Planning to Invest in India: Exchange Control Conditions You MUST Know

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LEGAL AND TAX COUNSELING WORLDWIDE

In today's time, countries that impose exchange controls are an exception than the rule. Surprisingly, countries like India[2], South Korea, South Africa, Russia, etc. (often regarded as 'Article XIV' countries), still have exchange control laws that foreign companies need to be mindful of. Over time, India has liberalized its exchange control laws by implementing multiple easing measures. However, contraventions of existing exchange controls may result in imposition of monetary penalties.

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Routes of Foreign Investments in India

Foreign investment in India can be made by a person resident outside India, by way of Foreign Direct Investment ("FDI"), foreign portfolio investment, foreign venture capital investment or investment by a non-resident Indian. For German companies wanting to set up a joint venture or subsidiary in India, FDI is the most commonly adopted route.

Snapshot of Indian Exchange Control Regime

Regulatory Authorities Involved

Foreign investment policies in India are regulated through Consolidated Foreign Direct Investment Policy (FDI Policy), issued and amended periodically by Department of Industrial Policy and Promotion (DIPP), Ministry of Commerce. However, FDI Policy enforcement is the responsibility of the Reserve Bank of India (RBI), in accordance with FEMA provisions. RBI has prescribed Foreign Exchange Management (Transfer or Issue of Securities by a Person Resident Outside India) Regulations, 2017 (TISPRO Regulations) to regulate various modes of foreign investments.

Foreign investment proposals (requiring government approval) are now required to be submitted online[3] and approved by the relevant authority within 8 to 10 weeks from the date of filing of the complete application.

Sectors

Prohibited Sectors: Sectors where FDI is prohibited include (i) atomic energy; (ii) lottery business; (iii) real estate business or construction of farm houses; (iv) trading in transferable development rights; (v) gambling and betting including casinos/lottery business; (vi) manufacturing of cigars, cheroots, cigarillos and cigarettes, of tobacco or of tobacco substitutes.

Permitted Sectors: Foreign investment in all sectors other than the Prohibited Sectors are allowed either under the automatic route or with approval, subject to prescribed sectoral conditions.

Others: In sectors/activities not listed in the FDI Policy, FDI is permitted up to 100% under automatic route.

Capital Instruments

FDI in India can be made through primary or secondary investment in the capital instruments of a company or limited liability partnership (LLP). FDI in LLP is permitted under the automatic route in LLPs operating in sectors/ activities where 100% FDI is allowed under the automatic route and there are no FDI-linked performance conditions. Capital instruments include equity shares, compulsorily convertible debentures, compulsorily convertible preference shares and share warrants.

Debt in foreign currency

Foreign debt is regulated in India and can be availed after meeting prescribed norms under external commercial borrowings regulations.

Downstream Investment

Downstream Investment is investment made by an Indian company/LLP, which is owned or controlled by non-residents, into another Indian company. Such investments need to comply with the entry route, sectoral caps, pricing guidelines and other sectoral conditions, as may be applicable.

Pricing

Unlisted companies

- Subscription of shares of an Indian company or acquisition from resident in India: Price shall not be less than the fair market value computed using any internationally accepted pricing methodology, on an arms-length basis, certified by relevant authorities.
- Sale of shares by a non-resident to resident: Price shall not be less than the fair market value computed using any internationally accepted pricing methodology, on an arms-length basis, certified by relevant authorities.
- Transfer of shares between non-residents: Pricing guidelines are not applicable.

Listed companies

Price shall not be lower than the price at which preferential allotment of shares can be made, under SEBI guidelines.

Reporting requirements under FEMA

Investments made under FDI route need to be reported to the RBI, at following stages:

- Allotment: within 30 days by the Indian company;
- Annual reporting of foreign assets and liabilities: by 15th day of July by the Indian company;
- Transfer: within 60 days from receipt of consideration by the resident party;

Recently, the regulator has introduced a single master form for various kinds of reporting, instead of the multiple reporting required currently. But the proposed regime is still a work in progress.

Penalties and compounding

Penalties in case of non-compliances can be up to three times the sum involved in such contravention, where the amount is quantifiable. Else, a penalty of up to INR 200,000 (approximately USD 3000)[4] can be imposed. If contravention is of continuing nature, further penalty up to INR 5,000 (approximately USD 75) per day, during which the contravention continues, can be imposed.

Compounding: RBI is empowered to compound any contravention defined under FEMA, for a specified sum, after offering an opportunity of personal hearing to the contravener, except where contravention pertains to dealing in or transfer of foreign exchange to unauthorized persons.

Structuring conditions

As per the extant conditions, not more than 25% of the total consideration can be paid by the buyer, on a deferred basis, within a period not exceeding eighteen months, from the date of transfer agreement. Additionally, the seller is restricted to provide an indemnity for an amount not more than 25% of the total consideration, for a period not exceeding eighteen months, from the date of full payment.

Exit conditions

As common in exits, optionality clauses are allowed under FDI scheme, subject to minimum lock-in period of one year, which shall be effective from the date of allotment of such capital instruments and the non-resident investor shall be eligible to exit without any assured return, as per pricing/ valuation guidelines.

Conclusion

Recent changes to the exchange control laws have eased the process of doing business in India. Number of regulatory approvals required have been significantly brought down resulting in a fast-track and less discretionary investment regime. Proper understanding of the law and timely compliance at each stage, will further ensure a quick and smooth outcome for the investors.

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[2] India is one of the original members who became a signatory to the International Monetary Fund Agreement with effect from December 27, 1945
[3] Link for Foreign Investment Facilitation Portal - http://fifp.gov.in/
[4] Assuming 1 USD = INR 65