

THE CHAMBER OF TAX CONSULTANTS - INTERNATIONAL TAXATION COMMITTEE

INTENSIVE STUDY COURSE ON FEMA



Regulations relating to Outbound Investments with Case studies and Issues

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Overview

- Overseas Direct investments under FEMA
- Overseas Direct Investments under LRS
- Branch outside India
- Practical Issues – ODI
- Case Studies – ODI
- Factors affecting choice of jurisdiction outside India



Overview

■ Abbreviations:

Authorised Dealer(AD),
Capital Account transaction (CAP),
Current Account Transaction(CAT),
Foreign Exchange(FE),
Government of India (GOI) ,
Notification no.(Notf.),
Person Resident Outside India(PROI),
Person Resident in India (PRII),
Non Resident Indian (NRI),
Overseas Citizen of India (OCI),
Person of Indian Origin (PIO),
Reserve Bank of India (RBI),
Indian Party (IP),
Joint Venture (JV),
Wholly owned Subsidiary (WOS)



Overseas Direct Investments under FEMA

- Regulated under separate Notification No. 120
- What is the rationale for having separate notification to regulate overseas direct investments?
- Shortcomings....
 - Ntf. No. 23(R)
 - Ntf. No. 14(R)
 - Ntf. No. 9(R)

Overseas Direct Investments - FEMA Ntf.

120

Regn. 6 – Conditions for Automatic approval

- Regn. 6A – Investments in Agricultural operations overseas directly or through Overseas Offices
- Regn. 6B – Investment in Listed Equity overseas by a listed Indian company
- Regn. 6C – Investment by Mutual Funds
- Regn. 7 – Investment by IP in Financial Services
- Regn. 8 – Investment by swap or exchange of shares
- Regn. 9 – Prior Approval Route
- Regn. 9A – Overseas Investments by Regd. Trust / Society
- Regn. 10 – Unique Identification Number
- Regn. 11 – Investment by Capitalization
- Regn. 12 – Export of Goods towards Equity
- Regn. 13 – Post investment changes / additional investment in existing JV / WOS
- Regn. 14 – Acquisition through bidding / tender
- Regn. 15 – Obligations of Indian Party
- Regn. 16 – Transfer by way of sale of shares of JV / WOS
- Regn. 17 – Transfer involving write-off
- Regn. 18 – Pledge of shares of JV / WOS
- Regn. 18A – Creation of charge on domestic and foreign assets



Overseas Direct Investments - FEMA Ntf.

120

Regn. 19 – Prior RBI approval for Proprietary in India to accept shares

- Regn. 19A – Overseas Investments by Proprietorships / unregistered Partnership Firm in India being recognized Star Export House
- Regn. 20 – Investments by Individuals for acquiring shares as consideration for professional services rendered
- Regn. 20A - Acquisition or Setting up of a JV or WOS abroad by resident individual (w.e.f. 5th Aug. 2013)
- Regn. 21 – Issue of foreign security (FCCB) by person resident in India
- Regn. 22 – Purchase / acquisition by way of gift / inheritance / ESOP
- Regn. 23 – Transfer of foreign security by way of pledge by person resident in India
- Regn. 24 – General permission for acquiring qualification / rights shares and foreign securities under ADR/GDR linked stock options schemes
- Regn. 25 – Prior RBI approval for qualification shares in excess of limits specified under Regn. 24
- Regn. 26 – Investments by Mutual Funds / Venture Cap.Funds
- Regn. 27 – Opening of Demat Accounts with foreign depositories by Indian Clearing Corporations and Clearing Members



Auto Route-How much can be Invested?

- Overall ceiling of the investment: “Financial Commitment” plus amount in EEFC A/c plus amount raised via ADR/GDR issue
- Financial commitment of the IP can not be more than 400% of the Net worth of the IP; however, financial commitment exceeding USD 1 (one) billion (or its equivalent) in a financial year would require prior approval of the Reserve Bank
- Net worth: Regn. 2(o)-Paid up capital and free reserves
- What is Financial Commitment? [Reg.2(f)]



Auto Route-Financial Commitment

- Financial Commitment Reg.2(f):
Amount of Direct Investment by way of contribution to the equity and loan and 100% of guarantees issued by an IP to or on behalf of its overseas JVC or WOS plus 50% of Performance Guarantee
- Contribution to Equity can be by
 - Cash contributions or
 - Purchase of Shares or by Capitalization of Exports and Repatriable Entitlements
 - Swap of IP's shares or
 - ADR GDR Swap
- Loan to Overseas Entity (only if Equity is issued to IP)
- Guarantees to or on behalf of overseas entity



Auto Route-Financial Commitment (con't)

- Guarantees to or on behalf of overseas entity
 - Cannot be open-ended; Period & amount to be specified
 - Corporate guarantees only
 - In case of performance guarantees by IP, 50% is considered for financial commitment; if invocation leads to breach of ceiling of 400% of net worth of IP, prior RBI approval is required before remitting funds from India [*Ref: Cir. No. 69 dt. 27/05/2011 & Master Direction 15 dt. 01.01.2016*]
 - Bank guarantee issued by a resident bank on behalf of an overseas JV / WOS of the IP, which is backed by a counter guarantee / collateral by the IP, shall be reckoned for computation of the financial commitment of the IP [*Ref: Cir. No. 96 dt. 28/03/2012 & Master Direction 15 dt. 01.01.2016*]]



Auto Route-What is Prohibited & Exempted?

Prohibitions:

- Portfolio Investment, Real Estate & Banking Sector
- As per RBI's FAQs on ODI, Indian banks operating in India can set up JVs/WOSs abroad provided they obtain clearance under the Banking Regulation Act, 1949, from the Department of Banking Regulation (DBR), CO, RBI

■ Exemptions:

- Investment through RFC A/c
- Bonus issue
- Investment by Persons Resident in India but not permanently resident in India.



Eligible Entities for Investment – Important definitions as per Notification 120

- Sec. 2(e): "Direct investment outside India" means investment by way of contribution to the capital or subscription to the Memorandum of Association of a foreign entity or by way of purchase of existing shares of a foreign entity either by market purchase or private placement or through stock exchange, but does not include portfolio investment
- Sec. 2(m): "Joint Venture (JV)" means a foreign entity formed, registered or incorporated in accordance with the laws and regulations of the host country in which the Indian party makes a direct investment
- Sec. 2(q): "Wholly Owned Subsidiary (WOS)" means a foreign entity formed, registered or incorporated in accordance with the laws and regulations of the host country, whose entire capital is held by the Indian party



Eligible Entities for Investment (con't)

- 'Foreign entity' is not defined
- But from aforesaid definitions, it is one that is formed, registered or incorporated in accordance with laws of host country
- So can a foreign Proprietorship, Partnership Firm, LLP, Trust be considered as 'Foreign Entity'?
- As per definition of 'Direct investment outside India', investment has to be by way of purchase of shares; hence foreign entity must have Share Capital. Therefore, does it exclude investment in Firm, LLP or Trust as such entities do not have Share Capital even though they fall within the definition of 'Foreign entity' as they are formed or registered in accordance with laws of host country?
- Portfolio Investment is not defined



Is Foreign Trust an eligible Entity for ODI?

- Trust is not a 'Person' as defined in Sec. 2(u) of FEMA, 1999
- Trust is not a 'Person' as defined in Sec. 2(31) of Income – Tax Act, 1961
- An overseas Trust may be formed or registered in accordance with laws of host country
- However, can it be regarded as eligible 'Foreign Entity' for overseas direct investment?
- No, as it does not have shares which can be purchased by the Indian Party
- An Indian Trust, however, is permitted to make overseas direct investment under approval route



Other types of Entities – Whether Eligible Entities or not for ODI

- AOP / BOI / Artificial Juridical Person:
 - Not defined in FEMA
 - But included as Persons in Sec. 2(u) of FEMA 1999 and in Sec. 2(31) of Income-Tax Act, 1961
 - AOP / BOI included in 'Person' in General Clauses Act, 1897
- Trust is not AOP / BOI
- Artificial Juridical Persons such as Board of Directors of a Company or Managing Committee of a Society are recognized only for the purpose of the relevant Statute/s



Overseas Direct Investment by Resident Individuals

- With effect from August 05, 2013,
 - a resident individual (single or in association with another resident individual or with an 'Indian Party' as defined in the Notification)
 - satisfying the criteria as per Schedule V of the Notification, may make
 - overseas direct investment in the equity shares and compulsorily convertible preference shares of a Joint Venture (JV) or Wholly Owned Subsidiary (WOS) outside India
- The limit of overseas direct investment by the resident individual shall be within the overall limit prescribed by the Reserve Bank of India under the provisions of Liberalised Remittance Scheme

Overseas Direct Investment by Resident Individuals (con't)

- Important conditions in Sch. V of Ntf. 120:
 - JV or WOS abroad should not be engaged in the real estate business or banking business or in the business of financial services activity
 - JV or WOS abroad shall be engaged in bonafide business activity
 - JV or WOS not to be located in the countries identified by the Financial Action Task Force (FATF) as "non co-operative countries and territories" as available on FATF website www.fatf-gafi.org or as notified by the Reserve Bank
 - Investment made out of the balances held in EEFC / RFC account shall also be restricted to the limit prescribed under LRS
 - JV or WOS shall be an operating entity only and no step down subsidiary is allowed to be acquired or set up by the JV or WOS
 - For the purpose of making investment under this Schedule, the valuation shall be as per Regulation 6(6)(a) of Ntf. 120



Overseas Direct Investment by Resident Individuals (con't)

- Important conditions in Sch. V of Ntf. 120:
 - Disinvestment (partially or fully) allowed by way of transfer / sale or by way of liquidation / merger of the JV or WOS
 - Disinvestment by a resident individual shall be allowed after one year from the date of making first remittance for setting up or acquiring the JV or WOS abroad. Investment made out of the balances held in EEFC / RFC account shall also be restricted to the limit prescribed under LRS
 - Disinvestment proceeds shall be repatriated to India immediately and in any case not later than 60 days from the date of disinvestment
 - No write off shall be allowed in case of disinvestments by the resident individuals



Overseas Direct Investment by Resident Individuals (con't)

- Important conditions in Sch. V of Ntf. 120:
 - The resident individual, making overseas direct investments under the provisions of this Schedule, shall submit Part I of the Form ODI, duly completed, to the designated authorised dealer, within 30 days of making the remittance
 - The obligations as required in terms of Regulation 15 of Notification 120 shall also apply to the resident individuals who have set up or acquired a JV or WOS under the provisions of this Schedule
 - The disinvestment by the resident individual may be reported by the designated AD to the Reserve Bank in Form ODI Part IV within 30 days of receipt of disinvestment proceeds



Branch outside India

FEMA Ntf. 10(R) gives general permission to a firm or company registered or incorporated in India to open a foreign currency account with a bank outside India in the name of its office (trading or non-trading) or its branch set up outside India or its representative posted outside India

- Conditions to be fulfilled: - The general permission is available to open an overseas branch and a bank account outside India only if the following conditions are fulfilled:
 - (i) Conducting normal business activities: The overseas branch or office has been set up or representative is posted overseas for conducting normal business activities of the Indian entity.
 - (ii) Permissible amount of remittance: The total remittances by the Indian entity shall not exceed -
 - Remittance for Initial expenses: - 15 per cent of the average annual sales/ income or turnover of the Indian entity during the last two financial years or up to 25 per cent of the net worth whichever is higher, where the remittances are made to meet initial expenses of the branch or office or representative.
 - Recurring expenses: - 10 per cent of such average annual sales/ income or turnover during the last financial year where the remittances are done to meet recurring expenses of the branch or office or representative.



Branch outside India (con't)

Above restrictions on remittances not applicable in a case where:

- 1) remittances are made out of funds held in EEFC account of the Indian entity, or
- 2) the overseas branch/ office is set up or representative posted by a 100% Export Oriented Unit (EOU) or a unit in Export Processing Zone (EPZ) or in a Hardware Technology Park or in a Software Technology Park, within two years of establishment of the Unit.

- (iii) The Overseas Branch/Officer/representative shall not enter into any contract or agreement in contravention of the Act, Rules or Regulations made thereunder;
- (iv) The account so opened, held or maintained shall be closed,
 - (a) if the overseas branch/ office is not set up within six months of opening the account, or
 - (b) within one month of closure of the overseas branch/ office, or
 - (c) where no representative is posted for six months,and the balance held in the account shall be repatriated to India;



Branch outside India (con't)

Important explanations –

- Purchase of acquisition of office equipment and other assets required for normal business operations of the overseas branch/ office/ representative will not be deemed as a capital account transaction;
- Transfer or acquisition of immovable property outside India, other than by way of lease not exceeding five years, by the overseas branch/ office/ representative will be subject to the Foreign Exchange Management (Acquisition and Transfer of Immovable Property outside India) Regulations, 2015.



Practical Issues - ODI Policy

Other key issues arising under ODI & LRS:

- What is the status of investments in unlisted pvt. companies done under LRS prior to Aug. 2013?
 - Is Form APR required to be filed?
 - But UIN was not required earlier under LRS. So will RBI issue UIN for such old cases?
 - Or do the above investments need to be liquidated / exited?
 - It is learnt that these matters of investment in the overseas companies are subject matter of Compounding
- What if investment in above company through LRS was in nature of portfolio investment?
 - If yes, will it be outside the purview of FEMA Ntf. 120 i.e. no requirement of filing of APR / disinvestment report / valuation, etc. ?
- What if investment in above company was made when person was resident outside India (or it was inherited from a person resident outside India) and he is now contemplating further investment in same company under LRS?
 - In such cases, will conditions of FEMA Ntf. 120 apply pro-rata to the two methods of investment or will the entire investment be subjected to the rigors such as filing of APR / valuation / divestment report, etc.?



Practical Issues - ODI Policy (con't)

Overseas Direct Investment under LRS:

■ Key Issues (con't):

- Portfolio Investment is not defined in FEMA or in any of its regulations. The Advance Law Lexicon defines the term 'portfolio investment' as "the purchase of foreign financial asset with the purpose of deriving returns from the security without intervening in the management of the foreign operations". Hence, issue arises as to whether investment in unlisted securities can be considered as portfolio investment if it does not involve management participation or control because, as per common parlance, only listed investments are generally considered as portfolio investments.



Practical Issues - ODI Policy (con't)

Overseas Direct Investment for purpose of attracting FDI:

- Often, when structuring foreign direct investment into India, the Indian co-promoters realize that their foreign co-promoters desire to route the FDI through a holding company in a suitable international jurisdiction due to various reasons such as efficient shareholder control, brand image, licensing of Intellectual Property, etc. As a result, the Indian co-promoters are required to contribute to the equity of the foreign holding company by way of ODI which then, in turn, makes FDI into India. Although, there is no specific bar in the FEMA regulations against such a structure, regulators have raised concerns over re-routing of funds to India / round-tripping.
- However, FEMA regulations have recognized that overseas direct investments may be made in JV / WOS in order to attract FDI into India as is evidenced from the old Form APR (point J.(v)) as well as the current one (point V(iv)).
- **Key Issues:**
 - While the concerns of the regulators can be appreciated, if the foreign holding company is utilizing its profit reserves to make FDI, would it still amount to re-routing / round-tripping?
 - What if amount is borrowed by the foreign holding company and invested in India?



Practical Issues - ODI Policy (con't)

- Investment by Navratna Oil Companies – Is it in nature of Branch operations?
- Gift of foreign securities by Resident to Resident – Whether it is a Current account transaction?



Practical Issues – Overseas Branch / Office by Residents

Provisions under FEMA relating to overseas Branch / office by Residents:

- If a person resident in India desires to enter into overseas market, he can enter either (i) by establishing the branch or liaison office outside India or (ii) by forming an independent company outside India in the nature of wholly owned subsidiary (WOS) or a joint venture (JV).
- Investment in JV / WOS abroad is governed by FEMA Ntf. 120 but there are no specific regulations governing the opening of branch office/representative office by Indian residents outside India except under FEMA Ntf. 10(R) which gives general permission to open of bank account in name of overseas branch / office / representative posted abroad for conducting normal business activities of the Indian entity and specifies limits for remittance to such bank accounts. As stipulated in Regn. 5(B)(c) of FEMA Ntf. 10(R), the overseas branch/ office/ representative shall not enter in any contract or agreement in contravention of the FEMA Act, Rules or Regulations.
- Section 2(v) of the Foreign Exchange management Act, 1999 defines “person resident in India”. As per sub-clause (iv), “an office, branch or agency outside India owned or controlled by a person resident in India” is said to be resident in India. Therefore for the purpose of FEMA, a branch office outside India of a company established in India is said to be person resident in India.
- **Key Issues:**
 - Whether overseas branch can undertake all transactions, including borrowings that a foreign JV / WOS can do?
 - Or whether overseas branch can only undertake such transactions as an Indian company can do?



ODI under LRS: Case Study - I

A. ODI- Investment by Individual under Liberalised Remittance Scheme

- **Mr. A desires to make investment in shares of a foreign company. He seeks guidance on the relevant provisions and routes available to him under FEMA.**

- **Leads:**
 - **Liberalised Remittance Scheme (LRS) under A.P.(Dir) Circular No. 64 dt. 04.02.2004 as amended**
 - **Overseas Direct Investment under Regn. 20A read with Schedule V of FEMA Ntf. 120**
 - **Discuss the possible alternatives through Indian company compared with LRS**

ODI under LRS: Case Study - I (con't)

Overview of legal framework:

- Under LRS, resident individuals can freely remit up to USD 2,50,000 per Financial Year (April-March) for any permitted current or capital account transaction or a combination of both
- Permissible capital account transactions by an individual under LRS includes:
 - making investments abroad - acquisition and holding shares of both listed and unlisted overseas company or debt instruments; acquisition of ESOPs; investment in units of Mutual Funds, Venture Capital Funds, unrated debt securities, promissory notes;
 - setting up Wholly Owned Subsidiaries and Joint Ventures (with effect from August 05, 2013) outside India for bonafide business subject to the terms & conditions stipulated in Notification No FEMA.263/RB-2013 dated March 5, 2013 which amended Notification No FEMA 120 relating to Overseas Direct Investments
- Under FEMA 120, "Direct investment outside India" means investment by way of contribution to the capital or subscription to the Memorandum of Association of a foreign entity or by way of purchase of existing shares of a foreign entity either by market purchase or private placement or through stock exchange, **but does not include portfolio investment (emphasis applied)**

ODI under LRS: Case Study - I (con't)

Discussions:

- From the definition of Direct investment outside India, it is evident that investment in the nature of portfolio investment does not fall under the same and hence is outside the purview of provisions specified in Ntf. FEMA 120
- The term 'portfolio investments' is not defined in FEMA or in any of its regulations. The Advance Law Lexicon defines the term 'portfolio investment' as "the purchase of foreign financial asset with the purpose of deriving returns from the security without intervening in the management of the foreign operations".
- Hence, in common parlance, portfolio investments may be considered as "hands-off" investments which are made only with the intention to earn returns and do not include control/ participation in decision making of an offshore entity by the resident individual.
- Therefore, the route available to Mr. A depends on whether his investment in foreign company is for undertaking business with participation / control in decision making by him or is "hands-off" i.e. in nature of portfolio investment.
- Issue arises as to whether investment in unlisted securities can be considered as portfolio investment if it does not involve management participation or control because, as per common parlance, only listed investments are generally considered as portfolio investments

ODI under LRS: Case Study - I (con't)

Discussions:

- The maximum amount of investment in foreign shares by resident individual is limited to the LRS limit of US\$ 250,000 whether through LRS or through ODI route
- If Mr. A's case falls under ODI route, it is subject to conditions specified in Schedule V of FEMA Ntf. 120. The following conditions are more restrictive in case of ODI by individual compared to ODI by a company / registered partnership firm / LLP:
 - The JV or WOS, to be acquired / set up by a resident individual under Schedule V, shall be an operating entity only and no step down subsidiary is allowed to be acquired or set up by the JV or WOS
 - The financial commitment by a resident individual to / on behalf of the JV or WOS, other than the overseas direct investments as defined under Regulation 2(e) read with Regulation 20A of this Notification, is prohibited. As per said definition, investment is permissible only by way of contribution to the capital or subscription to the Memorandum of Association of a foreign entity or by way of purchase of existing shares of a foreign entity; hence it may not be possible for Mr. A to grant loan to or issue guarantee on behalf of his JV / WOS abroad
 - In case an individual invests in JV / WOS along with Indian company as part of Indian Party, issue arises whether the above mentioned restrictive provisions relating to step down subsidiaries, loans & guarantees would apply to such ODI.



ODI under LRS: Case Study - II

Kindly examine the following issues:

- Is it possible to make payment for incorporation of foreign company to service provider before the incorporation?
- Is purchase of minimum shares from a company agent treated a purchase of shares of an existing company?



Case study – III

Investment outside India for co-production of the Film

A U.K. company engaged in production of International film, proposed its next production during F.Y. 2018-19 to be completed and released by 30th April 2019. The film is budgeted at a cost of GBP 1mn which is partly (equally) financed by Indian co-producer. On release of the film, Indian co-producer will have all the right in relation to Indian territory and U.K. company will have world wide rights except that of India. The film contemplates:-

- 30% of shooting in India at a cost of GBP 1,00,000.
- 50% of principal star cast from India for a consideration of GBP 2,00,000.
- Various pre productions & post production activities in U.K. at a cost of GBP 7,00,000 which includes payment to storywriter, choreography, supporting artists, cameraman, production co-ordinator, technicians & directors.
- Indian co-producer is a company with paid up capital & reserves of equivalent to GBP 1,00,000, contemplating the funding of its share of contribution of GBP 5,00,000 to part finance the film.
- Indian company is seeking immediate solution to finalise the structuring of the co-production finance as it did not have time to approach RBI for prior approval if any, kindly advise Indian company.

Case study – III (con't)

■ **Overview of legal framework**

- Section 6(3)(a) of Foreign Exchange Management Act deals with "Transfer or issue of any foreign security by a person resident in India". Regulation relating to this transaction is notified by RBI as Notification No. 120 dt 7.7.2004.
- As per regulation 6 of FEMA Notification no. 120 an Indian party may make direct investment in a Joint Venture or Wholly Owned Subsidiary outside India. According to regulation 2(k) "Indian party" means a company incorporated in India or a body created under an Act of Parliament or a partnership firm registered under the Indian Partnership Act, 1932 or a Limited Liability Partnership (LLP) as defined under clause (ma) of Regulation 2 of this Notification making investment in a Joint Venture or Wholly Owned Subsidiary abroad, and includes any other entity in India as may be notified by the Reserve Bank.
- Further as per regulation 6(2) The total financial commitment of the Indian Party in Joint Ventures / Wholly Owned Subsidiaries shall not exceed 400%, or as amended by the Reserve Bank from time to time, of the net worth of the Indian Party as on the date of the last audited balance sheet and as per regulation 2(o) Net worth' means paid up capital and free reserves.
- Other conditions of regulation of 6(2)



Case study – III (con't)

- Regulation 6(6) deals with investment outside India in **existing company** that is required to be valued by a Category I Merchant Banker Registered with Securities and Exchange Board of India (SEBI), or an Investment Banker/Merchant Banker outside India registered with the appropriate regulatory authority in the host country, where investment is more than USD 5 (Five) million; and
- (ii) in all other cases, by a Chartered Accountant or a Certified Public Accountant.

Case study – III (con't)

Conclusion

Case(a)

- Thus, Indian party can invest upto 400% of net worth (i.e. capital and reserve) in JV or WOS outside India without prior approval of RBI.
- In the given case Indian Party is Indian company and net worth of the company is GBP 1,00,000 and investment to be made is also GBP 5,00,000 (which is 500% of its net worth). Thus it needs to take prior approval of RBI subject to condition specified in the regulation i.e.
 - (i) The direct investment is made in an overseas JV or WOS engaged in a bonafide business activity.
 - (ii) The Indian Party is not on the Reserve Bank's Exporters caution list /list of defaulters to the banking system circulated by the Reserve Bank or under investigation by any investigation /enforcement agency or regulatory body.
 - (iii) The Indian party has submitted its Annual Performance Report in respect of all its overseas investments in the format given in Part II of the Form ODI
 - (iv) The Indian Party routes all transactions relating to the investment in a Joint Venture/Wholly Owned Subsidiary through only one branch of an authorised dealer to be designated by it.
- B. Further, valuation by CA of Foreign company will be required since it is an existing company, which may take "considerable time".

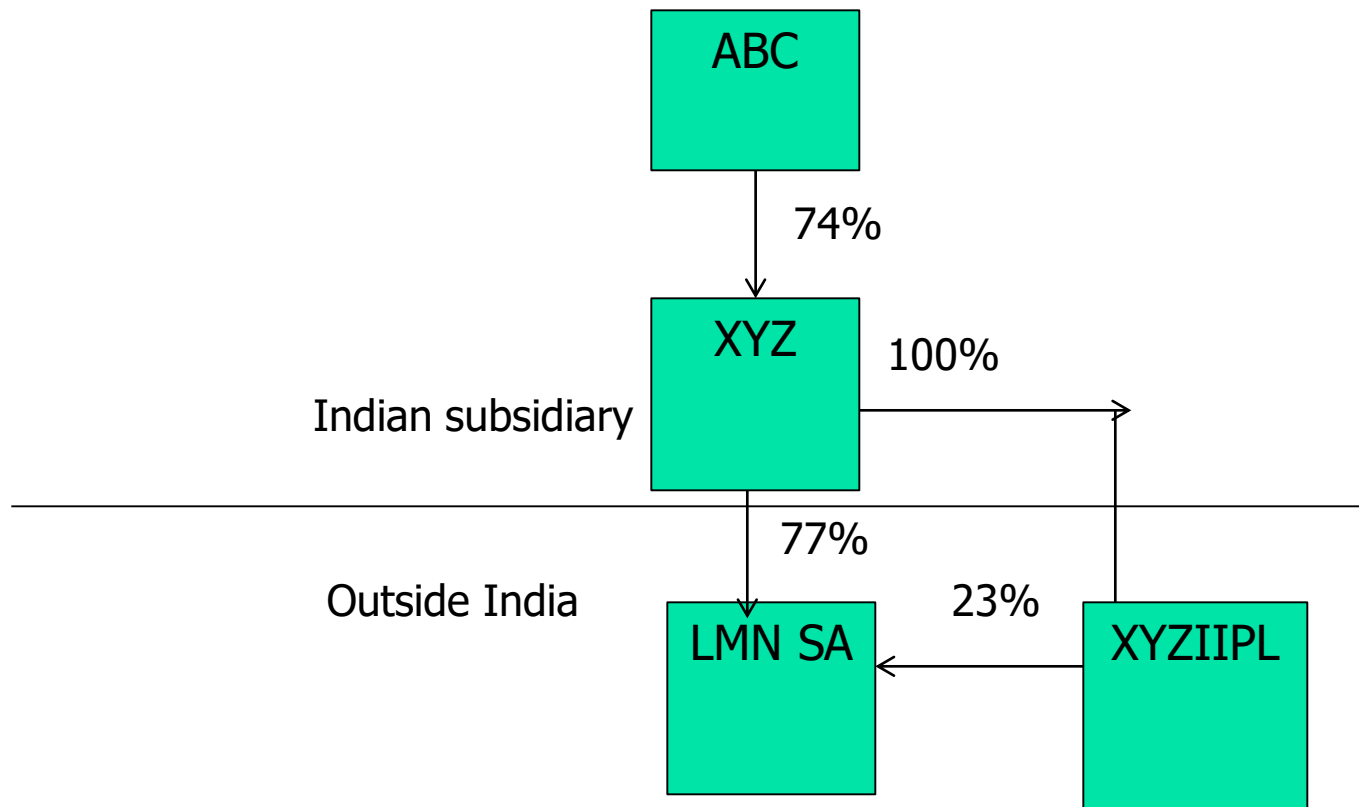
Case study - IV

Guarantee By PRII in favour Of Foreign Step Down Subsidiary

Background

- XYZ Limited (XYZ) is an Indian subsidiary of ABC Ltd. (ABC). ABC holds 74% stake in XYZ.
- LMN SA, Spain ('LMN') is a subsidiary of XYZ, where XYZ holds 77%. The balance 23% is held by XYZ International PTE Ltd (XYZIIPL), Singapore which is a wholly owned subsidiary of XYZ.
- AAA Bank India, had sanctioned a Euro 10 mn Non fund based (SBLC) facility at the request of XYZ in favour of AAA Bank Spain, who in turn had provided a Working capital facility of Euro 10 mn to LMN SA. The said facility was secured by way of a corporate guarantee by ABC.
- Due to RBI raising certain objection to the above arrangement, AAA Bank India has now sanctioned the Euro 10 mn Non fund based (SBLC) facility directly to LMN, Spain.
- The said facility is to be secured by way of a letter of Comfort from XYZ & a Corporate guarantee by ABC

Case study – IV (con't)





Case study – IV (con't)

Question for consideration

Based on discussions with the ABC, the clarification is sought

- A. Whether ABC can extend corporate guarantee for the arrangement?
 - If No, Can you suggest a minimal requirement to do so?
- B. Whether LMN is a first level step down subsidiary or a second level step down subsidiary for Indian party that intends to issue a corporate guarantee to AAA Bank, India for the purpose of providing the facility for Euro 10mn to LMN?
- Leads: Notf. 8 on Guarantee
 - Notf. 120 on overseas investment
 - Definition of Indian Party



Case study – IV (con't)

Overview of Legal framework on Guarantees:

- Issue of guarantees by a PRII is regulated by RBI under Foreign Exchange Management (Guarantees) Regulations, 2000 issued under Notification No. FEMA 8/2000-RB dated 3rd May 2000 ('FEMA 8') as amended from time to time.
- Regulation 5(b) of FEMA 8 permits a company in India which is promoter of a JV / WOS outside India to give a guarantee to or on behalf of the JV / WOS in connection with its business subject to the terms and conditions stipulated in Foreign Exchange Management (Transfer or Issue of any Foreign Security) Regulations, 2000.



Case study – IV (con't)

Overseas Investments:

- Direct Investments outside India are regulated by RBI under Foreign Exchange Management (Transfer or Issue of any Foreign Security) Regulations, 2000 issued under Notification No. FEMA 120/2000-RB dated 7th July 2004 ('FEMA 120') as amended from time to time. The procedural instructions are issued by the RBI vide A.P. (DIR Series) Circulars from time to time. Various existing instructions are consolidated vide Master Directions No. 15/2015-16 dated Jan. 01, 2016 as updated from time to time, on Direct Investments by Residents in Joint Ventures and Wholly Owned Subsidiaries abroad.
- **Relevant provisions regarding Financial Commitment under FEMA 120:**
- Regulation 6 specifies the conditions for Overseas Direct investments under the automatic route.
- In terms of Regulation 6(2) of the Notification, an Indian party has been permitted to make total financial commitment in overseas Joint Ventures (JV) / Wholly Owned Subsidiaries (WOS), not exceeding 400 per cent of the net worth as on the date of its last audited balance sheet

Case study – IV (con't)

Relevant provisions of the Master Direction: [Also Reg. 6(2)(i)]

'Financial Commitment':

- As consolidated by the aforesaid Master Direction in its Para B.1 (3), for the purpose of determining the 'total financial commitment' within the limit of 400% as specified above, the following shall be reckoned, namely:
 - 100% of the amount of equity shares;
 - 100% of the amount of compulsorily and mandatorily convertible preference shares;
 - 100% of the amount of other preference shares;
 - 100% of the amount of loan;
 - 100% of the amount of guarantee (other than performance guarantee) issued by the Indian party;
 - 100% of the amount of bank guarantee issued by a resident bank on behalf of JV or WOS of the Indian party provided the bank guarantee is backed by a counter guarantee / collateral by the Indian party.
 - 50% of the amount of performance guarantee issued by the Indian party provided that the outflow on account of invocation of performance guarantee results in the breach of the limit of the financial commitment in force, prior permission of the Reserve Bank is to be obtained before executing remittance beyond the limit prescribed for the financial commitment.



Case study – IV (con't)

- As provided in the Explanation to Regulation 6(3), an Indian Party may offer to a person resident outside India any form of guarantees, that is, corporate or personal / primary or collateral / guarantee by promoter company in India / guarantee by group company, sister concern or associate company in India, provided that:
 - a) total 'financial commitment' including all forms of guarantees remains within the overall ceiling stipulated for overseas investment by an Indian Party and
 - b) no guarantee is 'open ended'
- Definition of Net worth:
- Net worth has been defined in Regulation 2(o) of the said Notification as paid-up capital and free reserves.
- Indian Party has been defined in Regulation 2(k) as under:
- "Indian party" means a company incorporated in India or a body created under an Act of Parliament or a partnership firm registered under the Indian Partnership Act, 1932 or a Limited Liability Partnership (LLP) as defined under clause (ma) of Regulation 2 of this Notification making investment in a Joint Venture or Wholly Owned Subsidiary abroad, and includes any other entity in India as may be notified by the Reserve Bank;
- Provided that when more than one such company, body or entity make an investment in the foreign entity, all such companies or bodies or entities shall together constitute the "Indian party".



Case study – IV (con't)

- Issue of Guarantee by Indian Party to step down subsidiary of JV / WOS:
 - As provided in regulation 6(4) of FEMA Notf. 120, (i) An Indian Party may extend a loan or a guarantee to or on behalf of the Joint Venture / Wholly Owned Subsidiary abroad, within the permissible financial commitment, provided that the Indian Party has made investment by way of contribution to the equity capital of the Joint Venture.
 - Notwithstanding the above regulation, the following shall also be permitted.
 - **(ii) An Indian Party may extend corporate guarantee on behalf of its first generation step down operating company or SPV within the prevailing limit for overseas direct investment.**
 - Explanation: Issue of corporate guarantee on behalf of second level or subsequent level step down operating subsidiaries will be considered under the Approval Route, provided the Indian Party indirectly holds 51 per cent or more stake in the overseas subsidiary for which such guarantee is intended to be issued."

Case study – IV (con't)

- **Applicability to the case study:**
- As provided in Regulation 2(k) of FEMA 120, when more than one Indian company, body or entity make an investment in the foreign entity, all such companies or bodies or entities shall together constitute the "Indian Party". Accordingly, when more than one Indian company has participated in the investment in a foreign entity, all such Indian companies jointly constitute "Indian party". If 100% ownership of the foreign entity is held by such multiple Indian companies comprising the "Indian Party", the foreign entity will be in the nature of a wholly-owned subsidiary of the "Indian Party" and not a joint venture between the companies comprised in the "Indian Party". Thus FEMA does not seek to distinguish between the various entities located within India or the group structure in India but is concerned with the structure of the entities set up outside India. Under FEMA, the concept of JV / WOS and step down entities refers only to foreign entities and not to a wholly owned subsidiary in India which is part of the Indian Party.
- e.g. If Co. A is the holding company of Co. B in India and they both invest in a foreign entity Co. C, then, keeping in view the definition of "Indian Party" both Co. A and Co. B shall be the "Indian Party" and Co. C shall be its wholly-owned subsidiary abroad ('WOS'). Since Co. C is an WOS, it cannot be considered as first level step down subsidiary under FEMA even though it is a step down subsidiary for Co. A as per company law.



Case study – IV (con't)

In the instant case, XYZ, the Indian Party, is the holding company of LMN, which it has promoted along with XYZIPL. As LMN has direct investment from XYZ, it is a JV / WOS of the Indian Party and not a first level step down subsidiary. In case LMN had received entire investment from XYZIPL, it would have been construed as a first level step down subsidiary of XYZ. However, given the shareholding pattern of LMN, there is no issue whatsoever that it is a JV / WOS of Indian Party and not a first level or second level step down subsidiary.

- As regards extending corporate guarantee on behalf of LMN, it would be permissible under Regn. 6(2)(i)(c) of FEMA 120 within the financial commitment of 400% of the net worth of the Indian Party. As this is a direct case of Indian Party extending guarantee on behalf of its JV / WOS, it does not fall under provisions regulation 6(4)(ii) of FEMA notf. 120 that is applicable to first level and second level step down subsidiaries. Thus the Indian Party can extend the said guarantee under Regn. 6(2)(i)(c) without attracting the provisions relating to first or second level step down subsidiaries.



Case study – IV (con't)

Applicability to case study:

- Q. (a) Whether guarantee can be issued by ABC Ltd.
- Ans. (a) Since ABC is an India party, guarantee can be extended by it. However in view of the language used in the Notf. about who can provide loan or guarantee, it is advisable to make a small investment by ABC along with XYZ in to LMN ,in order to avoid any issue of contravention in future



Case study – IV (con't)

Applicability to case study:

- Q. (b) Whether LMN is a first level step down subsidiary or a second level step down subsidiary for Indian party that intends to issue a corporate guarantee to AAA Bank, India for the purpose of providing the facility for Euro 10mn to LMN?
- A. (b) As discussed in detail , LMN has received direct investment from the Indian Party, it shall be regarded as an JV / WOS of such Indian Party and not a step down subsidiary and guarantee can be extended under Regn. 6(2)(i)(c) of FEMA 120 within the limit of 400% of net worth without attracting the provisions & restrictions relating to step down subsidiaries. Further, even If LMN was an 100% subsidiary of XYZIPL, only in that case would it would be considered as 1st level step down subsidiary of the Indian Party and guarantee could be extended by such Indian Party under the automatic route as provided under regulation 6(4)(ii)of Notf. 120. Thus in no case is LMN a second level subsidiary which would have necessitated RBI approval for guarantee by Indian Party.



FACTOR AFFECTING OVERSEAS INVESTMENT

- General Factors
- Corporate Factors
- Tax Factors
- KYC & Bank Accounts



General Factors

The selection of the most suitable jurisdiction for either international trade or investment can often be difficult and requires very careful consideration. It is important to select a jurisdiction that is well suited to specific corporate and personal needs and it should meet the following criteria :-

- 1) Political and Economic Stability
- 2) Legislation
- 3) Basic Desirable Corporate Characteristics
- 4) Professional Infrastructure
- 5) Comparison of Company Law
- 6) Time Zone
- 7) Market globalization and deregulation
- 8) The Internationalization of business
- 9) The lifting of trade barriers
- 10) A trend towards steady global economic growth
- 11) Global relaxation of foreign exchange controls



Corporate Factors

1. Limited Liability
2. Directors liability [local]- directors are generally responsible for the acts of a company and its beneficial owners
3. Minimal or optional statutory filing obligation
4. Nominee shareholders allowed
5. The availability of bearer shares
6. Disclosure of beneficial ownership
7. Low capital requirements
8. Directors and/or shareholders meetings anywhere in the world
9. Audit requirements – optional or mandatory
10. On shore/Off shore business – facility
11. Redomiciliation



Tax Factors

1. To be relatively simple to set up and operate
2. To rely only upon a provision or an interpretation accepted by the revenues
3. Credible commercial basis / Principle Purpose Test / Limited LOB - MLI
4. To make possible a full reporting of all income and expenses and audited accounts
5. To avoid the use of a objectionable/ blacklisted device or location – Applicability of relevant special anti-avoidance regulations (SAAR) in the Treaty and provisions of GAAR in provisions of domestic law
6. Usually, to result in the payment of some tax, though significantly less tax under the structure than would be payable if it was not used
7. Double Taxation Agreements including the impact of recent mandatory standard on related action points accepted by Treaty Partners
8. Impact of TIEA
9. Taxation of Digital Payments



KYC & Bank Accounts

- Brief CV of shareholders who are individuals with identity proof of Residence
- Bank Reference
- Practice issues

ODI in select foreign jurisdictions – A comparison of Corporate features

	Dubai (DIFC) LLC Company	Mauritius GBC1 Company	Singapore Private Company
Liability of shareholders	Limited	Limited	Limited
Minimum number of shareholders	1	1	1
Maximum number of shareholders	Unlimited	Unlimited	50
Restriction on nationality/residency of shareholders?	None	Should not be resident of Mauritius	None
Corporate shareholders allowed?	Yes	Yes	Yes
Minimum number of directors	1	1	1
Restriction on nationality/residency of directors?	None	Majority of Mauritius resident directors is needed to obtain GBC1 license	At least 1 director should be an individual resident in Singapore
Local director requirement?	No	No	Yes at least 1

ODI in select foreign jurisdictions – A comparison of Corporate features (con't)

	Dubai (DIFC) LLC Company	Mauritius GBC1 Company	Singapore Private Company
Corporate directors allowed?	No	No	No
Shareholders' meeting requirement?	Yes	Yes	Yes, but can be waived
Shareholders' meetings location	Dubai DIFC	Anywhere	Anywhere
Minimum capital requirement	US\$1	US\$1	S\$1
Registered office needs to be in the country?	Yes	Yes	Yes
Company secretary/registered agent requirement?	Yes	Yes	Yes
Restrictions to foreign investors?	None	None	None
Time needed for registration	4 - 6 weeks	15 - 20 days	1 - 2 days

ODI in select foreign jurisdictions – A comparison of Tax features

	Dubai	Mauritius	Singapore
Corporation tax rate(s)	0%	- GBC1 companies at 15% - GBC2 companies at 0% - Other companies at 15% (Alternative Minimum Tax may apply)	17% but 75% of the first SGD 10,000 and 75% of the next SGD 290,000 are exempt
Capital gains tax rate(s)	0%	0%	0%
Capital losses	Not tax-deductible since capital gains are not taxable	Not tax-deductible since capital gains are not taxable	Not tax-deductible since capital gains are not taxable
Taxable period	N/A - no tax for Dubai DIFC companies	Calendar or accounting year	Calendar or accounting year
Tax return requirement	No	Yes	Yes
Tax return due date	N/A - No requirement for tax return	6 months after the tax year-end	30/11 of the following year

ODI in select foreign jurisdictions – A comparison of Tax features (con't)

	Dubai	Mauritius	Singapore
Tax residency requirements	Registered in Dubai DIFC and management and control exercised in Dubai	Management and control to be exercised in the Mauritius	Management and control to be exercised in Singapore
Tax rate on dividends from local investments	0%	0%	0%
Tax rate on dividends from foreign investments	0%	- GBC1 companies - 3% - Other companies - 15% (or Alternative Minimum Tax)	0% if the foreign tax burden is at least 15% and the tax has been paid. Otherwise corporation tax rates apply
Withholding tax on dividend payments to foreign shareholders	0%	0%	0%

ODI in select foreign jurisdictions – A comparison of Tax features (con't)

	Dubai	Mauritius	Singapore
Tax rate on interest income	0%	- GBC1 companies - 3% - Other company types - 15% (or Alternative Minimum Tax)	17%
Withholding tax on interest payments to foreign recipients	0%	- GBC1 companies - 0% - Other companies - 15%	15%
Tax rate on royalty income	0%	- GBC1 companies - 3% - Other company types - 15% (or Alternative Minimum Tax)	17%
Withholding tax on royalty payments to foreign recipients	0%	- GBC1 companies - 0% - Other companies - 15%	10%
Taxability of disposal of shares by foreign shareholder	No	No	No



Thank You
