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FAQs

Downstream Investment

November 2024

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November 2024

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1. What is Downstream Investment?

A foreign investor can invest in an Indian entity by acquiring equity instruments or capital, either directly or indirectly through another Indian entity. Here, the expression 'Indian entity' means an Indian company incorporated under the Companies Act, 2013 (CA 2013) or a Limited Liability Partnership (LLP) incorporated under the Limited Liability Partnership Act, 2008 (LLP Act) and does not include any other entities such as partnership firm, trust etc.

Further, the expression 'equity instrument' means equity shares, fully and compulsorily convertible debentures (CCD), fully and compulsorily convertible preference shares (CCPS) and share warrants issued by an Indian company.

When a foreign investor directly acquires equity instruments of an Indian entity subject to the requirements and conditions under the Foreign Exchange Management Act, 1999 and rules and regulations made thereunder (FEMA), particularly, the Foreign Exchange Management (Non-Debt Instruments) Rules, 2019 (NDI Rules), this will qualify as foreign direct investment (FDI). A subset of FDI is the indirect investment by a foreign investor through an Indian entity (where it has made FDI) into the equity instruments of another Indian entity. This indirect mode of FDI is known as downstream investment.

As defined in the NDI Rules, downstream investment is an investment made by an Indian entity or an Investment vehicle, having total foreign investment in it, in the capital instruments or the capital, as the case may be, of another Indian entity. The NDI Rules define "total foreign investment" to mean the total of direct foreign investment and indirect foreign investment and the same will be reckoned on a fully diluted basis.

Investment vehicle is defined under the NDI Rules to mean an entity registered and regulated under the regulations framed by SEBI or any other authority designated for that purpose and shall include - Real Estate Investment Trusts (REITs), Infrastructure Investment Trusts (InvIts), Alternative Investment Funds (AIFs) and mutual funds.

2. What is the Regulatory and Governing Framework for Downstream Investments?

Rule 23 of the NDI Rules provides a regulatory framework for downstream investments. Under this framework, the Indian subsidiaries of foreign investors or the FOCCs (*as explained below*) are treated differently in terms of their further downstream investment activities in India, as compared to other Indian entities, solely for the purpose of regulating downstream investments by the foreign investors.

3. How the Downstream Investment is Beneficial to the Foreign Investors?

Foreign investors who already have presence in India and intend to diversify investments or expand operations through acquisitions, downstream investment could be a better proposition considering that investment and acquisitions undertaken through the Indian subsidiary attracts relatively lesser compliances,

as compared to FDI. Downstream investment can also be used as an efficient tool for deploying surplus funds of Indian subsidiary to achieve investment goals of foreign investor in India.

4. What is a Foreign Owned or Controlled Company (FOCC)?

As clarified in the NDI Rules, an Indian entity which has received foreign investment and is – (a) not owned and controlled by resident Indian citizens; or (b) owned or controlled by non-residents, should be considered as foreign owned or controlled company (FOCC).

5. What Constitutes ‘Control’ While Determining whether an Indian Entity is the FOCC or not?

As clarified in the NDI Rules, in the context of Indian company, the expression ‘control’ means the right to appoint majority of the directors or to control the management or policy decisions including by virtue of their shareholding or management rights or shareholders agreement or voting agreement. In the context of LLP, ‘control’ means the right to appoint majority of the designated partners, where such designated partners, with specific exclusion to others, have control over all the policies of an LLP. Accordingly, an Indian company or LLP, where the control is vested with non-resident persons, are considered as the FOCC.

6. What Constitutes ‘Ownership’ while Determining whether an Indian Entity is the FOCC or not?

In the context of Indian company, ‘ownership’ test is considered to be fulfilled where more than 50% of equity instruments is beneficially held. In case of LLP, contribution of more than 50% of total capital and having majority profit share in such LLP will fulfil the ownership test. Accordingly, an Indian company or LLP, where the ownership is vested with non-resident persons, are considered as the FOCC.

7. What is Indirect Foreign Investment?

Indirect foreign investment means downstream investment received by an Indian entity (i.e., company or LLP) from –

- a) another Indian entity (i.e., company or LLP) which has received foreign investment; and is not owned and not controlled by resident Indian citizens or is owned or controlled by non-residents; or
- b) an investment vehicle whose sponsor or manager or investment manager is not owned and not controlled by resident Indian citizens or is owned or controlled by non-residents.

Please note that no entity other than a company or LLP such as partnership firms, trusts etc. is eligible to receive indirect foreign investment.

8. What are the Key Conditions Applicable for Receiving Indirect Foreign Investment by an Indian Entity?

An Indian entity which is proposing to receive indirect foreign investment should strictly adhere to entry route, sectoral caps, pricing guidelines and other attendant conditions (including reporting requirements) as applicable for FDI. Further, where the FOCC-LLP is planning to make downstream investment, it is allowed to do so only in a company or LLP operating in sectors where foreign investment up to 100% is permitted under automatic route and there are no FDI-linked performance conditions.

9. What are the Conditions to Qualify Downstream Investment as Indirect Foreign Investment?

The Indian investee entity which receives investment from the FOCC entity will qualify as indirect foreign investment upon fulfilling these conditions –

- a) such investment should have the approval of the board of directors of both Indian investee entity and Indian investor entity (i.e., FOCC), including approval of shareholders (if required under CA 2013); and
- b) the FOCC should use either the funds raised from abroad as FDI or its internal accruals for making downstream investment. Here, internal accruals mean the profits transferred to reserve account after payment of taxes.

Hence, the FOCC cannot use borrowed funds to make downstream investment.

10. What are the Guidelines to Compute Total Foreign Investment in Indian Companies?

The guidelines to compute total foreign investment, as prescribed in the NDI Rules, are as follows –

- a) any equity holding by a non-resident resulting from conversion of any debt instrument under any arrangement should be reckoned for total foreign investment. However, FCCBs (foreign currency convertible bonds) and DRs (depository receipts) having underlying instruments in the nature of debt should not be reckoned for total foreign investment;
- b) the methodology for calculating total foreign investment should apply at every stage of investment in Indian companies and thus in each and every Indian company;
- c) for the purpose of downstream investment, the portfolio investment held as on 31st March of the previous financial year in the Indian company (i.e., FOCC) making the downstream investment should be considered for computing its total foreign investment;
- d) indirect foreign investment received by a wholly owned subsidiary of an Indian company should be limited to the total foreign investment received by the company making the downstream investment.

11. Can Downstream Investment be made through LLP?

The FOCC-LLP can make downstream investment by way of subscribing to equity instruments or capital of another Indian entity (i.e., company or LLP) subject to the condition that such company / LLP operate in sectors where foreign investment up to 100% is permitted under automatic route and there are no FDI-linked performance conditions.

12. Which Entity amongst the FOCC and Indian Investee Entity is Responsible for Ensuring Compliance with the NDI Rules?

The FOCC which is making downstream investment should be responsible for ensuring compliance with the provisions of the NDI Rules. It is required to obtain a certificate from statutory auditor on an annual basis and the extent of compliance of the NDI Rules should be mentioned in the director's report attached to annual report of that FOCC. If the statutory auditor has given a qualified report, the same should be immediately brought to the notice of the regional office of the Reserve Bank of India (RBI) in whose jurisdiction the registered office of the FOCC is located and should also obtain acknowledgement from the regional office.

13. What are the Pricing Norms Applicable for Downstream Investment by the FOCC?

As per Rule 23(1) of the NDI Rules, indirect foreign investment should strictly adhere to the pricing norms under the NDI Rules as applicable for FDI. However, there is no adequate clarity about pricing applicability in case of different nature of transactions involving the FOCC. Specifically, Rule 23(5) of the NDI Rules prescribe pricing norms only in case of transactions where the FOCC is the seller, as below:

- Transfer by FOCC to Non-resident – Pricing won't apply;
- Transfer by FOCC to Indian resident – Pricing applies i.e. no reporting;
- Transfer by FOCC to FOCC – Pricing won't apply.

However, there is no clarity in case of transactions where the FOCC is acquiring equity instruments of another Indian entity, from a non-resident/resident/another FOCC and therefore, in the past, different views were taken by different Authorised Dealer (AD) banks while implementing such nature of transactions. Careful study of aforesaid 3 scenarios suggest that the FOCC is treated as 'non-resident' from pricing perspective hence, if this principle is followed, pricing norms should not be applied for transfer of equity instruments of an Indian company from non-resident to the FOCC. However, AD banks have taken different view on this in the past. While there is no official clarification as yet, basis the transactional experience, we understand the RBI is of the view that pricing norm should be applied where the FOCC is buying shares from non-resident. It means that the price at which the FOCC buys shares from non-resident should not be higher than fair market value (FMV) of shares of Indian investee company. Reason for this stance from the RBI could be to curb the flow of domestic funds outside India without any limit.

So, after considering the NDI Rules as well as the RBI's views in certain transactions, it may be broadly noted that, for the purpose of share purchase transactions, the FOCC is treated as 'non-resident' when it is dealing with resident person and as a 'resident' when it is dealing with non-resident person. Accordingly, the investment by the FOCC in the equity instrument of another Indian company (or capital of LLP) should comply with the pricing norms as explained below –

- a) In case of primary investment, the FOCC should subscribe to equity instrument / capital of Indian investee company / LLP at a price equal to or higher than FMV.
- b) In case of secondary investment by the FOCC, as per the NDI Rules – (a) in case of acquisition of equity instrument/capital from resident party, the purchase price should be at a price equal to or higher than FMV; and (b) in case of acquisition from non-resident party, the purchase price should be at a price equal to or lower than FMV.
- c) In case of sale of equity instrument/capital by the FOCC (i.e., disinvestment), as per the NDI Rules - (a) in case of sale of equity instrument/capital to resident party, the sale price should be at a price equal to or lower than FMV; and (b) in case of sale to non-resident party, the pricing norms do not apply and hence, the sale price can be anything as the parties mutually agree.
- d) In case of sale/purchase of equity instrument/capital of Indian investee company/LLP between two FOCC entities, the pricing norms do not apply, and hence the transaction price can be anything as the parties mutually agree.

14. How to Determine FMV of Equity Instrument/Capital for Undertaking Downstream Investment?

The pricing guidelines under the NDI Rules which applies to FDI shall equally apply to downstream investment transactions as well. Accordingly, the FMV of equity instrument / capital of Indian investee company / LLP should be worked out as per any internationally accepted pricing methodology for valuation of shares on arm's length basis, duly certified by a SEBI registered Merchant Banker or chartered accountant or a practicing cost accountant.

15. What are the Reporting Requirements in case of Downstream Investment by the FOCC in Different Scenarios?

As per Foreign Exchange Management (Mode of Payment and Reporting of Non-Debt Instruments) Regulations, 2019 (Reporting Regs), the FOCC which is making downstream investment is responsible to fulfil the reporting requirements, as explained here–

- a) **Primary investment by the FOCC:**
 - FOCC to notify the Secretariat for Industrial Assistance, Department for Promotion of Industry and Internal Trade (DPIIT) within 30 days of such investment i.e., date of remittance (DPIIT Intimation); and
 - FOCC to file Form DI with the RBI within 30 days from the date of allotment of equity instruments.

b) Secondary investment by the FOCC:

- **Purchase from non-resident:** FOCC to file – (i) Form FC-TRS within 60 days of transfer of equity instruments or receipt/remittance of funds, whichever is earlier; (ii) Form DI within 30 days from date of acquisition of equity instruments (practically, post the approval of Form FC-TRS); and (iii) to make DPIIT Intimation within 30 days of investment.
- **Purchase from resident party:** FOCC to file Form DI within 30 days from date of acquisition of equity instruments; and (ii) to make DPIIT Intimation within 30 days of investment.
- **Purchase from other FOCC:** This is a transaction between 2 resident entities and there is no fresh indirect foreign investment as such. However, practically, to record the details of Acquirer FOCC, Acquirer FOCC (in consultation with its AD bank) may be required to – (i) file Form DI within 30 days from date of acquisition of equity instruments; and (ii) to make DPIIT Intimation within 30 days of investment.

c) Disinvestment by the FOCC:

- **Sale of equity instrument to non-resident :** FOCC to file Form FC-TRS within 60 days of transfer of equity instruments or receipt/remittance of funds, whichever is earlier.
- **Sale of equity instrument to resident party:** No specific reporting applies. However, Indian investee company may have to undertake EMF correction by writing to the RBI FIRMS Helpdesk in order to delete indirect foreign investment details from the shareholding pattern of Indian investee company.
- **Sale of equity instrument to other FOCC:** This is a transaction between 2 resident entities and there is no fresh indirect foreign investment as such. However, practically, to record the details of Acquirer FOCC and secondary acquisition of such pre-existing indirect foreign investment, Acquirer FOCC (in consultation with its AD bank) may be required to – (i) file Form DI within 30 days from date of acquisition of equity instruments; and (ii) to make DPIIT Intimation within 30 days of investment.

16. What are the Broad Pricing and Reporting norms in case of the FOCC Undertaking Share Purchase Transactions with Resident / Non-resident / FOCC?

Based on the provisions of the NDI Rules and the RBI's views in certain transactions, the pricing and reporting requirements in different kind of transactions involving the FOCC may be understood in the below manner:

Seller	Buyer	Pricing	Reporting
FOCC	Indian resident	Yes	No reporting
Indian resident	FOCC	Yes	Form DI filing & DPIIT Intimation
FOCC	Non-resident	No	Form FC-TRS
Non-resident	FOCC	Yes	Form FC-TRS, Form DI filing & DPIIT Intimation
FOCC	FOCC	No	No reporting

17. What is the Procedure to be followed for Reporting Downstream Investment?

As per the NDI Rules and Reporting Regs, it is the responsibility of the FOCC, which is making downstream investment, to fulfil the reporting requirements. However, procedurally, both FOCC and Indian investee company have to undertake certain actions as explained below:

- Firstly, the Indian investee entity should create an Entity Master Form (EMF) in its name on the RBI's online platform called, FIRMS (Foreign Investment Reporting and Management System).
- Once EMF is created, the FOCC has to complete Business User (BU) registration process on FIRMS Portal which will be linked to CIN (Corporate Identification Number) of Indian investee entity and the bank account of the FOCC. It means that, where the FOCC is making downstream investment in more than one Indian investee entity, a separate BU registration is necessary for each investee entity.

Once the BU registration is completed, the FOCC can proceed with filing of Form DI and Form FC-TRS (wherever applicable) through the integrated form called - SMF (Single Master Form) on FIRMS online platform. Once they are filed, AD bank of the FOCC will verify and approve the forms.

The documents to be attached while filing Form DI:

- Form PAS-3 (return of allotment) or form SH-4 (securities transfer form)
- Board resolution copy.
- Shareholder's resolution, if any.
- Share valuation report (cut-off date of which not being older more than 90 days prior to the date of share allotment/transfer)
- Requisite declaration in prescribed form
- Any additional document(s) the concerned AD bank may require on case-to-case basis.

The documents to be attached while filing Form FC-TRS:

- Form SH-4 (securities transfer form) or relevant extracts of share transfer agreement along with consent letters of buyer and seller parties
- Share valuation report (cut-off date of which not being older more than 90 days prior to the date of share transfer)
- Non-resident declaration in prescribed format
- In case of sale by a non-resident to the FOCC, acknowledgement of initial FDI reporting copy
- FIRC / Debit Statement/ Outward remittance certificate and KYC report
- No objection/ tax clearance Certificate from Income Tax authority/Chartered Accountant.
- Government approvals, if any
- Any additional document(s) the concerned AD bank may require on case-to-case basis

For more details about EMF, BU creation, preparation and filing of Form DI and FC-TRS, please visit this link of RBI-FIRMS Portal - <https://firms.rbi.org.in/firms/faces/pages/login.xhtml>.

18. Investment in what nature of Instruments do qualify as Downstream Investment in an Indian Company.

Rule 23 of the NDI Rules defines downstream investment as an investment by the FOCC in “capital instruments” of an Indian company. However, the NDI Rules do not define the term “capital instruments”. This was defined under the erstwhile Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2017 (TISPRO 2017) which was replaced with “equity instruments” under the Rules to mean equity shares, debentures which are fully and compulsorily convertible into equity shares, preference shares which are fully and compulsorily convertible into equity shares debentures and share warrants issued by an Indian company. While it seems to be a drafting oversight, from the downstream investment definition standpoint, “capital instruments” may be considered to having same meaning as ascribed to “equity instruments”.

19. Whether the FOCC is Permitted to Invest in Non-equity Instruments?

The term ‘equity instruments’ (i.e., capital instruments) does not include optionally convertible or fully redeemable securities like OCPS (Optionally Convertible Preference Shares), OCDs (Optionally Convertible Debentures), RPS (Redeemable Preference shares) or NCDs (Non-convertible Debentures). Rule 23 of the NDI Rules defines downstream investment to mean investment by the FOCC only in equity instruments of an Indian company. Under CA 2013 which being a primary legislation for issuance of securities, the FOCC is not explicitly restricted from investing in non-equity instrument of an Indian company however, such investment should not qualify as downstream investment.

Having said that, where the FOCC invests in optionally convertible instruments like OCPS/OCDs, upon their conversion into equity shares, they should qualify as downstream investment and the FDI conditions (i.e., entry route, sectoral caps, pricing guidelines and other attendant conditions) would need to be complied with then. However, application of pricing norms at the time of conversion leads to a situation where the FOCC would not know the number of equity shares it will receive upon subscription and this reduces the attractiveness of OCPS and OCDs.

Since there is no adequate clarity in the NDI Rules with regard to investment by the FOCC in non-equity instruments and the AD banks have taken by different views around this, it is advisable to consult the concerned AD bank / the RBI and seek guidance, prior to undertaking such transaction.

20. Can the FOCC make Downstream Investment for Consideration other than cash?

Rule 23(4)(b) of the NDI Rules permits use of funds received from abroad or internal accruals for making downstream investment. Considering this specific requirement, downstream investment by the FOCC for consideration other than cash may not be permitted under automatic route and should require prior RBI’s approval.

21. Can the FOCC make a Downstream Investment against the Swap of Shares?

Rule 23(4)(b) of the NDI Rules permits use of funds received from abroad or internal accruals for making downstream investment. Since this rule specifically provides for the consideration to be in form of cash, downstream investment through swap of shares may require prior approval of the RBI.

22. Whether Deferred Payment (such as Post-closing Escrow, Indemnity or Price Adjustment) Arrangements would be Permitted in Downstream Investment Transaction?

Rule 9(6) of the NDI Rules permits the deferred payment arrangement only in case of cross-border transactions (i.e. between resident and non-residents) subject to conditions that – (i) the deferred payment (including in form of post-closing escrow/indemnity/price adjustment) should not exceed 25% of total consideration; and (ii) such deferred amount is paid within a period not exceeding 18 months from the date of the transfer agreement.

The FOCC, being an entity registered in India, is an Indian resident. Hence, where the transaction involving deferred payment arrangements is proposed between the FOCC and non-resident entity, this would qualify as cross-border transaction and hence, should be permissible subject to fulfilling the aforesaid conditionalities under Rule 9(6) of the NDI Rules.

In case of transaction proposed between the FOCC and Indian resident, since the FOCC is an Indian entity and Rule 9(6) of the NDI Rules applies only in case of cross-border transactions, it can be argued that the conditions under Rule 9(6) should not apply for the transactions between the FOCC and Indian resident. However, considering that the FOCC needs to be treated at par with non-resident when it is dealing with Indian resident entity, , practically, the RBI is taking a view that such transaction may not be allowed under automatic route and shall require prior approval of the RBI. Hence, it is advisable to consult the concerned AD bank / the RBI and seek guidance, prior to undertaking such transaction.

23. Whether the Restriction on Receiving FDI from Land-bordering Countries under Press Note 3 (2020) applies to Downstream Investment as well?

As per Rule 23 of the NDI Rules, downstream investment by the FOCC, being a sub-set of overall FDI framework, should also adhere to entry route and sectoral caps conditions as prescribed for FDI and the restriction on receiving FDI from land-bordering countries is one of the key entry route condition. Hence, the downstream investment from the FOCC (which has investors or beneficial owner from the land-bordering countries) shall require prior approval of the Government as per Press Note 3 (2020).

About NDA

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We are a research and strategy driven international firm with offices in Mumbai, Palo Alto (Silicon Valley), Bengaluru, Singapore, New Delhi, New York and Gift City. Our team comprises of specialists who provide strategic advice on legal, regulatory, and tax related matters in an integrated manner basis key insights carefully culled from the allied industries.

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Research@NDA

Research is the DNA of NDA. In early 1980s, our firm emerged from an extensive, and then pioneering, research by Nishith M. Desai on the taxation of cross-border transactions. The research book written by him provided the foundation for our international tax practice. Since then, we have relied upon research to be the cornerstone of our practice development. Today, research is fully ingrained in the firm's culture.

Over the years, we have produced some outstanding research papers, reports and articles. Almost on a daily basis, we analyze and offer our perspective on latest legal developments through our "Hotlines". These Hotlines provide immediate awareness and quick reference, and have been eagerly received. We also provide expanded commentary on issues through detailed articles for publication in newspapers and periodicals for dissemination to wider audience. Our NDA Labs dissect and analyze a published, distinctive legal transaction using multiple lenses and offer various perspectives, including some even overlooked by the executors of the transaction. We regularly write extensive research papers and disseminate them through our website. Our ThinkTank discourses on Taxation of eCommerce, Arbitration, and Direct Tax Code have been widely acknowledged.

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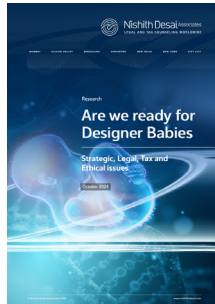
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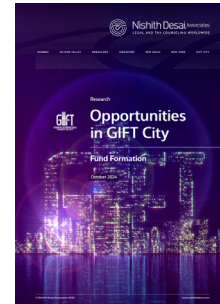
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