VENTURE CAPITAL & PRIVATE EQUITY IN INDIA: A PRIMER AND SELECT RESEARCH

June 2009

Nishith Desai Associates
Legal & Tax Counseling Worldwide
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For more information, please contact:
Mr. Siddharth Shah, siddharth@nishithdesai.com
Ms. Amrita Singh, amrita@nishithdesai.com
Mr. Nishchal Joshipura, nishchal@nishithdesai.com

" The role of private equity funds and venture capital investors continues to be significant even as start-ups and corporate eagerly await the end of the global economic downturn"

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RESEARCH PAPERS

01

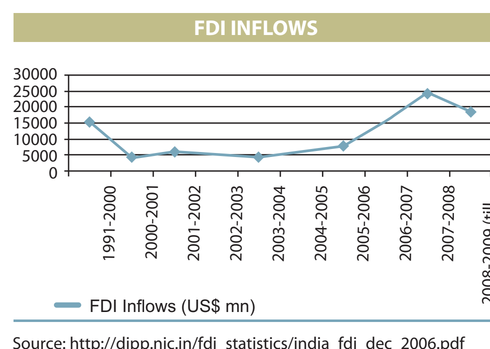
"Structuring any private equity/venture capital deal is a complex exercise. It not only requires integration and harmonization of legal and tax systems of various jurisdictions, but also their respective interplay with various aspects of public and private international law"

VENTURE CAPITAL & PRIVATE EQUITY INVESTMENTS IN INDIAN COMPANIES

As the global economy grapples with one of the largest crises till date, it is easy to understand why private equity funds the world over have ceased most of their investment activities. Having said that, the role as played by private equity ("PE") funds and venture capital ("VC") investors has not diminished and several start-ups and other such corporates eagerly await the end of the global economic downturn.

Due to the change in the Government of India's ("GoI") policies post- liberalization, in 1991 and subsequent privatization and globalization endeavours, India has seen significantly large inflows of foreign direct investments ("FDI"). The sources of these investments are largely attributable to the PE activities. As depicted in Figure 1, the last 2 years have seen more FDI activity than the entire period of 1991 to 2000. FDI peaked in 2007 when India was reckoned as a global hot-spot and as a fallout of the global economic crisis, there has been a slight tapering in FDI inflows.

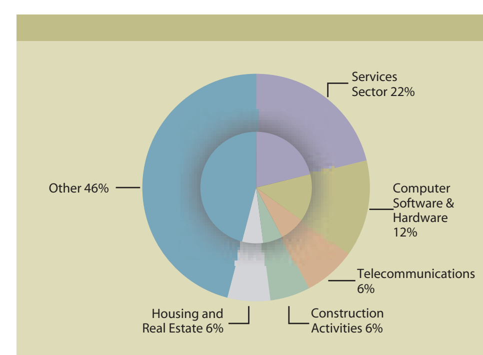
FDI INFLOWS



Source: http://dipp.nic.in/fdi_statistics/india_fdi_dec_2006.pdf

Figure 1

Traditionally, investments by VCs and the PE investors have been in high growth sectors such as Information Technology ("IT") until early 2001. With the technology slowdown following the dot-com bust, VCs and PEs have diversified their interest into other high potential sectors such as pharmaceuticals (especially biotech), manufacturing, infrastructure, banking, media and entertainment, retailing, Public Sector Undertakings ("PSU") disinvestments and business process outsourcing (BPO and IT-enabled services).



Source: http://dipp.nic.in/fdi_statistics/india_fdi_dec_2006.pdf

Figure 2

The above chart shows the percentage break-up of sector-wise FDI January 1991 and December 2006. A majority of foreign investment has gone into the old economy sectors like fuel, power, industrial machinery, etc. It is only over the past few years that new economy sectors like services (including software services and business process outsourcing) and telecom have attracted significant amounts of investment. The first phase of reforms ushered in a great deal of liberalization in the old economy sector and as a result, there was a sudden spurt of foreign investment in these sectors, with the services sector attracting the majority of investments after the electrical equipments sector.

We now go on to discuss the entire regulatory and legal landscape that contributed to and encouraged this surge in VC and PE activity until very recently.

REGULATORY FRAMEWORK

While the FDI policy formulated by the Secretariat for Industrial Assistance ("SIA") lays down the broad policy framework relating to foreign investments in India, the administration of the policy and its implementation are done through the exchange control laws. The Foreign Exchange Management Act, 1999 ("FEMA") confers powers on the Reserve Bank of India ("RBI") to frame detailed regulations in respect of various aspects of exchange control in a liberalized framework[1]. Similarly, the GoI has been empowered to frame rules[2]. The RBI and the GoI have accordingly announced a series of regulations and rules relating to various aspects of exchange control, including foreign investments into India. These regulations and rules give legislative effect and force to the policy formulated by the SIA.

The FEMA and the regulations relating to FDI framed thereunder by the RBI[3] ("FDI Regulations") have from time to time, on a progressive basis, been liberalizing the exchange control regime of India. Press note 7 of 2008 issued by the Department of Industrial Policy and Promotion, Ministry of Commerce and Industry is a summary of the present FDI policy and mirrors the changing environment for investment in India. Specifically speaking, Sub-regulation 4 of the FDI Regulations stipulates that an Indian entity shall not issue any security to a person resident outside India or shall not record in its books any transfer of security from or to such person unless permitted under FEMA. Sub-regulation 5 of the FDI Regulations lay down the conditions subject to which foreign investors would be permitted to invest into Indian securities. For sake of analysis, the Sub-regulation 5 has been classified into its

Classification of Sub-Regulation 5 of TISPRO Regulations

Sub-regulation	Deals with	Applicable schedule
5(1)	Investments by foreign individuals (other than citizens of Bangladesh and Pakistan) and foreign entities	Schedule 1
5(2)	Investments by registered Foreign Institutional Investors ("FIIs")	Schedule 2
5(3)(i)	Investments by Non Resident Indians ("NRIs") under Portfolio Investment Scheme in shares and debentures of an Indian Company	Schedule 3
5(3)(ii)	Investments by NRIs other than under Portfolio Investment Scheme in shares and debentures of an Indian Company on non-repatriation basis	Schedule 4
5(4)	Investments by NRIs or registered FIIs in securities other than shares and debentures of an Indian Company	Schedule 5
5(5)	Investments by registered Foreign Venture Capital Investors	Schedule 6
5(6)	Investments by registered FIIs in exchange traded derivative contracts	-
5(7)	Investments by NRIs out of INR funds on non-repatriation basis	-

Table 1

[1] See Section 47 of the FEMA.
[2] See Section 46 of the FEMA.
[3] The Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2000.

Each of the schedules to the FDI Regulations (as referred to in the above table) lays down specific conditions governing the investment by that particular category of investors. For example, FDI Scheme (that stipulates sectoral caps) forms part of Schedule 1 to the FDI Regulations.

FDI in most sectors is now under what is known as the "automatic route", which essentially means that an investor can bring in investment in those sectors without any prior approval from any regulatory authority and the only regulatory formality includes post facto filings with the RBI. There are certain prescribed conditions that are required to be met in order that a foreign investment be eligible for the automatic route. Some of these significant conditions are as follows:

- The investment should be within the sectoral equity caps prescribed, where applicable. The sectoral caps are set out in Annexure B to Schedule 1 of the FDI Regulations. For example, foreign investment in the Telecom Sector was enhanced up to 74% (49% under the automatic route, FIPB approval beyond 49%) subject to the guidelines issued by the GoI[4]. Similarly, while FDI up to 100% for the IT sector and for B2B e-commerce is permissible under the automatic route, investment in B2C e-commerce is not eligible for the automatic route. Call centers is another segment where FDI up to 100% is permitted. Up to 100% equity is permitted under the automatic route for investments in the pharmaceutical sector too.

- The investment should not be in a company which is engaged in the activity or manufacture of items listed in Annexure A to Schedule I of the FDI Regulations.

- The investment should not be in a company that requires an industrial license under Industrial Development (Regulation) Act, 1951 or under the locational policy notified vide Industrial Policy of 1991.

- The price at which the investment is made shall be in compliance with the formula prescribed under the FDI Regulations. The FDI Regulations prescribe a minimum price for foreign investment which is arrived at on the basis of a prescribed formula. However, as will be discussed later, an exemption has been provided from this entry-pricing requirement for investments made by Foreign VC Investors registered with the Securities and Exchange Board of India ("SEBI")[5].

- With the exception of the IT sector, investments by multinational financial institutions in the mining sector and in all other sectors, the foreign investor cannot avail of the automatic route if such investor already has an 'existing joint venture or technology transfer/trademark agreement' in the same field in India. An 'existing joint venture or technology transfer/trademark agreement' for the above purpose is one that is existing as on January 12, 2005[6]. However, this requirement applies essentially to strategic business investors and not to financial investors who may hold other portfolio investments in Indian companies. As regards Venture Capital Funds which are duly registered with SEBI, or where in the existing joint venture investment by either of the parties is less than 3% or where the existing venture/collaboration is defunct or sick, no approval needs be taken.

- In addition to all the above, the investments should also be in compliance with all the procedural requirements of the FEMA and the FDI Regulations and the FDI Policy as announced from time to time by the SIA.

[4] Press Note 3 (2007 Series), Department of Industrial Policy and Promotion.

[5] Vide Notification dated 26.12.2000 issued by RBI.

[6] Press Note 3 (2005 series)

In cases where any of the provisions of the FDI Regulations or the FDI Policy cannot be complied with, then such an investment transaction would require the prior approval of the Foreign Investment Promotion Board ("FIPB")[7]. The FIPB normally takes between 4-6 weeks to clear proposals. Transfers between two non-residents do not require any regulatory approvals from Indian Authorities[8]. Requirement of prior approval of the FIPB for secondary purchase of existing shares between resident and non-residents has been done away with, subject to fulfillment of certain reporting and other conditions.

VENTURE CAPITAL FUNDS

In India, both domestic and offshore venture capital funds investing in India are regulated by the SEBI. Earlier, SEBI only regulated the domestic VCFs, however, in September 2000, SEBI announced a new set of guidelines enabling foreign venture capital and private equity investors to register with SEBI under the new guidelines, the SEBI (Foreign Venture Capital Investors)

Regulations, 2000 ("FVCI Regulations"). The FVCI Regulations were substantially amended by the SEBI vide the SEBI (FVCI) (Amendment) Regulations, 2004.

THE SEBI (FOREIGN VENTURE CAPITAL INVESTOR) REGULATIONS, 2000 - "FVCI REGULATIONS"

It is not mandatory for an offshore fund to register with SEBI as a foreign venture capital investor ("FVCI"). However, SEBI and the RBI have extended certain benefits to SEBI registered FVCIs which make it beneficial to register with SEBI as a FVCI. FVCIs registered with SEBI would be entitled to the following benefits:

- As per Press Note 1 of 2005 issued by the Ministry of Commerce and Industry, GoI has exempted FVCIs (subject to certain conditions) from taking prior Governmental approval even though the FVCIs have already made investment in the same field.
- As per a RBI notification issued in December 2000, FVCIs shall benefit from free entry and exit pricing. Under the FEMA and the regulations issued thereunder, the entry and exit pricing of non-resident investors under the FDI route is regulated. For purchase of shares of an unlisted company, the minimum price to be paid by the non-resident investor is linked to the Net Asset Value ("NAV") of the shares. Similarly, for exits involving transfer from a non-resident to a resident, the exit price is capped at the price of the shares on the stock exchange (if the shares are listed) or to the NAV if the shares are unlisted. A special exemption has been carved out for FVCIs whereby they will be exempted from both the entry and exit pricing regulations.
- This could be a very significant benefit from the FVCI's point of view especially when they are looking at an exit from unlisted companies through strategic sale or through buy-back arrangement with the promoters. SEBI has also exempted FVCIs from the public offer provisions with respect to transfer of shares from FVCIs to the promoters, under the Takeover Code, if the portfolio company gets listed post investment. Therefore, in cases where the Promoters are buying back the shares from FVCIs, they will not be required to make an offer to the other shareholders of the Company, offering to buy up to 20% of the paid up capital of the company.
- FVCIs registered with SEBI have been accorded Qualified Institutional Buyer ("QIB") status and would accordingly be eligible to subscribe to securities at the

[7] Regulation 10 of the FDI Regulations.
[8] *ibid.*

Initial Public Offering ("IPO") of a VCU through the book-building route.

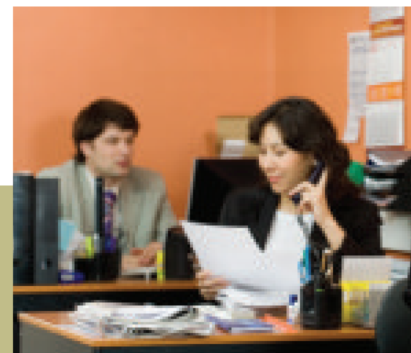
- FVCIs (as well as Venture Capital Funds) by virtue of being a QIB, are eligible to subscribe to the securities of Indian listed companies under the Qualified Institutional Placement route as prescribed under Chapter XIII A of the SEBI (Disclosure and Investor Protection) Guidelines, 2000 ("DIP Guidelines"). Under this route, as compared to Chapter XIII of the DIP Guidelines which governs preferential allotment, the time-period of conversion of issued securities which are convertible into equity shares is 60 months (i.e. 5 years) as opposed to the 18 months as prescribed for preferential allotment. Additionally, the currency of the shareholders' resolution is 1 (one) year under the QIP route as compared to the 15 days as provided in the case of preferential allotment. On the flip side, the QIP route requires the preparation of a placement document as well as mandates appointment of a merchant banker (as registered with SEBI), both of which are not the pre-requisites for a preferential allotment under Chapter XIII of the DIP Guidelines.

- Under the DIP Guidelines, the entire pre-issue share capital of a company going in for an IPO is locked for a period of one-year from the date of allotment in the public issue. However, an exemption from this requirement has been granted to domestic VC funds registered with SEBI and FVCIs, provided, the shares have been held by them for a period of at least one year as on the date of filing the draft prospectus with the Board. This would essentially allow the FVCI to exit from their investments post-listing. However, please note that for securities subscribed to in an IPO, there would be a lock-in of one year applicable to such investments.

- Generally the definition of a 'Promoter' under the SEBI (Disclosure and Investor Protection) Guidelines, 2000 is very broad and includes any person(s) who is in overall control of the company, or has a role to play in the formulation of a plan pursuant to which securities of the company are offered to the public (for example, decision of a company considering an IPO) or any person(s) named as promoter in any offer document of the company. A private equity investor generally reserves certain veto rights in the company and in most cases are actively involved in the IPO decision by the company. If the private equity investor is not registered as a FVCI, there is a possibility that the private equity investor be treated as a part of the promoter group thereby subjecting it to certain onerous requirements otherwise applicable to promoters. The SEBI has clarified that a SEBI registered VC fund or a FVCI would generally not be treated as promoters for the purpose of the above guidelines.

ELIGIBILITY CRITERIA

In order to determine the eligibility of an applicant, SEBI would consider, inter alia, the applicant's track record, professional competence, financial soundness, experience, whether the applicant is regulated by an appropriate foreign regulatory authority or is an income tax payer or submits a certificate from its banker of it's or it's promoter's track record where the applicant is neither a regulated entity nor an income tax payer. The applicant can be a pension fund, mutual fund, investment trust, investment company, investment partnership, asset management company, endowment fund, university fund, charitable institution or any other investment vehicle incorporated and established outside India.



REGULATORY FRAMEWORK

INVESTMENT CONDITIONS AND RESTRICTIONS

All investments to be made by an FVCI would be subject to the following conditions:

- FVCI is permitted to invest its entire corpus in a domestic SEBI VCF.
- At least two-thirds of the FVCI's investible funds shall be invested in unlisted equity shares or equity linked instruments of a Venture Capital Undertaking. Further, FVCIs can invest up to 33.33% by way of:

  1. Subscription to IPO of a VCU whose shares are proposed to be listed;
  2. Debt or debt instrument of a VCU in which the FVCI has already made an investment by way of equity;
  3. Preferential allotment of equity shares of a listed company, subject to a lock-in period of one year;
  4. The equity shares or equity linked instruments of a financially weak company (i.e. a company which has at the end of the previous financial year accumulated losses, which has resulted in erosion of more than 50% but less than 100% of its net worth as at the beginning of the previous financial year) or a sick industrial company whose shares are listed; and
  5. Special Purpose Vehicles which are created by an FVCI for the purpose of facilitating or promoting investment in accordance with the FVCI Amendments.

A VCU means a domestic company whose shares are not listed in a recognized stock exchange in India and which are not engaged in activities which have been classified under the negative list which broadly includes undertakings engaged in, non-banking financial services (excluding those non-banking financial services companies which are registered with the RBI and have been categorized as equipment leasing or hire purchase companies), gold financing (excluding those companies which are engaged in gold financing for jewellery), etc., and whose shares are not listed on a recognized stock exchange.

In a recent development, it has been noticed that the RBI while evaluating the FVCI registrations has issued letters to the domestic custodians citing that registrations shall be granted only if the proposed FVCI invests in the following 9 sectors as identified in the Finance Act, 2007, with regard to Section 10 (23FB) of the Income Tax Act, 1961, viz. nano technology, information technology of certain qualifying forms, seed research and development, biotechnology, pharmaceutical research, production of bio-fuels, construction and operation of certain hotel/convention centers having more than 3,000 of seating capacity, and finally, dairy and poultry industries. While a formal circular or an amendment to the FVCI Regulations to the above effect is yet to be promulgated, we understand that this is a significant step by the regulators with respect to curtailing the investment activities of FVCIs.

THE SEBI (VENTURE CAPITAL FUNDS) REGULATIONS, 1996 - "VCF REGULATIONS"

Domestic VCFs are regulated by SEBI under the VCF Regulations. Under the VCF Regulations, a domestic VCF can be organized either in the form of a trust or as a company including a body corporate and registered under these regulations. Further, the Limited Liability Partnership Bill, 2006 has also been passed by the Parliament recently.

The corporate structure poses certain disadvantages as compared to a trust structure. Some of the significant ones are:

- Distribution of income by way of dividends can only be out of profits or retained earnings. In the event the VCF does not earn profits on an investment or has accumulated losses, it will not be able to distribute the income as dividend to its shareholders/investors. Further, a certain percentage of distributable profits have to be transferred to a general reserve thus making the distribution of entire income difficult.

- Redemption of equity is still highly regulated and can be done only out of profits or fresh issue of shares (of a different class than those being redeemed). Thus, in a loss situation it would be difficult to redeem shares.

- Even winding up of a company takes a significantly long time, anywhere between 1-3 years, making the winding up of a fund a cumbersome and long drawn process.

INVESTMENT CONDITIONS AND RESTRICTIONS

In addition to the investment restrictions and conditions applicable to FVCIs, the following conditions would apply to a VCF:

- A VCF cannot invest more than 25% of its aggregate Capital Commitments in any one VCU (defined earlier).

- Minimum investment to be accepted from any investor should be Indian Rupees 500,000 except in the case of employees, principal officers or directors of the VCF, employees of the manager of the VCF where lower amounts may be accepted.

- Minimum capital commitments from its investors should be Indian Rupees 50 million in any scheme launched or fund set up by a Venture Capital Fund.

- A VCF cannot invest in associate companies. 'Associate company' means a company in which a director or trustee or sponsor or settlor of the VCF or the investment manager holds either individually or collectively, equity shares in excess of 15% of its paid-up equity share capital of VCU.

Further, prior to the enactment of the Finance Act 2007, a VCF was able to enjoy certain tax advantages so long as the VCF was registered with the Securities and Exchange Board of India and other conditions were met. A VCF, under these circumstances, was treated as a pass-through or flow-through vehicle, and thus income from its investments was not subject to a separate layer of tax at the VCF level. Under the Finance Act 2007, this special flow-through status and non-entity level tax would be limited to the following investments in certain domestic companies that are not publicly-traded: nano technology, information technology of certain qualifying forms, seed research and development, biotechnology, pharmaceutical research, production of bio-fuels, and construction and operation of certain hotel/convention centers having more than 3,000 of seating capacity, and finally, dairy and poultry industries. This represents a major shift that will revoke the otherwise tax-free status of VCFs investing outside of these

LIFE CYCLE OF A PRIVATE EQUITY DEAL

There are various stages in a venture capital or private equity deal.

STAGE I: IDENTIFYING THE TARGET

A critical aspect to be borne in mind while considering VC/PE investments in India is that most unlisted companies tend to have a relatively small capital base. Thus, while there are tremendous investment opportunities for VC/PE and strategic investors in India, one must allow for smaller deal sizes in comparison to those in other developed markets. However, in sectors which involve extensive investment in infrastructure (like telecom, cellular and basic telephony, for example) there are huge investment opportunities even in terms of deal size.

Irrespective of the size of the deal or the sector in which the investment is made, identifying the right companies for investment is very critical. Investors could be looking at opportunities either for long-term capital appreciation or for investments that make sense from a strategic business perspective. Investors typically consider several aspects of a potential investee company, like business focus and strategy for the company, its financials, the management team, its ranking in the industry in India etc. In technology sectors in particular, one also needs to look more closely at the sustainability of the products or services being offered by the company and the efficacy of its business model owing to constant threat of obsolescence.

STAGE II: TERM SHEET/ LETTER OF INTENT/ MEMORANDUM OF UNDERSTANDING

Once an investor has identified a potential investee company, negotiations begin between the investor and the company on the commercial outlines of possible investment. The process can sometimes take longer in India than in other markets to culminate if the company is part of large family-owned businesses or is already invested into by past investors. Investors might possibly have to deal at this stage with the equations among various family members who control the company and manage to get all of them on board with respect to the terms of the proposed investment, sometimes making the process delicate and long-winded. Even in cases not involving family-owned businesses, the potential investee company could be one which has gone through one or more previous rounds of funding, in which case the investor may have to deal with the previous investors of the company as it would often require the consent of such prior investors for taking on more investment.

Once the commercial terms are more or less agreed upon, the investor and the company may sign a term sheet or a memorandum of understanding ("MOU") or a letter of intent ("LOI") recording the terms agreed upon, which after due diligence, would be firmed up into a definitive agreement. Typically, such a term sheet, MOU or LOI is non-binding in nature (save and except for specific provisions such as confidentiality, expenses etc.), which needs to be substantiated by incorporating suitable language to that effect within such term sheet, MOU or LOI.

STAGE III: DUE DILIGENCE AND STRUCTURING

Legal and Financial Due Diligence

The legal and financial due diligence process is very critical to determine whether the company concerned presents a good investment opportunity to the investor, and also to determine the other important aspects of the deal such as valuation of the company, status of various compliances, the nature of representations and indemnities to be taken from the company and its founders, etc. Moreover, given India's complex corporate, securities, exchange control and taxation laws,

conducting thorough due diligence of the investee company is very crucial.

Structuring of Foreign Investments

The structuring of VC/PE investments is crucial from the legal, tax and exchange control standpoint. Further, the choice of instruments that could be issued to the investor also needs due deliberation.

- **Legal and exchange control**

  The chief concerns on this front include ascertaining corporate law issues, if any. The issuance or transfer of securities to the VC/PE investor needs to be in conformity with the Companies Act, 1956, as well as the rules as enacted thereunder. Additionally, the other concerns would include checking if the basic tenets of the relevant commercial laws, or of transaction-specific laws are followed. For instance, if a VC/PE investor is investing into an information technology service provider and if such an establishment is categorised under the software technology park of India regime, then the concerns or liabilities arising out of the same need to be borne in mind while structuring the deal.

  From the exchange control perspective, the FDI policy and FEMA would have to be given their due importance. In case of sectoral caps, care is to be taken that the same are not exceeded unless the parties are open to seeking the prior FIPB and GoI approval as set forth above.

  Additionally, Press Notes 2, 3 and 4 (of 2009 series) should be taken into consideration, in case the investment is to flow into an operating company, investment or holding company with downline investments or a combination of operating and investment / holding company.

- **Tax**

  Each transaction has potential tax exposures, and therefore it is critical that all the relevant tax consequences are spotted prior to the consummation of the transaction for appropriate and optimal structuring.

  It is quite encouraging to note that India has entered into double taxation avoidance treaties ("Tax Treaty") with several foreign countries. Therefore, foreign investors may consider investing in India from a country with which India has a Tax Treaty, as this would avoid the potential double taxation of income both in India as well as the home country. In the event that the home country of the investor does not have a Tax Treaty with India, the investment may be structured through a tax favorable jurisdiction.

  Choosing a jurisdiction which provides for maximum benefit is critical. While identifying a jurisdiction for locating the holding company, some of the important factors that one should consider are:

  1. Whether it has good Tax Treaty with India;
  2. Whether the local laws provide for flexibility in terms of choice of entities;
  3. What are the local taxes;
  4. Whether the corporate laws allow enough flexibility for repatriation of capital; and
  5. Whether there are any exchange controls which affect repatriation of income.

  Depending on the nature of income and the Indian operations, various jurisdictions like the UAE, Cyprus, Mauritius, Netherlands, etc. have been used as holding company jurisdictions for investing into India. The Tax Treaty with

Cyprus exempts any capital gains earned by a Cyprus entity on shares held in an Indian company from tax in India, as well as provides for the reduction of the tax payable on the interest on debentures. However, it is understood that the India-Cyprus Tax Treaty is undergoing re-negotiation. Additionally, Mauritius has emerged as the most favorable jurisdiction for investing into India because of the encouraging Tax Treaty that India has entered into with Mauritius and has in fact become one of the largest investors into India. The India-Mauritius Tax Treaty provides for favorable tax treatment in respect of dividends and capital gains. Like the Tax Treaty with Cyprus, the India Mauritius Tax Treaty also exempts any capital gains earned by a Mauritius entity on shares held in an Indian company from tax in India. Further, Mauritius does not impose any capital gains tax.

In a recent development, the Vodafone case in which the Indian tax authorities pulled up Vodafone for not withholding tax on the consideration paid for the acquisition of a Cayman Islands company through its Netherlands entity, a seemingly tax-free transaction so far as India's fiscal shores are concerned, has made investors and acquirers reconsider cross border tax planning. However, the extent to which it should raise concerns can be appreciated only after the tax authorities have made a determination on this issue.

By provisioning for the worst-case scenario, and in light of the subsequent notices that have been issued to the parties who have entered into Vodafone-like transactions, it is pertinent that due attention be paid to such issues at the time of structuring of the investments

- **Structuring the Instrument**

Having gone through the initial stages of due diligence and negotiations, and after having addressed the entry level exchange control issues, the next concern an investor is likely to look at is what kind of instrument it should get against its investment, and what level of protections and risks the investor should bear in mind with respect to these investments.

The simplest and perhaps the most obvious instrument that an investor can get to would be the equity share. However, for several reasons, an investor may wish to hold a part or whole of its investment in the form of some other instrument.

Some of the usual reasons in an Indian context why a foreign investor would prefer an instrument other than equity shares are outlined below:

1. The investor may wish to get a preference on dividend or liquidation or both.
2. The investor may wish to get disproportionate voting rights on its investment in return for the strategic value such investor may bring to the table.
3. Indian corporate and securities laws may place certain restrictions with respect to equity shares which may not suit the commercial understanding between the parties.
4. The investor may seek liquidity in overseas markets and the maximum flexibility in terms of exit options.

Given the above reasons, the following alternate instruments are usually resorted

to by investors in Indian companies who face any of the above problems. Understandably, the instrument chosen is based on those considerations that matter most to the investor and therefore, the transaction has to be viewed overall before determining which alternate instrument best suits the needs of an investor.

Instruments Denominated in Indian Rupees

1. Convertible Preference Shares - Under Indian company law, a preference share by definition gets a preference over the other shareholders as to dividends and recovery of capital in the event of liquidation. A convertible preference share is a preference share that is converted to equity shares based on a specified conversion ratio upon maturity. Till the time of conversion, the shareholder would continue to receive dividends at a specified rate. However, a convertible preference share will carry no voting rights till the time of conversion, except in very limited circumstances. It must be noted that this would not address the difficulties that exchange control sectoral caps may place, as fully convertible preference shares are treated the same as equity shares for the purpose of reckoning sectoral investment caps. With effect from 1 May, 2007 only preference shares which are fully and mandatorily convertible are eligible to be issued to persons resident outside India under the FDI scheme[9]. Further, the RBI has prescribed that the dividend payable on convertible preference shares issued to non-resident parties cannot be in excess of 300 basis points over the Prime Lending Rate ("PLR") of the State Bank of India on an annual basis.

2. Convertible Debentures - Debentures are debt instruments. In the case of a convertible debenture, the debenture holder would receive interest from the company till the maturity date, after which the debentures would be converted into equity shares ranking on par with the other equity shares of the company. Convertible debentures too are treated the same as equity shares for the purpose of reckoning sectoral caps, and this instrument would therefore not be very helpful in the event of difficulties posed by sectoral caps. In this context, the RBI, though its circular[10] dated June 08, 2007, has clarified that only instruments which are fully and mandatorily convertible into equity, within a specified time would be reckoned as part of equity under the foreign direct investment policy and eligible to be issued to persons resident outside India under the Foreign Direct Investment Scheme. Therefore, optionally or partly convertible or non-convertible debentures will be regarded as debt and a foreign investor will require prior approval from the FIPB and the RBI prior to investing through such optionally convertible or non-convertible instruments. Further, subscription to such optionally or partially convertible debentures will require compliance with the guidelines for external commercial borrowings which impose several restrictions on end-use, all-cost ceilings, eligible lenders and borrowers etc. As far as the rate of interest on the debentures issued to non-residents is concerned, the FDI Regulations are silent on this aspect.

[9] See RBI/2006-2007/434 A.P. (DIR Series) Circular No. 73, 8 June, 2007.

[10] RBI/2006-2007/435 A.P. (DIR Series) Circular Number 74.

However, by drawing an analogy with the payment of dividend on preference shares as discussed above, a view could be taken that the maximum permissible rate of interest that could be paid on the debentures as issued to non-residents on an annual basis is 300 basis points over the PLR of the State Bank of India.

3. Warrants - These are convertible instruments that can be converted into equity shares at the convenience of the holder, by paying a conversion price. A warrant is a right to subscribe to equity shares at a later stage. Warrants which have been issued and are outstanding are not taken into consideration for the purpose of reckoning sectoral investment caps. It is for this reason that warrants are often used as stop-gap instruments by foreign investors to ensure that they do not exceed the sectoral caps, but at the same time retaining the right to acquire the shares underlying the warrants within a specified timeframe, in the hope that the regulatory regime might change in the future, whereby the sectoral caps may either be done away with or enhanced. While this instrument may seem like a very effective way of overcoming the difficulties posed by the sectoral investment caps, it has its own limitations. Firstly, as a warrant is only a right to subscribe to shares at a later date, the investor would not get any of the rights attached to shares (including dividend, voting rights etc.). Therefore, this instrument makes sense only when used as a stopgap arrangement, with the investor's economic rights being compensated in other contractual arrangements with the company. Another problem with warrants could be that in the event the sectoral caps remain in place at the time when the company goes in for an IPO, then the investor would effectively have to forfeit the shares underlying the warrants. This is because a company that plans to do an IPO is required, under the securities laws of India, to convert all outstanding convertible securities, including warrants and options, into equity shares before doing the IPO[11] . Alternatively, if the company cannot convert them into equity shares for any reason, including any legal restrictions, the company would have to cancel all such outstanding convertible securities before the IPO. Therefore, warrants could pose an element of risk to the investment of the foreign investor in this context. Additionally, in recent times, the FIPB appears to have taken a view that warrants will require prior approval of the FIPB.

Instruments Denominated in Foreign Currency

1. A foreign investor would wish to receive an instrument denominated in foreign currency because of the liquidity it offers in an international market. Therefore, apart from being denominated in an internationally accepted currency, the instrument also has to be a universally recognized one. The two most commonly recognized foreign currency denominated securities that can be issued by Indian companies are Global Depository Receipts ("GDRs")/American Depository Receipts ("ADRs") and Foreign Currency Convertible Bonds ("FCCBs").

[11] Under the DIP Guidelines, all convertible instruments that are outstanding have to be either converted or cancelled prior to the IPO.

2. ADRs/GDRs - They are treated as foreign securities issued by an Indian company and these instruments are founded on underlying equity shares. The underlying shares are denominated in Indian Rupees while the ADRs and GDRs are usually denominated in dollars. Foreign investors in Indian companies who seek to have their investment evidenced by a dollar denominated instrument can therefore, seek to have ADRs/GDRs issued to them by the company by way of a private placement. This would mean that they would hold ADRs/GDRs that are not registered with the regulators or stock exchanges outside India. The holders of ADRs/GDRs can sell these instruments privately outside India or they could convert these instruments into the underlying equity shares at any point of time. In the event that the Indian company subsequently goes in for a publicly listed ADR/GDR offering in the US or such other market outside India, then the investor could seek concurrent registration of the ADRs/GDRs held by it. This right would typically be provided upfront in the investment transaction documentation. The regulatory regime in connection with ADRs and GDRs is discussed later in this paper.

3. FCCBs - These are basically considered as external commercial borrowings of the Indian company. They provide for an interest return to the investor for a specified maturity period at the end of which they can be converted into equity shares of the issuing company. FCCBs would in principle, provide essentially the same kind of comfort to the investor, i.e. liquidity in international markets. However, it may be mentioned that FCCBs are not as popular or commonly accepted internationally as are ADRs and GDRs. This is one reason why companies seeking to raise money through equity expansion prefer the ADR/GDR route to the FCCB route.

STAGE IV: DOCUMENTATION

Once the due diligence and the structuring exercise are completed, the critical stage of documentation comes into the picture. The documentation is typically by way of a share purchase agreement or a share subscription agreement, depending upon the deal commercials, coupled with a shareholders agreement. There can be several ancillary documents such as non-compete agreement, confidentiality agreement etc.

The shareholders agreement is an important document that binds the parties to the transaction as well as becomes binding against the company once the same is assimilated into the articles of association or charter documents of the company. It contains crucial clauses which pertain to the downside protection as well as exit options available to the investor.

Downside Protection

This may require some level of planning in addition to other factors influencing the investor's choice of the instrument it would like to receive in respect of its investment. While investors from the US, UK etc. are more familiar and conversant with certain mechanisms for providing these downside protections, some of these mechanisms may not work in India and may have to be either modified to suit Indian laws or replaced with alternate mechanisms that would work in the Indian legal system.

In most cases, particularly in private equity investments, the investor seeks to ensure a downside protection against dilution by way of a ratchet mechanism. The basic principle on which the ratchet mechanism operates is that whenever the company issues additional shares to a third party at a price that is lower than the investor's entry price, then such investor would get issued such number of additional shares at no cost to ensure anti-dilution of the investor at no additional cost. While this is a fairly accepted term in virtually all private equity investments, Indian law poses certain practical difficulties in giving effect to this kind of a ratchet mechanism.

Indian company law requires that no shares can be issued by a company at a discount to par value[12]. Therefore, it is not possible to issue shares at no cost to any shareholder as envisaged in the ratchet mechanism. One has to find indirect and often complicated means of funding the ratchet. Although these kinds of transactions have not been too numerous in India, the mechanisms which can be used to give effect to the ratchet given the constraints under Indian law are, by way of a bonus issue, or issuance of the additional shares at the least legally permissible price. Additionally, the investor typically has a veto right on any future issuances, particularly if such issuance is at a lower price than the investor's entry price. In the event the investor holds convertible instruments (such as preference shares), it may be easier to effect a ratchet mechanism by adjusting the conversion ratio.

Further, rights such as liquidation preference also need to be structured and documented carefully to mitigate risks of such rights being held unenforceable under Indian laws.

Exit Options

At the time when an investor makes an investment into a company in India, it is also thinking about the exit options open to it under Indian laws. Exit strategy is a very critical part of making investments, not only for private equity players but even for strategic business investors. It is often extremely critical for an investor to be able to divest its holdings and exit in the most profitable and expeditious manner. Further, given the constant changes in the business environment, the investor's exit strategy may have to be adaptable and flexible to change. Investors would therefore have to adopt an investment structure that would afford them maximum flexibility in their exit strategy and the most number of exit options.

The following are, broadly speaking, the most common exit options available to offshore private equity and strategic investors:

- IPO in India - If the Indian markets look promising, which currently are experiencing a slump, and the investor feels comfortable that an exit in the Indian stock markets would give it a good exit opportunity, then the investor could exit after an IPO. It must be noted however, that as per the DIP Guidelines, all pre-IPO share capital of a company would be locked-in for a period of one year after the completion of the IPO. An exception has been carved out in this regard for VCFs/FVCIs registered with the SEBI provided that they have held these shares for at least one year prior to the IPO. Therefore, offshore funds, which are registered with the SEBI as FVCIs would be entitled to this exception (provided that they have held these shares for at least one year prior to the IPO) and can divest their holdings immediately after an IPO.

[12] Section 79 of the Companies Act, 1956.

- ADR/GDR Listing - The investor could also, if it held its investment in the form of ADRs/GDRs as explained earlier, exit at the time of an ADR/GDR issue by the company in an overseas market. The investor would, pursuant to its registration rights under the investment transaction documents, be entitled to concurrent registration of the ADRs/GDRs held by it along with the public issue and would therefore get tradability in the overseas markets. Alternatively, even if the investor held its investment in the company in the form of equity shares, it could exit by way of a sponsored ADR/GDR program once the company gets listed. This would provide the investor the opportunity to exit in an overseas market at the time of an ADR/GDR issue by the company. However, under prevalent Indian laws, an Indian company is required to list in a recognized Indian stock exchange prior to or simultaneous with an overseas listing.

- Strategic Sale - The investor could also exit by way of a strategic sale of its holding in the company to another party who may wish to buy that stake for strategic reasons. If the transferee is an Indian resident, then as per the FDI Regulations notified by the RBI, if the investee company is listed at the time of exit, then the investor cannot exit at a price that is higher than the prevailing market price of the shares[13]. In case the Indian company is unlisted at the time of such exit through a strategic sale, then the exit price will have to be as determined by a chartered accountant or an investment banker registered with SEBI[14]. This exit pricing restriction can place a huge fetter on the ability of non-resident investors to charge a high premium to sell their stakes to parties who are interested in acquiring the same for reasons of high strategic importance. However, the RBI has carved out a specific exemption from this exit pricing restriction for FVCIs registered with SEBI and such entities can exit at a mutually agreed price. Further, if the strategic buyer happens to be another non-resident party, then again, the exit pricing restrictions of the RBI will not be applicable.

CONCLUSION

The private equity regime in India is still evolving. India continues to offer great investment opportunities not only in the knowledge sectors, but now also in more traditional sectors such as manufacturing, banking, pharmaceuticals and others, which are likely to attract significant amounts of investment. The regulators have also made their intentions clear that they are willing to go the extra mile to facilitate such inflow of venture capital investments into the country.

[13] See supra n.5.

[14] Ibid.

REAL ESTATE FUND INVESTMENTS

The potential is undeniable - with a size close to USD 14 billion and growth rate of around 30 percent every year, the Indian realty sector was bound to witness a sudden upsurge on account of multiple factors including rising domestic demand from the IT, ITES and the manufacturing sector, increased disposable income in the hands of individuals, unprecedented growth in the domestic consumerism, stable interest rate regime and last but not the least, the opening up of the real estate sector to foreign investment. On account of the attractiveness of the returns and the great potential ahead, it was not surprising to see the advent of dedicated real estate funds ("REFs") being floated to tap the appetite of domestic and foreign investors alike. The names doing the rounds are IndiaREIT, HDFC, Red Fort, ICICI Ventures, IL&FS, Kotak, Ascendas, Pantaloon and some others. Thus, this special feature analyzes the legal, regulatory and tax implications impacting India focussed REFs.

ADVANTAGE INDIA

Real estate is one of the fastest growing sectors in India. Market analysis pegs returns from realty in India at an average of 14 percent annually, with research estimates indicating that the Indian real estate market is expected to grow from the current USD 14 billion to a USD 102 billion in the next 10 years[1]. Indian real estate has huge potential demand in almost every sector especially commercial, residential, retail, industrial, hospitality, healthcare, special economic zones, etc. Commercial office space requirement is led by the burgeoning outsourcing and Information Technology Industry, and led to increase exponentially as the outsourcing boom moves into the manufacturing sector.

EXCHANGE CONTROL IMPLICATIONS

Prior to June 1, 2000, foreign investment in Indian securities, including the acquisition, sale and transfer of securities of Indian companies, was regulated by the Foreign Exchange Regulation Act, 1973 ("FERA") and the notifications issued by the Reserve Bank of India ("RBI") thereunder. Foreign investments into India are now regulated by the provisions of the Foreign Exchange Management Act, 1999 and the rules and regulations issued thereunder by the RBI or Central Government, as the case may be ("FEMA").

By and large, foreign direct investment is now permitted in almost all sectors in India via the "automatic route," save for some exceptional cases such as atomic energy, gambling, etc. (commonly referred to as the "negative list"). Under the automatic route, the details of the investments must be filed with the RBI within the prescribed time. However, if the investment is not in accordance with the prescribed guidelines or if the activity falls under the negative list, prior approval has to be obtained from the Foreign Investment Promotion Board ("FIPB").

With this brief discussion on the potential of the housing and real estate sector, we now proceed to discuss the legal, regulatory and tax implications of structuring India centric REFs, including some of the recent developments on

[1] http://www.icicibankcom/pfsuser/icicibank/ibanknri/nrinewversion/commercial.realestate.htm, visited on November 4, 2005

the regulatory front impacting the structuring and commercial decisions for REFs.

As per section 6 of FEMA, "any person may sell or draw foreign exchange to or from an authorized person for a capital account transaction". In other words, capital account transactions are prohibited unless specifically permitted by the RBI in pursuance of regulations issued under section 6(3) read with section 47 of FEMA. Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2000 ("TISPRO Regulations") are the relevant regulations issued by the RBI in this regard.

Sub-regulation 4 of the TISPRO Regulations stipulates that an Indian entity shall not issue any security to a person resident outside India or shall not record in its books any transfer of security from or to such person unless permitted under FEMA.

Sub-regulation 5 of the TISPRO Regulations lay down the conditions subject to which foreign investors would be permitted to invest into Indian securities. For sake of analysis, the sub-regulation 5 has been classified into its sub components in Table 1.

Classification of Sub-Regulation 5 of TISPRO Regulations

Sub-regulation	Deals with	Applicable schedule
5(1)	Investments by foreign individuals (other than citizens of Bangladesh and Pakistan) and foreign entities	Schedule 1
5(2)	Investments by registered Foreign Institutional Investors ("FIIs")	Schedule 2
5(3)(i)	Investments by Non Resident Indians ("NRIs") under Portfolio Investment Scheme in shares and debentures of an Indian Company	Schedule 3
5(3)(ii)	Investments by NRIs other than under Portfolio Investment Scheme in shares and debentures of an Indian Company on non-repatriation basis	Schedule 4
5(4)	Investments by NRIs or registered FIIs in securities other than shares and debentures of an Indian Company	Schedule 5
5(5)	Investments by registered Foreign Venture Capital Investors	Schedule 6
5(6)	Investments by registered FIIs in exchange traded derivative contracts	-
5(7)	Investments by NRIs out of INR funds on Non-repatriation basis	-

Table 1

Each of the schedules to the TISPRO Regulations (as referred to in the above table) lay down specific conditions governing the investment by that particular category of investors. For example, the Foreign Direct Investment ("FDI") Scheme (that stipulates the sectoral caps) forms part of Schedule 1 to the TISPRO Regulations.

Only NRIs/Persons of Indian Origin[2] ("PIOs") are permitted to invest in real estate and housing property and not other foreign residents, while infrastructure projects, integrated townships and other construction-development projects involving large infusion of foreign investments have been opened up for other foreign investors, albeit, subject to various conditions.

INVESTMENTS BY NRIS

As per TISPRO Regulations, NRIs are permitted to invest in the following activities in the real estate sector:

- Development of serviced plots and construction of built up residential premises;
- Investment in real estate covering construction of residential and commercial premises including business centers and offices;
- Development of townships;
- City and regional level urban infrastructure facilities;
- Investment in manufacture of building materials (which is also open to FDI);
- Investment in participatory ventures in the above; and
- Investment in housing finance institutions (which are also open to FDI as non-banking finance companies).

While the above list appears broader than the opportunities open for foreign investors (discussed herein below), the TISPRO Regulations unfortunately are silent as to whether NRIs investing through their offshore companies or through offshore REFs, would still be entitled to investment opportunities specified for NRIs, or whether such offshore companies owned 100 percent by NRIs would be regarded as 'foreign investor' and thus be ineligible for the above broader investment opportunities.

In addition to the above, NRIs and PIOs can acquire any immoveable property in India other than agricultural land/plantations/farmhouse, by way of purchase, gift or inheritance. In case of sale of such property, the NRIs/PIOs are permitted to repatriate the sale proceeds, subject to the following conditions[3]:

- In case of residential property, repatriation is allowed only up to a maximum of two properties;
- The amount to be repatriated cannot exceed the amount paid for acquisition of immovable property in foreign exchange;
- In the case of purchase of the property out of rupee funds, repatriation is allowed from the Non Resident Ordinary accounts up to USD 1 million per year, provided the property and/or sale proceeds in the NRO account.

INVESTMENTS BY OTHER FOREIGN INVESTORS

The first step towards opening of the real estate sector for foreign investors was taken by the Government of India vide issue of Press Note No. 4 (2001 series) which permitted FDI up to 100% for development of integrated townships[4], including housing, commercial premises, hotels, resorts, city and regional level urban infrastructure facilities such as roads and bridges, mass rapid transit systems and manufacture of building materials. Thus, while FDI in integrated townships was opened up in 2001, the real boost for foreign investment came with the issue of Press Note 2 (2005 series) dated March 3, 2005 ("Press Note 2") which not only dilutes the minimum development area for integrated townships from 100 acres to 25 acres but more importantly opened up the sector for foreign investment in many other forms of construction and development. Therefore, as per Press Note 2, 100 percent foreign investment is now permitted in townships, housing, built-up infrastructure and construction-development projects (which would include, but not be restricted to,

[2] PIO means an individual, not being a citizen of Pakistan, Bangladesh, Sri Lanka, China, Iran, Nepal or Bhutan, who (i) at any time held Indian Passport or (ii) ho or either of whose father or grandfather was a citizen of India by virtue of Constitution of India or the Citizenship Act,1955.

[3] Investments under the Foreign Exchange Management (Acquisition and Transfer of Immoveable Property in India) Regulations, 2000 issued by the RBI

[4] Development of land and providing allied infrastructure was considered forming an integrated part of township's development.

EXCHANGE CONTROL IMPLICATIONS

housing, commercial premises, hotels, resorts, hospitals, educational institutions, recreational facilities, city and regional level infrastructure), through the automatic route, subject to satisfaction of following conditions:

- Minimum area to be developed under each project:
  1. in case of development of serviced housing plots, a minimum land area of 10 hectares;
  2. in case of construction-development projects, a minimum built-up area of 50,000 square meters; and
  3. in case of a combination project, any one of the above two conditions would suffice.

- Capitalization and lock-in requirements:
  1. minimum capitalization of USD 10 million for wholly owned subsidiaries and USD 5 million for joint ventures with Indian partners. The funds would have to be brought in within six months of commencement of business of the company.
  2. original investment, i.e. the minimum capitalization amount cannot be repatriated before a period of three years from date of completion of minimum capitalization. However, the investor may be permitted to exit earlier with prior approval of the Government through the FIPB.

- At least 50 percent of the project must be developed within a period of five years from the date of obtaining all statutory clearances. The investor would not be permitted to sell undeveloped plots.

  For the purpose of Press Note 2, "undeveloped plots" would mean where roads, water supply, street lighting, drainage, sewerage, and other conveniences, as applicable under prescribed regulations, have not been made available. It will be necessary that the investor provides this infrastructure and obtains the completion certificate from the concerned local body/service agency before he would be allowed to dispose off serviced housing plots.

- The project shall conform to the norms and standards, including land use requirements and provision of community amenities and common facilities, as laid down in the applicable building control regulations bye-laws, rules, and other regulations of the State Government/Municipal/Local Body concerned.

- The investor shall be responsible for obtaining all necessary approvals, including those of the building/layout plans, developing internal and peripheral areas and other infrastructure facilities, payment of development, external development and other charges and complying with all other requirements as prescribed under applicable rules/bye-laws/regulations of the State Government/ Municipal/Local Body concerned. The State Government/Municipal/Local Body concerned, which approves the building / development plans, would monitor compliance of the above conditions by the developer.

Please refer to the actual text of Press Note 2 attached herewith in **Annexure 1.**

Despite the further liberalized policy introduced by Press Note 2, several questions remain unanswered in the press note. For example, whether foreign investment is permitted only at the "initial" or "development stage" or whether a foreign investor can participate in a project till an

"occupation certificate" is issued. Also, it is unclear as to whether the minimum capitalization has to be brought in within 6 months of commencement of business of the Indian company or within 6 months of signing of the investment agreement by the foreign investor. On account of the growth and economic opportunities of this sector, a clarification on these ambiguities is a must.

Apart from the above, foreign investment is also permitted in the following activities:

Roads & Highways, Ports and Harbours

100 percent FDI is permitted under the automatic route in projects for construction and maintenance of roads, highways, vehicular bridges, toll roads, vehicular tunnels, ports and harbours.

Airports

Upto 100 percent FDI permitted. However, investment by foreign investors beyond 74 percent requires prior approval of the FIPB.

Mass Rapid Metro Transit System

FDI up to 100 percent is permitted on an automatic basis in Mass Rapid Metro Transit System in all metres, including associated real estate development.

Special Economic Zones

100 percent FDI is permitted under the automatic route. Conditions relating to area, minimum outlay, etc. would be such as may be stipulated under the Special Economic Zones Act 2005 and rules issued thereunder.

Industrial Parks, Model Towns and Growth Centres

FDI up to 100 percent is permitted in Industrial Parks subject to the approval of Empowered Committee that has been setup by the Government of India and, inter alia, the following conditions:

- The industrial park should comprise of a minimum of 10 units and no single unit shall occupy more than 50% of the allocable area.
- The minimum percentage of the area to be allocated for industrial activity shall not be less than 66% of the total allocable area.

In the above context, the term "allocable area" in the industrial park means:

1. In the case of plots of developed land - the net site area available for allocation to the units, excluding the area for common facilities.
2. In the case of built up space - the floor area and built up space utilized for providing common facilities.
3. In the case of combination of developed land and built-up space - the net site and floor area available for allocation to the units excluding the site area and built up space utilized for providing common facilties.

Health care

100 percent FDI is allowed in this sector.

Hotels & Tourism

100 percent FDI is permitted. Hotels include restaurants, beach resorts, and other tourist complexes providing accommodation and/or catering and food facilities to tourists. Tourism related industry include travel agencies, tour operating agencies and tourist transport operating agencies, units providing facilities for cultural, adventure and wild life experience to tourists, surface, air and water transport facilities to tourists, leisure, entertainment, amusement, sports, and health units for tourists and Convention/Seminar units and organizations.

PRICING CONSTRAINTS

FEMA also regulates the price at which a foreign investor invests into an Indian company. Accordingly, shares in an unlisted Indian company9 may be freely issued to a foreign investor, subject to the following conditions being satisfied:

- The foreign investor subscribes to the Indian company's shares at a price that is not lower than the floor price computed on the basis of the "ex-CCI" formula which is the equivalent to the average of Net Asset Value per share and Profits Earnings Capacity Value per share;
- The consideration for the subscription is brought into India prior to or at the time of the allotment of shares to the foreign investor.

If any of the above conditions is not complied with, then the prior approval of the FIPB and/or the RBI would be required. However, if the foreign investor is a Foreign Venture Capital Investor registered with the Securities Exchange Board of India ("SEBI"), then the above pricing restrictions would not apply.

ACQUISITION OF SHARES THROUGH SECONDARY PURCHASE

Generally, for any transfer of shares between residents and non-residents resulting from purchase or sale transaction, no prior permission of the FIPB or the RBI is required provided such transfer of shares is done in compliance with the guidelines issued by the RBI and the price for such transfer is in accordance with the RBI pricing guidelines in this regard. As per the pricing guidelines, in respect of an investment into an unlisted company, the price is based on the "ex-CCI formula" and in case of listed companies; the pricing should be based on the trading price of the shares on a stock exchange and in respect of exit from an unlisted company, the price is based on the price determined by the investment banker or the chartered accountant and in case of listed companies; the pricing should be based on the trading price of the shares on a stock exchange. However, a specific exemption from the above pricing guidelines has been made for SEBI registered Foreign Venture Capital Investors.

EXISTING JOINT VENTURE OR COLLABORATIONS

As discussed above, under the Indian exchange control regime, FDI is permitted in various sectors in India without prior regulatory approval. However, as per the erstwhile Press Note 18 (of 1998) this automatic route of making investments into India was not available in the event the foreign investor "has or had any previous joint venture ("JV") or technology transfer/trademark agreement in the same or allied field". This condition was laid down in the guidelines pertaining to approval of foreign/technical collaborations under the automatic route with previous ventures/tie-up in India issued on December 14, 1998 by the Ministry of Commerce, Government of India (and commonly referred to as Press Note 18). Thus, where the foreign investor did not qualify for the automatic route, he needed to seek the prior approval of the FIPB by filing justification and proof before the FIPB that the new undertaking would not jeopardize the interests of the existing JV or technology/ trademark partner.

After several representations and back and forth by Government of India on this issue, Press Note 18 was finally scrapped and replaced by the new Press Note 1 (2005 series) dated January 12, 2005.

The said Press Note No. 1 has narrowed down the scope of the policy issue depicted under Press Note 18 to JVs under the "same" field. Thus, as per Press Note 1, prior FIPB approval is required only in cases where the foreign

investor has an existing JV or technology transfer or trademark agreement in the "same" field. The onus to provide requisite justification as also proof that the new proposal would or would not jeopardise the existing JV or other stakeholders would lie equally on the foreign investor or technology supplier and the Indian partner. Further, Press Note 3 (2005 series) has clarified that "existing" means JV or technology transfer or trademark agreements existing as on the date of Press Note 1, viz. January 12, 2005.

Even if the foreign investment is falling in the "same" field, the Government has carved out following exceptions, for which no prior FIPB approval is required:

- Investments are made by Venture Capital Funds registered with the SEBI;
- The existing JV investment by either party is less than 3 percent;
- The existing JV or collaboration is defunct or sick.

DEBT STRUCTURING

Leveraging is a critical component in structuring of real estate investments into India. Foreign debt structuring would especially trigger certain additional compliances under the Indian exchange control regime. Any debt to be taken by an Indian company from foreign sources has to comply with the External Commercial Borrowing Guidelines ("ECB Guidelines") issued by the RBI[5].

As per the ECB Guidelines, external borrowings are permitted on an automatic basis (i.e. without any prior regulatory approval) provided such borrowings comply with the conditions stipulated therein, inter alia, such as:

- Lender should qualify as a "recognized lender" as contemplated under the ECB Guidelines (e.g. suppliers of equipment, foreign collaborators, foreign equity holders, etc.);

- Minimum maturity period (e.g. in case of ECBs above USD 20 million and up to USD 500 million, the minimum average maturity is stipulated as 5 years);

- Maximum amount of ECB which can be raised in one financial year (viz. USD 500 million for corporates and USD 5 million for non-governmental organizations engaged in micro finance activities);

- All-in-cost ceilings (which includes rate of interest, other fees and expenses in foreign currency except commitment fee, prepayment fee, and fees payable in Indian Rupees, which is 300 basis points above 6 month LIBOR in case of ECBs having an average maturity period of between 3 to 5 years and 500 basis points above 6 month LIBOR in case of ECBs having an average maturity period of more than 5 years). However, as per a recent amendment[6] to the ECB Guidelines, the RBI has done away with the above-mentioned all-in-cost ceilings till June 30, 2009. Accordingly, eligible borrowers, proposing to avail of ECB beyond the permissible all-in-cost ceilings specified above could approach the Reserve Bank under the Approval Route;

- End-use restrictions, e.g. ECB proceeds cannot be used for working capital, general corporate purpose, acquisition of shares by an Indian company, repayment of existing Rupee loans, etc. As per the above-mentioned amendment[7] to the ECB Guidelines, the RBI has withdrawn the restriction as placed on the 'development of integrated township' as a permissible end-use of ECB and has therefore, allowed

[5] Circular no 16 dated October 4, 2004, A.P. (DIR Series) Circular No. 5 dated August 1, 2005

[6] Ref. A.P. (DIR Series) Circular No. 46 bearing number RBI/2008-09/343, dated January 2, 2009

[7] Ibid n. 6

PRICING CONSTRAINTS

real estate companies to avail ECB under the Approval Route, provided they are engaged in the development of integrated township, as defined in Press Note 3 (2002 Series) dated January 04, 2002, issued by DIPP, Ministry of Commerce & Industry, Government of India[8].

In case of debt being raised by Indian companies from local banks, the RBI has issued some indicative guidelines for banks to put in place a "risk management system" for identification, assessment and containing risks undertaken by banks in terms of their exposure to the real estate sector. The RBI has also prescribed certain additional disclosure norms for banks to report their real estate exposures to the RBI, as follows[9]:

- Direct exposure;
- Residential Mortgages-lendings fully secured by mortgages (self occupied by borrower or rented), individual housing loans up to Rs.15 lakh to be shown separately;
- Commercial real estate-lendings fully secured by mortgages, including non fund based limits;
- Indirect exposure - fund based and non-fund based exposures on National Housing Bank and housing finance companies;
- Annual reports of the banks should also disclose the gross exposure to real estate sector, including the direct and indirect exposure as above.

USE OF INSTRUMENTS

As per the RBI Circulars dated June 7, 2008 and June 8, 2008, FDI can be routed into Indian investee companies by using fully and compulsorily convertible preference shares or fully and compulsorily convertible debentures, and non-convertible, partially convertible or optionally convertible preference shares and/or debentures shall be considered to be ECB and therefore, be subject to the aforesaid ECB Guidelines.

These fully and compulsorily convertible preference shares and fully and compulsorily convertible debentures are regarded at par with equity shares and hence the same are permissible as FDI. Further, FDI as routed through the issuance or purchase of the same shall be considered towards satisfying the minimum capitalization norms.

VENTURE CAPITAL REGIME

In April 2004, SEBI opened a small window for real estate investments under the Venture Capital Fund ("VCF") and Foreign Venture Capital Investor ("FVCI") regime.

Investments by VCFs are governed by the SEBI (VCF) Regulations, 1996 ("VCF Regulations") whereas investments by FVCIs are governed by the SEBI (FVCI) Regulations, 2000 ("FVCI Regulations"). SEBI amended the VCF and FVCI Regulations by removing "real estate" from the Third Schedule-Negative List to these regulations. Thus, VCFs and FVCIs can invest in venture capital undertakings ("VCUs") engaged in real estate activities, subject to the investment conditions and

[8] Integrated township includes housing, commercial premises, hotels, resorts, city and regional level urban infrastructure facilities such as roads and bridges, mass rapid transit systems and manufacture of building materials. Development of land and providing allied infrastructure forms an integrated part of township's development. The minimum area to be developed should be 100 acres for which norms and standards are to be followed as per local bye-laws/rules. In the absence of such bye-laws/rules, a minimum of two thousand dwelling units for about ten thousand population will need to be developed.

[9] Ref. RBI/2004-05/ 503, DBS.CO.PP.BC 21/11.01.005/2004-05,dated June 29, 2005

restrictions as stipulated in the respective regulations. However, it is pertinent to note that since the last 2 years, SEBI has not granted any FVCI approval to any of the foreign investors for investing in real estate sector in India. For details regarding the investment conditions and restrictions as enumerated in the VCF Regulations, please refer to **Annexure 2.**

One of the important developments on the VCF front is the recent de-recognition of venture capital sector as a priority sector by RBI. Historically speaking, as per RBI's Master Circular on Lending to Priority Sector, investments made by the scheduled commercial banks in venture capital were reckoned under "priority sector lending", provided the VCFs/companies were registered with SEBI under the VCF Regulations. On July 1, 2005, this treatment was revoked by RBI and accordingly:

- Fresh investments by banks on or after July 1, 2005 in venture capital shall not be eligible for classification under priority sector lending;
- Investments, which have already been made/to be made by banks up to June 30, 2005, in venture capital shall not be eligible for classification under priority sector lending with effect from April 1, 2006.

This could have an impact on the marketing of REF securities as domestic banks have traditionally been one of the largest investors in VCFs.

On the FVCI front, the benefits available to a foreign investor which registers itself as an FVCI are as follows:

- As per the notification issued by the RBI, FVCIs benefit from free entry and exit pricing. Under the FEMA, the entry and exit pricing of non-resident investors under the FDI route is regulated. A special exemption has been granted to FVCIs whereby they will be exempted from both the entry and exit pricing regulations.
- SEBI has also exempted transfer of shares from FVCIs to the promoters from the public offer provisions under the Takeover Code, if the portfolio company gets listed post investment This ensures that if the promoters have to buy back the shares from the FVCIs, they will not be burdened with the public offer requirement which otherwise could require them to make an offer to the other shareholders of the company to buy from them up to 20 percent of the paid-up capital of the company.
- FVCIs registered with SEBI have been accorded "Qualified Institutional Buyer" status and would accordingly be eligible for subscribing to securities at the initial public offering of a Venture Capital Undertaking through the book-building route.
- Under the SEBI (Disclosure and Investor Protection) Guidelines, 2000, the entire pre-issue share capital of a company going in for an IPO is locked for a period of one-year from the date of allotment in the public issue. However, an exemption has been granted to domestic VCFs and FVCIs registered with SEBI, if the VCF and the FVCI have been holding shares in the issuer company at least a year prior to the filing of the offer document with SEBI. This would essentially allow the FVCIs to exit from their investments post-listing.
- Generally the definition of a 'promoter' under the SEBI (Disclosure and Investor Protection) Guidelines, 2000 is very broad and includes any person who has a role to play in the decision of a company going in

VENTURE CAPITAL REGIME

for an IPO. A private equity investor generally reserves certain veto rights in the company and in most cases is actively involved in the IPO decision by the Company. If the private equity investor is not registered as FVCI, there is a possibility that the private equity investor be treated as a part of the promoter group thereby subjecting it to certain onerous requirements otherwise applicable to promoters. SEBI has clarified that a SEBI registered VCF or an FVCI would not be treated as 'promoter' for the purpose of the above guidelines.

- As indicated earlier, SEBI has not granted any FVCI registrations to any foreign investor for the past 2 to 2½ years on account of certain policy-level issues and hence majority of foreign investments in Indian realty sector have been made under the FDI regime.

POSSIBLE STRUCTURES

FUND FORMATION

From the structuring perspective, the structures that can be evolved would depend on the type of investors, jurisdiction of investors and the type of real estate projects being targeted. The REF could either be a pure domestic fund set up as a VCF/VCC or a pure offshore fund set up as a company or FVCI, which would invest into domestic companies (VCUs) engaged in real estate activities. Several variants could then be carved out resulting in parallel or unified structures.

The structuring exercise also entails deciding upon an appropriate jurisdiction for setting up the fund. While India has a sizeable treaty network, not many of the treaties offer exemption from tax on capital gains, as is the case with Mauritius, Cyprus, Netherlands, etc. In this regard, Singapore is the "new kid on the block" as it offers same benefit on capital gains as the Mauritius treaty and thus becomes a jurisdiction worth exploring for structuring of the offshore pooling vehicle. Accordingly, as per the Protocol to the India-Singapore tax treaty; a Singapore fund can now enjoy the same Indian capital gains tax exemption as is the case with a Mauritius fund claiming under India-Mauritius tax treaty. However, the availability of capital gains tax exemption under the Protocol is subject to the following "limitation of benefits" provisions:

- the Singapore resident should not so arrange his affairs with the primary purpose of taking advantage of the benefits of the India-Singapore tax treaty. This would include instances where the resident does not have any bona fide business activities in Singapore;
- the Singapore resident should not be a shell/conduit company;

  For the purposes of this provision, a shell/conduit company is any legal entity falling within the definition of a resident with negligible or nil business operations or with no real and continuous business activities being carried out in Singapore. In addition -

  1. a Singapore resident shall be deemed to be a shell/conduit company if its total annual expenditure on operations in Singapore is less than S$200,000, in the immediately preceding period of 24 months from the date the gains arise; or

2. a Singapore resident is deemed not to be a shell/conduit company if it is listed on a recognised stock exchange in Singapore.

Thus, as is evident from the above, the limitation provisions stipulated under the Protocol may pose difficulties in claiming benefits under the India-Singapore tax treaty, there being no such caveats under the India-Mauritius tax treaty or for that matter under the India-Cyprus tax treaty. However, it is also pertinent to note that the India-Cyprus tax treaty is currently under renegotiation and it may be possible that the provisions relating to capital gains tax exemption benefits provided by the treaty may be amended. Accordingly, Mauritius still remains the most preferred jurisdiction to invest in Indian real estate sector.

In case of REFs, the choice narrows down further as India reserves the right to tax gains on direct or indirect holdings in properties. Added complications arise on account of the desire to use structured products for investments, entailing a regular flow of interest income to investors. In this scenario, Cyprus appears to be a more promising jurisdiction than Mauritius, especially since investor confidence is growing on account of its accession to the EU. The other critical component to be borne in mind while performing the structuring exercise is the exposure to Permanent Establishment ("PE"). PE is that degree of economic penetration which according to the agreement of treaty partners justifies a nation in treating a foreign person for income tax purposes in the same manner as domestic persons are treated[10] . It is pertinent to note that any profits derived from transfer of shares of an Indian company would be regarded as capital gains only if the foreign investor does not have a PE in India.

Here it would be pertinent to note the observations of the Andhra Pradesh High Court in the case of CIT vs. Visakhapatnam Port Trust[11] :

"In our opinion, 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."

Thus, according to Article 7 read with Article 5 of the tax treaties, the business of a foreign entity is subject to tax in India only to the extent the same is attributable to its PE in India. Thus, while structuring it is important to ensure that no PE exposure is created for the offshore pooling vehicle or the offshore investors as this may lead to loss of capital gains tax exemption under the tax treaty and may trigger Indian tax implications. A PE could be created if the offshore pooling vehicle/investor is regarded to have a fixed place of business in India, or has an office in India, or has a dependent agent in India. Further, it is important to note that in case offshore pooling vehicle/investor coming from a non treaty country, this exposure gets enhanced as the PE-equivalent concept under the ITA, viz. Business Connection ("BC") has a broader gamut and is defined in less clearer terms as compared to PE under a tax treaty scenario. While the PE/BC exposures may be structurally addressed, it is equally important that the checks-and-balances built into the structures are adhered to in practical and factual terms as determination of PE/BC is a fact driven exercise and there is no straight jacket formula available to mitigate the risk in its entirety.

[10] John Huston and Lee Williams, Permanent Establishments a planning primer [1993]

[11] 146 ITR 162 (AP)

POSSIBLE STRUCTURES

REF INVESTMENTS

By using the various tax-friendly jurisdictions, the following legal, tax and exchange-control efficient structures for routing REF investments could be explored:

- **Mauritius-India Structure**

  In this structure, the India-Mauritius tax treaty can be used to maximize the capital gains tax exemption benefits arising from exit by the Mauritius Fund. The equity shares and/or fully and compulsorily convertible preference shares ("FCCPS") could be issued or purchased under the FDI route by the Investor. This structure, besides being legally compliant, shall also be tax-efficient because, at the time of exit of the Investor, the capital gains tax as arising out of the transfer of the equity shares and/or FCCPS by the Investor shall be exempt from tax on account of the India-Mauritius tax treaty.

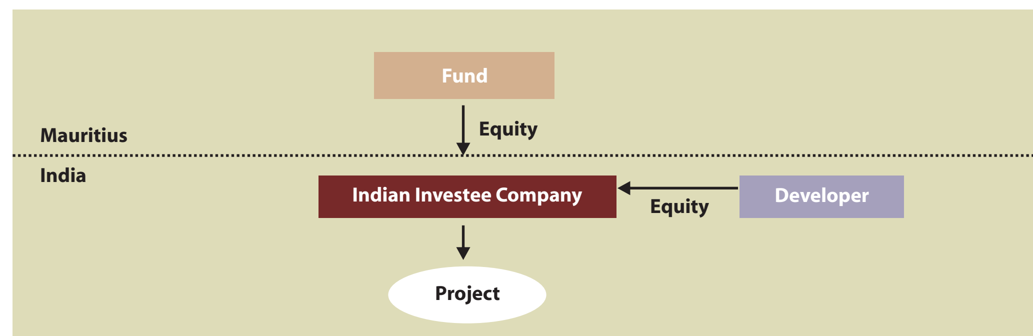


Figure 1

- **Cyprus-India Structure**

  This structure is distinct from the above structure on account of the fact that instead of equity or quasi-equity, quasi-debt instrument in the form of fully and compulsorily convertible debentures ("FCCDs") is used. As per the India-Cyprus tax treaty, the withholding tax rate on the interest paid on the FCCDs by the Indian company is reduced to 10%. Moreover, the Indian company gets the benefit of 33.99% tax saved by virtue of getting a tax deduction for such interest paid from its taxable income. Furthermore, the aforesaid India-Cyprus tax treaty also provides the same exemption with reference to capital gains tax as the India-Mauritius Double Taxation Avoidance Agreement.

However, there are news reports that suggest that the India-Cyprus tax treaty is undergoing renegotiation and that the provisions relating to capital gains tax exemption benefits may be amended

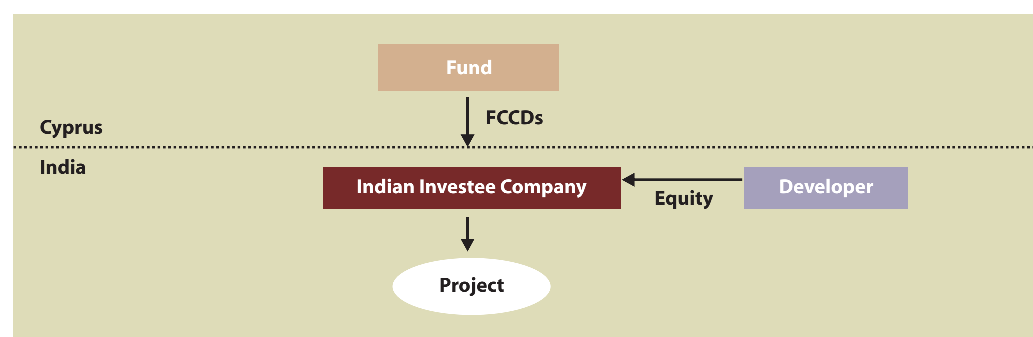


Figure 2

- **Mauritius- Cyprus- India Structure**

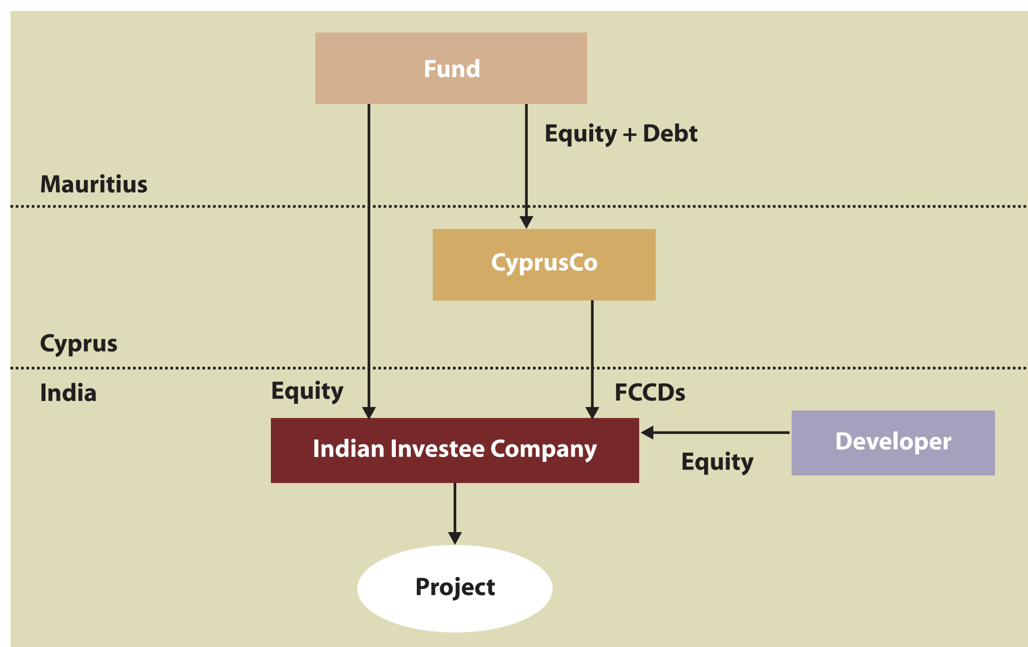


Figure 3

This structure is a combination of the previous two structures. It envisages the investment by way of equity, FCCPS as well as FCCDs. This structure could be explored depending on the commercials of the transaction.

A FEW POSERS?

In the backdrop of the regulatory and tax regime for India centric REFs discussed above, the following emerge as the key considerations in structuring of REFs:

- Need and options for segregation of funds pooled from NRIs, non NRIs and domestic investors-this is critical as it could impact the down line investment opportunities for the REFs;
- Structuring of the foreign investment under the FDI route versus the FVCI route-the ultimate choice of regime being driven by strategic and commercial considerations;
- Structuring of the management structure-domestic versus offshore manager, combination structures, etc. Structuring imperatives for incentivising the employees of offshore/domestic manager and foreign management team add to the significance of the structuring exercise;
- Structuring of creation of a pledge on the Indian immovable property in favour of a non-resident as a collateral for securing FCCDs;
- Structuring of the products to be offered to the clients depending on the risk appetite and preferences of the investors;
- Structuring of exit opportunities, listing options: domestic and abroad.

TAX IMPLICATIONS

Taxation of income in India is governed by the provisions of the ITA as amended by the Finance Acts, from time to time. The ITA lays down elaborate provisions in respect of chargeability to tax, determination of residency, computation of income, et al. Residents are subjected to tax in India on their worldwide income, whereas non-residents are taxed only on Indian source income, i.e. incomes received in India, income that accrues or arises to them in India or is deemed to accrue or arise in India[12]. Section 9 of the ITA stipulates the types of income, which under certain circumstances are deemed to accrue or arise in India, such as interest, royalty, income from any capital asset situated in India, etc. However, in case of a non resident taxpayer being resident of a country with which India has signed a tax treaty, he has the option of being taxed as per the ITA; only to the extent the provisions of the ITA are more beneficial to him.[13]

TAXATION OF INVESTEE COMPANIES

An investee company being a company incorporated in India is regarded as a tax resident of India and is subject to taxation in India on its worldwide income. Currently, domestic companies are taxed at the rate of 33.99 percent on their net profits. Every Indian company distributing dividends to its shareholders is required to pay a Dividend Distribution Tax ("DDT") of 16.995 percent. The dividends so paid by the Indian company are tax-exempt in the hands of the shareholders, irrespective of their residential status. Please note that the DDT is payable by the Indian company despite the fact that the profits from which the dividends are being distributed may be enjoying tax holiday/exemptions except in the case where the dividends are paid by a developer of special economic zone.

Characterization of income

The income of the investee company, depending on the facts and circumstances of the case, may be characterized as "business income" or "income from house property". In the event, the income is characterized and taxed as business income then same is subjected to the full corporate tax of 33.99 percent on net income, i.e. net of all business related expenses and specific tax holidays/exemptions[14] being claimed by the investee company.

In case income of the investee company is taxable as income from house property, only two deductions are available, first being the standard deduction at the rate of 30 percent against the annual value and second being deductions for interest payments if the investee company has borrowed funds for purposes of acquisition, construction, repair, renewal or reconstruction of the property. There is no limit on the amount of interest deductible in case of commercial properties and thus if the interest payable exceeds the rental income, the unabsorbed interest can be carried forward for set off in future years.

Interest Income

Any interest that accrues to an offshore fund is subject to a withholding tax of 10.56 percent in case of interest on Foreign Currency Convertible Bonds issued by the investee company under the Issue of Foreign Currency Convertible Bonds and Ordinary Shares (through Depository Receipt Mechanism) Scheme 1993 (the "Scheme"), or 21.115 percent on loans made to investee company in non-Indian currency not under the Scheme (e.g. under the ECB route) and at the rate of 42.23 percent in case of loans made to the investee companies in Indian currency. The withholding tax rates could stand reduced under the tax treaty, if any, between India and home jurisdiction of the offshore fund. Interest payments to investors in a domestic fund would attract interest withholding at varying rates depending on the tax classification of the investor in the domestic fund.

[12] Section 4 and 5 of the ITA Section 90(2) of the ITA

[13] Unless specified otherwise, all income tax rates mentioned in this article are inclusive of the currently applicable surcharge at the rate of 10 percent on domestic companies and 2.5 percent in case of foreign companies and the education cess of 3 percent on tax and surcharge.

[14] Under sections 80IA/IB of the ITA

Capital Gains

Currently, under the ITA, gains are classified as short-term and long-term depending upon the period of holding[15]. Long-term capital gains earned by an investee company upon sale of any property would be taxed at the rate of 22.66 percent and 33.99 percent in case of short-term capital gains. However, if the income from sale of property is characterized as business income, then the tax rate would be 33.99 percent. Accordingly, one would need to pay attention to the characterization of the gains as business income or capital gains which would again depend on the facts and circumstances of each case.

Minimum Alternate Tax

Where the tax payable by the investee company is less than 10 percent of its book profits, the tax will be deemed to be 10 percent (excluding surcharge and education cess) of such book profits as Minimum Alternate Tax.

Wealth tax

Buildings, residential and commercial premises held by the investee company will be regarded as assets as defined under Section 2(ea) of the Wealth Tax Act, 1957 and thus be eligible to wealth tax in the hands of the investee company at the rate of 1 percent on its net wealth in excess of the base exemption of INR 15,00,000. However, commercial and business assets are exempt from wealth tax.

Service Tax

The service tax regime was introduced vide Chapter V to the Finance Act, 1994. Subsequent Finance Acts, (1996 to 2003) have widened the service tax net by way of amendments to Finance Act, 1994. Service tax is levied on specified "taxable services" at the rate of 12.36[16] percent on the "gross amount" charged by the service provider for the taxable services rendered by him. The Finance Act, 2004 has introduced "construction services" as a taxable service and thus such services provided by the investee company would be subject to service tax in India. Further, the Finance Act, 2007, has brought services provided in relation to renting of immovable property, other than residential properties and vacant land, for use in the course or furtherance of business or commerce under the service tax regime.

Stamp Duty and other taxes

The real estate activities of the VCU would be subject to stamp duties and other local/municipal taxes, property taxes, which would differ from State to State, city to city and between municipals jurisdictions. Stamp duties may range between 3 to 14 percent.

Special Economic Zones

A Special Economic Zone ("SEZ") is a specified, delineated and duty-free geographical region that has different economic laws from those of the country in which it is situated. To provide a stable economic environment for the promotion of export-import of goods in a quick, efficient and trouble-free manner, the Government of India enacted the Special Economic Zones Act, 2005. Developers of SEZs and units set up in SEZs enjoy several fiscal benefits, such as exemption from income tax for specified periods, customs and excise duty exemptions, etc. A unit in the SEZ must however be net foreign exchange positive within a certain period. If a target company is a unit in an SEZ, or registered as any kind of export oriented unit ("EOU"), then its assets may be bonded by the customs authorities, and in such a case, they must be debonded prior to the transfer. Hundred per cent of the profits of the developer arising from the business of developing an SEZ, notified after April 1, 2005 under the SEZ Act, shall be deducted from taxable income. This deduction

[15] Gains earned on sale of assets (other than shares) if held for 36 months or less are classified as short term capital gains, whereas gains earned on sale such assets if held for more than 36 months are classified as long term capital gains.

[16] Excluding currently applicable education cess of 3 percent on service tax

can be claimed at the option of the assessee for any 10 consecutive years out of 15 years beginning from the year in which the SEZ has been notified by the Central Government. If a developer who sets up an SEZ after April 1, 2005, transfers the operation and maintenance of the SEZ to another developer, the transferee is entitled to the above deduction of profit for the remaining period.

TAXATION OF VCF/VCC

As per section 10(23FB) of ITA, a VCF registered with the SEBI under the VCF Regulations is accorded a "pass through" status for income tax purposes, provided that it has been set up to raise funds for investments in "Venture Capital Undertakings" i.e. unlisted or to be listed Indian portfolio companies, in certain specified sectors. These sectors include:

- nano-technology,
- information technology relating to hardware and software development,
- seed research and development,
- bio-technology,
- research and development of new chemical entities in the pharmaceuticals sector,
- production of bio-fuels,
- building and operating certain hotel and convention centers,
- dairy and poultry industries, and
- developing or operating and maintaining or developing, operating and maintaining certain infrastructure facilities.

If the VCF is given pass through status, the income of the VCF is taxable only in the hands of the investors.

Accordingly, the VCF, which is to be organised as a trust ("Trust") shall be accorded pass through status and will be tax exempt in India in respect of any income arising out of investments made in the specified sectors. The investors will be taxable in India in respect of income distributed by the Trust. As per the provisions of section 115U of the ITA, any income distributed by the Trust will be chargeable to tax in the hands of the investors in the same manner as if it were the income of the investors, had they made such investments directly in the Indian portfolio companies.

In the event that the Trust does not make investments into the specified sectors contained in section 10(23FB), pass through status will not be available to it under section 10(23FB) in spite of being registered as a VCF with the SEBI. However, the Trust may still be permitted pass through status as per the provisions of sections 161 to 164 of the ITA. In case of investments by the Trust in the real estate sector, the benefits of section 10 (23FB) will not be available and hence the Trust would be required to claim exemption under section 161 to 164 of the ITA. Similar provisions are also applicable to trusts not registered with SEBI.

TAXATION OF OFFSHORE FUND

The dividends earned by an offshore fund would be tax exempt in its hands. Interest income would be taxed at the rates mentioned under the heading 'interest' above. Capital gains would be taxed at the rate of 0 percent/10.56 percent/21.115 percent/31.67 percent/42.23 percent depending on the nature of security, period of holding and type of investor. As stated above, under certain treaties, capital gains are given partial or complete exemption from capital gains tax. On the other hand, if the income from investments are taxed as business income in the hands of the offshore fund set up as a company, then as stated above, such gains would not be subjected to tax in India in the absence of a permanent establishment/business connection in India or would be taxed at the rate of 42.23 percent on the gains attributable to the permanent establishment/business connection in India.

RECENT DEVELOPMENTS

REITs

Real Estate Investment Trusts ("REITs"), as commonly understood in the international context, are currently non-existent in India, although the same stand proposed through the draft SEBI (Real Estate Investment Trusts) Regulations, 2007 ("REITs Regulations"). This is a result of the several representations as made by players in the real estate industry to permit setting-up of REITs in India.

Why REITs?

The success of the REITs regime in offshore jurisdictions is an indication that REITs are not only popular but also inevitable on account of the following important benefits that they offer to small investors:

- **Liquidity**
  REITs have helped turn real estate liquid. Through the publicly traded REITs structure, investors can buy and sell interests in diversified portfolios of properties-as well as the management associated with them on an instantaneous basis.

- **Security**
  Because real estate is a physical asset with a long life during which it has the potential to produce income, investors always have viewed real estate as an investment option with security. Through REIT structures, small investors have the added level of security that was not available earlier. Low levels of debt practiced by several REITs also mean greater security for financial system as a whole.

- **Diversification**
  Investing in REITs and other publicly traded real estate companies provides diversification benefits because the correlation of REIT returns with the returns of other market sectors is relatively low. The correlation of returns in two different investment categories need not be negative to benefit from diversification. Even low to moderate positive correlation may help to increase long-term risk-adjusted returns[17].

- **Performance**
  Since their inception, REITs have provided competitive investment performance. REITs market performance has been roughly comparable to that of Standard & Poor's 500 Index and has exceeded returns on fixed debt instruments or direct investment in real estate. Since globally REITs also pay out annually almost all of their taxable income, a significant component of total return reliably comes from dividends[18].

Key Highlights of the Draft REITs Regulations

- **Eligibility Criteria for Registration**
  REIT shall be required to have a minimum net worth of Rs. 50,000,000 i.e. approx. USD 1,250,000. However, the REIT would also be eligible for registration, if it has a net worth of Rs. 30,000,000 i.e. approx. USD 750,000 which can be increased to Rs 50,000,000 i.e. approximately USD 1,250,000 within three years from the date of registration with SEBI. Further, the REIT should have adequate infrastructure and good professionals with requisite relevant experience.

- **Scheme**
  The schemes offered by a REIT ("Scheme") shall be close-ended and cannot be open for subscription for a period of more than ninety days. This means that the unit holders cannot redeem their units in the Scheme, but can exit by selling the units on the stock exchange. Further, the Scheme cannot guarantee or assure any returns to the unit holders but only mention indicative return assessed by an appraising agency and stated in monetary terms. A Scheme shall be launched only upon obtaining a rating from a credit rating agency and being appraised by an appraising agency.

[17] http://www.dollardex.com/sg/index.cfmcurrent/contnts/reitoverview&contentID-2289 visited on November 4, 2005.

[18] The REIT IPO Source Book Planning for Real Estate Investment Trust Initial Public Offering.

- **Trust Vehicle and Trustees**
  REITs Regulations provide that a Scheme shall be launched only by a trust registered under the Indian Trusts Act, 1882 and the trust deed shall provide for undertaking real estate investments as per REITs Regulations. The trustees of a REIT should be either a scheduled bank, trust company of such a scheduled bank, public financial institution, insurance company, or a body corporate.

- **Investment Limitations**
  A REIT shall be allowed to only invest in real estate which is generally income generating. However, a REIT shall also be allowed to invest in a building, which is unoccupied and non-income generating, or under redevelopment, provided the aggregate contract value of such properties does not exceed 20% of Scheme's total Net Asset Value. REIT shall not be allowed to invest in vacant land or participate in property development activities.

  A REIT under all its Schemes shall not have exposure of more than 15% of any single real estate project and 25% of all the real estate projects developed, marketed, owned or financed by a single group of companies.

- **Borrowing Restrictions**
  A Scheme can borrow for funding investments and operating expenses but it cannot borrow more than one-fifth of the value of the Scheme's total gross assets.

- **Distribution to Unit holders**
  The Scheme is required to distribute to unit holders at least 90% of its annual net profit after tax as dividends every year.

- **Listing**
  The REITs Regulations provide for compulsory listing of the Scheme on the stock exchanges immediately after the allotment of the units to the unit holders but not later than six weeks from the date of closure of the Scheme on the stock exchange.

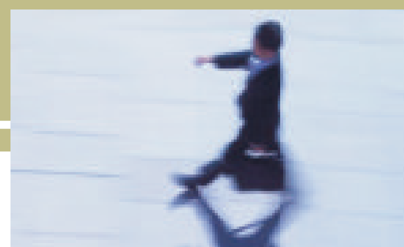
- **Fees**
  The application fees and registration fees payable for a REIT to SEBI shall be Rs. 25,000 (i.e. approx. USD 625) and Rs. 1,000,000 (i.e. approx. USD 25,000) respectively. Further, the filing fees for the offer document shall be Rs. 25,000 (i.e. approx. USD 625). In addition to above, the annual fees shall also be payable by a REIT depending on the Net Asset Value of the REIT.

- **Independence**
  At least 50% of the trustees of the REIT shall be independent persons and not directly or indirectly associated with the persons having a control over the REIT.

- **Valuation Report**
  Every Scheme shall be required to appoint an independent property valuer ("Principal Valuer") who will submit valuation report on properties to be acquired or sold by the Scheme or where new units are offered by the Scheme. The Principal Valuer shall follow the valuation methodology based on the 'valuation standards on properties' published from time-to-time by the concerned Indian institute or the international valuation standards issued from time-to-time by the International Valuation Standards Committee.

- **Real Estate Investment Management Company ("REIM")**
  The Schemes shall be managed by a REIM and the REIM shall be registered with SEBI. The eligibility criteria, application and registration fees and criteria for independence for REIM are similar to criteria prescribed for a REIT.

  It shall be the responsibility of the REIM to calculate the Net Asset Value of the



Schemes of the REIT on the basis of the annual valuation report and disclose the same to the unit holders as per the frequencies specified by SEBI.

REIM shall prepare quarterly report on its activities and submit the same to the trustees of the Trust within one month of the expiry of each quarter. The REIM shall also have certain other reporting requirements to SEBI.

- **Implications**

The following shall be implications of the draft REITs Regulations:

1. REITs could now directly invest in real estate properties unlike a domestic venture capital fund which currently is required to invest in a venture capital undertaking which in turn can own properties. This direct investment by REITs for owning underlying properties will help in reducing taxes by eliminating one entity layer in the ownership structure.

2. It remains to be seen whether a REIT would be eligible for a tax pass through under the domestic tax laws, as is currently available in developed countries, if at least 90% of its annual net profit after tax is distributed as dividends every year to the unit holders as per the REITs Regulations.

3. REITs will help private equity investors to exit from their investments in real estate projects with a shorter payback period as against the current scenario where they have to stay invested for usually four to six years till the real estate projects are completed.

4. It remains unclear from the REITs Regulations and the same will unfold over a period of time as to whether the REITs regime will be open for investment by foreign investors.

5. No mechanism has been prescribed under the REITs Regulations for the migration of the existing schemes registered under the SEBI (Venture Capital Funds) Regulations, 1996 to the proposed REITs regime. Accordingly, the existing domestic venture capital funds will have to wait for some more time to get a clear picture on migration of their existing schemes into a REIT Scheme.

6. As per the REITs Regulations, the development risk has been capped at 20% of the Scheme's Net Asset Value which is in line with the laws in developed countries.

7. For the foreign fund managers proposing to set up their REIT in India, it remains to be seen whether they will be allowed to set up their REIM in India under the automatic route as is currently available to other foreign owned asset management companies.

8. REITs will offer a convenient tool to retail investors, which will relieve them of the necessity to select, acquire, get registered and sell real estate properties and will help minimize the risks related to real estate investments. It remains to be seen whether the Indian REITs regime, once operational, will be able to garner as much interest as currently garnered by offshore REITs regimes in Singapore, Hong Kong, Australia etc.

REMFs

While the REITs Regulations are still in the draft form, SEBI has amended the SEBI (Mutual Funds) Regulations, 1996 ("MF Regulations"), on April 16, 2008, to include a new chapter 49A which provides for setting up and operations of Real Estate Mutual Funds ("REMFs").

Key Highlights of the REMF Regulations

Certain key features of the REMF Regulations are discussed below -

- **Eligibility**

1. In order to set up a new REMF, the sponsor should be carrying on the business in real estate for a period at least five years and fulfill all other eligibility criteria applicable for sponsoring a mutual fund, which provide that the sponsor should have a sound track record and general reputation of fairness and integrity in all his business transactions. The term "sound track record" means the sponsor should

    i. have a networth which is positive in all the immediately preceding five years;

    ii. the sponsor's networth in the immediately preceding year is more than the capital contribution of the sponsor in the asset management company;

    iii. the sponsor has profits after providing for depreciation, interest and tax in three out of the immediately preceding five years, including the fifth year;

    iv. the sponsor is a fit and proper person;

    v. the sponsor has contributed or contributes at least 40% to the net worth of the asset management company, provided that any person who holds 40% or more of the net worth of an asset management company shall be deemed to be a sponsor and will be required to fulfill the eligibility criteria specified in these MF Regulations; and

    vi. the sponsor or any of its directors or the principal officer to be employed by the mutual fund should not have been guilty of fraud or has not been convicted of an offence involving moral turpitude or has not been found guilty of any economic offence

2. Existing mutual funds can launch REMFs if they have adequate number of experienced key personnel/directors.

3. Interestingly, if the REMF has no key personnel with experience in finance and financial services, then 100% of the net assets will be required to be invested in real estate assets.

- **Investment restrictions**

1. REMFs are required to invest at least 35% of its net assets in real estate assets and can invest the balance in mortgage backed securities, securities of companies engaged in dealing in real estate assets or in undertaking real estate development projects and other securities, provided that, if taken together, investments by the REMF in real estate assets, real estate related securities (including mortgage backed securities) should not be less than 75% of the net assets of the REMF. The balance 25% can be invested by the REMF in any other securities. Regulation 49A of the REMF Regulations defines a 'real estate asset' as an identifiable immovable property (i) which is located within India in a specified area (to be specified by the SEBI); (ii) on which construction is complete and which is usable; (iii) which is evidenced by valid title documents; (iv) which is legally transferable; (v) which is free from all encumbrances; and (vi) which is not subject matter of any litigation. The REMF Regulations specifically exclude projects under construction, vacant

land, deserted property, land specified for agricultural use etc.

2. REMFs are not permitted to transfer real estate assets amongst its schemes.

3. REMFs are prohibited from engaging in the business of lending or housing finance activities.

4. REMF are not permitted to invest more than (i) 30% of all its net assets in more than one city, unless disclosed in the offer document; (ii) 15% of its net assets in a single real estate project; (iii) 25% of the issued capital of an unlisted company under all schemes together; and (iv) 15% of net assets of any of its schemes in equity / debentures of an unlisted company.

5. REMFs are prohibited from investing in (i) unlisted securities of the sponsor, its associate or its group company; or (ii) assets owned / previously owned by sponsor or the asset management company or their associates during the past 5 years. REMFs, may, however, invest in listed securities of such companies provided that such investment does not exceed 25% of its net assets.

- **Valuation of assets**

1. Each real estate asset of an REMF should be valued by two valuers accredited by a credit rating agency registered with the SEBI and appointed by the asset management company.

2. The valuation must take place every 90 days from date of purchase of the real estate asset, and the lower of the two values should be taken for the computation of net asset value ("NAV").

3. The NAV is required to be disclosed on a daily basis.

- **Tax Regime**

1. All income arising from the REMF registered under Section 10 (23D) of the Income Tax Act, 1961 will be tax exempt at the hands of the REMF.

2. Under the provisions of Section 10 (35) of the Income Tax Act, 1961 the returns received by the unit holders from the REMF will be tax exempt.

3. REMF will be liable to pay additional income tax on distributions of returns at the rate of 12.5% for individuals and 20% for others if it is not regarded as an equity oriented fund.

4. Unit holder will be exempt from long term capital gains tax if the units are purchased on the floor of a stock exchange and the securities transaction tax thereon has been paid.

- **REITs v. REMFs - An Analysis**

1. ***Investment Ability:*** Whilst REITs are required to invest only in real estate assets and cannot invest in securities, REMFs can invest in securities as well. The unique ability of REMFs to make hybrid investments (in securities and real estate) will not only allow them to make high risk high return investments in securities of a company undertaking construction development projects, but will also give them the leeway to acquire such real estate projects once they are completed.

2. ***Development Risk:*** REMFs are not permitted to invest in developing properties, which may mitigate the returns on real estate assets. REITs are permitted to invest in underdeveloped properties up to 20% of their corpus.

3. ***Valuation:*** Unlike REITs, where the valuation of the property is required

to be done by a SEBI registered valuer having a net worth of at least 5 crores, the valuers in case of REMFs are not required to be registered with the SEBI or satisfy such net worth requirements.

4. ***Taxation:*** Whilst the tax treatment of REITs is still unclear, tax treatment of REMFs, in line with mutual funds, is relatively certain. It, however, remains to be seen whether REMFs will be regarded as equity oriented funds or not. This is because a mutual fund qualifies as an "equity oriented" mutual fund, only if more than 65% of its total net assets are invested in equity shares of domestic companies, and the REMF Regulations require that only up to 65% of the net assets of an REMF be invested in securities.

5. ***Implications:*** Much in line with the REITs, REMFs are likely to have similar implications, which are as follows:

   i. ***Enhanced participation:*** Domestic retail investors can now participate in the growing real estate market in India, which they were otherwise unable to owing to soaring real estate prices.

   ii. ***Property:*** The requirement of the real estate assets to be entirely free from litigation in case of an REMF may not be practical, and it would have been better if certain threshold for litigation was stipulated.

   iii. ***Venture Capital:*** The REMF Regulations might disappoint a host of venture capital investors that were anxiously waiting for the REMF Regulations to convert themselves into REMFs as not only do the REMF Regulations not provide for any rollover mechanism, they also prohibit REMFs from acquiring real estate assets owned by the sponsor, or the asset management company, or any of its associates during the past 5 years.

   iv. ***Exit mechanism:*** REMFs will help private equity investors to exit from their investments in real estate projects with a shorter payback period as against the current scenario where they have to stay invested for usually 4 to 6 years till the real estate projects are completed. However, such an exit may be impacted by the restriction on an REMF to purchase assets from sponsors or their associates as mentioned earlier.

   v. ***Valuation:*** Further, the requirement to value the real estate assets every 90 days may not be practical in the Indian scenario and a period of 6 months for such valuations may have better suited. Such frequent valuations will only add to the administrative costs and expenses of REMF.

   vi. ***Tax mitigation:*** REMFs can now directly invest in real estate assets unlike a domestic venture capital fund which is required to invest in a venture capital undertaking which in turn can own properties. This direct investment by REMF for owning underlying properties will help in reducing taxes by eliminating one entity layer in the ownership structure.

   vii. ***Stamp duty implication:*** Heavy stamp duty rates might make investments in real estate assets unattractive. Recently, the

government was deliberating on waiving the stamp duty for REITs in accordance with international norms, and it remains to be seen if the waivers will extend to REMFs as well.

viii. ***Professionalism and transparency:*** REMFs will not only be instrumental in the growth and maturity of the real estate sector, they will also facilitate professional management, good corporate governance, transparency and more importantly alleviation of black money from real estate sector in India.

ix. ***FIIs:*** Though there is nothing in the extant REMF Regulations to exclude Foreign Institutional Investors from investing in REMFs, it remains to be seen whether restrictions would be imposed on FII investment in REMFs.

Essentially, the REMF Regulations will provide a platform for diversification and give investors a professionally managed investment in real estate as an asset class and result in price discovery of real estate projects as mutual funds will conduct greater due diligence and check the fundamentals (location, commercial viability and other aspects of realty projects) prior to making the investment.

Whilst REMFs are likely to go a long way in unlocking value and enhancing investor participation in real estate, especially in a country like India where real estate and gold remain the traditional investment favorites of households, it remains to be seen whether the globally successful REITs, regarded as specialized mutual funds with the ability to invest directly into real estate, will be able to outshine the newly launched REMFs in terms of investor participation and investment returns.

CONCLUSION

The Indian real estate industry is evolving from an "unorganized" sector to a more institutionalized and corporatized set up. The participation of foreign investment of specialized players and sophisticated investors in this transition phase will bring in transparency, accountability and emphasis on quality. The statistics doing the rounds these days evidently support the belief that Indian real estate sector promises to be a big draw for foreign investments into the country for times to come. Since real estate investment requires a longer term commitment from investors and the fact that foreign investors are willing to commit billions of dollars in this sector, demonstrates their growing confidence in the Indian economy. Further, the housing and real estate industry has significant linkages with other sectors of the economy and over 250 associated industries. A unit increase in expenditure in this sector has a multiplier effect and the capacity to generate income as high as five times.

India has come long way from the high tax rates and opaque administration days. Millennial India is a package deal of a vibrant democracy, a large reservoir of skilled manpower, an economy at the cutting edge of new technology and above all a huge and growing domestic market, healthy growth rate of approx. 8 percent p.a., implementation of second generation, infrastructure, advancements, exchange controls relaxations and government's commitment to move towards more transparency and simplification of the regulatory and tax regime to bring it at par with the best international practices-all add up to make India an attractive investment destination.

ANNEXURE 1

PRESS NOTE 2 (2005)

Subject

Foreign Direct Investment (FDI) in townships, housing, built-up infrastructure and construction-development projects

With a view to catalysing investment in townships, housing, built-up infrastructure and construction-development projects as an instrument to generate economic activity, create new employment opportunities and add to the available housing stock and built-up infrastructure, the Government has decided to allow FDI up to 100% under the automatic route in townships, housing, built-up infrastructure and construction-development projects (which would include, but not be restricted to, housing, commercial premises, hotels, resorts, hospitals, educational institutions, recreational facilities, city and regional level infrastructure),subject to the following guidelines:

a. Minimum area to be developed undereach project would be as under:

   i. In case of development of serviced housing plots, a minimum land area of 10 hectares.

   ii. In case of construction-development projects, a minimum built-up area of 50,000 sq.mts

   iii. In case of a combination project any one ofthe above two conditions would suffice.

b. The investment would further be subject to the following conditions:

   i. Minimum capitalization of US $10 million for wholly owned subsidiaries and US $5 million for joint ventures with Indian partners. The funds would have to be brought in within six months of commencement of business of the Company.

   ii. Original investment cannot be repatriated before a period of three years from completion of minimum capitalization. However, the investor may be permitted to exit earlier with prior approval of the Governmentthrough the FIPB.

c. At least 50% of the project must be developed within a period of five years from the date of obtaining all statutory clearances. The investor would not be permitted to sell undeveloped plots. For the purpose of these guidelines, "undeveloped plots" will mean where roads, water supply, street lighting, drainage, sewerage, and other conveniences, as applicable under prescribed regulations, have not been made available. It will be necessary that the investor provides this infrastructure and obtains the completion certificate from the concerned local body/service agency before he would be allowed to dispose of serviced housing plots.

d. The project shall conform to the norms and standards, including land use requirements and provision of community amenities and common facilities, as laid down in the applicable building control regulations, bye-laws, rules, and other regulations ofthe State Government/Municipal/Local Body concerned.

e. The investor shall be responsible for obtaining all necessary approvals, including those of the building/layout plans, developing internal and peripheral areas and other infrastructure facilities, payment of development external development and other charges and complying with all other requirements as prescribed under applicable rules/bye-laws/regulations of the State Government/ Municipal/Local Body concerned.

f. The State Government/ Municipal/ Local Body concerned, which approves the building/ development plans, would monitor compliance ofthe above conditions by the developer.

ANNEXURE 2

Investment Conditions and Restrictions under the VCF Regulations

MINIMUM INVESTMENTS A VENTURE CAPITAL FUND:

A 1. A venture capital fund may raise monies from any investor whether Indian, foreign or nonresident Indians byway of issue of units.

2. No venture capital fund set up as a company or any scheme of a venture capital fund setup as a trust shall accept any investment from any investor which is less than five lakh rupees:

Provided that nothing contained in sub-regulation (2) shall apply to investors who are,-

employees or the principal officer or directors of the venture capital fund, or directors of the trustee company or trustees where the venture capital fund has been established as a trust-or the employees of the fund manager or asset management company.

3. Each scheme launched or fund set up by a venture capital fund shall have firm commitment from the investors for contribution of an amount of at least Rupees five crores before the start of operations by the venture capital fund.

INVESTMENT CONDITIONS AND RESTRICTIONS:

B All investment made or to be made by a venture capital fund shall be subject to the following conditions, namely:-

a. venture capital fund shall disclose the investment strategy at the time of application for registration;

b. venture capital fund shall not invest more than 25% corpus of the fund in one venture capital undertaking;

c. shall not invest in the associated companies; and

d. venture capital fund shall make investment as enumerated below:

i. at least 66.67% of the investible funds shall be invested in unlisted equity shares or equity linked instruments of venture capital undertaking.

ii. Not more than 33.33% of the investible funds may be invested by way of:

a. subscription to initial public offer of a venture capital undertaking whose shares are proposed to be listed

b. debt or debt instrument of a venture capital undertaking in which the venture capital fund has already made an investment by way of equity

c. Preferential allotment of equity shares of a listed company subject to lock in period of one year

d. the equity shares or equity linked instruments of a financially weak company or a sick industrial company whose shares are listed

Explanation-1 For the purpose of these regulations, "a financially weak com pan/ means a company, which has at the end of the previous financial year accumulated losses, which has resulted in erosion of more than 50% but less than 100% of its net worth as at the beginning of the previous financial year

e. Special Purpose Vehicles which are created by a venture capital fund for the purpose of facilitating or promoting investment in accordance with these Regulations.

Explanation-The investment conditions and restrictions stipulated in clause (d) of regulation 12 shall be achieved by the venture capital fund by the end of its life cycle, (e) Venture capital fund shall disclose the duration of life cycle of the fund.

PROHIBITION ON LISTING

C. No venture capital fund shall be entitled to get its units listed on any recognised stock exchange till the expiry of three years from the date of the issuance of units by the venture capital fund. capital fund.

ARTICLES

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“In the context of deal terms and documentation, investor rights and particularly, provisions for liquidation preference and exit rights, have always been areas of much debate and negotiation”

THE progressive liberalisation of the foreign investment regime has provided a major boost to private equity and venture capital investments in Indian companies. With the advent of more sophisticated players in the private equity and venture capital arena, the deal terms also tend to get more complicated and sophisticated.

Many of the terms that are commonly employed in deals by these private equity players in other jurisdictions, may pose significant challenges in the Indian regulatory environment. In the context of deal terms and documentation, investor rights, and particularly provision for liquidation preference has always been an area of much debate and negotiation.

So what is liquidation preference? Liquidation preference is typically defined as the right of the investor (usually holding preference shares), to receive its investment amount plus certain agreed percentage of the proceeds in the event of a 'liquidation' of the company, in preference over the other shareholders. Contrary to a

LIQUIDATION PREFERENCE: GET YOUR BASICS RIGHT

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common perception equating 'liquidation' to 'winding up', 'liquidation event' is typically defined to include not only winding up of the company but also any 'liquidity event', which could include a sale of shares or substantial assets, an acquisition or merger of the company or in some cases even a 'nonqualified' IPO.

However, since the returns are typically expected to be higher in case of a 'liquidity event', as compared to a winding up of the company, in certain deals, 'liquidation event' and 'liquidity event' are dealt with separately. In this article, reference to 'liquidation' of a company includes a liquidity event.

Liquidation preference entitles the investor to a certain agreed return upon occurrence of a liquidation event, which is usually computed as a 'multiple ' of the amount invested. For instance, the liquidation preference can range from '1x' (that is an amount equal to the investment amount) to '3x' (that is an amount equal to three times the investment amount) or in certain instances even more. During negotiations, many a times this becomes a hotly negotiated issue since while the promoters and existing shareholders would want the investor's liquidation preference with a low multiple, the investor who is generally coming in at a higher valuation than others would ask for a higher multiple.

Broadly, there are two types of liquidation preference (i) non participating liquidation preference and (ii) participating liquidation preference. Under non-participating liquidation preference, the preference holder will be entitled to receive his predetermined returns (as discussed above), but shall not be entitled to receive any portion of the surplus proceeds to be distributed to the equity shareholders. On the other hand, under participating liquidation preference, the investor, after receiving his pre-determined returns, shall also be entitled to participate (whether fully or to a limited extent) along with the equity shareholders in the distribution of the surplus proceeds. With respect to enforceability of such liquidation preference right, under Section 85 of the Companies Act, 1956, preference shares are entitled to preference upon liquidation of the company. However, equity shareholders have not been specifically provided with such rights under the Act. The general view is that in private companies, a liquidation preference waterfall can be created amongst the equity shareholders, as the specific provisions under the Act which deal with different types of share capital are not applicable to private companies.

This would amount to creation of a class of equity shares with differential rights, and should be enforceable if the provisions are incorporated in the Articles of Association of the company. However, in cases of public companies, creation of a differential class of equity shares would require compliance with Companies (Issue of Share Capital with Differential Voting Rights) Rules, 2001, and may not be feasible.

Also, the law is unclear as to whether the liquidation preference in case of preference shares, can have a participating right as highlighted above, over and above the preference capital in the company. One view is that as long as the shareholders of a company agree to such preferred distribution and the same is captured in the terms of the preference shares and in the articles of the Company, then such provisions should be binding on the Company and its shareholders. However, the provisions of the Act does not specifically state whether the liquidator would be bound to respect such right inter se between the shareholders at the time of winding up of the company.

Apart from compliance with the Act and applicable foreign exchange laws, when structuring a liquidation preference clause, it is important to ensure that the investment document sets out the liquidation preference clause in an un-ambiguous manner, particularly in the context of seniority of different classes of shares. Albeit, legally speaking, enforceability of such provisions under law remains untested in Indian courts and hence the investors should look at adequately securing other forms of exits and protections for their investments through put options, drag and tag along rights, etc. over and above the liquidation preference.

ESCAPE LEGALLY

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Put options are increasingly being used by jittery private equity investors looking for an exit in India. But are they legal?

With the resounding 'pop' of the global credit bubble, foreign invesments in Indian companies are starting to dwindle and IPOs have disappeared. But aside from the apparent blow to the stock markets, there is also the problem of the millions of dollars that were invested by private equity funds in these companies in the hope of exiting through IPOs at favorable valuations. The definitive documents for such investments, in most cases a share subscription and shareholders agreement, typically provide for the investor's exit through an IPO. However, the agreement would also provide that if the investee company does not complete an IPO within the agreed time, the investor would have a so-called "buyback right" to cause the company to buy back its shares or a "put option right" to cause the management/promoter of the company to purchase the investor's stake at an agreed return.

A buyback is subject to certain restrictions and must be compliant with several company law procedures and filings. But most importantly, even in cases where an investee company has the liquidity to buy out the investor, it can only use 25% of its paid up capital and free reserves to buy back the investor's shares. So a buyback right against the company alone may not suffice. A put option right against the promoter, either coupled with the buyback right or exercised independently (subject to the promoter's liquidity), may be an alternative form of exit for an investor. This brings us to the legality of such exit rights and whether they are legally enforceable under Indian law.

Make The Distinction

It is important to distinguish put options from options or futures contracts and other similar derivative contracts. The former merely gives a person an option to sell its shares at a later date for which consideration is paid only if and when the shares are eventually sold at the time of the sale. So there is no fixed commitment to sell shares. With respect to derivative contracts, their purpose is to trade in the underlying security where consideration is paid for the very grant of the option. As the legality of derivative contracts is well settled and provided for under relevant regulations, this article will deal with the former and not derivative contracts.

Until 1995, all options in securities - any contract for the purchase or sale of a right to buy and / or sell securities in future (including a put or call option) - were illegal. The prohibition on entering into such contracts was governed by Section 20 of the Securities Contract Regulation Act, 1956 (SCRA) called "Prohibition of Options in Securities". Additionally, a notification issued under the SCRA in 1969 provided that all contracts for the sale and purchase of securities other than so-called spot delivery contracts or contracts settled through the stock exchange were void. Spot delivery contracts are contracts which provide for delivery of securities and payment of the purchase price for such securities to take place on the same or next day.

The SCRA was amended in 1995 to remove the prohibition of options in securities

AT A GLANCE

Private equity funds in India are trying to utilise their buyback right to cause targets to buy back their shares. They are also attempting to utilise their so-called put option right, to cause the management or promoter of the company to purchase their stake at an agreed return.

But there is debate over the legality of such exit rights and whether they are enforceable under Indian law.

All transactions in securities other than on a spot delivery basis or unless settled through the stock exchange are illegal. This begs the question of whether a put option is a forward contract and thus illegal.

followed by the 1969 Notification being repealed in 2000. However, another notification was issued on the same day that the 1969 Notification was repealed and oddly, the 2000 Notification is largely similar to the 1969 Notification.

To sum up the law on this subject as it stands today, all transactions in securities other than on a spot delivery basis or unless settled through the stock exchange are illegal. This brings us to the main point of our discussion: is a put option a forward contract and thus illegal?

Jethalal Case

To begin with, a put option may not even be treated as completed contract as it is more like a contingent contract. It would result in a contract for sale or purchase of securities only upon exercise of the option and not merely upon the grant of such option. Further, once the option is exercised, the option is exercised, the contract is typically performed immediately, on a spot delivery basis where the consideration for the shares is paid at the same time as the transfer of such shares. This line of reasoning was adopted by the High Court of Bombay in the Jethalal case. Though the case examines the provisions of the erstwhile Bombay Securities Contracts Control Act, 1925 (SCCA) as was in existence prior to the enactment of the SCRA, given the similarity between the two enactments, the court's reasoning may nonetheless be appreciated. Akin to the spot delivery contract under the SCRA, the erstwhile SCCA dealt with a 'ready delivery contract' defined as a contract for the purchase or sale of securities for the performance of which no time is specified and which is to be performed immediately or within a reasonable time.

In the Jethalal case, the plaintiff and the defendant entered into an agreement where the defendant was to procure the sale of the plaintiff's shares at a certain price per share after 12 months contingent on the occurrence of certain events. It was also agreed that if at the end of twelve months, the defendant failed to procure a sale of the shares, the defendant would himself purchase the shares and pay the price at which they were agreed to be sold.

As the defendant failed to procure a sale of the shares within the time stipulated in the agreement, the plaintiff filed a suit against him claiming damages for breach of the agreement to purchase the shares himself. The defendant contended that the agreement in question did not satisfy the definition of a "ready delivery contract" under the SCCA and was thus void under Section 6 of the SCCA, while the plaintiff believed the contrary.

In this case, the court held that a clear distinction must be borne in mind between a case where there is a present obligation under contract and the performance is postponed to a later date, and a case where there is no present obligation at all and the obligation arises by reason of some condition being complied with or some contingency occurring. The court held that as regards the contract entered into between the plaintiff and the defendant, at the date when the contract was entered into there was no present obligation with regard to the purchase or sale of the shares. The obligation undertaken by the

defendant to purchase the shares only ripened into a perfect obligation at the end of the year when the contingency took place. Therefore, it is only at the end of the year that there was contract of purchase or sale, and at the end of the year it is clear that the contract was to be performed immediately or within a reasonable time. The court thus held that the conract was valid and enforceable.

Exit rights should be structured so that once it becomes a contract (that is, upon the exercise of the put option), the parties should ensure that the consideration is paid and the securities are delivered either on the same day or the next day so as to bring it within the purview of a spot delivery contract, which is permissible under the SCRA. To be extra cautious, it is also advisable to structure put options and provide for such rights under the transaction documents such that it is abundantly clear that there is no fixed arrangement between the parties to buy/sell securities at a later date.

This has been the practice usually adopted by parties. However, a subsequent decision of the Bombay High court in *Niskalp Investments and Trading Co. v. Hinduja TMT* counters the principle laid out in the Jethalal case.

Hinduja Finance, one of the defendants, owned shares of Mody International Paper. The plaintiffs and Hinduja entered into a standard agreement in 1997 to provide for the plaintiff's purchase of shares of Mody from Hinduja.

Under the agreement, the Plaintiff's exit was to be provided by way of an IPO of Mody, failing which Hinduja was to buyback the plaintiff's stake at a 20% IRR on a spot delivery basis. Hinduja also had a general option to buyout the plaintiff at any time at an agreed price. As Mody did not complete the IPO and as Hinduja did not buyback the plainfiff's stake, it filed a suit for the recovery of the amount payable by Hinduja under the buyback/purchase arrangement. Hinduja contested the agreement as being void under the SCRA. The plaintiff relied on the Jethalal case to contend that the agreement in question is legal and enforceable. However, the court held that provisions of a spot delivery contract are *pari materia* different from the provisions of the SCCA. The court further held that an arrangement to buyback shares under a contract is not permissible and such an arrangement is hit by the provisions of the SCRA and thus void.

Gill & Co

The court appears to have reached such a conclusion solely on the basis of the Summons for Judgment 1977 in *Gill & Co. v. Inspat Finance & Another*. The court stated that the single judge in the Gill & Go case was considering an identical situation and by "considering all earlier judgments including the judgment of the apex court in *BOI Finance v. Custodian*", has come to the conclusion that the arrangement of buyback is contrary to the provision of the SCRA and is unenforceable in law.

However, the suit filed in the Gill & Co case was dismissed by the court on June 21 2005 for want of prosecution, as the parties had reached a settlement. Consequently the Summons for Judgment under the Gill & Co case, whatever the facts and circumstances or

line of reasoning were, is no longer valid. Even though the Gill & Co case was dismissed on June 12, 2005, the court appears to have relied on it when passing its judgment in the Hinduja Case on October 19, 2005.

With respect to the BOI case, brokers were found to be entering into "ready-forward contracts' (which are sometimes described as buy-back transactions) with various banks and financial institutions. These ready forward contracts essentially comprise two interconnected legs; the first or the 'ready' leg for the sale of securities to banks, and the second or 'forward' leg for the repurchase of the securities from the banks within a fixed period (two to four weeks) for a fixed price. In the BOI case, the Supreme Court thus dealt with the illegality of buy-back transactions in the context of repo transactions and buy/sell transactions entered into by banks.

On a plain reading of the BOI case, it is clear that it deals with transactions altogether different from a put option exercisable by the option holder which entails the other party buying back or purchasing shares from such option holder contingent on the occurence or non-occurrence of certain events at the option of the option holder.

So in reaching its fatal decision in the Hinduja case, the court has primarily relied on one case that had been dismissed and another that deals with fixed buy-sell arrangements by banks. In the Hinduja case, the reference to the plaintiff's put option against the seller (which became exercisable only if no IPO occurred) as a buyback arrangement, may have possibly led the court to construe such an attangement as being similar to a buyback arrangement under the BOI case.

Don't Scare Them Off

If the ruling of the Bombay High Court in the Hinduja case is not challenged, fairly customary albeit vital rights under share holders agreements such as put option rights and rights to cause the company to buyback its shares, even if settled on a spot delivery basis, would be regarded as unenforceable. Consequently, private equity players, many of whom have already quit given the current market scenario, would be hesitant to invest in India if their exit rights are not going to be enforceable.

The only defense available while seeking to enforce such exit rights would then be to restrict the scope and applicability of the SCRA.

The applicability of the SCRA has been settled through numerous juicial precedents. From the early 80s in *Dabiben Umedbhai Patel and Others v. Norman James Hamilton and Others*, to the more recent decision in *Mysore Fruit Products and Ors. v. The Custodian and Ors*, the view of the courts is that the SCRA applies not only to listed companies but also to an unlisted public company. The rationale for such a view is on the basis of the definition of securities under the SCRA, where the key criterion is that the securities are requited to be 'marketable'

According to the courts, a market contemplates a free transaction where shares can be sold and purchased without any restriction as to title. The shares which are sold in a market must, therefore, have a high degree of liquidity by virtue of their character of free transferability. So marketability implies the ease of selling and

includes any security which is capable of being sold in the market and does not necessarily entail only securities that are in actual fact sold on the stock exchange.

Consequently, as the shares of public companies are by their very nature freely transferable, the courts have held that the SCRA also applies to unlisted public limited companies. On the other hand, as shares of a private company do not possess the character of liquidity, in that it has the right to restrict the transfer of its shares, the SCRA may not apply to unlisted private limited companies.

Regardless of the principles outlined by the courts in determining the scope and ambit of the SCRA, the 2000 Notification and SCRA would need to be read in conjunction. As the purpose of the 2000 Notification is to prevent undesirable speculation in securities, the provisions of the said Notification and the SCRA vis-à-vis forward contracts should extend solely to listed entities and not unlisted companies. Especially so as arrangements amongst shareholders of unlisted companies (whether private or public limited companies) cannot be regarded as having speculative elements. Further, even with respect to listed companies, so long as such put options granted by promoters or other shareholders of such listed companies, are settled on a 'spot delivery basis', they should be regarded as being enforceable. Necessary amendments to the SCRA or a clarifying circular to this effect by the Securities and Exchange Board of India would be most welcome, especially in these market conditions. Such changes would provide comfort to shareholders as regards the enforceability of their exit via put options - an increasingly popular form of exit.

WELCOME TO INDIA: FOREIGN INVESTMENTS FRAMEWORK OVERHAULED!

Welcome to India: Foreign investments framework overhauled!

Pursuant to the press release[1] on the manner of calculating indirect foreign investments, Ministry of Commerce & Industry has issued two new press notes i.e. Press Note 2 and Press Note 3 of 2009 ("Press Notes"). Press Note 2 clarifies the manner and mechanism for calculating indirect foreign investments in Indian companies and Press Note 3 provides the guidelines for transfer of ownership or control of Indian companies that are engaged in sectors that have sectoral caps prescribed for foreign investments. The Press Notes not only provide the definitions that were missing in the press release, they have in fact overhauled the foreign investments framework for calculating the indirect foreign investments in Indian investee companies ("Op Co") which in turn have received investments from Indian investing companies ("Hold Co").

NEW FDI POLICY

The following chart broadly summarizes the intent of the Press Notes.

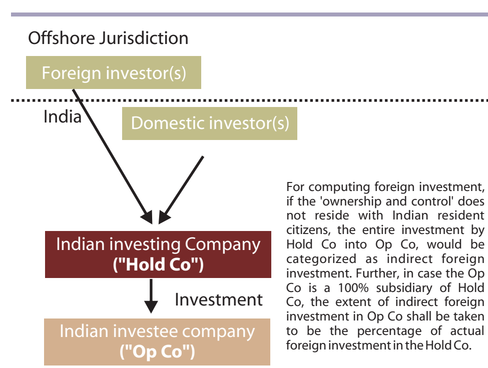

Figure 1

Press Note 2 (2009)

The key provisions of the Press Note 2 (2009) are as follows:

- **Definitions of "Owned" and "Controlled":**
  For the purpose of computing indirect foreign investments, "Owned" by resident Indian citizens would mean that the resident Indian citizens on a look through basis beneficially own more than 50% of the equity interest of the Hold Co. "Controlled" by resident Indian citizens would similarly mean that the resident Indian citizens on a look through basis have the power to appoint a majority of directors of the Hold Co.

- **Principle for computing indirect foreign investment:**
  The Op Co would not be treated as having indirect foreign investments as long as the Hold Co in which there are foreign investments, is ultimately 'owned and controlled' by Indian resident citizens. However, the foreign investments through the Hold Co would be considered for computing indirect foreign investments in the Op Co if the Hold Co is not 'owned and controlled' by Indian resident citizens on a look through basis or if the Hold Co is 'owned' or 'controlled' by 'non resident entities'. In these cases, the entire investment by the Hold Co into the Op Co would be categorized as indirect foreign investments into the Op Co. As a matter of added clarification, Press Note 2 (2009) states that in case of investment into an Op Co which is 100% owned by the Hold Co, the extent of indirect foreign investment in the Op Co, shall be taken to be the percentage of actual foreign investments in the Hold Co. It has also been clarified that the method of computation of indirect foreign investments would be made applicable at each layer of investments in Indian companies. This clearly indicates the alertness of the regulators to multi-layered structures.

[1] Foreign investments into India: Unshackled?

- **Types of foreign investments:**
  It has been clarified that for the purpose of calculating indirect foreign investment in an Op Co, all types of foreign investments i.e. FDI, FIIs, FVCIs, NRIs, ADRs, GDRs, FCCBs, convertible preference shares and convertible debentures would be considered.

- **Disclosure of details:**
  For cases where government approval is required, full details about the foreign investment including details about ownership, control including any shareholders agreement that affect appointment of the board of directors or manner of exercise of voting rights and differential voting rights, if any, in Hold Co are required to be disclosed.

- **Treatment of beneficial interest:**
  A declaration under Section 187 C of Companies Act, 1956 provides that a person is holding the shares of a company as a nominee of the original investor (registered owner) then the beneficial interest in such shares would be vested in the original investor. Press Note 2 (2009) provides that if there is a declaration under section 187 C of Companies Act, 1956, the investment in such shares would be counted as foreign investment regardless of the fact that such investment was made by a resident Indian citizen.

- **Exempt sectors/activities:**
  It is pertinent to note that for sectors such as insurance where methodology for calculating foreign investment is prescribed under sector specific statute or rules, the policy and methodology under the Press Notes shall not be applicable.

Press Note 3 (2009)

The key provisions of Press Note 3 (2009) are as follows:

- **Exempt sectors/activities:**
  The Press Note 3 (2009) does not apply to sectors/activities where there are no foreign investment caps.

- **Transfer of 'ownership' or 'control':**
  In cases of Indian companies that are engaged in sectors that have prescribed sectoral caps, in the following situations, prior Foreign Investment Promotion Board ("FIPB") approval would be required:

  1. The Indian company has received foreigninvestments and is owned or controlled by nonresident entity;
  2. The control or ownership of the Indian company currently owned or controlled by resident Indian citizens on a look through basis, is being or will be transferred to non resident entities either through fresh foreign investment or when such transfer is effected through direct acquisition or through corporate reorganisations, i.e. amalgamations or mergers.

IMPLICATIONS

The following are some of the implications arising as a consequence of the Press Notes:

- The definition of the term 'control' for the purposes of computing indirect foreign investments has been kept restricted to ability to appoint majority of directors. Prior to the issuance of the Press Notes, one of the concerns was that if minority investor protection rights provided to nonresidents in Hold Cos are construed as "control", then practically all investments by Hold Cos in Op Cos would have qualified as indirect foreign investments for the Op Cos as per the Press Note.

- There is an ambiguity as to whether Press Note 2 (2009) would be able to filter out the investments that are not made in compliance with the FDI policy. For e.g. a foreign investor intends to invest in an Op Co which is a credit information company where 49% foreign investment is allowed subject to FIPB approval. The question arises as to whether the foreign investor would need to obtain FIPB approval if it invests into a Hold Co (engaged in pharma sector) which is owned and controlled by Indian resident citizens and the Hold Co in turn holds 99% in the Op Co which is engaged in the credit information business. While it seems that the intention of the FDI policy to restrict investments (direct or indirect) in certain prescribed sectors still remains, the Press Note 2 (2009) does not seem to emphasize that.

- The Hold Co has been defined to mean an Indian company making investments through equity/preference/CCD in Op Co. Since optionally convertible debentures ("OCD") have not been covered in the definition of Hold Co, ambiguity remains as to whether indirect foreign investment would be considered in Op Co in a situation where the Op Co has issued OCDs to Hold Co and Hold Co in turn is either owned or controlled by foreign investors.

- For the purpose of calculating indirect foreign investment, all types of foreign investments such as FDI, FII, FVCI, etc. would be considered. However, it is pertinent to note that this in no way would dilute the applicability of the regime specific sectoral caps. For e.g. FDI and FII investment in commodity exchanges is permitted upto 26% and 23% respectively. However, the Press Note 2 (2009) does not allow the flexibility to infuse FDI in commodity exchanges beyond 26%.

EXPLANATORY ILLUSTRATIONS

Following are some of sector specific illustrations based on the Press Notes. For the purposes of the same, we assume that no direct foreign investments have been made in the Op Co.

- **Scenario 1:** Foreign investors control the Hold Co which is holding 40% stake in the Op Co. Op Co is engaged in the business of gambling and lottery in which FDI is currently prohibited.

  1. **Analysis:** Since the Hold Co is controlled by foreign investors, any downline investment by Hold Co in Op Co would be considered as indirect foreign investment which is currently prohibited for gambling under the extant FDI policy. In the instant case, an interesting situation would arise if the ownership and control of the Hold Co was with Indian resident citizens. In such a scenario, though against the spirit of FDI policy, it remains to be seen as to whether the downline investments by Hold Co in Op Co be ignored for calculating indirect foreign investment.

- **Scenario 2:** Hold Co is owned to the extent of 75% by foreign investors and Op Co is owned to the extent of 60% by the Hold Co and is in the business of courier services in which FDI is allowed upto 100% subject to FIPB approval.

  1. **Analysis:** The amount of indirect foreign investments into Op Co would stand at 60%. However, if Hold Co owned 100% in Op Co, then as per the Press Note 2 (2009), the indirect foreign investment in Op Co would have been 75%.

- **Scenario 3:** Foreign investors have on cumulative basis, 49% stake in the Hold Co and do not control the Hold Co. Hold Co in turn holds 95% stake in Op Co which is a loan company.

  1. **Analysis:** Since the Hold Co is neither owned nor controlled by foreign investors, indirect foreign investment should not be ascribed to Op Co which is a loan company. In this case, though against the spirit of FDI policy, question arises as to whether the Op Co would be required to be capitalized to the extent of USD 500,000 since the foreign investors indirectly through the Hold Co, own upto 49% equity in Op Co.

- **Scenario 4:** Foreign investors own an equity stake of 45% in the Hold Co. The Hold Co in turn holds 65% stake in the Op Co which is engaged into construction and development of real estate projects. The ownership and control of the Hold Co is with Indian resident citizens.

  1. **Analysis:** Since Hold Co is owned and controlled by Indian resident citizens, the investment by Hold Co in Op Co would not be considered as indirect foreign investment. In that case, though against the spirit of FDI policy, it remains to be seen whether the Op Co would be required to meet with the requirements of minimum capitalization and minimum built up area under Press Note 2 (2005).

CONCLUSION

The guidelines have come as a big sigh of relief for the foreign investors by bringing in the much needed clarity on the foreign investment norms. However, it remains to be seen as to how do the regulators tackle some of the cases mentioned in this article which do not seem to have been addressed by the Press Notes.

Source:

http://siadipp.nic.in/policy/changes/pn2_2009.pdf

http://siadipp.nic.in/policy/changes/pn3_2009.pdf

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93-B Mittal Court
Nariman Point
Mumbai 400 021, India
Tel: +91 22 6669 5000

Prestige Loka, G01
7/1, Brunton Road
Bangalore 560 025, India
Tel: +91 80 6693 5000

220 California Av
Suite 201, Palo Alto
CA 94306, USA
Tel: +1 650 325 7100

Level 30
Six Battery Rd
Singapore 049909
Tel: + 65 6550 9855

www.nishithdesai.com **nda@nishithdesai.com**