Exchange Control Risk related to new Income Tax Disclosure Scheme

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Budget 2026 introduced a new Foreign Assets Disclosure Scheme (**'Scheme'**) providing an option to individual taxpayers to regularise previous non-disclosures of foreign assets and income arising therefrom. Suo-moto disclosure of undisclosed foreign income and foreign assets up to ₹5 crore and cases involving reporting lapses is permitted, in situations where income has already been offered to tax but the corresponding foreign assets were erroneously not reported, up to ₹1 crore. Defaults can be regularised by eligible individuals. Such individuals would need to pay the prescribed tax and penalty and would consequently be afforded immunity from prosecution and penal consequences under the Income Tax Act and the Black Money (Undisclosed Foreign Income and Assets) and Imposition of Tax Act, 2015. The Scheme extends only to individuals; and other persons such as companies, LLPs, firms, trusts, or other non-individual entities would not qualify for disclosures under the Scheme.

Although the Scheme provides relaxation under income tax, such relief does not expand into regulatory regularisation under the exchange control framework. The bulwark for tax regularisation and that of exchange-control compliance operate in separate domains.

Given that dispensation granted under the Scheme does not extend to FEMA contraventions, it is of great importance that before making tax disclosures under the Scheme, individuals meticulously assess whether the transactions leading to foreign income and assets are compliant with the regulatory guidelines and the rules and regulations framed thereunder.

This article addresses possible violations that may arise in connection with such foreign assets and foreign income, along with resolution and options afforded for post-facto compliance under the exchange control guidelines.

A. Outbound Investments

Financial Services

Paragraph 1 of Schedule III of the Foreign Exchange Management (Overseas Investment) Rules, 2022 (**OI Rules**) prohibits resident individuals to make direct investments overseas in entities engaged in financial services activity. An overseas entity will be considered as engaged in the business of financial services activity if it engages in an activity, which if carried out by an entity in India, would necessitate registration with/ regulation by a financial sector regulator in India. Exceptions to this provision would include acquisition by way of inheritance, minimum qualification shares, sweat equity shares, shares under ESOP or employee benefit schemes.

Investments in foreign fintech platforms, investment advisory businesses, lending/funding ventures, trading applications, and crypto exchanges, may fall within the ambit of financial service activity as described in the overseas investment framework in India. Whilst such businesses may be well permitted and commercially virtuous in the host country, investment therein may result in a contravention of FEMA.

Multi-level investments

Paragraph 1 of Schedule III of the OI Rules, restrict resident individuals from making overseas direct investment in a foreign entity with a layered structure. Although an individual can make direct investments in a foreign entity, such entity cannot have any subsidiary/step-down subsidiary. This requirement would not extend to acquisition by way of inheritance, qualification shares, sweat equity shares, shares under ESOP or employee benefit schemes.

Thus, resident individuals investing in overseas start-ups or offshore holding companies operating through layered structures may inadvertently violate India's exchange control regimeand render the transaction non-compliant ab initio.

Unauthorised Overseas Funding

The exchange control framework strictly precludes unauthorised cross-border funding transactions through cash payments, informal settlement mechanisms or non-banking routes, such as cash funding (through associates/friends/relatives), hawala transactions, third-party funding structures and other unauthorised platforms/applications.

Unauthorised funding structures, often adopted for the ease of facilitating money transfers and for operational convenience, can result in substantive violations and penal implications under the cross-border regime.

Non-compliance with reporting requirements

Regulation 9 of the OI Regulations, requires a person resident in India making direct investments overseas to obtain a Unique Identification Number (**UIN**) from RBI before sending outward remittance or acquisition of equity capital in a foreign entity, whichever is earlier, by submitting to the Authorised Dealer (**AD**) bank, an application in Form FC. Further, share certificates or other documentary evidence as proof of such investment is also to be submitted to the designated AD bank within 6 months from the date of remittance/investment.

From a practical perspective, there is usually a time lag between incorporation of the foreign entity and opening of the bank account for remittance of funds overseas. This could possibly result in filings being deferred payments, and inadvertent delays in complying with reporting requirements prescribed. Furthermore, individuals often overlook furnishing share certificates or relevant documentary evidence of investment within the required timeline, resulting in non-adherence with regulatory requirements.

B. Monies Parked Abroad

Bank accounts and fixed deposits overseas must be critically reviewed under Regulation 7 of the Foreign Exchange Management (Realisation, Repatriation and Surrender of Foreign Exchange) Regulations, 2015 and, Paragraph 17 of the Master Direction on Liberalised Remittance Scheme (**LRS**), which set out obligations for repatriation and surrender of foreign exchange by persons resident in India. A person resident in India is required to surrender any foreign exchange received, realised, unspent or unused to an authorised person within 180 days from the date of such receipt, realisation, purchase, acquisition or from the date of his return to India, as applicable.

Resident individuals parking idle money in bank accounts or fixed deposits abroad beyond the prescribed time frame, would potentially be in contravention of the exchange control guidelines.

The provision relating to repatriation also applies to incomes earned from investments; and such income would need to be re-invested abroad or repatriated within 180 days as stated by law.

Concluding remarks

Whilst this article addresses only a few situations that may trigger FEMA non-compliance, similar instances are frequently observed and may have varying ramifications. Existence of a FEMA contravention does not bar disclosure under the Scheme. However, tax disclosures may also require a parallel evaluation under cross-border regulations.

FEMA being an intent-based law also grants relief in various situations, as stated hereunder:

- Section 6(4) permits residents to hold, own, transfer or invest in foreign currency, foreign security or overseas immovably property, if the same was acquired when the individual was a person resident outside India or inherited from a person resident outside India.
- For transactions that are within recent years, regularisation would be permissible by payment of a Late Submission Fee (LSF)
- For other contraventions, the matter may be compounded with the respective authority after necessary compliance.

In an increasingly integrated regulatory environment, tax disclosure without FEMA regularisation, risks substituting one compliance exposure with another, making coordinated multi-law remediation essential.

The views expressed are strictly personal and cannot be regarded as an opinion. For any queries or feedback please write to *shilpijain@hnaindia.com* and *stephaniemendonza@cnkindia.com.*