OVERVIEW OF FOREIGN EXCHANGE MANAGEMENT ACT

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BACKGROUND – EVOLUTION OF FOREIGN EXCHANGE REGULATIONS IN INDIA

Exchange regulations have always remained at the centre of Indian economy. Exchange controls were first introduced in India during the Second World War (1942). Soon after independence, they were formally reaffirmed in form of the first Foreign Exchange Regulation Act, 1949 (FERA). This was followed by FERA, 1973. The control framework under FERA was essentially transaction based in terms of which all transactions in foreign exchange including those between residents to non-residents were prohibited unless specifically permitted.

Transformation from control-to-management: FERA to FEMA

The 1970s and 1980s saw the rise of large external sector imbalances on account of persistent increase in adverse balance of payments situation. There was over dependence on official foreign aid. It was this balance of payment crisis that triggered the wave of economic liberalization. The Indian rupee became market determined in 1993. The need was felt to consolidate and amend the law relating to foreign exchange with the objectives of facilitating external trade and payments and for promoting the orderly development and maintenance of foreign exchange market in India. Accordingly, on June 1, 2000, the Foreign Exchange Management Act, 1999 (FEMA) was brought in force to replace the then existing Foreign Exchange Regulation Act, 1973 (FERA). FEMA has been enacted with an objective of facilitating external trade and payments and for promoting the orderly development and maintenance of foreign exchange market in India. As such it is quite opposed to FERA which was enacted to regulate or control the foreign exchange. FEMA provided a de jure status to the shift in policies with regard to the external sector reforms that began in 1990-91.

STRUCTURE OF FEMA

The present framework of exchange controls in India, consist of basic legislation (FEMA, 1999) and Notifications, Rules and Circulars [known as Authorized Persons Directions – AP (Dir Series)] issued by RBI. FEMA applies to the whole of India and all branches, offices and agencies outside India which are owned or controlled by a person resident in India. It also applies to any contraventions committed outside India by any person to whom FEMA applies.
There are 49 sections under FEMA, of which 9 sections (section 1 to 9) are substantive and the rest are procedural / administrative provisions as tabulated below:

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Section 46 of FEMA grants power to the Central Government to make rules to carry out the provisions of FEMA and Section 47 of FEMA grants power to the Reserve Bank of India (RBI) to make regulations to implement provisions and the rules made under FEMA. Thus RBI is entrusted with the administration and implementation of FEMA.

**CAPITAL ACCOUNT TRANSACTION AND CURRENT ACCOUNT TRANSACTION:**

In August 1994 India accepted Article VIII of the Articles of agreement of the International Monetary Fund and became fully convertible on the current account. Since India is fully convertible on the current account, all current account transactions (barring a small list of restricted items) are allowed through the normal banking channels. In case of capital account transactions, only the transactions which are explicitly enabled under the guidelines are allowed, remaining require specific approvals under FEMA.

Accordingly it is very important to understand the concept of Capital and Current Account Transactions to Comprehend FEMA.

A. Capital Account Transaction:
“Capital Account transaction” is defined under section 2(e) of FEMA as ‘a transaction which alters the assets or liabilities, including contingent liabilities, outside India of persons resident in India or assets or liabilities in India of persons resident outside India, and includes transactions referred to in sub-section (3) of section 6.’

Thus any transaction as a result of which the assets or liabilities outside India of a person who is resident in India and assets or liabilities in India of a person who is resident outside India are altered i.e. either increased or decreased, is a capital account transaction.

To put it in example, if a person resident in India acquires shares of a foreign company, his/her overseas assets will increase. Similarly, if the same person borrows from a non resident through External Commercial Borrowings (ECBs) his/her liability is created outside India. Hence, both the transactions lead to creation of asset or liability outside India of a person resident in India. Both the transactions are capital account transactions.

In case of a person resident outside India, if he acquires shares of an Indian company, his/her asset is created in India and if same person borrows from an institution in India for acquiring house in India, his/her liability will be created in India. Both these transactions lead to creation of asset or liability in India of a person resident outside India. Hence, both the transactions are capital account transactions.

The concept of Capital and Current Account transaction is to be seen from Balance of Payment point of view. If after the completion of transaction there remains any obligation to either pay or receive foreign exchange, the transaction would get colour of Capital Account transaction.

For example, import of Plant & Machinery is a current account transaction, as upon import the machinery is received in India and overseas supplier is say paid within six months from import and accordingly there is no future obligation on India as a country to honour foreign exchange obligation. In this example, from accounting perspective, though Plant & Machinery would be capital goods, but for FEMA it would be a current account transaction.

RBI has been empowered under section 6(2) of FEMA to specify, in consultation with the Central Government, any class or classes of Capital Account transactions which are permissible [i.e. over and above the transactions permitted under section 6(3)]. Section 6(3) of FEMA specifies the classes of capital account transactions which are regulated by RBI. Every transaction listed in this section is regulated by a corresponding notification/regulation.
FEMA Notification No. 1/2000-RB dated 3-5-2000 contains the list of permissible capital account transactions as well as list of prohibited capital account transactions.

**Prohibited Capital Account Transactions:**

**General Prohibition:**

A person shall not undertake or sell or draw foreign exchange to or from an Authorized person for any capital account transactions other than those permitted in the Schedules, provided the transaction is within the limit.

**Special Prohibition:**

No person resident outside India shall make investment in India, in any form, in any company or partnership firm or proprietary concern or any entity, whether incorporated or not, which is engaged or proposes to engage-

- In the business of chit fund, or
- As nidhi company, or
- In agricultural or plantation activities, or
- In real estate business, or construction of farm houses, or
- In trading in Transferable Development Rights (TDRs)

(real estate shall not include development of townships, construction of residential/commercial premises, roads or bridges).

**B. Current Account Transaction:**

“Current account transaction” is defined under section 2(j) of FEMA to mean ‘a transaction other than a capital account transaction and without prejudice to the generality of the foregoing such transaction includes,-

(i) payments due in connection with foreign trade, other current business, services and short-term banking and credit facilities in the ordinary course of business,

(ii) payments due as interest on loans and as net income from investments,

(iii) remittances for living expenses of parent, spouse and children residing abroad, and

(iv) expenses in connection with foreign travel, education and medical care of parents, spouse and children.’
All Current Account transactions are generally permitted unless specifically prohibited whereas all Capital Account transactions are generally prohibited unless specifically permitted.

Current Account transactions are divided into 3 schedules in Current Account Transaction rules:

Schedule I – Prohibited Transactions
Schedule II – Transactions requiring prior approval of Government of India
Schedule III – Transactions requiring prior approval of RBI

EXAMPLES TO UNDERSTAND CAPITAL AND CURRENT ACCOUNT TRANSACTIONS:

a. **Import of Machinery on hire purchase:**
   In this transaction the person has created future obligation for making payment to non-resident and hence has liability towards the non-resident. Therefore the said transaction is a capital account transaction.

b. **Transaction representing creation or acquisition of wealth, shares, loans or immovable properties:**
   Since such types of transactions would lead to creation of assets in or outside India by person resident outside or in India, as the case may be, the same are in nature of capital account transactions.

c. **Remittances out of winnings from lottery:**
   This comes under Prohibited list (Schedule I) of the Current account transaction. Hence although the same is in nature of current account such transactions are prohibited.
   However, an entity engaged in lottery business, imports any software or machinery to be utilized in lottery business in India, the same is a permissible transaction. Import of software or machinery will not result in violation of FEMA regulations in relation to current account transactions.
But any type of technical collaboration for lottery business including licensing for franchise, trademark, brand name, management contract or any contract for payment of royalty as such for such collaboration is prohibited under both current account transaction rules and also under FDI Policy. Hence, such transactions are not permissible.

d. **Options premium payable under NASDAQ:**
Options premium is the price paid by a person to buy an option contract, whether it is a call or put. So option premium is paid to acquire only specified rights for a contract. Under option contract there is no future obligation in addition to option premium paid at the time of entering into contract so it does not result into creation of any contingent liability and hence is a current account transaction. Whereas future contract would be a capital account transaction. Option contract may result into creation of contingent asset, and such contingent asset is not covered in the definition of Capital Account transaction.

e. **Opening a branch outside India:**
Opening a branch outside India is a current account transaction as it does not result into alteration of any assets and liabilities overseas, since overseas branch would be regarded as Resident of India. If however, such overseas branch proposes to acquire immovable property (say office premises) outside India, such acquisition would be regarded as Capital Account Transaction.

Opening a branch outside India is a permissible current account transaction and regulated by Notification No. 10/2000-RB dated 3-5-2000 dealing with Foreign Currency accounts by a person resident in India.

**OTHER IMPORTANT SECTIONS – SEC 6(4) AND SEC 6(5):**

**Section 6(4):**
A person resident in India may hold, own, transfer or invest in foreign currency, foreign security or any immovable property situated outside India if such currency, security or property was acquired,
held or owned by such person when he was resident outside India or inherited from a person who was resident outside India.

However, there was no clarity on the type of transactions that would be covered under section 6(4). Hence, RBI with a view to resolve the doubts, vide its A. P. (DIR Series) Circular No. 90 dated January 9, 2014 clarified that the following transactions shall be covered under Section 6(4) of FEMA, 1999:

a. Foreign currency accounts opened and maintained by such a person when he was resident outside India.

b. Income earned through employment or business or vocation outside India taken up or commenced, or from investments made, or from gift or inheritance received while such a person was resident outside India.

c. Foreign exchange including any income arising there from, and conversion or replacement or accrual to the same, held outside India acquired by way of inheritance from a person resident outside India.

d. A person resident in India may freely utilize all their eligible assets abroad as well as income on such assets or sale proceeds thereof received after their return to India for making any payments or to make any fresh investments abroad without prior approval of RBI

Thus, section 6(4) gives liberty to a person resident in India to keep with him any foreign currency or foreign security or immovable property which he might have acquired when he was resident outside India, without any compliance and reporting under FEMA.

**Section 6(5):**

A person resident outside India may hold, own, transfer or invest in Indian currency, security or any immovable property situated in India if such currency, security or property was acquired, held or owned by such person when he was resident in India or inherited from a person who was resident in India.

This section allows a person resident outside India to keep with him any currency, security or immovable property which he might have acquired when he was resident in India. In case if the person liquidates his investment owned by him in India, he can keep the funds in his NRO account. RBI vide Notification 13 (Remittance of assets) allows to remit the balances of sales proceeds of assets held by NRI subject to the limit of USD 1 million per financial year.
RBI had initially issued 25 notifications, covering capital account transactions prescribed in section 6(3) and certain miscellaneous provisions. Out of 25 notifications 15 are relating to capital account transactions, 1 for export of goods and services and 9 for other regulations. Given below is the gist of initial 25 notifications:

Notifications related to Capital Account Transactions:

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<td>Transfer or issue of any security or foreign security by any branch, office or agency in India of a person resident outside India</td>
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<td>Any borrowing or lending in foreign exchange in whatever form or by whatever name called</td>
<td>No. 3</td>
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<td>(d)</td>
<td>Any borrowing or lending in rupees in whatever form or by whatever name called between a person resident in India and a person resident outside India</td>
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<td>(f)</td>
<td>Export, import or holding of currency or currency notes</td>
<td>No. 6</td>
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<td>Transfer of immovable property outside India,</td>
<td>No. 7</td>
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other than a lease not exceeding five years, by a person resident in India

(h) Giving of a guarantee or surety in respect of any debt, obligation or other liability incurred -
by a person resident in India and owed to a person resident outside India
by a person resident outside India

No. 8
Sec 6(3)(j) read with Sec 47(2)

(i) Insurance
No. 12
Sec 47(2)

(j) Remittance of Assets
No. 13
Sec 47

(k) Transfer or issue of any Foreign Security
No. 120 dated July 07, 2004
Sec 6(3)(a) read with Sec 47

(l) Transfer or issue of any security by a person resident outside India
No. 20
Sec 6(3)(b) read with Sec 47

(m) Acquisition or transfer of immovable property in India, other than a lease not exceeding five years, by a person resident outside India
No. 21
Sec 6(3)(i) read with Sec 47(2)

(n) Establishment in India of Branch or Office or other place of business
No. 22
Sec 6(6)

(o) Investment in Firm or Proprietary Concern in India
No. 24
6(3)(h) read with Sec 47(2)

### Notification related to Export of Goods and Services:

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RESIDENTIAL STATUS UNDER FEMA:

Under FEMA, residential status is of two types viz. Person resident in India and Person resident outside India. In FERA, citizenship was considered as the deciding factor. However, FEMA lays emphasis on ‘residing’ which denotes permanency.

“Persons Resident in India” means -

(i) a person residing in India for more than one hundred and eighty-two days during the course of the preceding financial year but does not include —

A. a person who has gone out of India or who stays outside India, in either case -
   ▪ for or on taking up employment outside India, or
   ▪ for carrying on outside India a business or vocation outside India, or
for any other purpose, in such circumstances as would indicate his intention to stay outside India for an uncertain period.

B. a person who has come to or stays in India, in either case, otherwise than -
   - for or on taking up employment in India, or
   - for carrying on in India a business or vocation in India, or
   - for any other purpose, in such circumstances as would indicate his intention to stay in India for an uncertain period.

(ii) any person or body corporate registered or incorporated in India,

(iii) an office, branch or agency in India owned or controlled by a person resident outside India,

(iv) an office, branch or agency outside India owned or controlled by a person resident in India.

[Section 2(v)]

"Person Resident outside India" means a person who is not resident in India. [Section 2(w)]

FEMA is a regulatory law and therefore unlike Income Tax Act, which looks at only condition of number of days stay in or outside India to determine residential status for determining tax liability at the end of previous year, FEMA lays more emphasis on intention/purpose of leaving India or coming to India. Say for example, a person has left India on 1\textsuperscript{st} of February for employment. In this case even though the person has stayed for more than 182 days in India in preceding financial year but his intention going abroad was for employment. So immediately from the day he leaves India he will be treated as person resident outside India or Non Resident, under FEMA. Taking the above example forward now since the person becomes resident outside India, he can immediately open a foreign currency account outside India which otherwise would not have been possible if he was treated as person resident in India. Hence, while referring to the residential status of a person his purpose or intention matters the most.

SECTION 3 – DELINGS IN FOREIGN EXCHANGE:

Section 3 contains very important provisions and it has four sub-sections, which are explained hereunder:
a. *No person shall, save as otherwise provided, deal in or transfer any foreign exchange or foreign security to any person not being an authorised person.*

The word 'deal in' is a wide term and should include purchase, acquire, borrow, sell or otherwise transfer or lend or to exchange with. The intention here is to regulate dealings in foreign exchange through authorized persons (such as Banks, Money changers etc.). The transactions of Foreign exchange resulting in earnings or spending must be routed through Authorized Persons, except where specifically provided. Contravention of Sec 3(a) is a very serious offence and it cannot be compounded by RBI but has to be referred to Enforcement Directorate.

b. *No person shall make any payment to, or for credit of any person resident outside India (NR) in any manner.*

This provision is highly restrictive and debars resident for making any payment to or for the credit of any person resident outside India in any manner. This led to practical difficulties, such as when a NRI visits India to meet his relatives, even his close relatives cannot offer hospitality to him or such NRI cannot be given gift in INR in India. Realizing the practical difficulty and with a view to provide relaxations, a Notification No. 237 dated 25.09.2012 was issued allowing a resident individual to make a gift or grant loan to an NRI who is close relative, in rupees by way of crossed cheque/electronic transfer to NRO account. [Close relative shall have the same meaning as that of ‘relative’ under the Companies Act, 1956 and the amount so paid shall be within the permissible limit specified in Liberalised Remittance Scheme (LRS)].

c. *No person shall receive otherwise through an Authorised Dealer (AD) any payment by order or on behalf of any NR in any manner.*

Explanation – where any person in, or resident in, India receives any payment by order or on behalf of any person resident outside India through any other person (including an authorised person) without a corresponding inward remittance from any place outside India, then such person shall be deemed to have received such payment otherwise than through an authorised person.
d. **No person shall enter into any financial transaction in India as consideration for or in association with acquisition or creation or transfer of a right to acquire, any asset outside India by any person.**

Explanation – financial transaction means making any payment to, or for the credit of any person, or receiving any payment for, by order or on behalf of any person, or drawing, issuing or negotiating any bill of exchange or promissory note, or transferring any security or acknowledging any debt.

As per Notification No. 17 dated May 03, 2000 of FEMA, the above clauses 3(b), (c) and (d) of Section 3 shall not apply to any transaction entered into in Indian rupees by or with:

- A person who is a citizen of India, Nepal or Bhutan resident in Nepal or Bhutan or
- A branch situated in Nepal or Bhutan of any business carried on by a company or a corporation incorporated in any of the three nations or
- A branch situated in Nepal or Bhutan of any business carried on as partnership or otherwise by a citizen of any of the three nations.

**TO CONCLUDE WITH:**

To learn FEMA, the clarity on the concept of Capital and current count transactions is of paramount importance. Capital account transactions still being regulated, there is a need for professionals who could provide services in FEMA.

Though there is a strong desire to remove controls on even capital account, it seems that, controls on capital account would continue in India for quite many years to come, considering recent experience of global melt down of 2008 and suffering of economies with no control.