Fund Formation: Attracting Global Investors

Global, Regulatory and Tax Environment impacting India focused funds

February 2019
Fund Formation: Attracting Global Investors

Global, Regulatory and Tax Environment impacting India focused funds

February 2019

ndaconnect@nishthdesai.com
About NDA

At Nishith Desai Associates, we have earned the reputation of being Asia's most Innovative Law Firm – and the go-to specialists for companies around the world, looking to conduct businesses in India and for Indian companies considering business expansion abroad. In fact, we have conceptualized and created a state-of-the-art Blue Sky Thinking and Research Campus, Imaginarium Aligram, an international institution dedicated to designing a premeditated future with an embedded strategic foresight capability.

We are a research and strategy driven international firm with offices in Mumbai, Palo Alto (Silicon Valley), Bangalore, Singapore, New Delhi, Munich, and New York. 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.

As an active participant in shaping India’s regulatory environment, we at NDA, have the expertise and more importantly – the VISION – to navigate its complexities. Our ongoing endeavors in conducting and facilitating original research in emerging areas of law has helped us develop unparalleled proficiency to anticipate legal obstacles, mitigate potential risks and identify new opportunities for our clients on a global scale. Simply put, for conglomerates looking to conduct business in the subcontinent, NDA takes the uncertainty out of new frontiers.

As a firm of doyens, we pride ourselves in working with select clients within select verticals on complex matters. Our forte lies in providing innovative and strategic advice in futuristic areas of law such as those relating to Blockchain and virtual currencies, Internet of Things (IOT), Aviation, Artificial Intelligence, Privatization of Outer Space, Drones, Robotics, Virtual Reality, Ed-Tech, MedTech & Medical Devices and Nanotechnology with our key clientele comprising of marquee Fortune 500 corporations.

NDA has been the proud recipient of the RSG - FT award 4 times in a row (2014 - 2017) as the 'Most Innovative Indian Law Firm' and in 2016 we were awarded the 'Most Innovative Law Firm – Asia Pacific,' by Financial Times (London.)

We are a trust based, non-hierarchical, democratic organization that leverages research and knowledge to deliver extraordinary value to our clients. Datum, our unique employer proposition has been developed into a global case study, aptly titled 'Management by Trust in a Democratic Enterprise,' published by John Wiley & Sons, USA.
Accolades

A brief chronicle our firm’s global acclaim for its achievements and prowess through the years –


- **AsiaLaw 2019**: Ranked ‘Outstanding’ for Technology, Labour & Employment, Private Equity, Regulatory and Tax


- **Merger Market 2018**: Fastest growing M&A Law Firm


- **Asia Mena Counsel’s In-House Community Firms Survey 2018**: Only Indian Firm for Life Science Practice Sector

- **Who’s Who Legal 2019**: Global Thought Leaders - Nishith Desai (International Corporate Tax and Private Funds,) Dr. Milind Antani (Lifesciences) Vikram Shroff (HR and Employment Law,) and Vaibhav Parikh (Data Practices and Telecommunication)

- **IDEX Legal Awards 2015**: Nishith Desai Associates won the “M&A Deal of the year”, “Best Dispute Management lawyer”, “Best Use of Innovation and Technology in a law firm” and “Best Dispute Management Firm”
Please see the last page of this paper for the most recent research papers by our experts.

Disclaimer

This report is a copy right of Nishith Desai Associates. No reader should act on the basis of any statement contained herein without seeking professional advice. The authors and the firm expressly disclaim all and any liability to any person who has read this report, or otherwise, in respect of anything, and of consequences of anything done, or omitted to be done by any such person in reliance upon the contents of this report.

Contact

For any help or assistance please email us on ndaconnect@nishithdesai.com or visit us at www.nishithdesai.com
Dear Friend,

According to recent global LP surveys, India is being seen as the most attractive emerging market for allocating fresh commitments. While 2015 and 2016 saw a year-on-year decline in India-focused fund-raising, this may have been due to renewed focus by GPs on deal-making given the dry-powder overhang. India has also contributed to a rising trend of mega funds in Asia in 2017, with most of the PE funds aiming at larger fund sizes to be able to accommodate the targeted ticket size deals. In line with the large fund raises, PE/VC investments in 2018 have substantially surpassed the previous high recorded in 2017 on the back of significant growth in large deals.

The investor appetite for India risk has been robust and that led to healthy fund raising for several tier 1 GPs with track records. The fund-raising environment in 2017 (and continuing) has seen spurred efforts in India with the regulatory reforms in foreign exchange laws with respect to onshore funds introduced in the last quarter of 2015 and tax certainty brought about by the protocols signed by India to its double taxation avoidance agreements with various jurisdictions included Mauritius and Singapore. The regulatory changes are aimed at promoting home-grown investment managers by allowing Indian managed and sponsored AIFs with foreign investors to bypass the FDI Policy for making investments in Indian companies.

In 2017, India also saw a significant increase in investments from Foreign Portfolio Investors ("FPIs") and FDI. However, the Finance Act, 2018 for the financial year 2018-19 largely focused on the domestic audience. The biggest blow has been for the Indian capital markets with the introduction of a long-term capital gains ("LTCG") tax rate at the rate of 10% on listed equities, which were earlier exempt. A major talking point last year was the attempt to curtail participation in and control of FPIs by NRIs and OCIs. After prolonged engagement with the SEBI, Government and other stakeholders, the industry was successful in persuading the authorities to substantially dial back on the harsh measures, which could have frozen billions of dollars from flowing into India.

On a positive note, in 2017, the Central Board of Direct Taxes ("CBDT") released a circular exempting certain investment funds (including PE/VC funds) from the applicability of the indirect transfer provisions under the Indian Income Tax Act, 1961. The circular followed-up on the statements made by the Finance Minister while delivering the Union Budget 2017-18 around this issue.

During the Union Budget speech for the financial year 2018-19, the Finance Minister stated that the government will take additional measures to strengthen the environment for the growth and successful operation of AIFs in India.

The government has been proactive in trying to establish a regulatory and tax climate that is conducive for raising investment from foreign investors. In 2016, the government also made efforts to encourage domestic financial institutions such as pension funds and insurance firms to allocate investments towards alternative asset classes such as Indian AIFs. The regulatory regime continues to be streamlined with relaxation of pricing norms for foreign direct investments, clarity in relation to put / call options, rationalization of the foreign portfolio investment regime and proposals for further liberalization of investment caps.

Designing a fund is not just an exercise in structuring. It’s like being an architect is different from being a structural engineer. For India-focused funds, not only knowledge of Indian regulatory and tax framework is required but a deep insight into cross border legal and tax regimes is necessary, even when you are not raising funds from overseas.

The investment fund industry clearly seems to be in a very different market today. In mid-2016, Indian funds started seeing greater participation from domestic LPs (as compared to so far being primarily led by overseas
Fund Formation: Attracting Global Investors

Global, Regulatory and Tax Environment impacting India focused funds

Innovative structures varied from the traditional ‘blind-pool model’ are increasingly being seen. One of the major themes that has been continuing, especially from 2017, is the shift from ‘co-investment structures’ to ‘unified structures’, especially in funds with both domestic and foreign LP participation given the relaxation of FDI norms for investment in AIFs and tax certainty brought about by recent changes to the double taxation avoidance agreements of India with different countries. India, as an investment destination, has also gained popularity among hedge funds. Innovative structures such as hedge funds with private equity side pockets are also being adopted.

Other innovative structures are also coming up, with variations in the traditional unified structure, including a combination of a unified and a co-investment structure to cater to commercial expectations while complying with legal, regulatory and tax requirements. Changes in legal regimes are also altering sectoral focus – for example, the implementation of a newly introduced statute on insolvency and bankruptcy has led to substantial interest in creating investment platforms for accessing stressed assets.

Following closely on the footsteps of the observations by U.S. Securities and Exchange Commission (“SEC”) that there are several disconnects between “what [general partners] think their [limited partners] know and what LPs actually know”, SEBI mandates certain disclosure and reporting norms that AIFs have to observe.

However, from a regulatory viewpoint, the glare from the regulator to the alternative investments space has been at its peak. A manager to an alternative investment fund (“AIF”) must now contend with greater supervision and accountability to both the regulator and the investors. While bespoke terms are designed to maintain investor friendliness, given the recent observations by regulators in sophisticated jurisdictions, sight must not be lost on the disclosure norms and fiduciary driven rules that are now statutorily mandated. There is increasing guidance from SEBI, including on aspects such matters relating to treasury functions (permitted temporary investments) and investment restrictions under the regulations.

On the regulatory front, SEBI introduced further restrictions the use of participatory notes (“p-notes”) for accessing Indian markets. Recently, there were talks of allowing p-notes in International Financial Services Centers (“IFSCs”); however, SEBI seems to have taken a call to not permit dealing in p-notes even in IFSCs. SEBI is aiming to promote direct exposure as FPIs to access India markets. Through Finance Act, 2017, Category I FPIs and Category II FPIs were also exempted from indirect transfer tax provisions in India. Further, late in 2018, SEBI has issued guidelines and paved the way for the setup and operation of AIFs from GIFT City's IFSC.

There continues to be some market hesitation about the changes introduced by the protocol signed between India and Mauritius to amend the Mauritius India Double Taxation Avoidance Agreement (the “Protocol”) as it gives India a source based right to taxation of capital gains arising out of sale of shares. The Protocol should be seen as a welcome change as it brought certainty coupled with easing of tax rates in India and added benefits in respect of interest income. Mauritius will now emerge as the preferred jurisdiction for debt considering the lower withholding tax rates for interest income. Further, investments through Mauritius will be less likely to be questioned under the General Anti-Avoidance Rules which allows Indian tax authorities to re-characterize transactions on grounds of lack of commercial substance among other things, and has come into effect from April 01, 2017.

In the United States, the primary laws regulating investment funds are the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Company Act of 1940 and the Investment Advisers Act of 1940. Following the financial crisis of 2008, a number of legislations have been introduced. These include the Dodd-Frank Act, the Foreign Account Tax Compliance Act (“FATCA”) and the Jumpstart Our Business Startups Act (“JOBS Act”). These legislations were enacted with the twin
purpose of preventing future financial crisis on one hand and facilitating the process of economic recovery on the other. From an investment fund perspective, these statutes assume importance in the context of investor limitations and disclosure requirements that they usher into the regulatory regime.

The European Commission introduced the Alternative Investment Fund Managers Directive ("AIFMD") with a view to provide a harmonized and stringent regulatory and supervisory framework for the activities of fund managers within the European Union. The AIFMD seeks to regulate non-EU fund managers who seek to market a fund, set up outside the EU to investors in the EU.

Back home, in 2015, SEBI had constituted a standing committee called the Alternative Investment Policy Advisory Committee ("AIPAC") under the chairmanship of Mr. Narayana Murthy to advise SEBI on measures to further develop the alternative investment and startup ecosystem in India and to highlight any hurdles that might hinder the industry's development. The first AIPAC report of January, 2016 recommends various structural reforms and seeks to push regulation of funds to “next practices”. Some of the recommendations were adopted in the 2016 annual budget that was tabled by the Finance Minister. The second AIPAC report of December, 2016 recommends changes which pertain to more detailed disclosures in the offering documents by the GPs, better reporting norms, unlocking the domestic pool of capital (pension funds and insurance companies), performance statistics and benchmarks to be standardized for the industry. The third AIPAC report which was released on January 19, 2018 further proposes reforms in the Goods & Services Tax ("GST") regime as applicable to the growth of AIFs in India and promoting AIFs in India through the IFSCs. It also continues to advocate changes in the tax regime for Category III AIFs and recommendations made previously in AIPAC reports on application of corporate social responsibility ("CSR") funds for impact investing. The AIPAC reports mark a welcome start for necessary dialogue that is required between the industry and the regulator; however, the recommendations have not yet been translated into changes.

SEBI has also introduced an online system for filings related to Alternative Investment Funds (AIF). This online system can be used for application for registration, reporting and filing in terms of the provisions of AIF Regulations and circulars issued thereunder. Although there were certain teething issues faced in the transition to the online system, it is encouraging that SEBI, in line with the government's initiative to promote the alternative investment asset industry in India, is consistently making efforts towards ease of regulatory formalities to operate in the industry.

Separately, there is also emerging jurisprudence which suggests that the threshold of fiduciary duties to be met with by fund managers is shifting from "exercising supervision" to "making reasonable and proportionate efforts commensurate with the situations". A failure to perform such supervisory role could raise severe issues on fund managers' liabilities for business losses as would be seen in the case of fund directors in Weavering Macro Fixed Income Fund, which continues to hold the most value in terms of precedence in fund governance jurisprudence (summarized in our memo that can be accessed at http://www.nishithdesai.com/fileadmin/user_upload/pdfs/Research%20Papers/Fund_Governance.pdf). To add to this, there has been a very active enforcement of anti-corruption laws under the Foreign Corrupt Practices Act ("FCPA") against directors and executives.

Accordingly, apart from the expectation to set up investor-friendly structures, the shift in legal paradigm in which an investment fund operates, requires that attention be given to articulating disclosures in fund documents (including recording the economic substance and justifications in the fund's board minutes) and intelligently planning investment asset-holdings.

Globally, funds have been accorded pass through status to ensure fiscal neutrality and investors are taxed based on their status. This is especially relevant when certain streams of income may be tax free at investor level due to the status of the investor, but taxable at fund level. India has also accorded a pass-through status to Category I and
Category II AIFs registered with SEBI with a requirement to subject any income credited or paid by the AIFs to a withholding tax of 10% for resident investors and as per the “rates in force” for non-resident investors. Pass through status has still not been accorded to Category III AIFs. The tax uncertainty places Category III AIFs at a significant disadvantage against off-shore funds with similar strategies. From a regulatory perspective, SEBI (from June, 2017) has permitted participation of Category III AIFs in the commodity derivatives market with certain conditions.

While bespoke managed accounts are being created and structures that meet LPs’ demand to be more ‘closely aligned to the portfolio selection process’ are being set up, it is imperative to design funds which address the issues created by the continuously changing Indian and international regulatory and tax environment.

The shift in legal paradigm in which an investment fund operates requires that attention be given to articulating disclosures in fund documents (including recording the economic substance) and intelligently planning investment asset-holdings. In our experience, fund documentation is critical in ensuring protection for fund managers (GPs) from exposure to legal, tax and regulatory risks. Fund counsels are now required to devise innovative structures and advise investors on terms for meeting investor’s (LP) expectations on commercials, governance and maintaining GP discipline on the articulated investment strategy of the fund. All these are to be done in conformity with the changing legal framework.

The objective of this compilation is to bring to focus, aspects that need to be considered while setting up India-focused funds and some of the recent developments that impact the fund management industry.

Regards,

Nishith Desai
NDA Fund Formation Practice

Our Approach

At Nishith Desai Associates, we are particularly known and engaged by multinational companies and funds as strategic counsels. As engineers of some of the earliest innovative instruments being used by investment funds (both private equity and venture capital) in India we proactively spend time in developing an advanced understanding of the industry as well as the current legal, regulatory and tax regime.

Choice of Fund Vehicle

Structure follows strategy, and not vice versa. Developing an appropriate strategy is crucial in determining not just the structure, but also the architecture of the fund platform.

Selection of the fund vehicle requires careful planning and is driven by a variety of considerations as the same would have an impact on the investors in the fund; particularly in their home jurisdictions. While deciding on the optimum structure for a fund, varied objectives such as limited liability for investors, commercial convenience and tax efficiency for investors and managers need to be considered. To meet these objectives, varied entities such as pass-through trusts, limited liability partnerships, limited partnerships, limited liability companies, protected cell companies etc. can be considered. Offshore funds investing in India may require the presence of investment advisors in India to provide them with deal recommendations etc. This gives rise to tricky issues relating to the taxation of such offshore funds in India that would depend on whether the Indian advisor is regarded as a "permanent establishment" of the offshore fund in India or may lead to a risk of "place of effective management" of the offshore fund held to be in India. In this regard, we have successfully represented several funds before the Indian Authority for Advance Rulings and have obtained landmark rulings for them.

After the Organisation for Economic Co-operation and Development ("OECD") issued its report on Action Plan on Base Erosion and Profit Shifting ("BEPS"), there has been an increased pressure to ensure observance of key tax principles like demonstrating substance, establishing tax resident status and transfer pricing principles. Tax authorities in several mature financial centers are adopting substance over form approach.

The implementation of the General Anti-Avoidance Rules allows Indian tax authorities to re-characterize transactions on grounds of lack of commercial substance among other things. This has prompted a shift while structuring funds to concentrate several aspects constituting ‘commercial substance’ in the same entity. So, unless specific investors require ‘feeder’ vehicles for tax or regulatory reasons, an attempt is being made to pool LPs in the same vehicle that invests in the foreign portfolio. Mauritius, Netherlands, Singapore and Luxembourg continue being favorably considered while structuring India funds or funds with India allocation.

To accommodate both domestic investor base and offshore investor base, unified structures have emerged as a preferred choice for structuring India focused funds. There is also an increased participation from development financial institutions ("DFIs") in India focused funds, including unified structures. Accordingly, some global benchmarks need to be followed when designing the structure and calibrating the fund documents including the governance, fiduciary aspects and adherence to Environment and Social ("ESG") policies.
After the introduction of tax pass through for Category I and Category II AIFs, GPs have now started contemplating the structuring of Category I and Category II AIFs as LLPs. However, trusts continue to be the choice of vehicle for AIFs in India as compared to LLPs on grounds of stricter regulatory formalities and compliances in case of an LLP, lack of flexibility to determine the Fund’s own rules of governance (which are not the same as rules of corporate governance) in case of an LLP and the risk of mixing up of investment assets and liabilities of the AIF with the management assets and liabilities of the AIF manager (if the employees of the manager and / or the manager entity itself are expected to participate in the AIF LLP as well). LLPs in India, as currently governed by the Limited Liability Partnership Act, 2008, do not have the regulatory flexibility to implement fund governance norms alongside corporate governance norms.

Documentation

Once a decision has been taken on the optimum structure for the fund, the same has to be carefully incorporated in the fund documents including the charter documents for the fund entity, the private placement memorandum, the shareholders’ agreement, the share subscription or contribution agreement, the investment management agreement, the investment advisory agreement, etc. In particular, one would need to keep in mind the potential “permanent establishment” risk while drafting these documents. The private placement memorandum should also achieve a balance between the risk disclosure requirements and the marketing strategy. We also co-ordinate with overseas counsel to obtain requisite legends to keep the fundraising exercise compliant with the laws of each jurisdiction in which the interests of the fund are being marketed.

Advisory

In addition to preparing the necessary fund documents, we also advise the fund on the local registration requirements. Domestic funds may register themselves with SEBI pursuant to which they are required to comply with certain investment restrictions and other prescribed conditions. Domestic funds are also accorded pass-through status for Indian tax purposes upon the fulfillment of certain conditions. It is not mandatory for offshore funds to register with SEBI. However, there are certain benefits available to offshore funds that register with SEBI as “foreign venture capital investors” such as flexibility in entry and exit pricing, “Qualified Institutional Buyer” status, etc. Further, with respect to funds seeking to participate in the secondary markets, apart from drafting of the information memorandum which is circulated to the investors of such fund, we have also advised and assisted them in obtaining registration as foreign portfolio investors. We also advise funds on a day to day basis from an Indian tax and regulatory perspective in relation to the execution of “offshore derivative instruments” including “participatory notes”.

LP Negotiations

LPs (particularly the first close LPs and institutional investors) to India focused funds have increasingly started negotiating fund terms with the GPs with rigorous review of the fund documentation. Further, there is often a need to harmonize the fund documents to cater to the requirements of foreign institutional investors / DFIs, which may vary or differ from those of Indian financial institutions.

Funds with a mixed pool of investors (domestic and foreign, institutional and retail) often face various issues on fund terms including with respect to allocation of placement agent expenses, set-up costs for a feeder vehicle to cater to foreign investors, exposure of the corpus of the fund to exchange rate fluctuations. Therefore, it
not only becomes critical for GPs to ensure that they are able to accommodate the LP asks within the realms of the structure in the most efficient manner but also for the legal advisors to ensure that they are adequately incorporated in the fund documentation.

**Sponsor and Carry Structuring**

With an increasing industry demand for a skin-in-the-game, GPs of India focused funds have also begun exploring different innovative structures for employee GP commitment and carry structuring. Carry structuring involves a careful analysis of both regulatory and tax laws applicability on certain aspects, while looking at the jurisdiction of residence and taxation of the ultimate carry recipients and also the proportionality of investment in the fund vehicle by such recipients as employee GP commitment.

**Project Management**

Several Indian investment managers who are looking at raising funds with international investors need to offer tax efficient and regulatory compliant structures to the foreign investors that generally seek safety and repatriation of their original investments along with a tax-efficient way of receiving the gains earned. Thus, our focus on international tax and our in-depth understanding of the legal, regulatory and tax regimes for funds in different jurisdictions has enabled us to be at the cutting edge of structuring offshore and domestic funds.
Primary Contacts

Nishith Desai
nishith.desai@nishithdesai.com

Nishith Desai is the founder of the research-based strategy driven international law firm, Nishith Desai Associates (www.nishithdesai.com) with offices in Mumbai, Silicon Valley, Bangalore, Singapore, Mumbai – BKC, New Delhi, Munich and New York.

Nishith himself is a renowned international tax, corporate, IP lawyer researcher, published author and lecturer in leading academic institutions around the world. He specializes in Financial Services sector and assisted Government of Mauritius and Government of India in establishment of their offshore financial centers.

Soon after India opened up its economy to the outside world in 1991, he established the first five India Focused funds and pioneered the roots of asset management industry and the firm has now worked for over 900 funds across all classes of asset. As a pioneer in the Indian investment funds industry, Nishith is known for developing new models in fund formation such as the first India focused index fund, first private equity fund, first VC fund and real estate fund and was also a member of SEBI’s committee which developed original regulations for Foreign Venture Capital Investor (FVCI) and Venture Capital Funds regime. More recently, he has been involved with the formation and subsequent amendments to the AIF Regulations.

Richie Sancheti
richie.sancheti@nishithdesai.com

Richie leads the Funds Practice Group at Nishith Desai Associates and is based in Mumbai. With a strong funds background, he advises on optimum structures for setting up onshore and offshore investment funds. He advises fund managers in connection with the formation, carry allocation program and governance of private funds.

Richie specializes in all aspects of the formation and operation of venture capital, private equity and hedge funds that are focused on investing in India. He has extensive experience in designing fund structures and advising on “market” terms.

Richie is also a member of the firm’s international tax and private equity investment practice groups and advises clients on matters including private equity transactions.

Pratibha Jain
pratibha.jain@nishithdesai.com

Pratibha Jain is the Founding Partner and also the Head of the Delhi office of Nishith Desai Associates. She heads the Banking and Finance and Regulatory practice at NDA. Ms. Jain brings with her a breadth of international and Indian experience having worked in New York, Tokyo, Hong Kong and Mumbai.

Ms. Jain’s educational qualifications include B.A (Economics) Hons. and LL.B. degree from Delhi University, a Bachelor of Civil Law degree from the University of Oxford, and a LL.M. degree from the Harvard Law School.
Her areas of focus include FDI investments, banking and finance and corporate and regulatory advisory. Her client list includes marquee corporate and private equity clients including, Softbank, Amazon, Flipkart, Morgan Stanley, JP Morgan Chase, Deutsche Bank, Deutsche Boerse, Tiger Global, Soros, Norwest Venture Partners, General Atlantic, SAIF Partners, Everstone Capital, Bombay Stock Exchange and Ministry of Finance. She sits on various important committees including FICCI Capital Markets Committee and FICCI Sub-committee on Internet and Social Media.

She has worked on some of the most challenging projects in financial services and regulatory sector, including representing Ministry of Finance for structuring of India’s first sovereign wealth fund with proposed corpus of over six billion dollars and advising Ministry of Commerce on their policy on Bilateral Investment Treaties, representing FDI investors in multiple acquisitions and entry strategies into India, representing investors for facilitating listing of stock exchanges in India, representing underwriter’s for listing of Bombay Stock Exchange, representing investors in investigations by the Enforcement Directorate and representing FSSAI on creating regulations for audits.

Nishchal Joshipura
nishchal.joshipura@nishithdesai.com

Nishchal Joshipura is a Partner and co-heads the Fund Formation practice at Nishith Desai Associates. He is a Chartered Accountant, an MBA and a Lawyer. He is also a Partner in the Mergers & Acquisition and Private Equity practice. Nishchal specializes in legal and tax structuring of cross-border transactions and assists clients on documentation and negotiation of mergers and acquisition (M&A) deals. His other practice areas include Corporate & Securities laws, Transfer Pricing, International Taxation, Globalization, Structuring of Inbound / Outbound Investments, Private Equity Investments, Structuring of Offshore Funds, Taxation of E-Commerce and Exchange Controls. He has contributed several articles in leading publications like Asialaw and has been a speaker at many domestic and international conferences.

He has been highly "Highly Recommended" by various legal directories for legal and tax advice on M&A, Private Equity and Investment Funds. He has been nominated as a “Young Achiever” at the Legal Era Awards 2015 based on industry research, reviews, rating and surveys conducted by Legal Era.

Kishore Joshi
kishore.joshi@nishithdesai.com

Kishore Joshi heads the Regulatory Practice at Nishith Desai Associates. He has over two decades of experience in advising clients on securities and exchange control laws. He handles matters on various aspects related to foreign portfolio investors including the broad-based criteria, eligibility to trade P-Notes and the participation of various investor categories under the FPI route.

Kishore has interacted extensively with the securities and exchange control regulator and has made numerous representations seeking reform in the law. In addition, he regularly advises clients on fund investments, issues related to corporate and regulatory laws. He has made several presentations on inbound and outbound investments. Kishore holds a Bachelor's degree in law from Mumbai University and is a member of the Bar Council of Maharashtra & Goa.
Contents

1. GLOSSARY OF TERMS 01

2. CHOICE OF JURISDICTION FOR SETTING UP AN INDIA-FOCUSED FUND 04
   I. Why Offshore Investors are Pooled Outside India 04
   II. Why Onshore Investors are Pooled in India 04
   III. Which Jurisdictions are Typically Considered for Setting up India-Focused Funds Pooling Offshore Investors 05
   IV. Recent Changes 08

3. STRUCTURAL ALTERNATIVES FOR INDIA-FOCUSED FUNDS 09
   I. Structuring India-focused Offshore Funds 09
   II. Foreign Investment Regimes 09
   III. Certain Tax Risks 13

4. ALTERNATIVE INVESTMENT FUNDS IN INDIA 16
   I. Introduction 16
   II. Alternative Investment Funds 16
   III. Choice of Pooling Vehicle 17
   IV. Classification of AIFs 19
   V. Investment Conditions and Restrictions under the AIF Regulations 19
   VI. Key Themes under the AIF Regulations 21
   VII. Taxation of Alternative Investment Funds 24

5. TRENDS IN PRIVATE EQUITY 27
   I. Trending fund terms 27

6. FUND DOCUMENTATION 31
   I. At The Offshore Fund Level 31
   II. At The Onshore Fund Level 32
   III. Investor Side Letters 33
   IV. Agreements with Service Providers 33

7. HEDGE FUNDS 34
   I. FPI Regulations 34
   II. Participatory Notes and Derivative Instruments 41
   III. Onshore Hedge Funds 44

8. FUND GOVERNANCE 46
   I. Investment Manager 46
   II. Investment Committee 46
   III. Advisory Board 46
   IV. Aspects and Fiduciaries to be considered by Fund Directors 46
## 1. Glossary of Terms

<table>
<thead>
<tr>
<th>Sr.No.</th>
<th>Term</th>
<th>Explanation</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>AAR</td>
<td>Authority for Advance Ruling, Ministry of Finance, Government of India.</td>
</tr>
<tr>
<td>2</td>
<td>AIF</td>
<td>Alternative Investment Fund as defined under the SEBI (Alternative Investment Funds) Regulations, 2012.</td>
</tr>
<tr>
<td>4</td>
<td>AML</td>
<td>Anti-Money Laundering</td>
</tr>
<tr>
<td>5</td>
<td>AOP</td>
<td>Association of Persons</td>
</tr>
<tr>
<td>6</td>
<td>BACO</td>
<td>Best Alternative Charitable Option</td>
</tr>
<tr>
<td>7</td>
<td>BIPA</td>
<td>Bilateral Investment Promotion and Protection Agreements</td>
</tr>
<tr>
<td>8</td>
<td>BIS</td>
<td>Bank for International Settlements</td>
</tr>
<tr>
<td>9</td>
<td>CBDT</td>
<td>Central Bureau of Direct Taxes, Department of Revenue, Ministry of Finance, Government of India</td>
</tr>
<tr>
<td>10</td>
<td>CCD</td>
<td>Compulsorily Convertible Debentures</td>
</tr>
<tr>
<td>11</td>
<td>CCPS</td>
<td>Compulsorily Convertible Preference Share</td>
</tr>
<tr>
<td>12</td>
<td>Companies Act</td>
<td>The Companies Act, 1956 and/or the Companies Act, 2013 (to the extent as may be applicable).</td>
</tr>
<tr>
<td>13</td>
<td>COR</td>
<td>Certificate of Registration</td>
</tr>
<tr>
<td>14</td>
<td>DDP</td>
<td>Designated Depository Participant</td>
</tr>
<tr>
<td>15</td>
<td>DDT</td>
<td>Dividend Distribution Tax</td>
</tr>
<tr>
<td>16</td>
<td>DFI/DFIs</td>
<td>Development Financial Institutions</td>
</tr>
<tr>
<td>17</td>
<td>DTAA</td>
<td>Double Taxation Avoidance Agreement</td>
</tr>
<tr>
<td>18</td>
<td>ECB</td>
<td>External Commercial Borrowing</td>
</tr>
<tr>
<td>19</td>
<td>ESG</td>
<td>Environment, Social and Governance policies</td>
</tr>
<tr>
<td>20</td>
<td>FATF</td>
<td>Financial Action Task Force</td>
</tr>
<tr>
<td>21</td>
<td>FCCB</td>
<td>Foreign Currency Convertible Bond</td>
</tr>
<tr>
<td>22</td>
<td>FDI/ FDI Policy</td>
<td>Foreign Direct Investment / Consolidated Foreign Direct Investment Circular of 2017</td>
</tr>
<tr>
<td>23</td>
<td>FEMA</td>
<td>Foreign Exchange Management Act, 1999</td>
</tr>
<tr>
<td>24</td>
<td>FII</td>
<td>Foreign Institutional Investor</td>
</tr>
<tr>
<td>25</td>
<td>FII Regulations</td>
<td>SEBI (Foreign Institutional Investors) Regulations, 1995</td>
</tr>
<tr>
<td>26</td>
<td>FIPB</td>
<td>Foreign Investment Promotion Board, Department of Economic Affairs, Ministry of Finance, Government of India</td>
</tr>
<tr>
<td>27</td>
<td>FPI</td>
<td>Foreign Portfolio Investor</td>
</tr>
<tr>
<td>28</td>
<td>FPI Regulations</td>
<td>SEBI (Foreign Portfolio Investors) Regulations, 2014</td>
</tr>
<tr>
<td>29</td>
<td>FSC</td>
<td>Financial Services Commission, Mauritius</td>
</tr>
<tr>
<td></td>
<td>Term</td>
<td>Definition</td>
</tr>
<tr>
<td>---</td>
<td>--------------------------</td>
<td>---------------------------------------------------------------------------</td>
</tr>
<tr>
<td>30</td>
<td>FVCI</td>
<td>Foreign Venture Capital Investor</td>
</tr>
<tr>
<td>31</td>
<td>FVCI Regulations</td>
<td>SEBI (Foreign Venture Capital Investors) Regulations, 2000</td>
</tr>
<tr>
<td>32</td>
<td>FTS</td>
<td>Fees for Technical Services</td>
</tr>
<tr>
<td>33</td>
<td>GAAR</td>
<td>General Anti Avoidance Rules</td>
</tr>
<tr>
<td>34</td>
<td>GBC-1</td>
<td>Category 1 Global Business (GBC–1) License</td>
</tr>
<tr>
<td>35</td>
<td>GIIN</td>
<td>Global Impact Investing Network</td>
</tr>
<tr>
<td>36</td>
<td>GiIRs</td>
<td>Global Impact Investing Rating System</td>
</tr>
<tr>
<td>37</td>
<td>GPs</td>
<td>General Partners (Fund Managers)</td>
</tr>
<tr>
<td>38</td>
<td>GoI</td>
<td>Government of India</td>
</tr>
<tr>
<td>39</td>
<td>IC</td>
<td>Investment Committee</td>
</tr>
<tr>
<td>40</td>
<td>ICDR Regulations</td>
<td>SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009</td>
</tr>
<tr>
<td>41</td>
<td>Indian Rupee or “INR” or “Rs.”</td>
<td>The currency of Republic of India.</td>
</tr>
<tr>
<td>42</td>
<td>InvIT</td>
<td>Infrastructure Investment Trust registered with SEBI under the SEBI (Infrastructure Investment Trusts) Regulations, 2014</td>
</tr>
<tr>
<td>43</td>
<td>IOSCO</td>
<td>International Organization of Securities Commissions</td>
</tr>
<tr>
<td>44</td>
<td>IP</td>
<td>Intellectual Property</td>
</tr>
<tr>
<td>45</td>
<td>IPO</td>
<td>Initial Public Offer</td>
</tr>
<tr>
<td>46</td>
<td>IRIS</td>
<td>Impact Reporting &amp; Investment Standards</td>
</tr>
<tr>
<td>47</td>
<td>KYC</td>
<td>Know Your Customer</td>
</tr>
<tr>
<td>48</td>
<td>LoB</td>
<td>Limitations on DTAA Benefits</td>
</tr>
<tr>
<td>49</td>
<td>LLP</td>
<td>Limited Liability Partnership</td>
</tr>
<tr>
<td>50</td>
<td>LLP Act</td>
<td>Limited Liability Partnership Act, 2008</td>
</tr>
<tr>
<td>51</td>
<td>LPAC</td>
<td>Limited Partners’ Advisory Committee</td>
</tr>
<tr>
<td>52</td>
<td>LPs</td>
<td>Limited Partners (Fund Investors)</td>
</tr>
<tr>
<td>53</td>
<td>LRS</td>
<td>Liberalised Remittance Scheme</td>
</tr>
<tr>
<td>54</td>
<td>MAT</td>
<td>Minimum Alternate Tax</td>
</tr>
<tr>
<td>55</td>
<td>MIM</td>
<td>Multiple Investment Management</td>
</tr>
<tr>
<td>56</td>
<td>NAV</td>
<td>Net Asset Value</td>
</tr>
<tr>
<td>57</td>
<td>NCD</td>
<td>Non-convertible Debentures</td>
</tr>
<tr>
<td>58</td>
<td>NRI</td>
<td>Non-Resident Indian</td>
</tr>
<tr>
<td>59</td>
<td>OCB</td>
<td>Overseas Corporate Body</td>
</tr>
<tr>
<td>60</td>
<td>ODI</td>
<td>Offshore Derivative Instrument</td>
</tr>
<tr>
<td>61</td>
<td>ODI Regulations</td>
<td>Foreign Exchange Management (Transfer or Issue of any Foreign Security) Regulations, 2004</td>
</tr>
<tr>
<td>Term</td>
<td>Definition</td>
<td></td>
</tr>
<tr>
<td>--------</td>
<td>--------------------------------------------------------------</td>
<td></td>
</tr>
<tr>
<td>OEIC</td>
<td>Open-ended Investment Company</td>
<td></td>
</tr>
<tr>
<td>Offshore Fund</td>
<td>Means a pooling vehicle established outside India.</td>
<td></td>
</tr>
<tr>
<td>PAN</td>
<td>Permanent Account Number</td>
<td></td>
</tr>
<tr>
<td>PCC</td>
<td>Protected Cell Companies</td>
<td></td>
</tr>
<tr>
<td>PE</td>
<td>Private Equity</td>
<td></td>
</tr>
<tr>
<td>PPM</td>
<td>Private Placement Memorandum</td>
<td></td>
</tr>
<tr>
<td>P-Notes</td>
<td>Participatory Notes</td>
<td></td>
</tr>
<tr>
<td>POEM</td>
<td>Place of Effective Management</td>
<td></td>
</tr>
<tr>
<td>Protocol</td>
<td>Protocol signed between India and Mauritius to amend the Mauritian India Double Taxation Avoidance Agreement</td>
<td></td>
</tr>
<tr>
<td>QFI</td>
<td>Qualified Foreign Investor</td>
<td></td>
</tr>
<tr>
<td>RBI</td>
<td>Reserve Bank of India</td>
<td></td>
</tr>
<tr>
<td>REITs</td>
<td>Real Estate Investment Trusts</td>
<td></td>
</tr>
<tr>
<td>RE Funds</td>
<td>Real Estate Funds</td>
<td></td>
</tr>
<tr>
<td>SEBI</td>
<td>Securities and Exchange Board of India</td>
<td></td>
</tr>
<tr>
<td>SGD</td>
<td>Singapore Dollars</td>
<td></td>
</tr>
<tr>
<td>SITA</td>
<td>Singapore Income Tax Act</td>
<td></td>
</tr>
<tr>
<td>SMEs</td>
<td>Small and Medium-sized Enterprises</td>
<td></td>
</tr>
<tr>
<td>SPCs</td>
<td>Segregated Portfolio Companies</td>
<td></td>
</tr>
<tr>
<td>SPV</td>
<td>Special Purpose Vehicle</td>
<td></td>
</tr>
<tr>
<td>Tax Act or ITA</td>
<td>Income Tax Act, 1961</td>
<td></td>
</tr>
<tr>
<td>TDS</td>
<td>Tax Deducted at Source</td>
<td></td>
</tr>
<tr>
<td>TRC</td>
<td>Tax Residency Certificate</td>
<td></td>
</tr>
<tr>
<td>TISPRO Regulations</td>
<td>Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2017</td>
<td></td>
</tr>
<tr>
<td>USD</td>
<td>US Dollars</td>
<td></td>
</tr>
<tr>
<td>VCF</td>
<td>Venture Capital Fund</td>
<td></td>
</tr>
<tr>
<td>VCF Regulations</td>
<td>SEBI (Venture Capital Funds) Regulations, 1996</td>
<td></td>
</tr>
<tr>
<td>VCPE</td>
<td>Venture Capital and Private Equity</td>
<td></td>
</tr>
<tr>
<td>VCU</td>
<td>Venture Capital Undertaking</td>
<td></td>
</tr>
</tbody>
</table>
2. Choice of Jurisdiction for Setting up an India-Focused Fund

There are several factors that inform the choice of jurisdiction for setting up a pooled investment vehicle.

A suitable jurisdiction for setting up a fund should primarily allow tax neutrality to the investors. ‘Neutrality’ ensures investors are not subject to any higher taxes than if they were to invest directly. From a regulatory viewpoint, the jurisdiction should allow flexibility in raising commitments from resident as well as non-resident investors, making investments and distribution of profits.

The government is working towards easing the norms for effective mobilization of the domestic pool of investors in India (consisting of institutional investors like banks, insurance companies, mutual funds and high net worth individuals). The AIPAC reports\(^1\) have also recommended unlocking domestic capital pools for providing fund managers an access to domestic pools as this investor class currently constitutes approximately 10% of the total VCPE invested in India annually.

I. Why Offshore Investors are Pooled Outside India

India follows source based taxation on capital gains and taxes thereon may not be creditable in the home jurisdiction of the offshore investors. Accordingly, offshore structures are used for offshore investors to invest into India to avoid double taxation on the same income stream. Further, if the offshore investors are pooled outside India, the requirement to obtain a Permanent Account Number (“PAN”) card and filing of tax returns will only be on the Offshore Fund, as opposed to each of the offshore investors (in case of direct participation of such investors in an onshore pooling vehicle). Further, India does not have Bilateral Investment Promotion and Protection Agreements (“BIPA”) with all countries. Offshore investors are accordingly pooled in jurisdictions which have a BIPA with India, which may provide investors an access to several reliefs, including fair and equitable treatment, protection against expropriation, repatriability of capital, an efficient dispute resolution framework and other rights and reliefs. Further, India based structures with foreign participation which are not Indian managed and sponsored may require regulatory approvals, compliance with pricing norms and may be subject to performance conditions in certain sectors.\(^2\)

II. Why Onshore Investors are Pooled in India

Resident investors prefer onshore structures for the following reasons:

a. The Liberalised Remittance Scheme (“LRS”) issued by the Reserve Bank of India (“RBI”) allows Indian resident individuals to remit abroad up to USD 250,000 per person per financial year for any permissible current or capital account transaction or a combination of both, subject to the restrictions and conditions laid down in the Foreign Exchange Management Act, 1999 (“FEMA”) and related rules and regulations.

b. Regulation 7 of the Foreign Exchange Management (Transfer or Issue of any Foreign Security) Regulations, 2004 (“ODI Regulations”) stipulates certain conditions to be met by Indian corporations when making

---


2. Any downstream investment by an AIF (which receives foreign contributions) will be regarded as foreign investment if the Sponsor and the Investment Manager of the AIF are not Indian ‘owned and controlled’. The ownership and control is determined in accordance with the extant FDI Policy.
institutions in an entity outside India engaged in financial services activities (including fund or fund management vehicles). The conditions include, inter alia, that the Indian entity should have earned net profits during the preceding three financial years from the financial services activities; that it is registered with the regulatory authority in India for conducting the financial services activities; that it has obtained approval from the concerned regulatory authorities, both in India and abroad, for venturing into such financial sector activity; and has fulfilled the prudential norms relating to capital adequacy as prescribed by the concerned regulatory authority in India. However, as in the case of individual residents, Indian corporates investing abroad into a fund which in turn invests into India could raise round tripping concerns.

c. Under a domestic fund structure, the fund vehicle (typically a trust entity registered with SEBI as an AIF) is not to be taxed on any income that is earned from the investments. The income earned is taxable in the hands of the investors when the venture capital fund / AIF distributes the same to the investors. Further, the characterization of income in their hands is the same as that realized / distributed by the investee company to the fund. By contrast, if distributions were to be received in the form of dividend or interest from an Offshore Fund structure, the Indian resident investors would typically have to recognize the distribution as ‘income’ and as a result, could be taxed in India (at the time of receipt).

III. Which Jurisdictions are Typically Considered for Setting up India-Focused Funds Pooling Offshore Investors

A. Mauritius

In 2017-18, Mauritius topped the list with respect to FDI investments in India with $13.41 billion investments followed by Singapore. However, in 2018, Mauritius witnessed a 69.3 per cent decline in foreign direct investment (FDI) in India in the first six months ended September 2018.

India and Mauritius have shared close economic, political and cultural ties for more than a century. There has been close cooperation between the two countries on various issues including trade, investment, education, security and defense.

The India-Mauritius DTAA underwent a change through the Protocol signed between India and Mauritius on May 10, 2016. Prior to the Protocol, the India-Mauritius DTAA included a provision that exempted a resident of Mauritius from Indian tax on gains derived from the sale of shares of an Indian company. The Protocol however, gave India a source based right to tax capital gains which arise from alienation of shares of an Indian resident company acquired by a Mauritian tax resident (as opposed to the previous residence based tax regime under the India-Mauritius DTAA). However, the Protocol had provided for grandfathering of investments and the revised position became applicable to investments.
made on or after April 01, 2017. In other words, all existing investments up to March 31, 2017 had been grandfathered and exits / shares transfers in respect of such investments beyond this date would not be subject to capital gains tax in India. Additionally, the Protocol introduced a limitation of benefits provision which shall be a prerequisite for a reduced rate of tax (50% of domestic tax rate) on capital gains arising during a two-year transition period from April 01, 2017 to March 31, 2019.

The modification on capital gains taxation is limited to gains arising on sale of shares. This ensures continuity of benefit to other instruments and also provides much needed certainty in respect of the position of the India-Mauritius DTAA.

The sale of debentures continues to enjoy tax benefits under the India-Mauritius DTAA. That, coupled with the lower withholding tax rate of 7.5% for interest income earned by Mauritius investors from India, comes as big boost to debt investments from Mauritius. Prior to the Protocol, interest income arising to Mauritius investors from Indian securities / loans were taxable as per Indian domestic law. The rates of interest could go as high as 40% for rupee denominated loans to non-FPIs. The Protocol amended the DTAA to provide for a uniform rate of 7.5% on all interest income earned by a Mauritian resident from an Indian company. The withholding tax rate offered under the Mauritius DTAA is significantly lower than those under India’s treaties with Singapore (15%) and Netherlands (10%). This should make Mauritius a preferred choice for debt investments into India, going forward.

Further, the Protocol introduced Article 26A to the India-Mauritius DTAA. It provided that India and Mauritius shall lend assistance to each other in the collection of revenue claims. It allowed for Mauritius authorities to enforce and collect taxes of Indian revenue claims, as if such claims were its own, upon a request from Indian revenue authorities.

On a separate note, the FSC had introduced domestic substance rules to be satisfied by Mauritius based GBC-1 entities after January 01, 2015.

The same were amended vide circulars issued by the FSC on October 12 and 15, 2018 to be effective from January 01, 2019. Accordingly, new licenses would be issued i.e. Global Business Corporation (GBC) and Authorised Company (AC). The license requirements stipulate core income generating activities to be carried out by the GBC namely: (i) employing, either directly or indirectly, a reasonable number of suitably qualified persons to carry out the core activities; and (ii) having a minimum level of expenditure, which is proportionate to its level of activities. While determining the same, the FSC will take into consideration the nature and level of core income generating activities conducted (including the use of technology) by the GBC. The FSC also provided indicative guidelines for determining what would constitute as “a reasonable number of suitably qualified persons” and “a minimum expenditure which is proportionate to its level of activities”. Further, in order to qualify for tax holidays under the Mauritius Income Tax Act, the FSC also stipulated that the licensees would require to possess a physical office and also specified the minimum number of employees which should be resident in Mauritius and also minimum amount of annual operating expenditure that should be incurred in Mauritius or assets to be under their management depending on the type of office.

B. Singapore

Singapore is one of the more advanced holding company jurisdictions in the Asia-Pacific region. Singapore possesses an established capital markets regime that is beneficial from the perspective of listing a fund on the Singapore stock exchange. Further, the availability of talent pool of investment professionals makes it easier to employ / relocate productive personnel in Singapore.

---

3. This benefit shall only be available to such Mauritius resident who is (a) not a shell/conduit company and (b) satisfies the main purpose and bona fide business test.
During April – June 2018, India received the highest FDI from Singapore of USD 6.52 billion. India and Singapore are poised to see enhanced economic cooperation as well as an increase in trade and investment flows.

The India-Singapore DTAA, was co-terminus with the India-Mauritius DTAA, hence exemptions under the India-Singapore DTAA would continue to be applicable till such benefits were available under the India-Mauritius DTAA. Subsequent to the India-Mauritius DTAA being amended, India and Singapore also signed a protocol on December 30, 2016 to amend the India-Singapore DTAA. The amendments introduced were largely along the lines of those introduced under the India- Mauritius DTAA, wherein the fundamental change was to provide for source base taxation of capital gains arising out of sale of Indian shares held by Singapore residents as opposed to residence based taxation for the same.

Singapore does not impose tax on capital gains. Gains from the disposal of investments may however, be construed to be of an income nature and subject to Singapore income tax. Generally, gains on disposal of investments are considered income in nature and sourced in Singapore if they arise from or are otherwise connected with the activities of a trade or business carried on in Singapore. As the investment and divestment of assets by the Singapore based entity are managed by a manager, the entity may be construed to be carrying on a trade or business in Singapore. Accordingly, the income derived by the Singapore based entity may be considered income accruing in or derived from Singapore and subject to Singapore income tax, unless the Singapore-based fund is approved under Section 13R and Section 13X respectively of the Singapore Income Tax Act (Chapter 134) (“SITA”) and the Income Tax (Exemption of Income of Approved Companies Arising from Funds Managed by Fund Manager in Singapore) Regulations, 2010. Under these Tax Exemption Schemes, “specified income” derived by an “approved company” from “designated investments” managed in Singapore by a fund manager are exempt from Singapore income tax.

For fund managers considering Singapore resident structures, a combination of Singapore resident investment funds and Special Purpose Vehicles (“SPV”) can be considered, given the tax exemption schemes and the tax proposals for the companies under the domestic law.

The protocol to the India-Singapore DTAA inserted Article 28A to the DTAA which reads:

“This Agreement shall not prevent a Contracting State from applying its domestic law and measures concerning the prevention of tax avoidance or tax evasion.”

The language of the newly inserted Article 28A made it clear that the GoI sees the GAAR as being applicable even to situations where a specific anti-avoidance provision (such as an LoB clause) may already exist in a DTAA. Interestingly, similar language was not introduced by the protocol to the India- Mauritius DTAA.

Making the GAAR applicable to companies that meet the requirements of a LoB clause is likely to adversely impact investor sentiment.

C. Ireland

Ireland is a tax-efficient jurisdiction when investment into the Indian company is in the form of debt or convertible debt instrument. Interest, royalties and fees for technical services (“FTS”) arising in India and paid to an Irish resident may be subject to a lower withholding tax of 10% under the India-Ireland DTAA. This is a significant relief from the withholding under Indian domestic law which can be as high as 42% for interest and around 27% for royalties and FTS.

Ireland can, therefore, be explored for debt funds or real estate funds that provide structured debt and also film funds that provide production financing for motion pictures where cash flows received from distributors could be in the nature of royalties. However, the characterization of income would need to be assessed on a case-by-case basis.
However, the changes introduced by the protocols to the India-Mauritius and India-Singapore DTAA on taxation of interest income (as summarized above) make Mauritius and Singapore favorable choice of jurisdictions even for debt funds. The costs of setting-up in Mauritius or Singapore are likely to be less expensive than Ireland.

D. Netherlands

With its robust network of income tax treaties, Netherlands is an established international fund domicile.

In the context of inbound investments to India, Netherlands emerges as an efficient jurisdiction for making portfolio investments. In certain situations, the India-Netherlands DTAA provides relief against capital gains tax in India (that follows a source based rule for taxation of capital gains). Gains arising to a Dutch resident arising from the sale of shares of an Indian company to a non-resident buyer would not be taxable in India. However, such gains would be taxable if the Dutch resident holds more than 10% of the shares of the Indian company in case of sale to Indian residents. Even though the eligible holding is capped, the same structure works well for FPIs, who are restricted to participate (whether directly or indirectly or synthetically through offshore derivative instruments or “ODIs”) to less than 10% of the paid-up capital of an Indian company.

For a Dutch entity to be entitled to relief under the India-Netherlands DTAA, it has to be liable to pay tax in the Netherlands. This may not be an issue for entities such as Dutch limited liability companies (BVs), public companies (NVs) or Cooperatives investing or doing business in India.

In the case of KSPG Netherlands,4 it was held that sale of shares of an Indian company by a Dutch holding company to a non-resident would not be taxable in India under the India-Netherlands DTAA. It was further held that the Dutch entity was a resident of the Netherlands and could not be treated as a conduit that lacked beneficial ownership over the Indian investments. The mere fact that the Dutch holding company was set up by its German parent company did not imply that it was not eligible to benefits under the Netherlands-India DTAA.

It may be noted that difficulties with respect to treaty relief may be faced in certain situations, especially in the case of general partnerships (“VOF”) and hybrid entities such as closed limited partnerships, European economic interest groupings (“EEIG”) and other fiscally transparent entities.

IV. Recent Changes

The double tax avoidance arrangements of India with Singapore and Mauritius have undergone a change, as discussed above.

Further, several regulatory reforms have been made in India, particularly with respect to foreign investments into AIFs. Investments into Indian companies made by Indian managed and sponsored AIFs with foreign investors will now be deemed domestic investments.

For portfolio investors, the choice of jurisdiction acquires even more importance since the Finance Act, 2014 had revised the Tax Act to crystallize the position that securities held by an FPI will be considered “capital assets” and the gains derived from their transfer will be considered capital gains. Therefore, funds that have so far been taking a position that such income results in business income, may need to re-visit their structures in order to ensure that they operate from jurisdictions that allow them to obtain relief on paying such tax in India.

The Finance Act, 2017 has also introduced an amendment to Section 47 of the ITA to exempt gains arising upon the conversion of preference shares into equity shares from capital gains tax.

GAAR which was introduced in the ITA by Finance Act, 2012 has come into effect from April 1, 2017. However, anxiety still exists over the application of GAAR and it still remains unclear on how the Revenue Authorities will practically implement GAAR.

---

3. Structural Alternatives for India-Focused Funds

I. Structuring India-focused Offshore Funds

Private equity and venture capital funds typically adopt one of the following three modes when investing into India: (1) direct investment in the Indian portfolio company, (2) direct or indirect investment in an Indian investment fund vehicle, or (3) co-investment alongside the domestic fund vehicle directly in the Indian portfolio company. We explore all three models in the brief below.

II. Foreign Investment Regimes

India’s exchange control regime is set out within the Foreign Exchange Management Act, 1999 (“FEMA”) and the rules and regulations thereunder. FEMA regulates all inbound and outbound foreign exchange related transactions, in effect regulating (or managing) the capital flows coming into and moving out of the country. Subject to certain conditions, such as pricing restrictions, in most industry sectors, if the percentage of equity holding by non-residents does not exceed certain industry-specific thresholds (sectoral caps) then Foreign Direct Investment (“FDI”) does not require prior GoI approval. However, FDI requires prior GoI approval by the concerned ministry/department if it is in excess of sectoral caps, is in breach of specified conditions or is made in a sector which specifically requires the approval.

The RBI is given primary authority to regulate capital flows through the FEMA. Notably, Section 6 of FEMA authorises the RBI to manage foreign exchange transactions and capital flows in consultation with the Ministry of Finance pursuant to the Foreign Exchange Management (Transfer or Issue of Security

by a Person Resident Outside India) Regulations, 2017 (“TISPRO Regulations”).

The primary routes for foreign investment into India are (a) the FDI route, (b) FVCI route and the (c) FPI route. In a bid to simplify and rationalize the FPI regime, SEBI has introduced the Securities and Exchange Board of India (Foreign Portfolio Investors) Regulations, 2014 (“FPI Regulations”). Under the FPI Regulations, SEBI has harmonized FIIs, sub-accounts and qualified foreign investors into a single investor class with a view to ensure uniform guidelines and provide a single window clearance for different categories of foreign investors. Each of these inbound investment regimes has been discussed in subsequent chapters. Based on the investment strategy and sectoral focus of the concerned fund, the fund could efficiently combine the different investment regimes to make investments in India. The same may require that either the fund itself or an investment holding company obtain registration with SEBI as an FVCI or an FPI.

5. This refers to investment through capital instruments by a person resident outside India in an unlisted Indian company; or in 10 percent or more of the post issue paid-up equity capital on a fully-diluted basis of a listed Indian company. While the RBI allows capital account transactions, these are subject to the Foreign Exchange Management (Transfer or issue of security by a person resident outside India) Regulations 2017 (“TISPRO Regulations”) issued by the RBI. Thus, ‘direct’ investments by the offshore fund vehicles / special purpose vehicle (SPV) would need to comply with the provisions and restrictions stipulated under the TISPRO Regulations.

6. Given that the FVCI regime has been developed to attract venture capitalists, there are certain incentives attached to being recognised as one. This accordingly requires registration and approval from the regulators (SEBI and RBI). While granting approval to an FVCI, certain restrictions and conditions may be imposed including a restriction on the scope of investments that can be made by the FVCI. The RBI has recently been prescribing in its approval letter to FVCI applicants that the investments by FVCI entities are restricted to select identified sectors (which include, inter alia, infrastructure, biotechnology and IT related to hardware and software development). However, the RBI has relaxed such sectoral restrictions for investing FVCIs into “startups” (as defined in the relevant amendment to TISPRO regulations). It is also important to note that SEBI-registered FVCIs are specifically exempted from the RBI pricing guidelines.

7. The FPI Regulations classify FPIs into three categories based on their perceived risk profile. The FPI route as such is the preferred route for foreign investors who want to make portfolio investments and trade in Indian listed stocks on the floor of the stock exchange.
A. Pure Offshore Structure

A pure offshore structure is used where there is no intent to pool capital at the domestic (i.e. India) level. Under this structure, a pooling vehicle (Offshore Fund) can be set up in an offshore jurisdiction. Offshore investors will commit capital to the Offshore Fund which in turn will make investments into Indian portfolio companies (under one or more of the inbound investment regimes mentioned above) as and when investment opportunities arise.

The following diagram depicts a pure offshore structure:

- Offshore Investors
- Offshore Fund
- Eligible Investments
- Investment Advisor
- Investment Manager

B. Unified Investment Structure

A unified structure is generally used where commitments from both domestic and offshore investors are pooled into a domestic pooling vehicle (Onshore Fund). Alternatively, the unified structure can also be adopted by an India based management team that seeks to extract management fee and carry allocations for the entire structure at the Onshore Fund level.

Under this structure, a trust or an LLP or a company (i.e., the “Onshore Fund”) is formed in India. The domestic investors would directly contribute to the Onshore Fund whereas overseas investors will pool their investments in an offshore vehicle (“Offshore Fund”) which, in turn, invests in the Onshore Fund. The Onshore Fund could be registered with SEBI under the AIF Regulations. The unified structure has received a big boost as general permission has been granted under the FDI Policy to accept foreign investment in an AIF under the automatic route.

The following diagram depicts a typical unified investment structure:
Favorable reasons for a unified structure

a. **Non-applicability of foreign investment restrictions**: Under the unified structure, investments made by the Indian AIF with the capital contributions received from the offshore fund shall also be deemed to be domestic investments if the manager and sponsor of the AIF are Indian owned and controlled. Therefore, the restrictions placed on foreign investments such as FDI Policy related restrictions including sector specific caps (b) choice in instruments being limited to equity shares, fully, compulsorily convertible debentures and fully, compulsorily and mandatorily convertible preference (c) optionality clauses being subject to conditions (d) pricing guidelines, etc. shall not be applicable to the investments made in India through the unified platform (which would have been otherwise applicable in respect of investments directly made by the offshore fund in Indian opportunities).

b. **Consolidation of corpus**: A unified structure allows aggregation of the asset-under-management across both the offshore fund and the Indian AIF. A larger corpus at the Indian AIF level will help tap more capital from those LPs whose commitments are linked to the corpus of the Indian AIF and allow the manager to evaluate larger deals as the portfolio concentration requirements can be met using the larger aggregate pool at the AIF level. In this regard, it is important to understand the differences between pooling offshore investors directly into the Indian AIF versus a unified structure. There is a consolidation of corpus in both the cases, however, there are other reasons for pooling offshore investors in an offshore vehicle (i.e. unified structure) which are summarized below: (i) In case investment by offshore investors in the Indian AIF, each offshore investor may be required to obtain a PAN card from Indian income tax authorities and file income tax returns in India; (ii) While

---

8. The term “PAN” stands for Permanent Account Number.
making distributions to offshore investors under the direct structure, the AIF has to consider withholding tax rates in force between India and the concerned country of each of the relevant offshore investor. In case of the feeder set up, the tax status of the feeder is to be considered.

c. **Tax pass-through and DTAA eligibility:** Category I and Category II AIFs have been accorded tax pass through status under the Indian Income Tax Act, 1961, i.e. the income received by a unit-holder through the AIF will be chargeable to income-tax in the same manner as if it were the income arising to such unit-holder directly by the unit-holder.  
Accordingly, the tax liabilities of the offshore fund will remain the same (as would be for direct investments) under the unified structure. The protocols to the India-Mauritius DTAA and India-Singapore give India the right to tax capital gains arising from the transfer of equity shares. Despite the changes introduced by the protocols, Mauritius and Singapore continue to be favorable jurisdictions from a tax perspective as Mauritius and Singapore would continue to have the right to tax capital gains arising from the transfer of non-convertible debentures, compulsorily convertible debentures and optionally convertible debentures (depending on the terms of the conversion of the optionally convertible debentures).

d. **Favorable regime:** The GoI wants to promote onshore fund management activities. To that end, the benefits which are being made available to AIFs would also extend to the offshore fund in a unified structure.

With amendments brought about by the Finance Act, 2015 (the “2015 Act”) in relation to the criteria for determining the tax residence of companies incorporated outside India, a foreign company should not be a tax resident of India in a particular financial year if the company’s POEM in that financial year is not located in India. POEM has been defined to mean “a place where key management and commercial decisions that are necessary for the conduct of the business of an entity as a whole are, in substance, made”. The effective date of this amendment has been pushed by one year by the Finance Act, 2016. Accordingly, the said change should be relevant for foreign companies from the financial year 2016-17.

e. **Decision-making:** Under the unified structure, the offshore fund will make a principal investment-related decision i.e. whether or not to invest in the Indian AIF. The offshore fund may need to make additional decisions if certain offshore / Indian investments are required to be made directly by the offshore fund. Since most of the decisions in respect of the Indian AIF are to be taken by the India based investment manager, risks such as that of the offshore fund having a permanent establishment or its “place of effective management” (”POEM”) in India, are reduced.

### C. Co-investment / Parallel Investment Structure

A co-investment structure is adopted where the commercial expectation is to raise separate pools of capital for domestic investors and for offshore investors. Accordingly, separate pooling vehicles will need to be set up in India (i.e. Onshore Fund) and in an offshore jurisdiction (Offshore Fund). The Offshore Fund and the Onshore Fund typically have separate management structures. The Onshore Fund is managed by an India-based investment manager which entity may provide recommendations on investment opportunities to the management of the Offshore Fund on a non-binding basis.

9. S. 115UB read with s. 10(23FBA), s. 10(23FBB) and s. 194LBB of the Indian Income Tax Act, 1961.

10. With amendments brought about by the Finance Act, 2015 (the “2015 Act”) in relation to the criteria for determining the tax residence of companies incorporated outside India, a foreign company should not be a tax resident of India in a particular financial year if the company’s POEM in that financial year is not located in India. POEM has been defined to mean “a place where key management and commercial decisions that are necessary for the conduct of the business of an entity as a whole are, in substance, made”. The effective date of this amendment has been pushed by one year by the Finance Act, 2016. Accordingly, the said change should be relevant for foreign companies from the financial year 2016-17.
Typically, the co-investment ratio between the Offshore Fund and the Onshore Fund is the ratio of their undrawn capital commitments.

The following diagram depicts a typical co-investment structure:

The co-investment structure allows independent investments by the Offshore Fund and the Onshore Fund on the basis of their undrawn commitments in case the other runs out of dry powder. Further, it also provides greater flexibility to Onshore Fund allowing it to make investments irrespective of the Offshore Fund’s ability to do so.

Certain tax risks exist in such a structure. The Onshore Fund and the Offshore Fund may be taxed together in India as an ‘association of persons’ ("AOP") and thus, suffer disproportionately higher tax rates.

III. Certain Tax Risks

Owing to the uncertain nature of Indian income-tax laws, there are certain tax risks that may arise to an offshore fund depending on the complexity of the structure and the level of substance demonstrated by the offshore fund. The following is a brief summary of these tax risks:

A. Association of Persons (AOP) Risk

An AOP is a ‘person’ recognized under Section 2(31) of the Tax Act and is, therefore, a separate taxable entity. The Supreme Court of India has held that
in order to constitute an AOP, persons must join in a common purpose or common action and the object of the association must be to produce income - it is not enough for the persons to receive income jointly. The Court has also held that the question whether there is an AOP must be decided upon the facts and circumstances of each case. The Indian tax authorities may claim that the control and management of an offshore Fund vests with the domestic investment manager and therefore, the offshore Fund and the onshore fund together constitute an AOP. The consequence of constitution of an AOP would primarily be that all assessments would be conducted at the AOP level rather than qua the beneficiaries of the onshore fund.

B. Indirect Transfer of Capital Assets Risk

An amendment to the ITA had introduced a provision for the levy of capital gains tax on income arising from the transfer of shares / interest in a company / entity organized outside India which derives, directly or indirectly, its value substantially from the assets located in India. Pursuant to the said amendment, there is a possibility that Indian tax authorities may seek to tax the transfer of the shares in an offshore fund by investors outside India, or the redemption of shares by investors, notwithstanding that there is no transfer taking place in India, on the basis that the shares of the offshore fund derive substantial value from India.

However, Central Board of Direct Tax’s (“CBDT”) through Circular no. 4 of 2015 (“2015 Circular”) had clarified that a distribution of dividends by an offshore company with the effect of underlying Indian assets would not result in a tax liability since it does not result in indirect transfer of shares that derive their value substantially out of India.

The Finance Act, 2017 brought changes to clarify that the indirect transfer tax provisions shall not be applicable to an asset or capital asset that is held directly / indirectly by way of investment in a Category I or Category II FPI. This resolved concerns for a class of offshore funds which are registered as a Category I or Category II FPIs as redemptions by investors at the level of the fund shall not be subject to the indirect transfer taxation. Further, in multi-tiered structures, if the entity investing into India is a Category I or Category II FPI, any up-streaming of proceeds by way of redemption / buyback will not be brought within the Indian tax net.

The clarifications were implemented retrospectively from FY starting April 1, 2012, and therefore would help bring about certainty on past transactions that have been entered into by Category I and Category II FPI entities.

In November 2017, the CBDT notified that the indirect transfer provisions shall not apply to income arising or accruing on account of redemption or buyback of share held indirectly by a non-resident in the Category I and Category II AIFs, venture capital company or a venture capital fund, if it is in consequence of transfer of share or securities held in India by such funds and if such income is chargeable in India. Thus, adverse effect of indirect transfer provisions has been minimized by not taxing a non-resident for its capital gain, in case it made through such funds.

C. General Anti-avoidance Rule (“GAAR”) Risk

A statutory GAAR came into effect from the financial year beginning on April 01, 2017. GAAR, as it is currently drafted, empowers tax authorities to disregard or combine or re-characterize any part or whole of a transaction / arrangement such that the transaction / arrangement gets taxed on the basis of its substance rather than its form if such arrangement gets classified as an impermissible avoidance arrangement (i.e. arrangement which is not in arm’s length, misuses or abuse of tax laws, lacks or is deemed to lack commercial substance or is not carried out for bonafide purpose). This could result in any tax benefit being denied, including denial of DTAA benefits, shifting of residency of investors and / or re-characterization of capital gains.
income as any other classification. The CBDT has recently clarified by way of a circular\textsuperscript{11} that shares issued after March 31, 2017 upon the conversion of compulsorily convertible preference shares ("CCPS") acquired prior to April 01, 2017 should be grandfathered if the terms of the conversion were finalized at the time of issuance of the CCPS.

D. Tax Exposure Owing to Permanent Establishment

In a unified investment model or a parallel investment model, there could be a risk of the onshore fund or the Indian investment manager of the onshore fund being perceived to constitute a permanent establishment of the offshore fund if there is no evidence of independent decision-making at the offshore fund level. The Finance Act, 2015 had changed the criteria for determining tax residence of companies incorporated outside India. As per the amended criteria, to ensure that the company is not construed to be tax resident of India in a particular financial year, the company’s place of effective management or POEM in that financial year should not be located in India. POEM has been defined to mean “a place where key management and commercial decisions that are necessary for the conduct of the business of an entity as a whole are, in substance made”.

CBDT had notified the final POEM guidelines\textsuperscript{12} which emphasize that the test of POEM is one of substance over form and will depend on facts and circumstances of each case. Further, the guidance laid down different tests for companies with active and passive businesses outside India.

The POEM for an active company is presumed to be outside India if the majority of its board meetings are held outside India. To determine the POEM of passive companies, the persons who actually make key management and commercial decisions for the business as a whole will be identified, followed by identifying the place where decisions are actually taken.

POEM came into effect from April 01, 2017.

\textsuperscript{11}. CBDT Circular No.7 of 2017 dated January 27, 2017

\textsuperscript{12}. Circular No. 6 of 2017
4. Alternative Investment Funds in India

I. Introduction

Before the emergence of the Venture Capital Private Equity ("VCPE") industry in India, entrepreneurs primarily depended on private placements, public offerings and lending by financial institutions for raising capital. However, given the considerations involved, these were not always the optimal means of raising funds.

Following the introduction of the Securities and Exchange Board of India (Venture Capital Funds) Regulations ("VCF Regulations") in 1996, the VCPE industry successfully filled the gap between capital requirements of fast-growing companies and funding available from traditional sources such as banks, IPOs, etc. The VCPE industry has also had a positive impact on various stakeholders – providing much needed risk capital and mentoring to entrepreneurs, improving the stability, depth and quality of companies in the capital markets, and offering risk-adjusted returns to investors.

The growth in Venture Capital ("VC") funding in India can be attributed to various factors. Once the GoI started becoming more and more aware of the benefits of the VC investments and the criticality for the growth of the different sectors such as software technology and internet, favorable regulations were passed regarding the ability of various financial institutions to invest in a VCF. Further, tax treatments for VCFs were liberalized and procedures were simplified.

Subsequently, in 2012, SEBI took steps to completely overhaul the regulatory framework for domestic funds in India and introduced the Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012 ("AIF Regulations"). Among the main reasons cited by SEBI to highlight its rationale behind introducing the AIF Regulations was to recognize AIFs as a distinct asset class; promote start-ups and early stage companies; to permit investment strategies in the secondary markets; and to tie concessions and incentives to investment restrictions.

Here it is relevant to note that SEBI has adopted a practical grandfathering approach which provides that funds that are already registered under the VCF Regulations would continue to be governed by those regulations including for the purpose of raising commitments up to their targeted corpus. However, existing venture capital funds are not permitted to increase their targeted corpus. Further, new funds and existing funds that are not registered under any regime would need to be registered under the AIF Regulations.

II. Alternative Investment Funds

Subject to certain exceptions, the ambit of the AIF Regulations is to regulate all forms of vehicles set up in India for pooling of funds on a private placement basis. To that extent, the AIF Regulations provide the bulwark within which the Indian fund industry is to operate.

An AIF means any fund established or incorporated in India in the form of a trust or a company or an LLP or a body corporate which:

a. is a privately pooled investment vehicle which collects funds from investors, whether Indian or foreign, for investing it in accordance with a defined investment policy for the benefit of its investors; and

b. is not covered under the Securities and Exchange Board of India (Mutual Funds) Regulations, 1996, Securities and Exchange Board of India (Collective Investment Schemes) Regulations, 1999 or any other regulations of the Board to regulate fund management activities.
III. Choice of Pooling Vehicle

The AIF Regulations contemplate the establishment of funds in the form of a trust, a company, an LLP or a body corporate. The following table provides a comparison of these entities from an investment fund perspective:

<table>
<thead>
<tr>
<th>Issue</th>
<th>Trust</th>
<th>Limited Liability Partnership</th>
<th>Company</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>General</strong></td>
<td>The person who reposes or declares the confidence is called the “author of the trust”(^{13}); the person who accepts the confidence is called the “trustee”; the person for whose benefit the confidence is accepted is called the “beneficiary”; the subject matter of the trust is called “trust property”; the “beneficial interest” or “interest” of the beneficiary is the right against the trustee as owner of the trust property; and the instrument, if any, by which the trust is declared is called the “instrument of trust”/ “indenture of trust”</td>
<td>The concept of LLP was recently introduced in India under the Limited Liability Act, 2008 (“LLP Act”). An LLP is a hybrid form of a corporate entity, which combines features of an existing partnership firm and a limited liability company (i.e. the benefits of limited liability for partners with flexibility to organize internal management based on mutual agreement amongst the partners). The functioning of an LLP is governed by the LLP agreement.</td>
<td>A Company can be incorporated under the Companies Act, 2013.</td>
</tr>
<tr>
<td><strong>Entities Involved</strong></td>
<td>The Settlor: The Settlor settles a trust with an initial settlement. Terms of the indenture of trust (“Indenture”) shall administer the functioning of the trust (“Trust”).</td>
<td>Partner: A ‘partner’ represents an investor in the fund. To that extent, a partner has an obligation to fund its ‘commitment’ to the fund and is entitled to distributions based on fund documents (being the LLP Agreement in this case).</td>
<td>Shareholders: Shareholders hold the shares of the company and are granted special privileges depending on the class of shares they own</td>
</tr>
<tr>
<td></td>
<td>The Trustee: The Trustee is in charge of the overall administration of the Trust and may be entitled to a trusteeship fee. The Trustee may also appoint an investment manager, who in turn manages the assets of the Trust and the schemes / funds as may be launched under such Trust from time to time.</td>
<td>Designated Partner: Though the expression ‘designated partner’ is not explicitly defined, however, on a plain reading of the LLP it is understood that such ‘designated partner’ shall be the person responsible and liable in respect of the compliances stipulated for the LLP.</td>
<td>Directors: Directors have a fiduciary duty towards the company with respect to the powers conferred on them by the Companies Act, 2013 and by the Memorandum of Association and Articles of Association of the company. They are trustees in respect of powers of the company that are conferred upon them, for instance, powers of (a) issuing and allotting shares; (b) approving transfers of shares; (c) making calls on shares; and (d) forfeiting shares for non-payment of call etc. They must act bona fide and exercise these powers solely for the benefit of the company.</td>
</tr>
<tr>
<td></td>
<td>The Contributor: The contributor is the investor to the Trust (the Fund) and makes a capital commitment under a contribution agreement.</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

\(^{13}\): Commonly referred to as a ‘settlor’
### Management of entities

| The Trustee is responsible for the overall management of the Trust. In practice this responsibility is outsourced to an investment manager pursuant to an investment management agreement. |
| The LLP relies on the Designated Partner in this respect. In practice, this responsibility may be outsourced to an investment manager pursuant to an investment management agreement. |
| The board of directors manages the company involved. In practice this responsibility is outsourced to an investment manager pursuant to an investment management agreement. |

### Market Practice

| Almost all funds formed in India use this structure. The regulatory framework governing trust structures is stable and allows the management to write its own standard of governance. |
| Only a few funds are registered under this structure. The Registrar of Companies ("RoC") does not favor providing approvals to investment LLPs. As per section 5 of the LLP Act, 2008, only an individual or a body corporate is eligible to be a partner in an LLP. |
| There are no clear precedents for raising funds in a “company” format. |

The following diagram depicts an AIF that is set up in the form of a trust:

![Diagram](image-url)
IV. Classification of AIFs

As mentioned previously in our introductory chapter, the AIF Regulations were introduced with the objective of effectively channelizing incentives. For this purpose, the AIF Regulations define different categories of funds with the intent to distinguish the investment criteria and relevant regulatory concessions that may be allowed to them.

A description of the various categories of AIFs along with the investment conditions and restriction relevant to each category is summarized below:

<table>
<thead>
<tr>
<th>Category I AIF</th>
<th>Category II AIF</th>
<th>Category III AIF</th>
</tr>
</thead>
<tbody>
<tr>
<td>i. Category I AIFs are funds with strategies to invest in start-up or early stage ventures or social ventures or SMEs or infrastructure or other sectors or areas which the government or regulators consider as socially or economically desirable.</td>
<td>i. Category II AIFs are funds which cannot be categorized as Category I AIFs or Category III AIFs. These funds do not undertake leverage or borrowing other than to meet day-to-day operational requirements and as permitted in the AIF Regulations.</td>
<td>i. Category III AIFs are funds which employ complex or diverse trading strategies and may employ leverage including through investment in listed or unlisted derivatives.</td>
</tr>
<tr>
<td>ii. Under the AIF Regulations, the following funds are designated as sub-categories of Category I AIFs - venture capital funds, SME funds, social venture funds, infrastructure funds and such other AIFs as may be specified.</td>
<td>ii. AIFs such as private equity funds or debt funds for which no specific incentives or concessions are given by the Government of India or any other regulator are included in the Category II AIF classification.</td>
<td>ii. AIFs such as hedge funds or funds which trade with a view to make short-term returns or such other funds which are open ended and for which no specific incentives or concessions are given by the Government of India or any other regulator are included in the Category III AIF classification.</td>
</tr>
<tr>
<td>iii. AIFs which are generally perceived to have positive spillover effects on the economy and therefore, SEBI, the Government of India or other regulators may consider providing incentives.</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

a. AIFs may invest in securities of companies incorporated outside India subject to such conditions / guidelines that may be stipulated by SEBI or the RBI;

b. Co-investment in an investee company by a Manager / Sponsor should not be on more favourable terms than those offered to the AIF;
c. Only a specific percentage of the investible funds (25% for Category I and II AIFs and 10% for Category III AIFs) can be invested in a single investee company; remain locked-in the fund until distributions have been made to all the other investors in the fund. For a Category I or Category II AIF, the sponsor or the manager is required to have a continuing interest of 2.5% of the corpus of the fund or INR 50 million whichever is lower and in the case of a Category – III AIF, a continuing interest of 5% of the corpus or INR 100 million whichever is lower. For the newly introduced

V. Investment Conditions and Restrictions under the AIF Regulations

The AIF Regulations prescribe a general set of investment restrictions that are applicable to all AIFs and further prescribe a specific set of investment restrictions that are applicable for each category of
AIFs. SEBI is authorized to specify additional criteria or requirements as may be required. The following is the list of general investment conditions applicable to all AIFs:

a. AIFs should not invest in associates except with the approval of 75% of investors by value of their investments in the AIF; and

b. The un-invested portion of the investible funds may be invested in liquid mutual funds or bank deposits or other liquid assets of higher quality such as Treasury Bills, Collateralized Borrowing and Lending Obligations (“CBLOs”), commercial papers, certificates of deposits, etc. till deployment of funds as per the investment objective

The following table summarizes the investment restrictions that are applicable in respect of the various categories of AIFs:

### Investment Restrictions and Conditions for AIFs

| Category I AIFs | i. Category I AIFs shall invest in investee companies or venture capital undertakings or in special purpose vehicles or in limited liability partnerships or in units of other AIFs specified in the Regulations. |
| Category II AIFs | ii. A Category I AIF of a particular sub-category may invest in the units of the same sub-category of Category I AIFs. However, this investment condition is subject to the further restriction that Category I AIFs are not allowed to invest in the units of Fund of Funds. |
| Category II AIFs | iii. Category I AIFs shall not borrow funds directly or indirectly or engage in leverage except for meeting temporary funding requirements for more than thirty days, on not more than four occasions in a year and not more than 10% of its investible funds. |
| Category III AIFs | In addition to these investment conditions, the AIF Regulations also prescribe a set of investment conditions in respect of each sub-category of Category I AIFs. |
| Category II AIFs | i. Category II AIFs shall invest primarily in unlisted investee companies or in units of other AIFs as may be specified in the placement memorandum; |
| Category II AIFs | ii. Category II AIFs may invest in the units of Category I and Category II AIFs. This is subject to the restriction that Category II AIFs cannot invest in the units of Fund of Funds; |
| Category II AIFs | iii. Category II AIFs shall not borrow funds directly or indirectly or engage in leverage except for meeting temporary funding requirements for more than thirty days, on not more than four occasions in a year and not more than 10% of its investible funds; |
| Category III AIFs | iv. Category II AIFs may engage in hedging subject to such guidelines that may be prescribed by SEBI; |
| Category III AIFs | v. Category II AIFs may enter into an agreement with a merchant banker to subscribe to the unsubscribed portion of the issue or to receive or deliver securities in the process of market making under Chapter XB of the ICDR Regulations; and |
| Category III AIFs | vi. Category II AIFs shall be exempt from Regulations 3 and 3A of the Insider Trading Regulations in respect of investments in companies listed on SME exchange or SME segment of an exchange pursuant to due diligence of such companies. This is subject to the further conditions that the AIF must disclose any acquisition / dealing within 2 days to the stock exchanges where the investee company is listed and such investment will be locked in for a period of 1 year from the date of investment. |
| Category III AIFs | i. Category III AIFs may invest in securities of listed or unlisted investee companies or derivatives or complex or structured products; |
| Category III AIFs | ii. Category III AIFs may invest in the units of Category I, Category II and Category III AIFs. This is subject to the restriction that Category III AIFs cannot invest in the units of Fund of Funds; |
| Category III AIFs | iii. Category III AIFs engage in leverage or borrow subject to consent from investors in the fund and subject to a maximum limit as may be specified by SEBI; and |
| Category III AIFs | iv. Category III AIFs shall be regulated through issuance of directions by SEBI regarding areas such as operational standards, conduct of business rules, prudential requirements, restrictions on redemption and conflict of interest. |
VI. Key Themes under the AIF Regulations

A. Continuing Interest

The AIF Regulations require the sponsor or the manager of an AIF to contribute a certain amount of capital to the fund. The purpose of the clause is to have the sponsor or the investment manager to commit capital to the funds (i.e. to have skin-in-the-game). This portion is known as the continuing interest and will remain locked-in the fund until distributions have been made to all the other investors in the fund. For a Category I or Category II AIF, the sponsor or the manager is required to have a continuing interest of 2.5% of the corpus of the fund or INR 50 million whichever is lower and in the case of a Category – III AIF, a continuing interest of 5% of the corpus or INR 100 million whichever is lower. For the newly introduced angel investment funds, the AIF Regulations require the sponsor or the manager to have a continuing interest of 2.5% of the corpus of the fund or INR 5 million whichever is lower. Further, the sponsor or the manager (as the case may be) is required to disclose its investment in an AIF to the investors of the AIF.

B. Minimum Corpus

The AIF Regulations prescribe that the minimum corpus for any AIF shall be INR 200 million (“Minimum Corpus”). Corpus is the total amount of funds committed by investors to the fund by way of written contract or any such document as on a particular date. By its circular dated on June 19, 2014, (“Circular”) SEBI requires that where the corpus of an open-ended scheme falls below the Minimum Corpus (post redemption(s) by investors or exits), the Fund Manager is given a period of 3 months to restore the Minimum Corpus, failing which, all the interests of the investors will need to be mandatorily redeemed.

C. Minimum Investment

The AIF Regulations do not permit an AIF to accept an investment of less than INR 10 million crore (“Minimum Investment Amount”) from any investor unless such investor is an employee or a director of the AIF or an employee or director of the manager of the AIF in which case the AIF can accept investments of a minimum value of INR 2.5 lakh million. The Circular has specifically clarified that in case of an open-ended AIF, the first lump-sum investment received from an investor should not be less than the Minimum Investment Amount. Further, in case of partial redemption of units by an investor in an open-ended AIF, the amount of investment retained by the investor should not fall below the Minimum Investment Amount.

D. Qualified Investors

The AIF Regulations permit an AIF to raise funds from any investor whether Indian, foreign or non-resident through the issue of units of the AIF.

E. Foreign investment in AIFs

The RBI, in November, 2017, (“November Notification”) has issued TISPRO Regulations, 2017 replacing the TISPRO Regulation, 2000. In terms of the November Notification, foreign investments into an AIF are allowed under the automatic route and the Notification classifies downstream investment by an AIF as foreign investment only if the sponsor and/or the investment manager are not Indian “owned and controlled”. Prior to the Notification, foreign investments in AIFs required a specific approval from the FIPB and the downstream investments by such AIFs were also governed by the FDI Policy.

As per the November Notification,

14. CIR/IMD/DF/14/2014
15. Ibid.
16. Notification No. FEMA 20(R)/2017-RB.
i. Ownership of an Indian company shall mean beneficial holding of more than 50 percent of the capital instruments of such company.

ii. Ownership of an LLP shall mean contribution of more than 50 percent in its capital and having majority profit share.

Control shall mean 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. For the purpose of an LLP control shall mean 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.

In addition to the above, investments by NRIs under Schedule 4 of TISPRO Regulations will be deemed to be domestic investment at par with the investment made by residents.

F. Maximum Number of Investors

The AIF Regulations caps the maximum number of investors for an AIF at 1,000.

G. Private Placement

The AIF Regulations prohibit solicitation or collection of funds except by way of private placement. While the AIF Regulations do not prescribe any thresholds or rules for private placement, guidance is taken from the Companies Act, 2013.

H. Tenure

While Category I and Category II AIFs can only be closed-end funds, Category III AIFs can be open-ended. The AIF Regulations prescribe the minimum tenure of 3 years for Category I and Category II AIFs. SEBI, vide its circular dated October 01, 2015, clarified that the tenure of any scheme of the AIF shall be calculated from the date of the final closing of the scheme. Further, the tenure of any AIF can be extended only with the approval of 2/3rd of the unitholders by value of their investment in the AIF.

I. Overseas investments by AIFs

As per a circular dated October 1, 2015 issued by SEBI, an AIF may invest in equity and equity-linked instruments of off-shore VUCs, subject to certain conditions mentioned in this circular such as an overall aggregate limit of USD 500 million for all AIFs and VCFs registered under the SEBI (Venture Capital Funds) Regulations, 1996 and the guidelines stipulated by the RBI in this respect. Investments would be made only in those companies which have an Indian connection (i.e. company which has a front office overseas, while back office operations are in India) and such investments would be up to 25% of the investible funds of the AIF. The aforementioned circular clarifies that an offshore VCU means a foreign company whose shares are not listed on any of the recognized stock exchange in India or abroad. Such an investment by an AIF requires prior approval from SEBI. The allocation of investment limits would be done on a ‘first come-first serve’ basis depending on availability in the overall limit of USD 750 million, and in case an AIF fails to make the allocated investment within a period of 6 months from date of approval, SEBI may allocate such unutilized limit to another applicant.

J. Change in Circumstances

The Circular provides that in case any ‘material change’ to the placement memorandum (changes that SEBI believes to be significant enough to influence the decision of the investor to continue to be invested in the AIF), is said to have arisen in the event of (1) change in sponsor / manager, (2) change in control of sponsor / manager, (3) change in fee structure which may result in higher fees being charged to the unit holders and (4) change in fee structure or hurdle rate which may result in higher fees being charged to the unit holders. In

---

17. Circular No. (CIR/IMD/DF/Y/2013)  
18. Ibid
In pursuance of the SEBI (International Financial Services Centre) Guidelines, 2015, SEBI issued operating guidelines providing for the process with respect to registration, compliance and restrictions for setting up alternative investment funds in IFSC. Accordingly, each scheme of an AIF would be required to have a corpus of at least USD 3 million. Further, if the corpus of the AIF exceeds USD 70 million, the sponsor or manager of the AIF (Category I and Category II) would be required to appoint a custodian registered with SEBI for safekeeping of securities.

The Circular provided that the minimum investment amount in the AIF would be USD 150,000. Further, with respect to investors who are employees or directors of the AIF or the Investment Manager, the minimum investment amount would be USD 40,000. The Operating Guidelines require the Investment manager or sponsor to possess a continuing interest of not less than 2.5% of the corpus of the AIF or USD 750,000 whichever is lower in the AIF and such interest shall not be through the waiver of management fees. With respect to Category III AIFs, the manager or sponsor would be required to invest not less than 5% of the corpus of USD 1.5 million whichever is lower in the AIF. The Operating Guidelines allow an AIF set up in IFSC to invest in units of other AIFs set up in IFSC and India subject to the AIF Regulations.

In addition to the above, the Operating Guidelines permit a sponsor or investment manager of an existing AIF in India to act as a sponsor or investment manager of an AIF set up in IFSC by either setting up a branch in IFSC or incorporating a company or LLP in IFSC. However, the sponsor or manager to be set up in IFSC would be required to incorporate a company or LLP in IFSC.

With respect to angel funds, the Operating Guidelines provide that the minimum corpus of an angel fund shall be at least USD 750,000. The angel investor investing in the angel fund set up in IFSC, must satisfy the following conditions: (i) the angel investor should possess net tangible assets of at least USD 300,000 excluding value of its principal residence; (ii) a body corporate shall have a net worth of at least USD one million five hundred thousand. With respect to investment by angel funds setup in IFSC into venture capital undertakings in India, the investment should be not less than USD 40,000 and should not exceed USD one million five hundred thousand. Further, the venture capital undertakings should have a turnover of less than USD three million seven hundred and fifty thousand. Angel funds may invest in venture capital undertakings which are not promoted or sponsored by or related to an industrial group whose group turnover exceeds USD 45 million. The Manager or Sponsor of the angel fund should have a continuing interest of not less than 2.5% of the corpus of USD 80,000, whichever is lower and such interest should not be through the waiver of management fees.
VII. Taxation of Alternative Investment Funds

A. Taxation of funds registered as Category I or Category II AIFs

In response to a long-standing demand of the investment funds industry in India, the Finance Act, 2015, extended tax pass through status to AIFs that are registered with SEBI as Category I AIFs or Category II AIFs under the AIF Regulations.

Prior to the changes introduced by the Finance Act, 2015, only an AIF that was registered as a venture capital fund sub-category of Category I and venture capital funds registered under the VCF Regulations were eligible for the exemption under section 10(23FB) of the Tax Act.

The Finance Act, 2015 included a proviso to section 10(23FB) of the Tax Act pursuant to which, Category I and Category II AIFs that are registered under the AIF Regulations, will be taxed according to the new rules set forth in the newly introduced Chapter XII-FB of the ITA. Consequently, VCFs registered under the erstwhile VCF Regulations will continue to be eligible to claim the exemption under section 10(23FB) in respect of income from investments in venture capital undertakings.

The Finance Act, 2015 defines an “investment fund” to mean a fund that has been granted a certificate of registration as a Category I or a Category II AIF and provides that any income accruing or arising to, or received by, a unit-holder of an investment fund out of investments made in the investment fund shall be chargeable to income-tax in the same manner as if it were the income accruing or arising to, or received by such person, had the investments made by the investment fund been made directly by the unit-holder. In other words, the income of a unit-holder in an investment fund will take the character of the income that accrues or arises to, or is received by the investment fund.

However, the Act contemplates that income chargeable under the head ‘Profits and gains of business and profession’ will be taxed at the investment fund level and the tax obligation will not pass through to the unit-holders. In order to achieve this, the Act introduces two provisions:

a. Section 10(23FBA) which exempts income of an investment fund other than income chargeable under the head ‘Profits and gains of business or profession’; and

b. Section 10(23FBB) which exempts the proportion of income accruing or arising to, or received by, a unit-holder of an investment fund which is of the same nature as income chargeable under the head ‘Profits and gains of business or profession’.

Where the total income of an investment fund in a given previous year (before making adjustments under section 10(23FBA) of the ITA) is a loss under any head of income and such loss cannot be, or is not wholly, set-off against income under any other head of income, the Finance Act, 2015 allows such loss to be carried forward and set-off in accordance with the provisions of Chapter VI (Aggregation of Income and Set Off or Carry Forward of Loss).

Furthermore, the Finance Act, 2015 provides that the loss will not pass through to the unit holders of an investment fund and accordingly, the unit holders will be precluded from offsetting their proportionate loss from the investment fund against other profits and gains that they may have accrued. This is unlike under the rules for taxation for a trust, where a trust is regarded as being a determinate trust or where an investor’s contribution to the trust is regarded as a revocable transfer, in which case the investor retains the ability to off-set its proportionate losses against its other profits and gains.

Furthermore, the CBDT has notified\(^{21}\) that income received by investment funds would be exempted from TDS by portfolio companies. This should be helpful in case of interest/coupon payouts by portfolio companies to such funds. Previously, it was administratively difficult for investors to take credit of the TDS withheld by portfolio companies.

An important feature of the pass-through framework was the requirement to deduct tax at 10% on the income that is payable to the payee as outlined in the newly section 194LBB of the Tax Act. In view of the rule mandating the deemed credit of income to the accounts of unit-holders, the Finance Act, 2015 extended the requirement to deduct tax to scenarios where income is not actually paid or credited but only deemed to be credited.

While the pass-through regime was a welcome development, it was not without its set of difficulties. For example, the withholding provision applied to exempt income such as dividends and long-term capital gains on listed equity shares. Further, no clarity has been provided on whether the withholding obligation would also apply in respect of non-resident investors who were eligible to DTAA benefits.

The Finance Act, 2016 has amended section 194(LBB) of the Tax Act to enable deduction of withholding tax for non-residents at a rate which is in accordance with the provisions of the DTAA if they are eligible to DTAA benefits. However, it keeps the withholding rate unchanged for resident investors.

The only relief that is available to resident investors is that they are allowed to approach the revenue authorities for a reduced or a nil withholding certificate under section 197 of the Tax Act if they are entitled to any benefits as per their tax status or due to the stream of income that is being distributed by the investment fund. For example, if the investment fund is only distributing dividends it should be allowed to obtain a nil withholding certificate as such income is exempt from tax in the hands of the investor.

Moreover, CBDT vide a press release dated May 5, 2016 has clarified that it has given directions to officers in relation to determining the tax treatment of income arising from transfer of unlisted shares wherein it has decided that income arising from transfer of unlisted shares would be taxed as capital gains under the ITA irrespective of the period of holding. This would however, not be applicable in situations where (i) the genuineness of transactions in unlisted shares itself is questionable; or (ii) the transfer of unlisted shares is related to an issue pertaining to lifting of corporate veil; or (iii) the transfer of unlisted shares is made along with the control and management of underlying business and the Indian revenue authorities would take appropriate view in such situations.

In this regard, CBDT has issued a subsequent clarification dated January 24, 2017 (CBDT F.No.225/12/2016/ITA.II) stating that the exception to transfer of unlisted securities made along with control and management of underlying business would not apply to Category I & II AIFs.

**B. Taxation of Category III AIFs**

As mentioned earlier, AIFs are usually set up as trusts and consequently they are subject to the tax framework that is applicable to trusts in India. Under Indian tax law, a trust is not a separate taxable entity. Taxation of trusts is laid out in sections 161 to 164 of the Tax Act. Where the trust is specific, i.e., the beneficiaries are identifiable with their shares being determinate, the trustee is assessed as a representative assessee and tax is levied on and recovered from them in a like manner and to the same extent as it would be leviable upon and recoverable from the person represented by them.

In the case of AIG (In Re: Advance Ruling P. No. 10 of 1996), it was held that it is not required that the exact share of the beneficiaries be specified for a trust to be considered a determinate trust, and that if there is a predetermined formula by which distributions are made the trust could still be considered a determinate trust. The tax authorities can alternatively raise an

---

assessment on the beneficiaries directly, but in no case can the tax be collected twice over.

While the income tax officer is free to levy tax either on the beneficiary or on the trustee in their capacity as representative assessee, as per section 161 of the Tax Act, it must be done in the same manner and to the same extent that it would have been levied on the beneficiary. Thus, in a case where the trustee is assessed as a representative assessee, they would generally be able to avail of all the benefits / deductions etc. available to the beneficiary, with respect to that beneficiary's share of income. There is no further tax on the distribution of income from a trust.

On July 28, 2014, CBDT issued a circular to provide ‘clarity’ on the taxation of AIFs that are registered under the AIF Regulations.

The Circular states that if ‘the names of the investors’ or their ‘beneficial interests’ are not specified in the trust deed on the ‘date of its creation’, the trust will be liable to be taxed at the ‘maximum marginal rate’.

The Bangalore Income Tax Appellate Tribunal in the case of DCIT v. India Advantage Fund – VII held that income arising to a trust where the contributions made by the contributors are revocable in nature, shall be taxable at the hands of the contributors. The ruling comes as a big positive for the Indian fund industry. The ruling offers some degree of certainty on the rules for taxation of domestic funds that are set up in the format of a trust by regarding such funds as fiscally neutral entities. Globally, funds have been accorded pass through status to ensure fiscal neutrality and investors are taxed based on their status. This is especially relevant when certain streams of income maybe tax free at investor level due to the status of the investor, but taxable at fund level. Funds, including AIFs that are not entitled to pass through status from a tax perspective (such as Category III AIFs) could seek to achieve a pass-through basis of tax by ensuring that the capital contributions made by the contributors is on a revocable basis).

Further, the CBDT has issued a clarification (vide Circular No. 6 of 2016 dated February 29, 2016) that income arising from transfer of listed shares and securities, which are held for more than 12 months should be taxed as capital gains under the ITA unless the tax-payer itself treats these as its stock-in-trade and transfer thereof as its business income.
5. Trends In Private Equity

The standard of what constitutes an ‘alignment of interests’ between fund investors (LPs) and fund managers (GPs) of an India-focused fund or an India-based fund has undergone some degree of change over the years. Typically, LP participation in a fund is marked by a more hands-on approach in discussing and negotiating fund terms which by itself is influenced by a more comprehensive due diligence on the track record of the GP and the investment management team.

As discussed briefly earlier, unified structures have emerged as a preferred choice for structuring India focused funds. There is also an increased participation from DFIs in India focused funds, including unified structures. Accordingly, some global benchmarks need to be followed when designing the structure and calibrating the fund documents including the governance, fiduciary aspects and adherence to ESG policies and AML policies. With one or more DFIs or sovereign investors in the mix, the fund terms continue reflecting a more LP tilt in balance even for fund managers raising a series III or a Series IV fund.

There can be variations of a unified structure depending on the investment strategy of the fund, allocation of economics for the GP and certain legal and regulatory considerations involving the LPs. In addition to the above, there can be other variations to the investment structure depending on the commercials involved.

The overseas fund could directly invest in India based opportunities or adopt a co-investment structure (i.e. the offshore fund invests alongside the Indian fund in eligible investment opportunities).

The FDI Policy will however be applicable to investments made directly by an offshore fund in India.

An optimum structure should reconcile the investment strategy, team economics and LP preferences.

New investment funds with more focused strategies are seen coming up as India introduces favorable policy and regulatory changes such as introduction of the Insolvency and Bankruptcy Code, passing of a single goods and services tax (“GST”), tax initiatives for Small and Medium Enterprises, policy initiatives for the insurance sector and increased focus on technology driven payment mechanisms.

This chapter provides a brief overview of certain fund terms that have been carefully negotiated between LPs and GPs in the Indian funds context.

I. Trending fund terms

A. Investment Committee and Advisory Board

Sophisticated LPs insist on a robust decision-making process whereby an investment manager will refer investment and/or divestment proposals along with any due diligence reports in respect of such proposals to an investment committee comprising representatives of the GP. The investment committee is authorized to take a final decision in respect of the various proposals that are referred to it. In view of this, the composition of the investment committee and the nature of rights granted to certain members can become very contentious. The committee is also empowered to monitor the performance of investments made by the fund a view to limiting the quantum of expenses that are paid by the fund, LPs insist on putting a cap on expenses. The cap is generally expressed as a percentage of the size of the fund or as a fixed number can become a debatable issue depending on the investment strategy and objective of the fund. GPs often try to negotiate for annual caps for operating expenses, given the long tenure of VC/PE funds and the difficulty in ascertaining the appropriate cap for the entire tenure upfront; whereas, LPs prefer a cap for the entire tenure to be disclosed upfront in the fund documents. If an annual cap method is chosen,
LPs often seek the right to be consulted before setting the annual cap by GPs.

Separately, as a measure of aligning interests, LPs insist that allocations made from their capital contributions towards the payment of expenses should be included while computing the hurdle return whereas the same should not be included while determining management fee after the commitment period.

Additionally, certain LPs also insist that specific fund expenses associated with certain LPs must be allocated to LPs only. For instance, if an investor enters the fund through a placement agent, the placement fees to be borne by the fund shall be allocated from the capital contribution of the said investor. The ratio of distributions is accordingly expected follow the ratio of each investor's participation in the deals.

**B. Waterfall**

A typical distribution waterfall involves a return of capital contribution, a preferred return (or a hurdle return), a GP catch-up and a splitting of the residual proceeds between the LPs and the GP. With an increasing number of GPs having reconciled themselves to the shift from the 20% carried interest normal, a number of innovations to the distribution mechanism have been evolved to improve fundraising opportunities by differentiating product offerings from one another. Waterfalls have been structured to facilitate risk diversification by allowing LPs to commit capital both on a deal-by-deal basis as well as on a blind pool basis. Further, distribution of carried interest has been structured on a staggered basis such that the allocation of carry is proportionate to the returns achieved by the fund.

In a unified structure, the distribution waterfall at the Indian AIF level may require that distributions to the Offshore Fund be grossed-up to the extent of the expenses incurred at the Offshore Fund level. The distribution proceeds at the Indian AIF level could be allocated between the domestic investors and the offshore fund providing them INR and USD denominated preferred returns respectively.

While the taxation of carried interest remains unclear globally, several Indian GPs are considering allowing their employees (who are entitled to carry) to track the carry directly from the fund, including through structures such as employee welfare trusts.

**C. Giveback**

While there have been rare cases where some LPs have successfully negotiated against the inclusion of a giveback provision, GPs in the Indian funds industry typically insist on an LP giveback clause to provide for the vast risk of financial liability including tax liability. The LP giveback facility is a variant to creating reserves out of the distributable proceeds of the fund in order to stop the clock / reduce the hurdle return obligation. With a view to limiting the giveback obligation, LPs may ask for a termination of the giveback after the expiry of a certain time period or a cap on the giveback amount. However, this may not be very successful in an Indian context given that the tax authorities are given relatively long time-frames to proceed against taxpayers.

As bespoke terms continue to emerge in LP-GP negotiations, designing a fund may not remain just an exercise in structuring. The combination of an environment less conducive for fund raising and changes in legal, tax and regulatory environment along with continuously shifting commercial expectations requires that fund lawyers provide creatively tailored structural alternatives.

There are certain India specific issues which may complicate LP giveback negotiations beyond global standards. For example, a Category I or II AIF in India which is set up as a determinate trust could, separately and in addition to the LP giveback clause, seek a tax indemnity from each of its investors for the AIF, its manager or its trustee doing good any tax liability on behalf of any of such investors.
D. Voting rights

In a unified structure, the Indian AIF will issue different classes of units / shares (as applicable) to the domestic LPs and the offshore fund respectively upon receiving their capital contributions. In respect of issues where a vote is required to be cast by the offshore fund in its capacity as an investor in the Indian AIF, the board of the offshore fund may seek the recommendations of its shareholders (i.e. the offshore investors) on such matters and cast votes on the units / shares (as applicable) of the Indian AIF in a manner reflective of that and in keeping with their fiduciary obligations.

E. USD-INR hurdle rates

In a unified structure, the Indian AIF may either offer (i) an INR hurdle rate to all its investors, whether Indian or foreign; or (ii) an INR hurdle rate to Indian investors and a USD hurdle rate to foreign investors.

Commitments by the Indian investors and the offshore fund to the Indian AIF will be denominated and drawn down in Indian Rupees and commitments by the offshore investors to the offshore fund will be denominated and drawn down in US Dollars. This exposes the corpus of the Indian fund to exchange rate fluctuations which impacts the ratio of unfunded capital commitments among Indian investors and offshore investors.

There are a variety of options available to deal with the exchange rate fluctuations in a unified structure, depending on the commercial expectations. The exchange rate ratio may either be fixed from the date of the first closing itself, or may be closed at the time of final closing, as no further commitments will be expected after the final closing into the Indian AIF.

If there are certain unfunded commitments remaining at either the offshore fund level or the Indian AIF level due to currency fluctuations while the other vehicle’s unfunded capital commitments have reduced to nil (in case the GP is unable to align the ratio of drawdown between the two pools of investors with the exchange rate fluctuation), then the commitment period of the relevant vehicle may be terminated at the discretion of the manager / advisor (as applicable). Alternatively, with the approval of the requisite investors, such remaining capital commitments may also be utilized.

F. Co-investment Opportunities

In a unified structure, offering of co-investment rights to LPs of the offshore fund needs to be designed carefully to allow efficient implementation.

G. Key person events

Existing India funds are seen grappling with key person clauses given the reshuffling of investment management personnel (including spinoffs and formation of new ventures). Many large PE fund managers of India focused funds have recently seen senior level officials quit to start their own ventures.

GPBs are exploring ways of identification of key persons and related (proportionate) consequences, as LPs look to be as inclusive as possible while determining time commitment of key persons. While the CXO level personnel continue to be relevant, LPs also expect the GP team to take a haircut on its economics if it is unable to retain talent at the investment management team level. Concepts of ‘super key person’ and ‘standard key person’ are increasingly becoming common.

Consequences of key person events are not expected to be limited to suspension of investment period anymore, but if uncured, may also trigger consequences that are at par with removal for cause events.

H. Side-letter items

Typically, investors may seek differential arrangements with respect to co-investment allocation, membership to LPACs, excuse rights, specific reporting formats, prohibited investment sectors etc. An investor may also insist on including a ‘most favored nation’ (or MFN) clause to prevent any other investor being placed in a better position than itself.
It is relevant for all investors that the Indian AIF is able to effect the terms entered into by investors whether directly at the Indian AIF level or the offshore fund, including making available rights under MFN provisions.

I. Closing Adjustments

A common fund term in all private equity funds requires closing adjustments to be made when a new investor is admitted to the fund at any closing subsequent to the first closing.

In a unified structure, a new investor in the offshore fund would be required to compensate the existing investors at the offshore fund level as well as the Indian AIF level and vice-versa for a new investor participating subsequent to the first closing in the Indian AIF.

J. Excuse Rights

Domestic insurers continue to remain a significant source of asset allocation. Indian insurers regulated by the Insurance Regulatory and Development Authority of India are required to ensure that their capital contributions are not invested outside India. Likewise, other statutory / state-aided Indian institutional investors impose similar conditions while making commitment to a fund. Investment programs for several DFIs too require that they be excused from certain deals if the fund were to explore certain opportunities.

K. Removal of GPs

‘For cause’ removal typically refers to the premature termination of the manager’s services to the fund by the LPs, owing to events of default – mainly fraud, willful misconduct, and gross negligence.

The relevant question in the context of some of the recent funds has been on who determines whether a ‘Cause’ event has occurred. Global LPs are circumspect about the determination standard to be Indian courts, because of the perception that dispute resolution by way of litigation in India may take unreasonably long to conclude.
6. Fund Documentation

Fund counsels are now required to devise innovative structures and advise investors on terms for meeting investor's (LP) expectations on commercials, governance and maintaining discipline on the articulated investment strategy of the fund. All these are to be done in conformity with the changing legal framework.

To attract high quality LPs, it is essential that the fund documents (including the investor pitch and the private placement memorandum) include an articulation on the fund’s governance standard. It is also essential that global best practices are taken into account when preparing such fund documents including contribution agreements, LP side letters and closing opinion, and to ensure that the same are not just confined to Indian regulatory and tax aspects.

Enforceability of provisions contained in the fund documents, and their inter-se applicability on investors and fund parties is of utmost importance while designing fund documents. Investors expect their side letters to prevail with respect to them over the other fund documents, whereas, for collective claims by all investors, the charter documents should prevail.

Fund documents are an important aspect of the fundraising exercise. They are also critical to determine whether a pooling vehicle is in compliance with the applicable law across various jurisdictions. For an India-focused fund or a fund with India allocation which envisages LP participation both at the offshore level and at the Indian level, the following documents are typically prepared:

I. At The Offshore Fund Level

A. Private Placement Memorandum / Wrapper

The private placement memorandum ("PPM") is a document through which the interests of the fund are marketed to potential investors. Accordingly, the PPM outlines the investment thesis of a fund, summarizes the key terms on which investors could participate in the fund's offering and also presents the potential risk factors and conflicts of interest that could arise to an investor considering an investment in the fund. A wrapper is a short supplement that is attached to the PPM of a domestic fund (in case of "unified structure") to help achieve compliance with the requirements for private placement of the securities / interests of an offshore fund to investors in jurisdictions outside India. The use of a wrapper is common in the case of unified investment structures as the risks of the onshore fund are inherent in the shares / LP interests issued to investors to the offshore fund.

B. Constitution

A constitution is the charter document of an offshore fund in certain jurisdictions. It is a binding contract between the company (i.e. the Fund), the directors of the company and the shareholders (i.e. the investors) of the company.

C. Subscription Agreement

The subscription agreement is an agreement that records the terms on which an investor will subscribe to the securities / interests issued by an offshore fund. The subscription agreement sets out the investor's capital commitment to the fund and also records the representations and warranties made by the investor to the fund. This includes the
representation that the investor is qualified under law to make the investment in the fund.  

D. Advisory Agreement

The board of an Offshore Fund may delegate its investment management / advisory responsibilities to a separate entity known as the Investment Advisor or the Investment Manager. The Investment Advisory Agreement contains the general terms under which such investment advisor renders advise in respect of the transactions for the Fund’s board.

Sometimes, the investment advisor / manager of an offshore fund enters into a ‘sub-advisory agreement’ with an on-the-ground investment advisory entity (the sub-advisor). The sub-advisory agreement typically provides that the sub-advisor will provide non-binding investment advice to the investment advisor of the offshore fund for remuneration.

II. At The Onshore Fund Level

A. Private Placement Memorandum

AIF Regulations require that a concerned fund’s PPM should contain all material information about the AIF, including details of the manager, the key investment team, targeted investors, fees and other expenses proposed to be charged from the fund, tenure of the scheme, conditions or limits on redemption, investment strategy, risk factors and risk management tools, conflicts of interest and procedures to identify and address them, disciplinary history, terms and conditions on which the manager offers services, affiliations with other intermediaries, manner of winding up the scheme or the AIF and such other information as may be necessary for an investor to make an informed decision as to whether to invest in the scheme of an AIF.

SEBI has now directed fund managers to add by way of an annexure to the placement memorandum, a detailed tabular example of how the fees and charges shall be applicable to the investor and the distribution waterfall for AIFs.  

AIFs should also include disciplinary actions in its PPM.  

Any changes made to the PPM submitted to SEBI at the time of the application for registration as an AIF must be listed clearly in the covering letter submitted to SEBI and further to that, such changes must be highlighted in the copy of the final PPM.  

In case the change to the PPM is a case of a ‘material change’ (factors that SEBI believes to be a change significantly influencing the decision of the investor to continue to be invested in the AIF), said to arise in the event of (1) change in sponsor / manager, (2) change in control of sponsor / manager, (3) change in fee structure or hurdle rate which may result in higher fees being charged to the unit holders), existing unit holders who do not wish to continue post the change shall be provided with an exit option.

This change is critical for fund managers to note. Such disclosure reduces the space for ‘views’ being taken by a fund manager in a given liquidity event leading to distribution. This also requires that the fund manager engages more closely with the fund counsel to articulate the waterfall in a manner that they can actually implement with a degree of automation. Any deviance from the waterfall as illustrated in the fund documents could potentially be taken up against the fund manager.

---

23. In case the fund is set up in the format of a limited partnership, this document would be in the format of a limited partnership agreement (with the ‘general partner’ holding the management interests).
25. Regulation 11(2) AIF Regulations.
27. Paragraph 2(b)(i) of the SEBI Circular CIR/IMD/DF/14/2014.
While global investors prefer excluding the PPM from being an ‘applicable fund document’ to investors, SEBI expects the manager to ensure that each of the investors has read and agreed to the terms in the PPM. Also, as explained above, SEBI primarily reviews the PPM to grant registration as an AIF to the applicants. This often becomes a matter of concern during LP-GP negotiations.

B. Indenture of Trust

The Indenture of Trust is an instrument that is executed between a settlor and a trustee whereby the settlor conveys an initial settlement to the trustee towards creating the assets of the fund. The Indenture of Trust also specifies the various functions and responsibilities to be discharged by the appointed trustee. It is an important instrument from an Indian income-tax perspective since the formula for computing beneficial interest is specified. The formula for computing beneficial interest is required to establish the determinate nature of the trust and consequently for the trust to be treated as a pass-through entity for tax purposes.

C. Investment Management Agreement

The Investment Management Agreement is to be entered into by and between the trustee and the investment manager (as the same may be amended, modified, supplemented or restated from time to time). Under this Agreement, the trustee appoints the investment manager and delegates all its management powers in respect of the fund (except for certain retained powers that are identified in the Indenture of Trust) to the investment manager.

D. Contribution Agreement

The Contribution Agreement is to be entered into by and between each contributor (i.e. investor), the trustee and the investment manager (as the same may be amended, modified, supplemented or restated from time to time) and, as the context requires. The Contribution Agreement records the terms on which an investor participates in a fund. This includes aspects relating to computation of beneficial interest, distribution mechanism, list of expenses to be borne by the fund, powers of the investment committee, etc. A careful structuring of this document is required so that the manager/trustee retain the power to make such amendments to the agreement as would not amend the commercial understandings with the contributor.

III. Investor Side Letters

It is not uncommon for some investors to ask for specific arrangements with respect to their participation in the fund. These arrangements are recorded in a separate document known as the side letter that is executed by a specific investor, the fund and the investment manager. Typically, investors seek differential arrangements with respect to management fee, distribution mechanics, participation in investment committees, investor giveback, etc. An investor may also insist on including a ‘most favoured nation’ (“MFN”) clause to prevent any other investor being placed in a better position than itself. An issue to be considered is the enforceability of such side letters unless it is an amendment to the main contribution agreement itself.

IV. Agreements with Service Providers

Sometimes, investment managers may enter into agreements with placement agents, distributors and other service providers with a view to efficiently marketing the interests of the fund. These services are offered for a consideration which may be linked to the commitments attributable to the efforts of the placement agent / distributor.
7. Hedge Funds

‘Hedge funds’ lack a precise definition. The term has been derived from the investment and risk management strategies they tend to adopt.

The Indian regulators’ comfort in allowing access to global hedge funds is of recent origin. It was only gradually that several investment opportunities were opened for investors participating under the FII Regulations that allowed for a wider gamut of strategy implementation for a hedge fund.

The FPI Regulations have been in effect from June 01, 2014. This section deals with eligible participants under the FPI Regulations, the range of investment and hedge strategies that may be adopted and the scope of dealing with contract notes (swaps and offshore derivative instruments, i.e. ODIs).

On the onshore side, SEBI allows hedge strategies as a possible investment strategy that a ‘Category III’ AIF could adopt. This section also deals with the basic framework within which such onshore ‘hedge’ funds are allowed to operate.

I. FPI Regulations

Under the FPI regime, SEBI has harmonized foreign institutional investors, sub-accounts and qualified foreign investors regimes into a single investor class – foreign portfolio investors and provided a single window clearance through designated depository participants (“DDP”). With each investor registering directly as an FPI (under the respective three categories discussed later), the sponsored sub accounts structure seems to be over.

The FPI Regulations put into effect, several recommendations made by the Committee on Rationalization of Investment Routes and Monitoring of Foreign Portfolio Investments (“Committee”) chaired by Mr. K.M. Chandrasekhar in 2013. The key recommendations of the Committee were to combine the erstwhile portfolio investment categories of FIIs, sub-accounts and QFIs into a single investor class of FPIs. The other significant proposal pertained to the establishment of a self-regulatory mechanism for registration and monitoring of FPIs, which will be overseen by the DDP rather than directly by SEBI.

The Committee’s report was submitted on June 12, 2013 to SEBI. After considering the recommendations of the Committee, on January 07, 2014, SEBI notified the FPI Regulations. Subsequently, SEBI has also vide a Circular dated January 08, 2014, issued operating guidelines for DDPs. With the notification of the FPI Regulations, the FII Regulations stand repealed.

A. Meaning of FPI

The term ‘FPI’ has been defined to mean a person who satisfies the eligibility criteria prescribed under the FPI Regulations and has been registered under the FPI Regulations. No person is permitted to transact in securities as a FPI unless it has obtained a COR granted by the DDP on behalf of SEBI. An existing FII / Sub- Account holding a valid COR shall be deemed to be an FPI till the expiry of the block of three years for which fees have been paid under the FII Regulations.

In respect of entities seeking to be registered as FPIs, DDPs are authorized to grant registration on behalf of SEBI with effect from June 01, 2014.

The application for grant of registration is to be made to the DDP in a prescribed form along with the specified fees. The eligibility criteria for an FPI, *inter-alia*, include:

i. The applicant is a person not resident in India;  
ii. The applicant is resident of a country whose securities market regulator is a signatory to the International Organization of Securities

---

[30. The term “persons”, “non-residents” and “resident” used herein have the same meaning as accorded to them under the Tax Act.]
Commission’s Multilateral Memorandum of Understanding or a signatory to a bilateral Memorandum of Understanding with the SEBI;

iii. The applicant is not residing in a country identified in the public statement of the Financial Action Task Force (FATF):

a. as having strategic Anti-Money Laundering deficiencies; or

b. combating the Financing of Terrorism deficiencies; or

c. as not having made significant progress in addressing the deficiencies or not committed to an action plan developed with the FATF to address the deficiencies.

iv. The applicant being a bank, is a resident of a country whose Central bank is a member of Bank for International Settlements

v. The applicant is not a non-resident Indian;

A certificate of registration granted by a DDP shall be permanent unless suspended or cancelled by SEBI or surrendered by the FPI.

A DDP may grant conditional registration, subject to fulfilment of specified conditions.

For example, a conditional registration may be granted to an entity with a validity period of 180 days, to achieve the broad based criteria as required to qualify as a Category II FPI.

B. Categories of FPI

The FPI Regulations classify FPIs into three categories based on their perceived risk profile. An outline of the three categories is given below:

<table>
<thead>
<tr>
<th>Eligible Foreign Portfolio Investors</th>
<th>Government and Government-related investors such as central banks, Government agencies, sovereign wealth funds or international and multilateral organizations or agencies.</th>
<th>i. Appropriately regulated broad based funds;</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>ii. Appropriately regulated persons;</td>
</tr>
<tr>
<td></td>
<td></td>
<td>iii. Broad-based funds that are not appropriately regulated;</td>
</tr>
<tr>
<td></td>
<td></td>
<td>iv. University funds and pension funds; and</td>
</tr>
<tr>
<td></td>
<td></td>
<td>v. University related endowments</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Includes all eligible FPIs who are not eligible under Category I and II, such as endowments, charitable societies, charitable trusts, foundations, corporate bodies, trusts, individuals and family offices.</td>
</tr>
</tbody>
</table>

In relation to a Category II FPI, “appropriately regulated” means “regulated or supervised in same capacity in which it proposes to make investments in India”. In order to find out whether an entity is regulated in the same capacity, the DDP has the option of verifying if the FPI is allowed by its regulator to carry out such activity under its license / registration granted by the regulator.

If an FPI ceases to meet the eligibility requirements for a particular category, then it will be reclassified under another appropriate category and the FPI shall be required to provide the DDP with additional KYC documents. Fresh purchases would not be allowed until the additional documents are forwarded but the FPI will be allowed to sell the securities already purchased by it.

31. In case of an applicant being a bank or its subsidiary, the DDP is required to forward the details of the applicant to SEBI who would in turn request the RBI to provide its comments. The comments of the RBI would be provided by the SEBI to the DDP.

32. One of the conditions include that the applicant is an India dedicated fund or undertakes to make investment of at least 5% corpus of the fund in India.

33. Explanation 1 to Regulation 5(b) of the FPI Regulations.

34. SEBI, FPI FAQs, Question 18.

C. Status of Existing FIIs / Sub-Accounts and Rollover to FPI Regime

As discussed above, the FPI Regulations provide that any FII / or a sub-account which holds a valid certificate of registration shall be deemed to be an FPI until the expiry of the block of three years for which fees has been paid as per the FII Regulations. In other words, existing FIIs or sub-accounts will be deemed to be FPIs under the FPI Regulations.36

Further, the FPI Regulations provide that existing FIIs or sub-accounts can continue to buy, sell or deal in securities, for a period of one year from the date of commencement of the regulations, or until he obtains a certificate of registration as FPI, whichever is earlier.37 The FPI Regulations prescribe a conversion fee of USD 1,000 payable by the existing FII or sub-account to SEBI.38

In cases where an FII has multiple proprietor sub-accounts and one of them chooses to convert as FPI, then the conversion of all other sub-accounts of that FII to FPI will follow. This requirement applies only when the proprietary sub-account is the one being converted, in case of other sub-accounts, the remaining sub-accounts (whether proprietary or broad-based) do not have to convert.39

If an entity engages Multiple Investment Management (“MIM”) structure, then it is allowed to obtain multiple registrations with SEBI and these applicants will be required to appoint the same local custodian.40

For the purposes of investment limits, these multiple registrations will be clubbed and the same position will continue in the FPI regime.41 Investment limits will be monitored at the investor group level by the depositories based on the information provided by DDPs and necessary information will be shared between the depositories.42

Also, a fund which has NRIs as investors will not be barred from obtaining registration as a Category II FPI under the FPI regime (as was the case in the FII regime).43

D. Broad Based Criteria

Under the erstwhile FII Regulations, a “broad-based fund” meant a fund, established or incorporated outside India which has at least 20 investors with no individual investor holding more than 49% of the shares or units of the fund. It was also provided that if the broad-based fund had any institutional investor, it was not necessary for such fund to have 20 investors. Further, any institutional investor holding more than 49% of the shares or units of the fund would have to itself satisfy the broad based criteria.44

Under the FPI regime, every fund, sub-fund or share class needs to separately fulfill the broad based criteria where a segregated portfolio is maintained. Therefore, where a newly added class of shares is not broad-based then the FPI will have to provide an undertaking to the DDP that the new class will become broad based within 90 days from the date of DDP approval letter.45

The FPI Regulations continue to follow the broad-based criteria with two notable deviations. One, in order to satisfy the broad-based criteria, it would be necessary for a fund to have 20 investors even if one of the investors is an institutional investor. Two, for the purpose of computing the number of investors in a fund, both direct and underlying investors (i.e. investors of entities that are set up for the sole purpose of pooling funds and making investments) shall be counted. An FPI, who has a bank as an investor will be deemed to be broad based for the purposes of FPI Regulations as was the case in the FII regime.46

36. Regulation 2(3)(b) r/w Regulation 2(c)(g) of the FPI Regulations.
37. Proviso to Regulation 3(1) of the FPI Regulations.
38. Part A of the Second Schedule of the FPI Regulations.
39. Regulation 3(1) of the FPI Regulations.
40. A ‘custodian’ means a person who has been granted a certificate of registration to carry on the business of custodian of securities under the Securities and Exchange Board of India (Custodian of Securities) Regulations, 1996.
41. SEBI, FPI FAQs, Question 6.
42. SEBI, FPI FAQs, Question 58.
43. SEBI, FPI FAQs, Question 25.
44. Explanation 2 to Regulation 5.
45. SEBI, FPI FAQs, Question 49.
46. Regulation 5(b) of the FPI Regulations.
E. Investments

The FPI Regulations provide that investment in the issued capital of a single company by a single FPI or an investor group shall be below 10% of the total issued capital of the company. 47

The FPI Regulations further provide that in case the same set of ultimate beneficial owner(s) invests through multiple FPI entities, such FPI entities shall be treated as part of the same investor group and the investment limits of all such entities shall be clubbed at the investment limit as applicable to a single FPI. 48

As per the Operational Guidelines for Designated Depository Participants (Operational Guidelines) released by SEBI, for the purpose of ascertaining an investor group, the concerned DDPs shall consider all such entities having direct or indirect common shareholding / beneficial ownership / beneficial interest more than 50% as belonging to same investor group. 49 The investment limit of 10% and clubbing of investments has also been made applicable to offshore derivative instruments, as explained subsequently in this chapter.

Further, FPIs are allowed to offer cash or foreign sovereign securities with AAA rating or corporate bonds or domestic government securities, as collateral to the recognized stock exchanges for their transactions in the cash as well as derivative segment of the market, subject to norms specified by RBI, SEBI and Clearing Corporations. 50

Under the FPI Regulations, FPIs are permitted to invest in the following:

a. shares, debentures and warrants of companies, unlisted, listed or to be listed on a recognized stock exchange in India, through primary and secondary markets;

b. units of schemes floated by domestic mutual funds whether listed on a recognized stock exchange in India or not;

c. units of scheme floated by a Collective Investment Scheme;

d. derivatives traded on a recognized stock exchange;

e. Treasury bills dated government securities;

f. rupee denominated credit enhanced bonds;

g. security receipts issued by asset reconstruction companies;

h. perpetual debt instruments and debt capital instruments, as specified by the RBI from time to time;

i. listed and unlisted non-convertible debentures / bonds issued by an Indian company in the infrastructure sector, where ‘infrastructure’ is defined in terms of the extant External Commercial Borrowings (ECB) guidelines;

j. non-convertible debentures or bonds issued by Non-Banking Financial Companies (NBFCs) categorized as 'Infrastructure Finance Companies' (IFCs) by the Reserve Bank of India;

k. rupee denominated bonds or units issued by infrastructure debt funds;

l. Indian depository receipts;

m. Unlisted non-convertible debentures / bonds issued by an Indian company subject to the guidelines issued by the Ministry of Corporate Affairs, GoI from time to time;

n. Securitized debt instruments including as specified in the FPI Regulations and

o. such other instruments specified by SEBI from time to time.

In respect of investments in the secondary market, the following additional conditions shall apply: 51

---

47. Regulation 21(3) of the FPI Regulations.
48. Regulation 23(3) of the FPI Regulations.
49. Paragraph 4.2 of the Operational Guidelines.
51. Regulation 21(4) of the FPI Regulations.
An FPI shall transact in the securities in India only on the basis of taking and giving delivery of securities purchased or sold except in the following cases:

- any transactions in derivatives on a recognized stock exchange;
- short selling transactions in accordance with the framework specified by SEBI;
- any transaction in securities pursuant to an agreement entered into with the merchant banker in the process of market making or subscribing to unsubscribed portion of the issue in accordance with Chapter XB of the Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2009;
- any other transaction specified by SEBI.

The RBI, through a circular dated February 03, 2015, has introduced conditions for foreign portfolio investors (FPIs) to make future investments in and redeem corporate bonds. The circular has introduced the following changes:

- FPIs will be allowed to invest only in corporate bonds which have a minimum residual maturity of three years.
- FPIs will be prohibited from investing in corporate bonds with optionality clauses exercisable before three years have elapsed.
- FPIs will not be subject to a lock-in period and will be free to sell corporate bonds, including those with a maturity of less than three years, to domestic investors.

FPIs will not be allowed to make any further investment in liquid and money market mutual fund schemes.

As per the recent changes introduced by the RBI in the TISFRO Regulations, FPIs can also invest in the units of an investment vehicle; where “investment vehicle” shall mean an entity registered and regulated under the relevant regulations framed by SEBI or any other authority designated for the purpose and shall include REITs governed by the SEBI (REITs) Regulations, 2014, InvITs governed by the SEBI (InvITs) Regulations, 2014 and Alternative Investment Funds governed by the SEBI (AIFs) Regulations, 2012; and “unit” shall mean beneficial interest of an investor in the investment vehicle (as defined above) and shall include shares or partnership interests.

F. SEBI FPI Circular on Eligibility and KYC Norms:

In April 2018, SEBI issued a circular under which FPIs which have residents Indians (“RIs”)/ non-resident Indians (“NRIs”)/ overseas citizens of India (“OCIs”) as their beneficial owners, shall be prohibited from making investments in India. The abovementioned circular had been put on abeyance until December 31, 2018, and a committee constituted by SEBI to review such aspects of the abovementioned circular and ancillary matters had released an interim report recommending various measures to SEBI regarding changes to be made to the circular dated April 2018.

Accordingly, post consideration of the interim report submitted by the working group, SEBI, on September 21, 2018, released two circulars for FPIs in supersession of the aforesaid circular of April 2018 – one in relation to Know Your Client (“KYC”) requirements (“KYC Circular”) and the other in relation to eligibility conditions (“Eligibility Circular”).

I. Eligibility Circular:

- NRI / OCI / RI Participants:

The Eligibility Circular provides that participation by a single NRI / OCI / RI (including those of an NRI / OCI / RI controlled investment manager) should be restricted to 25% and in aggregate to below 50%. SEBI has clarified that the above limits will not apply to FPIs investing only in mutual funds in India. Further, The
Eligibility Circular also allows participation by RIs, through the Liberalised Remittance Scheme approved by the RBI, in FPIs that are global funds that have an India exposure of less than 50%.

b. NRI / OCI / RI management and control of FPIs:

The Eligibility Circular stipulates that NRI / OCI / RI should not be in control of FPIs (except for FPIs for which no objection certificate has been provided by SEBI). However, FPIs can be controlled by investment managers (“IMs”) which are owned and controlled by NRIs / OCIs / RIs if (i) the IM is appropriately regulated in its home jurisdiction and registers itself with SEBI as a non-investing FPI; or (ii) the IM is incorporated or set up in India and appropriately registered with SEBI. Further, SEBI has clarified that a non-investing FPI may be owned and / or controlled by a NRI / OCI / RI.

FPIs have been given 2 years from the date of the amended regulations (FPI Regulations are expected to be amended in line with the Eligibility Circular) or from the date of their registration, whichever is later. In case of a temporary breach, a period of 90 days is prescribed for returning to compliance.

II. KYC Circular:

The KYC Circular clarified the rules for determining beneficial owners (“BOs”) and other disclosures required to be made by FPIs.

a. BO identification and disclosure:

The KYC Circular stipulates that BOs should be identified as per Rule 9 of the PMLA Rules. BOs are natural persons who ultimately own or control an FPI. Based on the PMLA Rules standard, FPIs are required to maintain a list of BOs as per a format prescribed under Annexure A of the KYC Circular.

In a key addition to the requirements under the previous regime as well as the look-through principle enshrined under the PMLA Rules, the KYC Circular mandates the disclosure of intermediate shareholders / owner entities with holdings equal to and above the materiality thresholds in the FPI (25% for companies in non-high risk jurisdictions, 15% for partnerships and trusts in non-high risk jurisdictions and 10% for FPIs coming out of high risk jurisdictions). For such entities, the names of entities, percentage of holding, method of exercising control etc. are required to be disclosed in a format prescribed under Annexure B of the KYC Circular. An exception to such identification and disclosure has been provided for entities eligible to register as Category I FPIs.

G. FPIs in International Financial Services Centre (IFSC)

Through a Circular53 issued by SEBI, FPIs were permitted to participate in commodity derivatives contracts traded in stock exchanges in IFSC. This permission would be subject to certain conditions including that such participation would be “limited to the derivatives contracts in non-agricultural commodities only”. Further, the contracts would be cash settled on the settlement price determined on overseas exchanges and all transactions would be denominated in foreign currency only.

H. Protected Cell Companies

Prior to December 2013, there was a blanket ban on protected cell companies (“PCC”), segregated portfolio companies (“SPC”) or equivalent structures which used to ring-fence assets and liabilities under law from participating under the FII/FPI route.

Based on the representations made by our firm, SEBI had provided that entities that apply for registration under the FPI Regulations shall not be regarded as having an opaque structure if they are required by their regulator or under any law to ring fence their assets and liabilities from other funds / sub-funds.

in the entity. This applied for structures such as open-ended investment companies ("OEIC") in the UK. OEICs are typically set up in the format of umbrella companies that have several ‘sub funds’. Recent amendments to the OEIC regulations in the UK required that a PCC structure be adopted to ring fence liabilities between these sub-funds.

Opaque structures are not allowed to be registered as FPIs under the FPI regime and FPI applicants will have to submit declaration and undertakings to that effect. If an FPI’s regulator or any law requires it to ring fence its assets and liabilities from other funds or sub-funds then an FPI applicant will not be considered as an opaque structure merely for this reason and would be eligible to be registered as an FPI, provided it meets the following criteria:

a. the FPI applicant is regulated in its home jurisdiction;

b. each fund or sub-fund in the applicant satisfies broad-based criteria; and

c. the applicant has given an undertaking to provide information about its beneficial owners, if asked for it by SEBI.

I. Tax Treatment of FPI Investments

The tax treatment of FPIs registered under the FPI Regulations would be similar to the treatment accorded to FIIs. Accordingly, all such FPIs would be deemed to be Foreign Institutional Investors under Explanation (a) to section 115AD and would be taxed similarly.

The Tax Act with effect from April, 2015 states that securities held by an FPI will be considered “capital assets”, and gains derived from their transfer will be considered “capital gains”.

As a result of this amendment, gains arising on disposal / transfer of a range of listed securities including shares, debentures and eligible derivative instruments as may have been acquired under applicable laws, shall be taxed as capital gains (and not business income) under Indian domestic law.

The characterization has been a long standing point of contention under Indian tax law. This is because, under Indian tax treaties, the business income of a non-resident is not taxable in India unless the non-resident has a permanent establishment in India.

In comparison, capital gains are generally taxable unless the non-resident invests through a favorable DTAA jurisdiction such as Netherlands or France. While revenue authorities have tended to treat the income of FPI as capital gains on this account, the position has undergone much litigation in the past.

Further, Finance Act, 2017 has exempted gains made with respect to investments into Category I and Category II FPIs from indirect transfer tax provisions.

J. Easing of Access Norms

SEBI in consultation with all the concerned stakeholders has issued a circular to introduce certain the changes in extant regulatory provisions applicable to FPIs. The object of the circular is to ease the access norms for investment by FPI:

d. Discontinuance of requirements for seeking prior approval from SEBI in case of change in local custodian/ DDP. In such an event, the new DDP (i.e. transferee) may rely on the due diligence carried out by the old DDP. However, the new DDP is required to carry out adequate due diligence at the time when the FPI applies for continuance of its registration on an ongoing basis.

e. Exemption to FPIs having Multiple Investment Managers (MIM) structure from seeking prior approval from SEBI in case of Free of Cost (FOC) transfer of assets.

f. Private Banks and Merchant Banks that are regulated by an “appropriately regulator” may be classified as Category II. Further, they will be permitted to undertake investments on behalf of its investors.

Fund Formation: Attracting Global Investors

Global, Regulatory and Tax Environment impacting India focused funds

g. FPIs operating under the Multiple Investment Managers (MIM) structure are permitted to appoint multiple custodians.

h. Further, in respect of addition of share classes by existing registered FPIs, in case of FPIs maintaining a common portfolio of Indian securities is maintained across all classes of shares/fund/sub-fund and broad based criteria is fulfilled at portfolio level after addition of share class, prior approval from DDP is not required.

i. In case of an FPI maintaining a segregated portfolio in India, every fund / sub fund / share class needs to separately fulfil broad based criteria. Further, in case of addition of classes of shares for segregated portfolio, the FPI shall be required to obtain prior approval from DDP. However, for termination / winding up of share classes of shares of segregated portfolio, an intimation should be provided to DDP forthwith. For granting of such prior approval, DDPs shall obtain declaration and undertaking with respect to PCC, MCV status. Further, in case of addition of one or more than one share class, which are not broad based, an undertaking may be obtained by the DDP that all the newly added share classes shall attain broad based status within 180 days from the date of approval issued by DDP.

j. At the time of FPI registration / conversion, PCC/ Multi Class Vehicle Declaration & Undertakings and group is provided and the same are recorded then the requirement to resubmit at the time of continuance is being dispensed with.

II. Participatory Notes and Derivative Instruments

A. Overview

Participatory Notes ("P-Notes") are a form of Offshore Derivative Instruments ("ODI"). Section 2(1)(j) of the SEBI Foreign Portfolio Investors Regulations, 2014 provides that an “offshore derivative instrument” means any instrument, by whatever name called, which is issued overseas by a foreign portfolio investor against securities held by it that are listed or proposed to be listed on any recognised stock exchange in India, or unlisted debt securities or securitized debt instrument, as its underlying.

P-Notes are issued by FIIs (and eligible FPIs). The FPI Regulations specifically exclude Category-III FPIs and certain Category-II FPIs (those that are unregulated broad-based funds who rely on their investment managers to obtain registration as Category-II FPIs), from issuing, subscribing or otherwise dealing in ODIs.55

ODIs can only be issued (a) to those persons who are regulated by an appropriate foreign regulatory authority; and (b) after compliance with KYC norms. Accordingly, an FII (or an eligible FPI) seeking to issue ODIs to any person must be satisfied that such person meets the aforementioned two tests.56 Therefore, to be perceived / classified as reportable ODIs, the concerned offshore contracts would need to refer to an Indian underlying security and also be hedged in India to whatever extent by the issuer FII / FPI. Accordingly, unless so hedged, an ODI remains a contract note, that offers its holder a return linked to the performance of a particular underlying security but need not be reported under the disclosure norms set out under the FPI Regulations.

It is the issuing FII / FPI that engages in the actual purchase of the underlying Indian security as part of its underlying hedge to minimize its risks on the ODI issued. The position of the ODI holder is usually that of an unsecured counterparty to the FII / FPI (with inherent counterparty risks amongst others) and under the ODI (the contractual arrangement with the issuing FII / FPI) the holder of a P-Note is only entitled to the returns on the underlying security with no other rights in relation to the securities in respect of which the ODI has been issued.

55. Regulation 21 of the FPI Regulations.
56. Ibid.
The FPI Regulations provide that Category I FPIs and Category II FPIs (which are directly regulated by an appropriate foreign regulatory authority) are permitted to issue, subscribe to and otherwise deal in ODIs. However, those Category II FPIs which are not directly regulated (which are classified as Category-II FPIs by virtue of their investment manager being appropriately regulated) and all Category-III FPIs are not permitted to issue, subscribe to or deal in ODIs.

As compared to the FII regime, two differences emerge, (1) 'unregulated' broad based funds are not eligible to subscribe to ODIs, even if they are managed by an appropriately regulated person (which, under the FII Regulations, were eligible to hold ODIs) and, (2) entities that qualify as regulated broad based funds, may also issue ODIs under the FPI Regulations.

FPIs shall have to fully disclose to SEBI, any information concerning the terms of and parties to ODIs entered into by it relating to any securities listed or proposed to be listed in any stock exchange in India. On November 24, 2014, SEBI issued a circular ("Circular") aligning the conditions for subscription of ODIs to those applicable to FPIs. The Circular makes the ODI subscription more restrictive.

As per the Circular, read with the FPI Regulations, to be eligible to subscribe to ODI positions, the subscriber should be regulated by an International Organization of Securities Commissions ("IOSCO") member regulator or in case of banks subscribing to ODIs, such bank should be regulated by a Bank for International Settlements ("BIS") member regulator. The applicant is not resident in a country identified in the public statement of Financial Action Task Force as:

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

ii. a jurisdiction that has not made sufficient progress in addressing the deficiencies or has not committed to an action plan developed with the Financial Action Task Force to address the deficiencies;

It states that an FPI can issue ODIs only to those subscribers who meet certain eligibility criteria mentioned under regulation 4 of the FPI Regulations (which deals with eligibility criteria for an applicant to obtain registration as an FPI) in addition to meeting the eligibility criteria mentioned under regulation 22 of the FPI Regulations. Accordingly, ODIs can now only be issued to those persons who:

a. are regulated by an 'appropriate foreign regulatory authority;

b. are not resident of a jurisdiction that has been identified by Financial Action Task force ("FATF") as having strategic Anti-Money Laundering deficiencies; (c) do not have 'opaque' structures (i.e. PCCs / segregated portfolio and companies ("SPCs or equivalent structural alternatives); (d) comply with 'know your client' norms.

The Circular clarifies that 'opaque' structures (i.e., PCCs / SPCs or other ring-fenced structural alternatives) would not be eligible for subscription to ODIs.

The Circular further requires that multiple FPI and ODI subscriptions belonging to the same investor group would be clubbed together for calculating the below 10% investment limit.

The existing ODI positions will not be affected by the Circular until the expiry of their ODI contracts. However, the Circular specifies that there will not be a rollover of existing ODI positions and for any new ODI positions, new contracts will have to be entered into, in consonance with the rules specified in the Circular.58

57. Reference may be made to Explanation 1 to Regulation 5 of the FPI Regulations, where it is provided that an applicant (seeking FPI registration) shall be considered to be "appropriately regulated" if it is regulated by the securities market regulator or the banking regulator of the concerned jurisdiction in the same capacity in which it proposes to make investments in India.

SEBI has recently issued a circular59 ("ODI KYC Circular") to bring about uniformity and increase the transparency among ODI issuers for adopting systems and procedures to comply with the conditions mentioned under the FPI Regulations. The ODI KYC Circular requires that ODI issuers put in place necessary controls, systems and procedures with respect to ODIs to comply with the updated compliance requirements. These systems will undergo a periodical review and evaluation by the ODI issuers.

As per the ODI KYC Circular, ODI issuers shall now be required to identify and verify the beneficial owners (on a look through basis) in the subscriber entities, who hold in excess of 25% in case of a company and 15% in case of partnership firms / trusts / unincorporated bodies. ODI issuers shall also be required to identify and verify the person(s) who control the operations when no beneficial owner is identified basis the materiality threshold stated above.

SEBI has also given the format of KYC documentation to be followed by ODI issuers while obtaining such documentation from the ODI subscribers in respect of their beneficial owners. In addition to the initial KYC done at the time of on-boarding, the ODI issuers will be required to review the KYC for each client (a) once every three years for low-risk clients; and (b) every year for all other clients. The risk profile of the clients for this purpose will be done by the ODI issuers.

Further, the ODI KYC Circular requires that any ODI subscriber shall take prior consent of the ODI issuer for transferring the ODIs and such transfer shall be made only to persons in accordance with Regulation 22(1) of the FPI Regulations.

In addition to compliance with the above, ODI issuers will be required to file 'suspicious transaction reports', if any, with the Indian Financial Intelligence Unit, in relation to the ODIs issued by it in accordance with the Prevention of Money Laundering Act, 2002. These reports are submitted when the reporting entity identifies a 'suspicious transaction' in accordance with the Prevention of Money Laundering Act, 2002 and the rules made thereunder.

Further, SEBI has decided to insert an express provision in the FPI Regulations to prevent NRIs or the entities which are beneficially owned NRIs from subscribing to ODIs (SEBI Board Meeting Minutes dated April 26, 2017). Prior to the decision made by SEBI on April 26, 2017, there was no express prohibition on entities which are beneficially owned by NRIs from subscribing to ODIs. Further, SEBI, in a circular dated July 7, 2017, has mandated that issuers to ensure 'one-to-one' mapping (between the ODI on derivatives and the corresponding equity shares, on which the Issuer holds such derivatives) for satisfying the pre-requisite of hedging.

**B. Position of Tax on P-Notes**

Under sections 4 and 5 of the Tax Act, non-residents may be taxed only on income that accrues in India or which arises from sources in India. The source rules for specific types of income are contained in section 9, which specifies certain circumstances where such income is deemed to accrue or arise in India.

Capital gains from the transfer or sale of shares or other securities of an Indian company held as capital assets would ordinarily be subject to tax in India (unless specifically exempted).

Under section 9(1)(i) of the Tax Act, income earned by a non-resident from the transfer of a capital asset situated in India would be deemed to have been accrued in India (i.e. be sourced in India). Therefore, a non-resident may be liable to tax in India if it earns income from the transfer of a capital asset situated in India.

In *Vodafone International Holdings B.V. v. Union of India*, the Indian Supreme Court stated that the Indian tax authorities are to only “look at” a particular document or transaction when determining the taxability thereof, thus, indicating a form-over-substance approach with respect to taxation. Thus, in light of the above-mentioned determination, an indirect transfer of capital assets situated in India, between two non-residents, executed outside India was held to be not taxable under the Tax Act.

In response to the decision of the Supreme Court, a retroactive clarification was inserted in the Tax Act by the Finance Act, 2012, to state that such foreign shares or interest may be treated as a capital asset situated in India if it “derives, directly or indirectly, its value substantially from assets located in India”. The newly introduced Explanation 5 to section 9(1)(i) expands the source rule to cover shares or interest in a foreign company, the value of which is substantially derived from assets situated in India.

However, while the foreign shares / interest may be deemed to be situated in India, the charge of capital gains tax may not extend to that portion of its value relating to assets located outside India. Assets located outside India do not have any nexus with the territory of India to justify taxation under the Tax Act. It is, therefore, necessary to “read down” the amended section 9(1)(i) based on the nexus principle.

In case of an ODI holder, while the value of the ODI can be linked to the value of an asset located in India (equity, index or other forms of underlying securities from which the swap derives its value), it is a contractual arrangement that does not typically obligate the ODI issuer to acquire or dispose the referenced security.

The Protocol amending the India-Mauritius DTAA may have an adverse effect on ODI issuers that are based out of Mauritius. While most of the issuers have arrangements to pass off the tax cost to their subscribers, the arrangement may have complications due to a timing mismatch as the issuer could be subject to tax on a FIFO basis (as opposed to a one-to-one co-relation).

**III. Onshore Hedge Funds**

As has been previously discussed, SEBI introduced different categories of AIFs to cater to different investment strategies. Category III AIFs is a fund which employs diverse or complex trading strategies and may involve leverage including through investments in listed or unlisted derivatives.

While the general characteristics of Category III AIFs have been discussed previously, it is important to stress on certain key aspects. The AIF Regulations provide that Category III AIFs may engage in leverage or borrow subject to consent from the investors in the fund and subject to a maximum limit specified by SEBI. On July 29, 2013, SEBI issued a circular which lays down certain important rules relating to redemption restrictions and leverage.
A. Suspension of Redemptions

A Category III AIF cannot suspend redemptions unless the possibility of suspension of redemptions has been disclosed in the placement memorandum and such suspension can be justified as being under exceptional circumstances and in the best interest of investors or is required under AIF Regulation or required by SEBI. Further, in the event of a suspension of redemption, a fund manager cannot accept new subscriptions and will have to meet the following additional obligations:

a. Document reasons for suspension of redemption and communicate the same to SEBI and to the investors;

b. Build operational capability to suspend redemptions in an orderly and efficient manner;

c. Keep investors informed about actions taken throughout the period of suspension;

d. Regularly review the suspension and take necessary steps to resume normal operations; and

e. Communicate the decision to resume normal operations to SEBI.

B. Leverage Guidelines

SEBI limits the leverage that can be employed by any scheme of a fund to two times (2x) the net asset value ("NAV") of the fund. The leverage of a given scheme is calculated as the ratio of total exposure of the scheme to the prevailing NAV of the fund. While calculating leverage, the following points should be kept in mind:

a. Total exposure will be calculated as the sum of the market value of the long and short positions of all securities / contracts held by the fund;

b. Idle cash and cash equivalents are excluded while calculating total exposure;

c. Further, temporary borrowing arrangements which relate to and are fully covered by capital commitments from investors are excluded from the calculation of leverage;

d. Offsetting of positions shall be allowed for calculation of leverage in accordance with the SEBI norms for hedging and portfolio rebalancing; and

e. NAV shall be the sum of value of all securities adjusted for mark to market gains / losses including cash and cash equivalents but excluding any borrowings made by the fund.

The AIF Regulations require all Category III AIFs to appoint a custodian. In the event of a breach of the leverage limit at any time, fund managers will have to disclose such breach to the custodian who in turn is expected to report the breach to SEBI before 10 AM, IST (India Standard Time) on the next working day. The fund manager is also required to communicate the breach of the leverage limit to investors of the fund before 10 AM, IST on the next working day and square off the excess exposure to rebalance leverage within the prescribed limit by the end of the next working day. When exposure has been squared off and leverage has been brought back within the prescribed limit, the fund manager must confirm the same to the investors whereas the custodian must communicate a similar confirmation to SEBI.
8. Fund Governance

A pooled investment vehicle typically seeks to adopt a robust governance structure. The genesis of this obligation (other than as may be required under applicable laws) is in the generally accepted fiduciary responsibilities of managers with respect to the investor's money.

In a fund context, the decision making framework typically follows the following structure –

I. Investment Manager

The investment manager is concerned with all activities of a fund including its investment and divestment related decisions. These are typically subject to overall supervision of the board of directors of the fund (if set up in the format of a 'company').

II. Investment Committee

The Investment Committee ("IC") scrutinizes all potential transactions (acquisition as well as exit). The IC's role includes maintaining pricing discipline, ensuring that all transactions adhere to the fund's strategy and assessing the risk-return profile of the deals.

The functions of the IC typically include review of (1) transactions that are proposed by the investment manager, (2) performance, risk profile and management of the investment portfolio and (3) to provide appropriate recommendations to the investment manager.

III. Advisory Board

Typically, the Advisory Board's role is to provide informed guidance to the investment manager / IC of the fund based on the information / reports shared by the investment manager with the Advisory Board.

The Advisory Board typically provide recommendations to the investment manager / IC in relation to (1) managing "conflicts of interest" situations; (2) approval of investments including co-investment opportunities made beyond the threshold levels as may have been defined in the fund documents; (3) approval of reduction of equalization premium amount; (4) investment manager's overall approach to investment risk management and; (5) corporate governance and compliance related aspects.

IV. Aspects and Fiduciaries to be considered by Fund Directors

The emerging jurisprudence suggests that the threshold of fiduciaries that is required to be met by the directors is shifting from "sustained or systematic failure to exercise oversight" to "making reasonable and proportionate efforts commensurate with the situations". A failure to perform their supervisory role could raise several issues concerning liabilities of independent directors for resultant business losses as would be seen in the case of Weavering Macro Fixed Income Fund (summarized below).

As a matter of brief background, Weavering Macro Fixed Income Fund ("Fund") was a Cayman Islands based hedge fund. The Fund appointed an investment manager to 'manage the affairs of the Fund subject to the overall supervision of the Directors'. The Fund went into liquidation at which point in time, action for damages was initiated by the official liquidators against the former "independent" directors.

The Grand Court of Cayman Islands found evidence that while board meetings were held in a timely manner, the meetings largely recorded information that was also present in the communication to fund
investors and that the directors were performing ‘administrative functions’ in so far as they merely signed the documents that were placed before them.

Based on such factual matrix, the Grand Court held against the directors for willful neglect in carrying out their duties. It was also observed that based on their inactions, the defendant directors “did nothing and carried on doing nothing”. The measure of loss was determined on the difference between the Fund’s actual financial position with that of the hypothetical financial position had the relevant duties been performed by the directors.

The Grand Court ruled against each of the directors in the amount of $111 million. It was also observed, that the comfort from indemnity clauses are for reasonably diligent independent directors to protect those who make an attempt to perform their duties but fail, not those who made no serious attempt to perform their duties at all.

The Grand Court observed that the directors are bound by a number of common law and fiduciary duties including those to (1) act in good faith in the best interests of the fund and (2) to exercise independent judgment, reasonable care, skill and diligence when acting in the fund’s interests.

However, the Cayman Islands Court of Appeal (“CICA”) set-aside the order of Cayman Islands Grand Court in the case of Weavering Macro Fixed Income Fund Limited (In Liquidation) vs. Stefan Peterson and Hans Ekstrom, through its judgment dated February 12, 2015.

The CICA, while affirming the original findings of breach of duty by the directors held that there was no element of ‘wilful’ negligence or default on their part; therefore, the indemnity provisions in the Fund documents relieved the directors from liability arising out of breach of their duties.

The CICA held that the evidence available to the Grand Court was insufficient to support the finding that the directors’ conduct amounted to “wilful neglect or default”. The CICA accordingly set aside the earlier judgments against each of the directors for $111 million.

Further, in India, the recent case of RBI & Ors v Jayantilal N. Mistry & Ors. the Supreme Court of India considered the meaning of the term ‘fiduciary,’ and held that it referred to a person having a duty to act for the benefit of another (a ‘duty of loyalty’), showing good faith and candour (‘duty of care’), where such other person reposes trust and special confidence in the person owing or discharging the duty. The court took the view that the term ‘fiduciary relationship’ is used to describe a situation or transaction wherein one person (the beneficiary) places complete confidence in another person (the fiduciary) in regard to his affairs, business or transaction(s). The term also referred to a person who held a thing in trust for another (the beneficiary). The fiduciary is expected to act in confidence and for the benefit and advantage of the beneficiary, and to employ good faith and fairness in dealing with the beneficiary or with things belonging to the beneficiary. In the aforesaid case, the court held that “…RBI has no legal duty to maximise the benefit of any public sector bank, and thus there is no relationship of ‘trust’ between them.”

In a relevant case, HMRC v Holland, it was observed that the fact that a person is consulted about directorial decisions, or asked for approval, does not in general make him a director because he is not making the decision.

From a regulatory point of view, Regulation 21 of the AIF Regulations states that, in addition to the ‘trustee’ (the discharge of whose trusteeship services constitutes a fiduciary relationship with the investors), it is the ‘sponsor’ and the ‘investment manager’ of the AIF that are to act in a fiduciary capacity toward the investors.

In light of the above, it becomes important to ensure that the Advisory Board of the Fund is not given any roles or responsibilities with respect to the Fund which would subject the members to fiduciary duties.

---

61. AIR 2016 SC 1.
62. Ibid
We summarize below the duties of directors (of fund managers, in case the fund is not self-managed) based on the above judgments that should guide a director during the following phases in the life of a fund:

A. At the Fund Formation Stage

Directors must satisfy themselves that the offering documents comply with applicable laws, that all conflict of interest situations are addressed upfront, that the structure of the fund is not only legally compliant but also ethically permissible, that the terms of the service providers' contracts are reasonable and consistent with industry standards, and that the overall structure of the fund will ensure a proper division of responsibility among service providers. Directors must act in the best interests of the fund which, in this context, means its future investors.

In this respect, we believe ‘verification notes’ can be generated. The notes would record the steps which have been taken to verify the facts, the statements of opinion and expectation, contained in the fund’s offering document(s). The notes also serve the further purpose of protecting the directors who may incur civil and criminal liability for any untrue and misleading statements therein or material or misleading omissions therefrom. Alternatively, a ‘closing opinion’ may also be relied upon.

B. During the Fund’s Tenure

i. Appointment of Service Providers

Directors should consider carefully which service providers are selected for appointment. They should understand the nature of the services to be provided by the service providers to the fund.

ii. Agenda

The formalities of conducting proper board meetings should be observed. An agenda for such meetings should list the matters up for discussion, materials to be inspected, and inputs from the manager, the service providers and directors themselves. It should be circulated well in advance.

iii. Actions outside Board Meetings

The directors should review reports and information that they received from the administrator and auditors from time to time to independently assess the functioning of the fund and whether it is in keeping with the fund’s investment strategy and compliant with the applicable laws.

iv. Decision Making Process

Directors should exhibit that there was an application of mind when considering different proposals before it. The decision making process will also play a pivotal role in determining the substance of the fund from an Indian tax perspective as India moves away from its principle of “form over substance” to “substance over form” post April 01, 2017. For example, in case of investor ‘side letters’ that may restrict the fund's investments into a restricted asset class, etc., could raise issues. While execution of such ‘side letters’ may not be harmful to the fund, but an approval at ‘short notice’ may be taken up to reflect on the manner in which the directors perform their duties.

v. Minutes

Board meetings should be followed by accurately recorded minutes. They should be able to demonstrate how the decision was arrived at and resolution thereon passed. The minutes should reflect that the directors were aware of the issues that were being discussed. Clearly, a ‘boilerplate’ approach would not work.

vi. Remuneration

The remuneration for independent directors should be commensurate to the role and functions expected to be discharged by them. While a more-than adequate remuneration does not establish anything, an inadequate recompense can be taken as a ground
vii. Conflict of interest

If related party transactions or transactions that may raise conflict of interest cannot be avoided, a policy should be outlined where events and mechanisms to identify and resolve events which could lead to potential conflicts, should be recorded. Suitable measures that demonstrate governance and that the interest of the investors would be unimpaired, should be adopted.

The rulings discussed confirm that a fund’s board has duties cast on it and the ‘business judgment rule’ may ensure that liability is not shielded in all cases.

There are certain non-delegable functions for the directors to discharge on an on-going basis and none are more paramount than reviewing of the fund’s performance, portfolio composition and ensuring that an effective compliance program is in place. These functions require action ‘between’ board meetings and not only ‘during’ board meetings.

The Advisory Board of a fund plays an important role in resolving conflicts of interest. However, it is pertinent to note that while the Advisory Board may take a decision with reference to policies as may be defined under the fund documents, these decisions are not binding on the investment manager. While the Advisory Board may put forward its viewpoints in terms of the decisions arrived at by it, the Investment Manager possesses the final decision-making power.
9. International Tax Considerations

I. Taxation of Indirect Transfers

In India, residents are taxable on their worldwide income whereas non-residents are taxable on Indian source income i.e. income that accrues or arises, or is deemed to accrue or arise, or is received or is deemed to be received in India.

As stated above, for a non-resident to be subject to tax in India, the Tax Act requires that the income should be received, accrued, arise or deemed to be received, accrued or arisen to him in India. In this regard, section 9(1)(i) of the Tax Act provides the circumstances under which income of a non-resident may be deemed to accrue or arise in India:

Section 9(1): “The following income shall be deemed to accrue or arise in India: (i) all income accruing or arising, whether directly or indirectly, through or from any business connection in India, or through or from any property in India, or through or from any asset or source of income in India, or through the transfer of a capital asset situated in India.”

This source rule pertaining to a “capital asset situate in India” was examined by the Supreme Court of India in Vodafone International Holdings, which dealt with transfer of shares of a foreign company between two non-residents. It was held that a share is legally situated at the place of incorporation of the company. Therefore, while the shares of an Indian company would be considered situated in India, the shares of a company incorporated outside India would ordinarily be viewed as situated outside India.

This position has undergone a change pursuant to the Finance Act, 2012, which amended section 9 of the Tax Act through the insertion of Explanation 5 cited below:

“For the removal of doubts, it is hereby clarified that an asset or a capital asset being any share or interest in a company or entity registered or incorporated outside India shall be deemed to be and shall always be deemed to have been situated in India, if the share or interest derives, directly or indirectly, its value substantially from the assets located in India.”

Therefore, under the current law, shares of a foreign incorporated company can be considered to be “situate in India” if the company derives “its value substantially from assets located in India.

On the basis of the recommendations provided by the Shome Committee appointed by the then Prime Minister, the Finance Act, 2015 had made various amendments to these provisions which are summarized below:

A. Threshold test on substantiality and valuation

The Tax Act, pursuant to amendment by the Finance Act, 2015, provides that the share or interest of a foreign company or entity shall be deemed to derive its value substantially from the assets (whether tangible or intangible) located in India, if on the specified date, the value of Indian assets (i) exceeds the amount of INR 100 million; and (ii) represents at least 50% of the value of all the assets owned by the company or entity. The value of the assets shall be the Fair Market Value (“FMV”) of such asset without reduction of liabilities, if any, in respect of the asset.

64. Section 9(1) of the Tax Act.
65. (2012) 341 ITR 1. “asset being any share or interest in a company or entity registered or incorporated outside India shall be deemed to be situated in India, if the share or interest derives, directly or indirectly, its value from the assets located in India being more than 50% of the global assets of such company or entity.”
66. Explanation 6 to Section 9(1)(i) of the Tax Act.
Fund Formation: Attracting Global Investors
Global, Regulatory and Tax Environment impacting India focused funds

i. Date for determining valuation

Typically, the end of the accounting period preceding the date of transfer shall be the specified date of valuation. However, in a situation when the book value of the assets on the date of transfer exceeds by at least 15%, the book value of the assets as on the last balance sheet date preceding the date of transfer, then the specified date shall be the date of transfer. This results in ambiguity especially in cases where intangibles are being transferred.

ii. Taxation of gains

The gains arising on transfer of a share or interest deriving, directly or indirectly, its value substantially from assets located in India will be taxed on a proportional basis based on the assets located in India vis-à-vis global assets.

Exemptions: The Tax Act, pursuant to amendment by the Finance Act, 2015, provides for situations when this provision shall not be applicable. These are:

a. Where the transferor of shares of or interest in a foreign entity, along with its related parties does not hold (i) the right of control or management; and (ii) the voting power or share capital or interest exceeding 5% of the total voting power or total share capital or total interest in the foreign company or entity directly holding the Indian assets (Holding Co).

i. In case the transfer is of shares or interest in a foreign entity which does not hold the Indian assets directly, then the exemption shall be available to the transferor if it along with related parties does not hold the right of management or control in relation to such company or the entity; and

ii. any rights in such company which would entitle it to either exercise control or management of the Holding Co. or entitle it to voting power or total share capital or total interest exceeding 5% in the Holding Co. The 5% limit described above is a far cry from the 26% holding limit which was recommended by the Committee. Further, no exemption has been provided for listed companies, as was envisaged by the Committee.

b. In case of business reorganization in the form of demergers and amalgamation, exemptions have been provided. The conditions for availing these exemptions are similar to the exemptions that are provided under the Tax Act to transactions of a similar nature.

iii. Reporting Requirement

The Tax Act, pursuant to amendment by the Finance Act, 2015, provides for a reporting obligation on the Indian entity through or in which the Indian assets are held by the foreign entity.

The Indian entity has been obligated to furnish information relating to the offshore transaction which will have the effect of directly or indirectly modifying the ownership structure or control of the Indian entity. In case of any failure on the part of Indian entity to furnish such information, a penalty ranging from INR 500,000 to 2% of the value of the transaction can be levied.

In this context, it should be pointed out that it may be difficult for the Indian entity to furnish information in case of an indirect change in ownership, especially in cases of listed companies. Further, there is no minimum threshold beyond which the reporting requirement kicks in. This means that even in a case where one share is transferred, the Indian entity will need to report such change.

All in all, while these provisions provide some relief to investors, a number of recommendations as provided by the Committee have not been considered by the GoI. Some of these recommendations related to exemption to listed securities, P-Notes and availability of DTAA benefits. Further, there are no provisions for grandfathering of existing investment made in the past and questions 66. Explanation 6 to Section 9(1)(i) of the Tax Act arise as to the tax treatment on transactions undertaken between 2012 and 2015.
The Finance Act, 2017 brought changes to clarify that the indirect transfer tax provisions shall not be applicable to an asset or capital asset that is held directly/ indirectly by way of investment in an FII, a Category I FPI or a Category II FPI. This resolves concerns for a class of offshore funds which are registered as a category I or category II FPIs as redemptions by investors at the level of the fund shall not be subject to the indirect transfer taxation. Further, in multi-tiered structures, if the entity investing into India is a Category I or Category II FPI, any up-streaming of proceeds by way of redemption / buyback will not be brought within the Indian tax net. The provisions also exclude, from applicability of the indirect transfer tax provisions, situations where any redemptions or re-organizations or sales result in capital gains by investors in Category I or Category II FPIs.

The clarificatory explanations are applicable retrospectively from FY starting April 1, 2012, and therefore should help bring about certainty on past transactions that have been entered into by FII, Category I and Category II FPI entities.

Through Circular No. 28/2017

67. CBDT have clarified that the amendment shall not apply to income arising or accruing on account of redemption or buyback of share held by a non-resident in the specified funds, if it is in consequence of transfer of share or securities held in India by such fund and if such income is chargeable in India. The clarification resulted from concerns raised by investment funds set up as multi-tier investment structures, that the income derived in India on redemption of shares or interest could be subjected to multiple taxation on every upper level of the investment structure outside India. As a result of the circular, non-residents investing in multi-layered investment structures will be exempted from indirect transfer provisions on account of redemption of shares or interest outside India.

Thus, adverse effect of amendment has been minimized by not taxing a non-resident for its capital gain, in case it made through a specified fund.

II. General Anti-Avoidance Rule (GAAR)

Chapter X-A of the ITA provides for GAAR, which has come into effect from April 1, 2017. GAAR confers broad powers on the revenue authorities to deny tax benefits (including tax benefits applicable under the DTAA), if the tax benefits arise from arrangements that are “impermissible avoidance arrangements”.

The introduction of GAAR in the ITA is effective from financial year 2017-18 and brings a shift towards a substance based approach. GAAR targets arrangements whose main purpose is to obtain a tax benefit and arrangements which are not at arm’s length, lack commercial substance, are abusive or are not bona fide. It grants tax authorities powers to disregard any structure, reallocate / re-characterize income, deny DTAA relief etc. Further, the ITA provides that GAAR is not applicable in respect of any income arising from transfer of investments which are made before April 1, 2017.

Section 90(2A) of the ITA contains a specific DTAA override in respect of GAAR and states that the GAAR shall apply to an assessee with respect to DTAA, even if such provisions are not beneficial to the assessee.

On January 27, 2017, the CBDT issued Circular No. 7 of 2017 containing clarifications on the implementation of GAAR. Herein, the CBDT has clarified that GAAR will not interplay with the right of a taxpayer to select or choose the method of implementing a transaction. Further, the CBDT has clarified that GAAR shall not be invoked merely on the ground that an entity is located in a tax efficient jurisdiction. Specifically in response to a query raised with regard to issuance of P-notes referencing Indian securities, the CBDT has clarified that if the jurisdiction of an FPI is finalized based on non-tax commercial considerations and the main purpose of the arrangement is not to obtain a tax benefit, then GAAR will not apply.
Global, Regulatory and Tax Environment impacting India focused funds

The Supreme Court ruling in McDowell & Co. Ltd. v. CTO\textsuperscript{68} stated that under the Indian tax laws, even while predominantly respecting legal form, the substance of a transaction could not be ignored where it involved sham or colorable devices to reduce an entity’s tax liabilities.

Therefore, as per judicial anti-avoidance principles, the Indian tax authorities have the ability to ignore the form of the transaction only in very limited circumstances where it is a sham transaction or a colourable device.

The GAAR provisions extend the power of the Indian tax authorities to disregard transactions even when such transactions / structures are not a “sham” in case where they amount to an “impermissible avoidance arrangement”.

An impermissible avoidance arrangement has been defined as an arrangement entered into with the main purpose of obtaining a tax benefit. These provisions empower the tax authorities to declare any arrangement as an “impermissible avoidance arrangement” if the arrangement has been entered into with the principal purpose of obtaining a tax benefit and involves one of the following elements:

A. Non-arm’s Length Dealings

It refers to arrangements that create rights or obligations not normally created between independent parties transacting on an arm’s length basis.

B. Misuse or Abuse of the Provisions of the Act

It results directly or indirectly, in the misuse or abuse of the Tax Act.

C. Lack of Commercial Substance

Arrangements that lack commercial substance or are deemed to lack commercial substance- this would include round trip financing involving transfer of funds between parties without any substantial commercial purpose, self-cancelling transactions, arrangements which conceal, and the use of an accommodating party, the only purpose of which is to obtain a tax benefit. Arrangements are also deemed to lack commercial substance if the location of assets, place of transaction or the residence of parties does not have any substantial commercial purpose.

D. Non-Bona Fide Purpose

Arrangements that are carried out by means or in a manner which is not ordinarily employed for a bona fide purpose.

In the event that a transaction / arrangement is determined as being an ‘impermissible avoidance arrangement’, the Indian tax authorities would have the power to disregard entities in a structure, reallocate income and expenditure between parties to the arrangement, alter the tax residence of such entities and the legal situs of assets involved, treat debt as equity, vice versa, and the like. The tax authorities may deny tax benefits even if conferred under a DTAA, in case of an impermissible avoidance arrangement.

Investors have been worried about the scope of the GAAR provisions and concerns have been raised on how they would be implemented. A re-look at the scope of the provisions will definitely be welcomed by the investment community and it is hoped that when revised provisions are introduced, they will be in line with global practices.

III. Business Connection / Permanent Establishment Exposure

Offshore Funds investing in India have a potential tax exposure on account of having constituted a permanent establishment (“PE”) in India. In case of a PE determination, the profits of a non-resident entity are taxable in India only to the extent that the profits of
such enterprise are attributable to the activities carried out through its PE in India.

What constitutes permanent establishment?
Management teams for India focused Offshore Funds are typically based outside India as an onshore fund manager enhances the risk of the fund being perceived as having a PE in India. Although DTAs provide for the concept of a PE in Article 5 (as derived from the Organisation for Economic Co-operation and Development (“OECD”) and United Nations (“UN”) Model Convention), the expression has not been exhaustively defined anywhere. The Andhra Pradesh High Court, in CIT v. Visakhapatnam Port Trust 69, held that:

“The words "permanent establishment" postulate the existence of a substantial element of an enduring or permanent nature of a foreign enterprise in another country which can be attributed to a fixed place of business in that country. It should be of such a nature that it would amount to a virtual projection of the foreign enterprise of one country into the soil of another country.”

The presence of the manager in India could be construed as a place of management of the Offshore Fund and thus the manager could be held to constitute a permanent establishment. Consequently, the profits of the Offshore Fund to the extent attributable to the permanent establishment, may be subject to additional tax in India.

What tantamounts to business connection in the context of an Offshore Fund? ‘Business connection’ is the Indian domestic tax law equivalent of the concept of PE under a DTAA scenario. The term business connection, however, is much wider. The term has been provided as an inclusive definition per Explanation 2 to Section 9(1)(i) of the Tax Act, whereby a ‘business connection’ shall be constituted if any business activity is carried out through a person who (acting on behalf of the non-resident) has and habitually exercises in India the authority to conclude contracts on behalf of the non-resident.

Thus, the legislative intent suggests that (in absence of a DTAA between India and the jurisdiction in which the Offshore Fund has been set up) under the business connection rule, an India based fund manager may be identified as a ‘business connection’ for the concerned Offshore Fund.

It is important to note that the phrase ‘business connection’ is incapable of exhaustive enumeration, given that the Tax Act provides an explanatory meaning of the term which has been defined inclusively. A close financial association between a resident and a non-resident entity may result in a business connection for the latter in India. The terms of mandate and the nature of activities of a fund manager are such that they can be construed as being connected with the business activity of the Offshore Fund in India.

Accordingly, Offshore Funds did not typically retain fund managers based in India where a possibility existed that the fund manager could be perceived as a PE or a business connection for the fund in India. Instead, many fund managers that manage India focused Offshore Fund, tend to be based outside India and only have an advisory relationship in India that provide recommendatory services.

However, the Finance Act, 2015 introduced amendments to encourage fund management activities in India – by providing that having an eligible manager in India should not create a tax presence (business connection) for the fund in India or result in the fund being considered a resident in India under the domestic ‘place of effective management’ rule and introducing section 9A to the Tax Act.

While Section 9A may be well intentioned, it employs a number of rigid criteria that would be impossible for PE funds and difficult for FPIs to satisfy.

Under section 9A of the Tax Act, if the Fund is falling within the criteria given in Section 9A (3), then the said Fund will not be taken as resident in India merely because the eligible fund manager, undertaking fund management activities, is situated in India.

The conditions given under Section 9A are as follows: - (i) the fund must not be a person resident

69. 144 ITR 146
in India; (ii) the fund must be a resident of a country with which India has entered into an agreement under Section 90(1) or 90A(1) of the Tax Act or is established or incorporated or registered in a country or a specified territory notified by the GoI in this behalf; (iii) investment in the fund by persons resident in India should not exceed 5% of the corpus of the fund; (iv) the fund and its activities are subject to investor protection regulations in the country in which it is incorporated or resident; (v) the fund must have minimum twenty five members, who are not connected persons (vi) any member of the fund along with connected persons should not have any participation interest in the fund exceeding 10% (vii) the aggregate participation interest of ten or less members along with their connected persons in the fund, should be less than 50% (viii) the fund should not invest more than 20% of its corpus in any single entity (ix) the fund should not make any investment in its associate entity; (x) the monthly average of the corpus of the fund should not be less than INR 1 billion; however, this provision shall not be applicable in case of the year in which the fund is wound up. (xi) the fund should not carry on or control and manage, directly or indirectly, any business in India (xii) the fund should not engage in any activity which will constitute business connection in India; (xiii) the remuneration paid by the fund to the fund manager should be not less than the arm’s length price.

Added to this are certain relaxations provided to the fund set up by the government or the Central Bank of a foreign state or a sovereign fund, or any other fund as notified by the GoI These funds do not have to comply with the conditions given in clauses (v), (vi) and (vii) of the above given conditions.

Despite the efforts of the government, onerous conditions such as the requirement to have a minimum of twenty-five investors and the requirement to charge fee that is not less than the arm’s length price continue to act as roadblocks in the progress of the provision, as explained in detail below.

Furthermore, regard must also be had to the fact that Section 9A primarily caters to managers of open-ended funds. Private equity and venture capital funds are unlikely to consider using the provision as the minimum investor requirement, the requirement to not invest more than 20% of corpus in one entity and the restriction on “controlling” businesses in India make it impractical for such funds to consider using the safe harbour. This is in fact, a mismatch for the industry as India focused private equity and venture capital funds have a greater need to have management personnel based out of India.

A. No ability to “control and manage”

To qualify, the fund shall not carry on or control and manage, directly and indirectly, any business in India. It is unclear whether shareholders rights such as affirmative rights can be considered “control and management”. Further, this exemption will not be available to buy-out / growth funds, since such funds typically take a controlling stake and management rights in the portfolio companies;

B. Broad basing requirement

The fund is required to have a minimum of 25 members who are directly / indirectly unconnected persons. This seems similar to the broad-basing criteria applied to Category II FPIs and isn’t quite appropriate for private equity / venture capital funds which may often have fewer investors. Further, there is no clarity on whether the test will be applied on a look through basis (which could impact master-feeder structures);

C. Restriction on investor commitment

It is required that any member of the fund, along with connected persons should not have a participation interest exceeding 10%. It has also been stated that the aggregate participation of ten or less people should be less than 50%. This would
restrict the ability of the fund sponsor / anchor investor to have a greater participation.

It would also have an impact on master feeder structures or structures where separate sub funds are set up for ring fencing purposes;

**D. Fund manager cannot be an employee**

The exemption does not extend to fund managers who are employees or connected persons of the fund. Furthermore, it is not customary in industry to engage managers on a consultancy / independent basis, for reasons of risk and confidentiality, particularly in a private equity / venture capital fund context. Therefore, this requirement is likely to be very rarely met.

The proposed amendments do not leave funds worse off – however, they are unlikely to provide benefit to private equity / venture capital funds or FPIs. Firstly, a fund manager exemption is more relevant in a private equity / venture capital context, where on ground management is more of a necessity.

For the reasons discussed above, private equity / venture capital funds are unlikely to be able to take advantage of section 9A. If the intent was to provide PE exclusion benefits to FPIs investing in listed securities, it would have been more appropriate to clarify the risk on account of colocation servers in India on which automated trading platforms are installed. Secondly, FPI income is characterized as capital gains, and hence, the permanent establishment exclusion may only be relevant to a limited extent arrangement.
Sector Focused Funds

I. Social Venture Funds

A. Introduction

Even though social venture funds were existent in practice, it was only under the AIF Regulations that were formally recognized. Under the AIF Regulations, a social venture fund is defined as, “an alternative investment fund which invests primarily in securities or units of social ventures and which satisfies social performance norms laid down by the fund and whose investors may agree to receive restricted or muted returns.”

Typically, social venture funds tend to be impact funds which predominantly invest in sustainable and innovative business models. The investment manager of such fund is expected to recognize that there is a need to forecast social value, track and evaluate performance over time and assess investments made by such funds.

B. Characteristics of Social Venture Funds

Social venture funds tend to be different from venture capital funds or private equity funds not just in the investments that they make, but also in the nature of commitments that they receive from their limited partners / investors. The following is a list of some of the characteristics that a social venture fund may expect to have:

- Investors making grants (without expectation of returns) instead of investments;
- Fund itself providing grants and capital support considering social impact of such participation as opposed to returns on investment alone;
- Fund targeting par returns or below par returns instead of a fixed double digit IRR;
- Management team of the fund participating in mentoring, “incubating” and growing their portfolio companies, resulting in limited token investments (similar to a seed funding amount), with additional capital infused as and when the portfolio grows;
- Moderate to long term fund lives in order to adequately support portfolio companies.

Social venture funds also tend to be aligned towards environmental, infrastructure and socially relevant sectors which would have an immediate impact in the geographies where the portfolio companies operate.

C. Tools to Measure Social Impact

Managers of social impact funds rely on specific systems to quantify the social value of investments. Some of these include:

- Best Alternative Charitable Option (“BACO”), developed by the Acumen Fund.
- Impact Reporting & Investment Standards (“IRIS”), developed by Global Impact Investing Network (“GIIN”).
- Global Impact Investing Rating System (“GIIRS”).

D. Laws Relating to Social Venture Funds Investing into India

Offshore social venture funds tend to pool capital (and grants) outside India and make investments...
in India like a typical venture capital fund. Such Offshore Fund may not directly make grants to otherwise eligible Indian opportunities, since that may require regulatory approval.

Onshore social venture funds may be registered as a Category I AIF under the specific sub-category of social venture funds. In addition to the requirement to fulfill the conditions set out in the definition (set out above), social venture funds under the AIF Regulations are subject to the following specific restrictions and conditions:

- Requirement to have at least 75% of their investible funds invested in unlisted securities or partnership interest of ‘social ventures’;
- the amount of grant that may be accepted by the fund from any person shall not be less than twenty-five lakh rupees;
- Allowed to receive grants (in so far as they conform to the above investment restriction) and provide grants. Relevant disclosure in the placement memorandum of the fund will have to be provided if the social venture fund is considering providing grants as well; and
- Allowed to receive muted returns.

II. Media Funds

A. Media Funds – An Introduction

A media fund seeks to provide select sophisticated investors with an opportunity to participate in the financing of a portfolio of content, e.g., motion pictures and television serials.

In current times, when demand for high quality films and media products has increased, such pooling platforms play the role of providing organized financing to various independent projects or work alongside studios and production houses. A unique feature is the multiple roles and level of involvement that the fund manager can undertake for the fund and its various projects.

B. Media Funding Models

Most film funds take a ‘slate financing’ approach wherein the investment is made in a portfolio of films / media projects, as opposed to a specific project. However, as a variation, investors can even be introduced at the project specific level i.e. for a single production only.

In terms of risk mitigation, the slate financing model works better than a specific project model owing to risk-diversification achieved for the investor.

Apart from typical equity investments, film funds may additionally seek debt financing pursuant to credit facilities subject to compliance with local laws e.g., in the Indian context, debt financing by Offshore Fund may not work.

C. Risks and Mitigating Factors

Film fund investors should take note of media industry specific risks such as - risk of abandonment of the project (execution risks), failure to obtain distributors for a particular project, increased dependence on key artists, increasing marketing costs, oversupply of similar products in the market, piracy, etc.

To mitigate such risks, diversification in the projects could be maintained. Additionally, a strong and reliable green lighting mechanism could also be put in place whereby the key management of the fund decides the projects that should be green lit – based on factors such as budgeted costs, available distributorship arrangements, sales estimates and so on.

D. Life cycle of a Film Fund

The life of a film fund in term of economic performance is generally in the range of 8 to 10 years depending upon the sources of revenue. Typically, sources of revenue of a film are –
a. Domestic and international theatrical release of the film;

b. Domestic and international television markets; and

c. Merchandizing of film related products, soundtrack releases, home video releases, release of the film on mobile platforms, and other such online platforms.

Generally, a major portion of income from a film project is expected to be earned at the time of theatrical release of the film, or prior to release (through pre-sales). Consequently, the timing of revenue is generally fixed or more easily determinable in case of film investments, when compared to other asset classes.

The box office proceeds of a film typically tend to be the highest source of revenue and also a key indicator of expected revenue from other streams. Thus, keeping the timing of revenue flows in mind, film funds are often structured as close ended funds having a limited fund life of 7 to 9 years. The term may vary depending on the number of projects intended to be green lit or the slate of motion pictures or other media projects intended to be produced.

Typically, after the end of the life of the fund, all rights connected with the movie (including derivative rights) are sold or alternatively transferred to the service company or the fund manager on an arm’s length basis. Derivative rights including rights in and to prequels, sequels, remakes, live stage productions, television programs, etc. may also be retained by the investment manager (also possibly playing the role of the producer). Such transfer or assignment of residual rights is of course subject to the nature of and the extent of the right possessed by the fund or the concerned project specific SPV.

E. Sources of income of a film fund and tax treatment

i. Distributorship Arrangements

The fund or the project specific SPV, as the case may be, may license each project to major distributors across territories in accordance with distribution agreements. Pursuant to such distribution agreements, the fund could expect to receive net receipts earned from the distributions less a distribution fee payable to the distributor (which typically consists of distribution costs and a percentage of net receipts). Income of this nature should generally be regarded as royalty income. If the distributor is in a different jurisdiction, there is generally a withholding tax at the distributor level. The rate of tax depends on the DTAA between the countries where the distributor is located, and where the fund / its project specific SPV is located.

i. Lock Stock and Barrel Sale

The project exploitation rights may be sold outright on a profit margin for a fixed period or in perpetuity (complete ownership). This amounts to the project specific SPV selling all its interest in the IP of the movie for a lump sum consideration.

iii. Use of an Appropriate Intermediary Jurisdiction

Fund vehicles have historically been located in investor friendly and tax neutral jurisdictions. The unique nature of film funds adds another dimension i.e. intellectual property (“IP”) while choosing an appropriate jurisdiction. Generally, an IP friendly jurisdiction is chosen for housing the intellectual property of the fund or specific project. Further, since
considerable amount of income earned by the fund may be in the form of royalties, a jurisdiction that has a favourable royalty clause in its DTAA with the country of the distributor may be used. This assumes greater importance because the royalty withholding tax rate under the Tax Act is 25%.

Due to its protective regime towards IP, low tax rates and extensive treaty network, Ireland has been a preferred jurisdiction for holding media related IP.

F. Role of Services Company

In a film fund structure, certain acquisition, development, production and related services may be performed by a separate entity ("Services Company"). The Services Company may have a contractual relationship with the fund or its project specific subsidiaries, during the term of the fund. Depending upon circumstances of each project, the fund may engage the Services Company directly or through a special purpose subsidiary to provide production services. In respect of these services, the Services Company receives a fee which can be included within the fund’s operational costs. The role of the Services Company / fund may also be fulfilled by the fund manager. The Services Company / manager may also hold the intellectual property associated with each project that may be licensed to or acquired by the fund or its project specific subsidiaries.

G. Role of the Fund Manager

The fund manager may take up the responsibilities of the Service Company as indicated above. Once a specific project is selected and green-lit by the manager, all underlying rights necessary to produce and / or exploit the project may be transferred to the fund. In addition to such role, the manager would also be expected to play the role of the traditional manager of a pooled investment vehicle and expected to discharge its fiduciary obligations. To an extent, the same may require observing specific ‘conflict of interest’ mechanisms considering the multiple functions that may be performed in the context of a film fund.
Annexure II

Summary of Tax Treatment for Mauritius and Singapore Based Entities Participating in Indian Opportunities

The following table summarizes the (i) requirements for eligibility under the India-Mauritius DTAA and the India-Singapore DTAA; (ii) the substance requirements that companies in Mauritius and Singapore will have to demonstrate in order to claim benefits under the two DTAAAs and (iii) the tax rates that should be applicable to companies under the relevant DTAAAs read with the provisions of the domestic tax law.

<table>
<thead>
<tr>
<th>Parameters</th>
<th>Mauritius</th>
<th>Singapore</th>
</tr>
</thead>
<tbody>
<tr>
<td>Eligibility to DTAA benefits</td>
<td>A person is considered a resident of Mauritius for relief under the DTAA, as long as it is liable to tax in Mauritius by reason of domicile, residence or place of management. The Indian tax authorities issued a Circular (789 of 2000) stating that a tax residency certificate (TRC) issued by the Mauritius tax authorities constitutes sufficient proof of residence in Mauritius and entitlement to DTAA relief. The landmark decision of the Indian Supreme Court in Union of India v. Azadi Bachao Andolan upheld the validity of the aforesaid Circular 789. Following this case, a number of cases have confirmed DTAA benefits for Mauritius based investors including: Dynamic India Fund I; DDIT v. Saraswati Holdings Corporation; E*Trade; In Re: Castleton and D.B.Zwirn Mauritius Trading.</td>
<td>The management and control of business of the pooling vehicle must be in Singapore. Tax resident companies are eligible for DTAA benefits subject to (as a practical matter) being able to obtain a tax residency certificate from the Inland Revenue Authority of Singapore.</td>
</tr>
</tbody>
</table>

---

### Substance Requirements

The GBC would be required to carry out the core income generating activities: (i) employing, either directly or indirectly, a reasonable number of suitably qualified persons to carry out the core activities; and (ii) having a minimum level of expenditure, which is proportionate to its level of activities.

Further, while determining whether the activities constitute as core income generating activities, the FSC will take into consideration the nature and level of core income generating activities conducted (including the use of technology) by the GBC.

Under the Protocol, India shall tax capital gains arising from the sale of shares acquired on or after 1st April 2017 in a company resident in India with effect from financial year 2017-18.

The India-Singapore DTAA itself states the Substance requirement.

Subsequently negotiated protocol to the India-Singapore DTAA requires that the Singapore entity must not be a shell or a conduit entity. A shell / conduit entity is the one which has negligible or nil business operations or has no real and continuous business activities that are being carried out in Singapore.

A Singapore resident is deemed not to be a shell or conduit if it is listed on a recognized stock exchange or if its annual operational expenditure is at least SGD 200,000 per year in the two years preceding to the transfer of shares which are giving rise to capital gains. (The term “annual expenditure” means expenditure incurred during a period of twelve months. The period of twenty four months shall be calculated by referring to two blocks of twelve months immediately preceding the date when the gains arise.)

Accordingly, if the affairs of the Singapore entity are arranged with the primary purpose of taking benefit of capital gains relief, the benefit may be denied even if the Singapore entity is considered to have commercial substance under the GAAR provisions or incurs annual operational expenditure of SGD 200,000.

### Tax Implications under the Relevant DTAA

<table>
<thead>
<tr>
<th>Dividends</th>
<th>0% (as per the provisions of the Tax Act. Dividend distributions made by an Indian company to its shareholders are subject to a levy of DDT at an effective rate of 20.55% of the dividends distributed. The DDT payable by a company is in addition to the normal corporate tax).</th>
</tr>
</thead>
</table>

© Nishith Desai Associates 2018
<table>
<thead>
<tr>
<th>Capital Gains</th>
<th>India will have the right to tax capital gains which arise from alienation of shares of a company resident in India acquired by a Mauritian tax resident on or after April 1, 2017. All investments made prior to April 1, 2017 and any exits/share transfers from such investments will not be subject to capital gains tax in India; provided that there is no permanent establishment in India. The taxation of capital gains arising to Mauritius residents from alienation of shares between April 1, 2017 and March 31, 2019 from investments made after April 1, 2017 will not exceed 50% of the domestic tax. i. it is found that the affairs of the fund were arranged with the primary purpose to take advantage of the benefits of reduced rate of tax; or ii. it is found that the fund is a shell/conduit company, i.e. a legal entity falling within the definition of resident with negligible or nil business operations or with no real and continuous business activities that are carried out in Mauritius. Further, the fund will be deemed to be a shell/conduit company if its expenditure on operations in Mauritius is less than Mauritian Rs. 1,500,000, in the immediately preceding period of 12 months from the date the gains arise; provided that, if the fund is listed on a recognized stock exchange in Mauritius or its expenditure on operations in Mauritius is equal to or more than Mauritian Rs. 1,500,000, in the immediately preceding period of 12 months from the date the gains arise.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest</td>
<td>7.5% on all interest income earned from an Indian company. 15% on all interest income earned from an Indian company.</td>
</tr>
<tr>
<td>Tax Implications if the Company is not eligible to Claim Benefits under the Relevant DTAs</td>
<td>Short-term capital gains: Listed Securities (if the securities transaction tax is paid): 15% (plus applicable surcharge and cess). Unlisted Securities: 40% (plus applicable surcharge and cess). Long-term capital gains: Listed Securities (if the securities transaction tax is paid): 10% from the transfer listed equity shares, units of an equity oriented mutual fund, or units of a business trust where such gains exceed INR 100,000 Unlisted Securities: 10% (without indexation) or 20% (with indexation benefits) (plus applicable surcharge and cess).</td>
</tr>
</tbody>
</table>
The following research papers and much more are available on our Knowledge Site: www.nishithdesai.com

**NDA Insights**

<table>
<thead>
<tr>
<th>TITLE</th>
<th>TYPE</th>
<th>DATE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Blackstone’s Boldest Bet in India</td>
<td>M&amp;A Lab</td>
<td>January 2017</td>
</tr>
<tr>
<td>Foreign Investment Into Indian Special Situation Assets</td>
<td>M&amp;A Lab</td>
<td>November 2016</td>
</tr>
<tr>
<td>Recent Learnings from Deal Making in India</td>
<td>M&amp;A Lab</td>
<td>June 2016</td>
</tr>
<tr>
<td>ING Vysya - Kotak Bank : Rising M&amp;As in Banking Sector</td>
<td>M&amp;A Lab</td>
<td>January 2016</td>
</tr>
<tr>
<td>Sun Pharma – Ranbaxy: A Panacea for Ranbaxy’s ills?</td>
<td>M&amp;A Lab</td>
<td>January 2015</td>
</tr>
<tr>
<td>Reliance – Network18: Reliance tunes into Network18!</td>
<td>M&amp;A Lab</td>
<td>January 2015</td>
</tr>
<tr>
<td>Thomas Cook – Sterling Holiday: Let’s Holiday Together!</td>
<td>M&amp;A Lab</td>
<td>January 2015</td>
</tr>
<tr>
<td>Jet Etihad Jet Gets a Co-Pilot</td>
<td>M&amp;A Lab</td>
<td>May 2014</td>
</tr>
<tr>
<td>Apollo’s Bumpy Ride in Pursuit of Cooper</td>
<td>M&amp;A Lab</td>
<td>May 2014</td>
</tr>
<tr>
<td>Diageo-USL: ‘King of Good Times; Hands over Crown Jewel to Diageo</td>
<td>M&amp;A Lab</td>
<td>May 2014</td>
</tr>
<tr>
<td>Copyright Amendment Bill 2012 receives Indian Parliament’s assent</td>
<td>IP Lab</td>
<td>September 2013</td>
</tr>
<tr>
<td>Public M&amp;A’s in India: Takeover Code Dissected</td>
<td>M&amp;A Lab</td>
<td>August 2013</td>
</tr>
<tr>
<td>File Foreign Application Prosecution History With Indian Patent Office</td>
<td>IP Lab</td>
<td>April 2013</td>
</tr>
<tr>
<td>Warburg - Future Capital - Deal Dissected</td>
<td>M&amp;A Lab</td>
<td>January 2013</td>
</tr>
<tr>
<td>Real Financing - Onshore and Offshore Debt Funding Realty in India</td>
<td>Realty Check</td>
<td>May 2012</td>
</tr>
<tr>
<td>Pharma Patent Case Study</td>
<td>IP Lab</td>
<td>March 2012</td>
</tr>
<tr>
<td>Patni plays to iGate’s tunes</td>
<td>M&amp;A Lab</td>
<td>January 2012</td>
</tr>
</tbody>
</table>

© Nishith Desai Associates 2018
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.

Our dedication to research has been instrumental in creating thought leadership in various areas of law and public policy. Through research, we develop intellectual capital and leverage it actively for both our clients and the development of our associates. We use research to discover new thinking, approaches, skills and reflections on jurisprudence, and ultimately deliver superior value to our clients. Over time, we have embedded a culture and built processes of learning through research that give us a robust edge in providing best quality advices and services to our clients, to our fraternity and to the community at large.

Every member of the firm is required to participate in research activities. The seeds of research are typically sown in hour-long continuing education sessions conducted every day as the first thing in the morning. Free interactions in these sessions help associates identify new legal, regulatory, technological and business trends that require intellectual investigation from the legal and tax perspectives. Then, one or few associates take up an emerging trend or issue under the guidance of seniors and put it through our “Anticipate-Prepare-Deliver” research model.

As the first step, they would conduct a capsule research, which involves a quick analysis of readily available secondary data. Often such basic research provides valuable insights and creates broader understanding of the issue for the involved associates, who in turn would disseminate it to other associates through tacit and explicit knowledge exchange processes. For us, knowledge sharing is as important an attribute as knowledge acquisition.

When the issue requires further investigation, we develop an extensive research paper. Often we collect our own primary data when we feel the issue demands going deep to the root or when we find gaps in secondary data. In some cases, we have even taken up multi-year research projects to investigate every aspect of the topic and build unparallel mastery. Our TMT practice, IP practice, Pharma & Healthcare/Med-Tech and Medical Device, practice and energy sector practice have emerged from such projects. Research in essence graduates to Knowledge, and finally to Intellectual Property.

Over the years, we have produced some outstanding research papers, articles, webinars and talks. Almost on daily basis, we analyze and offer our perspective on latest legal developments through our regular “Hotlines”, which go out to our clients and fraternity. 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 Lab Reports 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 articles and disseminate them through our website. Our research has also contributed to public policy discourse, helped state and central governments in drafting statutes, and provided regulators with much needed comparative research for rule making. Our discourses on Taxation of eCommerce, Arbitration, and Direct Tax Code have been widely acknowledged. Although we invest heavily in terms of time and expenses in our research activities, we are happy to provide unlimited access to our research to our clients and the community for greater good.

As we continue to grow through our research-based approach, we now have established an exclusive four-acre, state-of-the-art research center, just a 45-minute ferry ride from Mumbai but in the middle of verdant hills of reclusive Alibaug-Raigadh district. Imaginarium AliGunjan is a platform for creative thinking; an apolitical ecosystem that connects multi-disciplinary threads of ideas, innovation and imagination. Designed to inspire ‘blue sky’ thinking, research, exploration and synthesis, reflections and communication, it aims to bring in wholeness – that leads to answers to the biggest challenges of our time and beyond. It seeks to be a bridge that connects the futuristic advancements of diverse disciplines. It offers a space, both virtually and literally, for integration and synthesis of knowhow and innovation from various streams and serves as a dais to internationally renowned professionals to share their expertise and experience with our associates and select clients.

We would love to hear your suggestions on our research reports. Please feel free to contact us at research@nishithdesai.com