Can a resident individual in India acquire/sell foreign securities without prior approval of the Reserve Bank?**

Resident individuals can acquire/sell foreign securities without prior approval in the following cases: -

- (i) As a gift from a person resident outside India
- (ii) By way of ESOPs issued by a company incorporated outside India under Cashless Employees Stock Option Scheme which does not involve any remittance from India;
- (iii) By way of ESOPs issued to an employee or a director of Indian office or branch of a foreign company or of a subsidiary in India of a foreign company or of an Indian company in which foreign equity holding is not less than 51 per cent;
- (iv) By inheritance from a person whether resident in or outside India;
- (v) By purchase of foreign securities out of funds held in the Resident Foreign Currency Account maintained in accordance with the Foreign Exchange Management (Foreign Currency Account) Regulations, 2000;
- (vi) By way of bonus/rights shares on the foreign securities already held by them;
- (vii) By way of shares in listed overseas companies that have at least a 10% share in an Indian company listed on a recognized stock exchange in India as on 1st January of the year of investment;

1.7 Can Indian Corporates invest overseas other than by way of direct investment?

Yes. Listed Indian Companies can invest upto 25 % of the net worth in overseas companies, listed on a recognized stock exchange, that have at least 10% share in an Indian company listed on a recognized stock exchange in India as on 1st January of the year of investment or by way of rated debt securities issued by the same companies.

1.8 Are there any other provisions by which an individual can acquire shares of a foreign company?

Yes, resident individuals can make investments in foreign securities upto USD 25000/ per annum provided the investments are in accordance with certain terms and conditions.

1.9 Whether an Indian entity can open a branch outside India?

Yes, a firm or body corporate registered or incorporated in India can open a branch outside India without RBI permission. However the overseas branch can acquire the immovable property for its business purpose with prior permission of the RBI. However, the branch can take immovable property on a lease for a period not exceeding 5 years at a time. Certain formalities are required to be done before setting up a branch outside India. RBI has permitted an Indian entity to remit upto 10% and 5% of its average annual sales/income or turnover during last two accounting years for initial and recurring expenses of the branch respectively.

2.0 INVESTMENT STRATEGY OUTSIDE INDIA

2.1 What are the appropriate legal structures for setting up overseas presence?

Deciding on the appropriate legal structure for setting up overseas presence is the first step in any outbound investment proposal and requires careful consideration and evaluation of various commercial and tax considerations. The overseas presence can be broadly in either of the following two ways:

- Setting up a 'Branch' abroad; or
- Setting up of a 'Wholly Owned Subsidiary' company ('WOS')/Joint Venture Company ('JV Co.').

2.2 What are the commercial considerations, which an Indian entity should consider before deciding the operating model of a branch or a company?

Following are some of the key commercial considerations that would be relevant in deciding the operating model of a branch or a Company:

- Ø **Limited vs. unlimited liability:** An overseas branch may be exposed to unlimited liability whereas overseas company being a corporate entity will have a limited liability.
- Ø **Administration and compliance cost:** Setting up a branch is easy and involves less compliance and administrative cost, as compared to setting up a subsidiary company. Further, it is comparatively easy to close down a branch as compared to liquidating a corporate entity.
- Ø **Joint Venture:** Joint venture arrangement with a local partner is possible only in case of subsidiary company rather than in a branch.
- Ø **Funding requirement for future expansion:** From a funding perspective, a subsidiary may be preferable since it would facilitate access to capital markets for raising fund for business expansion programmes.
- Ø **Market perception of a Branch vs. Subsidiary:** Generally, clients in the foreign jurisdiction would feel more comfortable in dealing with a wholly owned subsidiary (WOS) would essentially be a local company incorporated in that jurisdiction, as compared to a branch of an Indian company. WOS would also offer better market perception and goodwill as compared to a Branch. A local company also provides a perception of long-term interest in that country.
- Ø **Downstream Investment:** A WOS would facilitate convenience of making further downstream investments in other jurisdictions whenever required which is not feasible in a branch scenario.
- Ø **Immigration laws:** Under immigration laws of certain countries (for instance Australia), it is easier to obtain visas for the employees of the Indian Company, if incorporated as a local company, as compared to obtaining visas for personnel to be deputed to a branch. This aspect would be particularly relevant for Indian software companies, who depute people abroad either for 'onsite work' or to their overseas offices/entities.

3.0 CERTAIN ATTRACTIVE COUNTRIES FOR OUTBOUND INVESTMENT

- 3.1 It is very common that the foreign country will tax the profits earned by the company located therein. Tax rate in those countries can be in the range of 20 to 40%. When such overseas company will distribute the profits to an Indian entity by way of dividend, again Indian Government will levy tax @ 33.66%. The overall tax burden reaches to 40 to 60% of the profits earned. This is nothing but double taxation i.e. same income is taxed twice.
- 3.2 It is very important for an Indian entity to structure its outbound investment in such a way that the overall tax remains minimum. This is possible by setting up a holding company in some tax efficient countries so that such holding company can make investment in a

company located in the country where the India entity wants to do the actual business. This arrangement can avoid double taxation to some extent.

3.3 The tax efficient country will be one which has wide network of double tax avoidance agreements and which has proper legal and regulatory framework for commercial transactions. Singapore, Cyprus, Netherlands, Luxembourg, Ireland, Mauritius are some of the good jurisdictions to set up a holding company therein.

4.0 **LIMITATION CLAUSE**

This note is based on the FAQ's as appearing in the website of the Reserve Bank of India and is general in nature. In this note, we have attempted to summarise some of the significant aspects to be kept in mind by Clients to ensure compliance of FEMA regulations. Clients should ensure to verify specific provisions as applicable to each case before taking any business decisions. It would be pertinent to note that some changes are being made to the FEMA regulations on a continuous basis by way of notifications, clarifications etc issued by the RBI based on their practical experience in implementing the legislation.

It may be noted that nothing contained in this note should be regarded as our opinion and professional advice should be sought for applicability of legal provisions based on specific facts. Though reasonable efforts have been taken to avoid errors or omissions in this note we are not responsible for any liability arising to Clients directly or indirectly due to any statements or error contained in this Circular. It must be noted that the views expressed in the Circular are based on our understanding of the regulations as published the Government authorities may or may not agree or subscribe to such views.
