Liberalized Rules for Overseas Investment by Indian Entities: Laying the "Round Tripping" Ghost to Rest (or not just yet)

On August 22, 2022, the Ministry of Finance and Reserve Bank of India (the "**RBI**") introduced a new overseas investment regime comprising of Foreign Exchange Management (Overseas Investment) Rules, 2022 (the "**OI Rules**"), Foreign Exchange Management (Overseas Investment) Regulations, 2022 (the "**OI Regulations**") and Foreign Exchange Management (Overseas Investment) Directions, 2022 (the "**OI Directions**") (collectively, the "**Revised Framework**") in supersession of the Foreign Exchange Management (Transfer or Issue of Any Foreign Security) Regulations, 2004 (the "**FEMA 120**") and the Foreign Exchange Management (Acquisition and Transfer of Immovable Property Outside India) Regulations, 2015 (collectively, the "**Old Regime**").

The overhaul of the framework governing overseas investments by Indian entities includes the facilitation (subject to certain limitations) of structures that were earlier viewed unfavourably as "round tripping" under the Old Regime.

WHAT IS ROUND TRIPPING

Simply put, the term "round tripping" has been used to refer to a structure in which an Indian person invests in an offshore entity which further invests, or already has investments, in India.

REGULATORY CONCERNS ABOUT ROUND TRIPPING

Round tripping practices have in the past been frowned upon by the RBI. The RBI was concerned that Indian companies used such practices as a means to evade taxes and/or engage in money laundering. One *modus operandi* was that Indian companies incorporated offshore group companies (typically in tax havens) and channelled funds to them, generally under the garb of under-invoicing of exports and/or over-invoicing of imports. This allowed Indian entities to display higher costs and lesser profits in their books, resulting in lesser payment of income tax to the government. The offshore group entities then routed back money to India in the form of foreign direct investment or foreign portfolio investment. Since investments from specified jurisdictions were entitled to certain benefits (such as exemption from capital gains tax in India) under the relevant double tax avoidance agreements (DTAA), the unaccounted money made its way back to India without the need for any payment of taxes. Further, there were also instances where the money routed back was used to manipulate stock prices of listed Indian entities.[1]

AMBIGUOUS REGULATION OF ROUND TRIPPING UNDER THE OLD REGIME

There was no express prohibition of round tripping under the Old Regime.

In the absence of any express provisions, round tripping was sought to be regulated by the RBI under Regulation 6(2)(ii) of FEMA 120 which allowed direct investment in overseas wholly-owned subsidiary ("**WOS**") or joint-venture ("**JV**") (both as defined under the regulations) engaged in a 'bonafide' business activity. Although the term 'bonafide' activity was not defined, the RBI took a view that receipt of FDI pursuant to or in connection with an ODI transaction was not a bonafide activity under the automatic investment route.[2]

In 2019, round tripping was sought to be addressed way of a response to frequently asked questions ("**FAQs**") released by RBI which read as follows: "*FEMA 120 do not permit an IP to set up Indian subsidiary(ies) through its foreign WOS or JV nor do the provisions permit an IP to acquire a WOS or invest in JV that already has direct/indirect investment in India under the automatic route. However, in such cases, IPs can approach the Reserve Bank for prior approval through their Authorised Dealer Banks which will be considered on a case-to-case basis, depending on the merits of the case*".[3]

[1] *Sowmiyanarayanan & Ors. v. SEBI*, 2017 SCC OnLine SAT 108

[2] RBI order in the matter of: Binani Industries Limited, dated June 3, 2016

[3] RBI, Frequently Asked Questions on Overseas Direct Investments, updated on September 19, 2019

Given the above regulatory concerns, courts also viewed any "round tripping" structures in a negative light as "*abuse of treaty (benefits) for the fraudulent purpose of evading taxes*".[4]

EFFECT OF RESTRICTION ON ROUND TRIPPING

Fund raising options from offshore investors were restricted (and required prior RBI approval) if such investors had obtained investment from India. Similarly, Indian entities considering outbound investments faced a requirement of prior RBI approval if the target had any investment in India.

Although the objectives of the restriction on round tripping was laudable, such restriction also had an unintended chilling effect on legitimate transactions.

THE REVISED FRAMEWORK

Unlike the Old Framework, the OI Rules includes an express provision dealing with round tripping under Rule 19(3):

"*No person resident in India shall make financial commitment in a foreign entity that has invested or invests into India, at the time of making such financial commitment or at any time thereafter, resulting in a structure with more than two layers of subsidiaries.*"

The Revised Framework eases restrictions under the Old Regime to a large extent. The OI Directions clarify the prospective nature of the Revised Framework and do not permit any further layer to be added to existing structures having two or more layers of subsidiaries, implying that previous structures which have been approved by the RBI may continue to exist.

LAYERS OF SUBSIDIARIES

While the Revised Framework allows corporate structures in line with the permissible layers of subsidiaries under the Companies Act, 2013 ("**Companies Act**"), it is not entirely clear how the layers will be calculated.

[4] *New Delhi Television Limited v. Deputy Commissioner of Income Tax*, 2020 SCC OnLine SC 446, *Vodafone International Holdings BV v. Union of India and Anr.*, 2012 SCC OnLine SC 77, *Union of India and Anr. v. Azadi Bachao Andolan and Anr.*, 2003 SCC OnLine SC 1102.

The layers can either be calculated in relation to the Indian entity, in which case its step-down subsidiary ("**SDS**") will be the second layer, or in relation to the foreign entity which will cover an SDS of the foreign entity as well.

Given that the definition of 'subsidiary' under Rule 2(1)(y) also mentions a step-down subsidiary and such definition is limited to a subsidiary of a foreign entity, a plausible interpretation would be that the permitted layers of subsidiaries should be determined with reference to the foreign entity receiving financial commitment. At first glance, the RBI Master Direction – Reporting under the Foreign Exchange Management Act, 1999, as updated on September 30, 2022 (the "**RBI Master Directions on Reporting**"), appears to support this interpretation by requiring information in respect of any step-down subsidiary of the relevant foreign entity in **Form FC**. However, curiously, Form FC requires disclosure in respect of the foreign entity and any step-down subsidiary of the foreign entity (and not in respect of a subsidiary of the foreign entity).

EXPANDED DEFINITION OF SUBSIDIARY UNDER THE REVISED FRAMEWORK

The Revised Framework defines 'subsidiary' or 'step-down subsidiary' of a foreign entity as "*an entity in which the foreign entity has control*".[5] The OI Rules define 'control' as: "*the right to appoint majority of the directors or to control management or policy decisions exercisable by a person or persons acting individually or in concert, directly or indirectly, including by virtue of their shareholding or management rights or shareholders' agreements or voting agreements that entitle them to 10% or more of voting rights or in any other manner in the entity*".[6]

Accordingly, the Revised Framework prescribes a substantially lower threshold of 10% voting rights to identify an entity as a subsidiary in comparison to the Companies Act, 2013.

WILL THE EXPANDED DEFINITION OF SUBSIDIARY ALSO BE RELEVANT TO DETERMINING WHETHER A FOREIGN ENTITY IS A SUBSIDIARY OF THE RELEVANT INDIAN ENTITY

It is noteworthy that although the OI Rules explicitly define a "subsidiary" or a "step-down subsidiary" in the context of a foreign entity, paragraph IX of Form MC under the

[5] Rule 2(1)(y) of the OI Rules, 2022

[6] Rule 2(1)(c) of the OI Rules, 2022

RBI Master Directions on Reporting requires disclosure whether the Indian entity has "control" in the foreign entity (as per the definition under the OI Rules).

CONCLUSION

Although certain issues require the RBI's clarification, the liberalized regime in relation to ODI-FDI structures is a progressive move that will facilitate transactions which were otherwise unintentionally getting impacted by a broad-based application of an inchoate "round tripping" restriction under the Old Regime.

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