# Institute of Company Secretaries of India

Due Diligence under FEMA

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# Agenda

✓ 1 Brief overview of FEMA

2 Authorities Under FEMA

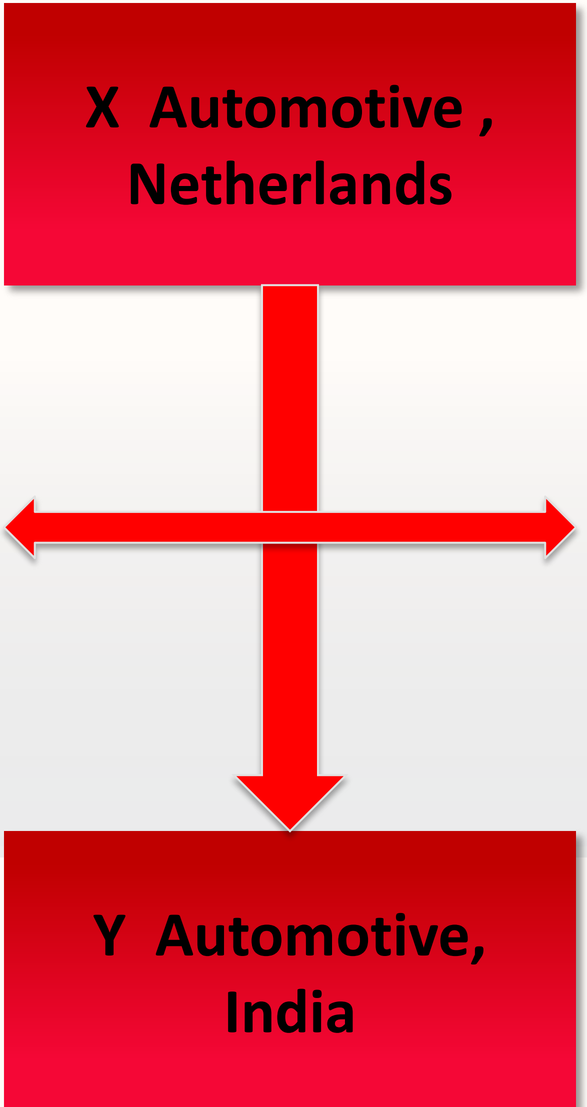
3 Jurisdiction under FEMA

4 Current Account Transactions under FEMA

5 Capital Account Transactions under FEMA

6 Various Entities under FEMA

7 Due Diligence of Incorporated Company




- Y Automotive, a company incorporated in India have received the technical know how from X automotive, a company incorporated in Netherland under technical collaboration agreement.
- Y ltd has to pay royalty at the rate of 6% on local sales and 7.5% on export sales

- Nature of transaction :

**Current account transaction**

**Or**

**Capital account transaction**

Ministry of Industry and commerce

# Unincorporated Entities

- Liaison office
- Branch Office

# Assets Side of Balance sheet

| Assets | Nature | Section | Regulations |
|---|---|---|---|
| Long Term Investments | Overseas Investment | Section (6)(3)(a) | FEM (Transfer or issue of any foreign security) Regulations, 2004 |
| Land and other Immovable assets | Branch Office outside India | Section 6 | FEM (Acquisition and transfer of Immovable Property Outside India) Regulations, 2000 |
| Plant and Machinery | Branch Office outside India | Section 6 | FEM (Foreign Currency accounts by a person resident in India) Regulations, 2000 |

# Asset Side of Balance sheet

| Assets | Nature | Section | Regulations |
|---|---|---|---|
| Cash and Bank Balance | Cash and Bank | | FEM (Foreign Currency Accounts by a person resident in India) Regulations, 2000 |
| Debtors | Export | Section 7 | FEM ( Export of Goods and Services) Regulations , 2000 |
| Inventory/Machinery etc | Import | Section 5 | FEM (Current Account) Rules, 2000 |
| Prepaid Expenses | Advance remittances | Section 5 | FEM (Current Account) Rules, 2000 |

# Liabilities

| Liability | Nature | Section | Regulations |
|---|---|---|---|
| Creditors | Trade Credit | Section 6(3)(d) | FEM(Borrowing or lending in foreign exchange ) Regulations , 2000 |
| Loans and Advances | External Commercial Borrowings | Section 6(3)(d) | FEM(Borrowing or lending in foreign exchange ) Regulations , 2000 |
| Loans and Advances | Foreign Currency Convertible Bond | Section 6(3)(d) | FEM(Borrowing or lending in foreign exchange ) Regulations , 2000 |
| Share capital | Equity | Section 6(3) | FEM(Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2000 ('Inbound Regulations') |

# Liabilities

| Liability | Nature | Section | Regulations |
|---|---|---|---|
| Share Capital | Compulsorily convertible Preference shares | Section 6(3)(b) | FEM(Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2000 ('Inbound Regulations') |
| Retained earnings | Bonus shares/Right shares | Section 6(3)(b) | FEM(Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2000 ('Inbound Regulations') |
| Miscellaneous Expenses – Pre incorporation Expenses | | Section 6(3)(b) | FEM(Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2000 ('Inbound Regulations') |
| Guarantee | Contingent Liability | | Foreign Exchange Management (guarantees) regulations, 2000 |

# Export Regulations

1 **Definition of Export**

2 **Obligation on Exporter**

✓ 3 **Realization, Receipt and Surrender**

4 **Manner of repatriation of Foreign Exchange**

5 Write off of Debts

6

6 **Reduction in Value of Export**

# Export of Goods and services

## Section 3(l) of FEMA

*export" , with its grammatical variations and cognate expressions, means—*

*(i) the taking out of India to a place outside India any goods,*

*(ii) provision of services from India to any person outside India.*

# Obligation on Exporter

- Every exporter of goods or software to any place outside India, is required to furnish a declaration in the specified form [Form GR , Form Softex] along with such supporting evidence containing true and correct material particulars in respect of the goods or software exported.
- Particulars include
  - IEC Code,
  - Specific identification number of the document,
  - The full export value of goods or software; and where the full value is not known then the value expected to be realized.

No Form prescribed for export of services nevertheless the amount has to be realized within the stipulated time

# Realization, Receipt and Surrender of Foreign Exchange

- Section 8 of FEMA deals with the realization and repatriation of foreign exchange.

- All reasonable steps to be taken to realize and repatriate to India within the time and in the manner specified by RBI.

- The person shall not do anything that has the effect of delaying the receipt of the foreign exchange or the foreign exchange ceases to be receivable in full or in part by him.

# Realisation of Foreign Exchange

Within the period of six months from the date of Export

In case of status holder exporter – within the period of 12 months

Sale contract - Terms of Credit exceeding 12 months – permission from RBI

If not possible to realize – Application to AD – Extension up to six months

Not under the investigation by ED/CBI || not able to realize for reasons beyond control || declaration by exporter || invoice amount does not exceed USD 1mn or 10% of average export realization of preceding 3 financial years [higher]

# Manner of repatriation of Foreign Exchange

- On receipt of the foreign exchange due, the exporter may:—
  - Sell it to an authorised dealer.
  - To the extent permitted, retain it in his foreign currency account.
  - Use it to settle a foreign exchange debt or liability.

- Foreign exchange received towards export of goods and service should be surrendered within 180 days from the date of its receipt.

**Retaining foreign exchange**

- An exporter of goods or services may retain up to 100% of foreign exchange earned by him with an authorised dealer in foreign currency in an account known as Exchange Earners Foreign Currency (EEFC) Account.

# Write off of Bad Debts

Write off is permitted where: —

- ❖ The amount is outstanding for 1 year or more.
- ❖ The total amount of write off allowed in a financial year does not exceed **10% of the total export proceeds** realized during the previous financial year.
- ❖ Satisfactory documentary evidence is furnished in support of the efforts made by the exporter for the recovery of the amount due.
- ❖ The case is not subject matter of any pending civil or criminal suit.
- ❖ The export is not under investigation by ED, CBI or any other law enforcement agency.
- ❖ The export has surrendered the proportionate export incentives availed/received under the Duty Drawback Scheme against the relevant exports.

**Exporters, whose cases are not covered by any of the above criterion - Prior Permission of Reserve Bank**

# Reduction in Value of Export Invoice

- Reduction in the value of export invoice after it is negotiated or sent for collection is permitted for genuine reasons if
  - **exporter not on the caution list of RBI,**
  - **the reduction does not exceed 25% of the invoice value**
  - **does not relate to the export of commodities subject to floor price stipulations.**
  - **exporter surrender proportionate export incentives availed**

- In case where the exporter has been in the export business for more than 3 years and his export outstandings **do not exceed 5% of the average annual export realization during the preceding 3 financial years reduction** in value of invoice is permitted without any ceiling i.e. even in excess of 25% of the invoice value.

# IMPORT

1. Definition of Import
2. Obligation of purchaser of forex
3. Time Limit of settlement of import payment
4. Advance remittance
5. ✓ Merchanting Trade

# Definition of Import

Section 3(p) of FEMA

*"import" , with its grammatical variations and cognate expressions, means bringing into India any goods or services;*

Import is regulated by

- Directorate General of Foreign Trade (DGFT)
- Foreign Trade Policy
- FEM (Current Account Transactions) Rules, 2000
- Directions issued by RBI under FEMA [Master Circular]

# Obligation of purchaser of foreign exchange

- Applications by persons, firms and companies for making payments, exceeding USD 500 or its equivalent, towards imports into India must be made on the appropriate **Form A-1**.
- Remittances against imports should be completed within prescribed time limits for making import payments or an approval from the AD/Reserve Bank of India must be obtained prior to the due date.
- Interest on delayed payments must be within the prescribed ceilings
- Evidence of Import to be submitted by importer to AD Banker

**A Half yearly statement of the importer defaulting in submission of evidence of Import is submitted by AD to RBI**

# Time Limit of settlement of import payment

Remittances against import to be completed within 6 months

Application to AD for payment beyond six months

AD may permit settlement of import dues delayed due to disputes, financial difficulties

Interest can be permissible at the rates prescribed for trade credit from time to time

# Time Limit of settlement of import payment

- Deferred payment arrangements, beyond a period of six months from date of shipment up to a period of less than three years, are treated as trade credits for which the procedural guidelines laid down in the Master Circular for External Commercial Borrowings and Trade Credits are to be followed.

# Advance Remittance for Goods

**Banks are permitted to allow advance remittance for import of goods without any ceiling if: -**

- ❖ **The importer holds a valid import license**
- ❖ **The remittance is made directly to the suppliers.**
- ❖ **The remittance exceeds US $ 50,00,000 the same is secured by a Bank Guarantee or irrevocable and non-transferable L/C from an international bank of repute situated outside.**
- ❖ **The goods must be physically imported into India within 1 year in case of capital goods and within 3 months in other cases from the date of remittance and the importer must furnish documentary evidence of the same.**
- ❖ **Where goods are, for any reason, not imported the amount remitted should be repatriated to India or used for any purpose permitted.**

# Advance Remittance for Services

- Importers of services can make advance payment without any limit to overseas suppliers of services. Where the remittance exceeds US $ 500,000 or its equivalent the same must be secured by a Bank Guarantee or irrevocable and non-transferable L/C from an international bank of repute situated outside. The Bank Guarantee or L/C must cover the period of supply to ensure recovery of payment.
- If the beneficiary of the advance remittance fails to fulfill his obligation under the contract or agreement with the remitter in India, the amount must be repatriated to India.

# Overseas Investment

1. Limit on Investment
2. ✓ Methods of Funding
3. Obligation of an Indian Party
4. Restructuring of balance sheet
5. Forms and other procedural aspects

# Direct investment outside India

- Investment by way of contribution to the capital or subscription to MOA of a foreign entity or by way of purchase of existing shares of a foreign entity by market purchase or private placement or through stock exchange.

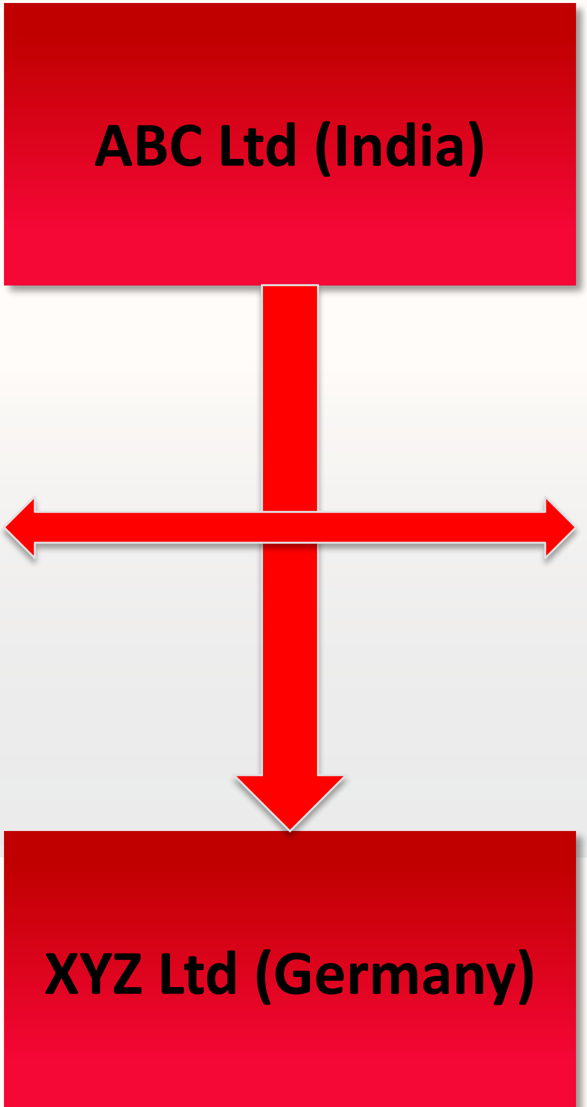
- Form ODI

# Limits on Investment

Financial Commitment up to 400% of Net worth of Indian Party

**Net worth**: Paid up capital + Free reserves

**Financial Commitment** :100% of capital contribution +Loan granted +100% of Corporate guarantee + 50% of the performance guarantee




- ABC Ltd , an Indian company invested in XYZ Ltd.
- ABC Ltd capital on the date of last audited balance sheet
    - Capital :- INR 50 Million
    - Reserves:-

      Securities premium: INR 100 Million

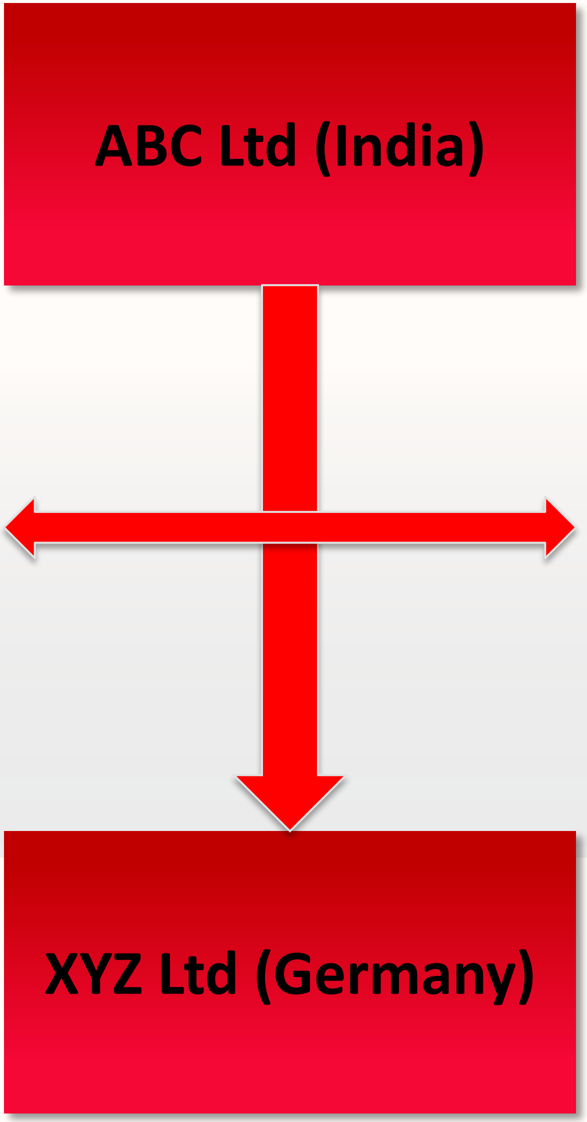
      General reserve:- INR 50 million

- NET WORTH = INR
- INVESTMENT = INR

# Loan and Guarantees

- The Indian party may extend loan/guarantee only to an overseas concern in which it has equity participation subject to certain exceptions in case of guarantee.

- Indian party may offer any form of guarantee provided
  - Within the overall prescribed
  - Not open ended[ amount and period specified]
  - To be reported to RBI




- ABC Ltd , an Indian company invested in XYZ Ltd. Net worth of ABC Ltd is 200 million.

- ABC investment in XYZ :

  Equity Contribution : 100 Million

  Loan :- 50 Million

  Corporate Guarantee :- 50 mn

  Performance Guarantee :- 50 mn

Financial Commitment :-

Automatic route/Approval route

# Methods of Funding

1. **Drawal of  foreign Exchange from am AD bank in India**
2. **Capitalization of exports**
3. Swap of shares
4. **Proceeds of External Commercial Borrowings/ Foreign Currency Convertible Bonds**
5. **In exchange of ADRs/ GLDS issued in accordance with the scheme for issue of FCCBs and ordinary shares (through depository receipt Mechanism ) Scheme, 1993**
6. **Balances held in EEFC account of the foreign Party**
7. **Proceeds of Foreign Currency Funds raised through ADR/GDR issues**

# Obligations of Indian Party

**Proof of Investment**

**Receive share certificates or any other document as an evidence of investment in the foreign entity within 6 months from the date of remittance**

**Repatriation of dues receviable .**

**All dues receivable from the foreign entity, like dividend, royalty, technical fees etc., within 60 days of its falling due.**

**Annual Performance Report**

**Every year within 60 days from the date of expiry of the statutory period as prescribed by the respective laws of the host country for finalisation of the audited accounts of the JV/WOS outside India in Form APR and Submit the Annual return on Foreign Liabilities and Assets**

# Restructuring of Balance sheet

1. **Listed Indian Companies – 25% of capital and other receivables**

2. **Unlisted Companies – 25% of capital and other receivables with approval of RBI**

# Post investment Changes

- Within 30 days of the approval of those decisions by the competent authority of the JV/WOS.

# Example

- B ltd a company incorporated in USA is a wholly owned subsidiary of A ltd an Indian company. C Ltd proposes to invest on B Ltd. Post investment by C Ltd the shareholding of A ltd would be reduced from 100% to 50%.

Is RBI required to be intimated?

# Forms

- Form ODI
- Form APR

# Acquisition of Immovable property outside India

✓ 1 **Definition**

2 **Limits on investment in Immovable Property**

# Definition of Immovable property

- Neither defined under the FEMA Act, nor defined under the relevant notification.
- Since immovable property is not defined, one has to take the meaning as understood in common parlance.
- Immovable property will include residential property, commercial property, agriculture property, etc.

# Definition of Expenses

- Office equipment's and other assets required for normal business operations of the overseas branch/office/representative

# Limits on investment

A company incorporated in India having overseas office, may acquire immovable property outside India for its business and for residential purposes of its staff, in accordance with the direction issued by RBI from time to time.

- **initial expenses** of 15% of the average annual sales/income or turnover during the last two financial years or 25% of its net worth, whichever is higher
- **recurring expenses** of 10% of the average annual sales/income or turnover during the last two financial years.

# Trade Credit

- Amount and Maturity
- All in cost ceiling
- Guarantee
- Reporting arrangements

# Trade Credit

- Trade Credit
  - Suppliers Credit
  - Buyers Credit

# Amount and Maturity

## Capital Goods

- Amount :- USD 20 million per import transaction
- Maturity period : < 1 year>3Years [from the date of shipment]

## Other Goods

- Amount :- USD 20 Million per import Transaction
- Maturity Period : Up to one year [from the date of shipment]

# All in Cost

**All-in-cost ceilings over 6 months LIBOR**

- Up to one year - 200 basis points
- More than one year but less than three years – 200 basis points

# External Commercial Borrowings

1. Eligible borrower
2. Recognised Lenders
3. Amount and Maturity
4. End use
5. End use not permitted
6. ✓ Structured Obligation
7. Prepayment

# Definition

- External Commercial Borrowings refer to commercial loans in the form of bank loans, buyers credit, suppliers credit, Securitized instruments availed of from the non resident lenders with a minimum maturity of 3 years

# Eligible Borrower

- Corporates, including those in the hotel, hospital, software sectors (registered under the Companies Act, 1956) and Infrastructure Finance Companies (IFCs) except financial intermediaries, such as banks, financial institutions (FIs), Housing Finance Companies (HFCs) and Non-Banking Financial Companies (NBFCs) are eligible to raise ECB.

- Individuals, Trusts and Non-Profit making organizations are not eligible to raise ECB.

- Units in Special Economic Zones (SEZ) are allowed to raise ECB for their own requirement. However, they cannot transfer or on-lend ECB funds to sister concerns or any unit in the Domestic Tariff Area.

# Recognised Lender

- international banks,
- international capital markets,
- multilateral financial institutions (such as IFC, ADB, CDC, etc.) / regional financial institutions and Government owned development financial institutions,
- export credit agencies,
- suppliers of equipment's,
- foreign collaborators and
- foreign equity holders (other than erstwhile Overseas Corporate Bodies (OCBs)).
  - A "foreign equity holder" to be eligible as "recognized lender" under the automatic route would require minimum holding of paid-up equity in the borrower company as set out below:
    - (i) For ECB up to USD 5 million - minimum paid-up equity of 25 per cent held directly by the lender,
    - (ii) For ECB more than USD 5 million - minimum paid-up equity of 25 per cent held directly by the lender and debt-equity ratio not exceeding 4:1 (i.e. the proposed ECB not exceeding four times the direct foreign equity holding)
- Individual lender subject to KYC norms

# All in cost

- All-in-cost includes rate of interest, other fees and expenses in foreign currency except commitment fee, pre-payment fee, and fees payable in Indian Rupees. The payment of withholding tax in Indian Rupees is excluded for calculating the all-in-cost.
- The all-in-cost ceilings for ECB are reviewed from time to time. The following ceilings are valid until reviewed: **Average Maturity Period All-in-cost Ceilings over 6 month LIBOR***
  - Three years and up to five years 300 basis points
  - More than five years 500 basis points

# Amount

The maximum amount of ECB which can be raised by a corporate

- USD 500 million or its equivalent during a financial year.

Hotel, hospital and software sectors

- USD 100 million or its equivalent in a financial year

# Maturity

ECB up to USD 20 million

- minimum average maturity of three years

ECB up above USD 20 million

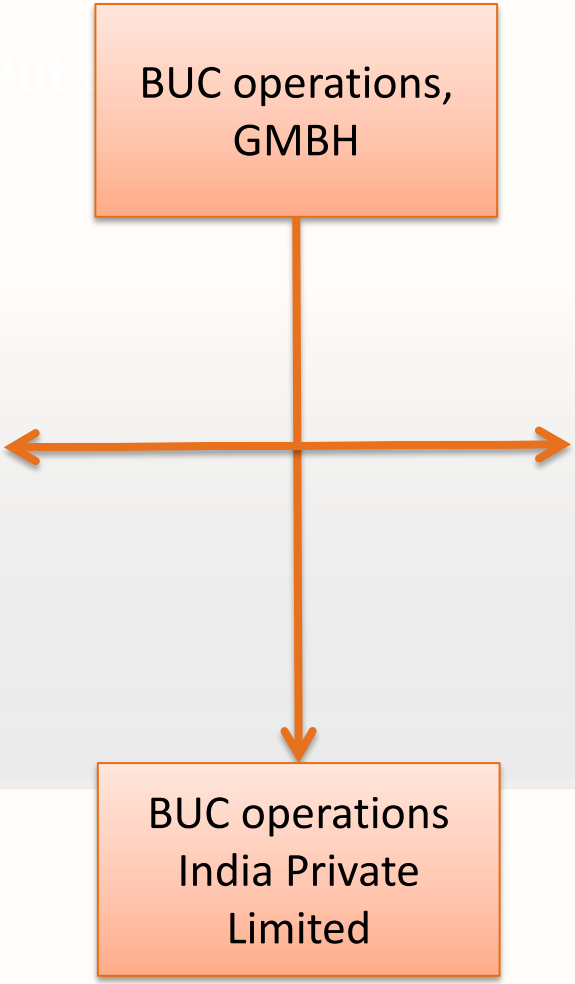
- minimum average maturity of five years

# Permitted end use

# ECB can be raised for investment [such as import of capital goods (as classified by DGFT in the Foreign Trade Policy), new projects, modernization/expansion of existing production units] in real sector - industrial sector including small and medium enterprises (SME), infrastructure sector and specified service sectors namely hotel, hospital, software in India.

# Overseas direct investment in Joint Ventures (JV)/ Wholly Owned Subsidiaries (WOS) subject to the existing guidelines on Indian Direct Investment in JV/ WOS abroad.

# Utilization of ECB proceeds is permitted for first stage acquisition of shares in the disinvestment process and also in the mandatory second stage offer to the public under the Government's disinvestment programme of PSU shares.




- BUC operations, GMBH holds 100% shareholding of BUC India
- BUC wants to set up of Factory at Surat SEZ and import capitaal goods.
- The Amount of Loan : USD 40 Million
- Maturity period :- 3 years
- Six month LIBOR for CHF is .23833% + 500 bp = 5.2383%

# End use not permitted

- For on-lending or investment in capital market or acquiring a company (or a part thereof) in India by a corporate
- For real estate
- For working capital, general corporate purpose and repayment of existing Rupee loans

# Post Loan agreement Changes

- » Modifications in the drawdown/repayment schedule
- » Changes in the currency of borrowing
- » Change of the AD bank
- » Changes in the name of the Borrower Company

# Forms

- Form 83
- Form ECB
- Form ECB 2

# Share Capital

- Route of Share capital
- Reporting of Share capital

## Share capital

- Equity Share

## Deferred Share Capital

- fully and mandatorily convertible debentures
- fully and mandatorily convertible preference shares

❖ Other types of Preference shares/Debentures i.e. non-convertible, optionally convertible or partially convertible are considered as debt.

❖ The inward remittance received by the Indian company vide issuance of DRs and FCCBs are treated as FDI and counted towards FDI.

# Relevance of Sectorial Caps

**10%**
- Shareholders holding 10% of equity capital can call for oppression and mismanagement

**26%**
- Can block the special resolution

**49%**
- Percentage just below the ordinary majority

**74%**
- Percentage below the special resolution

# Reporting Requirements

- Annexure II
- Annexure III
- FC GPR
- Annual Return on Foreign Liabilities and assets

RIGHT Share
BONUS Share

# Right share

- Sectoral Caps to be complied with
- Compliance with applicable regulations by Existing shares/debentures
- The right share or debentures purchased by the person resident outside India shall be subject to same conditions including restrictions in regard to reparability as are applicable to the original shares against which right shares or debentures are issued
- Pricing :-
  - IN case of listed Companies :- at a price as determined by company
  - In case of shares not listed on stock exchange :- at a price which is not less than the price at which the offer on right shares is made to resident shareholders.

- .

# Bonus Share

(1) Original Shares against which bonus shares are issued were acquired or held by the non resident shareholder in accordance with the Rules/Regulations applicable to such acquisitions

(2) The Bonus share acquired by the non resident shareholder shall be subject to the same conditions including restrictions in regard to repatriability as are applicable to original shares

# Limits on Pre incorporation Expense

1 **Foreign Exchange Management (Current Account Transactions) Rules, 2000**

2 **Schedule III [prior approval of the Reserve Bank]**

3 **Rule 5 - item 17**

Remittances exceeding

- 5% of investment brought into India or
- US$ 1,00,000

whichever is higher, by an entity in India by way of reimbursement of pre-incorporation expenses.

# Capitalization of Preincorporation Expenses

1. **Submission of FIRC for remittance of funds by the overseas promoters for the expenditure incurred;**

2. **Verification and certification of the pre-incorporation/ pre-operative expenses by the statutory auditor**

3. **Payments should be made directly by the foreign investor to the company**

4. **The capitalization should be completed within the period of 180 days permitted for retention of advance against equity**

# General Condition

General conditions:

- Special resolution of the company.
- Government’ s approval would be subject to pricing guidelines of the Reserve Bank and tax clearance.

# Foreign Currency Accounts

- Exchange Earners' Foreign Currency Account (EEFC) is an account maintained in foreign currency with an Authorised Dealer i.e. a bank dealing in foreign exchange.
- 100 per cent of foreign exchange earnings can be credited to the account, so that the account holders do not have to convert foreign exchange into Rupees and vice versa, thereby minimizing the transaction costs.
- Only in the form of a current account.
- No interest is payable on EEFC accounts.

# Guarantee

- If the Indian company has extended a guarantee to a loan taken by non-resident entity (may be its subsidiary abroad), such guarantees are part of contingent foreign liabilities.
- Foreign Exchange Management (guarantees) regulations, 2000

# Due Diligence Report

Check the applicability of provisions to the comapny

Check whether it has been complied with

If yes. Good

If no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