

Overview of FEMA

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Short Forms:

DOE	:	Department of Enforcement
FERA	:	Foreign Exchange Regulation Act
FC	:	Foreign Currency
FX	:	Foreign Exchange
FCNR	:	Foreign Currency Non-Resident Bank A/c.
IR	:	Indian Resident
IP	:	Immovable Property
NOR	:	Not Ordinarily Resident (Income-tax)
NR	:	Non-Resident (FEMA)
NRE	:	Non-Resident External Bank A/c.
NRI	:	Non-Resident of Indian Origin.
NRO	:	Non-Resident Ordinary Bank A/c.
OCI	:	Overseas Citizen of India.
PIO	:	Person of Indian Origin.
R	:	Resident (FEMA)
RFC	:	Resident Foreign Currency Bank A/c.

I. Structure of FEMA

As per the preamble to the law:

The **purpose of FERA** was to conserve foreign exchange, maintain exchange conversion rate (or Rupee value in the international market) and regulate its use in the interest of Indian economy.

It is NOT the **purpose of FEMA** to conserve foreign exchange (Fx). The purpose is to promote & maintain foreign exchange market in India. RBI states that it is not its purpose to maintain any **target value of Rupee** in the Fx market. RBI will try to minimise wide swings in FX market. Otherwise the value is to be determined in the open market.

FEMA is a very small Act. Main operating sections are only 1 to 9. Rest of the sections are procedural, administrative or enforcement provisions. In this paper I am focusing on sections 1 to 9.

Section 1 provides for the **Scope** of the application of the Act.

Section 2 provides for **definitions**.

Sections 3 to 9 provide for the main restrictions under FEMA. Then different notifications and circulars provide reliefs/permissions.

Some important definitions are dealt with at different paragraphs in this paper. Instead of trying to provide legal interpretation of the clauses, I have tried to explain the **concept** behind the law.

Section 3 (it replaces section 9 of FERA) provides for all the major prohibitions under the Law. This particular section is discussed at length below. Hawala is covered by Section 3 (c) & (d).

Section 4 provides that Except as provided under FEMA, no Indian resident shall hold: Foreign exchange or foreign security – whether inside or outside India; and immovable property outside India. This Section has become important due to amendments made by **Finance Act, 2015**.

Section 5 provides that a person may deal in foreign exchange (this is an exception / relief from the provisions of section 3) on **current account**. India has adopted chapter VIII status under IMF. Hence Rupee is now **convertible on current account**. I have discussed at length the meaning of “Current Account”. This is the jurisdiction of Central Government of India (GOI). Hence notifications under Section 5 are issued by the GOI.

Section 6 provides for restrictions under **Capital account**. Capital account means foreign investment into the country and Indian investment out of the country. Prima facie, Capital Account was under the jurisdiction of RBI. Hence all notifications under S.6 were to be issued by RBI. By Finance Act, 2015, FEMA has been amended to shift the jurisdiction to GOI. Effect of this change is that RBI is no longer an autonomous institution as far as administration of FEMA is concerned. RBI is like CDBT under Government. (Note – there are no absolutes.)

Foreign investment is further sub-divided. **NRI** investment is administered by RBI. Foreign Direct Investment (**FDI**) is administered by DIPP. FDI policy is declared by GOI. But certain administration like issue & transfer of shares is in RBI jurisdiction. DIPP & RBI do have differences of opinion in some cases. Foreign Institutional Investment (**FII**) is governed by SEBI & RBI. Overseas investment by Indian residents is governed by RBI.

Section 7 deals with **export** of goods and services. The exporter is duty bound to bring back the sale proceeds at the earliest. To ensure that he does bring back the funds, there is an elaborate procedure where RBI, Customs department and the Bank work together.

Section 8 provides that if an Indian resident is entitled to any assets outside India, he must dispose of the asset and **bring the sale proceeds back into India**.

Section 9 provides for certain **exemptions** from the provisions of sections 4 to 8.

Sections 13 (1A) to 13 (1D) and 37A give draconian powers to Enforcement Directorate. Violations covered u/s. 37A are not open for compounding.

Section 15. Compounding:

RBI has issued rules for compounding of violations under FEMA. Under FERA, RBI was permitted to give post-facto permissions, and to regularise innocent mistakes. However, RBI had no power to impose penalties. So where RBI considered a violation to be fit for penalty, there was no choice except to refer the matter to Department of Enforcement (DOE). Under FEMA RBI has the power to compound an offence by imposing penalty.

Violations covered u/s. 37A are not open for compounding.

This is a **brief summary** of the important provisions of FEMA. Sections 1 to 9 are completed in 7 pages of a book. Thereafter there are

several **notifications and circulars** which govern the actual transactions. FEMA is a **law constantly in transit**. In other words, from the extremely strict FERA, India moved some distance towards full convertibility. At present we are some where in between. Hence liberalisations are announced periodically. If the foreign exchange situation worsens, RBI liberalises ECB & foreign investment etc. If the situation improves, GOI liberalises current account expenditure abroad & RBI restricts ECB.

FEMA policy is vague. FEMA is contrary to businessman's logic. This results into unintended violations of FEMA. For a person not practising FEMA, (including some of the RBI managers who are transferred from other departments to FEMA), this whole situation is chaotic. This chaos is made more dangerous with penal provisions introduced in the year 2015.

The chaos is exacerbated by the fact that RBI keeps transferring managers every two to three years. Transfers are not new for us. Even Income-tax commissioners are transferred every three years. However, where ever they go, they still administer Income-tax Act. In RBI, the managers from different disciplines come into FEMA section.

"Brief Introduction of the structure of FEMA" completed.

Next: II - Concepts & Specific provisions

II. Concepts & Specific provisions.

Now let us see different provisions & concepts etc. in depth.

FEMA has certain concepts which are totally **different from Income-tax Act or Company Law**. We try to apply those tax concepts to FEMA and we get confused. In this paper, let us get clarity in differences.

Apart from different concepts, there are some other reasons that cause confusion. Constantly changing law, bad drafting of law and constantly changing RBI managers. We will see some illustrations.

II.1 Specific FEMA Provision - Section 3

Let us start with the main provision: Section 3.

1.1 Text of Section 3. (In a simplified language.)

No person shall -

- (a) **deal** in any foreign exchange or foreign security;
- (b) **make any payment** to or for the credit of any Non-Resident in any manner;
- (c) **receive** any money from a Non-Resident except through **bank**.

Explanation: Following transactions are not allowed:

Where a person in India receives any payment from a NR directly or through a middle man - including a bank - and there is no corresponding inward remittance from outside India.

- (d) settle consideration in India for a transaction or asset outside India.
In simple words, "No person shall indulge in **hawala**". For a simple illustration of hawala, please see Page 8, paragraph No. III.4.6.(ii) below.

Please note. FEMA was supposed to be a liberalisation of FERA. Under FERA, Section 9 (1) provided as under: "... no person **IN**, or resident in, India shall -

- (a) make any payment to or for the credit of any Non-Resident."

This meant that a Non-Resident was restricted under FERA only when the non-resident was in India.

Compared to this language, FEMA provides Section 3 (a) - "... No person shall -

- (b) make any payment to or for credit of any Non-Resident, in any manner."

Under FEMA, all persons are covered by the restriction - resident or non-resident.

1.2 Now given below are two sets of illustrations:

First set -the transactions which are **intended to be prohibited**. This part of the paper is to explain the purpose of each clause.

Second set - the **unintended transactions** which get caught. This explains unintended difficulties.

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1.3 First Set: Transactions **intended** to be **prohibited**.

Section 3 (a) We Indian residents are prohibited from using, holding or dealing in foreign exchange and foreign securities

Purpose is: Indian wealth should remain in India. We should hold only Indian rupee. We cannot hold any foreign currency, nor can we buy foreign shares and securities. Outward flow of funds is not allowed.

There is a **duopoly of GOI & RBI on foreign exchange**. We are not allowed to hold foreign exchange (Fx). Even if we earn Fx by export of goods or services, we have to surrender the Fx to our bank. We can hold only Indian rupee.

Section 3 (b) If a Non-Resident has to make payment to any Indian resident, let him (the NR) make the payment. Let the funds come in. If an Indian resident makes payment – which otherwise would have been made by a Non-Resident – that much inward flow would not happen. Any obstruction in Inward flow of funds is not allowed.

Section 3 (c) All inward receipts must be made through (authorised dealer) (bank) only. When flow of money is restricted through banks, free market in Fx market is controlled. Manipulation in exchange rate also can be controlled. Direct flows of money are prohibited. This is a provision to support GOI + RBI duopoly over our income and wealth.

Section 3 (d) “You shall not indulge in hawala”. Looks fine.

1.4 Second Set: Unintended transactions that get caught:

Consider an illustration of Mr. IR.

His son is an NRI. When his family comes home to visit parents, the two grand-daughters aged under 10 years would also visit India. If IR takes them to a restaurant, and pays the food bill for them; it would be a violation of FEMA. IR would be paying the bill for a non-resident which would otherwise be payable by the NR. If IR buys a gift – a toy of Rs. 100 for his grand-daughter, it would be violation of Section 3 (a) of FEMA. When this literal interpretation of the law was pointed out to General Manager, RBI; he said: “Rashmin, I have myself bought gifts for my non-resident relative visiting India”.

The fact is, RBI may never apply such literal interpretation of law. (This hope has proved wrong many times. Different managers have taken literal interpretations of FEMA causing very serious difficulties. This fact is illustrated in this paper below. See paragraph below on LRS & Returning NRIs) In any case, why draft a law which makes innocent citizens 'Violators of Law' & leave them at the mercy of Directorate of Enforcement (DOE)?

Compare FEMA with Income-tax to see the mistake in drafting the law in more details. Under **Income-tax Act** - section 5 determines the **scope of income** taxable in India. Section 6 defines who is a "Resident of India". Then detailed provisions are made for the income which is covered in the scope. Where ever tax commissioners have tried to tax any income which is beyond the scope of taxable income, Courts have struck down such attempts.

But FEMA is open-ended. Ask RBI managers: "Why do you draft & administer such a law?"

Answer has been: "It is not our intention to catch hold of innocent family transactions." The promise is: "We will implement the law according to its intent and purpose."

Now consider another illustration. An Indian resident brother gives loan/ gift to his non-resident brother. It is a violation of FEMA. Will RBI say that under FEMA we have no intention of preventing family transactions?

And if someone is caught in a FEMA violation which - for a common man is pure innocent transaction - will DOE let go the man because it is not the intent and purpose of FEMA?

II.2. Capital Vs. Current Account:

2.1 Jurisdiction:

Section 5 provides for current account restrictions. This was & is **Central Government's jurisdiction**. **Section 6** provides for capital account restrictions. This was **RBI's** jurisdiction. With Finance Act 2015 amendment made effective in the year 2019, the jurisdiction is with Central Government of India (GOI). Now RBI's autonomy is gone. It is reduced to a level of administrator - comparable to CBDT.

Earlier, (until 2015) under FEMA, the jurisdiction over Capital A/c. transactions was with RBI. However, FDI policy was declared by GOI through a Press Note. A Press Note has NO legal binding. (Anyone can

issue a Press Note. If the media considers the issues to be important, it will publish the Press Note. Apart from information, it has no value.) Hence unless RBI issued a notification under S.6 of FEMA, the FDI policy was largely a piece of paper, a declaration of intention.

Normally, RBI followed up with notifications in line with FDI policy declaration. However, in the year 2009, FIPB issued Press Notes regarding **Indirect Investment under FDI policy**. It was not acceptable to RBI & RBI refused to issue notification in line with FIPB Press Note. People were at a loss - "Which regulator to follow?"

Finally, SC passed adverse remarks "How can two Regulators hold two different views?" Then both GOI & RBI discussed & RBI came out with new notification in the year 2013. It is now Regulation 14 in Notification 20.

The new notification & its implications are discussed separately under a paper "Indirect Foreign Investment" by my partner - CA Naresh Ajwani.

2.2 In this part let us distinguish the two different kinds of **convertibilities** and their distinction from tax and accountancy concepts.

Under **Income-tax and Accountancy**, capital account has a different connotation. Under FEMA the concept is totally different. One must appreciate the difference to be able to interpret FEMA provisions.

Under FEMA, the concept derives its roots from **International Monetary Fund**. The IMF requires the Central Banks of all member countries to make regular and periodical reporting of their "Balance of Payments" (BOP) position. RBI makes regular reporting to IMF. In turn, RBI requires all banks (authorised dealers) to make periodical reporting to RBI about their BOP position. The IMF is concerned with the exchange liability which a country might have vis-à-vis the rest of the world. IMF is not concerned with domestic tax liabilities or depreciation and other charges under accountancy. **Any transaction that can create or alter or modify a country's assets and liabilities with the rest of the world, affects that country's BOP position. IMF is interested in knowing this position.**

2.3 **Illustration** - India Manufacturing Limited **imports machinery** worth Rs. 1 crore. From accountancy point of view, this is a capital account transaction. The machinery will be reflected on the assets side of the company's **balance sheet**. The asset will be written off over next few years by providing regular depreciation.

Under **Income-tax** also, this is a capital account transaction. It affects, the company's claim for depreciation and hence the tax liability.

IMF is not at all concerned with these issues. Hence, RBI is also not concerned. If the company makes full payment for the imported machinery immediately, there is no outstanding asset or liability. India does not remain liable to the outside world. The transaction of import has been completed. Hence, this is a **revenue transaction**.

2.4 Variation 1-

Now, if the India Manufacturing Limited imports machinery on **credit terms**, the nature of the transaction changes. Let us assume, that the import price will be paid in installments in next five years. This affects the company's liabilities. Hence, it is a **capital account** transaction.

2.5 Variation 2-

India Manufacturing Limited makes an **advance payment** for the import of the machinery. The advance payment would create an asset in the name of the company. It affects India's BOP position. Hence, it is a capital account transaction.

2.6 Once we have understood the difference between the concept under FEMA and under other laws, we have reached a stage of understanding. IMF reporting requirements are at the root. However, having reached this stage, IMF loses its significance. The concept is now defined under FEMA. Since it is a clearly demarcated definition, **while interpreting one has to look only at the law**. Whatever might be provided in the different provisions of IMF have no importance except for explaining the underlying purpose.

II.3. Retention of FX assets - Returning NRIs. (Circular 51 of 22nd September, 1992.) Section 6 (4).

3.1 Pre-liberalisation time (before 1992), FERA provision was that if a non-resident becomes Indian resident; he had to bring all his foreign assets into India. So people placed all the assets in a **discretionary trust** with a reputed bank in an offshore centre & came to India. RBI issued a press note (**Press Note** dated 16th January, 1989) advising NRIs against creation of such foreign trusts. RBI suggested that Returning NRIs may, instead, opt for "excellent" schemes offered by RBI. Apparently returning NRIs still held their assets abroad.

3.2 In 1992, RBI realised the facts on the ground. It issued a series of **six notifications** providing that a returning NRI could freely keep all his funds & assets abroad. These notifications were explained by Circular No. 51 of 1992. Now there was no need under FERA for returning NRIs to

transfer the assets to a discretionary trust abroad. He could continue to hold assets in his own name instead of taking a risk by holding assets in the name of a bank or other trustee.

- 3.3** Then FERA was replaced by FEMA. Six notifications & one circular have been reduced to one sentence in section 6(4). In the process of **précis** making there have been serious omissions. Consider:

Section 6(4) permits a NR becoming R to continue holding foreign assets which **he held on the date of coming to India**. What happens when he **converts** one asset into another? The new asset was not held on the date of his coming to India. He had shares in Co. A, which he sold. Then he bought shares of Co. B. Can he really hold shares of Co. B? The section does not permit it.

What happens to the **income** earned on assets held abroad? Naturally, the income has been acquired after returning to India. Under section 8 of FEMA, he has to bring the amount back into India.

- 3.4** This was pointed out to RBI in the year 2000 itself. RBI had two responses: "This was an unintended anomaly. The Act has to be amended. That is for the Parliament to do. We can't do anything about it."

As was expected, RBI managers changed. A new officer who did not read circular 51 of 1992 **literally interpreted S.6 (4)** and decided that many Returning NRIs had violated FEMA. We had to make detailed & repeated representations before RBI. After considerable representations RBI issued **Circular No. 90 dated 9th January, 2014** granting relief to Returning NRIs. A copy of the circular is given as Annex. II.

Drafting of FEMA Act, Rules & Regulations continues to be **poor**. Similar poor drafting of law is under Section 6 (5) and under LRS.

II.4. Non-Residents buying Immovable Property (IP) in India. FEMA Notification 21.

Prima facie, a non-resident is not allowed to buy Immovable Properties (IP) in India. However, an NRI or a PIO can purchase IP in India. [FEMA 21(4)]

- 4.1** A non-resident who has set up a branch or liaison office in India as per provisions under FEMA; can acquire IP necessary for such activities [FEMA 21(5)]. The following is an extract from our book published by Taxmann in the year 2000. A representation was also given to RBI in the year 2000. No action was taken on the same.

- 4.2** *Section 31 of FERA provided for control over transactions pertaining to immovable property in India. The control was based on citizenship rather than on residential status.*

A citizen of India, could acquire or transfer Immovable property in India without any approval. (Residential status was immaterial). The concept of "Sons of Soil" was the guiding principle.

Under FEMA, the control will depend on residential status. If a person is a non-resident, he will require approval of RBI to do any transaction pertaining to Immovable Property in India.

- 4.3** *This removal of restriction based on citizenship suggests a change in the policy of the Government. It can however cause a serious implication.*

Say, a foreign citizen comes to India for employment and becomes a resident. He can buy immovable property in India. As the person is a resident & is acquiring an Indian asset, it is not a capital account transaction u/s. 2(e). As it is not a capital account transaction, no controls under FEMA can be imposed. Sections 6(1) and 6(3) also do not apply.

After acquiring the property, the person can leave India & become a NR. Under S. 6(5), such person can hold the property. No approval is required.

He can also sell it. No approval is required U/s. 6(5).

- 4.4** *He can remit out of India these funds, amounts under \$ One Million Scheme.*

Thus an outright foreigner (say an Arab Sheikh) can acquire an immovable property in India as above. This can have important implications. It may be necessary for the government to clarify whether there is a change in the policy."

- 4.5** *When a loop hole is allowed to remain on the statute books for twenty years, one can trust people – Indians & foreigners - to take undue advantage of the loop hole. Several foreigners have purchased IP in India. In Goa, the phenomenon had acquired serious proportions. Both GOI & RBI have issued warnings, taken half-hearted measures but not amended FEMA. ???????*

II.5. Liberalised Remittance Scheme: (LRS):

- 5.1** *Please see Dr. Y. V. Reddy's book – "Advice & Dissent – My Life in Public Service" published in the year 2017. Pages 351 onwards.*

Governor Dr. Reddy and the then Finance Minister Mr. Jaswant Singh met and decided to announce a scheme of Liberalisation of FEMA. The discussion was:

Governor: "Yes Sir, we will allow our citizens to take money out - **no questions asked**. But within limits"

"Capital flows cannot be one way street."

Minister told industrialists: "**Go and conquer the world, we will be your supporters. You can take out money. No questions will be asked.**"

RBI: "**This is a 'no questions asked' window and is in addition to all the existing facilities.**"

This was the spirit at highest level. But RBI officers frustrated the spirit of the scheme.

5.2 GOI & RBI have issued notifications & circulars permitting Indian residents to remit funds abroad. Initially there were different circulars for medical expenses, for foreign travel, for education and so on. Then all these expenses were covered by **Current Account Rules**. Except for few prohibited purposes, Indian resident can remit funds abroad for all current account expenses. There are certain limits in some cases.

5.3 **Liberalised Remittance Scheme (LRS)** is different from current account expenses. Under LRS, a person can remit funds abroad and even invest abroad. Thus it covers **Capital as well as Current Account transactions**. Initially when the scheme was declared in the year 2004 RBI had clarified that under LRS, a person can remit funds abroad and then open bank accounts, give gifts or loans, even purchase shares, securities and immovable properties. Under the scheme at present every individual resident in India is permitted to remit abroad every year (April to March) \$ 2,50,000. Illustration: A family of four persons can even remit \$ 1 million and jointly purchase immovable property abroad worth \$ 1 million.

5.4 Under FERA Indian Rupee was totally controlled. In the year 1993, GOI & RBI started the process of making Rupee convertible on current a/c. Then came convertibility on capital a/c. for companies etc. under ODI scheme. In the year 2004 with LRS, partial convertibility of Rupee - even for Individuals was started.

The process of moving from "**Control Era**" (Pre 1991) to "**More Convertibility**" is a complex process. As far as LRS is concerned, RBI has taken repeatedly Forward & Backward steps. In some cases some managers

have made incorrect interpretations of the policy. And many IR investors have made many errors. We will see some illustrations.

- 5.4.1** Under the LRS, the Indian resident has to file relevant form with his bank and the remittance has to be made **from his Indian bank account**. Some people when they go abroad have made following error. Out of their foreign travel allowance, they have opened bank accounts, paid fees to the professionals abroad and made investments. The **foreign travel allowance** under current account remittance scheme cannot be mixed up with LRS. That allowance has to be used for travel expenses. One cannot create an asset out of an allowance permitted for expenses.

It should be noted that, as seen in the summary provisions (paragraph I above) under section 4 no Indian resident can hold assets abroad. Under section 8 if any Indian resident is entitled to any foreign assets, he has to bring the foreign exchange into India. Relief granted from these strict provisions are very specific. A relief is subject to the conditions and procedures prescribed. If a person does not follow the procedure prescribed, it becomes a violation of FEMA.

- 5.4.2** Some people have **booked flats under construction outside India**. In India, it is very common to book flats under construction. Under FEMA, we are not permitted to incur liabilities abroad. Let us say, a person wants to book a house worth \$ 5,00,000. He remits \$ 2,50,000 in the first year and books a flat under construction. He plans to pay the balance amount next year. This amounts to his incurring liability of \$ 2,50,000 abroad. My interpretation is: This is prohibited under FEMA and would be a violation of FEMA. Considering RBI FAQ, it seems - RBI had taken a view as under: As long as the IR investor does not commit payments exceeding LRS limit, it is OK. Later, RBI has realised its error and amended the FAQ. Now an IR is not permitted to commit foreign liabilities.

- 5.4.3** **When you book a property in Dubai, be cautious.**

5.4.4 Forward Step:

Initially, in the year **2004** RBI clarified that under LRS, a person can even purchase shares and securities abroad. Hence many individuals started incorporating companies abroad. Through the company they would acquire immovable property outside India or even start businesses outside India. RBI has repeatedly stated in its circulars & notifications that under LRS IR individuals can make remittances for **any permitted current & capital account - transactions**.

Backward Step:

In the year **2007** RBI reviewed the position. It considered that individuals should not be allowed to do business abroad. This was a

change of view. However, instead of making any specific announcement, or amending the circulars, RBI said in an FAQ that under LRS, a person cannot make investment “**which is otherwise prohibited under FEMA**”. This phrase has no meaning. Under section 3 dealing in foreign exchange is prohibited. An IR cannot remit funds abroad. Under section 4 keeping any assets abroad is prohibited. Under section 8 any foreign assets belonging to an IR have to be brought into India. If RBI’s interpretation was to be applied to the LRS circular, the LRS would be redundant. No Indian Resident can use LRS facility. Correct interpretation is – LRS has been issued to carve out a specific relief from all such restrictions. Except for the transactions specifically prohibited or restricted, all other transactions of Capital or Current Account are permitted under LRS upto the limit prescribed. LRS overrides other restrictions and is in addition to all other permissions. See Dr. Reddy’s book. Hence people ignored the FAQ and continued to incorporate companies abroad. In any case, FAQ has no binding effect. It was in the year 2010, that in a conference organised at Mumbai, RBI managers made it clear that LRS should not be utilised for incorporating companies abroad.

5.5 Around the year 2011, RBI took a view that if anyone has incorporated companies abroad under LRS, he should wind up the company and bring back the funds. He should apply to RBI for **compounding** of violation under FEMA.

5.6 Considerable representations were made before RBI. Finally in the year 2013, RBI came out with notification **No. FEMA 263/ RB-2013** dated **5th March, 2013** – but published on 5th August, 2013 – GSR No. 529 (E) providing that even individuals could incorporate companies abroad under LRS / ODI. However, the notification is with **prospective effect**. What about IRs who had incorporated companies abroad between the years 2004 & 2013? Orally managers said that – such IRs should apply for compounding. A token penalty will be levied and their investments will be regularised.

5.7 Double Backward:

Between 2013 & now, the managers have changed. New managers do not know about the history. They have raised a new issue – “This is a “Remittance Scheme”. So IR can only make remittances abroad. They may open **foreign bank accounts** for completing the process of LRS. But they cannot keep foreign bank accounts to hold foreign exchange abroad. Such an interpretation can place thousands of IR investors into trouble. This interpretation is **contrary** to circulars issued by RBI itself. I have a long list of such circulars. One illustration is enough. Master Direction dated 1st Jan, 2016.

It seems, every time the **managers change** at RBI, policy also changes. It is not even announced. And then managers apply new policies with retrospective effect to hold past transactions as violations of FEMA.

After amendment in FEMA by Finance Act, 2015; this is a **serious problem**. Please see paragraph V – Attack on Black Money.

5.8 New Problem under LRS:

Once an IR has invested abroad under LRS; can he make a **Will &** bequeath the foreign assets to his resident & non-resident heirs? Yes. However, can Indian resident heirs hold these foreign assets abroad?

Section 6 (4) permits an IR to hold the assets abroad only if these assets are inherited from non-residents. Hence technically, all IR heirs (who have inherited funds owned by IRs which were remitted abroad under LRS) must apply to RBI for a permission to retain the assets abroad; or sell off the assets & bring sale proceeds back to India.

Many FEMA advisors; most IR heirs and even RBI managers do not understand such technicalities. People won't apply to RBI. It is impractical to expect thousands of common men to apply to RBI. When the law is strict & incomprehensible; and consequences of even innocent violations are harsh; innocent citizens are exposed. Consider an illustration - Mr. I went abroad and became an NRI. He earned, saved & invested in property abroad. Then he returned to India. He made a Will and bequeathed the foreign assets to his son. After some years the son inherited the foreign property. We assume that u/s. 6 (4) he is allowed to retain the property abroad. After some years, son also died. Can his heirs keep the foreign property abroad? Such issues have not been considered by the RBI draftsmen.

5.9 LRS/ ODI Investments & Disclosures in Income-tax Returns:

Please make it a point to make full disclosure of foreign assets in form FAS in the Income-tax return. Even disclose all step down investments. Some persons create legitimate foreign entities as permitted under FEMA. Then these foreign entities have step down entities/ subsidiaries. The investors and his tax consultants consider it unnecessary to declare step down entities & their bank accounts.

Consider: Under PMLA, DTA & BEPS–Automatic Exchange of Information, Government of India will come to know about all such foreign entities & and their ultimate beneficial owners being tax resident in India. When the Finance Ministry gets such information; the appropriate authority will compare the information with FAS disclosures. If the two don't tally, Income-tax department and Department of

Enforcement will start an investigation. Then even for genuine investors, there can be difficulties. Please see paragraph V on “Attack on Black Money”.

Proving that your foreign assets are not black money will cause lot of heart-burn. Income-tax department has already started proceedings against assesseees who did not declare step down subsidiaries/assets.

5.10 For LRS, current notifications are: Naresh, please advise:

Capital A/c.	-	Capital A/c. Rules – Rule 4 & Schedule I.
Current A/c.	-	Current A/c. Rules Regulation 4 & Schedule III
Master Direction	-	No. 7/2015-16 dated 1 st Jan, 2016 Updated till 20 th June, 2018.

5.11 Overseas Citizens of India (OCI):

It has been loosely said that – “Now NRI investment will be treated as **Domestic Investment**”. However, one should note different terms used under FEMA – NR, PIO & OCI. Relevant amendment has been brought out in Notification 20 pertaining to foreign investment into India.

Section 2 (viiia) defines NRI as –

“an Individual resident outside India – who is citizen of India; or is an ‘Overseas Citizen of India’ cardholder within the meaning of Section 7 (A) of the Citizenship Act, 1955”.

The liberalisations recently made will be available only if the NRI is citizen of India or holds OCI card. It is advisable that all NRIs who are foreign citizens should acquire OCI cards.

“Concepts & Specific Provisions” completed.

Next: III. FEMA Restrictions from Different Angles.

III. FEMA Restrictions from different angles:

FEMA provides restrictions on transactions in several different manners. Let us see some different manners of restrictions. It may provide clarity.

III.1 Foreign Exchange & Indian Rupee:

FEMA regulations will apply to all foreign exchange transactions conducted by Indian residents; and by anyone in India.

It does not mean that FEMA does not apply to transactions **made in Indian Rupee**. There can be transactions conducted within India, in Indian Rupee. Still FEMA may regulate. Simple illustration –

A NR has NRO bank account in India. He wants to give loan to his relatives within India, in terms of Indian Rupee. This transaction is regulated. Section 6. Under Notification 5 (R) Rule (3) all such loans are prohibited. However, under Notification 3, Rule (6) loan upto \$ 2,50,000 (or Rupee equivalent) can be given to close relatives by foreign inward remittance only.

Conclusion – FEMA restrictions apply based on several different grounds. One must have comprehensive study of FEMA before deciding whether a transaction is permitted or not.

III.2 Restrictions based on Residential Status.

Notification 1 provides a list of restrictions based on Residential Status – as far as **Capital Account** is concerned. The notification provides two schedules separately for restrictions on Indian Residents and Non-Residents. To these schedules, we have added relevant notifications. Please see Annex.1 for Notification 1 (Pages 34 – 36.) A detailed summary of different restrictions under FEMA is given below,

III.3 Indian Residents' transactions abroad.

S.N. Sections

- | | | |
|------------|----------------------|--|
| 3.1 | Section 4 | restricts IRs from acquiring / holding/ transferring any assets outside India. |
| 3.2 | Section 8 | provides that if an IR is entitled to foreign assets; he must sell the foreign asset & bring the sale proceeds to India. |
| 3.3 | Section 6 (4) | grants specific reliefs to Returning NRs. |

Notifications

Notification No.	Subject
3.4	7 R 7 (4) (a) 7 (5) (1) (a) 7 (5) (3)
	Immovable Property Outside India Foreigners exempted from restriction. Gift or Inheritance from person – S.6 (4) Indian company can acquire – for its business & for residence of its staff. (See OID).
3.5	9
	Realisation & surrender of foreign exchange. Covers capital as well as current a/c. transactions. S.8
3.6	10
	Foreign bank accounts Capital a/c. section 9. Covers foreign currency account in India as well as outside India. SEZs & Diamond Dealers' A/c.s NR's project office in India. Indian company's foreign branch a/c. OID, LRS. and many other provisions.
3.7	11 (R)
	Possession of foreign currency. Covers capital & current account. Prohibited u/s. 4. Some permissions granted u/s. 9.
3.8	14 (R)
	Manner of receipt & payment of FX Receipt for export of goods & services. Payment for import of goods. Payment by International credit cards.
3.9	23 (R)
	Export of Goods & Services Current Account Transactions Notification GSR 381 (E) issued by C.G. Liberalised Remittance Scheme. RBI/ 2004/ 39 A.P. (DIR Series) Circular No. 64 dated 4 th Feb, 2004.

III.4 Non-Residents' transactions within India.

- 4.1** Section 6
6 (5) Capital A/c. Transactions.
Holding / selling assets in India.
- 4.2** 20 R FDI & other foreign investments into India.
- 4.3** 13 Foreign remittance of funds from India.
Prohibited u/s. 3.
Permitted by this Notification No. 13.
Covers capital & current A/c. transactions.
Foreigners retiring from Indian service
NRs inheriting assets in India.
- NRI \$ 1 mn. scheme.**
NR beneficiary in a trust settled by IR.
See paragraph V for elaboration.
Immovable property in India.
Bank Accounts, loans etc. in India.
- 4.4** 5 (R)/2016-RB NRO, NRE, FCNR bank accounts held by NRs.
PIO Definition.
- Deposits between IR & NR, private loans and
Company Deposits regulated.
- 4.5** 21 Immovable property in India
- 21 (3) **NR Indian citizen** can acquire & sell immovable
property in India except agricultural property or
plantation or farm house.
- 21 (4) **NR Foreign Citizen** – NRI can acquire or sell
immovable property in India except agricultural
property or planation or farm house.
- Receive gift from IR / NRI. Inherit from NR.
Sell to an Indian R.
- 4.6** 22 (R) **Branch in India.** Setting up a branch is capital
account.
Doing business & remitting profits is current account.

Note: Titles for paragraphs III.3 & III.4 above are for the sake of convenient grouping of regulations. However, in many cases, Residents'

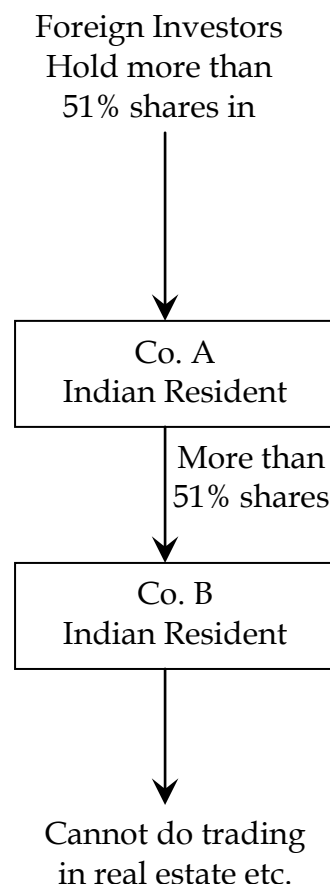
transactions within India & Non-Residents' transactions outside India also are liable to FEMA discipline.

Illustrations -

- (i) Illustration of Transaction within India, by Indian Resident in Indian Rupee with other Indian Resident.

Co. A is an Indian resident company. Co. A has foreign shareholders in the form of PE fund & portfolio investment - totalling 55%. Co. A has invested in 51% equity of Co. B. Co. B is also an Indian resident company.

Thus company B has Indirect Foreign Investment exceeding 50% equity. It cannot do business prohibited to Non-Residents. For example, it cannot trade in real estate & cannot carry on agricultural business.



(ii) Illustration on NR's transaction outside India in FC.

India	USA
Mr. R ↓ Transaction 1 ↓ Mr. NRI's father In India	Mr. NRI ↓ Transaction 2. ↓ Mr. R's son studying in USA

Mr. NRI gives U.S. \$ 2,000 to R's son in USA for his studies - in consideration of - Mr. R paying Rs. 1,40,000 to NRI's father in India. This is a **hawala transaction**. Under FEMA, under Section 3 this transaction is prohibited. Please note that both transactions are individually perfectly valid. But the fact that they are in consideration of each other, make them a hawala. (See discussion on S.3 in paragraph II.1 on pages 3 to 6.)

"FEMA Restrictions from different angles" completed

Next IV: Comprehensive Interpretation necessary under FEMA.

IV. Comprehensive Interpretation necessary under FEMA:

An illustration of restrictive drafting of law.

Extracts of Section 6 of FEMA:

Capital account transactions.

6. (1) *Subject to the provisions of sub-section (2), any person may sell or draw foreign exchange to or from an authorised person for a capital account transaction.*

(2) *The Reserve Bank may, in consultation with the Central Government, specify¹ –*

²[(a) *any class or classes of capital account transactions, involving debt instruments, which are permissible;]*

(b) *the limit up to which foreign exchange shall be admissible for such transactions;*

³[(c) *any conditions which may be placed on such transactions:]*

⁴**[Provided** *that the Reserve Bank or the Central Government shall not impose any restrictions on the drawal of foreign exchange for payment due on account of amortisation of loans or for depreciation of direct investments in the ordinary course of business.]*

⁵[(2A) *The Central Government may, in consultation with the Reserve Bank, prescribe –*

(a) *any class or classes of capital account transactions, not involving debt instruments, which are permissible;*

(b) *the limit up to which foreign exchange shall be admissible for such transactions; and*

(c) *any conditions which may be placed on such transactions.]*

(3) ⁶[***]

¹ See FEM (Permissible Capital Account Transactions) Regulations, 2000.

² Substituted by the Finance Act, 2015, w.e.f. a date yet to be notified. Prior to its substitution, clause (a) read as under :

"(a) any class or classes of capital account transactions which are permissible;"

³ Inserted by the Finance Act, 2015, w.e.f. a date yet to be notified.

⁴ Substituted by the Finance Act, 2015, w.e.f. a date yet to be notified. Prior to its substitution, proviso read as under :

"Provided that the Reserve Bank shall not impose any restriction on the drawal of foreign exchange for payments due on account of amortization of loans or for depreciation of direct investments in the ordinary course of business."

⁵ Inserted by the Finance Act, 2015, w.e.f. a date yet to be notified.

⁶ Omitted by the Finance Act, 2015, w.e.f. a date yet to be notified. Prior to its omission, sub-section (3) read as under :

"(3) Without prejudice to the generality of the provisions of sub-section (2), the Reserve Bank may, by regulations, prohibit, restrict or regulate the following—

(a) transfer or issue of any foreign security by a person resident in India;

(b) transfer or issue of any security by a person resident outside India;

- (4) *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*⁷.
- (5) *A person resident outside India may hold, own, transfer or invest in Indian currency, security or any immovable property situated in India if such currency, security or property was acquired, held or owned by such person when he was resident in India or inherited from a person who was resident in India.*
- (6) *Without prejudice to the provisions of this section, the Reserve Bank may, by regulation⁸, prohibit, restrict, or regulate establishment in India of a branch,*

-
- (c) transfer or issue of any security or foreign security by any branch, office or agency in India of a person resident outside India;
- (d) any borrowing or lending in foreign exchange in whatever form or by whatever name called;
- (e) any borrowing or lending in rupees in whatever form or by whatever name called between a person resident in India and a person resident outside India;
- (f) deposits between persons resident in India and persons resident outside India;
- (g) export, import or holding of currency or currency notes;
- (h) transfer of immovable property outside India, other than a lease not exceeding five years, by a person resident in India;
- (i) acquisition or transfer of immovable property in India, other than a lease not exceeding five years, by a person resident outside India;
- (j) giving of a guarantee or surety in respect of any debt, obligation or other liability incurred—
- (i) by a person resident in India and owed to a person resident outside India; or
- (ii) by a person resident outside India."

⁷ AP (DIR Series) (2013-14) Circular No. 90, dated 9-1-2014 clarifies that section 6(4) of FEMA, 1999 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.

⁸ See FEM (Establishment in India of Branch or Office or Other Place of Business) Regulations, 2000/FEM (Offshore Banking Unit) Regulations, 2002/FEM (Withdrawal of General Permission to OCBs) Regulations, 2003.

office or other place of business by a person resident outside India, for carrying on any activity relating to such branch, office or other place of business.

- ⁹[(7) 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.]

Extract of law completed.

Comments:

1. What is the restriction on a non-resident for holding assets in India? Prima facie, when FERA was replaced by FEMA, general discussion by Government of India was that now **FEMA** will be having a **negative list** as opposed to **FERA** which had a **positive list**. The implications are as under. FERA gave a list of transactions which were permitted. Hence whatever was not included in the list was not permitted. It was said that FEMA would have a negative list. In other words, specific transactions would be prohibited or regulated. Whatever is not included in the list, would, by definition, be permissible.

However, while drafting the FEMA law as well as notifications, the concept of negative list seems to have been lost. We can illustrate this issue by taking one matter in depth.

Can we say that a **non-resident of India can hold any assets in India** except when specifically prohibited under FEMA? For this purpose, look at the language of Section 6. We analyse a few sub-sections here.

2. **Section 6 (1)** authorises Reserve Bank of India to regulate transactions which require sale or drawal of **foreign exchange**. If a person does not require to draw any foreign exchange, can he go ahead and do the transaction? As far as Section 6 (1) is concerned, when no foreign exchange is involved, there is no restriction.

Illustration: A non-resident of India **inherits** certain properties from his Indian resident relative. Since inheritance does not involve any foreign exchange, under Section 6 (1), it is not prohibited.

3. **Section 6 (2) (a)** reads as under: The Reserve Bank may specify any class or classes of capital account transactions which are permissible.

What is the implication of this sentence?

Liberal interpretation: U/s. 6 RBI is authorised to regulate capital account transactions. RBI has issued several notifications under Section 6.

⁹ Inserted by the Finance Act, 2015, w.e.f. a date yet to be notified.

Wherever a notification is issued; that particular capital account transaction will be regulated. If there is no notification for a particular item, it would mean that there is no restriction. Consider an illustration of inheritance of assets. Wherever there is no restriction, the NR can inherit assets in India.

Conservative interpretation: Another interpretation of Section 6 (2) (a) is that RBI may permit certain capital account transactions. All the transactions which are not permitted by any particular notification or by a specific permission - cannot be undertaken. This second interpretation is more conservative. For our discussion here, let us go ahead by the conservative interpretation.

Notification 1 provides Capital Account transactions that are specified as permissible transactions - separately for Residents & Non-Residents. It is a better interpretation to say that - only the transactions specified by RBI are permitted & the transactions not specified by RBI - are not permitted. **FEMA has gone back to FERA in providing a "Positive List"**.

4. Now consider Section 6 (5).

A non-resident of India may hold any assets in India only if: (a) he had acquired those assets when he was resident in India; or (b) he had inherited the assets **"from a person who was resident in India"**.

What is the meaning of the phrase "from a person who was resident in India"?

The inheritor is a non-resident. The person who died should have been an Indian resident. At what stage he should have been an Indian resident? Should he be resident on the date of his death? Or should he be resident when he acquired the assets? Consider an illustration:

Mr. IR was an Indian citizen and Indian resident. On 1st January, 2015 he purchased a residential house in India. On 20th April, 2017 he died. Now we consider two probabilities.

(i) Between the date of purchase and date of death Mr. IR left India and became a non-resident.

(ii) Mr. IR continued to be Indian resident until the date of his death.

His son who is a non-resident of India has inherited the asset. Under Section 6 (5), is he permitted to inherit the assets?

5. Consider another illustration. Mr. NRI left India in the year 1980. He became non-resident and foreign citizen. He married to a girl who was

always a non-resident and foreign citizen. They had children who were non-residents and foreign citizens throughout their lives.

Mr. NRI's wife is also treated as an NRI, PIO & OCI. Both of them have made investments in India in: NRE & FCNR bank accounts, immovable property in India, a portfolio of shares in India.

In April, 2017 Mr. NRI and his wife died. As per their Wills their children inherit the assets. Now under a strict interpretation of Section 6 (5) what would be the consequences? Prima facie, since the children are non-residents of India, they cannot hold any foreign assets in India except as permitted under FEMA.

Section 6 (5) permits the children to inherit the assets from an Indian resident. However, both the deceased persons were non-residents of India at the time of their death as well as the time of their acquisition of Indian properties. Hence under Section 6 (5) the **children are not entitled to inherit the assets**. The NR heirs' permission to sell inherited assets also is provided by S.6 (5). So these heirs cannot sell the assets.

If the children **cannot inherit** the assets, under the same logic they **cannot even sell** the assets. **Notification 13(R) (3)** prohibits remittance of any assets abroad. Whether the remitter is R or NR.

Can FEMA override Indian Succession Act? Assuming FEMA can override, is it a fair and reasonable law?

6. Notification 13 (R):

Notification No. 13 R (4) (2) (i) permits an NRI/ PIO to remit abroad upto \$ 1 mn. every year, out of the inherited assets/ sale proceeds of the assets. Problem is: if they cannot inherit nor sell; how can they remit funds abroad?

Should they allow the inheritance to lapse?

If the law is so unfair, should any non-resident invest in India?

7. Reserve Bank has a policy of: (i) first prohibiting everything; (ii) then opening small windows and calling it liberalisation; (iii) & imposing several conditions for every liberalisation. Unless this approach is discarded, there will be no true liberalisation under FEMA.

8. Section 6 (5) could have been drafted more liberally. For example:

S. 6 (5) A person **resident outside India** may hold, own, transfer or invest in any asset situated in **India** if such asset was acquired, held or

owned by such person when he was resident in India or inherited from a person who had acquired the same in compliance with law.

----- X -----

Please note that while **interpreting FEMA**, reading one section or one notification is not adequate. You have to read several different connected sections. And there is no simple guideline to find out the connected sections. One who wants to be an expert in FEMA needs to read the whole law, remember and note down all the connected provisions under every subject. And then keep updating his list several times a year – as GOI & RBI keep issuing notifications & circulars.

“Comprehensive Interpretation necessary under FEMA” completed.

Next: Part V: Estate Planning & Trust under FEMA

V. Estate Planning & Trust under FEMA

For the last few years, there has been increasing discussion on Estate Planning. This leads to settlement of discretionary trusts outside India under LRS. People also discuss discretionary trusts within India including NR children as beneficiaries.

A. Some tax issues on Estate Planning (EP):

A.(i) India has no estate duty. There never was a talk at Government level of bringing back Estate Duty. Still some consultants expressed the fear that Estate Duty may come back. "Fear is the key". All that fear has proved to be baseless. So tax is not a consideration in Estate Planning.

A.(ii) There can be several non-tax reasons for EP.

In case of rich families, there may be a probability of disputes in sharing the estate. "Will" can be challenged & may lead to litigation. A trust properly drafted & settled during life time of the settlor can avoid chances of litigation & succession of estate can be smooth.

For promoters of public limited companies, a trust becomes very important tool for avoiding litigation & consequent freezing of voting rights in the public companies.

A.(iii) It should be noted that where a trust is settled to avoid litigation in distribution of estate after death of the settlor; the trust should be settled and assets effectively transferred to the Trustees while the settlor is alive. I have serious doubts about - "A trust where ownership of shares is transferred to trustees; but effective control over shares is still retained by the settlor". Such a trust may be challenged on the grounds that there was no real/ effective settlement.

Some people make a trust which comes into effect on the death of the settlor. Such a trust cannot achieve the objectives of:

- (a) Avoiding litigation after death; and
- (b) Avoiding probable, future imposition of estate duty.

A.(iv) Families that do not have such reasons may make simple "Will" & avoid other complications of a Trust that are briefly mentioned below.

A.(v) Tax Complications:

In case of trusts, an issue was raised whether S.56(2)(x) would apply at the time of - (a) settlement of trust (b) distribution of annual incomes; and (c) at the time of final dissolution of trust.

In my submission, in case of Specific Trusts, where the settlor & beneficiaries are related as defined u/s. 56 (2) (vii) explanation (e) – there will be no further application of S.56.

Finance Act 2017 has amended S.56. New clause is: S.56 (2) (x) 4th Proviso (X). This clause has exempted settlement of trust by an individual solely **for the benefit of relatives** of the individual.

The controversy may continue in case of discretionary trusts distributing trust fund/ trust income to beneficiaries.

Most foreign consultants advise to settle a discretionary trust where at least one NR NGO like Red Cross is a beneficiary. This advice is based on an interpretation that such foreign discretionary trusts won't be liable to Indian Income-tax.

However, such a trust will lose the exemption u/s. 56. Because the exemption is available if trust is settled exclusively for settlor's relatives only.

B. Trust under FEMA:

B.(i) There is no clear provision under FEMA for the residential status of a trust – whether specific or discretionary. Even after requests, RBI has refused to come out with specific policy guidelines for trusts.

B.(ii) Under the present environment of global **transparency** and global **attack on black money**, any Indian resident may play absolutely safe in having any interest in a foreign trust. Have all transactions of tax paid funds & make full disclosures. If this is not practical, don't be a beneficiary in a foreign trust.

B.(iii) A settlement under a trust will be subject to FEMA provisions where:

(a) The trust fund is transferred to the Trust immediately [See para A (iii) above.];

And

(b) Settlor is Indian resident; and

Any NR is a beneficiary

OR

(c) Settlor is a NR and

Any IR is a beneficiary.

In case of B.(iii) (b) above and a specific Trust, the settlor needs prior written permission of RBI before settling the trust.

In case of B.(iii) (c) above, FEMA sections 4 & 8 apply and the IR beneficiary is required to do all in his control to get his share realised & remitted to India. Failure to do so may attract provisions of S.13 (1A) & 37A.

In case of B.(iii) (b) above and a discretionary trust, RBI permission is required. RBI may not grant permission - except when the bonafide need for such a trust is clearly established.

B.(iv) Consider a trust that comes into effect on the date of death of the settlor. This may be a **Will-cum-Trust**. Settlor is IR & at least one beneficiary or trustee is a NR.

There is no clear provision under FEMA. However, the view within RBI and profession is that - Succession happens under the Succession law. Succession does not require RBI permission.

The NR beneficiaries who get their share of benefit under such a trust can remit the share abroad (after paying income-tax if applicable). Please see: Notification 13 (R) (4) (2) (i) & (ii) as well as discussion in paragraph IV.5 & 6 in this paper.

In short, this notification permits the NR beneficiary to remit abroad upto US \$ one million scheme every year out of the inheritance received. The fact that remittance is specifically permitted, corroborates the view that in case of succession (where the deceased was IR & heir is NR), no permission is needed under FEMA.

Conclusion:

Trusts can be useful in specific situations.

Trusts attract special controversies under tax & FEMA. If it is not an unavoidable necessity, avoid trusts where cross border transfers are involved.

“Estate Planning & Trust under FEMA” completed

Next: Para VI - Attack on Black Money

VI. Attack on Black Money

An important culmination of several events is – massive attack on black money.

1. **Prevention of Money Laundering Act (PMLA):**

Under PMLA, banks & financial intermediaries are to submit Suspicious Transaction Reports (STR). About a hundred countries have signed this agreement & it is operative for more than ten years.

Consider illustration. Mr. IR had black money in Tax Haven A. This was not criminal money and hence not covered under PMLA. Now Mr. IR shifted the money to another bank account in Tax Haven B. Bank clearance of transfer happens in USA. The clearing house reports a suspicious transaction to GOI. Once the information is received, while PMLA won't apply, GOI will take action under Income-tax Act & Black Money Law.

2. **Forced Transparency. BEPS:**

Tax Havens have been forced to abandon secrecy about their entities & ultimate beneficial owners. Almost all the tax havens popular with Indians, have signed – Automatic Exchange of Information Agreement. Most Tax Havens have been neutralised. This action is part of Base Erosion & Profit Shifting programme of G20 & OECD.

3. **Black Money Law:**

GOI passed the Black Money Law and made holding of black money outside India as a criminally punishable offense.

4. **FEMA amendments:**

These are two sets of amendments:

- (a) Section **13 (1A) to 13 (1D)** have been added to provide for penalty, prosecution and confiscation of Indian assets of a value equivalent to the foreign asset.
- (b) Section **37 A** has been added to provide for seizure of Indian assets of a value equivalent to the value of foreign assets.

These harsh provisions are for – assets held abroad. Not for Non-Residents' investments in India. This is a part of the attack on black money held abroad and not for non-residents' investments in India.

5. **Sections 13 (1A) to 13 (1D):**

For immediate reference, S.13 (1A) is reproduced below:

(1A) If any person is found to have acquired any foreign exchange, foreign security or immovable property, situated outside India, of the aggregate value exceeding the threshold prescribed under the proviso to sub-section (1) of section 37A,

he shall be liable to a penalty up to three times the sum involved in such contravention and confiscation of the value equivalent, situated in India, of the foreign exchange, foreign security or immovable property.

Note the issues:

- (a) There are two sets of provisions under the same law authorising the DOE to seize Indian assets for one offense. First set [S.13 (1A)] provides for straight confiscation of Indian assets. S.37 A provides for first seizure; then adjudication & then confiscation.
- (b) Both the sets provide for no notice and no opportunity for explanation. DOE can go ahead & seize / confiscate the assets. Then the aggrieved person may start his running around to save his assets.
- (c) Note the sentence: It provides - "Any person found to have acquired assets abroad ..." is liable for proceedings under the law.
Note: In reality DOE issues notice before taking action.
- (d) S.13 (1A) has been divided in the above extract into two parts:
 - (i) Main operative provision, the offense based on which action can start.
And
 - (ii) Consequences of the offense.
 - (i) What is the offense prescribed? "Holding of foreign assets".

Note that this phrase does not require that the person should be holding the foreign assets in contravention of FEMA. Just because he is holding foreign assets; the offense prescribed in the 1st phrase is completed.

- (ii) 2nd phrase provides for penalty upto 300% and confiscation upto 100% of the sum involved in "Such Contravention".

The words "Such Contravention" in the sentence mean the contravention specified in the first phrase. Holding of assets abroad is deemed to be a contravention & consequences follow.

- (e) These two sets of penalties are in addition to existing penalties; and not in replacement of existing penalties.
- (f) A fair interpretation of law in compliance with constitution would be:

DOE would investigate & would find out whether a particular person is holding assets abroad in violation of FEMA. Facts would be recorded. If there is a genuine violation, permission of higher authorities would be taken for further action.

Then a notice would be served on the person giving him an opportunity to explain. If he cannot explain, then a notice would be served to "Show cause why Indian assets should not be seized."

When the person fails to provide explanation; the Investigating Officer shall refer the matter to the Adjudicating Officer. The Adjudicating Officer will start the Adjudication Procedure. This means, the person would be again called upon to explain - (i) whether he has violated FEMA & (ii) why his Indian assets should not be seized.

Any seizure of assets without natural justice is likely to be struck down by appropriate Court of Law.

- (g) The Adjudicating Authority can give orders to -
 - (i) Seize assets upto 100% of the value;
 - (ii) Launch criminal prosecution; and
 - (iii) Impose penalty.
- (h) FERA was criminal law.
It was replaced by FEMA, a Civil Law.
Now FEMA has become a Criminal law with far more harsh provisions.

6. U/s. 37 A:

- (a) This section provides the offense - "holding assets abroad in violation of S.4". In this aspect it is better than S.13 (1A). Otherwise it is similar in all deficiencies.
- (b) For initiating action, what is required is - **a suspicion** by DOE that the person has foreign assets in violation of S.4 of FEMA. Based on

suspicion, DOE will record the reasons in writing & seize Indian assets.

No notice to be given.

No opportunity to be given.

- (c) The order for seizure of assets is not open for compounding u/s. 15.
- (d) In short, an absolutely harsh and unjust provision has been made into law. In my submission, this is unconstitutional.
- (e) More serious:
FEMA is a complex law that most people can't understand.

RBI keeps changing its - interpretation of Notification issued by itself. What was considered by RBI as legal in one year, can be considered as illegal in the next year.

- (f) There is no provision under FEMA for appeal against an order by RBI.

When RBI says that there is an offense, DOE accepts it & proceeds as if the offense is proved.

- (g) There is no provision for accountability of the RBI & DOE officer. Consider a patently wrongful order or seizure of assets causing stoppage of business of the aggrieved party. Assume that on appeal, the High Court quashes the seizure. By that time the aggrieved person would have suffered massive losses & DOE would have no consequences.
- (h) Attack on Black money is fully justified. However, in a democracy, every citizen has a right to claim & prove that the assets held by him are in compliance with law; and that he does not hold black money. No adverse consequences can be imposed before giving him adequate opportunity to prove his innocence.
- (i) Note that Black Money Law & FEMA are two separate laws. Consider - a person holds assets abroad - which have been acquired by remitting abroad - tax paid money, through banking channels. However, if as per RBI/ DOE, it is in violation of FEMA, S.13 (1A to 1B) & S.37A will apply.

“Attack on Black Money” Completed

Next: VII - International Economics & FEMA

VII. International Economics & FEMA.

1. Currency Note:

We have all (almost all) learned Economics in our college time. Let us remember some of it.

What is the value of a **Currency Note**? By itself, absolutely NIL. Whether the note is of one rupee or of a thousand rupees; its intrinsic value is NIL. Why do we accept rupee as reward for all our services that we provide or products that we sell?

Two Reasons:

- (A) Rupee is the **legal tender**. It is the law of the land. Rupee is an official medium of exchange, currency in India. And we have to accept it. Hence it is called a FIAT currency. Government wants us to accept it by a FIAT, an order.
- (B) It has become a **habit**. We do not ask some fundamental questions. Just do what everyone else is doing and has been doing for many years.

2. Functions of Money:

Money has three functions: (i) Medium of Exchange, (ii) Measure of Value, (iii) Store of Value. Any authority that issues currency notes has to ensure that the value of its currency is maintained, that it is easily exchangeable and it is a good measure for value of all commodities, assets & services.

3. What is the performance by Government of India & RBI?

Government of India (GOI) passed FERA and placed an absolute prohibition on taking money out of India, or dealing in any foreign currencies. Even if you may prefer a foreign currency as more stable than the Indian rupee, you are prohibited from exchanging rupee for foreign currency.

So the "**Exchange Function**" of money goes for a toss.

4. GOI has to maintain the **Value of Rupee**. However, GOI keeps resorting to deficit financing. Almost every year, for 70 years. Every deficit reduces the value of rupee. All the wizards in the Finance Ministry and Niti Aayog fully know that they themselves are resorting to deficit financing and depreciating the value of rupee. They are not maintaining stability in value of Rupee.

What is the result of inflation/ depreciation in value of rupee? Let us see just one issue. For last 3 years, the rate of inflation at Consumer

Price level has been ...say 5%. (We know that the whole sale price index – which GOI uses – shows less inflation than what we suffer as consumers.) Now let us say a person had placed a bank fixed deposit of Rs. 1,00,000 at the beginning of the 3 year period. Its value is going down as:

	Loss of	Net Value
Beginning of 1 st Year		1,00,000
End of 1 st Year	5%	95,000
End of 2 nd Year	5%	90,250
End of 3 rd Year	5%	85,740

You are losing the value of your bank fixed deposit every year. Government is ensuring this deliberately and with full knowledge (Knowledge and Intent are established. Fit case for penalty under the law.) But the depositor does not realise that he is losing value every year. Deposit receipt is for Rs. 1,00,000. And bank will still return him Rs. 1,00,000. The Depositor has only a vague idea that in “real” terms he has lost out. Anyone who has any bank fixed deposit, provident fund or pension accumulations; or even money stored in cash is a loser.

5. **Gold Price:**

Maintenance of the value of Rupee is the responsibility of Government of India (GOI) & RBI. Let us see whether they have been successful in maintaining Rupee value in a different manner. This calculation is done in two separate ways.

5.1 In the year 1947, US \$ to Indian Rupee conversion rate was – Rs. 4 = \$ 1. Today, the conversion rate is Rs. 70 = \$ 1. This means that against US \$, Rupee has depreciated to 5.71%.

However, we should also note that in the year 1947, gold price per troy ounce was \$ 35. In the year 2019, gold price has risen to \$ 1,300. In other words, US \$ has depreciated to 2.7%.

\$ has depreciated to 2.7% against gold. Rupee has depreciated to 5.7% against \$. It means that Rupee has depreciated to 0.15% compared to its 1947 value.

5.2 We can have an independent comparison of Rupee Vs. Gold.

Gold price in India in the year 1947 per 10 grammes was Rs. 90. In the year 2019, the gold price has gone up to Rs. 32,000 per 10 grammes. In other words, Rupee has depreciated to 0.28% of its own value in the year 1947.

Please note that gold price is highly suppressed price. There is another long story behind gold price manipulation. Whichever way we look at the value of Rupee, in just 70 years, it has depreciated to extremely low value. One reason for such dismal failure by GOI & RBI is poor management of Rupee value under FEMA.

6. 'The icing on the cake' (to use the most inappropriate phrase) is that banks give - you a small interest. GOI says "You have earned money. So pay tax on it." Net of tax & inflation, your interest is always negative.

Government of India manages fiscal policy and is duty bound to control inflation - or - **internal value of Rupee**. RBI is duty bound to manage **external value of Rupee**. Both functions are directly dependent on each other.

7. **FX Rate:**

RBI manages monetary policy and is supposed to maintain the FX conversion rate or **external value of Rupee**. Both - internal and external value of Rupee are closely having cause-effect-cause relationship.

Conclusion:

GOI and RBI do not perform the functions they are supposed to perform as issuers of currency. Hence Rupee keeps going down. Left to themselves, people would sell Rupee and buy other currencies. To maintain GOI monopoly on our income & wealth, FEMA is imposed on us. **FEMA legalises GOI-RBI failure**. Then if we act in our best commercial interest, we are held guilty under FEMA. And RBI + DOE will punish - us, the citizens of India for a violation committed by GOI + RBI.

VIII. Some More Issues to be clarified:

1. A currency may be **convertible or non-convertible**.

US \$, Euro, British Pound, Japanese Yen, etc. are freely convertible currencies. Indian Rupee, Chinese Yuan, etc. are not freely convertible currencies as there are domestic laws which prevent free conversion of the currency. Then there may be several small economies whose currencies have no market. Hence, practically they are not convertible. Whether a currency is convertible or non-convertible is a question of law as well as facts. Hence, RBI has not given a list of currencies which are either convertible or non-convertible. While, RBI has not given a definition of “**Convertible Foreign Exchange**”, Indian Income-tax Act as well as GST provide for some specific reliefs etc. based on whether the concerned receipts are made in convertible foreign exchange or not. This creates a practical difficulty. For example, a professional fee received in convertible foreign exchange is not liable to **GST**. As far as RBI is concerned, payments made from NRE Accounts are as good as convertible foreign exchange. Still, the payment instrument (cheque/ RTGS) will be mentioned in Indian Rupee. Hence, GST department has refused to accept NRE remittances as payment in convertible foreign exchange.

We have made representation to RBI to issue a circular giving clear definition of convertible foreign exchange. Let us hope, RBI gives such a clarification.

2. **Repatriable & Non-repatriable Investments:**

This term is used for foreign investment into India. All investments made by foreigners under Notification 20R, Regulation 16 (Sectoral Caps, etc.) are always fully repatriable investments. In other words, foreigners are not permitted to invest in India on non-repatriation basis. NRIs are permitted to invest in India on repatriation as well as non-repatriation basis. When NRIs invest in India on repatriation basis, their investment also is subject to the regular discipline applicable for foreign investment (Regulation 16). When NRIs invest on non-repatriation basis, the investment is more liberal. It would be covered under Regulation 20R, Schedule 4. The Schedule 4 specifically provides that **NRI investment on non-repatriation basis will be deemed to be domestic investment** at par with investment made by residents.

This deeming provision has following **implications:**

- (i) Please note that this relief to consider NRI investment as domestic investment is applicable only for investment covered under Notification 20R. It is not applicable to investment in **immovable property, loans**

within India, etc. For these subjects, one has to look at the relevant notifications. Other notifications do not have similar deeming provision.

(ii) Regulation 14 provides for down-stream investment/ indirect foreign investment. An Indian company to be considered to be – “Company owned by **resident Indian citizens**” would mean that only persons who are Indian citizens as well as Indian residents may be the shareholders in such companies. In other words, if an Indian citizen is a non-resident, and owns shares in an Indian company on repatriation basis, then that shareholding will not be considered as domestic investment. However, if the Indian citizen who is a non-resident has made investment on non-repatriation basis, then it shall be considered as domestic investment. The indirect foreign investment regulations will have appropriate consequences.

3. RBI and GOI administration under FEMA can be broadly divided into two aspects:

3.1 Maintaining **external value of Indian Rupee** in international exchange markets, and protecting Indian Rupee from **speculative attacks**.

(i) In this field, RBI – GOI have a mixed record. As already seen above, the value of Indian Rupee has drastically fallen. This has huge negative consequences on Indian economy. To explain this point would require another paper. The fact remains that a depreciating Rupee causes inflation. Hence, increases cost of living as well as cost of production. This reduces international competitiveness of Indian exports. Hence, the export lobby demands depreciation of Rupee and a vicious cycle goes on and on.

(ii) In the year 1997, there was a massive speculative attack on the currencies of South East Asian Countries. Indonesia, Malaysia, South Korea, Philippines and Thailand - five nations suffered massive losses. However, Indian Rupee did not crash. This was a strong success of RBI – GOI.

(iii) In the year 2013, there was a speculative attack on Indian Rupee. Rupee went down from Rs. 55 per \$ to Rs. 69 per \$. This was a failure by RBI – GOI and Indian economy has suffered.

(iv) In the current situation where Mr. Trump of USA keeps talking about trade wars, protecting exchange value of Indian Rupee is a very important function.

3.2 Management of Indian Rupee in terms of massive controls over imports, exports, cross border investments and **micro management** by RBI have proved **counterproductive**. This part of the law needs to be scrapped.

4. **Crypto Currency:**

In my submission, Crypto Currencies are illegal under FEMA. In any case, they are highly speculative and without any intrinsic worth. Primarily, smugglers and other people needing illegal transfer of money across the border would invest in Crypto Currencies. A conservative investor may always avoid a Crypto Currency.

5. RBI has developed a unique style of administration.

(i) Even a junior manager in RBI can hold an interpretation of law different from the interpretation held by his superiors. A senior manager would not force his view upon the junior manager. This is a praise worthy **independence in management**.

(ii) Under FERA, RBI had published **exchange control manual**. It gave guidance on interpretation of several sections and administration of law. Under FEMA, the exchange control manual has been scrapped. There is little **Institutional Memory** in RBI -as recognised by RBI management. RBI has tried to fill in the gap by issuing master directions. Still, however, a manager newly posted in FEMA section does not have guidance of past practices and views.

(iii) RBI managers keep changing every two or three years. Sometimes a person managing rural banking department may be transferred straight to FEMA section to deal with international investment.

(iv) Combination of these factors has resulted in a situation whereby every time a manager in a particular position changes, new interpretations come about. The new manager thinks that he is absolutely right in his interpretation. He has not made any change in administration. And yet, his interpretation may be different from or even contrary to the interpretation by his predecessor. This amounts to **changes in the law with retrospective effect without any legal support**.

We have heard retired RBI managers being completely frustrated. There have been occasions when say, Mr. X was in RBI. He drafted a particular notification or circular. Mr. X retired after a few years and started his own practice. Mr. Z, a fresh manager is now in charge of the same section. He holds a view completely different from the view held by Mr. X. When Mr. X tells Mr. Z: "My dear friend, I have drafted this Notification/ Circular. Its meaning and purpose are completely different from what you understand." Yet, Mr. Z would refuse to listen. Mr. X feels frustrated. All other Chartered Accountants and Lawyers are completely at a loss.

6. Consider the fact that FEMA is an unjustified law. Customs Duty rate is at present at a reasonable level. However, in the past, import licensing and very high Customs Duty rates were imposed with a view to conservation of foreign exchange. At that time, import licensing, high customs duty rates and FEMA together **gave birth to highly lucrative business of smuggling and hawala racketeering**. Time permitting I will explain the whole **vicious cycle**.
7. An investment may be **non-repatriable**. However, for a middle class NRI investor, it does not mean much.
- (i) All revenue incomes are fully repatriable after payment of due taxes.
 - (ii) Even capital amounts can be repatriated abroad under \$ One Million scheme.
8. **Interpretation of FEMA:**
- (i) The law is contrary to logic.
 - (ii) Exchange Control Manual is not available.
 - (iii) Under Tax law we have large number of judicial decisions providing for judicial interpretation of the law. Under FEMA, there is no such guidance available.
 - (iv) RBI does not give good clarifications. Even when an applicant makes a request for clarification, RBI either refuses or gives a letter which does not clarify anything.

Conclusions: FEMA is an Unjust Law

FEMA is a small Act and a vast subject. One can discuss so many issues under FEMA. However, in this presentation, my objective is to introduce the culture of FEMA and a few concepts under FEMA. If I have achieved this, my purpose would be fulfilled.

Thank you,



Rashmin Sanghvi.

Annexure -I

Extract of Notification No. FEMA 1 /2000-RB dated 3rd May 2000-

1. Short title and commencement:-
.....
2. Definitions:
.....
3. Permissible Capital Account Transactions:
 - (1) Capital account transactions of a person may be classified under the following heads, namely: -
 - (a) transactions, specified in **Schedule I**, of a person **resident In India**;
 - (b) transactions, specified in **Schedule II**, of a person **resident outside India**.
 - (2) Subject to the provisions of the Act or the rules or regulations or direction or orders made or issued thereunder, any person may **sell or draw foreign exchange** to or from an authorised person for a capital account transaction specified in the Schedules; Provided that the transaction is within the limit, if any, specified in the regulations relevant to the transaction.
4. Prohibition:

Save as otherwise provided in the Act, rules or regulations made thereunder,

 - (a) **no person** shall undertake or **sell or draw foreign exchange** to or from an authorised person for any capital account transaction,
 - (b) **no person resident outside India** shall make investment in India, in any form, in any company or partnership firm or proprietary concern or any entity, whether incorporated or not, which is engaged or **proposes to engage** –
 - (i) in the business of chit fund, or
 - (ii) as Nidhi Company , or
 - (iii) in **agricultural** or plantation activities or
 - (iv) in **real estate business**, or construction of farm houses or
 - (v) in trading in Transferable Development Rights (TDRs).

Explanation:

For the purpose of this regulation, “real estate business” shall not include

development of townships, construction of residential/commercial premises, roads or bridges.

SCHEDULE I [See Regulation 3(1)(A)]	
Classes of capital account transactions of Person resident in India	
a	Investment by a person resident in India in foreign securities (Notification No. FEMA 19 /2000-RB)
b	Foreign currency loans raised in India and abroad by a person resident in India (Notification No. FEMA 03 /2000-RB)
c	Transfer of immovable property outside India by a person resident in India (Notification No. FEMA 07 /2000-RB)
d	Guarantees issued by a person resident in India in favour of a person resident outside India (Notification No. FEMA 08 /2000-RB)
e	Export, import and holding of currency/currency notes (Notification No. FEMA 6 /2000-RB)
f	Loans and overdrafts (borrowings) by a person resident in India from a person resident outside India (Notification No. FEMA 03 & 04 /2000-RB)
g	Maintenance of foreign currency accounts in India and outside India by a person resident in India (Notification No. FEMA 10 /2000-RB)
h	Taking out of insurance policy by a person resident in India from an insurance company outside India (Notification No. FEMA 12 /2000-RB)
i	Loans and overdrafts by a person resident in India to a person resident outside India (Notification No. FEMA 3 & 4 /2000-RB)
j	Remittance outside India of capital assets of a person resident in India (US\$ 25,000 scheme – AP circular 64 dated 4 th February 2004; increased to US\$ 50,000 vide AP Circular 24 dated 20 th December, 2006; increased to US\$ 1,00,000 vide AP circular 51 dated 8 th May 2007; Notification 120 /2004-RB; Notification 1 /2000-RB;)
k	Sale and purchase of foreign exchange derivatives in India and abroad and commodity derivatives abroad by a person resident in India. (Notification No. FEMA 25 /2000-RB)
SCHEDULE II [See Regulation 3(1)(B)]	
Classes of capital account transactions of Person resident outside India	
a	Investment in India by a person resident outside India, that is to say,
I	Issue of security by a body corporate or an entity in India and investment therein by a person resident outside India; and (Notification No. FEMA 20 /2000-RB)

li	investment by way of contribution by a person resident outside India to the capital of a firm or a proprietorship concern or an association of persons in India. (Notification No. FEMA 24 /2000-RB)
b	Acquisition and transfer of immovable property in India by a person resident outside India. (Notification No. FEMA 21 /2000-RB)
c	Guarantee by a person resident outside India in favour of, or on behalf of, a person resident in India. (Notification No. FEMA 8 /2000-RB)
d	Import and export of currency/currency notes into/from India by a person resident outside India. (Notification No. FEMA 6 /2000-RB)
e	Deposits between a person resident in India and a person resident outside India. (Notification No. FEMA 5 /2000-RB)
f	Foreign currency accounts in India of a person resident outside India. (Notification No. FEMA 5 /2000-RB)
g	Remittance outside India of capital assets in India of a person resident outside India. (Notification No. FEMA 13/2000-RB)

RESERVE BANK OF INDIA
Foreign Exchange Department
Central Office
Mumbai - 400 001

RBI/2013-14/440

A.P. (DIR Series) Circular No. 90

January 9, 2014

To,
All Category- I Authorised Dealer Banks and Authorised Banks

Madam / Sir,

**Provisions under section 6 (4) of Foreign Exchange
Management Act, 1999 - Clarifications**

Attention of Authorized Dealers is invited to Section 6 (4) of FEMA, 1999 in terms of which 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.

2. We have been receiving representations with regards to nature of transactions covered under Section 6(4) of FEMA, 1999. In this regard it is clarified that Section 6(4) of FEMA, 1999 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.

3. Authorised Dealer Category - I banks may bring the contents of this circular to the notice of their constituents and customers concerned.
4. The directions contained in this circular have been issued under Section 10(4) and Section 11(1) of the FEMA, 1999 (42 of 1999) and are without prejudice to permissions/approvals, if any, required under any other law.

Yours faithfully,

(Rudra Narayan Kar)
Chief General Manager-in- Charge