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Structuring India Focused Funds

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Introduction

In 2012, the Securities and Exchange Board of India ("**SEBI**") took steps to completely overhaul the regulatory framework for domestic funds in India and introduced the Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012 ("**AIF Regulations**"). The idea was to recognize Alternative Investment Funds ("**AIFs**") as a distinct asset class, promote financing for start-ups and early stage companies, permit fund investment strategies in the secondary markets, and to tie concessions and incentives to investment restrictions.

The funds industry in India saw a momentous uptick in 2016. The pro-business environment in the country has been encouraging for foreign investors to participate in the India story. Increasingly, AIFs are being used to raise both domestic as well as overseas commitments for India focused investments. As of December 2016, AIFs have raised commitments of about $11 billion.[1]

India follows source based taxation on capital gains and taxes thereon may not be creditable in the home jurisdiction of the offshore investors. Accordingly, offshore structures have historically been used to invest in India to avoid double taxation on the same income stream.

In a bid to encourage setting up of domestic pooling structures and lend more certainty to position of tax, a tax-pass through status has been hardwired for certain categories of AIFs.[2] Further, earlier last year, the exchange control norms were revised so that Indian managed and sponsored AIFs receiving foreign investments, were put at par with domestic investors vis-à-vis making downstream investments.[3]

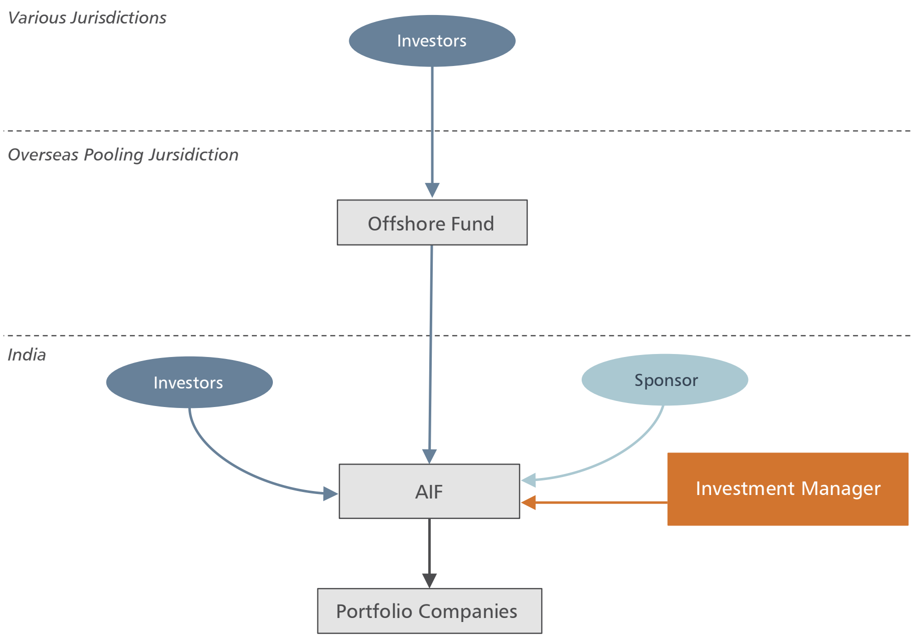
The investment trend among Indian investors is shifting from traditional assets to alternative investments including investments in financial instruments and complex investment products. Investors, both individuals and institutional, are becoming better equipped to assess their risk appetite with the help of home grown financial analysts and wealth managers. Consequently, in mid-2016, India focused funds started seeing greater participation from domestic LPs[4] (as compared to so far being primarily led by overseas investors).[5]

To accommodate both domestic investor base and offshore investor base, *unified structures* have emerged as a preferred choice for structuring India focused funds. There is also an increased participation from development financial institutions ("**DFIs**") in India focused funds, including unified structures. Accordingly, some global benchmarks need to be followed when designing the structure and calibrating the fund documents including the governance, fiduciary aspects and adherence to Environment and Social ("**ESG**") policies.

In this article, we discuss the 'unified structure' with applicable variations, for India-focused funds as being the most popular choice for most managers looking at both offshore and domestic pools of capital. We also look at the impact of major external developments on India-focused structures as protocols amending the India-Mauritius Treaty[6] and the India-Singapore Treaty[7] were signed on May 10, 2016 and Dec 30, 2016 respectively.

1. http://www.sebi.gov.in/cms/sebi_data/attachdocs/1485169430146.html
2. The Income Tax Act, 1961 only accords tax-pass through status to Category I and Category II AIFs at present.
3. Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) (Second Amendment) Regulations, 2016 (Notification No.FEMA.362/2016-RB).
4. References in this article to "LPs" are to investors and to "GPs" are to investment managers.
5. http://www.business-standard.com/article/markets/india-focused-funds-see-surge-of-domestic-investors-116031600657_1.html
6. Agreement For Avoidable Of Double Taxation And Prevention Of Fiscal Evasion With Mauritius, as amended from time to time (available at http://incometaxindia.gov.in/Pages/international-taxation/dtaa.aspx)
7. Agreement for avoidance of double taxation and prevention of fiscal evasion with Singapore (available at http://incometaxindia.gov.in/Pages/international-taxation/dtaa.aspx)

A basic structural representation of a unified structure should be:



Understanding the Unified Structure and its variations

Typically, a manager looking to pool capital from offshore investors as well as domestic investors for investments into Indian portfolio companies could consider a unified structure, where the offshore investors are pooled in a tax neutral jurisdiction and the domestic investors are pooled in the Indian fund (set-up as an AIF). The offshore fund (feeder vehicle) would then invest in the Indian AIF (the master fund), such that all the capital commitments are aggregated and pooled at the Indian AIF level.

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

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

Foreign Direct Investment Policy (**"FDI Policy"**)[8] will however be applicable to investments made directly by an offshore fund in India based investments.

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

Favorable reasons for a Unified Structure

Unified structures are gaining popularity for various commercial, legal and tax reasons which are briefly discussed in this section.

Non- applicability of foreign investment restrictions:
Under the unified structure, investments made by the Indian AIF with the capital contributions received from the offshore fund shall also be deemed to be domestic investments if the manager and sponsor of the AIF are Indian owned and controlled.

Therefore, the restrictions placed on foreign investments such as FDI Policy related restrictions including (a) sectoral caps (b) choice in instruments being limited to equity shares, fully, compulsorily convertible debentures and fully, compulsorily and mandatorily convertible preference (c) optionality clauses being subject to conditions (d) pricing guidelines, etc. shall not be applicable to the investments made in India through the unified platform (which would have been otherwise applicable in respect of investments directly made by the offshore fund in Indian opportunities).

Consolidation of corpus:
A unified structure allows aggregation of the asset-under-management across both the offshore fund and the Indian AIF. A larger corpus at the Indian AIF level will help tap more capital from those LPs whose commitments are linked to the corpus of the Indian AIF and allow the manager to evaluate larger deals as the portfolio concentration requirements can be met using the larger aggregate pool at the AIF level.

> "There can be variations of a unified structure depending on the investment strategy of the fund, allocation of economics for the GP and certain legal and regulatory considerations involving the LPs.

8. Refer to the Consolidated FDI Policy dated May 12, 2016 pursuant to the Foreign Exchange Management (Transfer or Issue of Securities to Persons Resident outside India) Regulations, 2000, available at http://dipp.nic.in/English/Policies/FDI_Circular_2016.pdf (the "FDI Policy")

In this regard, it important to understand the differences between pooling offshore investors directly into the Indian AIF versus a unified structure. There is a consolidation of corpus in both the cases, however, there are other reasons for pooling offshore investors in an offshore vehicle (i.e. unified structure) which are summarized below:

a) In case of direct investment by offshore investors in the Indian AIF, each offshore investor may be required to obtain a PAN[9] card from Indian income tax authorities and file income tax returns in India.

b) While making distributions to offshore investors under the direct structure, the AIF has to consider withholding tax rates in force between India and the concerned country of each of the relevant offshore investor. In case of the feeder set up, the tax status of the feeder is to be considered.

Tax pass-through and treaty eligibility:

Category I and Category II AIFs have been accorded tax pass through status under the Indian Income Tax Act, 1961, i.e. the income received by a unit-holder through the AIF will be chargeable to income-tax in the same manner as if it were the income arising to such unit-holder directly by the unit-holder.[10] Accordingly, the tax liabilities of the offshore fund will remain the same (as would be for direct investments) under the unified structure.

The protocols to the India-Mauritius DTAA and India-Singapore give India the right to tax capital gains arising from the transfer of equity shares. Despite the changes introduced by the protocols, Mauritius and Singapore continue to be favorable jurisdictions from a tax perspective as Mauritius and Singapore would continue to have the right to tax capital gains arising from the transfer of non-convertible debentures, compulsorily convertible debentures and optionally convertible debentures (depending on the terms of the conversion of the optionally convertible debentures).

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Favorable regime:

The Government of India wants to promote onshore fund management activities. To that end, the benefits which are being made available to AIFs would also extend to the offshore fund in a unified structure.

Decision-making

Under the unified structure, the offshore fund will make a principal investment-related decision i.e. whether or not to invest in the Indian AIF. The offshore fund may need to make additional decisions if certain offshore / Indian investments are required to be made directly by the offshore fund.

Since most of the decisions in respect of the Indian AIF are to be taken by the India based investment manager, risks such as that of the offshore fund having a permanent establishment or its “place of effective management” (“**POEM**”)[11] in India, are reduced.

Fund economics in a unified structure:

The unified structure brings with it, its own set of unique commercial terms which are required to be incorporated while giving due regard to the applicable legal, tax and regulatory restrictions. We discuss below some of the most commonly used fund terms which are often a subject of LP discussions in unified structures:

Voting rights of investors of the offshore fund in the Indian AIF:

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

USD-INR hurdle rates

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

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

9. The term “PAN” stands for Permanent Account Number.
10. S. 115UB read with s. 10(23FBA), s. 10(23FBB) and s. 194LBB of the Indian Income Tax Act, 1961.
11. With amendments brought about by the Finance Act, 2015 (the “2015 Act”) in relation to the criteria for determining the tax residence of companies incorporated outside India, a foreign company should not be a tax resident of India in a particular financial year if the company’s POEM in that financial year is not located in India. POEM has been defined to mean “a place where key management and commercial decisions that are necessary for the conduct of the business of an entity as a whole are, in substance, made”. The effective date of this amendment has been pushed by one year by the Finance Act, 2016. Accordingly, the said change should be relevant for foreign companies from the financial year 2016-17.

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

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

Co-investment opportunities

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

Extraction of fee and carry

The distribution waterfall at the Indian AIF level may require that distributions to the Offshore Fund be grossed-up to the extent of the expenses incurred at the Offshore Fund level.

The distribution proceeds at the Indian AIF level could be allocated between the domestic investors and the offshore fund providing them INR and USD denominated preferred returns respectively.

In certain situations, a unified structure allows flexibility to the GP team to extract its economics (fee and carried interest allocations) at either the Indian AIF level only or also at the offshore fund level.

However, it is important to ensure that the overall agreed maximum cap for the carried interest as well as management fees is not breached across the platform.

Side letter items

Typically, investors may seek differential arrangements with respect to management fee, co-investment allocation, membership to LPACs etc. An investor may also insist on including a 'most favored nation' (or MFN) clause to prevent any other investor being placed in a better position than itself.

It is relevant for all investors that the Indian AIF is able to effect the terms entered into by investors whether directly at the Indian AIF level or the offshore fund, including making available rights under MFN provisions.

Closing adjustments

A common fund term in all private equity funds requires closing adjustments to be made when a new investor is admitted to the fund at any closing subsequent to the first closing. In a unified structure, a new investor in the offshore fund would be required to compensate the existing investors at the offshore fund level as well as the Indian AIF level and *vice-versa* for a new investor participating subsequent to the first closing in the Indian AIF.

Conclusion

Only a few (key) of many structural variations and fund terms in a unified structure have been discussed in this article. These structures are evolving further as an increasing number of offshore LPs (including institutional investors) have started evaluating India-focused funds.

Investment proceeds received by the Indian AIF, being the master fund, are split on a pro rata basis among its direct investors and the offshore fund, being the feeder, in proportion to their investment.

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

Once a decision has been taken on the structure for the investment fund platform, the same has to be carefully incorporated in the fund documents including the charter documents for the fund entity, the private placement memorandum, the investment management agreement, the investment advisory agreement, etc. In particular, one would need to keep in mind the potential "permanent establishment" risk while drafting these documents. The private placement memorandum should also achieve a balance between the risk disclosure requirements and the marketing strategy.

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