

## **Katalyst Kaleidoscope**

August 2022: Overseas Investment Regime

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### Ministry of Finance Notification dated August 22, 2022 and RBI Notification dated August 22, 2022

The Overseas Investment regime has undergone several changes in terms of the two notifications mentioned above. For sake of simplicity of understanding, the references are made to the “Existing ODI regime” and “New Overseas Investment Regime (new OIR)”.

The RBI had published draft rules/regulations on August 9, 2021 regarding Overseas Direct Investment (‘ODI’)/ Overseas Portfolio Investment (‘OPI’) and sought feedback on the same (‘Draft ODI Rules’). After receiving feedback on the Draft ODI Rules, the Central Government and the Reserve Bank of India announced the new OIR on August 22, 2022.

Given below are some important aspects of the new OIR along with appropriate comments wherever there have been changes compared to the Existing ODI regime.

#### 1. Investment by Indian Entity (IE) in Equity Shares

##### a. General Conditions:

The total financial commitment made by IE in all foreign entity *shall not exceed 400 percent of its net worth* as on the date of the last audited balance sheet. The “net worth” definition seems to be linked to a stand alone entity as opposed to a consolidated situation including subsidiary under the Existing ODI regime; the implication of this would be that the base of 400% would be truncated. This seems unintended.

##### b. Investment into Non-Financial Services Sector:

- i. An IE may make ODI by way of investment in equity capital for the purpose of undertaking a *bonafide business activity*; “**Bonafide business activity**” shall mean any business activity permissible under any law in force in India and the host country or host jurisdiction, as the case may be.

##### c. Investment into Financial Services Sector:

- i. An IE **engaged in Financial Services Activity (FSA)** in India may make ODI in a foreign entity, which is directly or indirectly engaged in FSA, subject to following conditions:
  - the IE has **posted net profits during the preceding three financial years;**
  - the IE is **registered with or regulated by a financial services regulator in India;**

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- the IE has **obtained approval as may be required from the regulators of such FSA, both in India and the host country or host jurisdiction**, as the case may be, **for engaging in such financial services**.

This situation is more or less the same as under the existing ODI regime.

- ii. An IE not engaged in FSA in India may make ODI in a foreign entity, which is directly or indirectly engaged in FSA, **except banking or insurance**, subject to the condition that such IE has posted **net profits during the preceding three financial years**. This is a liberalization under the New OIR, since it is not there in the existing ODI regime.

### **d. ODI-FDI Structure (Round – tripping structure):**

- i. In May 2019, the RBI updated the Frequently Asked Questions in the existing ODI regime wherein question no. 64 clarified that the ODI Regulations dealing with transfer and issue of any foreign security to Residents do not permit an Indian Party to set up Indian subsidiary / subsidiaries through its foreign WOS or Joint Venture nor do the provisions permit an Indian Party to acquire a WOS or invest in JV that already has direct / indirect investment in India under the automatic route, and that any exemption sought from the said restriction would need prior approval through AD-Bank, before entering such transactions, which will be considered on a case-to-case basis, depending on the merits of the case.
- ii. As a welcome move, under the new OIR Rule 19(3) “Restrictions and Prohibitions”, IE’s can now make investment in foreign companies that have Indian subsidiaries (i.e., have an ODI-FDI structure without requiring prior RBI approval) subject to the condition that the entire investment structure not have more than 2 layers of subsidiaries. To that extent the round tripping issue seems to be addressed.

**Note** - Whilst the words “in India” are not mentioned explicitly in the OIR, however, a view can be taken that the layers of subsidiaries outside India should not be considered while determining computation of “two layers”. Accordingly, only the number of subsidiaries in the “Indian leg” should be considered for applying the restrictions.

### **e. Investment and Balance Sheet Restructuring:**

#### **i. Conditions for Transfer of shares of foreign Entity:**

- IE may divest the shares in foreign entity provided it is invested in the foreign entity for at least 1 year from the date of making overseas investment before making such transfer.
- Full disinvestment (other than liquidation) is permitted only when there are no equity/debt outstanding dues

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### ii. Conditions for restructuring of Balance sheet of foreign Entity:

- An IE is now permitted if it requires to restructure the balance sheet of its foreign entity (i.e., write off / diminution in value of investment) provided the foreign entity has made losses for previous 2 years as substantiated by its last audited balance sheet and such restructuring should not tantamount to diminution of total outstanding dues towards IE exceeding the proportionate accumulated losses.
- Further where the original investment made in foreign entity was more than USD 10mn or the amount of diminution exceeds 20% of total outstanding dues towards IE, diminution would need to be duly certified on **arm's length basis** by a valuer (certificate to be dated not more than 6 months prior to the date of transaction).

### f. Investment into Overseas Portfolio Investment :

Under the existing regime, OPI are not allowed by an Indian entity; this has been liberalized under the New OIR as explained below.

An Indian entity may make OPI which shall not exceed fifty percent of its net worth as on the date of its last audited balance sheet, subject to the following conditions:

- a listed Indian company may make OPI including by way of reinvestment
- an unlisted Indian entity may make OPI only in:
  - acquisition of equity capital by way of rights issue or allotment of bonus shares;
  - capitalisation, within the time period, specified for realisation under the Act, of any amount due towards the Indian entity from the foreign entity and the remittance of which is permitted under the Act or does not require prior permission of the Central Government or the Reserve Bank;
  - swap of securities;
  - merger, demerger, amalgamation or any scheme of arrangement as per the applicable laws in India or laws of the host country or the host jurisdiction, as the case may be.

**Note:** The reference in relation to an unlisted Indian entity, for making OPI only by way of rights issue or allotment of bonus shares seems to imply that an original investment by way of OPI can also be made since, otherwise, the question of getting entitled to rights issue or bonus issue does not arise

### g. Investment into IFSC:

- i. IFSC has been in focus of late, and the attempt appears to be to make IFSC a preferred destination, at least in certain situations. It is in this context that the changes need to be seen;

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the purpose appears to be partly to broad base and liberalise, and partly to clarify expressly certain aspects relating to IFSC.

- ii. It has been provided in the new OIR that a person resident in India may make Overseas Investment in an IFSC in India, within the limits provided in these rules.
- iii. A person resident in India may make Overseas Investment in an IFSC in the manner as laid down in Schedule I or Schedule II or Schedule III or Schedule IV (see Notes below), subject to following conditions:
  - in the case of an ODI made in an IFSC, the approval by the financial services regulator concerned, wherever applicable, **shall be decided within 45 days from the date of application complete in all respects, failing which it shall be deemed to be approved;**
  - an IE **not engaged in FSA** in India, making ODI in a foreign entity, which is directly or indirectly **engaged in FSA**, except banking or insurance, who **does not meet the net profit condition as required under these rules, may make ODI in an IFSC;**
  - a person resident in India may make contribution to an investment fund or vehicle set up in an IFSC as OPI;

**Notes:** (1) *Schedule I, II, III and IV refer respectively to ODI by IE, OPI by IE, Overseas investment by RI and Overseas investment other than by IE or RI.*

(2) *The aspects regarding deemed approval is very welcome and one hopes that this concept is extended to many other situations.*

- iv. A recognised stock exchange in the IFSC **shall be treated as a recognised stock exchange outside India for the purpose of these rules.**

### h. Pricing:

The existing ODI regime provides for a pricing floor in relation to inbound investment and pricing cap in relation to acquisition by a resident of shares in an Indian company from a non resident; the new OIR has done away with the pricing cap and floor and talks about an arm's length pricing as per the valuation done as per internationally accepted pricing methodology for valuation.

**Note:** Logically, the objective of RBI is to provide for minimum inflow in relation to inbound investment and cap an outflow where shares are purchased by a resident from a non resident; one would hope that it is clarified that arm's length pricing should be

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interpreted in accordance with this principle, and it is not required that the price should be exactly equal to the valuation which can be the interpretation on a literal reading of the provision.

### **i. Some other aspects:**

- i. In relation to a rights issue, it has been provided that a person resident in India may renounce such rights in favour of another resident, or even a non-resident.
- ii. Under the existing ODI regime, there is no definition of equity capital; however, under the new OIR, the term “equity capital” has been defined as meaning:
  - equity shares;
  - perpetual capital
  - irredeemable instruments
  - fully and compulsorily convertible instruments.

## **2. Investment by Resident Individuals (RI)**

### **a. Investment into Non-Financial Service Sector:**

- i. Any RI may make ODI by way of investment in equity capital or OPI, subject to the overall ceiling under the Liberalised Remittance Scheme ‘(LRS)’. Under the existing Overseas Investment regime, an individual is permitted to invest under the ODI regime in addition to the LRS route being available to him. However, these two routes have now been clubbed under LRS, and, to that extent, there is a narrowing down of the overseas investment option available to a RI.
- ii. A RI may make or hold an Overseas Investment by way of ODI in an operating foreign entity not engaged in financial services activity and which does not have subsidiary or step-down subsidiary where the resident individual has control in the foreign entity.

### **b. Investment into Financial Services Sector:**

- i. A RI may make an ODI or OPI in any entity engaged in FSA allowed including in the following situations:
  - inheritance;
  - acquisition of sweat equity shares,
  - acquisition of minimum qualification shares issued for holding a management post in a foreign entity; and

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- acquisition of shares or interest under an Employee Stock Ownership Plan or Employee Benefits Scheme

### c. Overseas Portfolio Investment by RI:

- OPI has been defined as investment other than ODI; ODI means investment of 10% or more of the equity capital of a listed foreign entity or where it is less than 10%, but where the investing entity has control, it would be considered as ODI. However, in relation to an unlisted entity, it would always be considered as ODI.
- Any RI may make OPI subject to the overall ceiling under the LRS. As explained in Point (a) (i) above, this amounts to a narrowing down of options for a RI.

### d. Acquisition of Immovable Property Outside India:

- Under the erstwhile regime, acquisition of immovable property was governed by the Foreign Exchange Management (Acquisition and transfer of immovable property outside India) Regulations, 2015 (“Immovable Property Regulation”). The same is now classified as a “non-debt instrument” under the OI Rules and will be governed thereunder.
- Certain key conditions / relaxations as provided under the new OI Regulations for acquisition of immovable property outside India are as under:
  - Where an immovable property outside India is acquired by a PRI on a lease not exceeding five years, no specific permission would be required by the RBI.
  - Further, PRI may acquire an immovable property outside India out of the income or sale proceeds of the assets (other than ODI) acquired overseas.
  - The cap of LRS (i.e. USD 2,50,000) on acquisition will now be consolidated in respect of relatives, if such relatives, being PRI, comply with the terms and conditions of the LRS.

### e. Investment into IFSC

- a person resident in India may make contribution to an investment fund or vehicle set up in an IFSC as OPI;
- a RI may make ODI in a foreign entity, including an **entity engaged in FSA, (except in banking and insurance), in IFSC, if such entity does not have subsidiary or step-down subsidiary outside IFSC** where the resident individual has control in the foreign entity.

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### 3. Investment by person other than IE & RI:

#### a. Investment in Financial Services Sector

This is not permitted.

#### b. Investment in Non-Financial Services Sector

- i. Any person being a **registered Trust or a registered Society** engaged in the educational sector or which has set up hospitals in India may make ODI in a foreign entity with the prior approval of the Reserve Bank subject to following conditions:
  - the foreign entity is engaged in the same sector
  - Trust or the Society, should have been in existence for at least three financial years.
  - trust deed in case of a Trust, and the MOA or rules or bye-laws in case of a Society shall permit the proposed ODI.
  - such investment have the approval of Trustee and governing body or council or managing or executive committee.
- ii. The Trust or the Society require special license or permission either from the Ministry of Home Affairs, Central Government or from the relevant local authority, as the case may be, the special license or permission has been obtained and submitted to the designated AD bank.

### 4. Financial Commitment by Indian Entity by modes other than equity capital:

- i. An Indian entity may lend or invest within the financial commitment limit as prescribed in the Foreign Exchange Management (Overseas Investment) Regulation, 2022, in any debt instrument issued by a foreign entity or extend non-fund-based commitment to or on behalf of a foreign entity (including overseas step-down subsidiaries of such Indian entity) subject to the following conditions:
  - the IE is eligible to make ODI;
  - the IE has made ODI in foreign entity;
  - the IE has acquired control in such foreign entity at the time of making such financial commitment.

### 5. Financial commitment by Indian entity by way of debt:

An IE may lend or invest in any debt instruments issued by a foreign entity (as per Para 4 above), subject to the following conditions:

- such loans are duly backed by a loan agreement and



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- the rate of interest shall be charged on an arm's length basis

### **6. Financial commitment by way of guarantee:**

- In terms of Para 4 above, the following guarantees may be issued to, or on behalf of:
  - the foreign entity;
  - step down subsidiary
- The guarantees could be of the following types:
  - corporate or performance guarantee by the IE
  - corporate or performance guarantee by a group company or a subsidiary or a promoter group company.
  - personal guarantee by the resident individual promoter of such IE.

### **7. Financial commitment by way of pledge or charge:**

- Indian party may pledge equity capital of the foreign entity outside India or charge on Indian entity assets or charge on assets of foreign entity outside India for fund/ non-fund-based facility for
  - any foreign entity outside India, value of pledge/ amount of facility, whichever is less shall be reckoned as financial commitment
  - Indian entity itself, no amount shall reckon as financial commitment
- ECB utilized for ODI to be reckoned for financial commitment entirely or in excess of amount of pledge/charge, as the case may be.

### **8. Reporting requirements for Overseas Investment:**

- ODI to be reported in Form FC;
- Form OPI notified for reporting OPI by person resident in India other than individuals;
- Form APR will have to be filed every year by 31 December; where foreign entity accounting year ends on December 31, APR to be filed by 31 December of next year;
- Filing of Form APR is not required where:
  - there is only one Indian resident investor in a foreign entity and
  - such resident investor neither has control nor holds more than 10% equity shares

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- In case more than one Indian resident has invested in the same foreign entity the Form APR has to be filed by a person resident in India having the highest stake in the foreign entity

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