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LEGAL AND TAX COUNSELING WORLDWIDE

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Fund Structuring & Operations

Global, Regulatory and Tax developments impacting India focused funds

July 2016

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Dear Friend,

The funds industry in India saw a momentous uptick in 2015. The pro-business environment in the country has been encouraging for foreign investors to participate in the India story.

The investor appetite for India risk has been robust and that led to healthy fund raising for several tier 1 GPs with track records. In 2015, India saw onshore PE-VC funds raising up to USD 2.9 billion collectively from Indian and foreign investors. The fund raising environment in 2016 has seen spurred efforts in India with the regulatory reforms in foreign exchange laws with respect to onshore funds introduced in the last quarter of 2015. The changes are aimed at promoting home-grown investment managers by allowing Indian managed and sponsored AIFs with foreign investors to bypass the FDI Policy for making investments in Indian companies.

The government has been proactive in trying to establish a regulatory and tax climate that is conducive for raising investment from foreign investors. The regulatory regime continues to be streamlined with relaxation of pricing norms for foreign direct investments, clarity in relation to put / call options, rationalization of the foreign portfolio investment regime and proposals for further liberalization of investment caps.

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

The investment fund industry clearly seems to be in a very different market today. Innovative structures varied from the traditional 'blind-pool model' are increasingly being seen. Some of the themes that continue in 2016 are the shift from 'comingled basis' of raising funds to 'separately managed accounts', deal-by-deal participation (opt-in / opt-out) and pledge-type structures. These changes are closely linked to the reduced LP tolerance for traditional terms and full fee structures for blind pool funds.

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

However, from a regulatory viewpoint, the glare from the regulator to the alternative investments space has been at its peak. A manager to an alternative investment fund ("**AIF"**) must now contend with greater supervision and accountability to both the regulator and the investors. While bespoke terms are designed to maintain investor friendliness, given the recent observations by regulators in sophisticated jurisdictions, sight must not be lost on the disclosure norms and fiduciary driven rules that are now statutorily mandated.

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

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

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

Back home, in 2015, SEBI had constituted a standing committee called the Alternative Investment Policy Advisory Committee (**"AIPAC"**) under the chairmanship of Mr. Narayana Murthy to advise SEBI on measures to further develop the alternative investment and startup ecosystem in India and to highlight any hurdles that might hinder the industry's development. The first AIPAC report of January, 2016 recommends various structural reforms and seeks to push regulation of funds to "next practices". Some of the recommendations have been adopted in the 2016 annual budget that was tabled by the Finance Minister. The AIPAC report marks a welcome start for necessary dialogue that is required between the industry and the regulator.

Moreover, there is also emerging jurisprudence which suggests that the threshold of fiduciary duties to be met with by fund managers is shifting from "exercising supervision" to "making reasonable and proportionate efforts commensurate with the situations". A failure to perform such supervisory role could raise severe issues on fund managers' liabilities for business losses as would be seen in the case of fund directors in Weavering Macro Fixed Income Fund (summarized in our memo that can be accessed at (http://www.nishithdesai.com/information/research-and-articles/nda-hotline/nda-hotline-single-view/article/rising-standards-of-fund-governance-fund-directors-beware. html?no_cache=1&cHash=84b3820190701f49c47d5326772d4876). To add to this, there has been a very active enforcement of anti-corruption laws under the Foreign Corrupt Practices Act (**"FCPA"**) against directors and executives.

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

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

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

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

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

Regards,

Nishith Desai

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NDA Fund Formation Practice

Our Approach

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

Choice of Fund Vehicle

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

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

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

Documentation

Once a decision has been taken on the optimum structure for the fund, the same has to be carefully incorporated in the fund documents including the charter documents for the fund entity, the private placement memorandum, the 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.

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The private placement memorandum should also achieve a balance between the risk disclosure requirements and the marketing strategy. We also co-ordinate with overseas counsel to obtain requisite legends to keep the fundraising exercise compliant with the laws of each jurisdiction in which the interests of the fund are being marketed.

Advisory

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

Project Management

Several Indian investment managers who are looking at raising international funds need to offer tax efficient and regulatory compliant structures to their foreign investors that generally seek not only safety and repatriation of their original investments, but also a tax-efficient way of receiving the gains earned as well. Thus, our focus on international tax and our in-depth understanding of the legal, regulatory and tax regimes for funds in different jurisdictions has enabled us to be at the cutting edge of structuring offshore and domestic funds.

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Primary Contacts

Nishith Desai

nishith.desai@nishithdesai.com

Nishith Desai is the founder of the multi-skilled, research based international law firm and has over 40 years of experience in cross-border transactional and advisory practice. He is an international tax and corporate law expert, researcher, published author and lecturer in leading academic institutions around the world. He has advised extensively on cross-border tax and regulatory implications of wealth transfer and succession planning. Mr. Desai was a member of SEBI's committee which developed original regulations for Foreign Venture Capital Investor (FVCI) and Venture Capital Funds regime. More recently, he has been involved with the formation and subsequent amendments to the AIF Regulations.

Richie Sancheti

richie.sancheti@nishithdesai.com

Richie leads the Investment Funds practice at Nishith Desai Associates. Richie advises on optimum structures for setting up onshore and offshore investment funds. He advises fund managers in connection with the formation, carry allocation program and governance of private funds. Richie is a frequent speaker at domestic and international conferences on private equity including the Indian Venture Capital Association, PERE Summit, EMPEA, etc.

Richie specializes in formation and operation of venture capital, private equity and open end funds that are focused on investing in India. He has extensive experience in designing fund structures and advising on market terms. Richie is also a member of the firm's international tax and private equity investment practice groups.

Pratibha Jain

pratibha.jain@nishithdesai.com

Pratibha Jain is a Partner and co-heads the Fund Formation practice at Nishith Desai Associates. She brings with her a breadth of international and Indian experience having worked in New York, Tokyo, Hong Kong and Mumbai. She was till recently the Vice President and Counsel for Goldman Sachs in India. She has earlier worked as an associate with Sullivan & Cromwell LLP in their New York, Tokyo and Hong Kong offices and with Skadden Arps Slate Meagher and Flom LLP in their Hong Kong office. Pratibha's educational qualifications include B.A (Economics) Hons. And LL.B. degree from Delhi University, a Bachelor of Civil Law degree from the University of Oxford, where she was a St. Catherine's College Bursary Holder; and a LL.M. degree from the Harvard Law School, where she was a Samuel Morse Lane Fellow. Pratibha has extensive experience in US and Indian securities laws. Her areas of focus include private equity, mergers and acquisitions, corporate and regulatory advisory and public policy matters.

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Nishchal Joshipura

nishchal.joshipura@nishithdesai.com

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

Mansi Seth

mansi.seth@nishithdesai.com

Mansi Seth heads Nishith Desai Associates' Indian practice in the US. She specializes in International Taxation, Funds, Private Equity Investments and Merger and Acquisitions. Mansi has advised several GPs with respect to their India-focused funds, including on devising onshore and offshore fund structures, investments, exits and carried interest structuring. She also focuses on cross border transactions in and out of India. Mansi obtained Bachelor of Laws (LL.B.) degree from National Law University, Jodhpur (India) and a Masters of Laws degree in Taxation at Georgetown University in Washington DC. She has presented in a number of International Bar Association conferences and was an IBA Tax Scholar in 2009.

Kishore Joshi

kishore.joshi@nishithdesai.com

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

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

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About NDA

Nishith Desai Associates (NDA) is a research based international law firm with offices in Mumbai, Bangalore, Palo Alto (Silicon Valley), Singapore, New Delhi, Munich and New York. We provide strategic legal, regulatory, and tax advice coupled with industry expertise in an integrated manner.

As a firm of specialists, we work with select clients in select verticals. We focus on niche areas in which we provide high expertise, strategic value and are invariably involved in select, very complex, innovative transactions.

We specialize in Globalization, International Tax, Fund Formation, Corporate & M&A, Private Equity & Venture Capital, Intellectual Property, International Litigation and Dispute Resolution; Employment and HR, Intellectual Property, International Commercial Law and Private Client. Our industry expertise spans Automotive, Funds, Financial Services, IT and Telecom, Pharma and Healthcare, Media and Entertainment, Real Estate, Infrastructure and Education. Our key clientele comprise marquee Fortune 500 corporations.

Equally passionate about philanthropy, social sector and start ups, our role includes innovation and strategic advice in futuristic areas of law such as those relating to Bitcoins (block chain), Internet of Things (IOT), Privatization of Outer Space, Drones, Robotics, Virtual Reality, Med-Tech and Medical Devices and Nanotechnology.

Nishith Desai Associates is ranked the 'Most Innovative Asia Pacific Law Firm in 2016' by the *Financial Times - RSG Consulting Group* in its prestigious **FT Innovative Lawyers Asia-Pacific 2016** Awards. With a highest-ever total score in these awards, the firm also won Asia Pacific's best 'Innovation in Finance Law', and topped the rankings for the 'Business of Law'. While this recognition marks NDA's ingress as an innovator among the globe's best law firms, NDA has previously won the award for 'Most Innovative Indian Law Firm' for two consecutive years in 2014 and 2015, in these elite *Financial Times* Innovation rankings.

Our firm has received much acclaim for its achievements and prowess, through the years. Some include:

IDEX Legal Awards: In 2015, Nishith Desai Associates won the "M&A Deal of the year", "Best Dispute Management lawyer", "Best Use of Innovation and Technology in a law firm" and "Best Dispute Management Firm". IDEX Legal recognized Nishith Desai as the Managing Partner of the Year in 2014.

Merger Market has recognized Nishith Desai Associates as the fastest growing M&A law firm in India for the year 2015.

World Tax 2015 (International Tax Review's Directory) recognized NDA as a Recommended Tax Firm in India

Legal 500 has ranked us in tier 1 for Investment Funds, Tax and Technology-Media-Telecom (TMT) practices (2011, 2012, 2013, 2014).

International Financial Law Review (a Euromoney publication) in its **IFLR1000** has placed Nishith Desai Associates in Tier 1 for Private Equity (2014). For three consecutive years, IFLR recognized us as the Indian "Firm of the Year" (2010-2013) for our Technology - Media - Telecom (TMT) practice

Chambers and Partners has ranked us # 1 for Tax and Technology-Media-Telecom (2015 & 2014); #1 in Employment Law (2015); # 1 in Tax, TMT and Private Equity (2013); and # 1 for Tax, TMT and Real Estate – FDI (2011).

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India Business Law Journal (IBLJ) has awarded Nishith Desai Associates for Private Equity, Structured Finance & Securitization, TMT, and Taxation in 2015 & 2014; for Employment Law in 2015

Legal Era recognized Nishith Desai Associates as the Best Tax Law Firm of the Year (2013).

ASIAN-MENA COUNSEL named us In-house Community 'Firm of the Year' in India for Life Sciences Practice (2012); for International Arbitration (2011); for Private Equity and Taxation in India (2009). We have received honorable mentions in ASIAN-MENA COUNSEL Magazine for Alternative Investment Funds, Antitrust/ Competition, Corporate and M&A, TMT, International Arbitration, Real Estate and Taxation and being Most Responsive Domestic Firm.

We have won the prestigious 'Asian-Counsel's Socially Responsible Deals of the Year 2009' by **Pacific Business Press.**

We believe strongly in constant knowledge expansion and have developed dynamic Knowledge Management ('KM') and Continuing Education ('CE') programs, conducted both in-house and for select invitees. KM and CE programs cover key events, global and national trends as they unfold and examine case studies, debate and analyze emerging legal, regulatory and tax issues, serving as an effective forum for cross pollination of ideas. Our trust-based, non-hierarchical, democratically managed organization that leverages research and knowledge to deliver premium services, high value, and a unique employer proposition has been developed into a global case study and published by John Wiley & Sons, USA in a feature titled 'Management by Trust in a Democratic Enterprise: A Law Firm Shapes Organizational Behavior to Create Competitive Advantage' in the September 2009 issue of Global Business and Organizational Excellence (GBOE).

Please see the last page of this paper for the most recent research papers by our experts.

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Contact

For any help or assistance please email us on ndaconnect@nishithdesai.com or
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1. Glossary of Terms

Sr No.	Term	Explanation
1.	**AAR**	Authority for Advance Ruling, Ministry of Finance, Government of India.
2.	**AIF**	Alternative Investment Fund as defined under the SEBI (Alternative Investment Funds) Regulations, 2012.
3.	**AIF Regulations**	SEBI (Alternative Investment Funds) Regulations, 2012.
4.	**AOP**	Association of Persons
5.	**CBDT**	Central Bureau of Direct Taxes, Department of Revenue, Ministry of Finance, Government of India
6.	**CCD**	Compulsorily Convertible Debentures
7.	**CCPS**	Compulsorily Convertible Preference Share
8.	**COR**	Certificate of Registration
9.	**DDP**	Designated Depository Participant
10.	**DDT**	Dividend Distribution Tax
11.	**DTAA**	Double Taxation Avoidance Agreement
12.	**ECB**	External Commercial Borrowing
13.	**FATF**	Financial Action Task Force
14.	**FCCB**	Foreign Currency Convertible Bond
15.	**FDI**	Foreign Direct Investment
16.	**FEMA**	Foreign Exchange Management Act, 1999
17.	**FII**	Foreign Institutional Investor
18.	**FIPB**	Foreign Investment Promotion Board, Department of Economic Affairs, Ministry of Finance, Government of India
19.	**FII Regulations**	SEBI (Foreign Institutional Investors) Regulations, 1995
20.	**FPI**	Foreign Portfolio Investor
21.	**FPI Regulations**	SEBI (Foreign Portfolio Investors) Regulations, 2014
22.	**FSC**	Financial Services Commission, Mauritius
23.	**FVCI**	Foreign Venture Capital Investor
24.	**FVCI Regulations**	SEBI (Foreign Venture Capital Investors) Regulations, 2000
25.	**GAAR**	General Anti Avoidance Rules
26.	**GBC–1**	Category 1 Global Business (GBC–1) License

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27.	**GPs**	General Partners (Fund Managers)
28.	**IC**	Investment Committee
29.	**ICDR Regulations**	SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009
30.	**Indian Rupee or "INR" or "Rs."**	The currency of Republic of India.
31.	**IPO**	Initial Public Offer
32.	**KYC**	Know Your Customer
33.	**LoB**	Limitations on Treaty Benefits
34.	**LLP**	Limited Liability Partnership
35.	**LLP Act**	Limited Liability Partnership Act, 2008
36.	**LPs**	Limited Partners (Fund Investors)
37.	**MAT**	Minimum Alternate Tax
38.	**NAV**	Net Asset Value
39.	**NCD**	Non-convertible Debentures
40.	**NRI**	Non Resident Indian
41.	**OCB**	Overseas Corporate Body
42.	**ODI**	Offshore Derivative Instrument
43.	**OEIC**	Open-ended Investment Company
44.	**Offshore Fund**	Means a pooling vehicle established outside India.
45.	**PCC**	Protected Cell Companies
46.	**PE**	Private Equity
47.	**PPM**	Private Placement Memorandum
48.	**P-Notes**	Participatory Notes
49.	**REITs**	Real Estate Investment Trusts
50.	**RE Funds**	Real Estate Funds
51.	**QFI**	Qualified Foreign Investor
52.	**RBI**	Reserve Bank of India
53.	**SEBI**	Securities and Exchange Board of India
54.	**SGD**	Singapore Dollars
55.	**SITA**	Singapore Income Tax Act
56.	**SMEs**	Small and Medium-sized Enterprises
57.	**SPCs**	Segregated Portfolio Companies

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58.	**SPV**	Special Purpose Vehicle
59	**Tax Act or ITA**	Income Tax Act, 1961
60.	**TDS**	Tax Deducted at Source
61.	**TRC**	Tax Residency Certificate
62.	**TISPRO**	Foreign Exchange Management (Transfer and Issue of Security by a Person Resident Outside India) Regulations, 2000
63.	**USD**	US Dollars
64.	**VCF**	Venture Capital Fund
65.	**VCF Regulations**	SEBI (Venture Capital Funds) Regulations, 1996
66.	**VCPE**	Venture Capital and Private Equity
67.	**VCU**	Venture Capital Undertaking

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2. Choice of Jurisdiction for Setting up an India- Focused Fund

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

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

The present Indian capital pool is predominantly contributed by foreign funds. Effective mobilization of the domestic pool of investors in India (consisting of institutional investors like banks, insurance companies, mutual funds and high net worth individuals) continues to face certain hurdles. The recent Alternative Investment Policy Advisory Committee (**"AIPAC"**) Report [1] has recommended unlocking domestic capital pools for providing fund managers an access to domestic pools as this investor class currently constitutes approximately 10% of the total VCPE invested in India annually.

I. Why Offshore Investors are Pooled Outside India

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

II. Why Onshore Investors are Pooled in India

Resident investors prefer onshore structures for the following reasons:

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

1. The report was issued on January 20, 2016 and can be accessed at http://www.sebi.gov.in/cms/sebi_data/attachdocs/1453278327759.pdf . Our memo on AIPAC can be accessed at http://www.nishithdesai.com/information/research-and-articles/nda-hotline/nda-hotline-single-view/newsid/3304/html/1.html?no_cache=1).

2. Any downstream investment by an AIF (which receives foreign contributions) will be regarded as foreign investment if the Sponsor and the Investment Manager of the AIF are not Indian 'owned and controlled'. The ownership and control is determined in accordance with the extant FDI Policy.

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b. Regulation 7 of the Foreign Exchange Management (Transfer or Issue of any Foreign Security) Regulations, 2004 (**"ODI Regulations"**) stipulates certain conditions to be met by Indian corporations when making investments in an entity outside India engaged in financial services activities (including fund or fund management vehicles). The conditions include, inter alia, that the Indian entity should have earned net profits during the preceding three financial years from the financial services activities; that it is registered with the regulatory authority in India for conducting the financial services activities; and that it has obtained approval from the concerned regulatory authorities, both in India and abroad, for venturing into such financial sector activity. However, as in the case of individual residents, Indian corporates investing abroad into a fund which in turn invests into India could raise round tripping concerns.

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

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

A. Mauritius

Mauritius has emerged as a favorite destination for overseas investment into Indian corporates, currently accounting for about 30% of total foreign inflows into India.

Mauritius has special relevance because of the BIPA between India and Mauritius. Currently, India does not have a BIPA with countries such as the US or the Cayman Islands. The BIPA provides a number of benefits including fair and equitable treatment, compensation for losses, protection against expropriation, ability to repatriate capital and returns, efficient dispute resolution framework, etc.

The tax treaty between Indian and Mauritius has recently undergone a change through the Protocol signed between India and Mauritius on May 10, 2016. Prior to the Protocol, the treaty included a provision that exempted a resident of Mauritius from Indian tax on gains derived from the sale of shares of an Indian company. The Protocol now gives India a source based right to tax capital gains which arise from alienation of shares of an Indian resident company acquired by a Mauritian tax resident (as opposed to the previous residence based tax regime under the treaty). However, the Protocol provides for grandfathering of investments and the revised position shall only be applicable to investments made on or after April 01, 2017. In other words, all existing investments up to March 31, 2017 have been grandfathered and exits / shares transfers

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in respect of such investments beyond this date will not be subject to capital gains tax in India. Additionally, the Protocol introduces a limitation of benefits provision which shall be a prerequisite for a reduced rate of tax (50% of domestic tax rate) on capital gains arising during a two year transition period from April 01, 2017 to March 31, 2019.

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

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

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

Based on the new rules, FSC may consider various factors while determining whether a GBC-1 entity is managed and controlled in Mauritius. These include: (i) existence of at least 2 resident directors with relevant expertise, (ii) principal bank account in Mauritius, (iii) accounting records maintained in Mauritius, and (iv)financial statements audited by a local Mauritian auditor. In addition, the FSC may take into account any one of the following criteria: (i) office premise in Mauritius, (ii) at least 1 full time employee in Mauritius, (iii) dispute resolution through arbitration in Mauritius, (iv) assets (excluding cash and shares of GBC-1 company) of at least USD 100,000 in Mauritius, (v) listing on Mauritius stock exchange, and (vi) annual expenditure that is reasonably expected from a similar entity managed and controlled in Mauritius.

B.Singapore

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

The popularity of Singapore as a jurisdiction for making inbound investment into India is linked to the India-Singapore tax treaty. Article 6 of the protocol to the India-Singapore DTAA states that the benefits in respect of capital gains arising to Singapore residents from sale of shares of an Indian Company shall only remain in force so long as the analogous provisions under the India-Mauritius DTAA continue to provide the benefit. Consequently, with the introduction of the 'Protocol' to the India-Mauritius DTAA, the benefits available in respect of capital gains under the India-Singapore DTAA also get impacted. Further, it is not clear whether the grandfathering of investments made before April 01, 2017 will be available to investments made by Singapore residents.

The benefits of the India - Singapore tax treaty should be available to entities that are liable to tax in Singapore based on their residence, domicile or any criterion of a similar nature. However, unlike the India - Mauritius tax treaty, capital gains tax, exemption under the India - Singapore tax treaty was available only on satisfaction of specific conditions referred to as the limitation on treaty benefits (**"LoB"**).[3]

3. The subsequently negotiated protocol to the India-Singapore Treaty requires that the Singapore entity must not be a shell or a conduit. A shell / conduit is an entity with negligible or nil business operations or with no real and continuous business activities carried out in Singapore.

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

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

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

The move has merits for groups that have ability to demonstrate substance (both in the entity and in Singapore as a jurisdiction).

C. Ireland

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

Ireland can, therefore, be explored for debt funds or real estate funds that provide structured debt and also film funds that provide production financing for motion pictures where cash flows received from distributors could be in the nature of royalties. However, the characterization of income would need to be assessed on a case-by-case basis.

D. Netherlands

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

In the context of inbound investments to India, Netherlands emerges as an efficient jurisdiction for making portfolio investments. In certain situations, the India-Netherlands tax treaty provides relief against capital gains tax in India (that follows a source based rule for taxation of capital gains). Gains arising to a Dutch resident arising from the sale of shares of an Indian company to non-resident buyer would not be taxable in India. However, such gains would be taxable if the Dutch resident holds more than 10% of the shares of the Indian company in case of sale to

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referring to two blocks of twelve months immediately preceding the date when the gains arise.

Separately, Article 3 of the Protocol to the India-Singapore Tax Treaty provides that, a Singapore resident company will not be entitled to the favorable treatment of taxation of capital gains on disposal of Indian securities where the affairs of the Singapore resident company are arranged with the primary purpose of taking advantage of the benefits of the capital gains tax exemption provision (i.e., entities not having bona fide business activities may be treated as being arranged with such primary purpose) or is a "shell or conduit" company.

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

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Indian residents. Even though the eligible holding is capped, the same structure works well for FPIs , who are restricted to participate (whether directly or indirectly or synthetically through ODIs) to less than 10% of the paid-up capital of an Indian company.

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

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

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

IV. Recent Changes

The double tax avoidance arrangement between India and Mauritius has undergone a change, as discussed above.

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

Furthermore, the investment conditions for SEBI registered Foreign Venture Capital Investors (**"FVCI"**) have also been relaxed recently by the RBI.

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

4. [2010] 322 ITR 696 (AAR).

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3. Structural Alternatives for India-Focused Funds

Structuring India-focused Offshore Funds

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

I. Foreign Investment Regimes

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

The RBI is given primary authority to regulate capital flows through the FEMA. Notably, Section 6 of FEMA authorises the RBI to manage foreign exchange transactions and capital flows in consultation with the Ministry of Finance pursuant to the Foreign Exchange Manager (Transfer or Issue of Securities to Persons Resident Outside India) Regulations, 2000 (**"TISPRO Regulations"**).

The primary routes for foreign investment into India are (a) the FDI[5] route, (b) FVCI[6] route and the (c) FPI[7] route. In a bid to simplify and rationalize the FPI regime, SEBI has introduced the Securities and Exchange Board of India (Foreign Portfolio Investors) Regulations, 2014 (**"FPI Regulations"**). Under the FPI Regulations, SEBI has harmonized FIIs, sub-accounts and qualified foreign investors into a single investor class with a view to ensure uniform guidelines and provide a single window clearance for different categories of foreign investors. Each of these inbound investment regimes has been discussed in subsequent chapters. Based on the investment strategy and sectoral focus of the concerned fund, the fund could efficiently combine the different investment regimes to make investments in India. The same may require that either the fund itself or an investment holding company obtain registration with SEBI as an FVCI or an FPI.

5. This refers to investments by way of subscription and / or purchase of securities of an Indian company by a non-resident investor. While the RBI allows capital account transactions, these are subject to the Foreign Exchange Management (Transfer or issue of security by a person resident outside India) Regulations 2000 ("**TISPRO Regulations**" issued by the RBI. Thus, 'direct' investments by the offshore fund vehicles / special purpose vehicle (SPV would need to comply with the provisions and restrictions stipulated under the TISPRO Regulations.
6. Given that the FVCI regime has been developed to attract venture capitalists, there are certain incentives attached to being recognised as one. This accordingly requires registration and approval from the regulators (SEBI and RBI). While granting approval to an FVCI, certain restrictions and conditions may be imposed including a restriction on the scope of investments that can be made by the FVCI. The RBI has recently been prescribing in its approval letter to FVCI applicants that the investments by FVCI entities are restricted to select identified sectors (which include, inter alia, infrastructure, biotechnology and IT related to hardware and software development). However, RBI has recently relaxed such sectoral restrictions for investing FVCIs into "startups' (as defined in the relevant amendment to TISPRO regulations). It is also important to note that SEBI-registered FVCIs are specifically exempted from the RBI pricing guidelines.
7. The recently notified FPI Regulations which repeals the FII Regulations significantly revises the regulation of foreign portfolio investments into India. Under the FPI regime, SEBI has harmonized the FII, sub-account and QFI regimes into a single investor class – foreign portfolio investors and provided a single window clearance through designated depository participants ("DDPs. The FPI Regulations classify FPIs into three categories based on their perceived risk profile. The FPI route as such is the preferred route for foreign investors who want to make portfolio investments and trade in Indian listed stocks on the floor of the stock exchange.

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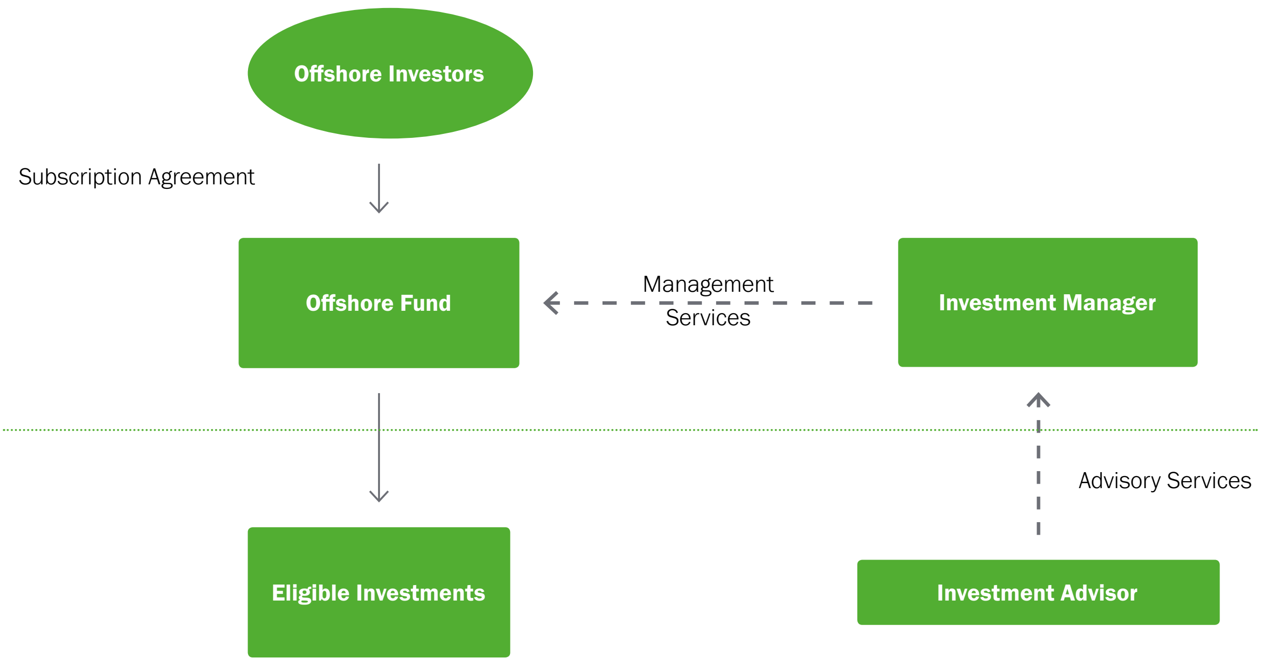
A.Pure Offshore Structure

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

The following diagram depicts a pure offshore structure:



B.Unified Investment Structure

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

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

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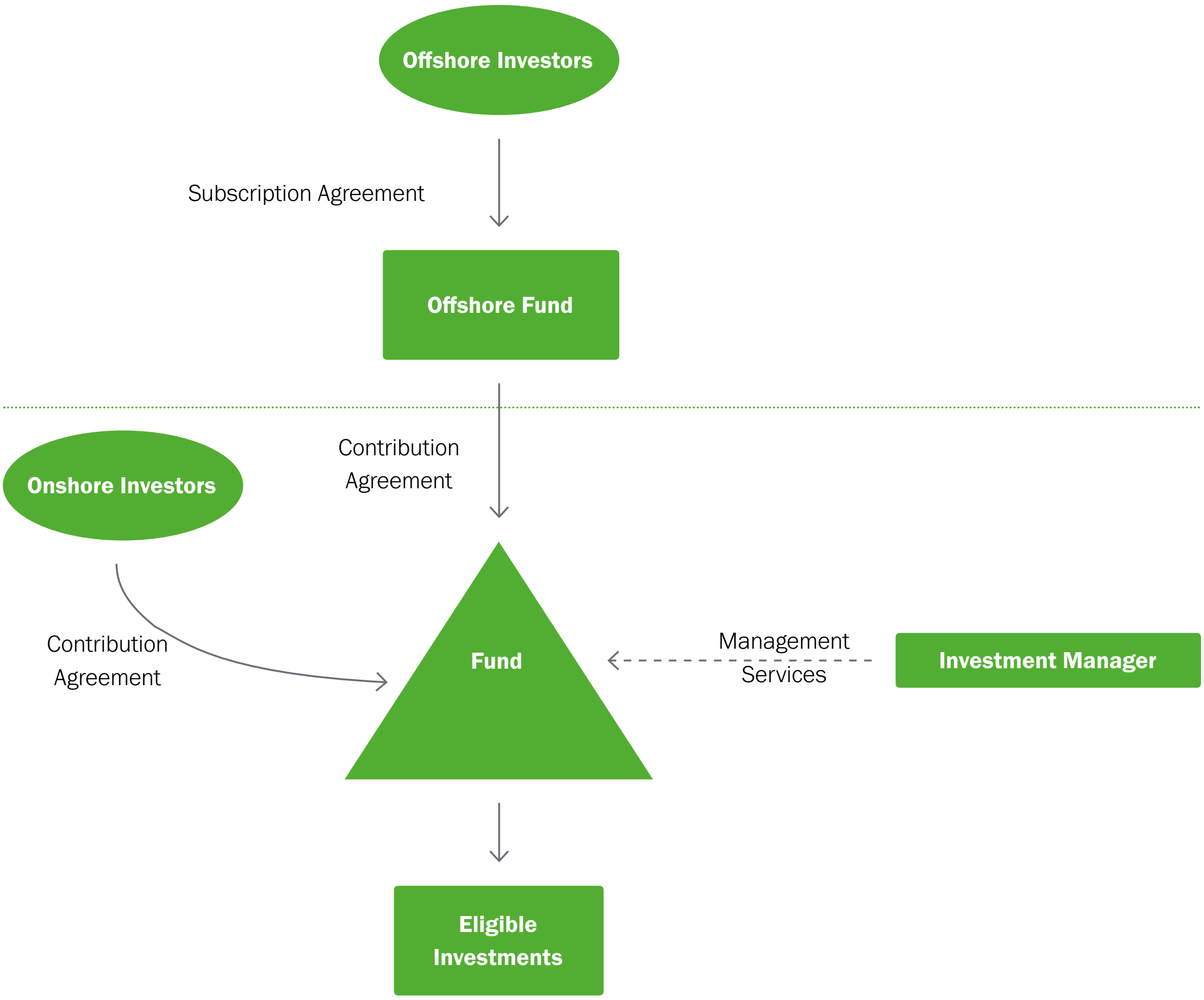
The following diagram depicts a typical unified investment structure:



C. Co-investment / Parallel Investment Structure

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

Typically, the co-investment ratio between the Offshore Fund and the Onshore Fund is the ratio of their undrawn capital commitments.

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

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

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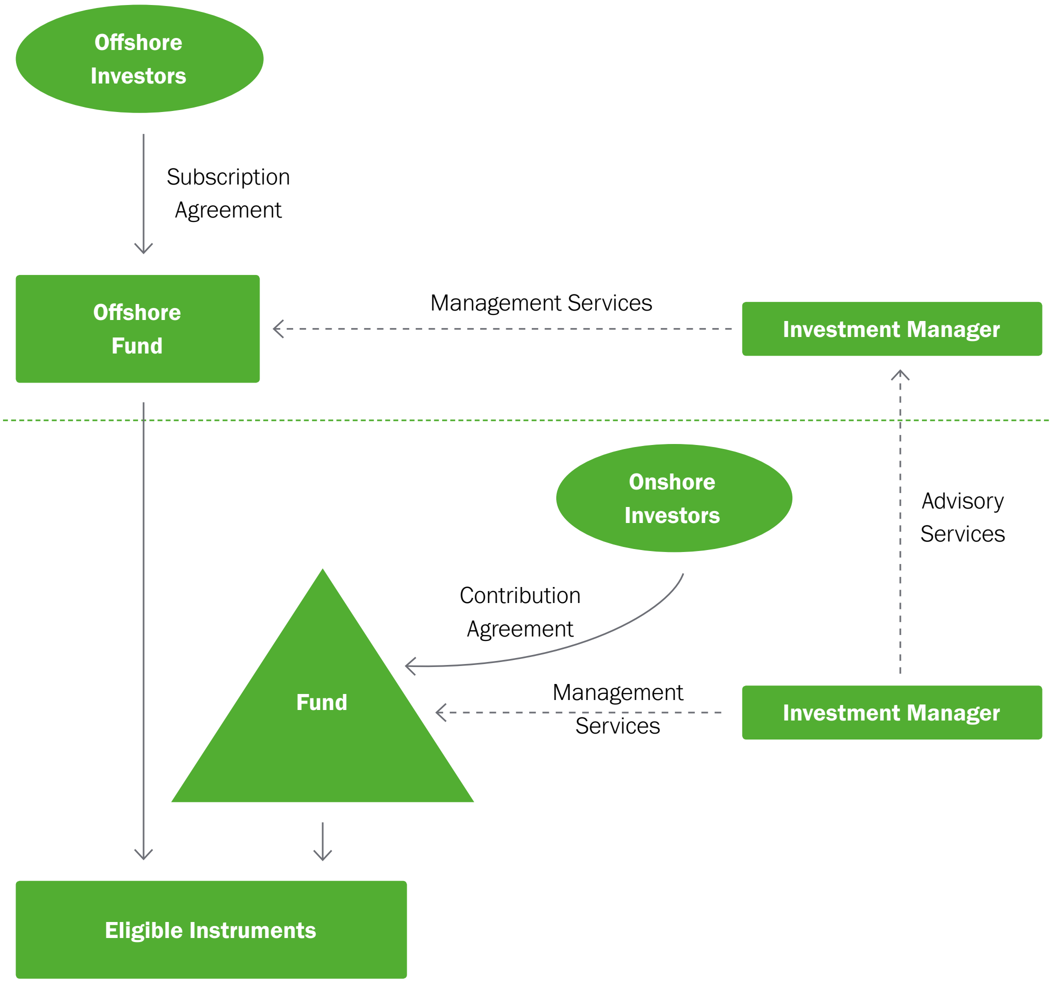
The following diagram depicts a typical co- investment structure:



II. Certain Tax Risks

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

A. Association of Persons (AOP) Risk

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

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B. Indirect Transfer of Capital Assets Risk

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

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

C. General Anti-avoidance Rule ("GAAR") Risk

A statutory GAAR is expected to come into effect from the financial year beginning on April 1, 2017. GAAR, as it is currently drafted, empowers tax authorities to disregard or combine or re-characterize any part or whole of a transaction / arrangement such that the transaction / arrangement gets taxed on the basis of its substance rather than its form if such arrangement gets classified as an impermissible avoidance arrangement. This could result in any tax benefit being denied, including denial of treaty benefits, shifting of residency of investors and / or re-characterization of capital gains income as any other classification. However, all investments made prior to the above mentioned effective date should be grandfathered.

D. Tax Exposure Owing to Permanent Establishment

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

On December 23, 2015 the Indian tax authorities released draft guidance for determining POEM of a company. The draft guidance emphasizes that the test of POEM is one of substance over form and will depend on facts and circumstances of each case. Further, the draft guidance contemplates different tests for companies with active and passive businesses outside India.

The POEM for an active company is presumed to be outside India if the majority of its board meetings are held outside India. To determine the POEM of passive companies, the persons who actually make key management and commercial decisions for the business as a whole will be identified, followed by identifying the place where decisions are actually taken. However, it is essential to note that the tax authorities have received a significant amount of critical feedback from various stakeholders and the same is expected to be considered before a final version of guidance is released.

Recently, the Finance Act, 2016 has deferred the implementation of POEM by one year and is slated to come into effect from April 01, 2017.

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4. Alternative Investment Funds in India

I. Introduction

Before the emergence of the Venture Capital – Private Equity (**"VCPE"**) industry in India, entrepreneurs largely depended on private placements, public offerings and lending by financial institutions for raising capital. However, these did not prove to be optimal means of raising funds.

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

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

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

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

II. Alternative Investment Funds

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

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

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

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

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III. Choice of Pooling Vehicle

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

Issue	Trust	Limited Liability Partnership	Company
General	The person who reposes or declares the confidence is called the "author of the trust"[8]; the person who accepts the confidence is called the "trustee"; the person for whose benefit the confidence is accepted is called the "beneficiary"; the subject matter of the trust is called "trust property"; the "beneficial interest" or "interest" of the beneficiary is the right against the trustee as owner of the trust property; and the instrument, if any, by which the trust is declared is called the "instrument of trust"/ "indenture of trust"	The concept of LLP was recently introduced in India under the Limited Liability Act, 2008 (**"LLP Act"**). An LLP is a hybrid form of a corporate entity, which combines features of an existing partnership firm and a limited liability company (i.e. the benefits of limited liability for partners with flexibility to organize internal management based on mutual agreement amongst the partners). The functioning of an LLP is governed by the LLP agreement.	A Company can be incorporated under the Companies Act, 2013. The control of the company is determined by its board of directors which is elected by the shareholders. Separate classes of securities could be issued to different shareholders that shall determine their rights and obligations (as distinct from other classes) from both, the 'voting' perspective as well as from a 'distribution' perspective. The class structure, however, would need to be in compliance with Companies Act, 2013, as and when all relevant sections thereof are brought into effect.
Entities Involved	**The Settlor:** The Settlor settles a trust with an initial settlement. Terms of the indenture of trust (**"Indenture"**) shall administer the functioning of the trust (**"Trust"**). **The Trustee:** The Trustee is in charge of the overall administration of the Trust and may be entitled to a trusteeship fee. The Trustee may also appoint an investment manager, who in turn manages the assets of the Trust and the schemes / funds as may be launched under such Trust from time to time. **The Contributor:** The contributor is the investor to the Trust (the Fund) and makes a capital commitment under a contribution agreement.	**Partner:** A 'partner' represents an investor in the fund. The LLP structure is conceptually akin to a limited partner as internationally understood in a LP structure. To that extent, a partner has an obligation to fund its 'commitment' to the fund and is entitled to distributions based on fund documents (being the LLP Agreement in this case). **Designated Partner:** Though the expression 'designated partner' is not explicitly defined, however, on a plain reading of the LLP it is understood that such 'designated partner shall be the person responsible and liable in respect of the compliances stipulated for the LLP.	**Shareholders:** Shareholders hold the shares of the company and are granted special privileges depending on the class of shares they own. **Directors:** Directors have a fiduciary duty towards the company with respect to the powers conferred on them by the Companies Act and by the Memorandum of Association and Articles of Association of the company. They are trustees in respect of powers of the company that are conferred upon them, for instance, powers of (a) issuing and allotting shares; (b) approving transfers of shares; (c) making calls on shares; and (d) forfeiting shares for non-payment of call etc. They must act bona fide and exercise these powers solely for the benefit of the company.
Management of entities	The Trustee is responsible for the overall management of the Trust. In practice this responsibility is outsourced to an investment manager pursuant to an investment management agreement.	The LLP relies on the Designated Partner in this respect. In practice, this responsibility may be outsourced to an investment manager pursuant to an investment management agreement.	The board of directors manages the company involved. In practice this responsibility is outsourced to an investment manager pursuant to an investment management agreement.

8. Commonly referred to as a 'settlor'.

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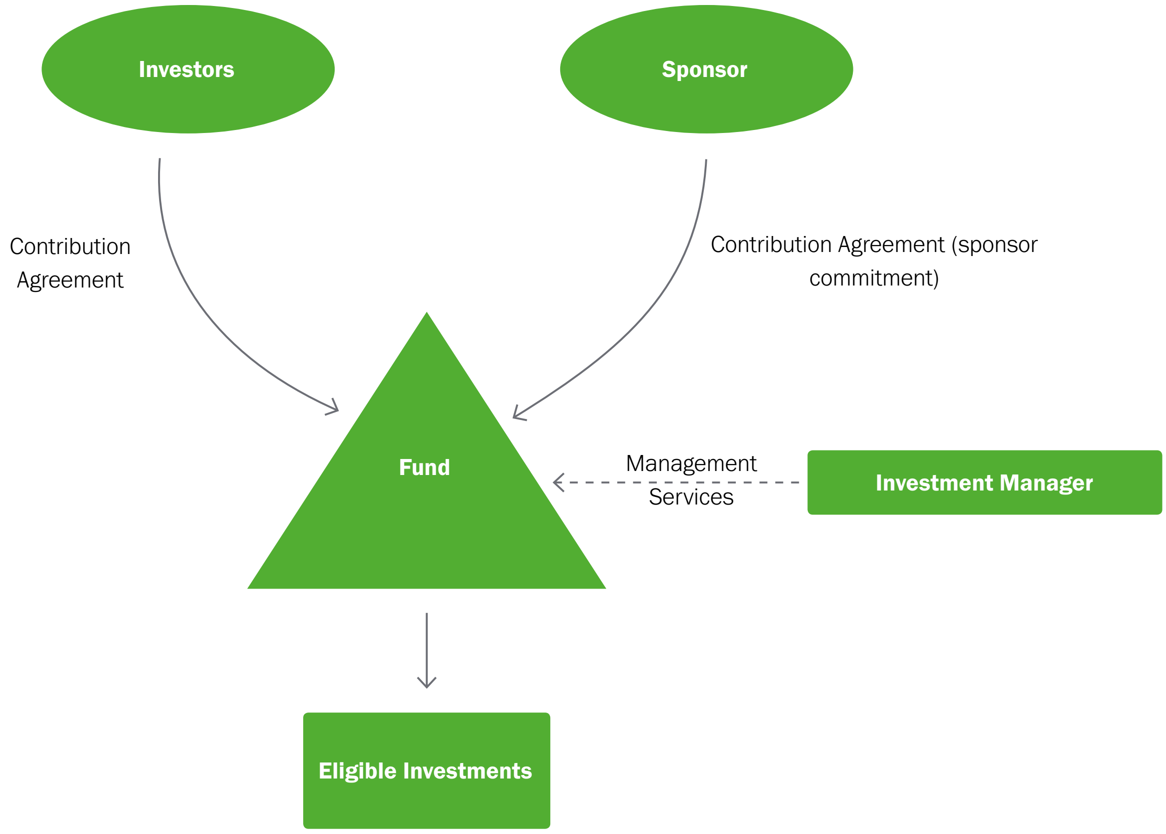
Market Practice	Almost all funds formed in India use this structure. The regulatory framework governing trust structures is stable and allows the management to write its own standard of governance.	Only a few funds are registered under this structure. The Registrar of Companies (**"RoC"**) does not favor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

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



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IV. Classification of AIFs

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

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

Category I AIF	Category II AIF	Category III AIF
i. Category I AIFs are funds with strategies to invest in start-up or early stage ventures or social ventures or SMEs or infrastructure or other sectors or areas which the government or regulators consider as socially or economically desirable. ii. Under the AIF Regulations, the following funds are designated as sub- categories of Category I AIFs - venture capital funds, SME funds, social venture funds, infrastructure funds and such other AIFs as may be specified. In September 2013, SEBI introduced 'angel investment funds' as a sub-class of the venture capital fund sub- category. iii.AIFs which are generally perceived to have positive spillover effects on the economy and therefore, SEBI, the Government of India or other regulators may consider providing incentives or concessions shall be classified as Category I AIFs.	i. Category II AIFs are funds which cannot be categorized as Category I AIFs or Category III AIFs. These funds do not undertake leverage or borrowing other than to meet day-to-day operational requirements and as permitted in the AIF Regulations. ii. AIFs such as private equity funds or debt funds for which no specific incentives or concessions are given by the Government of India or any other regulator are included in the Category II AIF classification.	i. Category III AIFs are funds which employ complex or diverse trading strategies and may employ leverage including through investment in listed or unlisted derivatives. ii. AIFs such as hedge funds or funds which trade with a view to make short-term returns or such other funds which are open ended and for which no specific incentives or concessions are given by the Government of India or any other regulator are included in the Category III AIF classification.

V. Investment Conditions and Restrictions under the AIF Regulations

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

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

b. Co-investment in an investee company by a Manager / Sponsor should not be on more favourable terms than those offered to the AIF;

c. Only a specific percentage of the investible funds (25% for Category I and II AIFs and 10% for Category III AIFs) can be invested in a single investee company;

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

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

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

Investment Restrictions and Conditions for AIFs

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

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VI. Key Themes under the AIF Regulations

A. Continuing Interest

The AIF Regulations require the sponsor or the manager of an AIF to contribute a certain amount of capital to the fund. This portion is known as the continuing interest and will remain locked-in the fund until distributions have been made to all the other investors in the fund. For a Category I or Category II AIF, the sponsor or the manager is required to have a continuing interest of 2.5% of the corpus of the fund or INR 5 crores whichever is lower and in the case of a Category – III AIF, a continuing interest of 5% of the corpus or INR 10 crores whichever is lower. For the newly introduced angel investment funds, the AIF Regulations require the sponsor or the manager to have a continuing interest of 2.5% of the corpus of the fund or INR 50 lakh whichever is lower. Further, the sponsor or the manager (as the case may be) is required to disclose its investment in an AIF to the investors of the AIF.

B. Minimum Corpus

The AIF Regulations prescribe that the minimum corpus for any AIF shall be INR 20 crores (**"Minimum Corpus"**). Corpus is the total amount of funds committed by investors to the fund by way of written contract or any such document as on a particular date. By its circular dated on June 19, 2014, SEBI requires that where the corpus of an open-ended scheme falls below the Minimum Corpus (post redemption(s) by investors or exits), the Fund Manager is given a period of 3 months to restore the Minimum Corpus, failing which, all the interests of the investors will need to be mandatorily redeemed.

C. Minimum Investment

The AIF Regulations do not permit an AIF to accept an investment of less than INR 1 crore (**"Minimum Investment Amount"**) from any investor unless such investor is an employee or a director of the AIF or an employee or director of the manager of the AIF in which case the AIF can accept investments of a minimum value of INR 25 lakh. The Circular has specifically clarified that in case of an open-ended AIF, the first lump-sum investment received from an investor should not be less than the Minimum Investment Amount.[9] Further, in case of partial redemption of units by an investor in an open- ended AIF, the amount of investment retained by the investor should not fall below the Minimum Investment Amount.[10]

D. Qualified Investors

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

E. Foreign investment in AIFs

The RBI has issued a notification dated November 16, 2015 [11] Notification No. FEMA 355/2015-RB (**"November Notification"**) as an amendment to TISPRO Regulations. In terms of the November Notification, foreign investments into an AIF are allowed under the automatic route and the Notification classifies downstream investment by an AIF as foreign investment only if the sponsor and/or the investment manager are not Indian "owned and controlled". Prior to the Notification, foreign investments in AIFs required a specific approval from the FIPB and the downstream investments by such AIFs were also governed by the FDI Policy.

However, the November Notification seemed to prohibit LLPs from acting as the sponsor or manager to an AIF. Subsequently, by a notification dated February 15, 2016 (**"February Notification"**) [12], RBI has clarified the position by permitting LLPs to act as the sponsor or manager of an AIF if they are Indian "owned and controlled". As per the notification, an LLP shall be considered to be Indian "owned and controlled" if:-

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9. CIR/IMD/DF/14/2014.
10. Ibid.
11. Notification No. FEMA 355/2015-RB
12. Notification No. FEM 362/2016-RB)

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a. More than 50% of the investment in such an LLP is contributed by resident Indian citizens and / or entities which are ultimately "owned and controlled" by resident Indian citizens; and

b. Such residents have a majority of the profit share.

Further, the February Notification also states that for the purposes of an LLP, "control" shall mean the right to appoint majority of designated partners, where such designated partners, ***with specific exclusion to others***, have control over all the policies of the LLP.

In addition to the above, the RBI had issued another notification dated February 16, 2016 [13] which states that investments by NRIs under Schedule 4 of TISPRO Regulations will be deemed to be domestic investment at par with the investment made by residents.

F. Maximum Number of Investors

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

G. Private Placement

The AIF Regulations prohibit solicitation or collection of funds except by way of private placement. While the AIF Regulations do not prescribe any thresholds or rules for private placement, guidance is taken from the Companies Act, 2013 (and the Companies Act, 1956).

H.Tenure

While Category I and Category II AIFs can only be closed-end funds, Category III AIFs can be open- ended. The AIF Regulations prescribe the minimum tenure of 3 years for Category I and Category II AIFs. SEBI, vide its circular dated October 01, 2015 (CIR/IMD/DF/7/2015), clarified that the tenure of any scheme of the AIF shall be calculated from the date of the final closing of the scheme. Further, the tenure of any AIF can be extended only with the approval of 2/3rd of the unit-holders by value of their investment in the AIF.

I. Overseas investments by AIFs

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

J. Liquidity Facility

The Circular provides that in case any 'material change' to the placement memorandum (changes that SEBI believes to be significant enough to influence the decision of the investor to continue to be invested in the AIF), is said to have arisen in the event of (1) change in sponsor / manager, (2) change in control of sponsor / manager, (3) change in fee structure which may result in higher fees being charged to the unit holders and (4) change in fee structure or hurdle rate which may result in higher fees being charged to the unit holders. In case of such 'material change', the existing investors who do not wish to continue post the change shall be provided with an exit option and such existing investors will be provided not less than one month for indicating their dissent.

13. Notification No. 362/2016-RB

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VII. Taxation of Alternative Investment Funds

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

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

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

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

The Finance Act , 2015 defines an "investment fund" to mean a fund that has been granted a certificate of registration as a Category I or a Category II AIF and provides that any income accruing or arising to, or received by, a unit-holder of an investment fund out of investments made in the investment fund shall be chargeable to income- tax in the same manner as if it were the income accruing or arising to, or received by such person, had the investments made by the investment fund been made directly by the unit-holder.[14] In other words, the income of a unit-holder in an investment fund will take the character of the income that accrues or arises to, or is received by the investment fund.

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

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

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

Where the total income of an investment fund in a given previous year (before making adjustments under section 10(23FBA) of the ITA) is a loss under any head of income and such loss cannot be, or is not wholly, set-off against income under any other head of income, the Finance Act, 2015 allows such loss to be carried forward and set-off in accordance with the provisions of Chapter VI (Aggregation of Income and Set Off or Carry Forward of Loss). Furthermore, the Finance Act, 2015 provides that the loss will not pass through to the unit holders of an investment fund and accordingly, the unit holders will be precluded from offsetting their proportionate loss from the investment fund against other profits and gains that they may have accrued. This is unlike under the current rules for taxation, where a trust is regarded as being a determinate trust or where an investor's contribution to the trust is regarded as a revocable transfer, in which case the investor retains the ability to off-set its proportionate losses against its other profits and gains.

Furthermore, the CBDT has notified [15] that income received by investment funds would be exempted from TDS by portfolio companies. This should be helpful in case of interest / coupon payouts by portfolio companies to such funds. Previously, it was administratively difficult for investors to take credit of the TDS withheld by portfolio companies.

14. Explanation 1 to Section 115UB of the Income Tax Act, 1961.

15. Vide Notification No. 51 / 2015 dated June, 2015

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

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

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

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

B.Taxation of Category III AIFs

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

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

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

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

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

The Bangalore Income Tax Appellate Tribunal in the case of *DCIT v. India Advantage Fund – VII* [16] held that income arising to a trust where the contributions made by the contributors are revocable in nature, shall be taxable at the hands of the contributors. The ruling comes as a big positive for the Indian fund industry. The ruling offers some degree of certainty on the rules for taxation of domestic funds that are set up in the format of a trust by regarding such funds as fiscally neutral entities. Globally, funds have been accorded pass through status to ensure fiscal neutrality and investors are taxed based on their status. This is especially relevant when

16. ITA No.178/Bang/2012

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certain streams of income maybe tax free at investor level due to the status of the investor, but taxable at fund level. Funds, including AIFs that are not entitled to pass through status from a tax perspective (such as Category III AIFs) could seek to achieve a pass through basis of tax by ensuring that the capital contributions made by the contributors is on a revocable basis.)

VIII. Finance Act, 2016

The Tax Act has a special taxation regime in respect of category-I and category-II AIFs that ensured tax pass through status for these AIFs. Under the aforementioned regime, income of the AIF (except business income) was exempt in the hands of the AIF and taxable in the hands of the investor. However, a major operational hurdle was placed on this provision due to the withholding requirements under Section 194 LBB of the ITA. Under Section 194 LBB, any income credited or paid by the investment fund was subject to a withholding tax of 10% which was required to be deducted by the AIF. This blanket requirement was considered to be at odds with the tax pass-through policy as it did not account for exempt investors and exempt streams of income.

Consequently, there was a demand to rationalize the tax withholding requirements to ensure that no such deduction is required at the time of making distributions to exempt investors, distributions of streams of income that are exempt from tax and the recognition of beneficial provisions of the various DTAAs that India has entered into.

The Finance Act, 2016 has rationalized the deduction requirements by making the following changes with respect to the amount that is required to be withheld by an investment fund:-

- **Distributions to non-residents (not being a company) or a foreign company:** Tax will be required to be deducted as per the “rates in force”. The term “rates in force” has been defined under Section 2(37A) of the Tax Act and the Finance Act, 2016 has amended the provision to include deductions under Section 194LBB. This would make the withholding rate subject to the rates that are applicable under the Tax Act or those in accordance with the applicable DTAA, whichever is more favorable. The amendment will ensure that there is nil or lower withholding of tax required when distributions are being made to investors who are residents of countries that have a beneficial DTAA with India. This is a welcome change that will favor unified fund structures and encourage participation by Non-Resident Indians (**“NRIs”**) / foreign residents into AIFs.

- **Distributions to residents:** Tax will be required to be deducted at the rate of 10%. This is a continuation of the existing provisions as far as distributions to residents are considered. Consequently, the provision still does not differentiate between taxable streams of income and steams of income not subject to tax. For example, an investment fund would still be required to deduct tax at 10% when distributing income earned from dividends received. This creates an anomaly as such dividend income is not subject to tax in the hands of the investor. Further, the provision also does not account for distributions to exempt domestic investors. However, Section 197 of the ITA has been amended to allow AIFs to obtain nil / reduced tax withholding certificates with respect to exempt investors and exempt streams of income.

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5. Trends in Private Equity

The standard of what constitutes an 'alignment of interests' between fund investors (LPs) and fund managers (GPs) of an India-focused fund or an India-based fund has undergone some degree of change over the years. Typically, LP participation in a fund is marked by a more hands-on approach in discussing and negotiating fund terms which by itself is influenced by a more comprehensive due diligence on the track record of the GP and the investment management team. This chapter provides a brief overview of certain fund terms that have been carefully negotiated between LPs and GPs in the Indian funds context.

I. Investment Committee and Advisory Board

Sophisticated LPs insist on having a robust decision-making process whereby an investment manager will refer investment and / or divestment proposals along with any due diligence reports in respect of such proposals to an investment committee comprising representatives of the LPs as well as the GP. The investment committee is authorized to take a final decision in respect of the various proposals that are referred to it. In view of this, the composition of the investment committee and the nature of rights granted to certain members can become very contentious. The committee is also empowered to monitor the performance of investments made by the fund on an on-going basis. Separately, any transaction that could involve a potential conflict of interest is expected to be referred for resolution to an advisory board consisting of members who are not associated with the GP.

II. Management Fee

Keeping with the global trend, there appears to be less tolerance among India-focused LPs to invest in a fund that provides a standard '2-20' fee – carry model. Since management fee bears no positive correlation to the performance of the investments made by the fund, LPs can be circumspect about the fee percentage. Further, issues may arise with respect to the base amount on which the management fee is computed. During the commitment period, fee is calculated as a percentage of the aggregate capital commitments made to a fund. After the commitment period, fee is calculated as a percentage of the capital contribution that has not yet been returned to the LPs. The fee percentage itself is generally a function of the role and responsibilities expected to be discharged by a GP. It is not uncommon to see early stage capital and VCFs charging a management fee that is marginally higher than the normal. Recently, LPs have requested that the management fee after the commitment period be charged on the amount of unreturned capital contribution which has been invested and not on the amounts utilized towards expenses or management fees.

III. Expenses

LPs express concern with respect to the kind of expenses that are charged to the fund (and by extension, to their capital contributions). With a view to limiting the quantum of expenses that are paid by the fund, LPs insist on putting a cap on expenses. The cap is generally expressed as a percentage of the size of the fund or as a fixed number can become a debatable issue depending on the investment strategy and objective of the fund. GPs often try to negotiate for annual caps for operating expenses, given the long tenure of VCPE funds and the difficulty in ascertaining the appropriate cap for the entire tenure upfront; whereas, LPs prefer a cap for the entire tenure to be disclosed upfront in the fund documents. If an annual cap method is chosen, LPs often seek the right to be consulted before setting the annual cap by GPs.

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

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IV. Waterfall

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

V. Giveback

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

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

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6. Fund Documentation

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

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

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

I. At the Offshore Fund level

A. Private Placement Memorandum / Wrapper

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

B. Constitution

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

C. Subscription Agreement

The subscription agreement is an agreement that records the terms on which an investor will subscribe to the securities / interests issued by an offshore fund. The subscription agreement sets out the investor's capital commitment to the fund and also records the representations and warranties made by the investor to the fund. This includes the representation that the investor is qualified under law to make the investment in the fund.[17]

D. Advisory Agreement

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

17. In case the fund is set up in the format of a limited partnership, this document would be in the format of a limited partnership agreement (with the 'general partner' holding the management interests).

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

II. At the Onshore Fund level

A. Private Placement Memorandum

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

SEBI has now directed fund managers to add by way of an annexure to the placement memorandum, a detailed tabular example of how the fees and charges shall be applicable to the investor and the distribution waterfall for AIFs.[18]

AIFs should also include disciplinary actions in its PPM.[19]It has been clarified by SEBI that AIFs should also include a disciplinary history of the AIF, sponsor, manager and their directors, partners, promoters and associates and a disciplinary history of the trustees or the trustee company and its directors if the applicant for AIF registration is a trust.[20]

Any changes made to the PPM submitted to SEBI at the time of the application for registration as an AIF must be listed clearly in the covering letter submitted to SEBI and further to that, such changes must be highlighted in the copy of the final PPM.[21] In case the change to the PPM is a case of a 'material change' (factors that SEBI believes to be a change significantly influencing the decision of the investor to continue to be invested in the AIF), said to arise in the event of (1) change in sponsor / manager, (2) change in control of sponsor / manager, (3) change in fee structure or hurdle rate which may result in higher fees being charged to the unit holders), existing unit holders who do not wish to continue post the change shall be provided with an exit option.[22]

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

B. Indenture of Trust

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

18. Paragraph 2(a)(i)of the SEBI Circular CIR/IMD/DF/14/2014.
19. Regulation 11(2) AIF Regulations.
20. Regulation 2(1)(c) of the AIF Regulations.
21. Paragraph 2(b)(i) of the SEBI Circular CIR/IMD/DF/14/2014.
22. Paragraph 2(b)(iv)(a) of the SEBI Circular CIR/IMD/DF/14/2014.

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The formula for computing beneficial interest is required to establish the determinate nature of the trust and consequently for the trust to be treated as a pass-through entity for tax purposes.

C. Investment Management Agreement

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

D. Contribution Agreement

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

III. Investor Side Letters

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

IV. Agreements with Service Providers

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

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7. Hedge Funds

'Hedge funds' lack precise definition and typically operate on an unregulated basis. The term seems to have derived from the investment and risk management strategies they tend to adopt.

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

As already, the FII Regulations stand repealed by the Securities and Exchange Board of India (Foreign Portfolio Investors) Regulations, 2014 which were notified by SEBI on January 07, 2014. The FPI Regulations have been in effect from June 01, 2014.[23] This section deals with eligible participants under the FPI Regulations, the range of investment and hedge strategies that may be adopted and the scope of dealing with contract notes (swaps and offshore derivative instruments, i.e. ODIs).

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

I. FPI Regulations

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

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

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

A. Meaning of FPI

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

In respect of entities seeking to be registered as FPIs, DDPs are authorized to grant registration on behalf of SEBI with effect from June 01, 2014. The application for grant of registration is to be made to the DDP in a prescribed form along with the specified fees. The eligibility criteria for an FPI, inter-alia, include:

23. SEBI Circular CIR/IMD/FIIC/6/2014 dated March 28, 2014, para 4(a).

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i. The applicant is a person not resident in India[24];

ii. The applicant is resident of a country whose securities market regulator is a signatory to the International Organization of Securities Commission's Multilateral Memorandum of Understanding or a signatory to a bilateral Memorandum of Understanding with the SEBI;

iii. The applicant is not residing in a jurisdiction identified by the Financial Action Task Force (FATF):

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

b. combating the Financing of Terrorism deficiencies; or

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

iv. The applicant being a bank[25], is a resident of a country whose Central bank is a member of Bank for International Settlements;

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

vi. The applicant is a fit and proper person as per the SEBI (Intermediaries) Regulations, 2008.

A certificate of registration granted by a DDP shall be permanent unless suspended or cancelled by SEBI or surrendered by the FPI. A DDP may grant conditional registration, subject to fulfilment of specified conditions.[26] For example, a conditional registration may be granted to an entity with a validity period of 180 days, to achieve the broad based criteria as required to qualify as a Category II FPI.

B. Categories of FPI

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

Category	Category I FPI	Category II FPI	Category III FPI
Eligible Foreign Portfolio Investors	Government and Government-related investors such as central banks, Governmental agencies, sovereign wealth funds or international and multilateral organizations or agencies.	i. Appropriately regulated broad based funds[27]; ii. Appropriately regulated persons[28]; iii. Broad-based funds that are not appropriately regulated[29]; iv. University funds and pension funds; and v. University related endowments already registered with SEBI as FIIs or sub-accounts.	Includes all eligible FPIs who are not eligible under Category I and II, such as endowments, charitable societies, charitable trusts, foundations, corporate bodies, trusts, individuals and family offices.

24. The term "persons", "non-residents" and "resident" used herein have the same meaning as accorded to them under the Tax Act.

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

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

27. Includes mutual funds, investment trusts, and insurance / reinsurance companies.

28. Includes banks, asset management companies, investment managers / advisors, portfolio managers.

29. This is subject to the fact that the investment manager of such

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In relation to a Category II FPI, "appropriately regulated" means "regulated or supervised in same capacity in which it proposes to make investments in India".[30]In order to find out whether an entity is regulated in the same capacity, the DDP has the option of verifying if the FPI is allowed by its regulator to carry out such activity under its license / registration granted by the regulator.[31]

If an FPI ceases to meet the eligibility requirements for a particular category, then it will be reclassified under another appropriate category and the FPI shall be required to provide the DDP with additional KYC documents. Fresh purchases would not be allowed until the additional documents are forwarded but the FPI will be allowed to sell the securities already purchased by it.[32]

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

As discussed above, the FPI Regulations provide that any FII / or a sub-account which holds a valid ertificate of registration shall be deemed to be an FPI until the expiry of the block of three years for which fees has been paid as per the FII Regulations. In other words, existing FIIs or sub-accounts will be deemed to be FPIs under the FPI Regulations.[33]

Further, the FPI Regulations provide that existing FIIs or sub-accounts can continue to buy, sell or deal in securities till the expiry of their registrations (as FIIs and sub-accounts respectively) or until such earlier time when the existing FIIs or sub-accounts make payment of the applicable conversion fee for converting into FPIs.[34]The FPI Regulations prescribe a conversion fee of USD 1,000 payable by the existing FII or sub-account to SEBI.[35]

In cases where an FII has multiple proprietor sub-accounts and one of them chooses to convert as FPI, then the conversion of all other sub-accounts of that FII to FPI will follow. This requirement applies only when the proprietary sub-account is the one being converted, in case of other sub-accounts, the remaining sub-accounts (whether proprietary or broad-based) do not have to convert.[36]

If an entity engages Multiple Investment Management (**"MIM"**) structure, then it is allowed to obtain multiple registrations with SEBI and these applicants will be required to appoint the same local custodian.[37] For the purposes of investment limits, these multiple registrations will be clubbed and the same position will continue in the FPI regime.[38] Investment limits will be monitored at the investor group level by the depositories based on the information provided by DDPs and necessary information will be shared between the depositories.[39]

Also, a fund which has NRIs for investors will not be barred from obtaining registration as FPI under the FPI regime (as was the case in the FII regime).[40]

D. Broad Based Criteria

Under the erstwhile FII Regulations, a "broad-based fund" meant a fund, established or incorporated outside India which has at least 20 investors with

broad based fund is regulated and undertakes that it will be responsible for the acts, omissions and other things done by the underlying broad-based funds.

30. Explanation 1 to Regulation 5(b) of the FPI Regulations.
31. SEBI, FPI FAQs, Question 18.
32. SEBI Circular CIR/IMD/FIIC/02/2014 dated January 08, 2014.
33. Regulation 2(1)(h) r/w Regulation 2(1)(g) of the FPI Regulations.
34. Proviso to Regulation 3(1) of the FPI Regulations.
35. Part A of the Second Schedule of the FPI Regulations.
36. Regulation 3(1) of the FPI Regulations.
37. A 'custodian' means a person who has been granted a certificate of registration to carry on the business of custodian of securities under the Securities and Exchange Board of India (Custodian of Securities) Regulations, 1996.
38. SEBI, FPI FAQs, Question 6.
39. SEBI, FPI FAQs, Question 58.
40. SEBI, FPI FAQs, Question 25.

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no individual investor holding more than 49% of the shares or units of the fund. It was also provided that if the broad-based fund had any institutional investor, it was not necessary for such fund to have 20 investors. Further, any institutional investor holding more than 49% of the shares or units of the fund would have to itself satisfy the broad based criteria.[41]

Under the FPI regime, every fund, sub-fund or share class needs to separately fulfill the broad based criteria where a segregated portfolio is maintained. Therefore, where a newly added class of shares is not broad-based then the FPI will have to provide an undertaking to the DDP that the new class will become broad-based within 90 days from the date of DDP approval letter.[42]

The FPI Regulations continue to follow the broad-based criteria with two notable deviations. One, in order to satisfy the broad-based criteria, it would be necessary for a fund to have 20 investors even if one of the investors is an institutional investor. Two, for the purpose of computing the number of investors in a fund, both direct and underlying investors (i.e. investors of entities that are set up for the sole purpose of pooling funds and making investments) shall be counted. An FPI, who has a bank as an investor will be deemed to be broad based for the purposes of FPI Regulations as was the case in the FII regime.[43]

E. Investments

The FPI Regulations provide that investment in the issued capital of a single company by a single FPI or an investor group shall be below 10% of the total issued capital of the company.[44]

The FPI Regulations further provide that in case the same set of ultimate beneficial owner(s) invests through multiple FPI entities, such FPI entities shall be treated as part of the same investor group and the investment limits of all such entities shall be clubbed at the investment limit as applicable to a single FPI.[45] As per the Operational Guidelines for Designated Depository Participants (Operational Guidelines) released by SEBI, for the purpose of ascertaining an investor group, the concerned DDPs shall consider all such entities having direct or indirect common shareholding / beneficial ownership / beneficial interest of more than 50% as belonging to same investor group.[46] The investment limit of 10% and clubbing of investments has also been made applicable to offshore derivative instruments, as explained subsequently in this chapter.

Further, FPIs are allowed to offer cash or foreign sovereign securities with AAA rating or corporate bonds or domestic government securities, as collateral to the recognized stock exchanges for their transactions in the cash as well as derivative segment of the market, subject to norms specified by RBI, SEBI and Clearing Corporations.[47]

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

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

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

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

d. derivatives traded on a recognized stock exchange in India;

e. dated government securities;

f. rupee denominated credit enhanced bonds;

g. security receipts issued by asset reconstruction companies;

41. Explanation 2 to Regulation 5.
42. SEBI, FPI FAQs, Question 49.
43. Regulation 5(b) of the FPI Regulations.
44. Regulation 21(7) of the FPI Regulations.
45. Regulation 23(3) of the FPI Regulations
46. Paragraph 4.2 of the Operational Guidelines.
47. SEBI Circular CIR/MRD/DRMNP/9/2013, March 20, 2013.

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h. perpetual debt instruments and debt capital instruments, as specified by the Reserve Bank of India from time to time;

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

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

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

l. Indian depository receipts; and

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

In respect of investments in the secondary market, the following additional conditions shall apply[48]:

An FPI shall transact in the securities in India only on the basis of taking and giving delivery of securities purchased or sold except in the following cases:

a. any transactions in derivatives on a recognized stock exchange;

b. short selling transactions in accordance with the framework specified by SEBI;

c. any transaction in securities pursuant to an agreement entered into with the merchant banker in the process of market making or subscribing to unsubscribed portion of the issue in accordance with Chapter XB of the Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2009;

d. any other transaction specified by SEBI.

48. Regulation 21(4) of the FPI Regulations.

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

a. FPIs will be allowed to invest only in corporate bonds which have a minimum residual maturity of three years.

b. FPIs will be prohibited from investing in corporate bonds with optionality clauses exercisable before three years have elapsed.

c. FPIs will not be subject to a lock-in period and will be free to sell corporate bonds, including those with a maturity of less than three years, to domestic investors.

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

As per the recent changes introduced by the RBI in the TISPRO Regulations,[49] FPIs can also invest in the units of an investment vehicle; where "investment vehicle" shall mean an entity registered and regulated under the relevant regulations framed by SEBI or any other authority designated for the purpose and shall include Real Estate Investment Trusts (**"REIT"**) governed by the SEBI (REITs) Regulations, 2014, Infrastructure Investment Trusts (**"InvIts"**) governed by the SEBI (InvIts) Regulations, 2014 and Alternative Investment Funds governed by the SEBI (AIFs) Regulations, 2012; and "unit" shall mean beneficial interest of an investor in the investment vehicle (as defined above) and shall include shares or partnership interests.

F. Protected Cell Companies

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

49. Notification No. FEMA 362 / 2016 - RB

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Based on the representations made by our firm, SEBI had provided that entities that apply for registration under the FII Regulations shall not be regarded as having an opaque structure if they are required by their regulator or under any law to ring fence their assets and liabilities from other funds / sub-funds in the entity. This applied for structures such as open-ended investment companies (**"OEIC"**) in the UK. OEICs are typically set up in the format of umbrella companies that have several 'sub funds'. Recent amendments to the OEIC regulations in the UK required that a PCC structure be adopted to ring fence liabilities between these sub-funds.

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

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

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

c. the applicant has given an undertaking to provide information about its beneficial owners, if asked for it by SEBI.[50]

G. Tax Treatment of FPI Investments

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

The Tax Act with effect from April, 2015 states that securities held by an FPI will be considered "capital assets", and gains derived from their transfer will be considered "capital gains". As a result of this amendment, gains arising on disposal / transfer of a range of listed securities including shares, debentures and eligible derivative instruments as may have been acquired under applicable laws, shall be taxed as capital gains (and not business income) under Indian domestic law.

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

In comparison, capital gains are generally taxable unless the non-resident invests through a favourable treaty jurisdiction such as Mauritius, Singapore or Cyprus (till the effect of the recently introduced protocol sets in). While revenue authorities have tended to treat the income of FPI as capital gains on this account, the position has undergone much litigation in the past.

II. Participatory Notes and Derivative Instruments

A. Overview

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

P-Notes are issued by FIIs (and eligible FPIs). The FPI Regulations specifically exclude Category-III FPIs and certain Category-II FPIs (those that are unregulated broad-based funds who rely on

50. SEBI Circular CIR/IMD/FIIC/21/2013 dated December 19, 2013.

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their investment managers to obtain registration as Category-II FPIs), from issuing, subscribing or otherwise dealing in ODIs.[51]

ODIs can only be issued (a) to those persons who are regulated by an appropriate foreign regulatory authority; and (b) after compliance with 'know your client' norms. Accordingly, an FII (or an eligible FPI) seeking to issue ODIs to any person must be satisfied that such person meets these two tests.[52] Therefore, to be perceived / classified as reportable ODIs, the concerned offshore contracts would need to refer to an Indian underlying security and also be hedged in India to whatever extent by the issuer FII / FPI. Accordingly, unless so hedged, an ODI remains a contract note, that offers its holder a return linked to the performance of a particular underlying security but need not be reported under the disclosure norms set out under the FPI Regulations.

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

The FPI Regulations provide that Category I FPIs and Category II FPIs (which are directly regulated by an appropriate foreign regulatory authority)[53] are permitted to issue, subscribe to and otherwise deal in ODIs. However, those Category II FPIs which are not directly regulated (which are classified as Category-II FPIs by virtue of their investment manager being appropriately regulated) and all Category-III FPIs are not permitted to issue, subscribe to or deal in ODIs.

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

FPIs shall have to fully disclose to SEBI, any information concerning the terms of and parties to ODIs entered into by it relating to any securities listed or proposed to be listed in any stock exchange in India. On November 24, 2014, SEBI issued a circular1(**"Circular"**) aligning the conditions for subscription of ODIs to those applicable to FPIs. The Circular makes the ODI subscription more restrictive.

As per the Circular, read with the FPI Regulations, to be eligible to subscribe to ODI positions, the subscriber should be regulated by an International Organization of Securities Commissions (**"IOSCO"**) member regulator or in case of banks subscribing to ODIs, such bank should be regulated by a Bank for International Settlements (**"BIS"**) member regulator.

It states that an FPI can issue ODIs only to those subscribers who meet certain eligibility criteria mentioned under regulation 4 of the FPI Regulations (which deals with eligibility criteria for an applicant to obtain registration as an FPI) in addition to meeting the eligibility criteria mentioned under regulation 22 of the FPI Regulations. Accordingly, ODIs can now only be issued to those persons who (a) are regulated by an 'appropriate foreign regulatory authority'; (b) are not resident of a jurisdiction that has been identified by Financial Action Task force (**"FATF"**) as having strategic Anti-Money Laundering deficiencies; (c) do not have 'opaque' structures (i.e. PCCs / segregated portfolio companies ("SPCs or equivalent structural alternatives); and (d) comply with 'know your client' norms.

51. Regulation 22 of the FPI Regulations.

52. Ibid.

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

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

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

The existing ODI positions will not be affected by the Circular until the expiry of their ODI contracts. However, the Circular specifies that there will not be a rollover of existing ODI positions and for any new ODI positions, new contracts will have to be entered into, in consonance with the rules specified in the Circular.[54]

SEBI has recently issued a circular [55] (**"ODI KYC Circular"**) to bring about uniformity and increase the transparency among ODI issuers for adopting systems and procedures to comply with the conditions mentioned under the FPI Regulations. The ODI KYC Circular requires that ODI issuers put in place necessary controls, systems and procedures with respect to ODIs to comply with the updated compliance requirements. These systems will undergo a periodical review and evaluation by the ODI issuers.

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

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

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

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

54. http://www.nishithdesai.com/information/research-and-articles/nda-hotline/nda-hotline-single-view/article/sebi-rewrites-rules-on-offshore- derivative-instruments-odi.html?no_cache=1&cHash=60c81c4a0fcc1c1ffbbe8d2aae5e2e5b.

55. CIR/IMD/FPI&C/59/2016 dated June 10, 2016.

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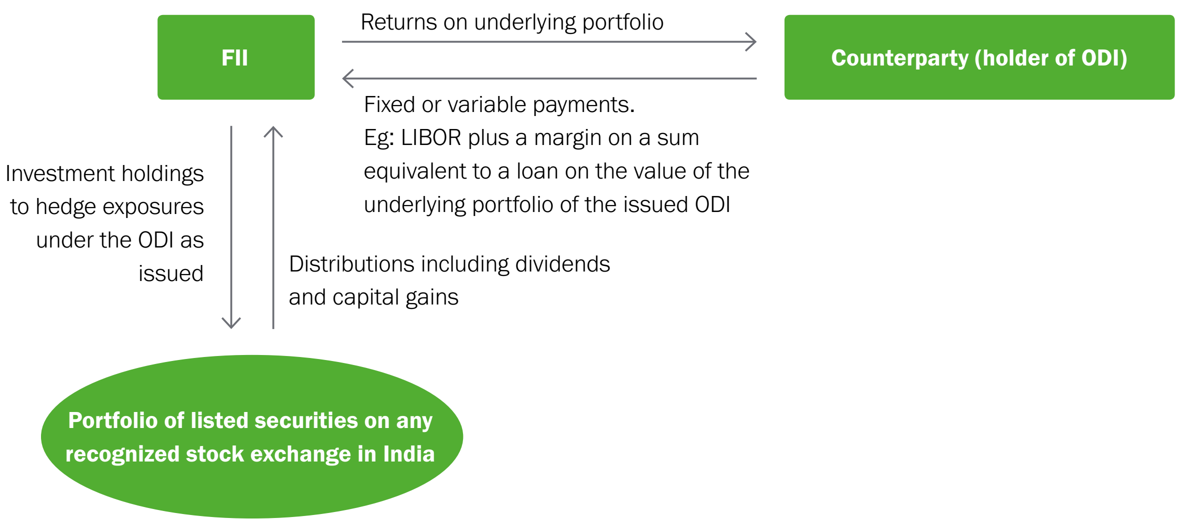

B.Position of Tax on P-Notes

Under sections 4 and 5 of the Tax Act, non-residents may be taxed only on income that accrues in India or which arises from sources in India. The source rules for specific types of income are contained in section 9, which specifies certain circumstances where such income is deemed to accrue or arise in India. Capital gains from the transfer or sale of shares or other securities of an Indian company held as capital assets would ordinarily be subject to tax in India (unless specifically exempted).

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

In Vodafone *International Holdings B.V. v. Union of India*,[56] the Indian Supreme Court stated that the Indian tax authorities are to only "look at" a particular document or transaction when determining the taxability thereof, thus, indicating a form-over-substance approach with respect to taxation. Thus, in light of the above-mentioned determination, an indirect transfer of capital assets situated in India, between two non-residents, executed outside India was held to be not taxable under the Tax Act.

In response to the decision of the Supreme Court, a retroactive clarification was inserted in the Tax Act by the Finance Act, 2012, to state that such foreign shares or interest may be treated as a capital asset situated in India if it "derives, directly or indirectly, its value substantially from assets located in India". The newly introduced Explanation 5 to section 9(1)(i) expands the source rule to cover shares or interest in a foreign company, the value of which is substantially derived from assets situated in India. However, while the foreign shares / interest may be deemed to be situated in India, the charge of capital gains tax may not extend to that portion of its value relating to assets located outside India. Assets located outside India do not have any nexus with the territory of India to justify taxation under the Tax Act. It is, therefore, necessary to "read down" the amended section 9(1)(i) based on the nexus principle.

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

56. Vodafone International Holdings B.V. v. Union of India & Anr. [S.L.P. (C) No. 26529 of 2010, dated 20 January 2012].

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

III. Onshore Hedge Funds

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

While the general characteristics of Category III AIFs have been discussed previously, it is important to stress on certain key aspects. The AIF Regulations provide that Category III AIFs may engage in leverage or borrow subject to consent from the investors in the fund and subject to a maximum limit specified by SEBI. On July 29, 2013, SEBI issued a circular [57] which laid down certain important rules relating to redemption restrictions and leverage.

A. Redemption Restrictions

A Category III AIF cannot impose redemption restrictions unless the possibility of suspension of redemptions has been disclosed in the placement memorandum and such suspension can be justified as being under exceptional circumstances and in the best interest of investors. This could mean that the practice of using 'gates' to limit the frequency and quantum of redemption may be impacted. Further, in the event of a suspension of redemption, a fund manager cannot accept new subscriptions and will have to meet the following additional obligations:

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

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

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

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

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

B. Leverage Guidelines

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

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

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

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

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

57. SEBI Circular CIR/IMD/DF/10/2013.

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

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

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8. Fund Governance

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

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

I. Investment Manager

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

II. Investment Committee

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

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

III. Advisory Board

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

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

IV. Aspects and Fiduciaries to be considered by Fund Directors

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

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

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

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

The Grand Court ruled against each of the directors in the amount of $111 million.

It was also observed, that the comfort from indemnity clauses are for reasonably diligent independent directors to protect those who make an attempt to perform their duties but fail, not those who made no serious attempt to perform their duties at all.

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

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

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

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

We summarize below the duties of directors based on the above judgments that should guide a director during the following phases in the life of a fund:

A.At the Fund Formation Stage

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

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

B.During the Fund's Tenure

i. Appointment of Service Providers

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

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ii. Agenda

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

iii. Actions Outside Board Meetings

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

iv. Decision Making Process

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

v. Minutes

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

vi. Remuneration

The remuneration for independent directors should be commensurate to the role and functions expected to be discharged by them. While a more-than-adequate remuneration does not establish anything, an inadequate recompense can be taken as a ground to question whether the concerned director intends to perform his / her duties to the Fund.

vii. Conflict of interest

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

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

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

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9. International Tax Considerations

I. Taxation of Indirect Transfers

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

As stated above, for a non-resident to be subject to tax in India, the Tax Act requires that the income should be received, accrued, arise or deemed to be received, accrued or arisen to him in India.[58] In this regard, section 9(1)(i) of the Tax Act provides the circumstances under which income of a non-resident may be deemed to accrue or arise in India:

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

This source rule pertaining to a "capital asset situate in India" was examined by the Supreme Court of India in Vodafone International Holdings [59], which dealt with transfer of shares of a foreign company between two non-residents. It was held that a share is legally situated at the place of incorporation of the company. Therefore, while the shares of an Indian company would be considered situated in India, the shares of a company incorporated outside India would ordinarily be viewed as situated outside India.

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

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

Therefore, under the current law, shares of a foreign incorporated company can be considered to be a "situate in India" if the company derives "its value substantially from assets located in India". The Tax Act is silent on how to compute / allocate the derivation of substantial value.

Therefore, in the absence of any binding statutory or judicial analysis, there is no clarity on the circumstances when shares of an offshore company substantially derive their value from assets located in India. Thus, there is an uncertainty on the applicability of the source rule in case of transfer of shares of an offshore company with assets in India and there is a possibility that Indian tax authorities may seek to tax the transfer or redemption of shares in an India-focused offshore fund by its investors notwithstanding that there is no transfer taking place in India, on the basis that the shares of the Fund derive substantial value from India.

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58. Section5(2) of the Tax Act.
59. (2012) 341 ITR 1.
asset being any share or interest in a company or entity registered or incorporated outside India shall be deemed to be situated in India, if the share or interest derives, directly or indirectly, its value from the assets located in India being more than 50% of the global assets of such company or entity."

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Where the shares of an offshore company are deemed to be capital assets situated in India under Section 9(1)(i), the entire gains arising of such transfer would be subject to the charging provisions of the Act, regardless of the extent to which such shares may also derive their value from assets and revenue abroad.

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

A. Threshold test on substantiality and valuation

The Finance Act, 2015, provides that the share or interest of a foreign company or entity shall be deemed to derive its value substantially from the assets (whether tangible or intangible) located in India, if on the specified date, the value of Indian assets (i) exceeds the amount of INR 10 Crore (INR 100 million); and (ii) represents at least 50% of the value of all the assets owned by the company or entity. The value of the assets shall be the Fair Market Value (**"FMV"**) of such asset, without reduction of liabilities, if any, in respect of the asset.

i. Date for determining valuation

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

ii. Taxation of gains

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

Exemptions: The Finance Act, 2015, provides for situations when this provision shall not be applicable. These are:

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

b. In case the transfer is of shares or interest in a foreign entity which does not hold the Indian assets directly, then the exemption shall be available to the transferor if it along with related parties does not hold (i) the right of management or control in relation to such company or the entity; and (ii) any rights in such company which would entitle it to either exercise control or management of the Holding Co. or entitle it to voting power exceeding 5% in the Holding Co.

Therefore, no clear exemption has been provided to portfolio investors as even the holding of more than 5% interest could trigger these provisions. This is a far cry from the 26% holding limit which was recommended by the Committee. Further, no exemption has been provided for listed companies, as was envisaged by the Committee.

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

iii. Reporting Requirement

The Finance Act, 2015, provides for a reporting obligation on the Indian entity through or in which the Indian assets are held by the foreign entity. The Indian entity has been obligated to furnish information relating to the offshore transaction which will have the effect of directly or indirectly modifying the ownership structure or control of the Indian entity. In case of any failure on the part of Indian entity to furnish such information, a penalty has been proposed to be levied. The proposed penalty ranges from INR 500,000 to 2% of the value of the transaction.

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

All in all, while these provisions provide some relief to investors, a number of recommendations as provided by the Committee have not been considered by the Government. Some of these recommendations related to exemption to listed securities, P-Notes and availability of treaty benefits. Further, there are no provisions for grandfathering of existing investment made in the past and questions arise as to the tax treatment on transactions undertaken between 2012 and 2015. Although in last year's budget, the Finance Minister had clarified that assessing officers will not issue retrospective notices in relation to these provisions. Yet another issue that has not been considered is the potential double taxation that can happen, especially in multi-layered structures.

Further, no changes have been made to the wide definition of 'transfer' which could potentially cover unintended activities like pledge / mortgage of property of the foreign company having assets located in India.

A fundamental question that ought to have been addressed is whether such tax policy is in consonance with global tax policies and the Finance Minister should have actually taken the bold step of scrapping the provisions from the Tax Act in entirety. In the current form, we can expect further litigation on various issues relating to the indirect transfer provisions for the foreseeable future.

II. General Anti-Avoidance Rule (GAAR)

While a statutory GAAR has been introduced in the Tax Act, Indian tax authorities cannot apply GAAR prior to the financial year beginning on April 01, 2017. Prior to such date, guidance needs to be taken from judicially-evolved anti-avoidance principles. In the following paragraphs, we briefly summarize certain judicial anti-avoidance rules as well as the outline for the GAAR regime.

The GAAR provisions were introduced in the ITA in 2012 and were slated for implementation from April 01, 2013. Owing to ambiguities in its scope and application, lack of safeguards and possibility of misuse by tax authorities, GAAR had been widely criticized. With a view to address the issues raised, the Government had appointed a Committee for consultation with stakeholders and the review of the GAAR provisions. Some of the recommendations of the Committee had been accepted and the GAAR provisions were amended in the 2013 Budget. At present, the implementation of GAAR has been deferred to be applicable from April 01, 2017 by the Finance Act, 2015. However, in spite of significant changes to the provisions, GAAR still empowers the Revenue with considerable discretion in taxing 'impermissible avoidance arrangements'.

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The Supreme Court ruling in McDowell & Co. Ltd. v. CTO[60] stated that under the Indian tax laws, even while predominantly respecting legal form, the substance of a transaction could not be ignored where it involved sham or colorable devices to reduce an entity's tax liabilities. Therefore, as per judicial anti-avoidance principles, the Indian tax authorities have the ability to ignore the form of the transaction only in very limited circumstances where it is a sham transaction or a colourable device.

The GAAR provisions extend the power of the Indian tax authorities to disregard transactions even when such transactions / structures are not a "sham" in case where they amount to an "impermissible avoidance arrangement". An impermissible avoidance arrangement has been defined as an arrangement entered into with the main purpose of obtaining a tax benefit. These provisions empower the tax authorities to declare any arrangement as an "impermissible avoidance arrangement" if the arrangement has been entered into with the principal purpose of obtaining a tax benefit and involves one of the following elements:

A. Non-arm's Length Dealings

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

B. Misuse or Abuse of the Provisions of the Act

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

C. Lack of Commercial Substance

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

D. Non-Bona Fide Purpose

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

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

The Finance Act, 2015, has reviewed the GAAR provisions and has deferred GAAR further by 2 years i.e., GAAR will now be applicable from April 01, 2017. Further, it has also been proposed to grandfather investments made up to March 31, 2017 and make GAAR applicable prospectively, i.e. to investments made only after April 01, 2017.

The Finance Minister has stated that considering that investor sentiment has turned positive and with a view to accelerate this momentum, it would be prudent to defer the implementation of GAAR. Further, the memorandum to the Finance Act, 2015 states that keeping in mind that the Base Erosion and Profit Shifting (**"BEPS"**) project under Organization of Economic Cooperation and Development is continuing and India is an active participant in the project, it would be proper that

60. 154 ITR 148.

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GAAR provisions are implemented as part of a comprehensive regime to deal with BEPS and aggressive tax avoidance.

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

III. Business Connection / Permanent Establishment Exposure

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

What constitutes permanent establishment? Management teams for India focused offshore funds are typically based outside India as an onshore fund manager enhances the risk of the fund being perceived as having a PE in India. Although tax treaties provide for the concept of a PE in Article 5 (as derived from the Organisation for Economic Co-operation and Development (**"OECD"**) and United Nations (**"UN"**) Model Convention), the expression has not been exhaustively defined anywhere. The Andhra Pradesh High Court, in CIT v. Visakhapatnam Port Trust (144 ITR 146), held that:

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

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

What tantamount to business connection in the context of an offshore fund? 'Business connection' is the Indian domestic tax law equivalent of the concept of PE under a tax treaty scenario. The term business connection, however, is much wider. The term has been provided as an inclusive definition per Explanation 2 to Section 9(1)(i) of the Tax Act, whereby a 'business connection' shall be constituted if any business activity is carried out through a person who (acting on behalf of the non-resident) has and habitually exercises in India and has the authority to conclude contracts on behalf of the non-resident. Thus, the legislative intent suggests that (in absence of a tax treaty between India and the jurisdiction in which the offshore fund has been set up) under the business connection rule, an India based fund manager may be identified as a 'business connection' for the concerned offshore fund.

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

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

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

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

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

Originally, the conditions given under Section 9A were as follows:- (i) the fund must not be a person resident in India; (ii) the fund must be a resident of a country with which India has entered into an agreement under Section 90(1) or 90A(1) of the Tax Act; (iii) investment in the fund by persons resident in India should not exceed 25% of the corpus; (iv) the fund and its activities are subject to investment protection regulations in the country in which it is incorporated; (v) the fund must have minimum twenty five members, who are not connected persons (vi) any member of the fund along with connected persons should not have any participation interest in the fund exceeding ten (vii) the aggregate participation interest of ten or less members along with their connected persons in the fund, should be less than fifty per cent (viii) the fund should not invest more than twenty per cent. of its corpus in any single entity (ix) the fund should not make any investment in its associate entity; (x) the monthly average of the corpus of the fund should not be less than one hundred crore rupees (xi) the fund should not carry on or control and manage, directly or indirectly, any business in India or from India (xii) the fund should not engage in any activity which will constitute business connection in India; (xiii) the remuneration paid by the fund to the fund manager should be at arm's length price.

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

Since the aforementioned conditions were considered to be too onerous, the Finance Act, 2016 has eased these conditions by making the following changes

a. Amendment of condition (ii) mentioned above which requires the fund to be a "resident" of a country with which India has entered into a DTAA or a Tax Information Exchange Agreement. This condition requires the fund to be "incorporated or registered" in such a country which eases the requirements for several entities such as US based pension funds and Luxembourg based SICAVs which are open ended collective investment schemes that do not qualify as tax residents in the jurisdictions they are based out of.

b. Condition (xi) mentioned above is proposed to be amended to remove the phrase "from India". This would remove the restriction on a Fund Manager from carrying on, controlling and managing any business from India.

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A. No ability to “control and manage”

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

B. Broad basing requirement

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

C. Restriction on investor commitment

It is required that any member of the fund, along with connected persons should not have a participation interest exceeding 10%. It has also been stated that the aggregate participation of ten or less people should be less than 50%. This would restrict the ability of the fund sponsor / anchor investor to have a greater participation. It would also have an impact on master feeder structures or structures where separate subfunds are set up for ring fencing purposes;

D. Fund manager cannot be an employee

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

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

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

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Annexure I

Sector Focused Funds

I. Social Venture Funds

A. Introduction

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

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

B. Characteristics of Social Venture Funds

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

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

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

C. Tools to Measure Social Impact

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

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

D. Laws Relating to Social Venture Funds Investing into India

Offshore social venture funds tend to pool capital (and grants) outside India and make investments in India like a typical venture capital fund. Such

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offshore funds may not directly make grants to otherwise eligible Indian opportunities, since that may require regulatory approval.

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

- Requirement to have at least 75% of their investible funds invested in unlisted securities or partnership interest of 'social ventures'[61] ;
- Allowed to receive grants (in so far as they conform to the above investment restriction) and provide grants. Relevant disclosure in the placement memorandum of the fund will have to be provided if the social venture fund is considering providing grants as well; and
- Allowed to receive muted returns.

II. Media Funds

A. Media Funds – An Introduction

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

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

B. Media Funding Models

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

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

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

C. Risks and Mitigating Factors

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

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

61. Regulation 2(1)(u) of the AIF Regulations states – "social venture" means a trust, society or company or venture capital undertaking or limited liability partnership formed with the purpose of promoting social welfare or solving social problems or providing social benefits and includes -

i. public charitable trusts registered with Charity Commissioner;

ii. societies registered for charitable purposes or for promotion of science, literature, or fine arts;

iii. company registered under Section 25 of the Companies Act, 1956;

iv. micro finance institutions.

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D. Life cycle of a Film Fund

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

a. Domestic and international theatrical release of the film;

b. Domestic and international television markets; and

c. Merchandizing of film related products, sound track releases, home video releases, releasing the film on mobile platforms, and other such online platforms.

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

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

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

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

i. Distributorship Arrangements

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

ii. Lock Stock and Barrel Sale

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

iii. Use of an Appropriate Intermediary Jurisdiction

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

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

F. Role of Services Company

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

G. Role of the Fund Manager

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

III. Real Estate Funds

Investment funds that specifically focus on real estate (**"RE Fund"**) have been in existence in the Indian funds industry under the VCF Regulations and now under the AIF Regulations. Under AIF Regulations, an RE Fund could be an AIF that is registered with SEBI as a Category II AIF since the category allows the eligible AIF to invest in equity and debt instruments.

A. Onshore Real Estate Funds: Investment Trend, Nature of Securities Subscribed and Returns

Typically, RE Funds invest in project specific single asset companies with the asset being self- liquidating, in most cases by subscribing to a mix of debt and equity instruments, as debt is favorable for investee companies to reduce book profits or tax burden. Additionally, redemption premium can be structured to provide equity upside. Nevertheless, if the income of the domestic fund is characterized as capital gains it gives a better position as compared to characterization of income as a business income or interest.

Subscription to debt instruments is also preferred because in the Indian context, exit by way of an IPO is a rarity as real estate companies seldom meet the listing requirements. Also, for distribution of dividends on equity instruments as a pre-requisite, the investee company shall require distributable profits. This again is difficult to achieve because the real estate industry is very capital heavy.

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B. Offshore Real Estate Funds

FPIs are allowed to invest in listed / to be listed NCDs of Indian companies. Under this route, any private or public company can list its privately placed NCDs on the wholesale debt market segment of any recognized stock exchange. An FPI can then purchase these NCDs on the floor of the stock exchange.

RBI and SEBI have permitted direct subscription of 'to be listed' NCDs by the FPI, thus, doing away with the requirement of a warehousing entity. These 'to be listed' NCDs have to listed on a recognized stock exchange within fifteen days of issuance, else, the FPIs are required to dispose-off the NCDs to an Indian entity / person.

Further, since NCDs are subscribed to by an FPI entity under the FPI route and not the FDI route, the restrictions applicable to the FDI investors in terms of pricing are not applicable to NCD holders. The FPI Regulations have retained the flexibility to invest in listed / to be listed NCDs.

C. Real Estate Investment Trusts ("REIT")

SEBI released the REIT Regulations on September 26, 2014. REITs would serve as an asset-backed investment mechanism where an Indian trust is set up for the holding of real estate assets as investments, either directly or through an Indian company set up as a SPV. However, the tax treatment of REITs continues to remain an issue.

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Annexure II

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

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

Parameters	Mauritius	Singapore
General		
Eligibility to treaty benefits	A person is considered a resident of Mauritius for relief under the tax treaty, as long as it is liable to tax in Mauritius by reason of domicile, residence or place of management. The Indian tax authorities issued a Circular (789 of 2000) stating that a tax residency certificate (TRC) issued by the Mauritius tax authorities constitutes sufficient proof of residence in Mauritius and entitlement to treaty relief. The landmark decision of the Indian Supreme Court in Union of India v. Azadi Bachao Andolan [62], upheld the validity of the aforesaid Circular 789. Following this case, a number of cases have confirmed treaty benefits for Mauritius based investors including: Dynamic India Fund I[63] ; DDIT v. Saraswati Holdings Corporation[64]; E*Trade; In Re: Castleton[65] and D.B.Zwirn Mauritius Trading.[66]	The management and control of business of the pooling vehicle must be in Singapore.[67] Tax resident companies are eligible for treaty benefits subject to (as a practical matter) being able to obtain a tax residency certificate from the Inland Revenue Authority of Singapore.
Substance Requirements	The Financial Services Commission encourages a company holding a Global Business Licence – 1 (**"GBL-1"**) to have substance in Mauritius. Obtaining a GBL-1 s a pre-requisite to obtaining a TRC which in turn is necessary to enjoy benefits under the India-Mauritius DTAA. Among other things, the FSC considers whether the company: i. has at least 2 directors, resident in Mauritius, who are appropriately qualified and of sufficient calibre to exercise independence of mind and judgment;	The 'substance' requirements from an India-Singapore treaty perspective comes from within the treaty itself. The subsequently negotiated protocol to the India-Singapore Treaty requires that the Singapore entity must not be a shell or a conduit. A shell / conduit entity isone with negligible or nil business operations or with no real and continuous business activities carried out in Singapore.

62. [2003] 263 ITR 707 (SC).
63. [2009] 111 TTJ 334.
64. [2010] 324 ITR 1 (AAR).
65. [2011] 333 ITR 32 (AAR).
66. AAR 1016/2010 dated 18th July, 2012.
67. Section 2 of the SITA, 1948.

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	ii. maintains at all times its principal bank account in Mauritius; iii. keeps and maintains, at all times, its accounting records at its registered office in Mauritius; iv. prepares, or proposes to prepare its statutory financial statements and causes or proposes to have such financial statements to be audited in Mauritius; v. provide for meetings of directors to include at least two directors from Mauritius; and vi. is authorized / licensed as a collective investment scheme / closed-end fund / external pension scheme administered from Mauritius. Further, the company must have a local administrator, a local auditor and a local custodian to ensure that all meetings of the board of directors are held and chaired in Mauritius. The same shall ensure that the central administration of the company is in Mauritius. The FSC now expects Mauritius entities to fulfill one out of the following six additional substance requirements by January 01, 2015: i. having office premises in Mauritius; ii. employing at least one person full-time at an administrative / technical level; iii. inserting a clause in its constitution providing that disputes arising from the constitution shall be resolved by way of arbitration in Mauritius; iv. holding assets (other than cash and shares / interests in another GBC-1 company) worth at least USD 100,000 in Mauritius; v. having its shares listed on a Mauritius stock exchange; and vi. incurring an annual expenditure that can reasonably be expected from a similar corporation controlled / managed from Mauritius.	A Singapore resident is deemed not to be a shell or conduit if it is listed on a recognized stock exchange or if its annual operational expenditure is at least SGD 200,000 per year in the two years preceding the transfer of shares giving rise to capital gains. The term "annual expenditure" means expenditure incurred during a period of twelve months. The period of twenty four months shall be calculated by referring to two blocks of twelve months immediately preceding the date when the gains arise. Accordingly, if the affairs of the Singapore entity are arranged with the primary purpose of taking benefit of capital gains relief, the benefit may be denied even if the Singapore entity is considered to have commercial substance under the GAAR provisions or incurs annual operational expenditure of SGD 200,000.

Tax Implications under the Relevant Treaty	
Dividends	0% (as per the provisions of the Tax Act. Dividend distributions made by an Indian company to its shareholders are subject to a levy of DDT at an effective rate of 20.36% of the dividends distributed. The DDT payable by a company is in addition to the normal corporate tax).

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Capital Gains	India will have the right to tax capital gains which arise from alienation of shares of a company resident in India acquired by a Mauritian tax resident on or after April 1, 2017. All investments made prior to April 1, 2017 and any exits/share transfers from such investments will not be subject to capital gains tax in India; provided that there is no permanent establishment in India. The taxation of capital gains arising to Mauritius residents from alienation of shares between April 1, 2017 and March 31, 2019 from investments made after April 1, 2017 will not exceed 50% of the domestic tax rate in India under the Tax Act subject to the limitation of benefits provision. The benefit of this reduced rate of tax will not be available if: (a) it is found that the affairs of the fund were arranged with the primary purpose to take advantage of the benefits of reduced rate of tax; or (b) it is found that the fund is a shell/conduit company, i.e. a legal entity falling within the definition of resident with negligible or nil business operations or with no real and continuous business activities carried out in Mauritius. Further, the fund will be deemed to be a shell/conduit company if its expenditure on operations in Mauritius is less than Mauritian Rs. 1,500,000, in the immediately preceding period of 12 months from the date the gains arise; provided that, if the fund is listed on a recognized stock exchange in Mauritius or its expenditure on operations in Mauritius is equal to or more than Mauritian Rs. 1,500,000, in the immediately preceding period of 12 months from the date the gains arise.	0% (pursuant to the provisions of the India-Singapore Tax Treaty, any capital gains earned by Singapore based entities on disposal of Indian securities should not be subject to tax in India. However, if such Singapore entities dispose any Indian securities prior to the completion of twenty four months from the date of incorporation of such entity, it is likely that the gains, if any, arising from such disposal, would be subject to tax in India if the "annual expenditure" is not met). Unless the DTAA with Singapore is renegotiated by India, benefits available in respect of capital gains under the India-Singapore DTAA shall fall away after April 01, 2017. Further, it is not clear whether the grandfathering of investments made before April 01, 2017 will be available to investments made by Singapore residents.
Interest	7.5% on all interest income earned from an Indian company.	15% (on a gross basis).
Tax Implications if the Company is not Eligible to Claim Benefits under the Relevant		
Treaties Capital Gains	Short-term capital gains: Listed Securities (if the securities transaction tax is paid): 15% (plus applicable surcharge and cess). Unlisted Securities: 30% (plus applicable surcharge and cess). Long-term capital gains: Listed Securities (if the securities transaction tax is paid): 0% Unlisted Securities: 10% (without indexation) or 20% (with indexation benefits) (plus applicable surcharge and cess).	

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Annexure III

Investment Regimes for Foreign Investors

Foreign investment in Indian securities is regulated by the FEMA. FEMA provides the statutory framework that governs India's system of controls on foreign exchange dealings. Through it, the government of India exercises its policy with respect to foreign investment in India and all dealings by residents of India with non-residents and with foreign currency. Without permission (general or special) from the RBI, the residents of India cannot undertake any transaction with persons resident outside India, sell, buy, lend or borrow foreign currency, issue or transfer securities to non-residents or acquire or dispose of any foreign security.

As per section 6(3)(b) of FEMA, the RBI has been given the authority to prohibit, restrict or regulate the transfer or issue of any Indian security by a person outside India. Accordingly, the RBI has prescribed TISPRO Regulations pursuant to which no person resident outside India and no company that is not incorporated in India (other than a banking company) can purchase the shares of any company carrying on any trading, commercial or industrial activity in India without the general or special permission of the RBI.

India permits foreign investments through several routes based on the nature and extent of the foreign investment (example - strategic vs. economic / portfolio investments). Limitations exist on investments in certain sectors of the Indian economy, price regulations for unlisted securities, statutory holding periods and various other restrictions on investing in Indian securities.

I. Foreign Direct Investment

A. Introduction

The TISPRO Regulations, the Consolidated FDI Policy and the Master Circular on Foreign Investments in India, prescribe the rules, regulations and policies governing FDI into India.

B. Instruments for FDI

As per the FDI Policy, FDI can be routed into Indian investee companies by using equity shares, fully compulsorily and mandatorily / Compulsorily Convertible Debentures (**"CCDs"**) and fully mandatorily and Compulsorily Convertible Preference Shares (**"CCPS"**). Debentures which are not CCDs or optionally convertible instruments are considered to be ECB and therefore, are governed by clause (d) of sub-section 3 of section 6 of FEMA read with Foreign Exchange Management (Borrowing or Lending in Foreign Exchange) Regulations, 2000 as amended from time to time.

Since, these CCPS and CCDs are fully and mandatorily convertible into equity, they are regarded at par with equity shares and hence, the same are permissible as FDI. Further, for the purpose of minimum capitalization, in case of direct share issuance to non-residents, the entire share premium received by the Indian company is included. However, in case of secondary purchase, only the issue price of the instrument is taken into account while calculating minimum capitalization.

Herein below is a table giving a brief comparative analysis for equity, CCPS and CCDs:

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Particulars	Equity	CCPS	CCD
Basic Character	Participation in governance and risk based returns	Assured Dividend – Convertible into Equity	Assured Coupon – Convertible into Equity
Liability to Pay	Dividend can be declared only out of profits	Fixed dividend if profits accrue	Fixed Interest payment - not dependent on accrual of profits
Limits to Payment	No cap on dividend	Dividend on CCPS cannot exceed 300 basis points over and above the prevailing SBI prime lending rate in the financial year in which CCPS is issued. No legal restriction on interest on CCD, however, in practice it is benchmarked to CCPS limits.	
Tax Efficiency	No tax deduction, dividend payable from post-tax income - Dividend taxable @ 15% [68] in the hands of the company		Interest expense deductible – Withholding tax as high as 40% but it can be reduced to 5% if investment done from favourable jurisdiction
Liquidation Preference	CCD ranks higher than CCPS in terms of liquidation preference. Equity gets the last preference.		
Others	Buy-back or capital reduction permissible	CCPS and CCDs need to be converted to equity before they can be bought back or extinguished by the Indian company.	

C. Calculation of Total Foreign Direct Investment

Total FDI in an Indian entity is said to be equal to the sum of direct FDI and indirect FDI. Direct FDI means the investment made directly by a non-resident entity. The method of calculation of indirect FDI is briefly explained below.

i. Case 1

If the investing company, which is owned and controlled by either resident Indian citizens or by Indian Companies which, in turn, are owned and controlled by resident Indian citizens, makes any investment, then the foreign investment is said to be nil.

ii. Case 2

If the investing company which is owned or controlled by "non-resident entities", the entire investment by the investing company into the target Indian Company would be considered as indirect foreign investment.

iii. Case 3

If the investing company is an operating-cum-investing / investing company which makes onward investment into its wholly owned subsidiary, then the indirect FDI in such wholly owned subsidiary shall be the mirror image of the percentage of direct FDI in the operating-cum-investing / investing company.

D. Pricing Requirements

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

- The price at which foreign direct investor subscribes / purchases the Indian company's shares is not lower than the valuation of shares done as per any internationally accepted pricing methodology for valuation of shares on arm's length basis, duly certified by a Chartered Accountant or a SEBI registered Merchant Banker.

68. All tax rates mentioned herein are exclusive of surcharge and education cess.

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However, if the foreign investor is subscribing to the memorandum of the company, such investments may be made at face value subject to eligibility to invest under FEMA[69] ;

- The consideration for the subscription / purchase is brought into India prior to or at the time of the allotment / purchase of shares to / by the foreign direct investor.

RBI has permitted that shares / debentures with an optionality clause can be issued to foreign investors.

If any of the above conditions is not complied with, then the prior approval of the FIPB and / or the RBI would be required. If the foreign investor is an FVCI registered with the SEBI, then the pricing restrictions would not apply. In addition, if the securities are listed, the appropriate SEBI pricing norms become applicable.

II. Foreign Venture Capital Investment

FVCI investors registered under the FVCI Regulations enjoy certain benefits as a result of such registration (including the non-applicability of pricing restrictions) which the SPV will not be able to take advantage of should the SPV elect not to seek or otherwise fail to obtain such registration. Further, under the current position of regulatory framework, the Reserve Bank of India imposes conditions that an FVCI can invest in only select identified sectors.

FVCIs can invest directly into eligible Indian portfolio companies subject to compliance with certain investment conditions and restrictions as stipulated under the FVCI Regulations and the Indian exchange controls.

The term "VCU" has been defined to mean a domestic company whose shares are not listed in India at the time of making investment and which is engaged in a business for providing services, production or manufacture of article or things which do not include activities or sectors such as non-banking financial companies, other than Core Investment Companies (**"CICs"**) in the infrastructure sector, Asset Finance Companies (**"AFCs"**) and Infrastructure Finance Companies (**"IFCs"**) registered with the RBI, gold financing, activities not permitted under the industrial policy of the Government of India, any other activity which may be specified by SEBI in consultation with the Indian government.

RBI has recently been prescribing in its approval letter to FVCI applicants, that the investments by FVCI entities be restricted to select sectors being infrastructure, biotechnology, IT related to hardware and software development, nanotechnology, seed research and development, research and development of new chemical entities in pharma sector, dairy industry, poultry industry, production of bio-fuels and hotel-cum-convention centers with seating capacity of more than 3,000. The scope of infrastructure for FVCI investments has been linked to the definition provided under the ECB guidelines.

In order to seek and obtain registration as an FVCI, it will be required to comply with the investment conditions and restrictions as laid down under the FVCI Regulations which are summarized herein below:

69. RBI clarified in its A.P. (DIR Series) Circular No. 36 dated September 26, 2012, that shares can be issued to subscribers (both non-residents and NRIs) to the memorandum of association at face value of shares subject to their eligibility to invest under the FDI scheme. The Department of Industrial Policy and Promotion, Ministry of Commerce and Industry, Government of India (DIPP) inserted this provision in the FDI Policy, providing that where non-residents (including NRIs) are making investments in an Indian company in compliance with the provisions of the Companies Act, 1956, by way of subscription to its Memorandum of Association, such investments may be made at face value subject to their eligibility to invest under the FDI scheme. This addition in the FDI Policy is a great relief to non-resident investors (including NRIs) in allowing them to set up new entities at face value of the shares and in turn reduce the cost and time involved in obtaining a DCF valuation certificate for such newly set up companies.

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a. An FVCI is required to designate its investible funds for investment into India at the time of seeking registration. Accordingly, the investment conditions and restrictions would be applicable with respect to such investible funds.

b. The investment restrictions on FVCI are required to be achieved by the end of its life cycle.

c. An FVCI is required to invest at least 66.67% of its investible funds in unlisted equity shares or equity linked instruments (i.e. instruments convertible into equity shares or share warrants, preference shares, debentures compulsorily or optionally convertible into equity) of a VCU.

d. A FVCI may invest up to 33.33% of its investible funds

- by way of subscription to an initial public offering (**"IPO"**) of a VCU whose shares are proposed to be listed on a recognized stock exchange;
- in debt / debt instruments of a VCU in which the FVCI has already made an investment by way of equity;
- preferential allotment of equity shares of a listed company subject to lock in period of one year;
- 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
- special purpose vehicles which are created by a FVCI for the purposes of facilitating or promoting investment in accordance with the FVCI Regulations.

The RBI governor in his statement on the sixth bi-monthly monetary policy statement, 2015-16 had said that as part of the Government's Startup India initiative, the RBI will take steps towards ease of doing business in India, including by allowing FVCIs registered with SEBI to invest in all start-ups irrespective of the sector in which such start-up operates. This change was necessary in the context of RBI, in its approval letter to FVCIs, restricting FVCIs from investing into sectors other than a list of ten permissible sectors.

Subsequently, on April 28, 2016, RBI made amendments (Notification No.FEMA.363/2016-RB) to the TISPRO Regulations, pursuant to which RBI permits FVCIs to make investments into India (the **"TISPRO FVCI Amendments"**).

The TISPRO FVCI Amendments have introduced the definition of "start-up" and allowed FVCIs to invest in such start-ups irrespective of the sector in which such start-up operates; however, the definition of "start-up" is open to interpretation and offers limited guidance to FVCIs for classifying its potential portfolio companies into this category. Further, the TISPRO FVCI Amendments have done away with the requirement earlier imposed on FVCIs to take prior approval from RBI for making FVCI investments and opening a foreign currency account and / or a rupee account with an authorised dealer bank. The amended TISPRO Regulations also contain an explicit provision on transfer of investments by FVCIs to residents or non-residents.

The FVCI Regulations have not yet been amended pursuant to the changes introduced in the TISPRO Regulations.

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III. Foreign Portfolio Investors

In January 2014, the FPI Regulations, which repealed the FII Regulations. The FPI Regulations significantly revised the regulation of foreign portfolio investments into India.

FPI Regulations seek to introduce a risk-based approach towards investor Know Your Customer (KYC) requirements, ease the entry process and reduce timelines for investor participants.

However, on the key issues which foreign investors currently deal with, viz. ambiguity on the 'broad based' criteria, eligibility to issue / subscribe to offshore derivative instruments and clubbing of investment limits, SEBI seems to have revisited the current position which may impact the industry. Interestingly, SEBI also seems to have changed the individual investment cap that an FPI can hold in Indian companies under the FPI Regulations, and introduced clubbing of investment limits for ODIs and FPIs in Indian companies.

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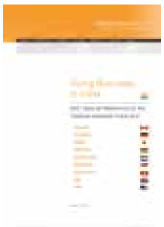

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LEGAL AND TAX COUNSELING WORLDWIDE

MUMBAI

93 B, Mittal Court, Nariman Point
Mumbai 400 021, India

tel +91 22 6669 5000
fax +91 22 6669 5001

SILICON VALLEY

220 S California Ave., Suite 201
Palo Alto, California 94306, USA

tel +1 650 325 7100
fax +1 650 325 7300

BANGALORE

Prestige Loka, G01, 7/1 Brunton Rd
Bangalore 560 025, India

tel +91 80 6693 5000
fax +91 80 6693 5001

SINGAPORE

Level 30, Six Battery Road
Singapore 049 909

tel +65 6550 9856

MUMBAI BKC

3, North Avenue, Maker Maxity
Bandra–Kurla Complex
Mumbai 400 051, India

tel +91 22 6159 5000
fax +91 22 6159 5001

NEW DELHI

C–5, Defence Colony
New Delhi 110 024, India

tel +91 11 4906 5000
fax +91 11 4906 5001

MUNICH

Maximilianstraße 13
80539 Munich, Germany

tel +49 89 203 006 268
fax +49 89 203 006 450

NEW YORK

375 Park Ave Suite 2607
New York, NY 10152

tel +1 212 763 0080

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