RESOURCE PAPER 46

INDO-JAPAN CHAMBER OF COMMERCE & INDUSTRY

# FOREIGN DIRECT INVESTMENT IN INDIA


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# PREFACE

I have great pleasure in presenting a Resource Paper on India's Foreign Direct Investment. As part of our bilateral activities, enlightening the business community of India and Japan on the various India-Japan recent economic updates, we present to the readers this important resource material. We hope it would be useful to the Japanese business community. Members are most welcome to write to us on any specific subject matter that requires detailed information and we will be happy to provide.

The author of this resource paper Mr. K. Ramesh is a Corporate Lawyer at PSS Legal Advisors LLP, a boutique Corporate Law Firm with specialists having extensive experience of several decades across various sectors. The Firm has an Advisory, Transaction and Litigation Practice in Corporate, Commercial and Civil Law with an exclusive focus on assisting foreign companies with their entry into India and taking care of all legal requirements thereafter.

Mr. Ramesh is a veteran in Foreign Exchange Law and Mergers and Acquisitions practicing Corporate Lawyer with 37+years of rich experience. Apart from his Degrees in Law and Science, he is a qualified Chartered Accountant, Company Secretary and a Fellow of the Insurance Institute of India. This unique combination of professional qualifications coupled with practical expertise and passion results in his holistic, integrated and practical approach from legal, tax and accounting angles.

He has a super specialization in Foreign Exchange Law including inbound and outbound investments, foreign collaborations, Joint ventures et al., He also specialises in cases before the Enforcement Directorate relating to Foreign Exchange Management Act and has handled several complicated and sensitive cases. He also advises on all foreign exchange matters relating to the Reserve Bank of India.

His expertise extends to the structuring of various aspects and contracts involving Mergers and Acquisitions, corporate transactionsand advisory on all aspects of corporate law. He also handles arbitration. He was an Advisor to the 'NRI Services portal' of The Hindu Business Line.

October 2023

**Suguna Ramamoorthy**
Secretary General IJCCI

# Foreign Direct Investment in India

## Foreign Direct Investment (FDI)

FDI in India is a supplement to domestic capital, technology, and skills for accelerated economic growth and development. FDI has a longer-term interest in an enterprise in contrast with Foreign Portfolio Investment. FDI has been progressively increasing in India since liberalization of foreign investment policy since 1991 and the extant FDI Policy is transparent, predictable, and easily comprehensible.

## Policy & Legal framework

The Department for Promotion of Industry and Internal Trade (DPIIT), Ministry of Commerce & Industry, Government of India makes policy pronouncements on FDI through Consolidated FDI Policy Circular / Press Notes / Press Releases which are notified by the Department of Economic Affairs (DEA), Ministry of Finance, Government of India as amendments to the Foreign Exchange Management (Non-Debt Instruments) Rules, 2019 under the Foreign Exchange Management Act, 1999 (42 of 1999) (FEMA or the legal framework for foreign direct investment).

## Trends in the recent past & prospects

Since liberalization of economy initiated by the Government of India, foreign capital, technology transfer, participation of foreign nationals in the Key management of Indian enterprise and engagement of Indian professional in overseas commercial ventures is progressively increasing to the mutual advantage of India and other countries. This past trend is witnessing further impetus post-pandemic world which desires de-coupling of supply chain from a single source to multiple source and India with a pool of young talented people with favorable geography and on-going ease of doing business rules is a preferred destination for foreign businesses. This new geopolitical development is together with the Government of India 'Make in India' program with Production Linked Incentive Scheme **(PLI Scheme)** and fastest growing economy is expected to see further rise in FDI and technology transfer in the coming decade.

**Scope of this write up**

This article is intended to deal with certain key aspects of FDI to lay foreign investors, in simple business language, leaving technical details or legal ease to be worked out for specific case based on the merits by professionals. The key aspects of FDI can be dealt with under the heads (1) Definitions (important ones) (2) Eligible Investors (3) Investee company in India (4) Prohibited & permitted sectors (5) Types of Instruments, Issue and Transfer of securities invested, including conversion of loans into equity (6) Entry routes of investments (7) Sector-wise investment ceiling (8) Down stream investment (9) Reporting of FDI (10) Repatriation of Investments / income (11) Technology Transfer (12) Compliance and regularization of Violation, if any.

**Key Definitions:**

**'FDI'** means investment through capital instruments by a person resident outside India in an unlisted Indian company; or in ten percent or more of the post issue paid-up equity capital on a fully diluted basis of a listed Indian company.

**'Startup Company'** means a private company incorporated under the Companies Act, 2013 and identified under G.S.R. 127(E) dated 19th February 2019 issued by the DPIIT, Ministry of Commerce and Industry.

**'Automatic route'** means the entry route through which investment by a person resident outside India does not require the prior approval of the Reserve Bank of India or the Central Government.

**'Government Route'** means the entry route through which investment by a person resident outside India requires prior Government approval and foreign investment received under this route shall be in accordance with the conditions stipulated by the Government in its approval.

## Who are Eligible investors?

A non-resident entity (or entity outside India) can invest in India under FDI. However, an entity of a country, which shares land border with India or where the beneficial owner of an investment into India is situated in or is a citizen of any such country, can invest only under the Government route.

## Investee Company in India

The Common structure of investee (or the enterprise in which investment is made) in India are the Company or LLP (Limited Liability Partnership). Investment may also be made in Start-up Companies. Start-ups can issue equity or equity linked instruments or debt instruments to FVCI against receipt of foreign remittance, as per the ScheduleVII of Foreign Exchange Management (Non-Debt Instruments) Rules, 2019. In addition, start-ups can issue convertible notes to person resident outside India subject to certain conditions.

## FDI - Prohibited Sector

FDI is prohibited in a very few sectors, not of any national importance to the Government of India such as: (a) Lottery Business including Government / private lottery, online lotteries, etc. (b) Gambling and Betting including casinos (c) Chitfunds (d) Nidhicompany (e) Trading in Transferable Development Rights (TDRs) (f) Real Estate Business or Construction of Farmhouses. 'Real estate businesses' shall not include development of townships, construction of residential /commercial premises, roads or bridges and Real Estate Investment Trusts (REITs) registered and regulated under the SEBI (REITs) Regulations 2014. (g) Manufacturing of cigars, cheroots, cigarillos and cigarettes, of tobacco or of tobacco substitutes (h) Activities / sectors not open to private sector investment e.g. (i) Atomic Energy and any Foreign technology collaboration in any form including licensing for franchise, trademark, brandname, management contract is also prohibited for Lottery Business, Gambling and Betting activities.

**FDI - Permitted Sector**

Other than the prohibited sector mentioned above, FDI is permitted freely in all sectors, and these are detailed under the separate paragraph below titled Caps on FDI or sectoral cap. It is to be noted that the cap or ceiling of foreign equity is prescribed only in certain strategic sectors with conditionalities. All other sectors such as manufacturing or services FDI is freely permitted up to 100 per cent without any conditions. It is to be noted that when the liberalization started in 1991 only a few select sectors were made available for foreign investment. This has been liberalized to limit FDI just for a few sectors (prohibited sectors) and freely permit FDI in all other sectors.

**Instruments of investments, issue / transfer of shares etc.**

**Types of Instruments under FDI:**

Indian investee companies can issue:

- Equity shares
- Fully, compulsorily, and mandatorily convertibledebentures and
- Fully, compulsorily, and mandatorily convertible preference shares subject to pricing guidelines/valuation norms prescribed under FEMA Regulations. The price/conversion formula of convertible capital instruments should be determined upfront at the time of issue of the instruments. The price at the time of conversion should not in any case be lower than the fair value worked out at the time of issuance of such instruments. The valuation shall be in accordance with the extant FEMA regulations, as per any internationally accepted pricing methodology on an arm's length basis for the companies.

It is to be noted that the Indian Companies Act, 2013 permits other types of Preference shares/Debentures i.e., non-convertible, optionally convertible or partially convertible instruments, but these are treated as debt under FEMA regulations and not as FDI.

## Issue of share to non-residents Investors

### Time of issue of shares.

The capital instruments should be issued within 60 days from the date of receipt of the inward remittance received through normal banking channels. Incase, the capital instruments are not issued within 60 days from the date of receipt of the inward remittance, the amount of consideration so received should be refunded within fifteen days from the date of completion of sixty days to the non-resident investor by outward remittance through normal banking channels. Non-compliance with the above provision would be considered a contravention under FEMA and would attract penal provisions.

### Issue price of shares.

Price of shares issued to persons resident outside India under the FDI Policy, shall not be less than -

- Subscription to MOA. However, where non-residents (including NRIs) are making investments in an Indian company in compliance with the provisions of the Companies Act, as applicable, byway of subscription to its Memorandum of Association (MOA), such investments may be made at face value subject to theire ligibility to invest under the FDI scheme.
- For unlisted Companies - the fair valuation of shares done by a SEBI registered Merchant Banker or a Chartered Accountant as per any internationally accepted pricing methodology on arm's length basis; and
- For Listed Companies - the price worked out in accordance with the SEBI guidelines, as applicable, where the shares of the company are listed on any recognized stock exchange in India;
- Pricing for Transfer of Shares - the price applicable to transfer of shares from resident to non-resident as per thepricing guidelines laid down by the Reserve Bank from time to time, where the issue of shares is on preferential allotment.

- ***Other mode of acquisition of shares by non-resident investors.*** Non-resident investors are also permitted to acquire Indian Companies shares in other forms such as rights issue, bonus issue, Employee Stock Option Plan (ESOP), through merger or de-merger or amalgamation, sweat equity subject to applicable regulations and documentation with ease and minimum procedures under the FEMA.

**Transfer of shares and convertible debentures by non-resident investors**

Subject to FDI sectoral policy (relating to sectoral caps and entry routes), applicable laws and other conditionalities including security conditions, non-resident investors  may transfer their shares without RBI approval.

- ***Transfer from non-resident to another non-resident.*** Government approval is not required for transfer of shares in the investee company from one non-resident to anothernon-resident in sectors which are under automatic route. In addition, approval of Government will be required for transfer of stake from onen on-resident to another non-resident in sectors which are under Government approval route.
- ***Transfer by Resident to Non-resident Private arrangement.*** A person resident in India can transfer by way of sale, shares/convertible debentures (including transfer of subscriber's shares), of an Indian company under private arrangement to a person resident outside India.
- ***Transfer by Non-resident to Resident Private arrangement.*** General permission is also available for transfer of shares/convertible debentures, by way of sale under private arrangement by a person resident outside India to a person resident in India.
- ***Transfer of shares of a listed company through broker.*** A person resident outside India can sell the shares and convertible debentures ofan Indian company on a recognized Stock Exchange in India through a stockbroker registered with stock exchange or a merchant banker registered with SEBI.

- ***Pricing of Transfer.*** The fair value of the shares under transfer shall be certified by a Chartered Accountant (for unlisted companies) & the price shall be the quoted price in the market (for listed Companies).

- ***Reporting.*** The Form FC-TRS should be submitted to the AD Category-I Bank with enclosures,within 60 days of transfer of capital instruments or receipt/remittance of funds whichever is earlier.

***Transfer of shares requiring Prior Permission from RBI.*** Only in the following limited cases transfer of shares from Non-resident investors require prior RBI clearance.

- Transfer is at a price which falls outside the pricing guidelines prescribed under Foreign Exchange Management (Non-Debt Instruments) Rules, 2019.

- Transfer of capital instruments by the non-resident acquirer involving deferment of payment of the amount of consideration.

- Transfer of any capital instrument, by way of gift by a person resident in India to a person resident outside India.

## Conversion of ECB/LumpsumFee/Royalty etc. into Equity

Indian companies have been granted general permission for conversion of External Commercial Borrowings (ECB) (excluding those deemed as ECB) in convertible foreign currency into equity shares/fully compulsorily and mandatorily convertible preference shares, subject to the compliance with (I) valuation at the time of such conversion (II) sectoral cap, if any and (III) any other requirements of other applicable Indian law.

## Entry Routes for FDI

The entry for FDI is under two routes: (A) Automatic Routeor (B) the Government Route Under the Automatic Route, the non-resident investor or the Indian company does not require any approval from Government of India for the investment. Under the Government Route, prior approval of the Government of India is required. Proposals for foreign investment under Government Route, are considered by respective Administrative Ministry/Department.

## Caps on FDI or Sectoral Cap

Investments can be made by person resident outside India in the capital of aresident entity only to the extent of the percentage of the total capital as specified inthe FDI policy. This is also called “sectoral cap” (or equity ceiling up to which the concerned sector needs no approval and when the ceiling is breached, the FDI require prior Government Approval). Most manufacturing and service sectors are permitted 100% under FDI under the Automatic Route, i.e., requiring no prior Government Approval. The Table of various sectors under sectoral cap and entry conditions in various sectors are detailed in Chapter 5 of the FDI Policy issued by the Government of India. Besides the entry conditions on foreign investment, the investment/investors are required to comply with all relevant sectoral laws, regulations, rules, securityconditions,and state/ locallaws/ regulations. The said Table deals with different sectors such as Agriculture, Plantation, Mining, Defense, Petroleum & Natural gas, Manufacturing, civil Aviation, and so on. A ceiling on foreign equity is prescribed in addition to conditions for investment in certain strategic sectors only and most of the important sectors such as manufacturing or service sectors are permitted up to 100 per cent for FDI. That is, in manufacturing FDI is permitted fully for foreign investors and they can form an Indian entity with fully their own equity or Wholly owned Company, without any need to have Indian partner at all.

## Foreign investment into/ downstream investment by eligible indian entities

The Indian Companies in which FDI is made, may invest in another Indian Company **(Downstream Investment or indirect foreign Investment).** ‘Downstream investment’means indirect foreign investment, by an eligible Indian entity, into another Indian Company/LLP, by way of subscription or acquisition.

The FDI Policy provides for comprehensive downstream investment guidelines. Further the foreign total investment is an aggregate of foreign direct investment + foreign indirect investment (read down-stream investment).

## Reporting - FDI

The reporting requirements for any investment in India by a person resident in India under Foreign Exchange Management (Non-DebtInstruments) Rules, 2019 are specified by the RBI. Regulation 4 of the Foreign Exchange Management (Mode ofPayment and Reporting of Non-Debt Instruments) Regulations, 2019 vide notificationNo. FEMA. 395/2019 - RB dated 17.10.2019 issued by the RBI stipulates the reporting requirement for any investment in India by a person resident outside India.

There are two levels of reporting for FDI - one at the time of inward remittance for FDI and another upon issue of shares to foreign investors. Within 30 days of inward remittance 'advance reporting' sharing basic details about the transaction (that is name of the investor, investee company, type of instruments etc.) are to be filed and within 30 days of issue of shares to foreign investor, reporting shall be made in Form FC GPR. Both these reporting is done digitally to RBI.

All the reporting is required to be done through the Single Master Form (SMF) available on the Foreign Investment Reporting and Management System (FIRMS) platform at https://firms.rbi.org.in. The user manual for reporting is available at https: //firms.rbi.org.in/firms/faces/pages/login.xhtml. The format of the SMF and KYC report is available in the user manual.

## Repatriation of Investment & Income

Foreign investors may like repatriate (means taking back the investment made in India in foreign exchange) their investment and/or the income (such as dividend, interest) earned out such investment.

## Technology Transfer

Technology transfer is freely permitted to Indian Company by an agreement drawn between the owner of technology and the Indian Company. In the event the foreign investor desires to transfer technology to the Joint Venture Company, it can do so protecting its interest through a properly drawn up

Foreign Technology License Agreement, subject to terms and conditions the Licensor may deem fit. Any technology payment such as Lumpsum or royalty (as a percentage of Sale) are freely repatriable through Banker, subject to payment of applicable local taxes. In the event, the foreign investor desires to protect the technology jealously, instead of transferring technology, it can use the technology in its own wholly owned subsidiary.

**Appointment of Foreign Technicial or Director**

Employing foreign technician for erection of machinery or enabling smooth technology transfer or any training of Indian employees is freely permissible. Salary or fee to foreign technician can be freely remitted through Bank, subject to applicable local taxes. Similarly, foreigners can be freely appointed to the office of the Board of Directors of the Indian Company. Any compensation to such directors such as sitting fee, or professional fee if any, or qualification shares are freely permissible under the extant FDI Policy.

**Remittance and Violation**

The Government has provided elaborate schemes for reporting, remittance, and regularization of any violation of FDI policy. In terms of the Foreign Exchange Management Act, 1999 (FEMA), all current account transactions such as dividend, interest, royalty etc. are freely repatriable, through Bankers themselves. These do not have any restrictions nor do these remittances require any approval. The repatriation is governed by the provisions of the Foreign Exchange Management (Current Account Transactions) Rules, 2000, as amendedfrom time to time. Even Capital account transactions such Sale proceeds of securities are freely repatriable subject payment of applicable taxes.

**Remittance of sale proceeds/Remittance on windingup/Liquidation of Companies:**

Sale proceeds of shares and securities and their remittance is ‘remittance of asset’ governed by The Foreign Exchange Management (Remittance of

Assets) Regulations, 2000 under FEMA. AD Category-I bank can allow the remittance of sale proceeds of a security (net of applicable taxes) to the seller of shares resident outside India, provided the security has been held on repatriation basis, the sale of security has been made in accordance with the prescribed guidelines and NOC/tax clearance certificate from the Income Tax Department has been produced.

**Remittance on windingup/liquidation of Companies:**

ADCategory-I banks have been allowed to remit windingup proceeds of companies in India, which are under liquidation, subject to payment of applicable taxes. Liquidation may be subject to any order issued by the court windingup the company or the official liquidator in case of voluntary winding up under the provisions of the Companies Act, asapplicable. AD Category-I banks shall allow the remittance provided the applicant submits:

a. No objection or Tax clearance certificate from Income Tax Department for the remittance.

b. Auditor's certificate confirming that all liabilities in India have been either fully paid or adequately provided for.

c. Auditor's certificate to the effect that the windingup is in accordance with the provisions of the Companies Act, as applicable.

d. In case of winding up otherwise than by a court, an auditor's certificate to the effect that there are no legal proceeding spending in any court in India against the applicant or the company underliquidation and there is no legal impediment in permitting the remittance.

**Compliance with Law and Regularization of any Violation**

FDI is a capital account transaction and thus any violation of FDI regulations is covered under the penal provisions of the FEMA. Reserve Bank of India administers the FEMA and Directorate of Enforcement under the Ministry of Finance is the authority for the enforcement of FEMA. The Directorate takesup investigation in any contravention of FEMA.

If a person violates/contravenes any FDI Regulations, by way of breach/ non-adherence/non-compliance/contravention of any rule, regulation, notification, press note, press release, circular, direction or order issued in exercise of the powers under FEMA or contravenes any conditions subject to which an authorization is issued by the Government of India/Reserve Bank of India, he shall, upon adjudication, be liable to a penalty up to thrice the sum involved insuch contraventions where such amount is quantifiable, or up to two lakh Rupees where the amount is not quantifiable, and where such contraventions is a continuing one, further penalty which may extend to five thousand Rupees for every day after the first day during which the contraventions continues.

In order to reduce the transaction costs to the litigants, the Reserve Bank of India has made Compounding available, whereby simple contraventions which are 'procedural lapses' are done at the option of the willing litigant through compounding by RBI taking a lenient view and levying a nominal penalty which can be regularized upon payment of such penalty. RBI has also made a delay in compliance to beregularized upon payment of Late Service Fee (LSF) and these are administrated digitally without human intervention to make regularization easier and effective saving investment in time and cost of investors.

**Ease of Compliance**

The Compliance of legal and regulatory aspects dealt with above is being made progressively easier through digital platforms, and India has a large reservoir of talented professionals (such as Chartered Accountants, Company Secretaries, lawyers etc.) available to assist the investors in completing legal compliancesfor FDI - companies.

INDO-JAPAN CHAMBER OF COMMERCE & INDUSTRY
No. 21, Kavignar Bharathidasan Road, Teynampet, Chennai 600 018.
Tel: 91-44-4855 6140 E-mail: indo-japan@ijcci.com Website: www.ijcci.com