E A S Sarma

Former Secretary to Government of India

To

Shri Ajay Seth

Secretary (DEA)

Ministry of Finance

Govt of India

Dear Shri Seth

I refer to the revised overseas investment rules issued by the Union Finance Ministry vide GSR 646(E) dated 22-8-2022 on overseas direct investment (ODI).

Apparently, these rules were notified on the basis of a draft notification placed in the public domain about a year ago, calling for feedback. I am not sure whether the Ministry had received any objections on the draft and whether the same were carefully examined, before notifying the Rules one year later.

One important change that has got incorporated in the notified rules, as compared to the earlier draft, whatever be the provocation for it, is that the last year's draft clearly stipulated that the proposed relaxations would be prohibited if there was any indication whatsoever that the investment in question was being made to avoid taxation and not by way of a genuine business transaction. In contrast, the latest notified rules [Rule 19(3)] have dropped that stipulation altogether and substituted it with the condition that "*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, either directly or indirectly, resulting in a structure with more than two layers of subsidiaries*". In other words, an overseas investment would still be permissible now, if the foreign entity in question invests into India, either directly or indirectly, either through a subsidiary registered in the main overseas location or in a third country, irrespective of whether the investment implies tax avoidance or outright evasion. Often, some companies do create such layers of subsidiaries spread over more than one country, primarily to evade domestic taxation.

It is surprising that such a paradigm change should be introduced within one year of the publication of the draft last year! By introducing such a change, has the Finance Ministry indirectly done something that will legalize tax evasion through money laundering?

This is further compounded by the absence of any stipulation regarding the nature of the country where the overseas investee company is located. In the absence of such a stipulation, it is possible that a domestic company invests in an overseas company located in a country where there are not enough safeguards to prevent money laundering.

For example, SEBI has, vide its recent notification, SEBI/HO/AFD-1/PoD/CIR/P/2022/108 dated 17-8-2022 on Guidelines for overseas investment by Alternative Investment Funds (AIFs) / Venture Capital Funds (VCFs), has stipulated that

"*(iv) AIFs/VCFs shall not invest in an overseas investee company, which is incorporated in a country identified in the public statement of Financial Action Task Force (FATF) as:*

(a) a jurisdiction having a strategic Anti-Money Laundering or Combating the Financing of Terrorism deficiencies to which counter measures apply; or

(b) a jurisdiction that has not made sufficient progress in addressing the deficiencies or has not committed to an action plan developed with FATF to address the deficiencies"

I am surprised that the 2022 ODI notification fails to qualify the destination country in a similar manner. In the absence of such a stipulation, it is possible that some domestic companies make ODI in countries where there are no safeguards against money laundering and therefore create opportunities for outright tax evasion. I am sure that it is not the intention of the Finance Ministry to create such opportunities.

There is another component of the 2022 ODI Rules that raises concerns. Rule 3(1) states that

"*the total financial commitment made by an Indian entity in all the foreign entities taken together at the time of undertaking such commitment shall not exceed 400 percentof its net worth as on the date of the last audited balance sheet or as directed by the Reserve Bank, in consultation with Central Government from time to time*"

The upper limit of 400% could cause the domestic ecomnomy's exposure to undue risk, especially when more than one domestic company takes advantage of this relaxation, which needs to be carefully analysed.

There are other equally important lacunae in the 2022 ODI Rules.

The High Level Advisory Group (2019) set up by the Ministry of Commerce considered among others, the restrictions required for ensuring that overseas investment opportunities may not be misused for laundering money and evading taxes. That Group had recommended a stipulation to the effect that an Indian party should be allowed to undertake ODI in a structure which already has an existing FDI structure in India <u>only if</u> the total value of existing FDI does not exceed 25% of the consolidated net worth of the foreign entity in which ODI is being made; and, any additional FDI should be allowed only if such funds are not directly or indirectly from India.

The latest ODI rules are totally silent on this aspect. Apparently, the Finance Ministry has not cared to consider the High Level Advisory Group's recommendations.

I am somewhat perplexed about the timing of the 2022 ODI Rules, at a time when India's external debt, especially short-term external borrowings are mounting, when foreign exchange remittances are plateauing, when the import bill on several important commodities like oil, gas, fertilisers, coal and so on is increasing, with the rupee has come under pressure in the exchange market and when the foreign exchange reserves are depleting.

I request the Finance Ministry to revisit the ODI regime in view of these concerns and make sure that it does not open the floodgates to unhealthy money laundering that hurts the economy.

Regards,

Yours sincerely,

E A S Sarma

Visakhapatnam

18-9-2022