Expansion into overseas markets
The tax and regulatory framework

As the Indian GDP grows, the Indian industry continues to expand across the global, supplemented by digitalization. In recent years, there's been an increase in Indian investments in foreign countries in the form of Indian industries opening places of business – subsidiaries and joint ventures outside India. According to the Department of Economic Affairs[1], the actual Overseas Direct Investment (ODI) outflow from April 2000 to July 2023 stood at USD 2,88,920 million, of which FY 2021-22 has seen an actual ODI outflow of USD 18,066 million. The top country of choice for ODI has been Singapore, followed by the USA and the UK. Easier access to technology, research and development, a wider global market, reduced cost of capital and other benefits increase the competitiveness of Indian entities and boost their brand value.

"Overseas Direct Investment" or "ODI" means investment in or acquisition of unlisted equity capital of a foreign entity or investment in 10% or more of the paid-up equity capital of a listed foreign entity. It also includes investment of less than 10% in a listed entity if such investment is with control in the foreign entity.

Indian investors keen to invest abroad are required to undertake a few compliances under various laws in India. As Indian investors are remitting their funds outside India with the objective of earning income outside India, two important laws to be complied with are the 'Foreign Exchange and Management Act, 1999' (FEMA) and the 'Income-tax Act, 1961' (IT Act). Any non compliances under these laws can attract hefty penalties and hinder the ease of doing business. This article enumerates some relevant aspects of these laws.

1. Monthly Fact Sheet for December 2023 available on https://dea.gov.in/overseas-direct-investment

Some provisions of Foreign Exchange and Management Act, 1999 (FEMA)

The RBI governs ODI, since overseas investments result in outflow of Indian foreign exchange and it announced a revised ODI policy on 22 August 2022. The ODI framework consists of Rules, Regulations and Directions as follows:

- Foreign Exchange Management (Overseas Investment) Rules, 2022
- Foreign Exchange Management (Overseas Investment) Regulations, 2022
- Foreign Exchange Management (Overseas Investment) Directions, 2022

Who can invest outside India?

An Indian entity may make an investment outside India. Indian entity includes a company formed under the Companies Act 2013, or a body corporate incorporated by any law for the time being in force or a Limited Liability Partnership formed under the Limited Liability Partnership Act, 2008 or a partnership firm registered under the Indian Partnership Act, 1932.

A resident individual may also make ODI by way of investment in equity capital or Overseas Portfolio Investment (OPI).

The foreign entity should be an operating entity not engaged in financial services activity. A foreign entity having individual investment cannot have step-down subsidiaries where the individual has control in the foreign entity.

Manner of making ODI and the pricing

An Indian Entity may invest in any of the following modes:

- Subscribe to the memorandum
- Acquire or purchase the shares of a foreign entity
- By way of rights issue or allotment of bonus shares
- The swap of securities
- Merger, demerger, amalgamation or any scheme of arrangement as per the applicable laws
- Capitalization of any amount due towards the Indian entity from the foreign entity subject to certain conditions.

Detailed instructions and conditions have been provided for each of the above modes of investment.

A resident individual may also acquire shares in overseas entities through inheritance, gift, acquisition of sweat equity shares, shares or interest under Employee Stock Ownership Plan or Employee Benefits Scheme subject to compliance with FEMA.

Further, pricing guidelines have been provided for the acquisition of shares by an Indian entity. The transfer of shares by a non-resident to a resident or by a resident Indian party to a non-resident may be made at arm's length, determined according to the internationally accepted pricing methodology for valuation.

Amount of ODI

The total financial commitment (FC) made by an Indian entity in all the foreign entities taken together at the time of undertaking such commitment should not exceed 400% of its net worth as of the date of the last audited balance sheet. Financial Commitment includes the total investment made in ODI, debt advanced, and non-fund-based facilities (e.g. Guarantees) extended by the Indian entity to all its foreign entities.

The investment by a resident individual is subject to the overall ceiling under the Liberalised Remittance Scheme, i.e., USD 250,000.

Any FC exceeding the aforesaid limit is subject to RBI approval.

Financial commitment in the form of debt

An Indian entity may advance a debt to a foreign entity in which it has made ODI and has acquired control in such a foreign entity. Such loans must be duly backed by a loan agreement, and the rate of interest shall be charged on an arm's length basis.

Financial commitment in the form of a guarantee

Guarantees may be issued on behalf of the foreign entity or its step down subsidiary in which the Indian entity has acquired control. Guarantee may be in the form of a corporate guarantee or a performance guarantee, personal guarantee by resident individual promoter or bank guarantee backed by collateral or a counter-guarantee by the Indian entity or group entity issued by an Indian bank. Guarantee cannot be open-ended.

Where a guarantee has been extended jointly and severally by two or more Indian entities, 100% of the amount of such guarantee shall be reckoned towards the individual limits of each of such Indian entities for the purpose of FC limit. In the case of a performance guarantee, 50% of the amount of the guarantee is reckoned towards the FC limit.

Unique Identification Number (UIN)

Every foreign investment is required to be reported to the RBI through the AD banker and an UIN is required to be obtained. An application in Form FC may be made along with the requisite documents to the AD banker for allotment of UIN on or before making an ODI. The UIN signifies taking a record of the investment for maintaining the database, however, it is not an approval of the RBI for the investment. Any remittance towards a foreign entity can be allowed by the AD bank only after obtaining the necessary UIN for such entity.

Other filings under FEMA

A person making an ODI is required to submit a copy of the share certificate with the AD banker. Furthermore, such person also needs to file the Annual Performance Report (APR) with the AD banker for each foreign entity by 31 December every year and where the accounting year of such foreign entity ends on 31 December, the APR shall be submitted by 31 December of the next year.

Divestment of ODI by way of sale

The Indian entity may transfer its shares held in an overseas entity subject to complying with the following conditions:

- It does not result in any write-off of the investment made
- Such transfer must be at arm's length price
- The Indian entity does not have any outstanding dues from the foreign entity
- Foreign entity must be an operating entity for at least one year and relevant documentation is completed
- The Indian entity is not under investigation by any Indian regulatory authority
- The Indian entity is required to realize and repatriate to India all dues receivable from the foreign entity with respect to its investment therein within 90 days from the date when such receivables fall due or the date of such transferor divestment, etc.

Relevant provisions under the Indian Income-tax law

The foreign entity is likely to qualify as an associated enterprise and hence, the transfer pricing provisions shall apply. The transactions between the entities need to be at arm's length.

Further, the income received from a foreign subsidiary or joint venture by the Indian entity could be in the form of dividends, royalties, service fees and interest. Such income may also be taxed in the source foreign country subject to the provisions of the tax treaty between the two countries. The Indian entity may be eligible to claim credit of the taxes paid in the source country against its tax liability on the same income in India. Such credit is subject to the provisions of the relevant tax treaty and the rules under the Indian Income tax law. Furthermore, the credit cannot exceed the tax liability in India on the same income.

Lastly, the transfer of investment in foreign entities is taxable as capital gain. It is recommended to make the transfer at fair market value as prescribed under the Income tax law. Should the transfer be lower than the prescribed fair market value, then the differential is taxable in hands of both the transferor and the purchaser.

Conclusion

ODI has gained significant momentum and has helped Indian entities enhance their brand value. However, it does require careful adherence to various laws and regulations. As ODI involves the outflow of foreign currency from India, it is closely monitored by RBI. It thus becomes necessary to keep an eye on the latest rules and regulations and consult legal and financial experts promptly.

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Our multidisciplinary teams serve a wide range of industries, with a specific focus on healthcare, food processing, and banking and financial services. Over the last decade, we have built and leveraged capabilities across key global markets to provide transnational support to numerous clients.

From inception, our founders have propagated a culture that values professional standards and personalized service. An emphasis on collaboration and ethical conduct drives us to serve our clients with integrity while delivering high quality, innovative results. We act as partners to our clients, and take a proactive stance in understanding their needs and constraints, to provide integrated solutions. Quality at Nexdigm is of utmost importance, and we are ISO/IEC 27001 certified for information security and ISO 9001 certified for quality management.

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