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Research

Private Investments in India

A Comprehensive Guide to Equity, Debt, and Dispute Resolutions

January 2025

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Abbreviations

Abbreviation	Meaning / Full Form
AAR	Authority for Advanced Rulings
ADR	American Depository Receipt
AIF	Alternative Investment Funds
AIF Regulations	SEBI (Alternative Investment Funds) Regulations, 2012
BITs	Bilateral Investment Treaties
CA 1956	Companies Act 1956
CA 2013	Companies Act 2013
CBDT	Central Board of Direct Taxes
CCDs	Compulsorily Convertible Debentures
CCPS	Compulsorily Convertible Preference Shares
CLB	Company Law Board
Contract Act	Indian Contract Act, 1872
DDP	Designated Depository Participant
DDT	Dividend Distribution Tax
DTAA / Tax treaties	Double Taxation Avoidance Agreements
EBITDA	Earnings Before Interest Tax Depreciation Ammortization
ECB	External Commercial Borrowing
FCY	Foreign Currency
FDI	Foreign Direct Investment
FDI Policy	Foreign Direct Investment Policy dated October 15, 2020
FEMA	Foreign Exchange Management Act, 1999
FIPB	Foreign Investment Promotion Board
FII	Foreign Institutional Investor
FPI	Foreign Portfolio Investor
FPI Regulations	SEBI (Foreign Portfolio Investment) Regulations, 2019
Funds	Investment fund
FVCI	Foreign Venture Capital Investor
FVCI Regulations	SEBI (Foreign Venture Capital Investors) Regulations, 2000

Abbreviation	Meaning / Full Form
FY	Financial Year
GAAR	General Anti-Avoidance Rules
GDR	Global Depository Receipt
GOI	Government of India
GP	General Partner
ICA	International Commercial Arbitration
ICDR Regulations	SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2018
IOSCO	International Organization of Securities Commission
IPO	Initial Public Offering
ITA	Income Tax Act, 1961
LTCG	Long Term Capital Gains
LoB	Limitation on Benefits
LP	Limited Partner
MAT	Minimum Alternate Tax
NBFC	Non-Banking Financial Companies
NCD	Non-Convertible Debenture
NRI	Non-Resident Indian
OECD	Organization for Economic Co-operation and Development
OCD	Optionally Convertible Debenture
OCI	Overseas Citizen of India
OCRPS	Optionally Convertible Redeemable Preference Share
ODI	Offshore Derivative Instruments
OHC	Offshore Holding Company
PAN	Permanent Account Number
Press Note 8	Press note 8 of 2015 notified by the DIPP on July 30, 2015
Press Note 12	Press note 12 of 2015 notified by the DIPP on November 24, 2015
P-Notes	Participatory Notes
PD	Private Debt
PE	Private Equity
PF	Pension Fund

Abbreviation	Meaning / Full Form
PIO	Person of Indian Origin
PIPE	Private Investment into Public Equity
PIS	Portfolio Investment Scheme
QFI	Qualified Foreign Investor
R&W Insurance	Representation and Warranties Insurance
RBI	Reserve Bank of India
REITs	Real Estate Investment Trust
RoE	Return on Equity
Rs./INR	Rupees
SEBI	Securities and Exchange Board of India
SGD	Singapore Dollar
STCG	Short Term Capital Gains
STT	Securities Transaction Tax
SWF	Sovereign Wealth Fund
TRC	Tax Residency Certificate
UN	United Nations
USD	United States Dollar

Private Equity Investments

Foreign Exchange Management Act, 1999 is the principal legislation in India governing all foreign exchange transactions in India. India's foreign exchange management framework grants RBI, in consultation with GOI the power to specify any class or classes of capital account transactions, involving debt instruments, which are permissible and regulations governing non-debt instruments.[1] Other than RBI and GOI, the SEBI regulates the dealings in securities that are listed or offered to the public.

Foreign investment into India can be broadly made through either of the following routes:

1. Foreign Direct Investment **("FDI")**;
2. Foreign Venture Capital Investment **("FVCI")**;
3. Foreign Portfolio Investor **("FPI")**; and
4. Alternative Investments Funds **("AIFs")**

A. FDI

In order to bring clarity and certainty in the policy framework, the DIPP for the first time issued a consolidated policy relating to FDI in India on April 1, 2010,[2] which subsumed and superseded all the previous Press Notes / Press Releases / Clarifications / Circulars issued by DIPP. The DPIIT now revises the FDI policy as per the requirements but releases press notes frequently for clarification and amendments; the last policy is effective from October 15, 2020.

An LLP/company with foreign investment operating in sectors/activities where (i) 100% foreign investment is allowed through the automatic route; and (ii) there are no foreign investment linked performance conditions, can be converted into a company or LLP (as applicable) as per requirements under the automatic route.[3]

Further, the government has also allowed entities such as companies, trusts and partnership firms incorporated outside India, which are owned and controlled by NRIs, to invest in India under the FDI regime.[4]

I. FDI into Indian companies is regulated as below:

Prohibited Sectors: There are some sectors where FDI is prohibited, including:

i. Activities/sectors not open to private sector investment e.g. (i) atomic energy and (ii) railway operations[5];
ii. Lottery business including government/private lottery, online lotteries etc[6];

1 CBIC, https://old.cbic.gov.in/resources/htdocs-cbec/finact2015.pdf, Page 57.
2 DIPP, https://dpiit.gov.in/sites/default/files/fdi_circular_1_2010%20%207_1.pdf.
3 DPIIT, https://dpiit.gov.in/sites/default/files/FDI-PolicyCircular-2020-29October2020_0.pdf, Page 16.
4 DPIIT, https://dpiit.gov.in/sites/default/files/FDI-PolicyCircular-2020-29October2020_0.pdf, Page 14.
5 DPIIT, https://dpiit.gov.in/sites/default/files/FDI-PolicyCircular-2020-29October2020.pdf, Page 28.
6 DPIIT, https://dpiit.gov.in/sites/default/files/FDI-PolicyCircular-2020-29October2020.pdf, Page 28.

iii. Chit funds[7];

iv. Nidhi company[8];

v. Real estate business dealing in land and immovable property with a view or earning profit therefrom[9]; provided that it does not include development of townships, construction of residential premises, roads or bridges and Real Estate Investment Trusts (REITs) registered and regulated under the SEBI (REITs) Regulation 2014[10]. It is to be noted that earning of rent/income on the lease of the property, not amounting to transfer, will not fall within this category[11];

vi. Trading in transferrable development rights;

vii. Gambling and betting including casinos / lottery business; and

viii. Manufacturing of cigars, cheroots, cigarillos and cigarettes, of tobacco or of tobacco substitutes.

Sectors under automatic route: Under the automatic route, for investments into an Indian company (carrying on business in the specified sectors that are identified as under 'automatic route') prior approval of RBI or GOI is not required.

Sectors under automatic route with 100% FDI: FDI, up to 100%, is permitted in most sectors in India under the 'automatic route', including agriculture and animal husbandry, plantation, mining, coal and lignite, manufacturing, broadcasting carriage services, airports, construction development, industrial parks, trading, telecom services, B2B E-Commerce, pharmaceuticals and railways infrastructure, among others.

One key development in this year has been the liberalization of the space sector. Through a notification dated March 05, 2024 and subsequent amendment to the NDI Rules, the Ministry of Commerce and Industry laid down the news thresholds for space sector. As per the notification, sectors related to space shall be categorized into three categories:

Category	FDI limit
Category 1: i. Satellites-manufacturing & operation ii. Satellite data products iii. Ground segment & User segment	Up to 74% under automatic route and beyond 74% up to 100% under government approval route
Category 2: i. Launch vehicles and associated systems or subsystems ii. Creation of spaceports for launching and receiving spacecraft	Up to 49% under automatic route and beyond 49% up to 100% under government approval route
Category 3: i. Manufacturing of components and systems/sub-systems for satellites, ground segments and user segments	Up to 100% under automatic route

7 DPIIT, https://dpiit.gov.in/sites/default/files/FDI-PolicyCircular-2020-29October2020.pdf, Page 28.

8 DPIIT, https://dpiit.gov.in/sites/default/files/FDI-PolicyCircular-2020-29October2020.pdf, Page 28.

9 Press Note 1 (2022), https://dpiit.gov.in/sites/default/files/Press_Note_1_2022_14March2022.pdf.

10 DPIIT, https://dpiit.gov.in/sites/default/files/FDI-PolicyCircular-2020-29October2020.pdf, Page 28.

11 Press Note 1 (2022), https://dpiit.gov.in/sites/default/files/Press_Note_1_2022_14March2022.pdf.

In few sectors, which are under the automatic route, foreign investment cannot exceed specified limits. Sectors with such limits are:

h. **Insurance:** Per the Press Note 2 (2021)[12], the FDI cap into the insurance companies is 74%[13] under the automatic route subject to verification by Insurance Regulatory and Development Authority of India **("IRDAI")**. It is pertinent to note that 100% FDI is allowed for insurance intermediaries such as insurance brokers, re-insurance brokers etc.[14]. Further, FDI in this sector is subject to compliance with the provisions of the Insurance Act, 1938 and allied rules. The foreign investors can now exercise ownership and control over Indian insurance companies subject to compliance with any rules or regulations prescribed by IRDAI.

   Further, the DPIIT on March 14, 2022 issued Press Note 1 of 2022 through which FDI up to 20% under the automatic route is now permitted in the Life Insurance Corporation **("LIC")**, subject to compliance with the Life Insurance Corporation Act, 1956 and applicable provisions of the Insurance Act, 1938. To facilitate this amendment, the definition of "Indian Company" under the FDI Policy has been broadened to include body corporates established or constituted under any Central or State Act. The relaxation of the definition is not only limited to LIC and other entities such as the Oil and Natural Gas Corporation Limited, but National Thermal Power Corporation Limited etc. will now fall within the extended ambit of the definition.

i. **Infrastructure company in the securities market:** 49% FDI is permitted under automatic route subject to compliance with the applicable SEBI regulations.

j. **Power Exchanges:** 49% FDI investment is permitted under automatic route in power exchanges registered under Central Electricity Regulatory Commission (Power Market) Regulations, 2010. The foreign investment shall be in compliance with SEBI regulations and other applicable laws/regulations[15].

k. **Pension Sector:** 74% FDI through automatic route is permitted in pension sector. Foreign investment in the pension funds is allowed as per the Pension Fund Regulatory and Development Authority Act, 2013[16].

Sector specific conditionalities: While FDI in most of sectors have now been brought under the automatic route in the last few years, in order to ensure some checks and balances, either the sectoral regulators have been given the baton to approve FDI or the policy has put in place conditionalities for the FDI to fall under the automatic route. Some of the key sectors in this regard are as follows:

a. **Other Financial Services:** 100% FDI is allowed under the automatic route in financial services which are regulated by financial sector regulators, viz., RBI, SEBI, IRDAI, Pension Fund Regulatory and Development Authority, National Housing Bank or any other financial sector regulator as may be notified by GOI, subject to conditionalities, including minimum capitalization norms, as specified by the concerned regulator/government agency[17].

b. **Telecom Services:** DPIIT, in its press note 4 (2021 series)[18] has allowed 100% FDI in telecom services through automatic route subject to certain conditions. Previously, only 49% of FDI was allowed through the automatic route and anything beyond should be through the government route.

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12 Press Note 2 (2021),:https://dpiit.gov.in/sites/default/files/pn2-2021.pdf.

13 Press Note 2 (2021),:https://dpiit.gov.in/sites/default/files/pn2-2021.pdf.

14 Press Note 2 (2021),:https://dpiit.gov.in/sites/default/files/pn2-2021.pdf.

15 DPIIT,;https://dpiit.gov.in/sites/default/files/FDI-PolicyCircular-2020-29October2020_0.pdf, Page 64.

16 PFRDA,: https://egazette.gov.in/WriteReadData/2021/228305.pdf.

17 DPIIT,: https://dpiit.gov.in/sites/default/files/FDI-PolicyCircular-2020-29October2020_0.pdf, Page 65.

18 DPIIT,:https://dpiit.gov.in/sites/default/files/pn4-2021.PDF.

c. **FDI Policy changes in E-commerce:** 100% FDI permitted in companies engaged in the activity of buying and selling through the e-commerce platform only in the Business to Business (B2B) segment. While FDI into marketplace model of e-commerce is allowed 100% under the automatic route, FDI is not permitted in inventory-based model of e-commerce[19]. The policy also subsumes the Press Note 2 (2018 series) which provides that inventory of a vendor will be deemed to be controlled by an e-commerce entity if more than 25 percent of purchases of such vendor are from the marketplace entity or its group companies. Further, the FDI policy prohibits any entity to have equity participation in the marketplace entity or its group companies from which the products are being procured.

d. **Single brand product retail trading ('SBRT'):** FDI is allowed up to 100% under the automatic route. Foreign investment in SBRT is subject to conditions namely: (i) products to be sold should be of a 'single brand' and the products should be sold under the same brand internationally[20] (ii) to be covered within 'single brand' product retail trading, products should be branded during manufacturing[21] (iii) non-resident entity/ entities, whether owner of the brand or otherwise, shall be permitted to undertake single brand product retail trading in India for the specific brand, directly or through legally tenable agreement executed between with the Indian entity undertaking single brand retail trading and the brand owner[22] (iv) if the FDI is proposed to be beyond 51% then sourcing of 30% of the value of the goods purchased should be done from India, preferably from Indian micro, small and medium enterprises, village and cotton industries, artisans and craftsmen, in all sectors[23] (v) single brand product retail trading entity operating through brick and mortar stores, is permitted to undertake retail trading through e-commerce, however retail trading through e-commerce can also be undertaken prior to opening of bricks and mortar stores.[24]

Sectors under GOI approval route - There are some sectors where FDI is allowed only with the approval of the GOI. Some of them are:

e. **Print Media:** (i) Print media, specifically publishing of newspaper, periodicals and Indian editions of foreign magazines dealing with news and current affairs is allowed upto 26% FDI under the government approval route[25] (ii) Print media, specifically publishing/ printing of scientific and technical magazines/ specialty journals/ periodicals (subject to compliance with the legal framework as applicable and guidelines issued in this regard from time to time by Ministry of Information and Broadcasting) and publication of facsimile edition of foreign newspapers is allowed to have 100% foreign investment with prior approval of government.[26]

f. **Multi brand retail trading:** – 51% foreign investment is permitted under the government approval route, which investment shall be in compliance with conditions prescribed including (i) minimum capitalization of USD 100 million (ii) 50% of the total FDI in the first tranche of USD 100 million to be invested in the backend infrastructure within 3 years (iii) retail sales outlets may be set up in those states which have agreed or agree in future to allow FDI in multi brand retail trade (iv) 30% mandatory local sourcing requirement from Indian micro, small, medium industries which have a total investment in plant and machinery not exceeding USD 2 million, etc.[27]

19 DPIIT,:https://dpiit.gov.in/sites/default/files/FDI-PolicyCircular-2020-29October2020.pdf, Page 51.
20 DPIIT,:https://dpiit.gov.in/sites/default/files/FDI-PolicyCircular-2020-29October2020_0.pdf, Page 52.
21 DPIIT,:https://dpiit.gov.in/sites/default/files/FDI-PolicyCircular-2020-29October2020_0.pdf, Page 52.
22 DPIIT,:https://dpiit.gov.in/sites/default/files/FDI-PolicyCircular-2020-29October2020_0.pdf,page, Page52.
23 DPIIT,:https://dpiit.gov.in/sites/default/files/FDI-PolicyCircular-2020-29October2020_0.pdf,page, Page 52.
24 DPIIT,:https://dpiit.gov.in/sites/default/files/FDI-PolicyCircular-2020-29October2020_0.pdf, Page 52.
25 DPIIT,:https://dpiit.gov.in/sites/default/files/FDI-PolicyCircular-2020-29October2020_0.pdf,Page 38.
26 DPIIT,:https://dpiit.gov.in/sites/default/files/FDI-PolicyCircular-2020-29October2020_0.pdf, Page 38.
27 DPIIT,:https://dpiit.gov.in/sites/default/files/FDI-PolicyCircular-2020-29October2020_0.pdf, Page 54.

g. **Terrestrial broadcasting and up-linking of 'News & Current Affairs' TV:** Foreign investment up to 49% is permitted under the government approval route, subject to compliance with certain guidelines laid down for the broadcasting sector.

Sectors with partial automatic route and partial government route: In certain sectors a foreign investor can invest up to a certain percentage of shareholding of an Indian company under the automatic route. Government approval will be required for any investment beyond the specified percentage. These sectors are:

a. **Private Sector Banks:** Up to 74% foreign investment is permitted, in which up to 49% is under the automatic route and foreign investment beyond 49% and up to 74% is under government approval route.

b. **Railways Infrastructure:** While 100% FDI is allowed in the railways infrastructure sector under the automatic route, proposals involving FDI beyond 49% in sensitive areas are required to be brought before the Cabinet Committee of Security (CCS) for consideration by the Ministry of Railways **("MoR")** from a security point of view on a case to case basis.[28]

c. **Defence:** 100% FDI is permitted into defence sector (subject to the industrial license under Industries (Development and Regulation) Act, 1951) and manufacturing of small arms and ammunition under Arms Act, 1959 has been permitted. FDI upto 74% can be invested under the automatic route, and for investment above 74%, government approval will be required wherever it is likely to result in access to modern technology or for other reasons to be recorded. Provided that FDI up to 74% under automatic route shall be permitted for companies seeking new industrial licences[29].

d. **Broadcasting Carriage Services:** 100% FDI is permitted under the automatic route in broadcasting services including teleports, Direct to Home services, cable networks, mobile networks etc., provided that any infusion of fresh foreign investment, above 49% in a company which is not seeking license / permission from sectoral Ministry for change in the ownership pattern or transfer of stake by existing investor to new foreign investor, would require GOI approval.[30]

e. Category 1 and 2 of space sector investments as mentioned above.

Other key measures towards further liberalization of the FDI regime:

a. **FDI in company which does not have operations:** Indian company which does not have any operations and also does not have any downstream investments, will be permitted to have infusion of foreign investment under automatic route for undertaking activities which are under automatic route and without FDI linked performance conditions. However, approval of the GOI will be required for such companies for infusion of foreign investment for undertaking activities which are under government route, regardless of the amount or extent of foreign investment[31].

b. **Entities controlled by NRI:** A company, trust and partnership firm incorporated outside India and owned and controlled by non-resident Indians can invest in India with special dispensation as available to NRIs under the FDI Policy.

c. **Foreign Investment Facilitation Portal (FIFP):** FIFP is the online single point interface of the GOI for investors to facilitate FDI. This portal is being administered by the DPIIT and Ministry of Commerce & Industry and facilitates the single window clearance of applications which are through approval route. Upon receipt of the FDI application, the concerned administrative ministry/department shall process the application as per the Standard Operation Procedure (SOP).

28 DPIIT,:https://dpiit.gov.in/sites/default/files/FDI-PolicyCircular-2020-29October2020_0.pdf, Page 56.

29 DPIIT,:https://dpiit.gov.in/sites/default/files/FDI-PolicyCircular-2020-29October2020_0.pdf, Page 34.

30 DPIIT,:https://dpiit.gov.in/sites/default/files/FDI-PolicyCircular-2020-29October2020_0.pdf, Page 36.

31 DIPP,:https://dpiit.gov.in/sites/default/files/FDI-PolicyCircular-2020-29October2020_1.pdf, Page 21.

II. Downstream Investment

Indirect FDI is referred to as the downstream investment made by an Indian company, which is owned or controlled by non-residents, into another Indian company. As per the FDI Policy such downstream investment is also required to comply with the same norms as applicable to direct FDI in respect of relevant sectoral conditions on entry route, conditionalities and caps with regard to the sectors in which the downstream entity is operating.

Such downstream investments would be regarded as indirect FDI in an Indian entity if they have been made in the following manner: (a) another Indian entity which has received foreign investment and (i) is not owned and not controlled by resident Indian citizens or (ii) is owned or controlled by persons resident outside India **("either referred to as Non-Indian Entity")**; or (b) an investment vehicle whose sponsor or manager or investment manager (i) is not owned and not controlled by resident Indian citizens or (ii) is owned or controlled by persons resident outside India[32].

Downstream investment into Indian entities are subject to conditions prescribed under the FDI Policy including prior approval of the board of directors, pricing guidelines and requirement of funds for investments to be brought from abroad or arranged through internal accruals[33] (i.e. profits transferred to reserve account after payment of taxes). The first level Indian entity making downstream investment shall be responsible for ensuring compliance with the provisions of the NDI Rules for the downstream investment made by it at the second level and so on and so forth. Such first level company shall obtain a certificate to this effect from its statutory auditor on an annual basis. Compliance of these regulations shall be mentioned in the director's report in the annual report of the Indian company. In case statutory auditor has given a qualified report, the same shall be immediately brought to the notice of the regional office of the RBI in whose jurisdiction the registered office of the company is located and shall also obtain acknowledgement from the regional office of the RBI in this regard[34].

The first level Indian entity shall further file Form DI with the RBI in line with the Payment and Reporting Regulations as well as on FIFP in the form available at www.fifp.gov.in[35], within 30 (Thirty) days from allotment of equity instruments and must notify the Secretariat for Industrial Assistance, DPIIT within 30 (Thirty) days of such investment, even if allotment has not been done[36].

III. Instruments for FDI

Under the FDI regime, investment can only be made into equity shares, fully, compulsorily and mandatorily convertible preference shares **("CCPS")** and fully compulsorily and mandatorily convertible debentures **("CCD")**, subject to fulfilment of certain conditions, partly paid equity shares and warrants[37]. Equity instruments can contain an optionality clause subject to a minimum lock-in period of one year or as prescribed for the specific sector, whichever is higher, but without any option or right to exit at an assured price[38].

32 Ministry of Finance,:https://egazette.nic.in/WriteReadData/2019/213332.pdf, Page 68.

33 DPIIT,:https://dpiit.gov.in/sites/default/files/FDI-PolicyCircular-2020-29October2020_0.pdf, Page 22.

34 Ministry of Finance,:https://egazette.nic.in/WriteReadData/2019/213332.pdf Page 66.

35 DPIIT,:https://dpiit.gov.in/sites/default/files/FDI-PolicyCircular-2020-29October2020.pdf , Page 22.

36 Nishithdesai,:https://www.nishithdesai.com/fileadmin/user_upload/pdfs/Research_Papers/Doing_Business_in_India.pdf, Page 15.

37 Press Note 1 (2022):https://dpiit.gov.in/sites/default/files/Press_Note_1_2022_14March2022.pdf.

38 Ministry of Finance,:https://egazette.nic.in/WriteReadData/2019/213332.pdf, Page 55.

The validity of options in an agreement has been under strict judicial scrutiny and a conclusion to the debate is still required from Hon'ble Supreme Court of India. In the recent division bench of the Bombay High Court ruling on February 02, 2023, the case of "Percept Finserve Private Limited and Another. vs. Edelweiss Financial Services Limited", upheld the validity of put-options clause in a contract stating that merely because the contract contains a put option in respect of securities, the contract cannot be termed as a trade or contract in derivatives and hence cannot be termed as illegal under the provisions of Section 18A of the Securities Contracts (Regulations) Act[39]. Further, Delhi High Court's ruling in Cruz City, and Docomo, validity of damages on breach of optionality clause in a contract was upheld[40]. This view was further approved by the Hon'ble Supreme Court of India in the case of "Vijay Karia & Ors. v. Prysmian Cavi E Sistemi SRL & Ors". Additionally, the Hon'ble Bombay High Court and the Hon'ble Madras High Court has in the case of "Banyan Tree Growth Capital L.L.C. v. Axiom Cordages Limited and Others" and "GPE (India) Limited & Ors. v. Twarit Consultancy Services Private Limited & Another" respectively had also affirmed this view.

Investment under FDI regime by swap of shares under the automatic route is permitted, subject to the condition that irrespective of the amount, valuation of the shares involved in the swap arrangement will be made by a merchant banker registered with the SEBI or an investment banker outside India registered with the appropriate regulatory authority in the host country.[41]

Herein below is a table setting out a brief comparative analysis for equity, CCPS and CCD:

Particulars	Equity	CCPS	CCD
Basic Character	Participation in governance and risk based returns.	Fixed dividend – convertible into equity	Assured coupon – convertible into equity.
Returns	Dividend may be declared out of profits of the company.		Fixed or variable interest coupon - not dependent on profits.
Tax Implication	Dividend is taxable in the hands of shareholder at the applicable marginal tax rate. Additionally, at the time of paying dividends to shareholders, the company is required to withhold taxes (under Section 194 of the ITA) on the dividends at the rate of 10% (exclusive of surcharge and cess) when paying to a resident shareholder and 20% (exclusive of surcharge and cess) when paying to a non-resident shareholder (subject to tax treaty relief that may be applicable between India and the country of residence of the shareholder receiving the dividend).		Interest expense deductible – Withholding tax as high as 35% (exclusive of surcharge and cess) but it can be reduced to 5% (exclusive of surcharge and cess) depending on the nature of the instrument and if investment done from favourable jurisdiction (i.e., DTAA with beneficial terms).
Statutory Liquidation Preference	CCDs ranks higher than CCPS in terms of liquidation preference. Equity gets the last preference. However, liquidation preference may be fixed contractually. . However, Section 53(2) of the Insolvency and Bankruptcy Code, 2016 states that any contractual arrangements between creditors with equal ranking that disrupt the order of priority set out in Section 53(1) will be disregarded by the liquidator in an insolvency event, meaning that the liquidation process will follow the statutory priority regardless of any prior contractual agreements between parties with equal ranking. [42]		

39 Percept Finserve (P) Ltd. v. Edelweiss Financial Services Ltd., 2023 SCC OnLine Bom 319.

40 NTT Docomo Inc. v. Tata Sons Limited, O.M.P.(EFA)(COMM.) 7/2016 and IAs 14897/2016, 2585/2017.

41 Ministry of Finance,: https://egazette.nic.in/WriteReadData/2019/213332.pdf, Page 65.

42 Section 53 of the Insolvency and Bankruptcy Code, 2016.

Others	Buy-back or capital reduction permissible. For tax implications refer to Chapter 4.	CCPS and CCDs need to be converted to equity before they can be bought back or extinguished by the Indian company.

Convertible Notes

Convertible notes are currently governed under the NDI Rules and the conditionalities applicable for issuance of convertible notes are as follows:

i. **Definition of a convertible note:** It means an instrument issued by a startup company acknowledging receipt of money initially as debt, which is repayable at the option of the holder, or which is convertible into such number of equity shares of such startup company, within a period not exceeding 10 (Ten) years from the date of issue of the convertible note, upon occurrence of specified events as per the other terms and conditions agreed to and indicated in the instrument[43]. A convertible note will have to be necessarily converted into equity shares or repaid back within a period of 10 (Ten) years.[44] This conversion or repayment can be triggered by the events or under terms and conditions as mutually agreed between the startup and the investor. Provided that an individual who is citizen of Pakistan or Bangladesh or an entity which is registered or incorporated in Pakistan or Bangladesh will not be allowed to issue convertible notes[45].

ii. **Eligible Issuer:** Convertible notes can only be issued by entities classified as a 'start-up' as per the definition laid down by the G.S.R notification dated February 19, 2019 **("DPIIT Notification")**[46]. As per the DPIIT Notification, an entity (i.e. a private limited company / LLP or a registered partnership firm) incorporated / registered in India shall be considered as a 'startup'.

iii. **Minimum capitalization:** The notification prescribes a minimum investment size of not less than INR 25,00,000 (USD 38,461.54) to be invested by each foreign investor, to be invested upfront in a single tranche[47].

iv. **Prior government approval:** A startup company, engaged in a sector where investment by a person resident outside India requires government approval, may issue convertible notes to a person resident outside India only with such approval. Further, issue of equity shares against such convertible notes shall be in compliance with the entry route, sectoral caps, pricing guidelines and other attendant conditions for foreign investment[48].

v. **Transfer of convertible notes:** A person resident outside India may acquire or transfer by way of sale, convertible notes, from or to, a person resident in or outside India, provided the transfer takes place in accordance with the entry routes and pricing guidelines as prescribed for capital instruments[49].

43 Ministry of Finance,:https://egazette.nic.in/WriteReadData/2019/213332.pdf, Page 54.

44 Press Note 1 (2022):https://dpiit.gov.in/sites/default/files/Press_Note_1_2022_14March2022.pdf.

45 RBI, Notification No.FEMA.377/2016-RB:https://rbi.org.in/Scripts/NotificationUser.aspx?Id=10825&Mode=0.

46 DPIIT,:https://www.startupindia.gov.in/content/dam/invest-india/Templates/public/198117.pdf.

47 DPIIT,:https://www.startupindia.gov.in/content/dam/invest-india/Templates/public/198117.pdf.

48 Ministry of Finance,:https://egazette.nic.in/WriteReadData/2019/213332.pdf, Page 64.

49 Ministry of Finance,:https://egazette.nic.in/WriteReadData/2019/213332.pdf, Page 64.

IV. Pricing requirements

FEMA also regulates the entry and exit price of investments made under the FDI regime. The pricing requirements are different for companies having their shares listed and unlisted.

Unlisted Companies

For unlisted companies, the price at which foreign direct investor subscribes or purchases the equity shares from a person resident in India shall not be lower than the price computed by any internationally accepted pricing methodology **("Fair Value")** as calculated by a chartered accountant or a merchant banker registered with SEBI or a practising cost accountant[50]. In case of the transfer of equity shares from a non-resident to a resident, such transfer shall not be at a price higher than the Fair Value[51].

Listed Companies

For transfer of listed companies shares in case of an off-market transfer, the price at which the foreign investor subscribes or purchases the shares from a person resident in India shall not be lower than the price prescribed under the SEBI ICDR Regulations:

i. volume weighted average price of 90 trading days of the related equity shares quoted on the recognized stock exchange preceding the relevant date;

ii. volume weighted average price of 10 trading days of the related equity shares quoted on the recognised stock exchange preceding the relevant date[52];

Similarly, the same pricing methodology will be applicable when the non-resident transfers shares (off-market) of a listed company to a resident. Please note the consideration for the subscription / purchase has to be brought into India prior to or at the time of allotment / purchase of shares to / by the foreign investor.Additionally, on the stock exchange, the transfers would be as per the prevailing price of the scrip at the time of transfer.

Transfer of shares for deferred consideration

The NDI Rules permit the transfer of shares between a resident buyer and a non-resident seller or vice versa on a deferred consideration basis[53], subject to: (i) the deferred consideration should not exceed 25% of the amount[54]; (ii) the deferred consideration should be paid within a period of 18 (Eighteen) months from the date of the agreement for transfer of shares[55]; (iii) the deferred consideration may be paid under an escrow arrangement, whose term shall not exceed 18 (Eighteen) months[56]; and (iv) if the total consideration is paid, the seller can furnish an indemnity valid for a period of 18 (Eighteen) months, for deferred portion of the condition[57].

50 DPIIT,:https://dpiit.gov.in/sites/default/files/FDI-PolicyCircular-2020-29October2020_0.pdf , page 65.

51 DPIIT,:https://dpiit.gov.in/sites/default/files/FDI-PolicyCircular-2020-29October2020_0.pdf , page 65.

52 SEBI,:https://www.sebi.gov.in/legal/regulations/jul-2022/securities-and-exchange-board-of-india-issue-of-capital-and-disclosure-requirements-regulations-2018-last-amended-on-july-25-2022-_61425.html, Page 114.

53 Ministry of Finance,:https://egazette.nic.in/WriteReadData/2019/213332.pdf, Page 60.

54 Ministry of Finance,:https://egazette.nic.in/WriteReadData/2019/213332.pdf, Page 60.

55 Ministry of Finance,:https://egazette.nic.in/WriteReadData/2019/213332.pdf, Page 60.

56 Ministry of Finance,: https://egazette.nic.in/WriteReadData/2019/213332.pdf, Page 60.

57 Ministry of Finance,:https://egazette.nic.in/WriteReadData/2019/213332.pdf, Page 60.

B. FVCI regime

SEBI had introduced the SEBI (Foreign Venture Capital Investors) Regulations, 2000 **("FVCI Regulations")** to encourage foreign investment into venture capital undertakings. The FVCI Regulations make it mandatory for an offshore fund to register itself with SEBI if such fund intends to avail of benefits under the FVCI regime[58]. SEBI, last year, on September 6, 2024, notified various amendments to the FVCI Regulations. Such amendments have brought the registration process on par with that of the Foreign Portfolio Investors, including the submission of registration application and documents with the Designated Depository Participants.

Additionally, the eligibility criteria applicable to FVCIs have also undergone changes in order to align them with the criteria applicable to FPIs. The licensing regime has also been. revamped with additional conditions, such as the requirement for an FVCI to inform SEBI and DDPs in case it falls short of the eligibility criteria prescribed, wherein DDPs are now also required to verify such compliance. Lastly, beneficial owners of an FVCI now constitute 'material information' of an FVCI, meaning thereby they must be disclosed to SEBI and their respective DDPs.[59]

These amendments have come into force on January 1, 2025.

There are certain benefits extended by SEBI and RBI to FVCIs:

i. **Free pricing:** Registered FVCIs benefit from free entry and exit pricing and are not bound by the pricing restrictions applicable to the FDI investment route.

ii. **Instruments:** An FVCI can invest in equity instruments, equity-linked instruments (instruments optionally or mandatorily convertible into equity share) or debt instruments. Unlike FDI regime where investors can only subscribe to only equity shares, CCDs and CCPS, FVCIs can also invest into Optionally Convertible Redeemable Preference Shares **("OCRPS")**, Optionally Convertible Debentures **("OCDs")**, even Non-Convertible Debenture **("NCDs")** and Non-Convertible Preference Shares **("NCPS")**.

   These instruments must be issued by: (i) companies engaged in the specified sectors and whose securities are not listed at the time of issuance of securities to an FVCI; or (ii) 'start-ups', irrespective of the sector in which the start-up is engaged in. In addition, FVCIs are also permitted to invest in units of a Category I Alternative Investment Fund (Cat-I AIF) or units of a scheme or of a fund set up by a VCF or by a Cat-I AIF[60].

iii. **Lock-in:** Under the SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2018 **("ICDR Regulations")** the entire pre-issue share capital (other than certain promoter contributions which are locked in for a longer period) of a company conducting an initial public offering **("IPO")** is locked for a period of 6 (Six) months from the date of allotment in the public issue[61]. However, an exemption from this requirement has been granted to registered FVCIs, provided, the shares have been held by them for a period of at least 6 (Six) months from the date of purchase by the FVCI. This exemption permits the FVCI to exit from its investments, post-listing[62].

58 SEBI,:https://www.sebi.gov.in/sebi_data/commondocs/fvci_updated_21December2010.pdf, Page 5.

59 SEBI,:https://www.sebi.gov.in/legal/regulations/sep-2024/securities-and-exchange-board-of-india-foreign-venture-capital-investors-amendment-regulations-2024_86505.html, Page 23.

60 Ministry of Finance,:https://egazette.nic.in/WriteReadData/2019/213332.pdf, Page 98.

61 SEBI,:https://www.sebi.gov.in/legal/regulations/may-2023/securities-and-exchange-board-of-india-issue-of-capital-and-disclosure-requirements-regulations-2018-last-amended-on-may-23-2023-_72390.html, Page 170.

62 SEBI,:https://www.sebi.gov.in/legal/regulations/may-2024/securities-and-exchange-board-of-india-issue-of-capital-and-disclosure-requirements-regulations-2018-last-amended-on-may-17-2024-_80421.html, Page 28.

iv. **Exemption under the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011 ("Takeover Code"):** SEBI has also exempted promoters of a listed company from the public offer provisions in connection with any transfer of shares of a listed company, from FVCIs to the promoters, under the Takeover Code.

v. **QIB Status:** FVCIs registered with SEBI have been accorded qualified institutional buyer **("QIB")** status and are eligible to subscribe to securities at an IPO through the book building route[63].

vi. **Broader list of eligible sectors:** List of sectors in which FVCI can invest is specified in NDI Rules:[64]

a. Biotechnology;

b. IT related to hardware and software development;

c. Nanotechnology;

d. Seed research and development;

e. Research and development of new chemical entities in pharmaceuticals sector;

f. Dairy industry;

g. Poultry industry;

h. Production of bio-fuels;

i. Hotel-cum-convention centers with seating capacity of more than three thousand; and

j. Infrastructure sector.

The FDI Policy allows startups and Cat-I AIF or VCF, irrespective of the sector they operate in, to raise 100% funds from SEBI registered FVCI under the automatic route. Start-ups can issue equity or equity linked instruments or debt instruments to FVCI against receipt of foreign remittance. However, if the investment is made through an equity instrument, the FVCI must comply with sectoral caps, entry routes and other specified conditions.

However, the FVCI Regulations specify that[65]:

a. at least 66.67% of the investible funds of a FVCI shall be invested in unlisted equity shares or equity-linked instruments of venture capital undertaking[66];

b. up to 33.33% of the investible funds of a FVCI may be invested by way of: (i) subscription to an initial public offer of a venture capital undertaking or investee company as defined in the AIF Regulations [67], whose shares are proposed to be listed; (ii) debt or debt instrument of a venture capital undertaking or investee company as defined in the AIF Regulations[68], in which the FVCI entity has already invested by way of equity; or preferential allotment of equity shares of a listed company, subject to a lock-in period of one year[69];

63 SEBI,:https://www.sebi.gov.in/legal/regulations/may-2024/securities-and-exchange-board-of-india-issue-of-capital-and-disclosure-requirements-regulations-2018-last-amended-on-may-17-2024-_80421.html, Page 9.

64 https://enforcementdirectorate.gov.in/fema.

65 Regulation 11 of the FVCI Regulations. These investment conditions may be achieved by the FVCI at the end of its life cycle.

66 SEBI,:https://www.sebi.gov.in/legal/regulations/sep-2024/securities-and-exchange-board-of-india-foreign-venture-capital-investor-regulations-2000-last-amended-on-september-6-2024-_86924.html, Page 16.

67 In Regulation 2, Clause 1 (o).

68 In Regulation 2, Clause 1 (o).

69 SEBI,:https://www.sebi.gov.in/legal/regulations/sep-2024/securities-and-exchange-board-of-india-foreign-venture-capital-investor-regulations-2000-last-amended-on-september-6-2024-_86924.html, Page 16.

C. FPI regime

SEBI had issued (Foreign Portfolio Investors) Regulations, 2019 **("FPI Regulations")**, along with the consolidated operational guidelines **("Operational Guidelines")** for FPIs, DDPs and Eligible Foreign Investors on November 5, 2019, in order to facilitate implementation of the FPI Regulations. This was followed by a Master Circular for FPIs, DDPs and EFIs **("Master Circular")** dated December 19, 2022 which further was superseded by a Master Circular, dated May 30, 2024[70] , consolidating various SEBI circulars and guidelines on the subject[71].

An FPI is allowed to purchase equity instruments of a listed or to-be-listed Indian company government securities, and listed/unlisted corporate bonds, and such investments are subject to the limits specified by SEBI and/or the RBI. The investment is made by an FPI as an inward remittance from abroad through its foreign currency denominated account and normal a account

I. Categories

Each investor shall register directly as an FPI, wherein the FPIs have been classified into the following two categories on the basis of risk-based approach towards know your customer.

Category I FPI: This category shall include; (i) Government and Government related investors including entities controlled or at least 75% directly or indirectly owned by such government or government related investors; (ii) pension funds and university funds; (iii) appropriately regulated entities such as insurance entities, banks, asset management companies, investment managers, investment advisors, portfolio managers, broker dealers and swap dealers; (iv) entities from FATF member countries or any country specified by the central government by an order or by way of an agreement or treaty with other sovereign governments subject to eligibility conditions provided in the FPI regulations; (v) an entity (a) whose investment manager is from an FATF member country and is registered as a Category I FPI or (b) which is at least 75% owner, directly or indirectly by an eligible entity who is a from an FATF member country and falls within the categories mentioned in (ii) to (iv) above[72]

Category II FPI: This category shall include appropriately regulated funds not eligible as Category-I foreign portfolio investor; endowments and foundations; charitable organisations; corporate bodies; family offices; individuals; appropriately regulated entities investing on behalf of their client; unregulated funds in the form of limited partnerships and trusts[73].

II. Investment limits

Individual limits: The total holding of one single FPI or an investor group shall be lower than: (i) 10% of the total paid-up equity share capital issued by an Indian company, on a fully diluted basis or (ii) 10 % of the

70 SEBI,:https://www.sebi.gov.in/legal/master-circulars/may-2024/master-circular-for-foreign-portfolio-investors-designated-depository-participants-and-eligible-foreign-investors-_83689.html.

71 https://www.nishithdesai.com/NewsDetails/15049.

72 https://www.sebi.gov.in/legal/regulations/jun-2024/securities-and-exchange-board-of-india-foreign-portfolio-investors-regulations-2019-last-amended-on-june-26-2024-_84596.html, Page 5,6.

73 https://www.sebi.gov.in/legal/regulations/jun-2024/securities-and-exchange-board-of-india-foreign-portfolio-investors-regulations-2019-last-amended-on-june-26-2024-_84596.html, Page 6.

paid-up value of each series of debentures, or preference shares, or share warrants issued by an Indian company[74]. If two or more Foreign Portfolio Investors (FPIs) have shared ownership, either directly or indirectly, of over 50 percent or share common control, they will be considered as part of the same investor group. Consequently, their combined holding must be less than 10%[75].

Aggregate limits: The total holdings of all FPIs put together, including any other direct and indirect foreign investments in the Indian company shall not exceed 24% of paid-up equity capital on a fully diluted basis or paid up value of each series of debentures or preference shares or share warrants. Further, post April 1, 2020 aggregate limit shall be the sectoral caps as mentioned in the NDI rules, with respect to the company's fully paid up equity capital on a fully diluted basis or the paid-up value of each series of debentures and preference shares[76].

Provided that Indian company had the option to decrease the aggregate limit specified above to lower threshold limit of 24% or 49% or 74%, with the approval of its board of directors and its general body through a resolution and a special resolution, respectively before 31st March 2020. Furthermore, Indian company which has decreased its aggregate limit to 24% or 49% or 74%, may increase such aggregate limit to 49% or 74% or the sectoral cap or statutory ceiling respectively with the approval of its board of directors and its general body through a resolution and a special resolution. However, once the aggregate limit has been increased to a higher threshold, the Indian company cannot reduce the same to a lower threshold.[77]

III. Consideration

FPIs can purchase instruments of an Indian company through public offer or private placement, subject to the individual/ aggregate limits, and the following conditions:

1. In case of subscription by way of public offer, the price of the shares issued to FPIs shall not be less than the price at which shares are issued to resident investors[78].
2. In case of subscription by way of private placement, the price shall not be less than: (i) the price arrived at in terms of the pricing guidelines (as applicable to FDI investment) issued by SEBI; or (ii) the fair price worked out as per any internationally accepted pricing methodology for valuation of shares, on an arm's length basis. Such fair price arrived at shall be certified by a SEBI registered merchant banker or chartered accountant or a practicing cost accountant[79].
3. If foreign investment by an FPI is made upto an aggregate limit of 49% of the paid-up equity share capital of the Indian company, or the applicable statutory/sectoral cap, whichever is lower, no government approval or compliance with sectoral conditions is required. However, it must be ensured that such an investment does not result in transfer of ownership and control of the resident Indian company to non-resident investors[80].

74 Enforcement Directorate,:https://enforcementdirectorate.gov.in/fema?page=0, Page 94.
75 Enforcement Directorate,:https://enforcementdirectorate.gov.in/fema?page=0, Page 95.
76 Enforcement Directorate,:https://enforcementdirectorate.gov.in/fema?page=0, Page 94.
77 Enforcement Directorate,:https://enforcementdirectorate.gov.in/fema?page=0, Page 94.
78 Enforcement Directorate,:https://enforcementdirectorate.gov.in/fema?page=0, Page 95.
79 Enforcement Directorate,:https://enforcementdirectorate.gov.in/fema?page=0, Page 95.
80 Enforcement Directorate,:https://enforcementdirectorate.gov.in/fema?page=0, Page 72.

4. The FPI Regulations further prescribe that the transaction of business in securities by an FPI shall be carried out only through SEBI registered stock brokers. However, an exemption is provided while transacting in corporate bonds[81].

IV. Instruments

FPI entities are permitted to invest by way of the following instruments:

1. Listed or to-be listed shares, debentures and warrants of a company;
2. Listed/unlisted units of schemes floated by a recognized mutual fund;
3. Units of schemes floated by a collective investment scheme;
4. Units of real estate investment trusts, infrastructure investment trusts and unit of applicable Alternate Investment Funds;
5. Derivatives traded on a recognized stock exchange;
6. Non-convertible debentures/ bonds issued by an Indian company;
7. Treasury bills and dated government securities;
8. Commercial papers issued by an Indian company;
9. Rupee denominated credit enhanced bonds;
10. Security Receipts **("SRs")** issued by ARCs (to this extent, FPIs are allowed to invest up to 100% of each; tranche in SRs issued by ARCs, subject to RBI guidelines and within the applicable regulatory cap);
11. Units of domestic mutual funds or Exchange-Traded Funds which invest less than or equal to 50% in equity;
12. Debt instruments issued by banks, eligible for inclusion in regulatory capital;
13. Rupee denominated bonds or units issued by Infrastructure Debt Funds;
14. Indian depository receipts;
15. Securitized debt instruments including (i) any certificate or instrument issued by a special purpose vehicle (SPV) set up for securitisation of asset/s with banks, Financial Institutions or NBFCs as originators;
16. Municipal bonds[82]; and
17. debt securities issued by InvITs and REITs.[83]

SEBI issued a circular dated August 24, 2023, mandating additional disclosures by certain objectively identified FPIs[84] , viz.,

81 SEBI,:https://www.sebi.gov.in/legal/regulations/jun-2024/securities-and-exchange-board-of-india-foreign-portfolio-investors-regulations-2019-last-amended-on-june-26-2024-_84596.html, Page 13.

82 RBI,:https://m.rbi.org.in/Scripts/BS_FemaNotifications.aspx?Id=12099, and SEBI,.https://www.sebi.gov.in/legal/regulations/jun-2024/securities-and-exchange-board-of-india-foreign-portfolio-investors-regulations-2019-last-amended-on-june-26-2024-_84596.html, Page 13.

83 RBI,:https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=12188&Mode=0.

84 SEBI,:https://www.sebi.gov.in/legal/circulars/aug-2023/mandating-additional-disclosures-by-foreign-portfolio-investors-fpis-that-fulfil-certain-objective-criteria_75886.html, Page 1.

a. FPIs holding more than 50% of their Indian equity assets under management in a single Indian Corporate Group;

b. FPIs that individually, or along with their investor group, hold more than INR 25,000 crore (~USD 3 billion) of equity asset under management in the Indian markets.

Such FPIs were mandated to provide the granular details of all entities holding any ownership, economic interest, or exercising control in the FPI, on a full look-through basis, up to the level of all natural persons, to their respective DDPs, unless they realign their holdings within the prescribed timelines. A Standard Operating Procedure was also released pursuant to this circular. Kindly note that certain FPIs and investors have been exempt from making additional disclosures as per Paragraph 3.3 of the SOP[85] .

V. ODIs / P-Notes

ODI means any instrument, by whatever name called, which is issued overseas by a foreign portfolio investor against securities held by it in India[86], as its underlying units Participatory Notes **("P-Notes")** are a form of ODIs.

P-Notes are, by definition a form of ODI including but not limited to swaps[87], contracts for difference[88], options[89], forwards[90], participatory notes[91], equity linked notes[92], warrants[93], or any other such instruments by whatever name they are called.

Below is a diagram that illustrates the structure of an ODI.

85 https://country.db.com/india/documents/other-information/SOP-for-disclsoures-under-August-24-Circular-March-2024.pdf.

86 SEBI,:https://www.sebi.gov.in/legal/regulations/jun-2024/securities-and-exchange-board-of-india-foreign-portfolio-investors-regulations-2019-last-amended-on-june-26-2024-_84596.html, Page 2.

87 A swap consists of the exchange of two securities, interest rates, or currencies for the mutual benefit of the exchangers. In the most common swap arrangement one party agrees to pay fixed interest payments on designated dates to a counterparty who, in turn, agrees to make return interest payments that float with some reference rate.

88 An arrangement made in a futures contract whereby differences in settlement are made through cash payments, rather than the delivery of physical goods or securities. At the end of the contract, the parties exchange the difference between the opening and closing prices of a specified financial instrument.

89 An option is a financial derivative that represents a contract sold by one party to another party. It offers the buyer the right, but not the obligation, to call or put a security or other financial asset at an agreed-upon price during a certain period of time or on a specific date.

90 A forward contract is a binding agreement under which a commodity or financial instrument is bought or sold at the market price on the date of making the contract, but is delivered on a decided future date. It is a completed contract – as opposed to an options contract where the owner has the choice of completing or not completing.

91 Participatory notes (P-notes) are a type of offshore derivative instruments more commonly issued in the Indian market context which are in the form of swaps and derive their value from the underlying Indian securities.

92 An Equity-linked Note is a debt instrument whose return is determined by the performance of a single equity security, a basket of equity securities, or an equity index providing investors fixed income like principal protection together with equity market upside exposure.

93 A Warrant is a derivative security that gives a holder the right to purchase securities from an issuer at a specific price within a certain time frame.

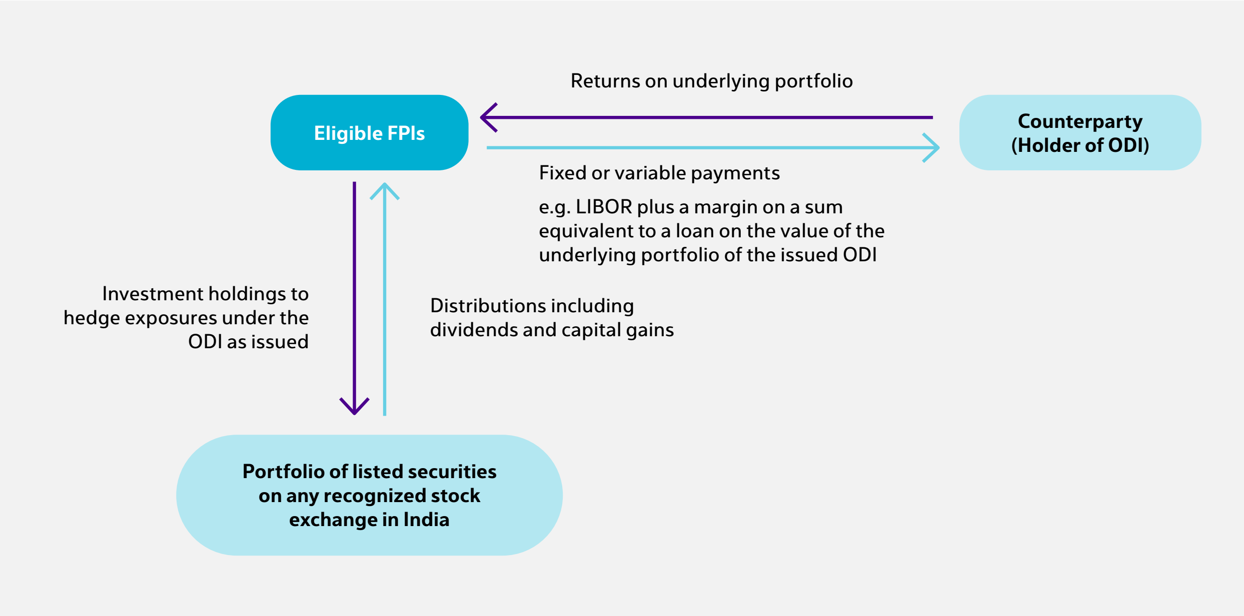

Fig 1: Investment through ODIs.

The position of the holder of an ODI is usually that of an unsecured counterparty to the FPI.

Under the ODI (the contractual arrangement with the issuing FPI), the holder of a P-Note is entitled only 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.

Regulation 21(1)(b) of the FPI Regulations states that ODIs can be issued to persons eligible for registration as Category I FPIs, including an entity eligible for such license by virtue of its investment manager being situated in an FATF member jurisdiction. Moreover, in such cases, the investment manager is not required to be actually registered as a Category I FPI with SEBI[94]. Hence, an unregulated fund from an FATF member country or an entity from a non-FATF member country, having an investment manager located in an FATF member country, registered as a Category II FPI with SEBI should be able to subscribe to the ODIs since such fund / entity should be eligible to register as a Category I FPI with SEBI, without surrendering its Category II FPI license. Moreover, ODIs are issued after compliance with the 'know your client' norms as specified by SEBI[95].

SEBI issued a circular, dated December 17, 2024, mandating ODI issuing FPIs to now have a separate dedicated registration for issuance of such ODIs[96] . Notably, ODI issuing FPIs are now prohibited from issuing ODIs with derivatives as the underlying, and are also prohibited from hedging their ODIs with derivative positions on stock exchanges in India, thereby requiring them to fully hedge their positions with the same scrip on a one-to-one basis[97].

94 SEBI,:https://www.sebi.gov.in/legal/regulations/jun-2024/securities-and-exchange-board-of-india-foreign-portfolio-investors-regulations-2019-last-amended-on-june-26-2024-_84596.html, Page 6.

95 SEBI,:https://www.sebi.gov.in/legal/regulations/mar-2023/securities-and-exchange-board-of-india-foreign-portfolio-investors-regulations-2019-last-amended-on-march-15-2023-_69570.html , Page 15.

96 SEBI,:https://www.sebi.gov.in/legal/circulars/dec-2024/measures-to-address-regulatory-arbitrage-with-respect-to-offshore-derivative-instruments-odis-and-fpis-with-segregated-portfolios-vis-vis-fpis_89986.html, Page 1.

97 SEBI,:https://www.sebi.gov.in/legal/circulars/dec-2024/measures-to-address-regulatory-arbitrage-with-respect-to-offshore-derivative-instruments-odis-and-fpis-with-segregated-portfolios-vis-vis-fpis_89986.html, Page 2.

The circular, further, has mandated the applicability of the granular disclosure requirements for ODI subscribers breaching either of the two objective criteria for ODI subscribers, viz., ODI subscribers having more than 50% of their equity ODI positions in ODIs referenced to securities of a single Indian corporate group, and ODI subscribers having equity positions worth more than INR 25,000 crore (~ USD 3 billion) in the Indian markets[98] . ODI subscribers falling in the first category are required to either re-align their positions within 10 days from the breach of the threshold or make additional disclosures within 30 days from the expiry of the re-alignment timeline, failing which the ODI subscriber shall become ineligible to hold positions through any ODI issuing FPI. ODI subscribers falling in the second category are required to either re-align their positions within 90 days from the breach of the threshold or make additional disclosures within 30 days from the expiry of the re-alignment timeline, failing which the ODI subscriber shall become ineligible to hold positions through any ODI issuing FPI. In case of such ineligibility, the ODI issuing FPIs shall redeem all ODI positions held by such subscribers within 180 days from the date of such ineligibility.

D. Alternative Investment Funds:

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: (i) 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 99; and (ii) 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 SEBI to regulate fund management activities[100].

98 SEBI,:https://www.sebi.gov.in/legal/circulars/dec-2024/measures-to-address-regulatory-arbitrage-with-respect-to-offshore-derivative-instruments-odis-and-fpis-with-segregated-portfolios-vis-vis-fpis_89986.html, Page 2.

99 SEBI,:https://www.sebi.gov.in/legal/regulations/jul-2023/securities-and-exchange-board-of-india-alternative-investment-funds-regulations-2012-last-amended-on-july-4-2023-_74146.html , Page 3.

100 SEBI,:https://www.sebi.gov.in/legal/regulations/jul-2023/securities-and-exchange-board-of-india-alternative-investment-funds-regulations-2012-last-amended-on-july-4-2023-_74146.html , Page 3.

Key Aspects of Alternative Investment Funds:

Continuing Interest	The AIF Regulations require the sponsor or the manager of an AIF to contribute a certain amount of capital to the fund. The purpose of the clause is to have the sponsor or the investment manager to commit capital to the funds (i.e. to have skin-in-the game). This portion is known as the continuing interest and will remain locked-in the fund until distributions have been made to all the other investors in the fund. For a Category I AIF or Category II AIF, the sponsor or the manager is required to have a continuing interest of 2.5% of the corpus of the fund or INR 50 million whichever is lower[101] and in the case of a Category – III AIF, a continuing interest of 5% of the corpus or INR 100 million whichever is lower[102]. For the newly introduced angel investment funds, the AIF Regulations require the sponsor or the manager to have a continuing interest of 2.5% of the corpus of the fund or INR 5 million whichever is lower[103].
Minimum Corpus	The AIF Regulations prescribe that the minimum corpus for any AIF shall be INR 200 million ("Minimum Corpus")[104]. 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[105].
Minimum Investment	The AIF Regulations do not permit an AIF to accept an investment of less than INR 10 million ("Minimum Investment Amount") from any investor[106] unless such investor is an employee or a director of the AIF or an employee or director of the manager of the AIF in which case the AIF can accept investments of a minimum value of INR 2.5 million[107].
Maximum Number of Investors	The AIF Regulations caps the maximum number of investors for an AIF at 1,000[108].
Tenure	While Category I and Category II AIFs can only be close-ended funds, Category III AIFs can be open ended[109]. The AIF Regulations prescribe the minimum tenure of 3 years for Category I and Category II AIFs[110]. Further, the tenure of close ended AIFs can be extended up to two years subject to the approval of 2/3rd of the unit holders by value of their investment in the AIF[111].
Private Placement	The AIF Regulations prohibit solicitation or collection of funds except by way of private placement[112]. While the AIF Regulations do not prescribe any thresholds or rules for private placement, guidance is taken from the CA, 2013.

101 SEBI,:https://www.sebi.gov.in/legal/regulations/jul-2023/securities-and-exchange-board-of-india-alternative-investment-funds-regulations-2012-last-amended-on-july-4-2023-_74146.html , Page 20.

102 SEBI,:https://www.sebi.gov.in/legal/regulations/jul-2023/securities-and-exchange-board-of-india-alternative-investment-funds-regulations-2012-last-amended-on-july-4-2023-_74146.html , Page 20.

103 SEBI,:https://www.sebi.gov.in/legal/regulations/jul-2023/securities-and-exchange-board-of-india-alternative-investment-funds -regulations-2012-last-amended-on-july-4-2023-_74146.html , Page 40.

104 SEBI,:https://www.sebi.gov.in/legal/regulations/jul-2023/securities-and-exchange-board-of-india-alternative-investment-funds -regulations-2012-last-amended-on-july-4-2023-_74146.html , Page 19.

105SEBI,:https://www.sebi.gov.in/legal/regulations/jul-2023/securities-and-exchange-board-of-india-alternative-investment-funds -regulations-2012-last-amended-on-july-4-2023-_74146.html, Page 5.

106 SEBI,:https://www.sebi.gov.in/legal/regulations/jul-2023/securities-and-exchange-board-of-india-alternative-investment-funds -regulations-2012-last-amended-on-july-4-2023-_74146.html, Page 19.

107 SEBI,:https://www.sebi.gov.in/legal/regulations/jul-2023/securities-and-exchange-board-of-india-alternative-investment-funds-regulations-2012-last-amended-on-july-4-2023-_74146.html, Page 19.

108 SEBI,:https://www.sebi.gov.in/legal/regulations/jul-2023/securities-and-exchange-board-of-india-alternative-investment-funds -regulations-2012-last-amended-on-july-4-2023-_74146.html, Page 20.

109 SEBI,:https://www.sebi.gov.in/legal/regulations/jul-2023/securities-and-exchange-board-of-india-alternative-investment-funds -regulations-2012-last-amended-on-july-4-2023-_74146.html, Page 22.

110 SEBI,:https://www.sebi.gov.in/legal/regulations/jul-2023/securities-and-exchange-board-of-india-alternative-investment-funds -regulations-2012-last-amended-on-july-4-2023-_74146.html, Page 22.

111 SEBI,:https://www.sebi.gov.in/legal/regulations/jul-2023/securities-and-exchange-board-of-india-alternative-investment-funds -regulations-2012-last-amended-on-july-4-2023-_74146.html, Page 22.

112 SEBI,:https://www.sebi.gov.in/legal/regulations/jul-2023/securities-and-exchange-board-of-india-alternative-investment-funds -regulations-2012-last-amended-on-july-4-2023-_74146.html, Page 20.

Standardized PPM	SEBI introduced template(s) for PPM, subject to certain exemptions, and mandatory performance benchmarking for AIFs (other than angel funds, and / or those falling under exemptions explained below) with provisions for additional customized performance reporting [113]. The mandatory template provides for two parts: Part A – section for minimum disclosures [114], and Part B – supplementary section to allow full flexibility to the Fund in order to provide any additional information, which it deems fit [115].
Audit of PPM	SEBI has also made it mandatory for AIFs (other than angel funds, and / or those falling under exemptions explained below) to carry out an annual audit of such compliance by an internal or external auditor/legal professional. The audit of sections of PPM relating to 'Risk Factors', 'Legal, Regulatory and Tax Considerations' and 'Track Record of First Time Managers' shall be optional [116].
Performance Benchmarking	SEBI has also introduced mandatory benchmarking of the performance of the AIFs and a framework for facilitating the use of data collected by benchmarking agencies to provide customized reports [117]. Any association of AIFs ("Association"), which in terms of membership, represents at least 51% of the number of AIFs, may notify one or more benchmarking agencies, with whom each AIF shall enter into an agreement for carrying out the benchmarking process [118]. The agreement between the benchmarking agencies and AIFs shall cover the mode and manner of data reporting, specific data that needs to be reported, terms including confidentiality in the manner in which the data received by the benchmarking agencies may be used, etc. AIFs, for all their schemes which have completed at least one year from the date of 'First Close', shall report all the necessary information including scheme-wise valuation and cash flow data to the benchmarking agencies in a timely manner [119]. The form and format of reporting shall be mutually decided by the Association and the benchmarking agencies. If an applicant claims a track-record on the basis of India performance of funds incorporated overseas, it shall also provide the data of the investments of the said funds in Indian companies to the benchmarking agencies, when they seek registration as an AIF [120].

Classification of AIFs:

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.

Category I: These 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 including AIFs which are generally perceived to have positive spill over effects on the economy. Sub-categories of Category I AIFs includes venture capital funds, SME funds, social impact funds, infrastructure funds, special situation funds and such other AIFs as may be specified [121].

Category II: 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

113 SEBI,:https://www.sebi.gov.in/legal/circulars/feb-2020/disclosure-standards-for-alternative-investment-funds-aifs-_45919.html, Page 1 and 2.

114 SEBI,:https://www.sebi.gov.in/legal/circulars/feb-2020/disclosure-standards-for-alternative-investment-funds-aifs-_45919.html, Page 1.

115 SEBI,:https://www.sebi.gov.in/legal/circulars/feb-2020/disclosure-standards-for-alternative-investment-funds-aifs-_45919.html, page 1.

116 SEBI,:https://www.sebi.gov.in/legal/circulars/feb-2020/disclosure-standards-for-alternative-investment-funds-aifs-_45919.html, page 1.

117 SEBI,:https://www.sebi.gov.in/legal/circulars/feb-2020/disclosure-standards-for-alternative-investment-funds-aifs-_45919.html, page 2.

118 SEBI,:https://www.sebi.gov.in/legal/circulars/feb-2020/disclosure-standards-for-alternative-investment-funds-aifs-_45919.html, page 2.

119 SEBI,:https://www.sebi.gov.in/legal/circulars/feb-2020/disclosure-standards-for-alternative-investment-funds-aifs-_45919.html, page 3.

120 SEBI,:https://www.sebi.gov.in/legal/circulars/feb-2020/disclosure-standards-for-alternative-investment-funds-aifs-_45919.html, page 3.

121 SEBI,:https://www.sebi.gov.in/legal/regulations/jul-2023/securities-and-exchange-board-of-india-alternative-investment-funds-regulations-2012-last-amended-on-july-4-2023-_74146.html, Page 12.

and as permitted in the AIF Regulations. It includes 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[122].

Category III: Category III AIFs are funds which employ complex or diverse trading strategies and may employ leverage including through investment in listed or unlisted derivatives. It includes 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[123].

SEBI has, through the Securities and Exchange Board of India (Alternative Investment Funds) (Second Amendment) Regulations, 2023, recently introduced a new registration category for AIFs known as specified AIFs[124] under Regulation 19 of the AIF Regulations, wherein SEBI has the power to lay down the framework for AIFs other than the funds falling in the three categories stated above[125].

Investment Conditions and Restrictions under the AIF Regulations:

Category 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 Category I AlFs of the same subcategory or in units of Category II AIFs specified in the AIF Regulations[126]. They may engage in hedging, including credit default swaps in accordance with the conditions as may be specified by SEBI[127]. Moreover, 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[128].

Category II: Category II AIFs shall invest in investee companies or in the units of Category I or other Category II AIFs as may be disclosed in the placement memorandum[129]. Moreover, 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[130]. It is also provided that Category II AIFs may engage in hedging and may buy or sell credit default swaps, subject to specified guidelines and conditions as may be prescribed by SEBI[131].

It may be noted that, Category II AIFs shall be exempt from Regulations 3 (sub regulations 1 and 2) and Regulation 4 (sub- regulation 1) of the Insider Trading Regulations in respect of investments in companies

122 SEBI,:https://www.sebi.gov.in/legal/regulations/jul-2023/securities-and-exchange-board-of-india-alternative-investment-funds-regulations-2012-last-amended-on-july-4-2023-_74146.html , Page 13.

123 SEBI,:https://www.sebi.gov.in/legal/regulations/jul-2023/securities-and-exchange-board-of-india-alternative-investment-funds-regulations-2012-last-amended-on-july-4-2023-_74146.html, Page 13.

124 SEBI,:https://www.sebi.gov.in/legal/regulations/jul-2023/securities-and-exchange-board-of-india-alternative-investment-funds-regulations-2012-last-amended-on-july-4-2023-_74146.html, Page 13.

125 SEBI,:https://www.sebi.gov.in/legal/regulations/jul-2023/securities-and-exchange-board-of-india-alternative-investment-funds-regulations-2012-last-amended-on-july-4-2023-_74146.html, Page 35.

126 SEBI,:https://www.sebi.gov.in/legal/regulations/nov-2021/securities-and-exchange-board-of-india-alternative-investment-funds-regulations-2012-last-amended-on-november-09-2021-_34621.html, Page 22.

127 SEBI,:https://www.sebi.gov.in/legal/regulations/jul-2023/securities-and-exchange-board-of-india-alternative-investment-funds-regulations-2012-last-amended-on-july-4-2023-_74146.html , Page 32.

128 SEBI,:https://www.sebi.gov.in/legal/regulations/jul-2023/securities-and-exchange-board-of-india-alternative-investment-funds-regulations-2012-last-amended-on-july-4-2023-_74146.html, Page 32.

129 SEBI,:https://www.sebi.gov.in/legal/regulations/jul-2023/securities-and-exchange-board-of-india-alternative-investment-funds-regulations-2012-last-amended-on-july-4-2023-_74146.html, Page 33.

130 SEBI,:https://www.sebi.gov.in/legal/regulations/jul-2023/securities-and-exchange-board-of-india-alternative-investment-funds-regulations-2012-last-amended-on-july-4-2023-_74146.html, Page 33.

131 SEBI,:https://www.sebi.gov.in/legal/regulations/jul-2023/securities-and-exchange-board-of-india-alternative-investment-funds-regulations-2012-last-amended-on-july-4-2023-_74146.html, Page 33.

listed on SME exchange or SME segment of an exchange pursuant to due diligence of such companies subject to certain conditions provided in the regulations[132].

Category III: Category III AIFs may invest in securities of listed or unlisted investee companies, derivatives, units of other AIFs or complex or structured products[133]. Further, Category III AIFs may deal in 'goods' received in delivery against physical settlement of commodity derivatives[134]. They may also buy or sell credit default swaps as may be prescribed by SEBI[135]. Moreover, 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 as well as disclosure conditions[136]. Furthermore, Category III AIFs shall be regulated through issuance of directions regarding areas such as operational standards, conduct of business rules, prudential requirements, restrictions on redemption and conflict of interest as may be specified by the Board[137].

Change in Circumstances

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 (not including internal restructuring)[138];
2. change in control of sponsor / manager[139]; and
3. change in fee structure or hurdle rate which may result in higher fees being charged to the unit holders[140].

SEBI has published a circular on June 21, 2023 to standardise the approach to valuation of investment portfolio of the AIF's, which stated that any change in the methodology and approach for valuation of investments of scheme of AIFs shall be construed as a 'material change' significantly influencing the decision of the investor to continue to be invested in the scheme of the AIF[141].

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[142].

132 SEBI,:https://www.sebi.gov.in/legal/regulations/jul-2023/securities-and-exchange-board-of-india-alternative-investment-funds-regulations-2012-last-amended-on-july-4-2023-_74146.html, Page 33.

133 SEBI,:https://www.sebi.gov.in/legal/regulations/jul-2023/securities-and-exchange-board-of-india-alternative-investment-funds-regulations-2012-last-amended-on-july-4-2023-_74146.html , Page 34.

134 SEBI,:https://www.sebi.gov.in/legal/regulations/jul-2023/securities-and-exchange-board-of-india-alternative-investment-funds-regulations-2012-last-amended-on-july-4-2023-_74146.html, Page 34.

135 SEBI,:https://www.sebi.gov.in/legal/regulations/jul-2023/securities-and-exchange-board-of-india-alternative-investment-funds-regulations-2012-last-amended-on-july-4-2023-_74146.html, Page 34.

136 SEBI,:https://www.sebi.gov.in/legal/regulations/jul-2023/securities-and-exchange-board-of-india-alternative-investment-funds-regulations-2012-last-amended-on-july-4-2023-_74146.html, Page 34.

137 SEBI,:https://www.sebi.gov.in/legal/regulations/jul-2023/securities-and-exchange-board-of-india-alternative-investment-funds-regulations-2012-last-amended-on-july-4-2023-_74146.html, Page 34.

138 SEBI,:https://www.sebi.gov.in/legal/circulars/jun-2014/guidelines-on-disclosures-reporting-and-clarifications-under-aif-regulations_27118.html, page 3.

139 SEBI,:https://www.sebi.gov.in/legal/circulars/jun-2014/guidelines-on-disclosures-reporting-and-clarifications-under-aif-regulations_27118.html, Page 3.

140 SEBI,:https://www.sebi.gov.in/legal/circulars/jun-2014/guidelines-on-disclosures-reporting-and-clarifications-under-aif-regulations_27118.html, Page 3.

141 SEBI,:https://www.sebi.gov.in/legal/circulars/jun-2023/standardised-approach-to-valuation-of-investment-portfolio-of-alternative-investment-funds-aifs-_72924.html, Page 2.

142 SEBI,:https://www.sebi.gov.in/legal/circulars/jun-2014/guidelines-on-disclosures-reporting-and-clarifications-under-aif-regulations_27118.html, Page 3.

E. NRI Investment

I. Investment on repatriation basis

Under the NDI Rules a Non-resident Indian (NRI) or an Overseas Citizen of India (OCI) may purchase or sell equity instruments of a listed Indian company on repatriation basis, on a recognized stock exchange in India[143]. Furthermore, NDI Rules specify that NRI/OCI may without limit purchase or sell units of (i) domestic mutual funds which invest more than 50 percent in equity[144]; and (ii) purchase or sell shares in public sector enterprises being disinvested by the GOI, provided the purchase is in accordance with the terms and conditions stipulated in the notice inviting bids[145]. Additionally, an NRI/OCI may subscribe to the National Pension System governed and administered by Pension Fund Regulatory and Development Authority (PFRDA), provided such person is eligible to invest as per the provisions of the Pension Fund Regulatory and Development Authority Act, 2013[146].

Individual Limits: The NDI rules specify that total holding by any individual NRI or OCI shall not exceed 5% of the total paid-up equity capital on a fully diluted basis or shall not exceed 5% of the paid-up value of each series of debentures or preference shares or share warrants issued by an Indian company[147].

Aggregate Limits: The total holdings of all NRIs and OCIs put together shall not exceed 10% of the total paid-up equity capital on a fully diluted basis or shall not exceed 10% of the paid-up value of each series of debentures or preference shares or share warrants. Provided that the aggregate ceiling of 10% may be raised to 24% if a special resolution to that effect is passed by general body of Indian company 148. Such NRI investment on a repatriation basis will be subject to the FDI policy and NDI rules with respect to sectoral caps and conditionalities wherever applicable[149].

II. Investment on Non-repatriation Basis

Under the NDI Rules, a NRI/OCI including a company, a trust and a partnership firm incorporated outside India and owned and controlled by NRIs or OCIs, may purchase or contribute, as the case may be, on non-repatriation basis, (i) an equity instrument issued by a company without any limit either on the stock exchange or outside it; (ii) units issued by an investment vehicle without any limit, either on the stock exchange or outside it; (iii) the capital of a Limited Liability Partnership without any limit; (iv) convertible notes issued by a startup company in accordance with the NDI Rules. These investments shall be deemed to be domestic investment at par with the investments made by residents. Furthermore, the NDI Rules specify that an NRI or an OCI may without limit purchase or sell units of (i) domestic mutual funds which invest more than 50% in equity[150].

143 Ministry of Finance,:https://egazette.nic.in/WriteReadData/2019/213332.pdf, Page 96.

144 Ministry of Finance,:https://egazette.nic.in/WriteReadData/2019/213332.pdf, Page 96.

145 Ministry of Finance,;https://egazette.nic.in/WriteReadData/2019/213332.pdf, Page 96.

146 Ministry of Finance,:https://egazette.nic.in/WriteReadData/2019/213332.pdf, Page 96.

147 Ministry of Finance,:https://egazette.nic.in/WriteReadData/2019/213332.pdf, Page 96.

148 Ministry of Finance,:https://egazette.nic.in/WriteReadData/2019/213332.pdf, Page 96.

149 Ministry of Finance,:https://egazette.nic.in/WriteReadData/2019/213332.pdf, Page 96.

150 Ministry of Finance,:https://egazette.nic.in/WriteReadData/2019/213332.pdf, Page 97.

However, NRIs or OCIs, shall not make any investment on non-repatriation basis in equity instruments or units of a Nidhi company or a company engaged in agricultural or plantation activities or real estate business or construction of farm-houses or dealing in transfer of development rights[151]. A NRI/OCI or an eligible investor holding equity instruments or units of an Indian company on a non-repatriation basis may transfer the same to a person resident outside India by way of gift with the prior approval of the RBI and after satisfying several conditions including (i) size of gift should not exceed 5% of the paid up capital of the Indian company or each mutual funds scheme[152], (ii) the value of the gift transferred in a year should not exceed rupee equivalent of USD 50,000[153], (iii) the donor or donee in such transfer shall be 'relatives' within the meaning of Section 2(77) of the Companies Act, 2013; and (iv) the applicable sectoral cap in the Indian company is not breached[154].

151 Ministry of Finance,:https://egazette.nic.in/WriteReadData/2019/213332.pdf, Page 97.

152 Ministry of Finance,:https://egazette.nic.in/WriteReadData/2019/213332.pdf, Page 60.

153 Ministry of Finance,:https://egazette.nic.in/WriteReadData/2019/213332.pdf, Page 60.

154 Ministry of Finance,:https://egazette.nic.in/WriteReadData/2019/213332.pdf, Page 60.

Private Debt Investments

Private debt investments are usually in the form of structured debt instruments customized to suit the needs of the borrower and the investor. These instruments may either take the form of listed / unlisted NCDs (subscribed to under the FPI (simple route and voluntary retention route) or redeemable debentures or shares (subscribed to under the FVCI route, subject to the sector limitation for the FVCIs). ECBs also provide for alternative lending mechanism to the investors due to its long-term investment scheme and simplified regulatory practices.

Private debt can be structured in the manner that is commercially best suited – with a coupon that is payable annually, or a coupon that is paid only upon cash flows in the company, or any other trigger event. The amount of coupon payable can also be a function of underlying equity price, EBITDA or any other commercially agreed variable. Since the coupon paid is a deductible for the investee company, and in many ways the instrument works more as a form structured equity than structured debt, private debt is quickly gaining ground in the Indian context.

To summarize, private debt offers the following benefits:

1. **Tailored financing:** Unlike Indian banks, which may be unable to tinker with their financial terms and are generally averse to advance loans to few sectors such as software, bio-technology, real estate etc. Private debt would not only offer highly tailored solutions (such as longer coupon moratoriums, profit linked coupons etc.) but would also cater to niche industry segments where banks may be apprehensive to lend, or may have significantly higher exposure limits.
2. **Tax optimization:** Private debt offers tax optimization to the investee company since any coupon paid on the debt is a deductible for the Indian company, which results in a saving of approximately 30% corporate income tax for the investee company.
3. **Structured transaction:** Return of capital is a huge challenge in case of equity or instruments mandatorily convertible into equity. However, with private debt investors can structure their investment as quasi-debt or quasi-equity or both. Investors can structure their investments in private debt in such a way that they have an option to protect their downside and to link their upside to the profits, share price, EBITDA of the investee company.
4. **Security creation:** Private debt allows the investee company to create security interest on the assets of the company or the shares of the founders. Security is created in favour of a local security trustee that would act on the instructions of the debenture holders. Security creation would not be permissible if the instrument for FDI investments or investments where the instrument is either equity or mandatorily convertible into equity.

Some of the benefits of private debt vis-à-vis through PE in the Indian context are set out in the table below:

Sl. No.	Particulars	Private Debt	Private Equity
1	Assured returns	Investors are eligible for assured returns on their investment through interest and redemption premium, both of which can be legally assured.	Returns on PE investments cannot be assured. Put options are not looked at favorably and will be subject to the conditionalities prescribed by the RBI. However, in the Cruz City and Docomo, court has upheld put options providing downside protection to the investors. This view has also been reiterated by the Hon'ble Supreme Court, Delhi High Court and the Madras High Court.[1]
2	Capital repatriation	Capital can be fully repatriated.	Repatriation of capital limited to buy-back or reduction of capital and subject to the conditionalities as set out later in this paper.
3	Tax benefits	Interest payments are a deductible expense of the borrower [However, characterisation of redemption is deemed capital gains as per section 50AA of the ITA. Please refer to the discussion in Chapter IV for more detail.].	After abolishment of DDT by FA 2020, dividends are now taxed at the hands of shareholders and not investee company. Further, there is also a withholding tax at the rate of 10% (plus applicable surcharge and cess) on all dividends paid by Indian companies to resident shareholders; and at the rate of 20%, or the rate in the relevant DTAA (whichever is more beneficial to the taxpayer) in the case of non-resident shareholders. This arrangement will now allow non-resident shareholders to claim credit for taxes withheld in India. Further, in the case of inter-corporate dividends, a deduction is allowed at the hands of a company receiving dividends (as per Section 80M) to the extent that the same is further distributed as a dividend within the same FY (one month prior to the due date of filling the ITR). Buyback is taxed in the hands of the shareholders as dividend income, with capital loss allowed to be booked in the hands of the shareholder as per the provisions of the ITA. Please refer to section 3.1 in Chapter IV for a detailed discussion on tax implications on buyback.
4	Sources of payment	Interest may be paid out of any source of the borrower.	Dividends can be paid out of profits only. Reduction of capital may be done without profits but is a court driven process and subject to lender approvals.
5	Security	Debt may be secured by creation of security over the assets of the borrower.	No security creation is possible to secure the investment amount or returns thereon.
6	Equity upside	Returns may be structured as interest or redemption premium and linked to cash flow, share price etc. hence achieving equity like structure with tax optimization.	Returns may be structured by way of dividends or capital reduction, both of which may be tax inefficient structures.

1 Banyan Tree Growth Capital L.L.C. v. Axiom Cordages Limited and Others, 2020 SCC Online Bom 781; Vijay Karia & Ors. v. Prysmian Cavi E Sistemi SRL & Ors., (2020) 11 SCC 1; and GPE (India) Limited & Ors. v. Twarit Consultancy Services Private Limited & Anr., 2023 SCC OnLine Mad 46.

In India, foreign investment in private debt can be currently made through either FPI regime (through simple route and voluntary retention route), FVCI regime, External Commercial Borrowings, or Non-Banking Financial Institutions.

A. The FDI Route:

Under the FDI regime, investment can only be made into: (i) equity; (ii) CCPS; and (iii) CCDs issued by an Indian company. Instruments which are not fully, compulsorily and mandatorily convertible (for instance, an optionally convertible preference share or a non-convertible debenture) shall be considered to be foreign capital in the form of an ECB. ECBs are separately governed under the ECB regime.

Debt investments under the FDI route should be by way of subscription to CCDs. Such debt investment is subject to all norms applicable to FDI. It may be noted here that the FDI regime essentially permits investments having an 'equity flavour'; in debt investments through CCDs there is a definite commitment to convert the CCDs into common equity shares of the investee Indian company.

No Assured Returns

While interest accrued and payable on CCDs is permitted, given the legal character of the instrument, an instrument issued to a non-resident investor under the FDI route cannot otherwise guarantee to such foreign investor an assured return on the investment. An instrument issued under the FDI route subject to an optionality clause (such as a 'put option') in favour of the non-resident investor shall not considered to be FDI compliant unless it complies with the conditions prescribed by the NDI Rules. The valuation norms prescribed under the NDI Rules for such optionality clauses prohibit any guaranteed returns to the non-resident investor. However, the Delhi High Court rulings in Cruz City and Docomo matters (which was also reiterated by the Hon'ble Supreme Court, Delhi High Court and Madras High Court)[2], have clarified that optionality clauses offering downside protection to the foreign investor should not be construed as one guaranteeing assured returns.

B. FVCI regime

Under Schedule VII of the NDI Rules and the FVCI Regulations, FVCIs can invest, inter alia, in NCDs and OCDs of an Indian venture capital undertaking or a venture capital fund. As discussed in Chapter 2, investments by FVCIs are subject to certain restrictions. In addition, the FVCI Regulations specify that:[3]

a. at least 66.67% of the investible funds of a FVCI shall be invested in unlisted equity shares or equity-linked instruments of venture capital undertaking[4]; and

2 Banyan Tree Growth Capital L.L.C. v. Axiom Cordages Limited and Others, 2020 SCC Online Bom 781; Vijay Karia & Ors. v. Prysmian Cavi E Sistemi SRL & Ors., (2020) 11 SCC 1; and GPE (India) Limited & Ors. v. Twarit Consultancy Services Private Limited & Anr., 2023 SCC OnLine Mad 46.

3 Regulation 11 of the FVCI Regulations. These investment conditions may be achieved by the FVCI at the end of its life cycle.

4 https://www.sebi.gov.in/legal/regulations/feb-2023/securities-and-exchange-board-of-india-foreign-venture-capital-investor-regulations-2000-last-amended-on-february-07-2023-_69489.html), Page 10.

b. not more than 33.33% of the investible funds of a FVCI may be invested by way of, inter alia, debt or debt instrument of a venture capital undertaking in which the FVCI has already made an investment by way of equity[5].

C. FPI regime

Under Schedule 1 of the NDI Rules, read with the provisions of the FPI Regulations, FPIs are currently, permitted to invest in, inter alia, listed or to be listed NCDs issued by an Indian company. FPIs are permitted to hold, deliver or cause to be deliver securities only in the dematerialized form[6]. Foreign exchange control regulations currently permit foreign investments into India by way of unlisted or listed NCDs. Subscribing to NCDs was the most preferred route of foreign investment by FPIs due to substantial regulatory flexibility with respect to structuring returns from investment, as well as tax planning. RBI issued circular which introduced limits on exposure a single FPI could take into a single borrower group to 30% of the debt portfolio, as well as the maximum extent to which a single investor could subscribe in a single bond issuance which was set at 50% of the relevant issue[7].

Corporate Debt:

FPIs are permitted to invest in corporate bonds with minimum residual maturity of above one year, subject to the condition that short-term investments in corporate bonds by an FPI shall not exceed 30% of the total investment of that FPI in corporate bonds[8]. Furthermore, investment limits in corporate bonds shall be INR 6678.71 billion[9].

Government Securities:

FPIs are permitted to invest in Central Government securities (G-secs), including in Treasury Bills, and State Development Loans (SDLs) without any minimum residual maturity requirement, subject to the condition that short-term investments by an FPI under either category shall not exceed 30%[10] of the total investment of that FPI in that category. Furthermore, investment limits in government securities general and government securities long term is INR 2678.90 billion and INR 1368.90 billion respectively[11].

Listing of NCDs on the wholesale debt market of the Bombay Stock Exchange is a fairly simple and straight forward process which involves the following intermediaries:

a. Debenture trustee, for protecting the interests of the debenture holders and enforcing the security, if any;

b. Rating agency for rating the NCDs (There is no minimum rating required for listing of debentures); and

c. Registrar and transfer agent, and the depositories for dematerialization of the non-convertible debentures.

5 https://www.sebi.gov.in/legal/regulations/feb-2023/securities-and-exchange-board-of-india-foreign-venture-capital-investor-regulations-2000-last-amended-on-february-07-2023-_69489.html), Page 10.

6 SEBI,:https://www.sebi.gov.in/legal/regulations/mar-2023/securities-and-exchange-board-of-india-foreign-portfolio-investors-regulations-2019-last-amended-on-march-15-2023-_69570.html, Page 14.

7 RBI,:https://rbidocs.rbi.org.in/rdocs/notification/PDFs/NT199035211F142484DEBA657412BFCB17999.PDF, page 4.

8 RBI,:https://rbidocs.rbi.org.in/rdocs/notification/PDFs/NT199035211F142484DEBA657412BFCB17999.PDF, page 2.

9 RBI,:https://www.rbi.org.in/scripts/FS_Notification.aspx?Id=12295&fn=5&Mode=0.

10 RBI,:https://rbidocs.rbi.org.in/rdocs/notification/PDFs/NT199035211F142484DEBA657412BFCB17999.PDF, page 2.

11 RBI,:https://www.rbi.org.in/scripts/FS_Notification.aspx?Id=12295&fn=5&Mode=0.

Using the NCD structure bears certain distinct advantages over other structures:

a. RBI issued certain conditions that FPIs will be allowed to invest only in those NCDs which have a minimum residual maturity of one year and FPIs are prohibited from investing in NCDs with optionality clauses exercisable prior to one year;

b. Assured returns to the investor by way of interest / redemption premium, irrespective of profits of the issuer company;

c. No specified limit on interest / redemption premium;

d. Interest expense is deductible from the taxable income of the issuer company. In some cases, redemption premium may also be allowed to be deducted from the taxable income of the company;

e. Security of investment by way of creation of charge on the assets of the borrower; and

f. Cost-effective implementation.

Under the Insolvency and Bankruptcy Code, 2016, NCDs come under the definition of financial debt which gives investors various powers such as (i) to initiate the corporate insolvency resolution process in the capacity as financial creditors, (ii) right of representation and voting rights in the committee of creditors. Additionally, in case of liquidation subscribers of NCDs will get priority in distribution of assets as compared to equity shareholders. Furthermore, the Enforcement of Security Interest and Recovery of Debt Laws and Miscellaneous Provisions (Amendment) Act, 2016 **("Amendment Act")** (which amended inter alia the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 **("SARFAESI Act")** and the Recovery of Debts due to Banks and Financial Institutions Act, 1993 **("DRT Act")** introduced the inclusion of listed debt securities within the purview of SARFAESI Act and the DRT Act. It grants, a SEBI registered debenture trustee (appointed for custody of the security interest created to secure such debt securities) the right to enforce the security interest, in case of non-payment of any amount payable on such debt securities, after the borrower company has been served with a 90 (Ninety) days' notice for payment of dues.

A comparison between the key features of FPIs and FVCIs is provided below:

Sl. No.	Particulars	FPI	FVCI
1	Registration	Registration with DDP is mandatory.	Registration with SEBI is mandatory under the FVCI Regulations.
2	Investment instruments permitted	Listed or to-be-listed and unlisted NCDs of Indian companies.	NCD, OCD or OCRPS of Indian venture capital undertaking and/ or venture capital funds.
3	Maximum interest payable	No limits specified on interest payable.	No limits specified on interest payable.
4	Sectoral restrictions	No sectoral restrictions – FPIs may invest in debt securities of Indian companies engaged in any sector.	Sectoral restrictions are present – FVCIs may invest in the infrastructure sector or in Indian venture capital undertakings as discussed in Chapter 2.

D. CCD vs. NCD

Following table gives a brief comparative analysis of investment through FDI (CCDs) and FPI (NCDs) route:

Particulars	CCD – FDI	NCD – FPI
Equity Ownership	Initially debt, but equity on conversion.	Mere lending rights; however, veto rights can ensure certain degree of control.
ECB Qualification	Assured returns on FDI compliant instruments may be construed as ECB.	Purchase of NCDs by the FPI from the Indian company on the floor of the stock exchange is expressly permitted and shall not qualify as ECB.
Coupon Payment	Interest pay out may be limited to SBI PLR + 300 basis points. Interest can be required to accrue and paid only out of free cash flows.	Arm's length interest pay out should be permissible resulting in better tax efficiency, (i.e., for the payout to be treated as interest income, subject to availability of beneficial provisions under the respective tax treaty). Higher interest on NCDs may be disallowed. Interest can be required to accrue only out of free cash flows. Redemption premium may also be treated as business expense.
Pricing	Fair Value applicable.	Fair Value not applicable.
Security Interest	Creation of security interest is not permissible either on immoveable or movable property.	Listed NCDs can be secured (by way of pledge, mortgage of property, hypothecation of receivables etc.) in favor of the debenture trustee who acts for and in the interest of the NCD holders.
Sectoral conditionalities	Only permissible for FDI compliant activities.	Sectoral restrictions not applicable.
Equity Upside	Investor entitled to equity upside upon conversion.	NCDs are favorable for the borrower to reduce book profits or tax burden. Additionally, redemption premium can be structured to provide equity upside which can be favourable for lender since such premium may be regarded as capital gains which may not be taxed if the investment comes from Singapore.
Administrative expenses	No intermediaries required.	NCD listing may cost around INR 1 to 1.5 million (USD 15,384.615 to USD 23,076.923) including intermediaries cost.

E. Voluntarily Retention Route

The 'voluntary retention route' **("VRR")** provides for investments by FPIs into debt to provide them an additional avenue for investment into the Indian debt market. Broadly, investments through VRR will be free of the macro-prudential and other regulatory norms applicable to FPI investments in debt markets, provided FPIs voluntarily commit to retain a required minimum percentage of their investments in India for a period. Participation through VRR will be entirely voluntary[12].

Committed Portfolio Size

Under the VRR, the FPI applies / bids for allocation of limits under the VRR, and the limit allotted to the FPI is referred to as the committed portfolio size **("CPS")**. The VRR provisions provide that an individual FPI shall not be allotted more than 50% of the amount offered under each allotment or auction[13]. An FPI is expected to invest a minimum of 75% of the CPS within 3 (Three) months from the date of allotment[14], and this limit of 75% of the CPS shall remain invested throughout the retention period[15]. It would be pertinent to note that (i) cash holdings in the FPI Rupee Account shall be reckoned for computation of funds invested[16]; and (ii) only the face value of securities invested in shall be considered for computation of funds invested[17].

Retention Period

Moreover, when submitting an application / bidding for limits under VRR, an FPI is required to voluntarily commit the time-period for which the CPS shall be invested in India[18] (such period referred to as the "Retention Period"). The minimum Retention Period is 3 (Three) years upfront, or as notified by RBI at the time of each allotment[19]. During the Retention Period, the FPI may transfer their investments to another FPI(s), and the transferee FPI(s) shall be bound by the terms and conditions applicable to the transferor FPI. Furthermore, the FPIs are free to exit or stay invested in India upon the expiry of the Retention Period[20]. Accordingly, the FPI may (i) liquidate the portfolio and exit; or (ii) hold the investments until date of maturity or until sold.

F. Investment in debt securities through non-banking financial companies

Non-banking financial companies **("NBFC")** are Indian companies registered with the RBI under the provisions of the RBI Act, 1934 **("RBI Act")**. NBFC may be registered for a number of financing activities, including lending. NBFCs are categorised based on their primary business, the asset size, as well as based on whether they accept deposits or not. There are various options for investments through NBFCs for foreign investors which depend on the short-term and long-term goals of the investors:

12 RBI,:https://rbidocs.rbi.org.in/rdocs/notification/PDFs/NOTI1568FB1320A4A304297BF1E900F5225209C.PDF, Page 3.
13 RBI,:https://rbidocs.rbi.org.in/rdocs/notification/PDFs/NOTI1568FB1320A4A304297BF1E900F5225209C.PDF, Page 5.
14 RBI,:https://rbidocs.rbi.org.in/rdocs/notification/PDFs/NOTI1568FB1320A4A304297BF1E900F5225209C.PDF, Page 5.
15 RBI,:https://rbidocs.rbi.org.in/rdocs/notification/PDFs/NOTI1568FB1320A4A304297BF1E900F5225209C.PDF, Page 5.
16 RBI,:https://rbidocs.rbi.org.in/rdocs/notification/PDFs/NOTI1568FB1320A4A304297BF1E900F5225209C.PDF, Page 5.
17 RBI,:https://rbidocs.rbi.org.in/rdocs/notification/PDFs/NOTI1568FB1320A4A304297BF1E900F5225209C.PDF, Page 5.
18 RBI,:https://rbidocs.rbi.org.in/rdocs/notification/PDFs/NOTI1568FB1320A4A304297BF1E900F5225209C.PDF, Page 3.
19 RBI,:https://rbidocs.rbi.org.in/rdocs/notification/PDFs/NOTI1568FB1320A4A304297BF1E900F5225209C.PDF, Page 5.
20 RBI,:https://rbidocs.rbi.org.in/rdocs/notification/PDFs/NOTI1568FB1320A4A304297BF1E900F5225209C.PDF, Page 5.

Captive NBFCs

Acquisition/registration of an NBFC in India, and using such an NBFC for on-lending purposes is one such option. This strategy of debt financing is very popular for debt investors looking at a growth play, and ultimately intend to sell the entire NBFC with its loan portfolio to a strategic player, or take the NBFC public by listing on a recognised stock exchange in India. However, unattractive with investors aiming for short term returns.

On-lending NBFCs

In this method, Indian NBFC as an intermediary entity for on-lending is another option often used. The NBFC acts as an intermediate, borrowing from the foreign investor and on-lending the funds to domestic borrowers. This option may be preferred when investors are looking at a yield play, since the immediate returns are passed on to the investors offshore. Additionally, the option may also be considered in a growth play, since the lending by the NBFC continuously helps expand the loan book of the NBFC as well.

Securitisation

A third alternative which has gained significant traction in the recent past is the practice of NBFCs originating / generating loans and securitising the same. The pass-through certificates issued by the securitization trusts are acquired by foreign investors directly, thereby providing them an indirect exposure to the Indian debt markets, this his option is preferred since (a) it provides investors exposure to the Indian markets, (b) provides an option for easy repatriation, (c) is tax efficient, and (d) ensures the lending NBFC (originator) retains 'skin in the game', including by acting as the servicing agent for these loans.

The regulatory regime around NBFCs went through an over-haul through the introduction of Master Direction – Reserve Bank of India (Non-Banking Financial Company – Scale Based Regulation) Directions, 2023 **('Scale Based Regulations')**. The Scale Based Regulation divides the regulation of NBFCs as a function of the size, activity and perceived riskiness of different categories of NBFCs. The Scale Based Regulations divide NBFCs into the following categories:

Base Layer	The Base Layer shall comprise of: a. non-deposit taking NBFCs below the asset size of ₹1,000 crore; and b. NBFCs undertaking the following activities: i. NBFC-Peer to Peer Lending Platform (NBFC-P2P) ii. NBFC-Account Aggregator (NBFC-AA) iii. Non-Operative Financial Holding Company (NOFHC) and iv. NBFC not availing public funds and not having any customer interface
Middle Layer	The Middle Layer shall consist of a. all deposit taking NBFCs (NBFCs-D), irrespective of asset size, b. non-deposit taking NBFCs with asset size of ₹1,000 crore and above; and c. NBFCs undertaking the following activities: i. Standalone Primary Dealer (SPD) ii. Infrastructure Debt Fund-Non-Banking Financial Company (IDF-NBFC) iii. Core Investment Company (CIC) iv. Housing Finance Company (HFC) v. Non-Banking Financial Company-Infrastructure Finance Company (NBFC-IFC)
Upper Layer	The Upper Layer shall comprise of those NBFCs which are specifically identified by the Reserve Bank as warranting enhanced regulatory requirement based on a set of parameters and scoring methodology as provided in the Annex I to Scale Based Regulations. The top ten eligible NBFCs in terms of their asset size shall always reside in the upper layer, irrespective of any other factor.
Top Layer	The Top Layer will ideally remain empty. This layer can get populated if the Reserve Bank is of the opinion that there is a substantial increase in the potential systemic risk from specific NBFCs in the Upper Layer. Such NBFCs shall move to the Top Layer from the Upper Layer.

NBFCs are not allowed to lend any single borrower exceeding 15% of its owned fund or any single group of borrowers exceeding 25% of its owned fund. In the same context, NBFCs are not allowed to invest in the shares of another company exceeding 15% of its owned fund or in the shares of a single group of companies exceeding 25% of its owned fund. Furthermore, NBFCs are not allowed to lend and invest exceeding 25% of its owned fund to a single party or 40% of its owned fund to a single group of parties[21].

Important terms in case of NBFCs:

21 RBI,:https://rbi.org.in/Scripts/NotificationUser.aspx?Id=12179&Mode=0.

Tier-1 Capital	Tier 1 Capital for NBFCs (except NBFC-Base Layer) means owned fund as reduced by investment in shares of other non-banking financial companies and in shares, debentures, bonds, outstanding loans and advances including hire purchase and lease finance made to and deposits with subsidiaries and companies in the same group exceeding, in aggregate, ten per cent of the owned fund; and perpetual debt instruments issued by a non-deposit taking non-banking financial company in each year to the extent it does not exceed 15% of the aggregate Tier I Capital of such company as on March 31 of the previous accounting year[22]. NBFC- Base Layer are not eligible to include perpetual debt instruments in their Tier 1 Capital.
Tier-II capital	Tier 1 Capital for NBFCs (except for NBFC-Base Layer) includes the following, (a) preference shares other than those which are compulsorily convertible into equity; (b) revaluation reserves at discounted rate of 55% (c) General provisions and loss reserves to the extent these are not attributable to actual diminution in value or identifiable potential loss in any specific asset and are available to meet unexpected losses, to the extent of one and one fourth percent of risk weighted assets; (d) hybrid debt capital instruments; (e) subordinated debt[23]. NBFC-Base Layers are not eligible to include perpetual debt instruments in their Tier 2 Capital.
Owned Fund	The aggregate of (i) the paid-up equity share capital; (ii) compulsorily convertible preference shares; (iii) free reserves; (iv) the balance in securities premium account; and (v) capital reserve account, to the extent that it represents the surplus arising out of the proceeds of sale of assets less (1) accumulated balance of loss; (2) deferred revenue expenditure; and (3) other intangible assets[24].
Net Owned Fund	It means Owned Fund minus (i) investment made by the company in shares of its subsidiaries, group companies, and all other NBFCs; and (ii) book value of all debentures, bonds, outstanding loans and advances (including hire-purchase and lease finance) made to and deposits with its subsidiaries and group companies, to the extent that it exceeds 10% of the owned fund[25].
Capital Risk Adequacy Ratio	It means the ratio of the aggregate of Tier 1 and Tier 2 capital to the risk weighted assets of the company. Assets are assigned weights as given in the NBFC Regulations.
Principal Business	A company is regarded as an NBFC if it satisfies the following two requirements: (i) more than 50% of the company's total assets (netted off by intangible assets) are financial assets; and (ii) income from the financial assets is more than 50% of the gross income[26]. The determination of these factors is to be done basis the last audited balance sheet of the company, and these factors will determine the 'principal business' of a company. This test is also referred to as the '50-50 test[27].

Acquisition/Transfer of Control of NBFCs:

An NBFC (all layers) shall require prior written permission of the RBI for any of the following:

a. Any takeover or acquisition of control of the NBFC, which may or may not result in change of management;

b. Any change in the shareholding of the NBFC, including progressive increases over time, which would result in acquisition/transfer of shareholding of 26% (prior approval would not be required in case of any shareholding going beyond 26% due to buyback of shares/reduction in capital where it has approval of a competent court. However, the same is to be reported to the RBI no later than one month from its occurrence)

22 5.1.34 of the Master Direction on Scale Based Regulations.

23 5.1.35 of the Master Direction on Scale Based Regulations.

24 5.1.25 of the Master Direction on Scale Based Regulations.

25 RBI,:https://www.rbi.org.in/Scripts/FAQView.aspx?Id=92, Q.18.

26 RBI,:https://www.rbi.org.in/Scripts/FAQView.aspx?Id=92, Q. 2.

27 RBI,:https://www.rbi.org.in/Scripts/FAQView.aspx?Id=92 Q. 2.

c. Any change in management of the NBFC which would result in change in more than 30% of the directors, excluding independent directors (prior approval would not be required in case of directors who get re-elected on retirement by rotation)

G. External Commercial Borrowing

External commercial borrowings **("ECB")** under RBI framework is one of the traditional sources of offshore debt financing into India. Debt financing via ECB is regulated by the RBI. The regulatory framework with respect to ECBs govern various aspects, including the eligible lenders and borrowers, maximum outflow on the funds availed, the end-use restrictions, and minimum maturity.

The main benefit of the ECB route is the lack of any registration for the lender, and simplified eligibility for the lender. Under any other offshore debt options in India (FVCI or FPI), the lender entity needs to be registered with SEBI as an FVCI or FPI. However, ECB permits unregistered entities to lend to Indian entities without registration, subject to the lending entity being from an FATF or International Organization of Securities Commissions **("IOSCO")** compliant jurisdiction.

However, ECB suffers some major drawbacks. First, all ECB must comply with minimum maturity requirements which are quite long. This generally rules out any short-term funding options under the ECB route. Second, the ECB route has all-in cost ceilings imposed, which are not very attractive. For INR ECB, the ceilings imposed are slightly higher than the available bank lending rates. While the rates are higher in case of FCY ECB, the hedging requirements are a dampener. In effect, the all-in cost ceilings discourage any distressed funding or any lending to stressed borrowers, since lenders are unable to obtain a higher return for the higher risk being undertaken.

Some of the key aspects of ECB regulations are:

Eligible Lender:

A lender who is resident in a FATF or IOSCO compliant country shall be eligible to provide ECB facilities to Eligible Borrowers[28]. In addition, multilateral and regional financial institutions where India is a member have also been recognized as lenders. Individuals as lenders shall only be permitted if they are foreign equity holders or are subscribing to bonds/debentures listed abroad. Indian banks having foreign branches or subsidiaries can provide only foreign currency ECB facilities[29]. However, eligible borrower will be an entity which is eligible to receive foreign direct investment shall be permitted to raise ECB including port trusts, units in SEZ, SIDBI etc[30].

Minimum Average Maturity Period (MAMP):

Raising of funds by way of ECB is subject to certain minimum maturity, referred to as minimum average maturity period (MAMP), which shall be 3 (Three) years for External Commercial Borrowings. Additionally, for manufacturing sector, borrowers may raise ECBs with MAMP of 1 (One) year (for ECB up to USD 50 million or its equivalent per financial year) and If the ECB is raised from foreign equity holder, the MAMP will be 5 (Five) years if the ECB is raised for working capital purposes, general corporate purposes or repayment

28 RBI,:https://rbidocs.rbi.org.in/rdocs/notification/PDFs/5MD2603201979CA1390E9E546869B2A9A92614DEDBF.PDF, page 8.

29 RBI,:https://rbidocs.rbi.org.in/rdocs/notification/PDFs/5MD2603201979CA1390E9E546869B2A9A92614DEDBF.PDF, page 8.

30 RBI,:https://rbidocs.rbi.org.in/rdocs/notification/PDFs/5MD2603201979CA1390E9E546869B2A9A92614DEDBF.PDF, page 8.

of Rupee loans. Moreover, any call and put option agreed upon the parties in any ECB transaction document shall not be exercisable prior to completion of MAMP[31].

End Use Restriction:

The revised ECB framework only proposes negative list which includes real estate activities, investment in capital market, equity investment, working capital purposes (except from foreign equity holder), general corporate purposes (except from foreign equity holder), repayment of Rupee loans (except from foreign equity holder), on-lending to entities for the above activities[32].

Securities Permitted:

Security creation is permitted freely under the ECB Regulations, and can be created in favor of the non-resident lender directly or in favor of a resident security trustee. These include mortgage over immovable properties, charge over current assets, pledge of shares and personal / corporate guarantees. In addition to these, credit enhancement / guarantees by non-residents are also permitted, subject to such non-resident party being an eligible lender under the ECB guidelines[33].

Hedging requirement for Foreign Currency ECB:

The Indian borrower is required to follow the guidelines for hedging issued by the concerned sectoral or prudential regulator in respect of foreign currency exposure. Companies borrowing in FCY are mandatorily required to hedge 70 per cent of their ECB exposure in case average maturity of ECB is less than 5 (Five) years[34].

All in cost ceiling:

The 'all-in cost' ceiling has been set at Benchmark Rate plus 450 points for INR denominated ECB[35]. In case of FCY denominated ECB: (i) Benchmark Rate plus 550 points for existing ECBs linked to LIBOR whose benchmarks are changed to alternative reference rate (ARR); and (ii) benchmark rate plus 500 points for new ECBs[36]. 'Benchmark Rate' in case of FCY is defined as any widely accepted interbank rate or ARR of 6-month tenor, applicable to the currency of borrowing. In case of INR ECB, Benchmark Rate is the prevailing yield of the government securities of corresponding maturity[37].

31 RBI,:https://rbidocs.rbi.org.in/rdocs/notification/PDFs/5MD2603201979CA1390E9E546869B2A9A92614DEDBF.PDF, page 9.

32 RBI:https://rbidocs.rbi.org.in/rdocs/notification/PDFs/5MD2603201979CA1390E9E546869B2A9A92614DEDBF.PDF, page 10.

33 RBI:https://rbidocs.rbi.org.in/rdocs/notification/PDFs/5MD2603201979CA1390E9E546869B2A9A92614DEDBF.PDF, page 16.

34 RBI,:https://rbidocs.rbi.org.in/rdocs/notification/PDFs/5MD2603201979CA1390E9E546869B2A9A92614DEDBF.PDF, page 10.

35 RBI,:https://rbidocs.rbi.org.in/rdocs/notification/PDFs/5MD2603201979CA1390E9E546869B2A9A92614DEDBF.PDF, page 9.

36 RBI,:https://rbidocs.rbi.org.in/rdocs/notification/PDFs/5MD2603201979CA1390E9E546869B2A9A92614DEDBF.PDF, page 9.

37 RBI,:https://rbidocs.rbi.org.in/rdocs/notification/PDFs/5MD2603201979CA1390E9E546869B2A9A92614DEDBF.PDF, page 5.

Tax Considerations and Evolving Structures

A. Overview of Indian Taxation System

Income tax law in India is governed by the Income Tax Act, 1961 **("ITA")**. Under the ITA, residents are taxed on their worldwide income in India, whereas non-residents are taxed only on income sourced in India (i.e., only and to the extent that such income accrues or arises, or is deemed to accrue or arise in India or is received or deemed to be received in India).[1] Companies are held to be resident in India for tax purposes if (a) they are incorporated in India, or (b) their place of effective management **("POEM")** is in India. Therefore, it is possible for a company incorporated outside India to be considered as an Indian resident for a given year if its POEM is considered to be in India during that year.

India has entered into over 90 Double Taxation Avoidance Agreements (**"DTAAs"** or **"tax treaties"**). DTAAs are bilateral agreements with other countries to restrict and limit the domestic sovereign rights of each contracting state, to tax different kinds of income flowing between the contracting states. To the extent a DTAA offers a more beneficial rate of tax as compared to the ITA, a taxpayer may choose to avail of the more beneficial tax treatment under the DTAA. In order to avail benefits under the DTAA, a non-resident is required to furnish a tax residency certificate **("TRC")** from the government of which it is a resident in addition to satisfying the conditions prescribed under the DTAA for applicability of its provisions. Further, the non-resident should also file tax returns in India and furnish certain prescribed particulars in Form 10F to the extent they are not contained in the TRC. For the purpose of filing tax returns in India, the non-resident is required to obtain a tax ID in India (called the permanent account number **"PAN"**). PAN is also required to be obtained to claim the benefit of lower withholding tax rates, whether under domestic law or under the DTAA. If the non-resident fails to obtain a PAN, payments made to the non-resident may be subject to withholding tax at the rates prescribed under the ITA or 20%, whichever is higher (despite a lower tax rate under the relevant provision of the ITA, on such a payment to a non-resident). Previously, the CBDT had issued a circular dated June 24, 2016 clarifying that in case of payment of payment of interest, royalty, FTS and payments on transfer of any capital asset, a non-resident deductee availing lower withholding tax rates shall not be required to obtain a PAN, provided the following details and documents are provided: 1) name, e-mail id, contact number; 2) address in the country of residence; 3) Tax Residency Certificate (TRC), if the law of country of residence provides for such certificate; and 4) Tax Identification Number (TIN) in the country of residence, or any other equivalent government registration.[2] However, given that the section 115A was amended to change the withholding rate on dividends, interest (on foreign currency loans), royalties and FTS to non-residents from 10 to 20%, section 206AA may not be relevant for such streams of income anymore. However, for LTCG on a transfer, payable to a non-resident (where the domestic tax rate is now 12.5%), section 206AA (read with rule 37BC) may continue to be applicable.

1 Section 4 read with section 5 of the ITA.

2 Rule 37BC, Income Tax Rules, 1962.

I. Place of Effective Management

Since the inception of the ITA in 1961 and up until the FY 2014-15, a foreign company was considered a resident in India only if the control and management of its affairs was wholly situated in India. This test of residence was both objective and predictable for the taxpayers.

In 2015, the Finance Act amended Section 6(3) of the ITA to provide that a foreign company would be considered to be a tax resident of India if it's POEM was found to be situated in India (the **"POEM Test"**).[3] 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 POEM in that financial year should not be located in India.

Subsequently, the Indian tax authorities released guidelines for the determination of POEM **("POEM Guidelines")**, which emphasized that the test is one of substance over form and will depend on facts and circumstances of each case. Further, the POEM Guidelines contemplates an active business test to determine whether companies are engaged in active businesses outside India.[4] On satisfaction of the active business test, the POEM for a company is presumed to be outside India if the majority of its board meetings are held outside India. For companies that do not satisfy the active business test, the persons who actually make key management and commercial decisions for the business as a whole are required to be identified, followed by identifying the place where decisions are actually taken. Further, POEM does not apply to companies having turnover or gross receipts less than INR 500 million during a financial year.[5]

For a detailed analysis of the POEM Guidelines please refer to our hotline.[6]

II. Corporate tax

- From AY 2025-26, Indian resident companies are taxed at 30% generally (excluding surcharge and cess). In cases where the turnover of such an Indian company does not exceed INR 4000 mn in the FY 2022-2023 the applicable rate is 25% (excluding surcharge and cess). This has been done in order to encourage medium and small enterprises to shift to company structures and make the taxation regime more viable for them. Additionally, if the total income such Indian companies (availing the above-mentioned tax regimes) is (i) between INR 10 mn to INR 100 mn, the applicable surcharge is 7% of the taxable amount; and (ii) if the total income exceeds INR 100 mn, the applicable surcharge is 12% of the taxable amount.
- In order to promote growth of the domestic sectors and investment into India, there is a preferential tax regime for certain Indian companies (under section 115BAA of the Income-tax Act, 1961). As per section 115BAA, the concessional corporate tax rate applicable to such Indian companies is at 22% (excluding surcharge and cess) provided certain specified deductions/ benefits are not availed (for example, carry forward of losses, additional depreciation, MAT credits, etc). The taxpayer has to specifically opt for this regime before filing the income-tax return and the option cannot be subsequently withdrawn once opted.
- Further, a concessional tax rate of 15% (excluding surcharge and cess) also exists for new Indian companies engaged in manufacturing and production (by way of Section 115 BAB), subject to certain conditions being

3 Explanation to Section 6(3) defines POEM to mean a place where key management and commercial decisions that are necessary for the conduct of business of an entity as a whole are, in substance made.

4 The Active Business Test is satisfied (i.e. a company is deemed to be engaged in active business outside India) if the following conditions are all met on an average basis across the previous year and two years prior to that.

5 Circular of CBDT dated February 24, 2017.

6 http://www.nishithdesai.com/information/research-and-articles/nda-hotline/nda-hotline-single-view/newsid/3763/html/1.html.

fulfilled. One of requisite conditions is that the company has to be set up and registered on or after October 01, 2019; and must have commenced manufacture or production of the article or thing before March 31, 2024. Note that for both sections 115BAA and 115BAB, the benefits are available from AY 2020-2021.

- Additionally, for both preferential regimes mentioned above (i.e., under Section 115BAB and Section 115 BAA), there is a fixed surcharge rate of 10% of the taxable amount, regardless of the company's total income.
- Similar to the concession provided to manufacturing companies under section 115BAB, Finance Act 2023 introduced section 115BAE, to provide a concessional rate of tax of 15% for new manufacturing co-operative societies set up after April 01, 2023 (commencing manufacturing or production by 31st March, 2024).
- Non-resident companies are taxed at the rate of 40% on income derived from India, to the extent that the profits of the non-resident entity are attributable to a permanent establishment in India. Additionally, if the total income of such non-resident companies is (i) between INR 10 mn to INR 100 mn, the applicable surcharge is 2% of the taxable amount; and (ii) if the total income exceeds INR 100 mn, the applicable surcharge is 5% of the taxable amount. In case of dividend distribution and charge on distributions pursuant to a scheme of buyback executed under the Companies Act, 2013, the surcharge would be at the rate of 12% on tax payable. The Finance Bill 2024 has proposed to reduce the tax required to be withheld on income of non-resident companies to 35% (excluding surcharge and cess). This has been done with an aim to bring parity in the taxation of domestic and foreign companies.
- Further, 4% cess on the quantum of income-tax and surcharge is applicable to all taxpayers.

III. Tax on dividends and share buy-back

Dividends distributed by Indian companies were previously subject to a distribution tax (DDT) at the rate of 15% on a grossed-up basis, payable by the company (abolished with effect from April 01, 2020). The dividend income has since, been taxable in the hands of the recipients (i.e., shareholders or unit-holders) as 'Income from Other sources', as set out in Section 56:

1. **Resident Recipient:** At the tax rates applicable to the recipient (i.e., the shareholder). Additionally, the Indian company declaring dividends will also be required to withhold/deduct taxes at the rate of 10% (excluding surcharge and cess) while making the dividend payment to the resident recipient, as per Section 194.
2. **Non-resident Recipient:** at the rate of 20% (excluding surcharge and cess), or rate provided under the relevant tax treaty (whichever is more beneficial to the non-resident unit holders). This will be withheld/deducted by the Indian company at the time of making the dividend payment, as per Section 195.

The previous fixed 10% dividend tax at the hands of resident shareholders (for dividends in excess of INR 1 mn) under Section 115BBDA is also deemed redundant by way of the above-mentioned changes.

As per Section 115QA, an Indian company would also be liable to pay a fixed distribution tax at the rate of 20% (23.3% including surcharge and cess), on gains arising to shareholders from distributions made in the course of buy-back or redemption of shares, if the buy-back is in accordance with companies laws in force. The buy-back of shares is exempt from taxation at the hands of the investors (i.e., the shareholders). Finance Bill 2024 has proposed to remove this provision with effect from October 01, 2024.

With a view to clarify the taxation on buy back of shares, the Bill has proposed to introduce a new sub clause within the definition of 'dividend' under section 2(22) of the ITA . Thereby, buy back of shares would be taxed as dividend in the hands of the shareholders. As explained in the memorandum the Bill, this change has been brought forth with a view to bring parity in taxation of income distributed to shareholders. It is also proposed to disallow interest expense on such dividends paid by the company as deductions (under section 57 of the ITA), while determining their income from other sources.

Further, the 'full value of consideration' of such shares, has been deemed as nil; thereby allowing a capital loss to be booked in the hands of the shareholder (which they may carry forward as per the ITA). This change has been introduced through an amendment in Section 46A. For shareholders subjected to a buy-back, and having a capital loss on such shares, they may set off such losses against existing or future gains. However, in the instance of shareholders not having gains to off-set at a future stage, the accumulation of losses may not be as helpful.

The explicit characterization of such payments as dividends for the purposes of the ITA, should imply the availability of treaty benefits (of reduced tax rates for dividend income), on such buy-back payments.

Lastly, for distributions being made by foreign companies, or funds, it may now be difficult to escape the characterization of its distributions as 'dividends' for the purposes of Section 2(22), given that an explicit amendment has been proposed to include distributions made by such companies subject to Section 68 of the Companies Act 2013. While, given that the language requires the company to make distributions subject to Section 68 of the Companies Act 2013 (which foreign companies/funds may not be subject to), one may still argue for the characterization of such income as capital gains in the hands of the recipient; though, the intent of the law may not favor such interpretation.

IV. Capital gains

Tax on capital gains depends upon the (i) holding period of a capital asset before the sale; and (ii) the manner in which the sale is effected.

- **In the case of listed securities:** If the listed securities are held for 12 months or less, gains from its sale will qualify as STCG; and if held for longer, will qualify as LTCGs per Section 112A, LTCG arising (on or after April 01, 2018) from the transfer of listed equity shares, units of an equity-oriented mutual fund, or units of a business trust where such gains exceed INR 100,000 (approx. USD 1500), is taxable at the rate of 10% (excluding surcharge and cess). The Finance Bill 2024 has proposed to increase this rate to 12.5%, for such gains that exceed INR 125,000 (for LTCG across asset classes). On the other hand, STCG from the sale of listed securities (being listed equity shares or unit of an equity oriented mutual fund on the floor of the recognized stock exchange), where STT has been paid, was taxed at the rate of 15% (this rate is applicable to both, resident and non-resident unit holders). The Finance Bill 2024 has proposed to increase this rate to 20% (excluding surcharge and cess). STCG from the sale of other listed securities (i.e., where STT is not paid) are taxed as per the ordinary corporate tax rates applicable to the taxpayer. This should be 35% in the case of non-resident companies which make STCG.
- **In the case of unlisted securities:** If the unlisted securities are held for 24 months or less, gains from its sale will qualify as STCG; and if held for longer, will qualify as LTCG. As proposed in the Finance Bill 2024, LTCG earned by both residents and non-residents on sale of unlisted securities are to be taxed at 12.5% (without indexation benefit). On the other hand, STCG from the sale of unlisted securities is taxed as per the tax rates generally applicable to the taxpayer.
- Foreign institutional investors or foreign portfolio investors are also subject to tax at 15% on STCG and 10% on LTCG (Section 115AD). Th Bill has, in order to bring parity in the rates applicable to taxpayers, proposed to tax STCG and LTCG in the hands of FPIs at 20% and 12.5% respectively. All income earned by such Foreign Institutional Investors or Foreign Portfolio Investors are also treated as capital gains

income. In the case of earn-outs or deferred consideration, Courts have held that capital gains tax is required to be withheld from the total sale consideration (including earn out) on the date of transfer of the securities / assets.

In case the specified fund making the investment is an investment division of an offshore banking unit, the capital gains tax apply to the extent that the income is attributable to the investment unit of such banking division (i.e., in the case of a Category 1 portfolio investor under the SEBI (Foreign Portfolio Investors) Regulations, 2019.

- India also has a rule to tax non-residents on the transfer of foreign securities the value of which may be substantially (directly or indirectly) derived from assets situated in India. Therefore, the shares of a foreign incorporated company can be considered to be "situated in India" and capable of yielding capital gains taxable in India, if the company's share derives their value "substantially from assets located in India".[7] Please refer below for a detailed explanation on taxation of indirect transfers. However, income derived from the transfer of P-notes and ODIs derive their value from the underlying Indian securities and is not considered to be income derived from the indirect transfer of shares in India because it does not constitute an 'interest' in the Indian securities.
- Under the erstwhile Section 56(2)(viib) of the ITA, tax was levied on private companies that issued shares to residents and non-residents for a consideration that is more than the fair market value of such shares (popularly known as 'angel tax'). Therefore, where the consideration paid to a resident company (for a primary issuance of equity) is more than the fair market value of the shares, the recipient of the consideration (i.e., the Indian company issuing shares) would be taxed on the difference as 'income from other sources'. The introduction of angel tax created a lot of controversies and posed substantial challenges for companies as well as investors (from a technical and policy perspective). Further, angel tax provisions gave rise to litigation as tax authorities started challenging the valuation methodology adopted by taxpayers (which has remained a vexed issue despite significant jurisprudence on the same). The Finance Bill 2024 proposes to abolish the angel tax from 1st April 2025. This change will have the effect of increased capital in the hands of companies in India.
- The ITA (under section 115UB) contains rules regarding taxation of distributions made by business trusts to unit holders. At present, business trusts act as a pass through in respect of interest income and dividend income received from a special purpose vehicle, and rental income (in case of REITs). Such income is taxable at the hands of the unit holder. Income from the sale of units of a business trust is taxable as capital gains. Finance Act 2023, in a bid to bring distributions in the form of debt repayment by business trusts to unit holders, introduced Section 56(2)(xii) to tax such distributions as "income from other sources". The effect of such an amendment was that redemption of units of business trust held by a unit holder may fall within the net of 'income from other sources' instead of capital gains.
- In relation to unlisted bonds or debentures, the Bill proposes to amend section 50AA of the ITA to deem the capital gains arising on its transfer or redemption or maturity to be STCG in nature. Accordingly, any payment received by an investor on transfer or redemption or maturity of unlisted bond or debenture will be characterized as STCG and tax rate of such gains will be the income tax rate applicable to such investor depending on its form and residency. In the case of non-residents, taxation of any redemption premium earned will have to be analysed in light of the applicable tax treaty. Accordingly, the income from redemption of a bond or debenture may be characterized as interest (if the applicable tax treaty specifically qualifies such as interest) or as capital gains. In case of non-residents, where redemption premium is specifically included in definition of interest under the relevant tax treaty, one will have to analyze whether (i) non-resident can offer such amount received on redemption of bonds / debenture as interest (instead of STCG under section 50AA) or (ii) can claim exemption (if any) under capital gains article.

7 Explanation 5, and 6, Section 9(1), ITA.

In cases of transfers of unlisted shares of a company, at less than the fair market value, the fair market value would be deemed to be the full value consideration for computing capital gains (Section 50CA). Further, it has been provided that this provision does not apply to any consideration received / accruing on transfer by certain class of persons and subject to fulfillment of conditions.[8]

The other major concern with this provision is that when read with Section 56, it leads to a situation of double taxation since (a) the transferor company is taxed on a notional capital gains on the difference between the notional fair market value of the shares and the actual consideration received; and (b) the transferee company is taxed under Section 56 in respect of the difference between the notional fair market value of the shares and the consideration actually paid. This provision can lead to a lot of hardship, especially in situations such as distress sale or where the business prospects have eroded. In such circumstances, double taxation can lead to a significant concern for the parties to the transaction. The CBDT is empowered to prescribe transactions undertaken by certain class of persons to which the provisions of Section 56(2)(x) of the ITA shall not apply. On account of the amended definition of 'securities' in Section 2(h) of Securities Contracts (Regulations) Act **("SCRA")**, wherein it was clarified that units issued by pooled investment vehicles fall within the purview of 'securities' -units of AIF's are considered as 'securities', attracting the applicability of Section 56, as elucidated above.

Coupled with the fact that the scope of Section 56 has been further expanded to cover a wide category of persons this provision could lead to an undesirable economic double taxation on the notional amount which is the difference between the fair market value and the actual consideration.

V. Minimum Alternate Tax ("MAT")

Section 115JB imposes an obligation on companies to pay a MAT of 15% of its book profit (calculated in accordance with the provisions of the Companies Act, 2013), if the tax otherwise payable on total income is lesser after taking into account other allowable deductions under the ITA. Thus, MAT was intended to be a measure akin to a presumptive tax and an anti-avoidance measure. It has no correlation to actual profits and impacts genuine businesses in India. While the ask was to eliminate MAT altogether, the Government has retained these provisions albeit with tweaks. The Government has repeatedly expressed the intention to phase out the various exemptions available under the ITA, however, as it may be several years before it can benefit from the phasing out of such exemptions, the Government has decided to not do away with MAT.

Further, it is the difference between the MAT paid and the tax computed under the normal ITA provisions that can be carried forward as credit for future years and be set off against tax payable under normal ITA provisions. However, MAT credit will not be allowed to be carried forward to the extent that the amount of Foreign Tax Credit **("FTC")** that can be claimed against MAT exceeds the amount of FTC that is claimable against tax computed under the normal ITA provisions.

8 The CBDT has notified the class of persons in Notification No.42 /2020 dated 30 June 2020.

VI. Thin Capitalization Norms

The FA 2017 had introduced the Thin Capitalization Rules within the ITA to curb companies from enjoying excessive interest deductions, while effectively being akin to an equity investment. This move has had a severe impact on investments into India through the debt route – both in respect of Compulsorily Convertible Debentures **("CCDs")** and NCDs, which are widely used methods for funding into India.

Consequently, Section 94B was introduced which provides that where an Indian company or permanent establishment of a foreign company makes interest payments (or similar consideration) to its associated enterprise, such interest shall not be deductible at the hands of the Indian company/ PE to the extent of the "Excess Interest". Excess Interest has been defined to mean an interest amount that exceeds 30% of the Earnings before Interest, Taxes, Depreciation and Amortization **("EBITDA")** of the Indian company / the permanent establishment. In the event that the interest payment payable/ paid is less than Excess Interest, the deduction will only be available to the extent of the interest payment payable/ paid. Interest payments which are less than INR 10 million (approximately USD 150,000) are exempt from the above requirement (on a per assessment year basis). However, it has been clarified that the thin capitalization rules would not apply to interest paid in respect of a debt issued by a lender which is a permanent establishment in India of a non-resident engaged in the business of banking or insurance, or to Finance Company located in any International Financial Services Centre or to such class of non-banking financial companies as notified by the central government.

The provisions were an outcome of the BEPS Action Plan 4 adopted by the OECD which proposed a 10 to 30% of EBITDA range for limit on interest payments in intra group transactions. In line with the BEPS Action Plan, the Thin Capitalization Rules provide for a de minimis threshold, provision for carry forward of the Excess Interest for a period of 8 years and exemptions to banking and insurance companies.

Other key points include:

- **Associated enterprise:** The Thin Capitalization Rules are applicable not only in case of interest payments to 'associated enterprises', as defined under the ITA but they also cover third party lenders who provide a loan on the basis of an associated enterprise either providing an explicit or implicit guarantee to such third party lender or depositing or a corresponding amount with the lender. This is to cover situations where indirect deposits / guarantees are made by associated enterprises with financial institutions on the basis of which a loan is provided by the financial institution to the assessee.
- **Meaning of debt:** The definition of 'debt' is wide and covers any loan, financial instruments, financial lease, financial derivative or any other arrangement giving rise to interest, discount or other financial charges. This could potentially cover debt instruments like masala bonds, NCDs, CCDs, ECBs etc.
- **De-minimis threshold:** Interest payments which are less than INR 10 million (ealize. USD 150,000) are exempt from the above requirement (on a per assessment year basis).
- **Exception:** An exception has been carved out for Indian companies / PE of foreign companies engaged in the banking or insurance business or fall within the meaning of a non-banking financial company (NBFC) as notified by the central government.
- **Carry forward of interest deductibles:** As a clarification, Section 94B also provides for a carry forward of interest expenditure which is not wholly deductible against income under the head 'profit or gains arising from business' to the next assessment year (for e.g. In case of a loss making Indian company). The carry forward of interest deductible is available for eight assessment years but cannot exceed the Excess Interest.

VII. Tax withholding requirement for AIFs

With respect to the amount that is required to be withheld by an investment fund, please note the following:

- **Distributions to non-residents (not being a company) or a foreign company:** Tax is required to be deducted as per the "rates in force". The term "rates in force" has been defined under Section 2(37A) of the ITA and was subsequently amended to include deductions under 194LBB (i.e., the applicable withholding provision). This would make the withholding rate subject to the rates that are applicable under the ITA or those in accordance with the applicable DTAA, whichever is more beneficial to the tax-payer. No withholding tax should be required in respect of any income which is not chargeable to tax under the ITA when such income is paid or credited to the account of non-residents.
- **Distributions to residents:** Tax is required to be deducted at the rate of 10%. Subsequently, the resident investors are eligible to avail credit for the taxes withheld.
- In terms of Section 197A(1F) of the ITA and the notification issued by CBDT (Notification No. 51, dated June 25, 2015), any income (other than business income) receivable / received by the AIF from the investment made in portfolio companies should be exempt from withholding tax provisions and the portfolio companies should not be liable to withhold tax at the time of credit or at the time of payment, whichever is earlier, of such income to the Fund.

B. Specific Tax Considerations for PE Investments

I. Availability of Treaty Relief

Benefits under a DTAA are available to residents of one or both of the contracting states that are liable to tax in the relevant jurisdiction. However, some fiscally transparent entities such as limited liabilities companies, partnerships, limited partnerships, etc. may find it difficult to claim treaty benefits. For instance, Swiss partnerships have been denied treaty benefits under the India-Switzerland DTAA. However, treaty benefits have been allowed to fiscally transparent entities such as partnerships, LLCs and trusts under the US and UK DTAAs, insofar as the entire income of the entity is liable to be taxed in the contracting state; or if all the beneficiaries are present in the contracting state being the jurisdiction of the entity.

Benefits under the DTAA may also be denied on the ground of economic substance or commercial rationale requirements (both of which have been perused in detail by Indian courts in leading jurisprudence on treaty eligibility – to determine whether the taxpayer may indeed be characterized as a 'resident' of the other state; and consequently, untiled to benefits under the relevant treaty). For instance, the India-Singapore DTAA and now, the India – Mauritius DTAA denies benefits under the DTAA to resident companies which do not meet the prescribed threshold of total annual expenditure on operations. The limitation on benefits **("LoB")** clause under the India-Luxembourg DTAA permits the benefits under the DTAA to be overridden by domestic anti-avoidance rules. India has, in the last couple of years, amended the DTAA with Mauritius, Singapore and Cyprus, which has a significant impact on fund structuring. India has also announced signing of a Protocol amending agreement with Japan for providing internationally accepted standards for effective exchange of information on tax matters, exemption of income interest from taxation. India's revised tax treaty with Korea, will have a significant effect in India in respect of income derived in fiscal tears beginning on or after 1st April, 2017.

Recently, Mauritius approved an amendment of the protocol to the India-Mauritius DTAA to include the 'principal purpose test' as a measure of denying treaty benefits (i.e., if one of the principal purposes of the transaction / structure is to avail a tax benefit under the treaty, then such a benefit may be denied – unless, the grant of such a benefit is in line with the object and purposes of the treaty). While this has yet to be notified by the Indian government (and as such is not in force), the application of this amendment may have far reaching impact with respect to investments into India from Mauritius. The application of the abovementioned rule has been discussed further below.

Multilateral Instrument

The OECD released the Multilateral Convention to implement Tax Treaty related measures to prevent Base Erosion and Profit Shifting. MLI is an agreement negotiated under Action 15 of the OECD/G20 BEPS Project. As opposed to bilateral Double Taxation Agreements, the MLI is intended to allow jurisdictions to swiftly amend their tax treaties to include the tax treaty-related BEPS recommendations in multiple DTAs. MLI seeks to curb tax planning strategies that have the effect of shifting profits to low or no tax jurisdictions, supplements or modifies existing tax treaties etc.

The final impact of the MLI on a Double Taxation Agreements is dependent on both the contracting states to the treaty having deposited their respective instruments of ratification with their final MLI Positions with the OECD Depositary. The MLI includes both mandatory provisions (i.e. the minimum standards under the BEPS Project) as well as non-mandatory provisions.

The mandatory provisions in the MLI which could impact the application of the applicable tax treaty are as under:

- To include a statement of intent in the preamble of the covered DTAA that states the "Purpose of a covered DTAA" is to eliminate double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance in the "Purpose of a covered DTAA" article.
- In the article on "Preventing treaty abuse", a general anti-abuse rule commonly known as the Principal Purpose Test (PPT) will be included. Under the PPT, tax treaty benefits can be denied if one of the principal purposes of an arrangement or a transaction was to directly or indirectly obtain tax benefit that is contrary to the objective and purpose of the DTA.

There is limited guidance or jurisprudence at present on how the above will be interpreted and applied by the Revenue authorities. To align with the MLI and to ensure prevention of granting of Tax Treaty benefits in inappropriate circumstances in order to prevent Base Erosion and Profit Shifting, the Finance Act, 2020 amended Section 90(1) to provide that the Central Government shall enter into agreement(s) for the avoidance of double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance (including through treaty shopping arrangements aimed at obtaining reliefs provided in the said agreement for the indirect benefit to residents of any other country or territory).

II. Permanent Establishment and Business Connection

Profits of a non-resident entity are typically not subject to tax in India. However, where a permanent establishment is said to have been constituted in India, the profits of the 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 permanent establishment in India and are not remunerated on an arm's length basis.

A permanent establishment may be constituted where a fixed base such as a place of management, branch, office, factory, etc. is available to a non-resident entity; or where a dependent agent habitually exercises the authority to conclude contracts on behalf of the non-resident entity. Under some DTAAs, employees or personnel of the non-resident entity furnishing services for the non-resident entity in India may also constitute a permanent establishment. The Delhi High Court ruling in e-Funds IT Solutions/ e-Funds Corp vs. DIT 9 laid down the following principles for determining the existence of a fixed base or a dependent agent permanent establishment:

i. The mere existence of an Indian subsidiary or mere access to an Indian location (including a place of management, branch, office, factory, etc.) does not automatically trigger a permanent establishment risk. A fixed base permanent establishment risk is triggered only when the offshore entity has the right to use a location in India (such as an Indian subsidiary's facilities); and carries out activities at that location on a regular basis.

ii. Unless the agent is authorized to and has habitually exercised the authority to conclude contracts, a dependent agent permanent establishment risk may not be triggered. Merely assigning or sub-contracting services to the Indian subsidiary does not create a permanent establishment in India.

iii. An otherwise independent agent may, however, become a permanent establishment if the agent's activities are both wholly or mostly wholly on behalf of foreign enterprise and that the transactions between the two are not made under arm's length conditions.

With non-residents are residents of countries with whom India does not share a DTAA, the concept of 'business connection' would apply to such non-residents deriving profits from India. This is the Indian domestic tax law equivalent of the concept of permanent establishment, but with a much wider ambit and has been defined inclusively under the ITA.

Section 9A provides 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.

However, while this change may be well intentioned, it employs a number of rigid criteria that would be impossible for PE funds and difficult for FPIs to satisfy:

1. **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, particularly in a PE/VC fund context, it is expected that the fund brings in management expertise that enables the company to grow.

2. **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 2 FPIs and isn't quite appropriate for PE/VC 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).

3. **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 10 or less people should be less than 50%. This would restrict the ability of the fund sponsor/ anchor investor to have a greater participation. It would also have an impact on master feeder structures or structures where separate sub-funds are set up for ring fencing purposes.

9 TS-63-HC-2014 (DEL); MANU/DE/0373/2014.

4. **Fund manager cannot be an employee:** The exemption does not extend to fund managers who are employees or connected persons of the fund. Further, it is not customary in industry to engage managers on a consultancy/ independent basis, for reasons of risk and confidentiality, particularly in a PE/VC fund context. Therefore, this requirement is likely to be very rarely met.

5. **Restriction on participation by Indian resident:** The aggregate participation or investment in the fund, directly or indirectly, by persons resident in India does not exceed five percent of the corpus of the fund. However, the proviso clarifies that any contribution made by the eligible fund manager during the first three years of operation of the fund, not exceeding twenty-five crore rupees, would not be taken into account for this calculation.

Note that for entities based out of jurisdictions with which India shares a treaty, Section 9A should not lead to a taxable presence in India (so long as such an entity does not create a PE in India as per Article 5 of the relevant tax treaty). Further, the Finance Act, 2020 had extended the applicability of the safe harbour rules and advance pricing agreement provisions regarding the determination of income attributable to a business connection or a permanent establishment of a non-resident in India.

III. Indirect transfer of shares in India

As stated above, for a non-resident to be subject to tax in India, the ITA requires that the income should be received, accrued, arise or deemed to be received, accrued or arisen to him in India. The indirect transfer tax provisions essentially provide that where there is a transfer of shares or interest of a foreign company or entity, whose value is derived substantially from assets located in India, in such case, income arising from such transfer can be brought within the Indian tax net.

The indirect transfer tax provisions, a controversial set of provisions brought about in light of the Vodafone3 case, expanded the existing source rules for capital gains. The indirect transfer tax provisions were introduced with retrospective effect by the Finance Act, 2012 by way of Explanation 5 to Section 9(1)(i) of the ITA, "clarifying" that an offshore capital asset would be considered to have a situs in India if it substantially derived its value (directly or indirectly) from assets situated in India.

These provisions which are summarized below:

a. **Threshold test on substantiality and valuation:** The share or interest of a foreign company or entity shall be deemed to derive its value substantially from the assets (whether tangible or intangible) located in India, if on the specified date, the value of Indian assets (i) exceeds the amount of INR 100 million (USD 1.54 million); and (ii) represents at least fifty per cent of the value of all the assets owned by the company or entity. The value of the assets shall be the fair market value of such asset, without reduction of liabilities, if any, in respect of the asset. The manner of determination of the fair market value of the assets are provided in accordance with rule 11UB of the Income Tax Rules, 1962.

b. **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% of 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 may result in ambiguity in cases where intangibles are being transferred.

c. **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 (as per valuation required to be conducted by a merchant banker or a chartered accountant as per Rule 11UB).

Exemptions: Situations when this provision shall not be applicable:

a. Where the transferor of a shares 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.

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 ITA to domestic transactions of a similar nature.

The indirect transfer tax provisions are not be applicable to an asset or capital asset that is held directly/indirectly by way of investment in a Category I or Category II FPI. On November 7, 2017, the Central Board of Direct Taxes (CBDT) issued a circular clarifying that indirect transfer tax provisions do not apply to income received by non-residents from the redemption or buy-back of shares or interests in Category I or II Alternative Investment Funds (AIFs) or Venture Capital Funds/Companies. This applies as long as the income arises from the transfer of shares or securities in India and is subject to tax in India. The benefit is limited to cases where the redemption or buy-back proceeds do not exceed the non-resident's proportional share of the total consideration received by the funds from such transfers. This circular aims to alleviate concerns for offshore funds registered as Category I or II Foreign Portfolio Investors (FPIs), ensuring that redemptions or buy-backs at the fund level are not subject to indirect transfer taxation. Additionally, for multi-tiered structures, if the investing entity is a Category I or II FPI, upstreaming of proceeds through redemption or buy-back will not be taxed in India. The provisions also exclude redemptions, reorganizations, or sales resulting in capital gains for investors in Category I or II FPIs from indirect transfer tax.

The clarificatory explanations are applicable retrospectively from FY starting April 1, 2012.

The amendment had however, left out a large chunk of the affected sector i.e. Category III FPIs, PE and VC investors investing in Indian securities.

In a significant development, The Taxation Laws (Amendment) Bill, 2021, nullified the retrospective applicability of the FA 2012 amendment, prior to specified date (28th May 2012). It was clarified that taxes collected pursuant to demand order issued in respect of indirect transfers undertaken prior to the specified date are to be refunded, without any interest. Further, any orders passed for transactions prior to the specified date stand nullified provided that the litigation is withdrawn and there is no claim against the government for costs, damages etc.

IV. General Anti-Avoidance Rule ("GAAR")

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

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

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

The CBDT has clarified (vide Circular No. 7 of 2017) that GAAR will not interplay with the right of a taxpayer to select or choose the method of implementing a transaction. Further, the CBDT has clarified that GAAR shall not be invoked merely on the ground that an entity is located in a tax efficient jurisdiction. Specifically, in response to a query raised with regard to issuance of P-notes referencing Indian securities, the CBDT has clarified that if the jurisdiction of an FPI is finalized based on non-tax commercial considerations and the main purpose of the arrangement is not to obtain a tax benefit, then GAAR will not apply. The CBDT has further clarified that, in situations where the anti-abuse is sufficiently addressed by the LOB provision in the DTAA, GAAR shall not apply. However, what the standard for the LOB to be sufficiently addressed is not provided and may result in additional complexities. Lastly, a recent decision of the Telangana High Court[10] ruled on the applicability of GAAR, holding that the GAAR and specific anti avoidance rule **("SAAR")** can both apply based on the facts of the case.

V. Transfer pricing regulations

Under the Indian transfer pricing regulations, any income arising from an "international transaction" is required to be computed having regard to the arm's length price. There has been litigation in relation to the mark-up charged by the Indian advisory company in relation to services provided to the offshore fund / manager. Income tax authorities have also initiated transfer pricing proceedings to tax foreign direct investment in India. In some cases, the subscription of shares of a subsidiary company by a parent company was made subject to transfer pricing regulations, and taxed in the hands of the Indian company to the extent of the difference in subscription price and fair market value.

As per Section 92CE - a resident taxpayer who has entered into an international transaction, is required to make a secondary adjustment in the event that a primary adjustment as per transfer pricing provisions:

1. has been made suo moto by the taxpayer in his income tax return,
2. has been made by the Assessing Officer and accepted by the taxpayer,
3. has been determined by and advanced pricing agreement,

10 Ayodhya Rami Reddy Alla vs. PCIT [WP Nos. 46510 and 46467 of 2022 (Telangana High Court)].

4. is made as per safe harbor rules under the ITA,
5. is a result of mutual agreement procedure under a tax treaty

The provisions further prescribe that where, as a result of primary adjustment, there is an increase in the taxpayer's total income or a reduction in allowable loss, a secondary adjustment shall have to be made.

Further, on 9 August 2023, the CBDT issued a notification, extending the applicability of the transfer pricing safe harbour rules to FY 2022-23, without any further modifications. No new notification has been issued further extending the applicability of the above rules beyond this period.

VI. Withholding Obligations

Tax would have to be withheld at the applicable rate on all payments made to a non-resident, which are taxable in India. Withholding tax obligations also arise with respect to specific payments made to residents. Failure to withhold tax could result in tax, interest and penal consequences. Therefore, often in a cross-border transaction, the purchasers structure their exits cautiously and rely on different kinds of safeguards such as contractual representations, tax indemnities, tax escrow, nil withholding certificates, advance rulings, tax insurance and legal opinions. Such safeguards have been described in further detail under Annexure II.

Structuring through intermediate jurisdictions

Investments into India are often structured through holding companies in various jurisdictions for number of strategic and tax reasons. For instance, US investors directly investing into India may face difficulties in claiming credit of Indian capital gains tax on securities against US taxes, due to the conflict in source rules between the US and India. In such a case, the risk of double taxation may be avoided by investing through an intermediary holding company.

While choosing a holding company jurisdiction it is necessary to consider a range of factors including political and economic stability, investment protection, corporate and legal system, availability of high quality administrative and legal support, banking facilities, tax treaty network, reputation and costs.

India has entered into several BITs and other investment agreements with various jurisdictions, most notably, Mauritius. Structuring investment into India, may be the best way to protect a foreign investor's interest. Indian BITs are very widely worded and are severally seen as investor friendly treaties. Indian BITs have a broad definition of the terms 'investment' and 'investor'. This makes it possible to seek treaty protection easily through corporate structuring. BITs can also be used by the investors to justify the choice of jurisdiction when questioned for GAAR. However, the Government has formulated a model text for Indian BIT **("Model BIT")**. In order to ensure that the foreign investors do not use the protection under BIT when questioned for GAAR, the Model BIT requires all investors to comply with the tax laws of India.

Please refer to **Annexure III** for detailed note on BITs.

Over the years, a major bulk of investments into India has come from countries such as Mauritius, Singapore and Netherlands, which are developed and established financial centers that have favorable tax treaties with India. The following table summarizes some of the key advantages of investing from Mauritius, Singapore, Netherlands and Cyprus:

Head of Taxation	Mauritius	Singapore	Netherlands	Cyprus
Capital gains tax on sale of Indian securities	Mauritius has the right to tax capital gains arising from alienation of shares acquired on or prior to April 1, 2017 in a company resident in India. It is pertinent to note that there is no local tax in Mauritius on capital gains, Mauritius residents. From April 1, 2017, India shall have the right to tax capital gains arising from alienation of shares acquired on or after April 01, 2017 in a company resident in India. Lower tax rate is proposed for the period between April 1, 2017 and March 31, 2019 i.e. tax on alienation of shares during this period shall not exceed 50% of the domestic tax rate in India. Such reduced tax rate shall only be available to such Mauritius resident who is (a) not a shell/ conduit company and (b) satisfies the main purpose and 'bonafide' business test. Further, a Mauritius resident shall be deemed to be a shell/ conduit company if its total expenditure on operations in Mauritius is less than INR 2,700,000 (approximately 40,000 US Dollars) in the 12 months immediately preceding the alienation of shares.	Singapore has the right to tax capital gains arising from alienation of shares acquired on or prior to April 1, 2017 in a company resident in India. It is pertinent to note that there is no local tax in Singapore on capital gains, Singapore residents. From April 1, 2017, India shall have the right to tax capital gains arising from alienation of shares acquired on or after April 01, 2017 in a company resident in India. Lower tax rate is proposed for the period between April 1, 2017 and March 31, 2019 i.e. tax on alienation of shares during this period shall not exceed 50% of the domestic tax rate in India. Such reduced tax rate shall only be available to such Singapore resident who satisfy the following 'substance' criteria and expenditure test: (a) if the Company has not arranged its affairs for the primary purpose of gaining exemption of tax on capital gains; (b) if the Company is deemed not to be a shell company or a conduit, that is, if its total annual expenditure on operations is equal to or more than S$ 200,000 in Singapore in the immediately preceding period of 2 years or if it is listed on a recognized stock exchange of the contracting state.	As per the Tax Treaty, the Netherlands has the right to tax capital gains arising to Dutch residents from the sale of Indian securities, except when the Dutch company holds more than 10% of the shareholding of the Indian Co, and shares are being sold to an Indian resident. In such circumstances, India will have the right to levy the tax on capital gains. Domestic Tax on Capital Gains in the Netherlands: CIT Rate applies. However, Netherlands offers a participation exemption from the payment of taxes on capital gains (provided certain other conditions mentioned above are met).	As per the revised DTAA between India and Cyprus, India shall have the right to tax capital gains arising from the transfer of investments made on or after April 01, 2017. The treaty provides for source based taxation of capital gains arising from alienation of shares, instead of residence based taxation provided under the existing DTAA. However, a grandfathering clause has been provided for investments made prior to April 1, 2017, in respect of which capital gains would continue to be taxed in the country of which taxpayer is a resident.

Head of Taxation	Mauritius	Singapore	Netherlands	Cyprus
Tax on dividends	Non-resident recipient is taxed at the rate of 5% of gross amount of dividends (if the recipient is a beneficial owner of 10% of the company paying dividends), otherwise at 15%, as per the treaty.	Non-resident recipient is taxed at the rate of 10% of gross amount of dividends (if the recipient is a beneficial owner of 25% of the company paying dividends), otherwise at 15%, as per the treaty	Non-resident recipient is taxed at the rate of 10% of gross amount of dividends (if the recipient is a beneficial owner of the dividends) as per the DTAA. However, please note that Netherlands had issued a directive in 2012 stating that this rate should stand reduced to 5% (if the beneficial holding of theecipeent is at least 10%) on account of the Most Favoured Nation (MFN) clause in the Protocol to the India Netherlands DTAA. The Supreme Court of India has ruled against the taxpayer, and denied the benefits of a lower withholding rate in this regard. Subsequently, a review petition was filed against this decision of the Supreme Court, which was also dismissed. You may read more about it in our analysis on the same.[11]	Non-resident recipient is taxed at the rate of 10% (if the recipient is a beneficial owner of the dividends) of gross amount of dividends as per the DTAA.

11 https://nishithdesai.com/SectionCategory/33/Tax-Hotline/12/53/TaxHotline/10816/1.html.

Head of Taxation	Mauritius	Singapore	Netherlands	Cyprus
Withholding tax on outbound interest	7.5% (if the recipient is a beneficial owner of the interest).	10% of the gross interest (if the interest is paid on a loan granted by a bank carrying on a bona fide banking business or by a similar financial institution; otherwise 15%.	10%(if the recipient is a beneficial owner of the interest)	10% (if the recipient is a beneficial owner of the interest)
Withholding tax on outbound royalties and fees for technical services	15% (for royalties). FTS[12] taxed at the rate of 10%.	10%	10%	10%
Other comments	The protocol to the India Mauritius DTAA was amended to introduce the principle purposes test **("PPT")**. However, this amendment is yet to be notified by the government of India, and as such, is not in effect.	There are specific limitations under Singapore corporate law (e.g. with respect to buyback of securities).	To consider anti-abuse rules introduced in connection with certain passive holding structures.	

12 Fees for Technical Services.

Exits for Private Equity and Private Debt Investments

IPO

Globally one of the most popular forms of exit for the PE investors is through the IPO. The year 2023 witnessed more than 234 (two hundred and thirty-four) IPOs in India, where the proceeds raised were approximately USD 7.89Billion. This performance is in-line with the 2022 of the Indian capital markets where a total of 150 listings raised approximately USD 7.99Billion in proceeds.

It is pertinent to note that under ICDR Regulations, the minimum promoters' contribution has to be locked in for

for a period of 18 (Eighteen) months from the date of allotment in the IPO whereas if the company that proposes to get listed wants to use the promoter's minimum contribution for civil work, miscellaneous fixed assets, purchase of land, building and plant and machinery "capital expenditure", then the lock-in period shall be 3 (Three) years from the date of allotment in the IPO.[1]

The promoters' holding in excess of minimum promoters' contribution shall be locked-in for a period of 6 (Six) months from the date of allotment in the IPO. The entire pre-issue capital held by persons other than the promoters shall be locked-in for a period of 6 (Six) months from the date of allotment in the IPO[2].

SPAC

SPAC is a prominently new but a prudent way to access the capital markets at an international level with an option of being listed domestically. In 2020, 248 (Two Hundred and Forty Eight) SPACs raised more than $83 billion globally and in 2021, a total of 613 (Six Hundred and Thirteen) SPACs raised $145 billion. The first Indian company to onboard the SPAC odyssey is ReNew Power, one of India's leading renewable energy producers, that got merged with Nasdaq-listed RMG Acquisition Corp. II, it is the first Indian company to raise more than $1 billion by combining with a U.S SPAC, and this deal was proudly done with the assistance from Nishith Desai Associates.

A SPAC is a company with no operations that offers securities for cash and places substantially all the offering proceeds into a trust or escrow account for future use in the acquisition of one or more private operating companies. After the IPO, the SPAC will acquire targets or business combination transactions and then the company will continue the operations of the acquired company or companies as a public company.

A SPAC will typically provide for a two-year period to identify and complete an initial business combination transaction. However, some SPACs have opted for shorter periods, such as 18 months.
The SPAC's governing instruments may permit it to extend that time period. If a SPAC seeks to extend the

1 SEBI,https://www.sebi.gov.in/legal/regulations/may-2023/securities-and-exchange-board-of-india-issue-of-capital-and-disclosure-requirements-regulations-2018-last-amended-on-may-23-2023-_72390.html, Page 26.

2 SEBI,https://www.sebi.gov.in/legal/regulations/may-2023/securities-and-exchange-board-of-india-issue-of-capital-and-disclosure-requirements-regulations-2018-last-amended-on-may-23-2023-_72390.html, Page 26.

time period, it may be required to seek shareholders' approval. If a SPAC lists its securities on an exchange, it is required to complete an initial business combination within three years of its IPO.

SPACs cannot identify acquisition targets prior to the closing of the IPO. If the SPAC had a specific target under consideration at the time of the IPO, detailed information regarding the target IPO registration statement, potentially including the target's, would be required to be included in the financial statements, thus delaying the IPO and rendering it similar in form and substance to a traditional IPO.

Trade Sale

The investor could also exit either by way of a sale of shares of Indian company or by selling the offshore holding company **("OHC")**, holding the shares of Indian company to another party. If the transfer of shares of the Indian company is between a non-resident and resident, then the pricing requirements of the NDI Rules will apply as mentioned earlier. Pricing guidelines shall not apply in case of the sale of the OHC unless purchased by a resident.

Buy-back

In this exit option, shares held by the foreign investor, are bought back by the investee company. Buy-back of securities is subject to certain conditionalities as stipulated under Section 68 of the CA 2013, such as:

- Buy-back normally requires a special resolution[3] passed by the shareholders of the company unless the buy-back is for less than 10% of the total paid-up equity capital and free reserves of the company[4];
- Buy-back cannot exceed 25% of the total paid up capital and free reserves of the company in one financial year[5]; and
- Post buy-back, the debt equity ratio of the company should not be more than 2:1 [6].

A company can only utilize the following funds for undertaking the buy-back (a) free reserves (b) securities premium account, or (c) proceeds of any shares or other specified securities.

From a tax perspective, traditionally, the income from buyback of shares had been considered as capital gains in the hands of the recipient and accordingly if the investor is from a favourable treaty jurisdiction, he could avail the treaty benefits. However, The Bill has proposed the buy back of shares to be taxable as dividend in the hands of the shareholders.

For distributions being made by foreign companies, or funds, it may now be difficult to escape the characterization of its distributions as 'dividends', given that an explicit amendment has been proposed to include distributions made by such companies subject to Section 68 of the Companies Act. While, given that the

3 Under Companies Act 2013, a Special Resolution is one where the votes cast in favor of the resolution (by members who, being entitled to do so, vote in person or by proxy, or by postal ballot) is not less than three times the number of the votes cast against the resolution by members so entitled and voting. (The position was the same under the Companies Act, 1956).

4 MCA,:https://www.mca.gov.in/content/mca/global/en/acts-rules/ebooks/acts.html?act=NTk2MQ==#Power_of_Company_to_Purchase_its_Own_Securities.

5 MCA,:https://www.mca.gov.in/content/mca/global/en/acts-rules/ebooks/acts.html?act=NTk2MQ==#Power_of_Company_to_Purchase_its_Own_Securities.

6 MCA,:https://www.mca.gov.in/content/mca/global/en/acts-rules/ebooks/acts.html?act=NTk2MQ==#Power_of_Company_to_Purchase_its_Own_Securities.

language requires the company to make distributions subject to Section 68 of the CA (which foreign companies/funds may not be subject to), one may still argue for the characterization of such income as capital gains in the hands of the recipient; though, the intent of the law may not favour such interpretation. Please refer to section 1.3 in chapter IV above for a detailed analysis.

Depository Receipts ("DRs")

SEBI issued the framework for issuance of depository receipts ('DR') on October 10, 2019 **("DR Framework")**.[7] The DR Framework draws reference to Section 41 of the CA 2013, Companies (Issue of Global Depository Receipts) Rules, 2014 **('GDR Rules')**, the Depository Receipts Scheme, 2014 ('DR Scheme'), RBI notification dated December 15, 2014, central government notification dated September 18, 2019 and central government notification dated October 07, 2019.

The DR Framework rationalises the old DR Scheme and it enables companies to access larger pools of capital from investors with a higher risk appetite. This can provide better valuations for Indian companies thereby providing a lucrative exit option for investors. Broadly, the DR Framework has been introduced with the intention to provide the Indian firms, domestic investors and foreign investors freedom to access financial markets within the prevalent foreign investment regime in India. The key features of the DR Framework are:

a. Listed company must be in compliance with the requirements prescribed under the SEBI (Listing Obligations and Disclosure Requirements) Regulations 2015 and any amendments thereof[8].

b. Listed company shall ensure that DRs are issued only with permissible securities. **("Permissible Securities")**. Permissible Securities has been defined to include securities as defined in the Securities Contracts (Regulation) Act, 1956 whether issued by a company, mutual fund, government or any other issuer and similar instruments issued by private companies[9].

c. A foreign depository having the legal capacity to issue DRs (i.e. a person which is not prohibited from acquiring Permissible Securities), that is regulated in a permissible jurisdiction and that has the legal capacity to issue depository receipts in the permissible jurisdiction, may issue DRs[10].

d. A company, whether listed, can issue shares for issue of DRs only in permissible jurisdictions **("Permissible Jurisdictions")**[11].

e. It does not prescribe any specific pricing norms for issuance of DRs. The only restriction imposed is that the Permissible Securities shall not be issued to a foreign depository at a price less than the price for the public offer/ preferential allotment/ qualified institutions placement to domestic investors under the applicable laws[12]

7 SEBI,:https://www.sebi.gov.in/web/?file=https://www.sebi.gov.in/sebi_data/attachdocs/oct-2019/1570708261193.pdf#page=4&zoom=page-fit,444,-54.

8 SEBI,:https://www.sebi.gov.in/web/?file=https://www.sebi.gov.in/sebi_data/attachdocs/oct-2019/1570708261193.pdf#page=4&zoom=page-fit,444,-54, Page 1.

9 SEBI,:https://www.sebi.gov.in/web/?file=https://www.sebi.gov.in/sebi_data/attachdocs/oct-2019/1570708261193.pdf#page=4&zoom=page-fit,444,-54, Page 3.

10 SEBI,:https://www.sebi.gov.in/web/?file=https://www.sebi.gov.in/sebi_data/attachdocs/oct-2019/1570708261193.pdf#page=4&zoom=page-fit,444,-54, Page 2.

11 SEBI,:https://www.sebi.gov.in/web/?file=https://www.sebi.gov.in/sebi_data/attachdocs/oct-2019/1570708261193.pdf#page=4&zoom=page-fit,444,-54, Page 3.

12 SEBI,:https://www.sebi.gov.in/web/?file=https://www.sebi.gov.in/sebi_data/attachdocs/oct-2019/1570708261193.pdf#page=4&zoom=page-fit,444,-54, page 5.

f. Voting rights should be exercised by the foreign depository in respect of underlying securities; the scheme provides that voting rights on permissible securities, if any, shall be exercised by the DR holder through the foreign depository pursuant to voting instruction only from such DR holder[13].

Externalisation

One of the means of exit for shareholders of a company and also a way of accessing global public capital is by setting up of an OHC. In this structure, the promoter flips his interest in the Indian company to an OHC set up in a tax optimized jurisdiction which can be used to raise global capital offshore or to give an exit to offshore investors. In externalization, while exiting one should take into account potential tax liability due to indirect transfer. Please refer to Chapter 4 for a detailed analysis on taxation of indirect transfers.

While deciding the country for setting up of an OHC, the investor should broadly consider the following points:

i. whether the country is a sophisticated and reputed jurisdiction with an established banking framework and a well-developed corporate law system;

ii. whether the county has an independent, efficient and mature judicial system;

iii. if the country has a treaty with India for the avoidance of double taxation or not and what are terms of the treaty; and

iv. if the country have treaties for avoidance of double taxation with other major jurisdictions; and

v. what is the corporate tax rate in that country.

13 SEBI,:https://www.sebi.gov.in/web/?file=https://www.sebi.gov.in/sebi_data/attachdocs/oct-2019/1570708261193.pdf#page=4&zoom =page-fit,444,-54, page 5.

Dispute Resolution

There has been a long-standing requirement for a stable and efficient dispute resolution system in order to ensure quick enforcement of contracts. In order to achieve this objective, the Government, has been introducing measures for speedy and efficient resolution of commercial disputes. Some of the key measures are set out in the following paragraphs.

A. Judicial Decisions

Historically, judicial discourse had failed to adopt a pro-arbitration approach. However, recent judicial trends show a positive change, wherein, Indian courts are increasingly adopting a pro-arbitration approach and reducing judicial interference in arbitral proceedings. Indian courts have encouraged timely completion of arbitrations and minimal judicial interference. For instance, recently, the Supreme Court observed that applications for appointment of an arbitrator must be decided and disposed of at the earliest, otherwise the object and purpose of the Arbitration and Conciliation Act, 1997 **("A&C Act")** shall be frustrated.[1]

B. Growth Of Arbitral Institutions In India

Arbitral proceedings can be of two types: ad hoc or institutional. The advantages of institutional arbitration over ad hoc arbitration are as follows:

1. Availability of pre-established rules and procedures, which assure that arbitration will get off the ground and proceed to conclusion expeditiously;
2. Administrative assistance from institutions providing a secretariat or court of arbitration;
3. Lists of qualified arbitrators, often categorized by fields of expertise;
4. Physical facilities and support services for arbitration proceedings; and
5. An established format with a proven record.

The major institutional arbitration centres in India are the Mumbai Centre for International Arbitration, **("MCIA")**, the Delhi International Arbitration Centre and the Nani Palkhivala Arbitration Centre, Chennai. The total value of disputes under MCIA's administration crossed 1 billion USD by the year 2022. The total value of new case filings in the year 2023 alone was above INR 300 crores (approximately USD 36 million). The reposition of faith in the MCIA by the courts is worth highlighting. The Indian Supreme Court and the Bombay High Court has referred multiple matters to be administered under the MCIA Rules. The Singapore International Arbitration Centre **("SIAC")** has entered into a memorandum of agreement with the Gujarat International Finance Tec-City Company Limited to collaborate to promote and resolve international commercial disputes at India's International Financial Services Centre in Gujarat International Finance Tec-City.

1 M/S Shree Vishnu Constructions v. The Engineer-in-Chief Military Engineering Service & Ors., (2023) 8 SCC 329.

C. Legislative Changes

The Commercial Courts, Commercial Division and Commercial Appellate Division of High Courts Act, 2015 ("Commercial Courts Act")

The Commercial Courts Act provides for the establishment of commercial courts in India, which have the jurisdiction to try commercial disputes of a value more than INR 300,000 (approximately USD 3,655). Further, the Commercial Courts Act has streamlined the processes which has led to expeditious completion of proceedings. The estimated time line for completion of proceedings is approximately 16 weeks. Global practices such as case management hearing and "cost to follow event" have been introduced. Further, the institution of appeals needs to be done within 60 days from the date of decision and courts must endeavour to dispose the appeals within 6 months.

Amendments to the Arbitration and Conciliation Act, 1996

A recent intervention in the realm of arbitration is the Arbitration and Conciliation (Amendment Act), 2021 **("Arbitration Amendment Act")**. The changes introduced in the Arbitration Amendment Acts provide for a slight modification to the standards for enforcing arbitral awards. The earlier amendments in the year 2015 and 2019 included significant changes to the A&C Act towards making India an arbitration friendly regime.

Throughout these years, the amendments to the A&C Act have been enacted with the aim to promote an expeditious and efficient mechanism for the resolution of commercial disputes. The amendments also aim to ensure that court processes and arbitration proceedings complement each other. Unfortunately, Indian courts remain overburdened with a substantial backlog of pending cases which renders litigation extremely time consuming. Alternatively, arbitration proceedings are expeditious and efficient. Therefore, where a foreign investor faces a commercial dispute with an Indian party, it would be advisable for the investor to refer their disputes to arbitration rather than litigate under the general civil laws.

The Insolvency and Bankruptcy Code, 2016 ("IBC/Code")

The Code created a framework to expeditiously resolve insolvency and bankruptcy issues and the process of money recovery. Reform in bankruptcy laws was long overdue and was necessary to improve the ease of doing business in India, and for meeting global standards. The Code represents a radical change in the field of insolvency with the creation of a specialized cadre of insolvency professionals, an integrated adjudicatory body for conducting / supervising the process of insolvency resolution, and liquidation and specialized regulatory bodies. With the passage of almost eight years since the introduction of the Code, it has achieved substantial progress towards providing a robust insolvency resolution mechanism in the country.

Like any other nascent legislation, the IBC also had its own deficiencies in the initial stages. However, the Insolvency and Bankruptcy Board of India **("IBBI")** and the government have been constantly trying to plug the gaps and introduce practical amendments, which would reduce the possibility of litigation and make the entire process fairer to each participating stakeholder.

Undoubtedly, the Code has bolstered the stressed asset market in India. This demonstrates that the Code is a significant step in the right direction. Statistics show that since the inception of the Code, there has been a steady increase in the rate of realization for creditors.

A concerted effort by the legislature as well as stakeholders is required to address the challenges faced by the Code. This is being exemplified by regular amendments to the existing law, regulations, etc., which are aimed at bringing the Indian legal framework on par with international standards.

Upon initiation of the insolvency resolution process under the Code **("CIRP")**, the Code provides for a period of moratorium wherein initiation and continuation of suits and proceedings against the corporate debtor are prohibited. As a result, post commencement of the CIRP, an investor will be unable to enforce its contractual rights of exit. Therefore, parties should try to build such a mechanism in the 'Event of Default' clause such that the the investor has the ability to invoke EOD and seek exit upon receipt of a notice by a creditor or filing of an application seeking initiation of CIRP under the Code.

The nature of instruments used for an investment is equally critical. Recent jurisprudence indicates that hybrid instruments having a pre-determined date of conversion might be treated as equity and not debt. This might pose a serious question on the possibility of repayment to the investor as any amount payable to the investor, if treated as equity, assumes the lowest priority in repayment hierarchy under the Code.

Impact of introduction of National Company Law Tribunals (NCLTs):

Previously, matters involving same companies or parties would be spread across various forums such as High Courts for winding up and merger/amalgamation schemes, the Company Law Board (CLB) for oppression and mismanagement, and the Board of Industrial Financial Reconstruction, pursuant to reference under Sick Industrial Companies Act, 1985. On multiple occasions, litigants would adopt an approach of moving before various forums thereby causing multiplicity of proceedings and consequent delays. The introduction of NCLTs was aimed at consolidating the various forums and providing a one stop shop for adjudication of company related matters.

The NCLT and NCLAT are expected to dispose of appeals, applications and petitions filed before it within a period of 3 months from the date of the filing.[2] Previously, the High Courts were burdened with company matters including winding up proceedings. The transfer of such proceedings to the NCLTs has reduced the burden on the High Courts.

Earlier, an appeal from an order of the CLB was filed before the High Courts. Since an appeal from an order of the NCLT now lies before the NCLAT, High Courts have a further reduced burden. Initially, there was an area of concern regarding the overburdening of the NCLAT. However, with the constitution of the Chennai Bench of the NCLAT, the same has been seemingly resolved. NCLTs offer a one stop shop towards a completely new and improved process for insolvency resolution and liquidation of companies in India.

Class Action Suit

In the year 2013, a new Companies Act was introduced, which brought into effect the statutory remedy of class action proceedings. A class action proceeding is one where a group or class of people who are similarly affected can initiate a proceeding collectively. This allows the reduction of time and costs, and also inspires confidence amongst the parties as they act collectively. Previously, class action proceedings were initiated in form of representative suits, minority action for oppression and mismanagement, proceedings before consumer forums, or through public interest litigation. However, none of these provided a holistic remedy.

2 Section 422 of the Companies Act, 2013.

A dearth of such remedy was felt particularly in the wake of the Satyam Scam, where the public shareholders in India had no remedy as opposed to the bondholders in the United States. With the notification of Section 245 of the CA, 2013, members and depositors in a company have an additional remedy in form of class action proceedings which could be initiated before the NCLT.

The surge in shareholder activism in India in the last few years makes the introduction of the class actions remedy highly interesting. It is a critical tool in the hand of minority shareholders who may question the decisions made by the management and the intent thereof.

Drafting Relevant Clauses

Dispute Resolution Clauses

When drafting dispute resolution clauses in investment agreements, it is crucial to ensure clarity and precision to avoid common pitfalls. Provisions pertaining to 'Governing Law', 'Dispute Resolution', and 'Jurisdiction' should be carefully tailored to reflect the parties' intentions, and most importantly, to ensure enforceability. A well-drafted dispute resolution clause can help avoid costly and prolonged litigation by providing clear procedural guidance in case of a dispute. However, ambiguous or poorly drafted clauses (commonly termed 'pathological' clauses) often lead to disputes over interpretation and ascertaining parties' intent, thereby leading to costly and prolonged litigation.

To mitigate the aforesaid risk, parties should (a) specify a clear governing law that aligns with geographical preference of the parties to transaction, (b) choose a well-recognized arbitration institution, and (c) define seat and language of arbitration. Exclusive jurisdiction clauses should also be explicit to prevent conflicting claims in multiple forums. A simpler way to achieve the above is to make use of standard arbitration clauses drafted by recognized arbitral institutions.

Caution in Drafting Boilerplate Clauses in Agreements

Boilerplate clauses of an agreement acquire significance when a dispute arises between the parties. Most of the times, such disputes pertain to interpretation of the terms of the contract. A mistake in drafting these clauses could prevent the parties from achieving a favourable outcome in the dispute. For instance, the 'Entire Agreement' clause in a contract, (which provides that the written agreement is the complete agreement, and that the full contractual terms are to be found in the document and not elsewhere), prevents parties from relying on any understanding or statements made, both oral and written, during negotiations and claiming that the agreed terms are different from the written contract. When multiple agreements have been entered into, and a contradiction exists between the terms of the prior and the latest agreement, the Bombay High Court has held the presence of the 'Entire agreement' clause, constituted and represented the entire agreement between the parties and had cancelled or superseded all prior arrangement, agreements or understandings.[3] If an agreement forms part of a composite interrelated transaction, and parties intend to refer to and rely upon contractual obligations in other agreements, parties should avoid replicating standard entire agreement clauses into the agreements as the same may prevent the parties from placing such reliance on other agreements.

3 Neelkanth Mansions and Infrastructures Private Limited and Ors. v. Urban Infrastructure Ventures Capital Limited and Ors, 2022 BOM CR 3 602.

Similarly, a no-waiver clause becomes relevant when one (aggrieved) party becomes aware that the other party has breached the agreement between the two parties. A no-waiver clause ensures that the terms and conditions of an agreement are not changed or modified unless both parties agree to the proposed change or modification in writing, and thus prevents parties from inadvertently waiving their rights.

In the context of private equity investments, we often come across situations where during the routine working of the company, the quorum requirements for board meetings or investor consent requirement for reserved matter items are sometimes not adhered to. Typically, investors would not like to call default or raise issues unless they perceive the conduct in the circumstances to be egregious. In such situations, a no waiver clause protects the investors and ensures that the quorum/consent requirements remain effective and that the non-invocation of default in any one instance does not adversely impact the rights.

A severability clause removes certain terms from the contract if such terms are illegal, invalid, or unenforceable due to the operation of law. In doing so, the severability clause preserves the remainder of the contract as valid and enforceable, thereby making the enforceable terms independent of such unenforceable terms and/or their severance. The existence of a severability clause could also simplify the exercise of the court in preserving a portion of the contract which gives effect to the intent of the parties.[4]

Similarly, a clause of 'Specific Performance' can prove helpful in obtaining interim injunctive reliefs in legal proceedings. In an application for injunctive interim reliefs, an applicant is required to establish, inter alia, that the applicant will suffer irreparable harm and loss in case the reliefs are not granted. A clause on Specific Performance specifies that the agreement is specifically enforceable at the instance of each party and that non-defaulting party will suffer irreparable damage and harm in the event of any breach of the agreement. Therefore, inclusion of a clause on Specific Performance is likely to help establish the intent of the parties to treat the performance of the contract as inviolable, and the intention of the parties to seek interim injunctive relief, if required.

Thus, parties should be cautious while drafting boiler plate provisions in their contracts. These clauses have a great impact on the implementation of other provisions of the contract that may have been heavily negotiated and carry substantive rights of the parties. Given the fact that such clauses are usually the first port of call once a dispute arises and tend to ensure primacy and enforcement of the written word, the use of well drafted provisions could significantly reduce the time and money spent in resolution of disputes.

4 Shin Satellite Public Co. Ltd. v. M/s. Jain Studios Limited 2006 SCC 2 628.

Annexure I-Debt Funding Paper

The ECB Route is a highly regulated investment route. Typically, in the nature of commercial loans to eligible resident Indian entities, ECBs can be raised through secured NCDs and OCDs issued by the eligible resident Indian entities.

However, it may be noted that NCDs issued to FPIs shall not be construed to be investments routed through the ECB Route. Provisions regarding ECB are further included in the following regulations framed under FEMA:

- Foreign Exchange Management (Borrowing or Lending in Foreign Exchange) Regulations, 2018; and
- Foreign Exchange Management (Guarantees) Regulations, 2000, notified vide Notification No. FEMA 8/2000-RB dated May 03, 2000.

The ECB framework is governed by RBI's Mater Director on External Commercial Borrowings, Trade Credits and Structured Obligations which got enforced on March 26, 2019 and it supersedes the older master direction issued by RBI

I. Routes for Raising ECB

ECBs can be raised under either:

a. The automatic route; or

b. The approval route (i.e. where the terms of the ECB would require a prior approval from the RBI before the loan can be availed).

With respect to the automatic route, each specific case is examined by an Authorized Dealer Category-I banks **("AD Banks")**.

For the approval route, the prospective borrowers are required to send their requests to the RBI through their AD Banks for examination. Between the two routes, there are some differences in the form of amount of borrowing, eligibility of borrowers, permissible end-uses, etc.

II. Procedural Requirements

Borrowings under all tracks of the ECB framework are subject to the following procedural requirements:

c. Loan Registration Number[1]

Any draw-down in respect of an ECB as well as payment of any fees / charges for raising an ECB should happen only after obtaining the Loan Registration Number **("LRN")** from RBI.
To obtain the LRN, borrowers are required to submit duly certified Form ECB, which also contains terms and conditions of the ECB, in duplicate to the designated AD Banks.

d. Changes in terms and conditions of ECB[2]

1 RBI,:https://www.rbi.org.in/Scripts/BS_ViewMasDirections.aspx?id=11510.

2 RBI,:https://www.rbi.org.in/Scripts/BS_ViewMasDirections.aspx?id=11510.

Changes in ECB parameters in consonance with the ECB norms, including reduced repayment by mutual agreement between the lender and borrower, should be reported to the DSIM through revised Form ECB at the earliest, in any case not later than 7 days from the changes effected. While submitting revised Form ECB the changes should be specifically mentioned in the communication[3].

III. Parking of ECB proceeds domestically[4]

ECB proceeds meant for Rupee expenditure should be repatriated immediately for credit to their Rupee accounts with the AD Banks in India. ECB borrowers are also allowed to park ECB proceeds in term deposits with AD Banks in India up to a maximum period of 12 months. These term deposits should be kept in unencumbered position.

IV. Raising Rupee-denominated ECBs[5]

Eligible resident Indian entities have now been allowed to borrow through rupee-denominated ECBs that are (a) All entities eligible to raise FCY ECB; and (b) Registered entities engaged in micro-finance activities, viz., registered Not for Profit companies, registered societies/trusts/ cooperatives and Non-Government Organisations[6].

Compliances required through the ECB[7]

I. Minimum Average Maturity Period

MAMP for ECB will be 3 years. Call and put options, if any, shall not be exercisable prior to completion of minimum average maturity. However, for the specific categories mentioned below, the MAMP will be as prescribed therein:

ECB raised by manufacturing companies up to USD 50 million or its equivalent per financial year.	**1 year**
ECB raised from foreign equity holder for working capital purposes, general corporate purposes or for repayment of Rupee loans	**5 years**
ECB raised for (i) working capital purposes or general corporate purposes (ii) on-lending by NBFCs for working capital purposes or general corporate purposes	**10 years**
ECB raised for (i) repayment of Rupee loans availed domestically for capital expenditure (ii) on-lending by NBFCs for the same purpose	**7 Years**
ECB raised for (i) repayment of Rupee loans availed domestically for purposes other than capital expenditure (ii) on-lending by NBFCs for the same purpose	**10 years**

3 RBI,:https://www.rbi.org.in/Scripts/BS_ViewMasDirections.aspx?id=11510.

4 RBI,:https://www.rbi.org.in/Scripts/BS_ViewMasDirections.aspx?id=11510.

5 RBI,:https://www.rbi.org.in/Scripts/BS_ViewMasDirections.aspx?id=11510.

6 RBI,:https://www.rbi.org.in/Scripts/BS_ViewMasDirections.aspx?id=11510.

7 RBI,:https://www.rbi.org.in/Scripts/BS_ViewMasDirections.aspx?id=11510.

II. Eligible Borrowers[8]:

All entities eligible to receive FDI. Further, (i) port trusts; (ii) units in SEZs; (iii) SIDBI; and (iv) EXIM Bank of India

III. Recognised Lenders/Investors[9]

Recognised lenders / investors for Track III ECBs are the following:

The lender should be resident of FATF or IOSCO compliant country, including on transfer of ECB. However,

a. Multilateral and Regional Financial Institutions where India is a member country will also be considered as recognised lenders;

b. Individuals as lenders can only be permitted if they are foreign equity holders or for subscription to bonds/ debentures listed abroad; and

c. Foreign branches / subsidiaries of Indian banks are permitted as recognised lenders only for FCY ECB (except FCCBs and FCEBs). Foreign branches / subsidiaries of Indian banks, subject to applicable prudential norms, can participate as arrangers/underwriters/market-makers/traders for Rupee denominated Bonds issued overseas. However, underwriting by foreign branches/subsidiaries of Indian banks for issuances by Indian banks will not be allowed.

IV. All-in-cost[10]

The 'all-in cost' ceiling has been set at 'Benchmark Rate' plus 450 points[11]. 'Benchmark Rate' in case of FCY is defined as 6-months LIBOR rate of different currencies or any other 6-month interbank interest rate applicable to the currency of borrowing. In case of INR ECB, Benchmark Rate is the prevailing yield of the Government of India securities of corresponding maturity[12]. It includes rate of interest, other fees, expenses, charges, guarantee fees, Export Credit Agency (ECA) charges, whether paid in foreign currency or Indian Rupees (INR) but will not include commitment fees and withholding tax payable in INR[13]

V. End-use Prescriptions[14]

The negative list, for which the ECB proceeds cannot be utilised, would include the following [15]:

a. Real estate activities.

b. Investment in capital market.

c. Equity investment.

d. Working capital purposes except from foreign equity holder.

8 RBI,:https://www.rbi.org.in/Scripts/BS_ViewMasDirections.aspx?id=11510.

9 RBI,:https://www.rbi.org.in/Scripts/BS_ViewMasDirections.aspx?id=11510.

10 RBI,:https://www.rbi.org.in/Scripts/BS_ViewMasDirections.aspx?id=11510.

11 RBI,:https://rbidocs.rbi.org.in/rdocs/notification/PDFs/5MD2603201979CA1390E9E546869B2A9A92614DEDBF.PDF,page 9.

12 RBI,:https://rbidocs.rbi.org.in/rdocs/notification/PDFs/5MD2603201979CA1390E9E546869B2A9A92614DEDBF.PDF,page 5.

13 RBI,:https://www.rbi.org.in/Scripts/BS_ViewMasDirections.aspx?id=11510.

14 RBI,:https://www.rbi.org.in/Scripts/BS_ViewMasDirections.aspx?id=11510.

15 RBI,:https://www.rbi.org.in/Scripts/BS_ViewMasDirections.aspx?id=11510.

e. General corporate purposes except from foreign equity holder.

f. Repayment of Rupee loans except from foreign equity holder.

g. On-lending to entities for the above activities.

Limits and Leverage[16]:

Under the aforesaid framework, all eligible borrowers can raise ECB up to USD 750 million or equivalent per financial year under auto route. Further, in case of FCY denominated ECB raised from direct foreign equity holder ECB liability-equity ratio for ECBs raised under the automatic route cannot exceed 7:1. However, this ratio will not be applicable if outstanding amount of all ECBs, including proposed one, is up to USD 5 million or equivalent. Further, the borrowing entities will also be governed by the guidelines on debt equity ratio issued, if any, by the sectoral or prudential regulator concerned.[17]

16 RBI,:https://www.rbi.org.in/Scripts/BS_ViewMasDirections.aspx?id=11510.

17 RBI,:https://www.rbi.org.in/Scripts/BS_ViewMasDirections.aspx?id=11510.

Annexure II

Specific Tax Risk Mitigation Safeguards for Private Equity Investments

In order to mitigate tax risks associated with provisions such as those taxing an indirect transfer of securities in India, buy-back of shares, etc., parties to M&A transactions may consider or more of the following safeguards.

- **Nil withholding certificate:** Parties could approach the income tax authorities for a nil withholding certificate. There is no statutory time period prescribed in the ITA with respect to disposal of applications thereof, which could remain pending for long without any clarity on the time period for disposal. In the last few years, there have not been many instances of such applications that have been responded to by the tax authorities. However, as per an internal departmental instruction (Dated January, 2014) the department is required to decide such applications within one month.

- **Advance Ruling:** Advance rulings obtained from the Authority for Advance Rulings **("AAR")** were binding on the taxpayer and the Government. An advance ruling may be obtained even in GAAR cases. The AAR was statutorily mandated to issue a ruling within six months of the filing of the application, however due to backlog of matters; it was taking about 8-10 months to obtain the same. An advance ruling may be potentially challenged in the High Court and finally at the Supreme Court. In recent years, the AAR has been disbanded, bringing about, as its replacement, the Board of Advance Rulings **("BAR")**, which has started functioning and become operational from 2023. The mandate, timeline, and rules applicable to the BAR have stayed relatively the same as was applicable to the AAR. One of the points where the Bar takes a departure from the AAR is the constitution of the bench for BAR. While the constitution of the AAR had 3 members included a law member and a retired judge presiding as Chairperson, the constitution of the BAR comprises of 2 members, both from the Revenue department itself. This has led to the anticipation that the rulings might be more favoured towards the tax authorities; however, whether these fears have any merit is yet to be seen. More importantly. Contrary to the AAR decisions, BAR rulings are not binding in nature, and may be directly appealed before the High Court. Existing AAR cases were transitioned to the BAR. Due to the BAR's structure, many applicants wanted to withdraw their applications but faced issues because withdrawal was only permitted within 30 days of filing, which had already elapsed. To address this issue, a new provision was introduced vide Finance Bill 2024 to allow for the withdrawal of these transferred applications until October 31, 2024. This change helps taxpayers who were struggling with the process of withdrawing their advance ruling applications.

- **Contractual representations:** Parties may include clear representations with respect to various facts which may be relevant to any potential claim raised by the tax authorities in the share purchase agreement or such other agreement as may be entered into between the parties.

- **Escrow:** Parties may withhold the disputed amount of tax and potential interest and penalties and credit such amount to an escrow instead of depositing the same with the tax authorities. However, while considering this approach, parties should be mindful of the opportunity costs that may arise because of the funds getting blocked in the escrow account.

- **Tax insurance:** A number of insurers offer coverage against tax liabilities arising from private equity investments. The premium charged by such investors may vary depending on the insurer's comfort regarding the degree of risk of potential tax liability. The tax insurance obtained can also address solvency issues. It is a superior alternative to the use of an escrow account.

- **Legal opinion:** Parties may be required to obtain a clear and comprehensive opinion from their counsel confirming the tax liability of the parties to the transaction. Relying on a legal opinion may be useful to the extent that it helps in establishing the bona fides of the parties to the transaction and may even be a useful protection against penalties associated with the potential tax claim if they do arise.
- **Tax indemnity:** Tax indemnity is a standard safeguard used in most M&A transactions. The purchasers typically seek a comprehensive indemnity from the sellers for any tax claim or notice that may be raised against the purchaser whether in relation to recovery of withholding tax or as a representative assessee. The following key issues may be considered by parties while structuring tax indemnities:
  - **Scope:** The indemnity clause typically covers potential capital gains tax on the transaction, interest and penalty costs as well as costs of legal advice and representation for addressing any future tax claim.
  - **Period:** Indemnity clauses may be applicable for very long periods. Although a limitation period of four years from the relevant FY (or 6 years for when income exceeds INR 5,000,000) has been prescribed for initiating reopening for earlier tax cases, the ITA does not expressly impose any limitation period on proceedings relating to withholding tax liability.. The period for issuing a notice for reassessment/ reopening was changed to 3 years from the relevant AY (or 10 years in case income escaping assessment exceeds INR 5,000,000) vide FA 2021. This time period was further proposed to be changed via Finance Bill 2024, to 3 years and 3 months (or 5 years and 3 months in case of income escaping assessment exceeding INR 5,000,000) form the relevant AY. These changes further streamline the timelines for litigation and clarify time periods to indemnity clauses.
  - **Ability to indemnify:** The continued ability and existence of the party providing the indemnity cover is a consideration to be mindful of while structuring any indemnity. As a matter of precaution, provision may be made to ensure that the indemnifying party or its representatives maintain sufficient financial solvency to defray all obligations under the indemnity. In this regard, the shareholder/s of the indemnifying party may be required to infuse necessary capital into the indemnifying party to maintain solvency. Sometimes back-to-back obligations with the parent entities of the indemnifying parties may also be entered into in order to secure the interest of the indemnified party.
  - **Conduct of proceedings:** The indemnity clauses often contain detailed provisions on the manner in which the tax proceedings associated with any claim arising under the indemnity clause may be conducted.
  - **Dispute Resolution Clause:** Given that several issues may arise with respect to the interpretation of an indemnity clause, it is important that the dispute resolution clause governing such indemnity clause has been structured appropriately and covers all important aspects including the choice of law, courts of jurisdiction and/or seat of arbitration. The dispute resolution mechanism should take into consideration urgent reliefs and enforcement mechanisms, keeping in mind the objective of the parties negotiating the master agreement and the indemnity.

Annexure III – Bilateral Investment Treaties

India has entered into several BITs and other investment agreements. Relying on the BITs in structuring investment into India, may be the best way to protect a foreign investor's interest. Indian BITs are very widely worded and are severally seen as investor friendly treaties. Indian BITs have a broad definition of the terms 'investment' and 'investor'. This makes it possible to seek treaty protection easily through corporate structuring. BITs can also be used by the investors to justify the choice of jurisdiction when questioned for GAAR.

The model clauses for Indian BITs include individuals and companies under the definition of an "investor". Further, companies are defined to include corporations, firms and associations. More importantly, Indian BITs adopt the incorporation test to determine the nationality of a corporation. This is a very beneficial provision as a holding company, which even though is merely a shell company, would not be excluded from treaty benefits.

Further, the word "investment" is defined to include every kind of asset established or acquired including changes in the form of such investment, in accordance with the national laws of the contracting party in whose territory the investment. It specifically includes the following within the ambit of investment:-

i. movable and immovable property as well as other rights such as mortgages, liens or pledges;

ii. shares in and stock and debentures of a company and any other similar forms of participation in a company;

iii. rights to money or to any performance under contract having a financial value;

iv. intellectual property rights, in accordance with the relevant laws of the respective contracting party; and

v. business concessions conferred by law or under contract, including concessions to search for and extract oil and other minerals.

The benefit of this is that even if the foreign parent or subsidiary is merely a shareholder in a locally incorporated Indian company, they would be able to espouse claims under the treaty by the virtue of their investment in the nature of shares in India. This again aids corporate structuring and enables an investor to achieve maximum treaty benefits. Thus, if the parent company incorporated within a non-treaty jurisdiction (P), carries out operation in India through an Indian subsidiary (S) which is held through an intermediary incorporated within a treaty jurisdiction (I), the parent company can seek protection of their investment in the subsidiary through the treaty benefits accrued to the intermediary (See fig 1).

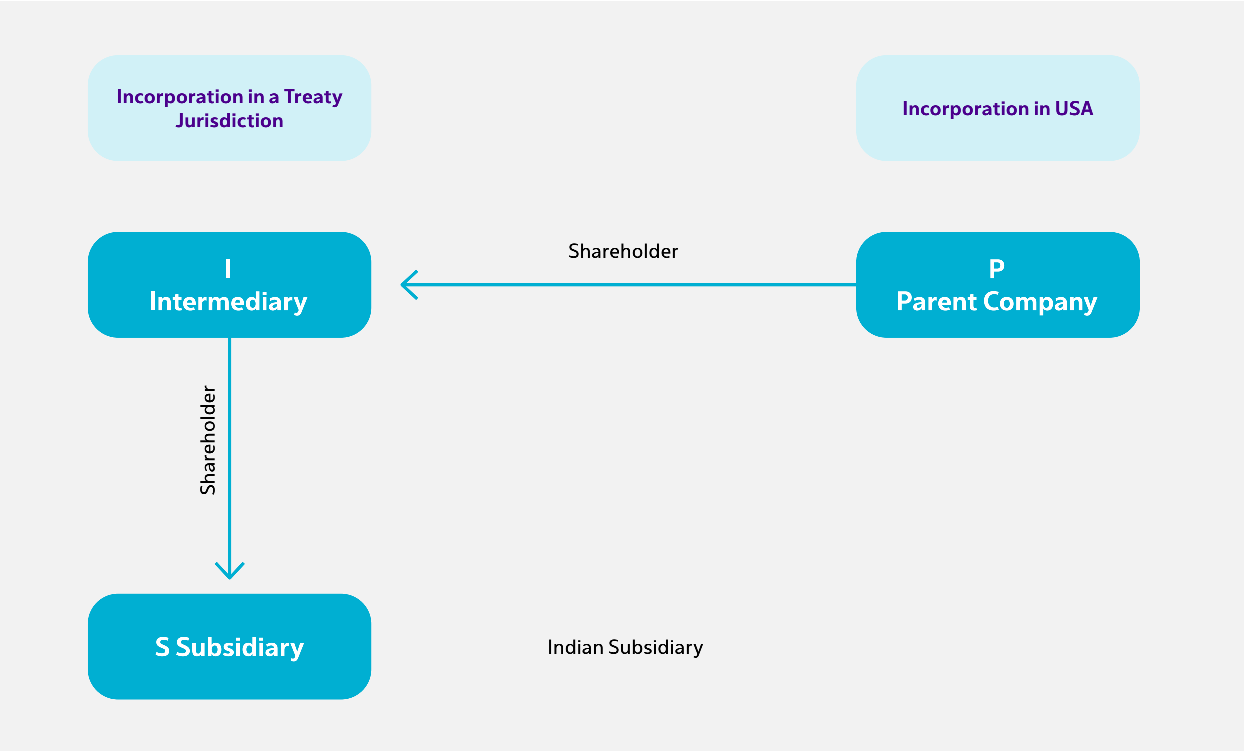

Fig 1: Operations through an India subsidiary which is held through an intermediary in a treaty jurisdiction.

Further, it is an established principle under international law that minority shareholder rights too are protected under BITs. This gives a right to the non-controlling shareholders to espouse claims for losses to their investments. This also enables an investor to diversify its investments through different treaty jurisdictions which will enable the investor to bring multiple claims under different proceedings to ensure full protection of one's investment (See fig. 2). The exact right guaranteed to a particular structure will vary on case to case basis and can be achieved to the satisfaction of the investors by pre-analyzing treaty benefits at the time of making the investments.

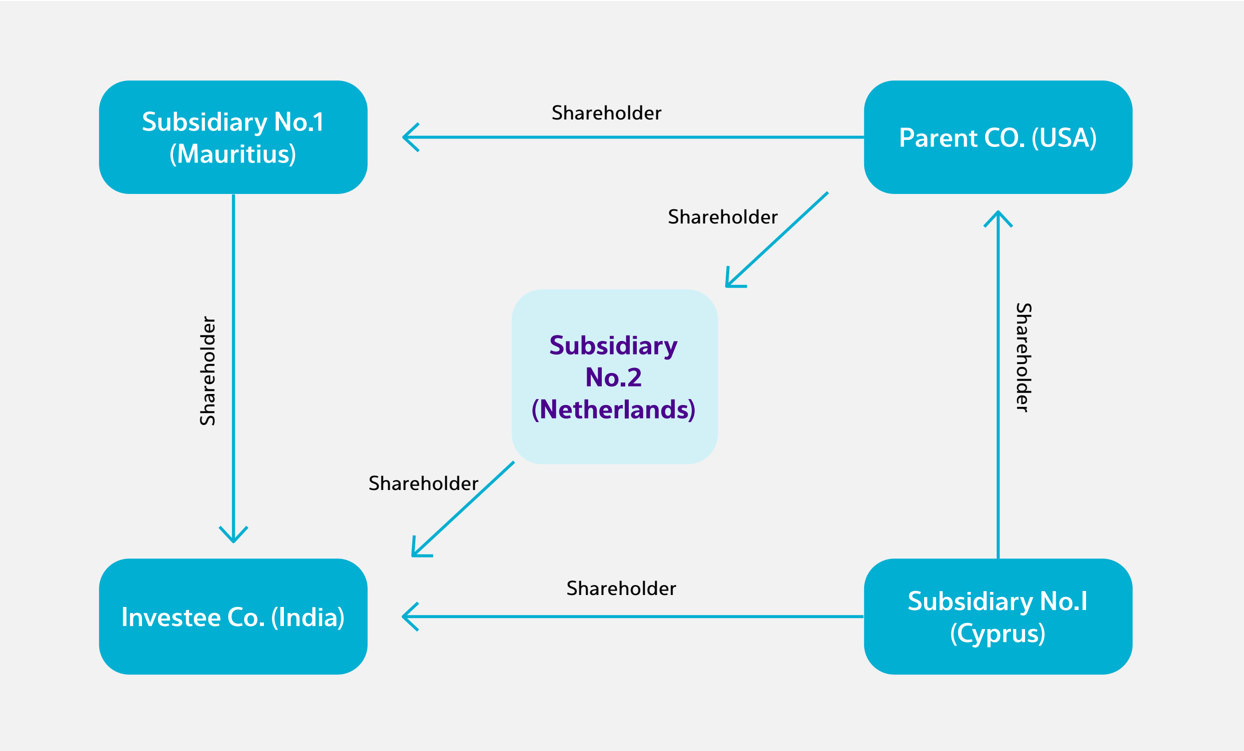

Fig 2: Investment in Indian Investee Company through multiple Subsidiaries in different treaty jurisdiction.

An important point further in favour of the foreign investor investing in India is that India has lucrative BITs with almost all tax efficient jurisdictions including Mauritius, Netherlands, Switzerland, Cyprus, Singapore etc. This enables an investor to achieve maximum benefit from one's investment.

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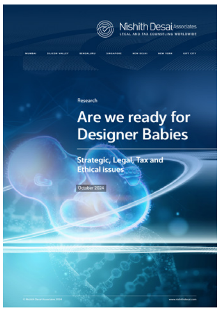

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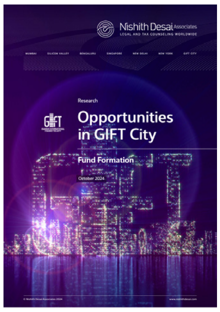

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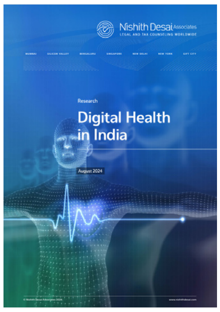

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