Corpsec Hotline

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SETTING UP SHOP - REVISITED

Under the present provisions of the Foreign Exchange Management Regulations, the Reserve Bank of India ("RBI") approves applications made for setting up of a Branch Office ("BO") or Liaison Office ("LO") by foreign entities on a case by case basis. Such applications are subject to the foreign entity meeting certain eligibility criteria such as track record, financial position etc.

Further, the RBI also monitors the activities of a BO/LO by verifying the audited accounts, certificates and other documents filed by the BO/LO on an annual basis, in respect of procedural compliance.

With a view to streamlining the process, the RBI has proposed to delegate certain powers to Authorized Dealers with respect to the opening and closing of a BO/LO. Additionally to achieve greater transparency, the RBI is also seeking to make public the eligibility criteria that need to be satisfied by a foreign entity for setting up a BO/LO in India. The RBI has published the notification for delegation of powers as well as the eligibility criteria for public comments.

Present Situation:

1. The RBI approves the setting up of the BO or LO on a case to case basis subject to fulfillment of certain criteria. The criteria was hitherto not publicly known and led to a certain lack of transparency in the reasons for rejection of an application.
2. The BO/LO is required to submit an Annual Activity Certificate obtained from its auditors directly to the RBI. The RBI was consequently burdened with the obligation to review the same causing other applications and responses from the RBI to be delayed.
3. The RBI looks into all cases of extension of the validity period for approvals. The lack of publicly known criteria meant that such extensions were not easy to obtain.
4. No identification number for BO/LO. This made communication with the RBI more cumbersome, and did not allow the RBI to easily correlate new submissions with old information. This is particularly cumbersome where a name change has occurred.
5. Prior to the winding up of a BO/LO, submission of a 'No Objection or Tax Clearance Certificate' from Income Tax Authorities to the RBI was required. This certificate took some time to obtain and hence made the process of closure of a BO/LO lengthy.

Eligibility criteria for setting up of BO/LO:

As mentioned above, the criteria for considering the applications by the RBI for setting up of BO/ LO was not in public domain and now the RBI has proposed to make the criteria public.

Applications for setting up of BO/LO are considered on two levels of criteria - basic and additional. Under the basic criterion, an application of a foreign entity has to fall either under the RBI route or the government route.

The RBI route applies to applications from foreign entities which are engaged in sectors where sectoral cap for foreign direct investment (FDI) under the automatic route is 100%. Under this route, the RBI grants permission to set up BO /LO on its own without reference to any other ministry or authority.

The RBI has placed the sectors for which sectoral cap for FDI under automatic route is less than 100 % under the government route. Under this route, the RBI considers the applications of foreign entities in consultations with the Government of India, Ministry of Finance, Department of Economic Affairs (DEA) and the respective administrative ministry.

Under the additional criteria, the foreign entity has to satisfy two conditions. The first condition is that foreign entity must have a profit-making track record during the immediately preceding five years in the home country for setting up of a BO and during the immediately preceding three years in the home country for setting up of a LO.

Under the second condition, for setting up of a BO, foreign entity must have minimum net worth of USD 100,000 and minimum net worth of USD 50,000 for setting up a LO.

Changes proposed with effect from July 1, 2008:

1. With effect from July 1, 2008, a BO and LO have to submit an Annual Activity Certificate to their Authorized Dealer instead of RBI. The said Certificate has to be provided within one month of the date of finalization of the accounts.
2. Authorized Dealers have been permitted to extend the validity period of an approval for a LO for a further period

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of three years subject to fulfillment of certain conditions by the LO. It may be noted that there can be no extension of the validity period of an approval for LOs of entities which are NBFCs and those engaged in construction and development sectors. Upon expiry of the validity period, these entities have to either close down or be converted into a full-fledged Joint Venture (JV) / Wholly Owned Subsidiary (WOS), in conformity with the extant FDI policy.

3. RBI will allot a Unique Identification Number (UIN) to both the existing as well as the new BO /LO which is required to be quoted in all correspondence to the RBI and Authorized Dealer.
4. An entity with a LO /BO has the option of submitting an undertaking, along with a certificate from the Chartered Accountant for closure of LO/ BO instead of having to submit an Income Tax Clearance Certificate obtained from Income Tax Authorities.

Impact and Implications:

1. The RBI has made clear that applications from banks and insurance companies will continue to be directly received and examined by the Department of Banking Operations and Development, Reserve Bank, Central Office and the Insurance Regulatory and Development Authority (IRDA), respectively. The new guidelines are therefore not applicable to such entities.
2. The option to submit an undertaking by the applicant along with Certificate obtained from a Chartered Accountant for the closure of a BO/LO is a step towards faster process. Obtaining the Tax Clearance Certificate from Income Tax Authorities does take a considerable amount of time which makes the process of closure quite lengthy.
3. The criterion of a profitable track record is neither unduly high nor inordinately onerous and hence ensures that only real and commercial ventures try to set up a presence in the country. However, there appears to be no latitude to a foreign entity which has been in existence for less than the prescribed period but has been profitable and meets the net worth criterion prescribed.
4. It is evident from the draft circular that though RBI has proposed to delegate certain powers to Authorised Dealers, the power of approving the set up of BO/LO is still with the RBI and the change is merely that an applicant will have to route documents through the Authorized Dealer who will forward the same with its comments to the RBI.
5. The effective date for delegating the power to the Authorized Dealer in respect of extension of validity period of Liaison Office is not mentioned in the circular. However, it appears that the RBI intends to delegate this function with effect from July 1, 2008.
6. Mr. Kishore Joshi, a senior member of the Corporate and Regulatory Practice feels that “in certain cases the RBI should consider the net worth of the ultimate parent which desires to set up BO/LO through its subsidiary. A subsidiary being the immediate “parent” of the BO/LO is sometimes set up to act as a hub for the offices in the Asian region and may not fulfill the additional criterion of profit track record and net worth.” The RBI has considered such circumstances in the past and has approved LOs based on an undertaking from the ultimate parent that it will be responsible for the funding of the proposed LO in India. It is hoped that the RBI will find a way to retain this flexibility.

Conclusion

It is hoped that this delegation of function by the RBI to the Authorized Dealer will lead to more expeditious disposal of applications to set up and close Branch and Liaison offices in India.

Source: RBI: Circular

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