Applicability of FEMA to Outbound Investments

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1. Introduction

Indian economy is growing at fast rate and is now significant part of global economy. Hence, Government and RBI thought it fit to liberalise the policy of Indian investment outside India. The revised policy has been announced on 22-8-2022. In this article we will understand the following topics pertaining to FEMA provisions pertaining to Outbound Investments in detail:

i. History pertaining to Out bound Investments and how the regulations have liberalized with time
ii. Meaning of Capital Account transactions
iii. Exemptions from applicability of Overseas Investment Rules and Regulations
iv. Overall Construct of the New OI rules and Regulations
v. Acquisition and Transfer of Immovable properties outside India

2. History

Regulations pertaining to Outbound Investments was notified by RBI as Notification No. Fema 19/ Rb Dt.3.5.2000 [Notf. 19]. Notification 19 was superseded by Notification No. FEMA 120/RB dt. 7.7.2004. In August 2022.
RBI, with effect from August 22, 2022 has combined erstwhile FEMA Notification No. FEMA 120/RB (Transfer or Issue of Foreign Security) Regulations, 2004 ('erstwhile ODI regulations') and FEMA Notification No. 7(R) (Acquisition and Transfer of immovable property outside India) Regulations, 2015 into FEMA (Overseas Investment) Rules, 2022 ('OI Rules') and FEMA (Overseas Investment) Regulations, 2022 ('OI Regulations') and the erstwhile regulations stand superseded

2.1. Initially only a Company incorporated in India could make investments Abroad, a resident Indian, a partnership firm in India or any other resident entity is not permitted to invest abroad. Proprietary concern engaged in profession was also permitted to invest outside India w.e.f. 1.1.2002. With effect from 7th July, 2005 it was notified that even partnership firm registered under Indian Partnership Act, 1932 is eligible to Invest Outside India.

2.2. The financial commitment by Companies, Registered Partnership firms or a body created under an Act of Parliament, was initially permitted up to 100% of the Net Worth which was later increased to 200% of the Net Worth and later increased to 400% of Net Worth (current limit)

2.3. Resident individuals were permitted to set up a Joint Venture or a Wholly Owned Subsidiary outside India with effect from August 5, 2013 and subject to the terms and conditions stipulated in Notification No. FEMA 263/RB-2013 dated August 5, 2013. The annual permitted limit of Investment at that time was USD 75,000 which has been increased to USD 2,50,000

3. Capital Account Transactions

3.1. According to Sec 2 (e) of FEMA - Capital Account transaction means a transaction which alters the assets or liabilities, including contingent liabilities, outside India of persons resident in India or assets or liabilities in India of persons resident outside India, and includes transactions referred to in sub- section (3) of section 6

3.2. Capital account transactions are generally prohibited unless permitted. They are regulated by RBI.

3.3. Prior to its omission w.e.f. 15.10.2019, Section 6(3) contained ten sub clauses covering a wide range of transactions. For each of such categories RBI has issued separate notifications.

No.	Transactions specified under Sec 6(3)	Ntf. No
1	Transfer/Issue of Foreign Security by a PRII	Notf.No.120
2	Transfer/Issue of any Security by a PROI	Notf.No.20(R)
3	Transfer/Issue of Security/Foreign security by branch, office or agency in India by PROI	Notf.No.2
4	Borrowing/Lending in Foreign currency in whatever form or by whatever name called	Notf.No.3(R)
5	Borrowing/Lending in Rupees in whatever form or by whatever name called between a PRII and a PROI	Notf.No.4
6	Deposits between PRII and PROI	Notf.No.5 (R)
7	Export, Import or holding of currency or currency notes	Notf.No.6 (R)
8	Transfer of Immovable property outside India, other than a lease ≤ 5 years, by PRII	Notf.No.7 (R)
9	Acquisition/Transfer of Immovable property in India, other than a lease ≤ 5 years by PROI	Notf.No.21 (R)
10	Giving of a guarantee/surety in respect of any debt, obligation or other liability incurred: 1)By PRII owed to PROI or 2) By PROI	Notf.No.8

It may be noted that Section 6(3) of FEMA has been omitted by the Finance Act, 2015 w.e.f. 15.10.2019. Instead, Section 6(2A) has been inserted by the Finance Act, 2015 to provide that the Central Government may, in consultation with the Reserve Bank, prescribe any class or classes of capital account transactions, not involving debt instruments, which are permissible. Simultaneously, Section 6(2)(a) has been amended by the Finance Act, 2015 w.e.f. 15.10.2019, by providing that the Reserve Bank may, in consultation with the Central Government, specify any class or classes of capital account transactions, involving debt instruments, which are permissible. Newly inserted Section 6(7) states that "for the purposes of this section, the term "debt instruments" shall mean, such instruments as may be determined by the Central Government in consultation with the Reserve Bank". Thus, the Central Government has the power to regulate capital account transactions other than debt instruments i.e. equity capital whereas the Reserve Bank has the power to regulate capital account transactions involving debt instruments.

3.4. The above-mentioned capital account transactions are also notified through Notification FEMA 1, segregating the transactions of residents and non-residents as Schedule I & Schedule II respectively

3.5. Only the transactions specified in Schedules I & II are permissible Capital Account transactions under broad heading, any transaction not specified in in Schedules I & II cannot be undertaken by Resident or Non-resident as the case may be.

3.6. Notification No. FEMA 1 /2000-RB dated 3rd May 2000 "Foreign Exchange Management (Permissible Capital Account Transactions) Regulations, 2000".

Permissible Capital Account Transactions are as under:

a. Transactions, specified in **Schedule I**, of a person resident in India.
b. Transactions, specified in **Schedule II**, of a person resident outside India.

Since this article deals with FEMA implications on outbound investments, permitted capital account transaction for a PRII has been elaborated below

Schedule I - Classes of capital account transactions of persons resident in India (PRII)

i. Investment by a PRII in foreign securities.
ii. Foreign currency loans raised in India and abroad by a PRII.
iii. Transfer of immovable property outside India by a PRII.
iv. Guarantees issued by a PRII in favour of a person resident outside India.
v. Export, import and holding of currency/currency notes.
vi. Loans and overdrafts (borrowings) by a PRII from a PROI.
vii. Maintenance of foreign currency accounts in India and outside India by a PRII.
viii. Taking out of insurance policy by a PRII from an insurance company outside India.
ix. Loans and overdrafts by a PRII to a PROI.
x. Remittance outside India of capital assets of a PRII.
xi. Sale and purchase of foreign exchange derivatives in India and abroad and commodity derivatives abroad by a PRII.

4. Section 6(4) Exemptions

4.1. Section 6(4) of FEMA: A person resident in India may hold, own, transfer or invest in foreign currency, foreign security or any immovable property situated outside India if such currency, security or property was acquired, held or owned by such person when he was resident outside India or inherited from a person who was resident outside India.

4.2. Foreign Exchange Management Overseas Investment Rules, 2022, and Foreign Exchange Management Overseas Investment Regulations, 2022 does not apply to any acquisition or transfer of any investment made in accordance with Section 6(4) of FEMA. Therefore, the limits of financial commitment, pricing guidelines, RBI compliance or repatriation requirement will not apply to investments made by a person resident in India (PRII) from his/her income earned or investments made while he/she were a person resident outside India (PROI)

4.3. As per AP (DIR Series) Circular No. 90 dated 9th January, 2014, it was clarified that Section 6(4) covers the following transactions:

(i) Foreign currency accounts opened and maintained by such a person when he was resident outside India;

(ii) Income earned through employment or business or vocation outside India taken up or commenced while such person was resident outside India, or from investments made while such person was resident outside India, or from gift or inheritance received while such a person was resident outside India;

(iii) Foreign exchange including any income arising therefrom, and conversion or replacement or accrual to the same, held outside India by a person resident in India acquired by way of inheritance from a person resident outside India.

(iv) A person resident in India may freely utilise all their eligible assets abroad as well as income on such assets or sale proceeds thereof received after their return to India for making any payments or to make any fresh investments abroad without approval of Reserve Bank, provided the cost of such investments and/ or any subsequent payments received therefor are met exclusively out of funds forming part of eligible assets held by them and the transaction is not in contravention to extant FEMA provisions

5. New ODI regulations (Overall construct – Rules, Regulations, Directions)

The new framework of Overseas Direct Investment comprises of the following:

i. Foreign Exchange Management (Overseas Investment) Rules, 2022 (“OI Rules”)
Issued by Ministry of Finance on 22nd August, 2022, OI Rules provides the regulatory framework for making of overseas investment covering the permissions, conditions for making overseas investment, restrictions from making Overseas Direct Investment (‘ODI’), pricing guidelines, transfer, liquidation and restructuring of ODI. While the OI Rules have been framed by Ministry of Finance, however, the same will be administered by the RBI as per Rule 3 (1)

Rule	Provision
2 to 4	Definitions, Power of RBI to administer and non-applicability of rules
5	Classification of debt and non-debt instruments
6	Continuity of certain investments made as per the Act, Rules or Regulations
7	Rights and Bonus Shares
8	Prohibition on Investments outside India
9	Overseas Investment
10	No Objection Certificate
11 to 15	Manner of making overseas investment by : ▪ Indian Entity (Schedule I & II) ▪ Resident Individual (Schedule III) ▪ Entities other than Resident Individual and Indian Entity (Schedule IV) ▪ PRII in International Financial Service Centre (IFSC) (Schedule V)
16	Pricing Guidelines
17	Transfer or Liquidation
18	Restructuring
19	Restrictions and Prohibitions
20	Requirements to be specified by Reserve Bank
21	Restriction on acquisition or transfer of immovable property outside India
Schedules	**Provision**
I	Manner of making ODI by Indian Entity (IE)
II	Manner of making OPI by Indian Entity
III	Manner of making OI by Resident Individual (RI)
IV	OI by PRII other than IE and RI
V	OI in IFSC by PRII

ii. Foreign Exchange Management (Overseas Investment) Regulations, 2022 ("OI Regulations")

Issued by RBI on 22nd August, 2022, OI Regulations , provides only the operational part covering conditions for undertaking Financial Commitment ('FC'), investment in debt instruments, consideration in case of acquisition or transfer of equity capital of a Foreign Entity ('FE'), mode of payment, obligations of Persons Resident in India ('PRII'), reporting requirements, and consequence of delay in reporting

Regulation	Provision
2	Definitions
3	Financial commitment (FC) by Indian Entity by modes other than equity capital

4	Financial commitment by Indian entity by way of debt
5	Financial commitment by way of guarantee
6	Financial commitment by way of pledge or charge
7	Acquisition or transfer by way of deferred payment
8	Mode of Payment
9	Obligations of PRII
10	Reporting requirements for Overseas Investment
11	Delay in reporting
12	Restriction on further financial commitment or transfer

iii. <u>Foreign Exchange Management (Overseas Investment) Directions, 2022 ("OI Directions")</u>
Issued by RBI on 22nd August, 2022, it deals with the implementation aspects of OI Rules and OI Regulations

Part	**Provision**
I	Definitions and Associated Details
II	General Provisions ▪ Non Applicability if OI Rules & Regulations ▪ Permission to make OI ▪ Approval from CG/RBI ▪ NOC ▪ Rights & Bonus shares ▪ Acquisition of Foreign Entity through bidding ▪ ODI in startups ▪ Acquisition/Transfer by Deferred Payment ▪ Mode of Payment ▪ Pricing Guidelines ▪ Transfer/Liquidation ▪ Restructuring ▪ Opening of Foreign Currency Account Abroad by Indian Entity ▪ Obligations of PRII ▪ Reporting and Delay in Reporting ▪ Restriction on further financial commitment/transfer ▪ Restrictions and Prohibitions
III	Specific Provisions ▪ FC by Indian Entity

	▪ OI by Resident Individual ▪ OI by PRII other than RI and IE ▪ OI by PRII in IFSC ▪ Acquisition or Transfer of Immovable Property outside India
IV	Other operational instructions to AD Banks

iv. Master Direction – Reporting under Foreign Exchange Management Act
Updated by RBI on 22nd August, 2022, it deals with reporting requirements under FEMA, including that relating to ODI

v. FAQ on Purchase of immovable property outside India by Resident Individual
Updated by RBI on 06th April, 2023, It resolved common queries pertaining to Purchase of immovable property outside India by Resident Individual

6. Non-Applicability of New OI Rules and Regulations

The New OI Rules and Regulations shall not apply to the following:

i. Any investment made outside India by a financial institution in an IFSC
ii. Acquisition or transfer of any investment outside India made out of Resident Foreign Currency Account
iii. Acquisition or transfer of any investment outside India made out of foreign currency resources held outside India by a person who is employed in India for a specific duration irrespective of length thereof or for a specific job or assignment, duration of which does not exceed three years or
iv. Investment made in accordance with section 6(4) of the Act.

7. Important Definitions as per new OI Rules and key changes arising therefrom

i. ***Overseas Direct Investment (ODI)*** *- means investment by way of acquisition of unlisted equity capital of a foreign entity, or subscription as a part of the memorandum of association of a foreign entity, or investment in ten per cent, or more of the paid-up equity capital of a listed foreign entity or investment with control where investment is less than ten per cent. of the paid-up equity capital of a listed foreign entity;*

a. Modes of Acquisition of ODI:

(i) subscription as part of memorandum of association or purchase of equity capital, listed or unlisted;
(ii) acquisition through bidding or tender procedure;

(iii) acquisition of equity capital by way of rights issue or allotment of bonus shares;
(iv) capitalisation, within the time period, if any, specified for realisation under the Act, of any amount due towards the Indian entity from the foreign entity, the remittance of which is permitted under the Act or does not require prior permission or RBI / Central Govt.;
(v) the swap of securities;
(vi) merger, demerger, amalgamation or any scheme of arrangement as per the applicable laws in India or laws of the host country or the host jurisdiction, as the case may be.

b. Modes of Acquisition of ODI in case of Listed Foreign Entity:

- Investment in 10% of more of paid up share capital of a listed foreign entity
- Investment with control in less than 10% of the paid up share capital of a listed foreign entity

c. Once an ODI, it will always remain an ODI even if the investment falls under 10% in listed foreign entities

ii. ***Overseas Portfolio Investment (OPI)*** *- means investment, other than ODI, in foreign securities, but not in any unlisted debt instruments or any security issued by a person resident in India who is not in an IFSC*

a. An Indian entity may make OPI which shall not exceed fifty percent of its net worth as on the date of its last audited balance sheet,
b. Listed Indian companies are permitted to make OPI including by way of reinvestment.
c. Unlisted Indian companies however can only acquire equity capital by way of OPI by means of rights/bonus, capitalization of amount due, swap of securities or merger, demerger, amalgamation or any scheme of arrangement as per the applicable laws in India or laws of the host country.
d. Individuals may also make OPI up to the Liberalized Remittance Scheme (LRS) limit.

ODI v OPI:
In the old regime, there was no segregation between a direct investment and a portfolio investment and there was no clear definition of portfolio investment. The new regime, however, has clearly defined ODI and OPI.

The New Regime defines ODI as (a) acquisition of unlisted equity capital or subscription to the memorandum of association of a foreign entity; or (b) investment in 10% or more of the paid-up share capital of a listed company; or (c) acquisition of 'control' (i.e., acquiring management control or voting rights above 10%) of a listed company.

OPI, on the other hand, has been defined as investment other than ODI in foreign securities and cannot be made in (i) unlisted debt instruments; (ii) any securities issued by a person resident in India that is not in an international financial services center.

In view of the above definitions, any investment in equity capital of an unlisted company is considered ODI. The only exceptions to this are acquiring shares of less than 10% as qualification shares or under a sweat equity plan or employee benefits scheme. This means that shares acquired by resident individuals in an unlisted company by way of gift will be classified as ODI under the new regime, whereas under the old regime it could have been classified as portfolio investment so long as there was no management participation. Now, as ODI, the attendant conditions (like, investing in financial services, step down subsidiary) will be applicable. Accordingly, resident individuals can no longer explore the gift option to acquire equity in unlisted foreign companies that have subsidiaries. Further, in such instances, several reporting obligations may become applicable to individuals, which is cumbersome.

Further, in case of inheritance of foreign securities, it appears from the provisions of Schedule III of the OI Rules that such overseas investment would be classified only as ODI even if such inheritance is less than ten per cent of the equity capital, whether listed or unlisted, of a foreign entity without control. This seems to be an inadvertent implication and may be clarified in due course of time by the regulator.

iii. ***Control*** *- means the right to appoint majority of the directors or to control 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 per cent. or more of voting rights or in any other manner in the entity;*

a. **Hence, the term Control**

- Means:
  - the right to appoint majority of the directors; or
  - to control management or policy decisions; or
    - by persons acting individually or in concert, directly or indirectly
  - 10% or more of voting rights (by means of Shareholding, Management Rights, Shareholder Agreement or Voting Agreement)

b. The definition of Control as per Companies Act does not include the 10% voting right threshold. The definition of control is only required to be referred to in case of investment of less than 10% in listed foreign entities.

iv. ***Equity capital -*** *means equity shares or perpetual capital or instruments that are irredeemable or contribution to non-debt capital of a foreign entity in the nature of fully and compulsorily convertible instruments*

a. The above definition does not include optionally convertible instruments. The definition clearly states that only contribution to non-debt capital of a foreign company will be considered as Equity Capital. There is ambiguity whether Compulsory Convertible Debentures can be considered as part of equity capital? It may be noted that Foreign Exchange Management (Non-Debt) Instrument Rules specifically cover a Compulsorily Convertible Debentures into the definition of "equity instruments" of an Indian company.

v. ***Foreign entity*** - *means an entity formed or registered or incorporated outside India, including International Financial Services Centre that has limited liability:*
Provided that the restriction of limited liability shall not apply to an entity with core activity in a strategic sector;

The above definition indirectly clarifies that investment in US LLCs will be permitted as such entities have limited liability, the erstwhile ODI provisions were not clear whether investment in LLCs is permitted or not

vi. ***Strategic sector*** *shall 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*

a. The term start up is not defined in the new OI Rules
b. The term "core activity" has not been defined in the new OI Rules. The erstwhile ODI Regulations defined "core activity" as an activity whose turnover was not less than 50% of the total turnover in the previous financial year

vii. ***Financial commitment*** - *means the aggregate amount of investment made by a person resident in India by way of Overseas Direct Investment, debt other than Overseas Portfolio Investment in a foreign entity or entities in which the Overseas Direct Investment is made and shall include the nonfund- based facilities extended by such person to or on behalf of such foreign entity or entities;*

viii. ***Indian entity*** *means–*
(i) a company defined under the Companies Act, 2013 (18 of 2013);
(ii) a body corporate incorporated by any law for the time being in force;
(iii) a Limited Liability Partnership duly formed and incorporated under the Limited Liability Partnership Act, 2008 (6 of 2009); and
(iv) a partnership firm registered under the Indian Partnership Act, 1932 (9 of 1932)

Under the old regime, there was the concept of Indian Party which is done away with in the new regime. Now, concept of Indian party (IP)where all the investors from India in a foreign entity were together considered as IP, has been substituted under the new regime with the concept of Indian entity where each investor entity shall be separately considered as an Indian entity.

ix. ***Overseas Investment*** *- means financial commitment and Overseas Portfolio Investment by a person resident in India;*

x. ***Round-tripping –***

Round-tripping / ODI to FDI structure had not been clearly identified or permitted under the previous ODI regime and had been addressed only by way of an FAQ, where a clarification was issued that the RBI will consider such structures on merits under the approval route. RBI FAQs had prohibited an Indian Party to set up an Indian subsidiary(ies) through its foreign WOS or JV and also prohibited an Indian Party to acquire a WOS or invest in JV that already had direct/indirect investment in India under the automatic route. In such cases, the Indian Party was required to approach the Reserve Bank for prior approval through AD Bank which was considered on a case to case basis, depending on the merits of the case.

Under the new regime, the OI Rules states that investment in any foreign entity is restricted if such foreign entity has a step- down subsidiary in India and such investments results in a structure having more than two layers of subsidiaries. Thus, it permits a combination of overseas investment followed by a foreign direct investment back into India, subject to being restricted to two layers. The exemption is provided to the entities covered under Rule 2 (2) of Companies (Restriction on Number of Layers) Rules,2017. The new OI Rules thus seems to have diluted the stringent norms under the erstwhile provisions.

xi. ***Gift of foreign securities to Resident Individual –***

Under the previous ODI regime, a general permission had been provided to an individual resident in India to acquire foreign securities by way of gift from a person resident outside India.

The new OI Guidelines now state that any gift of foreign securities from a person resident outside India to an individual resident in India may be made only in accordance with the Foreign Contribution (Regulation) Act, 2010 ("FCRA"). This is a key restriction imposed upon investments by resident individuals, especially since there is no clarity on the compliances required to be fulfilled under the FCRA. The FCRA norms are applicable only where such shares may be considered as 'foreign contribution' under the FCRA. The FCRA allows a resident to receive foreign contribution from a relative. Thus, it appears that a gift from a non-resident may be acceptable as long as such non-resident is a relative of the resident individual. A 'relative' in such case shall be as defined under the Companies Act, 2013.

8. **Investment in immovable property outside India**

The Foreign Exchange Management (Overseas Investment, or OI) Rules, notified by the Reserve Bank of India (RBI) on 22 August 2022, supersedes the erstwhile notification 7(R) governing acquisition and transfer of immovable property outside India. Rule 21 of the OI Rules pertains to Acquisition and Transfer of Immovable Property outside India. Rule 21 provisions does not apply to:

i. Property held by a national of a foreign state
ii. Acquired by a person resident in India (PRII) on or before the 8th day of July, 1947 and continued to be held by such person with the permission of the Reserve Bank
iii. Acquired by a person resident in India on a lease not exceeding five years

8.1. Acquisition of Immovable Property from PRII - a PRII may acquire immovable property outside India by way of **inheritance** or **gift** or **purchase** from a PRII who has acquired such property as per the foreign exchange provisions in force at the time of such acquisition. It may be noted that the transferring PRII may have acquired the immovable property when he was PROI as a result of which the acquisition would be in accordance with the foreign exchange provisions in force at the time of acquisition.

As the new OI regime permits PRII to acquire foreign immovable property from another PRII, it appears that payment for the same may be made in INR in India, similar to transfer of ODI assets from one Indian Party to another.

8.2. Acquisition of Immovable Property from PROI – A PRII can acquire immovable property outside India from a PROI through any of the following means:

i. By way of inheritance.
ii. By way of purchase out of foreign exchange held in RFC account.
iii. By way of purchase out of the remittances sent under the Liberalised Remittance Scheme (LRS). Remittance under LRS may be consolidated in respect of relatives, provided the property is jointly held by the relatives.
iv. Jointly with a relative who is a PROI.
v. Out of the income or sale proceeds of the assets, other than ODI, acquired overseas under the provisions of the Act – This was not permitted under Notification 7(R), This means that any income earned by a PRII on investments made via LRS (Eg: Portfolio Investment) can also be used to acquire property outside India.

8.3. Acquisition of Immovable Property by an Indian Entity – An Indian Entity having an overseas office can acquire immovable property for the business and residential purpose of its staff

8.4. Transfer of Immovable Property

i. A PRII can transfer the property by way of inheritance, gift or sale to a PRII
ii. A PRII can transfer the property by way of inheritance or sale to a PROI
iii. A PRII can create charge on such property

9. <u>Conclusion</u>

The revised framework aims to enhance the ease of doing business in India. The framework introduces some new definitions like Control, OPI, step down subsidiary, startups etc. and provides clarity with respect to various existing definitions e.g., Overseas Investment (OI), Overseas Direct Investment (ODI), Indian entity, etc. It also provides clarity in certain rules to help with the implementation. Additionally, the revised OI Rules and regulations aims to provide clarity on various concepts such as the distinction between ODI and OPI Rules, liberalization of ODI to FDI structure, introduction of arm's-length criteria for issue/transfer of equity capital or debt by a foreign entity, statutory auditor's certificate for undertaking ODI and for Annual Performance Report etc.

The new framework also liberalizes rules pertaining to Disinvestment, Investment in Financial Sectors by Non-financial Indian Entities, reduces need for seeking specific approvals and liberalizes global operations by Indian Corporate.