CROSS BORDER TRANSACTIONS – DECODING PRACTICAL ISSUES IN OVERSEAS DIRECT INVESTMENTS UNDER FEMA

CA Viral Satra
Email : viral@shahmodi.com

Introduction:

A cross border transaction is basically any transfer of property, goods or services between individuals or business entities who reside in various jurisdictions. The transaction may be either of buying or selling or goods or receipt of provision of services or even making investments or entering into joint ventures. Under FEMA transactions are classified under two categories i.e. Capital Account Transactions and Current Account Transactions. In both cases the transactions happen between persons resident of India and persons resident of other countries.

In this article we will deal with practical issues involved in transaction of Overseas Direct Investment (ODI). ODI is a capital account transaction. Let's understand briefly what a Capital Account Transaction means? As per Section 2(e) of FEMA 1999, Capital Account transaction *means a transaction which alters assets or liabilities including contingent liabilities, outside India of person resident in India or assets and liabilities in India of persons resident outside India and includes transactions referred to in sub-section (3) of Section 6.*

Thus, when assets or liabilities outside India for a person resident in India get altered then the transaction is a capital account transaction. Say for example when a resident person acquires equity shares of a foreign entity in that case his assets outside India get altered and hence the same is considered to be a capital account transaction. Therefore, in case of ODI either a resident person incorporates an entity outside India or acquires stake in entity outside India. Since ODI happens between persons of two jurisdictions i.e. India and countries outside India it is a type of cross border transaction.

Practical Issues in ODI

Central Government vide notification dated 22nd August 2022 notified new Foreign Exchange Management (Overseas Investment) Rules 2022 ("OI Rules") which superseded the Foreign Exchange Management (Transfer or Issue of Any Foreign Security) Regulations, 2004. Any ODI made by a person resident in India is guided by provisions of OI Rules 2022.

ODI in terms of Rule 2(q) of OI Rules means –

With the new provisions in place let us understand few practical issues being faced in ODI:

A. Whether ODI can be made in LLC or LLP outside India?

Under erstwhile provisions direct investment outside India could be made by way of contribution to capital or subscription to MOA of foreign entity or by way of purchase of existing shares of foreign entity. Foreign entity was however not defined anywhere in erstwhile provisions. Therefore, there was no clarity whether ODI could be made in foreign entity having unlimited liability like partnerships or LLCs which is nothing but a hybrid unincorporated business structure that combines characteristics of corporation with those of partnerships and sole proprietorships.

In new provisions of OI Rules, Rule 2(f) defines foreign entity as *entity formed or registered or incorporated outside India including International Financial Service Centres that has Limited Liability*.

This is further explained in Para 1 of Part I of Overseas Investment Directions. As per Para 1 of OI Directions, Limited Liability means a structure such as a limited liability company, limited liability partnerships etc. where liability of the person resident in India is clear and limited. Thus, LLCs or LLPs formed or registered or incorporated outside India are considered to be foreign entities and ODI can be made in such foreign entities. The ambiguity which was prevalent in erstwhile provisions has been clarified in the new provisions.

B. Whether Deferred Consideration and ODI in company having shares with NIL PAR value allowed?

Deferred Consideration:

Deferred Consideration is a term used to refer to the consideration that will or may be payable sometime in the future rather than at time of completion of transaction. Deferred consideration is usually encountered in connection with asset and share sales.

In erstwhile provisions of ODI, deferred consideration was not allowed under automatic route. Further the same was not allowed even after obtaining prior RBI approval. In many countries specially UAE they issue Share Certificates immediately upon incorporation of company whereas the actual remittance for subscription usually goes only after bank account is opened. This resulted in consideration getting deferred resulting in contravention as per erstwhile provisions. RBI considered the same as contraventions and matters were required to be compounded. In genuine scenarios the investor did not have any intention to receive share certificates without sending remittances. But host countries regulations were such that they were left with no choice but to receive the share certificates even if the shares were not subscribed.

Therefore, with intention to provide relief to investors and government decided to relax the provisions and thereby allowed deferred consideration by dispensing away the requirement of prior approval for same. Now as per Regulation 7 of Overseas Investment Regulations 2022 ("OI Regulations") payment for subscribing to equity shares of overseas entity can be deferred for such definite period as agreed from the date of agreement. The person making investment has to enter into agreement at the time of transfer of foreign securities and agree upon a period upto which the consideration will be deferred. Further the consideration has to be determined up front and has to be in compliance with pricing guidelines.

Despite relaxing the provisions, the contravention of deferred consideration are still taking place. This is because as per the new provisions if a person resident of India agrees to make Financial Commitment in an overseas entity then such person has to file Form ODI for such financial commitment immediately irrespective of whether or not remittance is being made. In such cases since remittance is not taking place immediately the same results in deferment of consideration. Regulation 10(2)(a) of OI Regulations clearly specifies that a person who has made ODI or financial commitment shall report the same either at time of financial commitment or at time of making remittance whichever is earlier. In case where remittance is to be sent at later stage then if Form FC is not filed the same is then considered as delay in filing of Form FC resulting in levy of Late Submission Fees ("LSF").

Further, in such cases if share certificates are also received then one more additional contravention of deferment of consideration takes place. AD Banks are suggesting for making necessary compliances for deferred consideration and getting Form FC filed twice, one for financial commitment and one for actual remittance. Therefore, one has to be very careful and ensure that moment they agree for any financial commitment in overseas entity whether or not remittance is being made, Form FC needs to be filed immediately and necessary documents for deferred consideration also need to be submitted in compliance of regulation 7 of OI Regulations.

NIL PAR Value Shares:

In USA it is seen that companies do not have any face value to equity shares. The companies there can have equity shares with NIL Par Value. Now in such cases if a person resident in India subscribes to such equity shares having NIL Par value then at the time of receipt of shares no remittance will be made because the shares do not have any face value resulting in NIL consideration.

Again, in erstwhile provisions this transaction of subscription to shares having NIL Par Value was not allowed under automatic route and even the provisions had no reference for the same. Hence such transactions required prior RBI approval. Now with concept of deferred consideration being allowed in new provisions, once can say that as and when the person agrees to subscribe or purchase the shares having NIL Par Value then one must ensure that he or she complies with provisions of Regulation 7 of OI Regulations. As and when the shares are acquired Form FC can be filed and at that time only the period after which the consideration will be paid for such NIL par value shares will be required to be decided along with pricing which also being determined upfront.

C. Valuation of shares for secondary transfer or fresh allotment by company

As per Rule 16 of OI Rules, issue of transfer of equity capital shall be subject to a price arrived on an arm's length basis as pert valuation obtained as per any internationally accepted pricing methodology. Thus, whether it is issue of equity shares or transfer of equity shares, in either of cases obtaining of valuation certificate is mandatory. However, the provisions do not specify or mention the period of validity of the valuation report so obtained.

AD Banks are taking a view that in case of ODI, valuation report is valid for 6 months. Again, there is ambiguity as to the period of 6 months has to be calculated whether from date of valuation or whether from date of signing of report. Say for e.g. if fair valuation is arrived as on 31st March 2023 and say report is signed on 31stJuly 2023. Now the actual transaction takes place on 31st October 2023. Now the question arises as to from which date 6 months needs to be calculated. If 6 months are calculated from date of valuation which is 31st March 2023 then the report should be valid on till 30th September 2023. In this case transaction being done after 6 months the report would be considered as invalid. However, if the 6 months are calculated from date of signing of report which is 31st July 2023, then still 6 months are time is not over and hence report should be considered as valid.

Different are being taken by different AD Banks. Some consider date of valuation and some consider date of signing as base date for calculation of 6 months period. RBI however needs to provide clarity on the same.

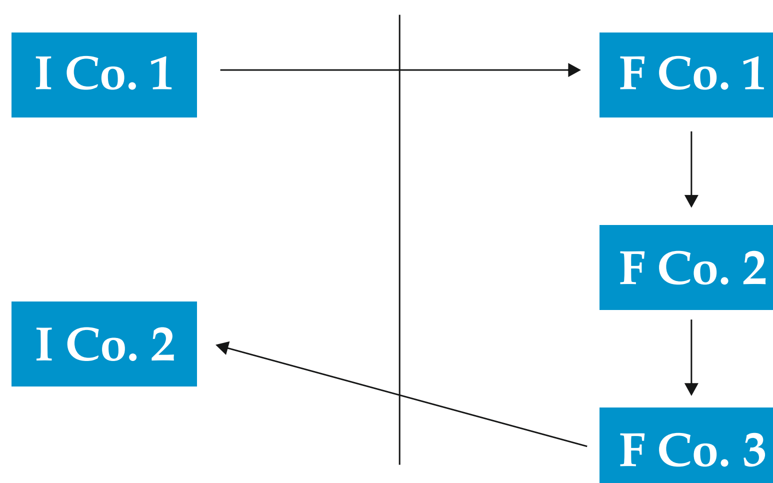
D. Round Tripping

Another important issue on which government has tried to give some clarity. Round Tripping is nothing for bringing Indian funds back to India via investments outside India. FD-ODI structures are nothing but round tripping of funds. In erstwhile provisions round tripping was not allowed. all such type of structures required prior approval.

However, the provisions relating to round tripping are relaxed and now allowed upto two layers of investment in India. As per Rule 19(3) of OI Rules, *no person resident in India shall make financial commitment in a foreign entity that has invested or invests into India, at the time of making such financial commitment or at any time thereafter, either directly or indirectly, resulting in a structure with more than two layers of subsidiaries.*

Now the question arises as to from where the counting of two layers should start. Whether it should start from India or whether it should start from first foreign entity which in turn has step down investment or whether it should start from first step down subsidiary and so on.

Now subsidiary as per 2(y) of OI Rules is defined as subsidiary or step down of a foreign entity means an entity in which the foreign entity has control. So if foreign entity does not have control in any of its step down company it will not be treated as subsidiary. Going by the provisions of Rule 19(3) the counting of number of layers of subsidiaries will start from below the foreign entity.



Now in above example, I Co. 1 has made ODI in F Co. 1 which is main foreign entity. F Co. 1 has two step down subsidiaries viz. F Co. 2 and F Co. 3 and it has control in both. And F Co. 3 in turn has made investment back into India. So, the calculation of two layers of subsidiaries will start from subsidiaries below F Co. 1 because F Co. 1 is main foreign entity in which I Co. 1 has made ODI. First layer subsidiary is F Co. 2 and second layer is F Co. 3. After F Co. 3 there is no other layer of subsidiary outside India. F Co. 3 has made investment in I Co. 2. Thus, the above structure is a permissible one as per Rule 19 of OI Rules where F Co. 1 does not have more than two layers of subsidiaries for making of investment back into India.

E. Requirement of Audited Accounts for filing of Annual Performance Report(“APR”)

This is another important issue which is faced at the time of filing of APR. As per Regulation 10(4) of OI Regulations, APR is required to be filed every year before 31st December based on audited financial statement of overseas entity if person resident in India has control in foreign entity. Thus, if a person has control in foreign entity then even if host country laws do not mandate for audit of overseas entity still for purpose of filing of APR one will require to get the accounts audited.

This mandatory requirement of audit for entities in jurisdictions where audit is not mandatory is posing lot of challenges to investors because they are not getting audited financials for doing APR compliance. In erstwhile provisions it was mentioned that if laws of host country did not mandate for audit then APR can be submitted basis certification from statutory auditor of Indian entity. However, in new provisions this can be done in case when person resident in India does have control in foreign entity and if laws of host country do not provide for mandatory auditing of books only then APR may be submitted basis unaudited financial statements certified as such by statutory auditor of Indian entity or by a chartered accountant.

Now in case where audit is to be done only for purpose of APR, the question arises whether it needs to be compulsorily done by CPA from host country or whether it can be done by an Indian Chartered Accountant. AD Banks in many cases are allowing the companies to get the audit done from Indian Chartered Accountants based on request of customer. There is no specific format of audit report prescribed by ICAI for specific purpose audits. Since the audit of foreign entity will be done specifically for limited purpose of submission of APR once can refer to Illustration 5 for format of audit report on financial statements prepared in accordance with general purpose compliance Framework in SA 700 (Revised) – Forming an opinion and reporting on Financial Statements.

F. Issue of Employee Stock Option Plans (ESOP)

As per para 3 of Schedule III of OI Rules, a resident individual who is an employee or a director of an office in India or branch of an overseas entity or a subsidiary in India of any overseas entity or of an Indian entity in which the overseas entity has direct or indirect holding, is allowed to acquire shares under ESOP scheme offered by such entity globally on an uniform basis. Acquisition of shares under ESOP scheme of less than 10 percent of foreign entity shall be treated as Overseas Portfolio Investment (“OPI”) for resident individual.

AD Banks allow remittances to be made towards acquisition of shares acquired under in overseas entity under the scheme. There is no limit on the amount of remittance made towards acquisition of shares / interest under ESOP scheme, such remittances shall be reckoned towards LRS limit of individual. In case investment is of less than 10% it will be OPI and necessary reporting in Form OPI shall be done by the employer concerned in accordance with Regulation 10(3) of OI Regulations. Form OPI is to be filed within 60 days from end of half year. If such investment qualifies as ODI then Form FC is to be filed by concerned resident individual.

When remittance for acquisition of shares under ESOP is made by resident individual himself the same will be done under LRS Limit of USD 2,50,000 and Tax Collected at Source ("TCS") @ 20% will be collected by bank making the remittance. If however, Indian company makes payment for acquisition of shares under ESOP on behalf of employee to foreign entity then same will be considered as reimbursement of expenses for Indian company and there will be no TCS at time of remittance. Further the amount paid by Indian company will be considered to be as perquisite for employee and TDS will be deducted by Indian company on such perquisite.

ESOP will be taxed in two stages. Firstly when an employee exercises his option at the exercise price and thereafter, when shares are sold. In first stage, difference between the exercise price and the fair value of shares will be taxable as perquisite in the hands of employee and employer deducts TDS on such perquisite. When shares are disposed off they will attract capital gains tax which can be either short term or long term depending upon period of holding.

Conclusion

Even though Central Government has provided many relaxations under new provisions, some of practical issues pose challenges before the investors thereby resulting in unnecessary delays in compliances. Sometimes AD Banks take so much of time for processing of transactions that the transaction becomes commercially unviable for investors. May be with passage of time these practical issues will also get settled resulting in ease of doing transactions and quick disposal of applications at AD Bankers end.