

Regulatory Digest

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REEVALUATING DIFFERENTIAL TREATMENT OF LLPs IN FDI MATTERS: A CALL FOR PARITY!!

- While FDI norms for companies are progressively eased, LLPs continue to face significant restrictions.
- Ambiguity and broad interpretation of FDI-linked performance conditions limits foreign investment opportunities for LLPs in key sectors.
- Given recent regulatory enhancements aligning LLP governance with corporate structures, the government should revisit the FDI framework to remove unnecessary restrictions.

BACKGROUND:

It has been more than 15 years since the Government introduced the Limited Liability Partnership Act, 2008 ("LLP Act") to facilitate the formation of Limited Liability Partnerships (LLPs) as an incorporated business structure alternative to a company.

An LLP was not eligible for receiving foreign investment until 2011. Between 2011 to 2015, foreign investment was permitted under the approval route in sectors/activities where 100% FDI was allowed under the automatic route and had no FDI-linked performance conditions. In November 2015, the government further eased regulations, permitting 100% foreign investment under the automatic route in these sectors. Additionally, foreign-owned or controlled LLPs were allowed to make downstream investments in another Indian entity under the automatic route.

Since then, the government has introduced various FDI reforms, including enhancing sectoral caps and relaxing sectoral conditions for companies. However, no substantial relaxations have been afforded to foreign investment in LLPs.

In fact, LLPs are subject to differential and inferior treatment and face more onerous restrictions than companies regarding foreign investment. We have discussed below some of these areas as below.

A. Direct Restrictions on Foreign Investment:

- Entry Route and Sectoral Restrictions:** Currently, there is a blanket restriction imposed on LLPs under 3 broad scenarios – (a) sectors where FDI upto 100% is permitted under automatic route subject to certain conditions (which arguably are construed as FDI-linked performance conditions); (b) sectors where FDI is permitted under automatic route upto however a threshold less than 100% such as 26% / 49% / 74%; and (c) sectors where the FDI is allowed only under approval route (as LLPs are restricted to approach the government to seek approval for receiving foreign investment). On the contrary, the companies are free to receive foreign investment in all these scenarios subject to fulfilling conditions or by seeking requisite approvals. There appears no cogent reason for restricting the LLPs when the necessary checks and balances in form of stringent conditions and government's approvals etc. are already built in the framework to regulate foreign investments. Except a few sensitive sectors (like defence, core-banking, insurance, NBFC etc.) wherein justifiably the government has policy level concerns and even the Indian controlled or owned LLPs are restricted to engage in such sectors, the LLPs should be allowed to receive foreign investment in all other sectors subject to sectoral limits and conditions at par with the companies and no distinction should be made.

A similar relaxation should also be extended in order to allow downstream investment by LLPs owned or controlled by foreign partners in another Indian entity operating in such sectors and for conversion of such LLPs into a company or vice versa

- Ambiguity Around 'FDI-linked performance conditions':** Rule 2(m) of the Foreign Exchange Management (Non-debt Instruments) Rules, 2019 ("NDI Rules") read with consolidated FDI Policy Circulars defines "FDI linked performance conditions" as "the sector-specific conditions specified in Schedule I of the NDI Rules for companies receiving foreign investment." This is defined in a much broader sense construing to include every condition(s) stipulated for a sector. This interpretation would have a wider ramification on the ability of LLPs to receive foreign investment in key sectors like agriculture, animal husbandry, plantation, mining, e-commerce, wholesale trading, SBRT, construction and development of projects, pharmaceutical (greenfield), other financial services (OFS) as they contain some condition(s) and fall in this category and resultantly, only a few sectors like software development, business consultancy etc., remain open for LLPs to raise foreign investment. In contrast, companies can receive foreign investment in all sectors (except prohibited ones) subject to sectoral conditions and the government's approval wherever necessary.

A closer examination of these conditions suggests that some are compliance-based rather than performance-based. In fact, as per Para 3.2.5 of the FDI policy issued in the year 2012, for the first time, the foreign investment

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into LLP was permitted, and the government had clarified that '*FDI-linked performance conditions*' are the conditions which are stipulated in the sectors "*such as 'Non-Banking Finance Companies' or 'Development of Townships, Housing, Built-up infrastructure and Construction-development projects' etc.*" A similar clarification was available in the subsequent FDI policies issued in the years 2013, 2014 and 2015. Hence, it seems that the intent of the DIPPP, Government was to differentiate FDI-linked performance-based conditions from the general / compliance-based conditions.

FDI-linked performance conditions are essentially the specific obligations imposed on foreign investors as part of a country's FDI policy. These conditions ensure that FDI contributes to the local economy, promotes domestic industry, and aligns with national development goals. Such conditions are typically in the nature of - local sourcing requirements, export obligations, technology transfer & R&D commitments, employment & skill development requirements, investment in infrastructure or specific sectors. Noticeably, the sectors like NBFC, Development of Townships, Housing, Built-up infrastructure and Construction-development projects have such specific conditions viz. minimum capitalisation norms, minimum area to be developed under each project, minimum lock-in period for foreign investment, which are linked to the performance and manner of utilization of FDI proceeds. For all the other sectors, no such performance-based conditions are prescribed. The conditions prescribed for other sectors are the general / compliance-based conditions. However, given the current definition, interpretations vary. A regulatory clarification or an amendment to the definition of "*FDI linked performance conditions*" would help prevent unintended restrictions on foreign investment in LLPs.

- **Restriction to Operate in Regulated Financial Sector:** Considering the ambiguity around the scope of '*FDI linked performance conditions*', if one needs to treat general conditions specified for OFS sector as the conditions of such nature, then the LLPs with foreign investment cannot undertake even the regulated financial services such as investment advisory, portfolio management, alternate investment funds (AIF), stock broking, merchant banking, asset management to name a few. These are well regulated by the financial regulator (i.e., SEBI) by way of prescribing adequate checks, disclosures and compliance obligations and hence, restricting foreign investment into such regulated financial services for the LLPs seems unreasonable. As such, an LLP is a body corporate recognised under both LLP Act and CA 2013 and the SEBI regulations regulating these financial services does allow a body corporate under CA 2013 to render such services and hence, an LLP is permitted to engage in such activities by obtaining requisite licence.

B. Other Areas of Differential Treatment to LLPs

- **Applicability of pricing norms:** While Indian companies can issue equity instruments to the non-residents at face value during the initial subscription to memorandum of association and at any price while issuing equity instruments under rights or bonus issue (subject to fulfilling certain conditions) without complying with the pricing guidelines under the NDI Rules, no similar relaxation is afforded in case of initial capital contribution and subsequent contribution on a pro-rata basis (i.e., rights basis) by the foreign partners in an LLP. This inconsistency should be addressed.
- **Restriction on raising ECBs:** The RBI's External Commercial Borrowing (ECB) framework permits the FDI-eligible Indian entities to raise ECBs from the recognized foreign lenders. However, the term 'FDI' denotes investment only in the equity instruments of an Indian company and hence, foreign investment through contribution towards capital or acquisition or transfer of profit share of an LLP fall outside the ambit of FDI. Resultantly, the LLPs are ineligible to raise ECB despite the stringent compliance requirements already in place for such borrowings. Given the certain commercial benefits involved, LLPs should also be allowed to access ECBs.
- **Restriction on Swap and Non-Cash Transactions:** Unlike Indian companies which are allowed to issue equity instruments to non-residents as a part of any cross-border share swap transaction, LLPs cannot engage in equity swap transactions under the NDI Rules. This restriction persists even after recent amendments to facilitate cross-border share swaps. Considering share swap has become an attractive investment strategy due to its commercial viability as against cash-based transactions, LLPs should also be permitted to issue capital or profit shares in exchange for another LLP's capital or profit share/company's equity instruments/equity capital of foreign company.

Additionally, other general permission routes for FDI through non-cash consideration, such as investment against import of capital goods, machinery, pre-incorporation expenses or any other legitimate payments, should be extended to LLPs without requiring government or RBI's approval.

- **Convertible note by an Indian startup:** Currently, as per the NDI Rules, only a private company which is recognized as startup by the DPIIT is eligible to raise funds from non-resident investors through the convertible notes. LLP, which is recognised as a startup by the DPIIT, is not given this option. Considering that convertible note has been the most effective funding tool for startups, the LLP startups should also be granted this flexibility.
- **Deferred payment arrangement:** For secondary purchase/sale of equity instruments of an Indian company between resident and non-resident investors, the deferred payment arrangements (escrow, indemnity, price adjustments) are permitted upto a period of 18 months and subject to such deferred consideration not exceeding 25% of the total consideration. However, this option is not available for cross-border transfer of capital contribution or profit share of an LLP, which is unjustified.
- **Indirect holding of beneficial interest by non-resident:** Under the NDI Rules, the beneficial ownership in the company's shares is recognized as foreign investment, even when such shares are held by a resident Indian. In October 2023, the LLP rules were amended to introduce similar concepts like '*Registered Partner*' and '*Beneficial Partner*' mirroring the concepts of '*Registered owner*' and '*Beneficial owner*' under CA 2013. As such, indirect foreign beneficial ownership in LLPs should also be recognized as foreign investment.
- **Remitter and Beneficial owner:** Currently, in case of primary or secondary investment by non-residents in the company's equity instruments, a non-resident remitter may transfer funds while another non-resident holds the investment subject to Know Your Customer (KYC) related compliances by both the parties. This flexibility is beneficial for multinational investors managing multiple entities. However, LLPs are not extended this facility, creating an artificial distinction.

LLPs offer operational flexibility, tax benefits, and reduced compliance burdens compared to companies while still enjoying limited liability protection. Furthermore, LLPs are already recognized by financial regulators as a body corporate and are permitted to undertake regulated financial services.

Recent amendments have further aligned LLP governance with corporate regulations, including SBO disclosures, maintenance of registers, designated partner limitations, and enhanced government oversight. Given these regulatory enhancements, the differential treatment of LLPs in foreign investment matters now seem redundant.

Hence, the government should revisit the FDI framework to eliminate existing restrictions and align LLPs with companies in terms of foreign investment policies. This would improve ease of doing business for investors and enhance India's attractiveness as an investment destination.

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