Nishith Desai Associates

LEGAL AND TAX COUNSELING WORLDWIDE

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Research

Fund Formation: Attracting Global Investors

Global, Regulatory and Tax Environment Impacting India Focused Funds

February 2024

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Dear Friend,

Venture capital ("**VC**"), private equity ("**PE**") and other fund managers have continued their raising and investment efforts despite global events that were unprecedented in the 21st century — such as the Russian aggression in Ukraine and the recent conflict between Israel and Hamas-led Palestinian militant groups.

It has been observed that the Indian investment funds industry has seen steady and tremendous growth and the investments in alternative investment funds ("**AIFs**") are on rise with approximately INR 8.5 lakh crore of capital commitments raised.[1] Further, with the AIF industry rapidly maturing in India, we are also observing an increased focus on sustainable investments considering environmental, social and governance ("**ESG**") as drivers for value creation.

Accounting for 20.1% of the investments by value in total, real estate has emerged as the top sector benefiting from AIF investments. Information technology and information technology enabled services ranks a distant second accounting for 6.3% of AIF investments by value whereas financial services (excluding Non-Banking Financial Companies ("**NBFC**")) accounted for 6.1% of the investment value. Herein, one may observe that AIFs are making funds available to capital intensive sector (and without much leverage due to the inherent nature of AIFs). Further, according to 2023 global surveys conducted, India has now overtaken China to be the most attractive emerging market (especially in relation to emerging debt) for allocating fresh commitments as per a survey of 85 sovereign wealth funds and 57 central banks (which represent over USD 21 trillion of AUM).[2]

Due to recessionary headwinds, investor appetite for risk has been dwindled and the same has led to decreased fund raising by startups in 2023 wherein Indian Startups received investments of USD 7 billion in the first three quarters as opposed to USD 22 billion raised by Indian startups in the first three quarters of 2022.[3]

India witnessed a 22% decrease in FDI inflows in FY 2022–2023 compared to FY 2021–2022 with the former having USD 46 billion as compared to the latter's USD 58.7 billion. The decrease in FDI inflows maybe attributed to recessionary market sentiments and the hiking of interest rates globally.

The International Financial Services Centre in Gujarat International Finance Tec-City ("**GIFT IFSC**") has gained considerable popularity over the past couple of years after the launch of the International Financial Services Centre Authority (Fund Management) Regulations, 2022 ("**FM Regulations**"). There are about 63 registered funds registered with IFSCA and names of some of the largest players in the industry can be seen in the list.[4]

IFSCA has continued to innovate and rolled out a regulatory sandbox for sustainable finance, as well as ensured greater transparency with respect to how ESG funds curate their investment portfolio in addition to providing grants to innovative solutions addressing green finance. We have been appointed on the Expert Committee to Onshore the Indian innovation to GIFT IFSC.[5]

1 Data relating to activities of AIFs, SEBI: https://www.sebi.gov.in/statistics/1392982252002.html.

2 2023 Invesco Global Sovereign Asset Management Study: https://www.invesco.com/content/dam/invesco/apac/en/pdf/insights/2023/july/igsam-main-study-july-2023.pdf.

3 Indian Startup Funding Falls To $1.7 Bn In Q3 2023. Inc42: https://inc42.com/buzz/indian-startup-funding-falls-to-1-7-bn-in-q3-2023/.

4 https://www.ifsca.gov.in/Directory/index/f63YeymdLdI=.

5 https://ifsca.gov.in/IFSCACommittees#.

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In 2023, we also observed how the new Foreign Exchange Management (Overseas Investment) Rules, 2022 (“**OI Rules**”), Foreign Exchange Management (Overseas Investment) Regulations, 2022 (“**OI Regulations**”), and the Foreign Exchange Management (Overseas Investment) Directions, 2022 (“**OI Directions**”) played out in practice. While the new OI framework has liberalized the overseas investment regime for Indian entities, it seems to have imposed certain (possibly unintended) curbs on the Indian individuals seeking to invest in offshore opportunities. Interestingly, the revised framework also permits round-tripping of funds in certain specific circumstances; however, industry players have been circumspect in exploring these structures. There is a considerable lack of clarity in these rules about overseas investment into funds by Indians. The language has been framed to indicate that Indian residents and listed entities may only invest in overseas funds which are regulated. Most overseas jurisdictions regulated the manager, and not the fund or in other cases, exempt both the fund and manager from regulation. This is leading to practical issues, and more clarity is awaited from the regulator.

The taxation regime has largely remained unchanged, the Union Budget for financial year (“**FY**”) 2023–24 (“**Union Budget**”) has introduced taxation on the distributions made by Real Estate Infrastructure Trusts (“**REIT**”) and Infrastructure Investment Trusts (“**InvIT**”) (hereinafter collectively referred to as “**Business Trusts**”) that are in the form of debt repayment / proceeds from amortization of debt; such income would now be taxable in the hands of the unitholder as income from other sources at slab rates. Further, the Income-tax Act, 1961 (“**ITA**”) also stands amended so as to increase the applicable tax rates on fees for technical services (applicable on non-residents) from 10% to 20%. While the changes appears to be minor, it is likely to have several implications for non-residents in terms of claiming the lower tax rate under the applicable tax treaty. The Government had also announced the launch of the ‘Vivad se Vishvas II’ in order to expedite the settlement of contractual disputes involving the Government wherein arbitral awards were challenged.

Additionally, the introduction of the General Anti-Avoidance Rules (“**GAAR**”) in Indian domestic law has brought in a shift toward a ‘substance over form’ approach in India, an approach that is also reflected in other actions of the Indian government –in actively participating in the Organization for Economic Co-operation and Development’s (“**OECD**”) Base Erosion and Profit Shifting (“**BEPS**”) project, recent policy changes, etc. Further, as a result of Action Plan 15 of the BEPS project, the Multilateral Instrument (“**MLI**”) was brought into force on July 1, 2018 and it entered into force for India on October 1, 2019. The MLI seeks to introduce a limitation of benefit (“**LoB**”) rule (detailed or simplified) or the principal purpose test (“**PPT**”) to covered tax agreements (“**CTAs**”). Since few countries have chosen the LoB rule, it is anticipated that several Indian tax treaties will be modified by the PPT. Having said this, it will be important to examine the interplay of the provisions of GAAR and the PPT rule under the tax treaties and determine its impact on fund structuring.

To combat the ambiguity instilled by the adverse ruling by the Bangalore bench of the Custom, Excise and Service Tax Appellate Tribunal (“**CESTAT**”) upholding levy of service tax on carried interest, the expert committee constituted by the Central Government (headed by M Damodaran) has recommended that carried interest income of the investment manager continue be treated as capital gains without the applicability of goods and service tax (“**GST**”) on the same.

With beneficial provisions, with respect to capital gains, under various tax treaties being revised, GPs and investors are now considering other factors such as infrastructure for fund set up, timeline for grant of registration, manner of KYC processes etc. while deciding the jurisdiction to set up the fund.

With the intent of increasing domestic participation in the alternative investment funds industry, the Government has authorized non-Government provident funds, superannuation funds, and gratuity funds to invest in the units issued by Category I and Category II AIFs subject to certain terms and conditions.[6] Additionally, Government efforts to encourage domestic financial institutions ("**Domestic FIs**") such as pension funds and insurance firms to allocate investments towards alternative asset classes such as Indian AIFsis catalyzing domestic participation in AIFs.

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

The investment fund industry clearly seems to be in a very different market today. In mid-2016, Indian funds started seeing greater participation from domestic LPs (as compared to so far being primarily led by overseas investors). Innovative structures varied from the traditional 'blind-pool model' are increasingly being seen. GPs are increasingly evaluating different structures to contain any possible tax liability and minimize onerous regulatory compliances. There is also an increasing shift from the traditional unified structures to co-invest structures. India, as an investment destination, has been dominating the hedge funds market as well. Innovative structures such as hedge funds with PE side pockets are also being adopted.

Other innovative structures are also coming up, with variations in the traditional unified structure, including a combination of a unified and a co-investment structure to cater to commercial expectations while complying with legal, regulatory and tax requirements. Changes in legal regimes are also altering sectoral focus — for example, the implementation of a newly introduced statute on insolvency and bankruptcy has led to substantial interest in creating investment platforms for accessing stressed assets. Following closely on the footsteps of the observations by U.S. Securities and Exchange Commission ("**SEC**") that there are several disconnects between "what [general partners] think their [limited partners] know and what LPs actually know", SEBI mandates certain disclosure and reporting norms that AIFs have to observe.

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

SEBI has taken a position against parties to a fund who are not actively dissolving AIFs post their SEBI-approved tenure in accordance with the AIF Regulations. Moreover, SEBI has also been recently observed clamping down on AIFs that are indirectly engaging in leverage (by pledging the securities of their portfolio companies) and AIFs that are exceeding concentration norms by investing an amount in excess of 25% of its investible funds in a single portfolio company.

6 Notification F. No. 1/8/2021-PM, Department of Economic Affairs, Ministry of Finance dated March 15, 2021.

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

Globally, funds have been accorded pass through status to ensure fiscal neutrality and investors are taxed based on their status. This is especially relevant when certain streams of income may be tax free at investor level due to the status of the investor, but taxable at fund level. India has also accorded a pass-through status to Category I and Category II AIFs registered with SEBI or regulated under the FM Regulations with a requirement to subject any income credited or paid by the AIFs to a withholding tax of 10% for resident investors and as per the "rates in force" for non-resident investors. Pass through status has still not been accorded to Category III AIFs. The tax uncertainty places certain types of Category III AIFs at a significant disadvantage against off-shore funds with similar strategies. Further, from a regulatory perspective, SEBI has permitted participation of Category II and Category III AIFs in credit default swaps with certain conditions. The ITA also has a regime for ensuring tax neutral reallocation of offshore funds to GIFT City.

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

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

Regards,

Nishith Desai

NDA Fund Formation Practice

Our Approach

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

We provide end-to-end assistance to clients in formulating the fund structure, documentation, liaising with regulatory authorities and merchant banker for obtaining license and responding to their queries. We have developed expertise in assisting the client with LP negotiations considering industry best practices.

Diagnostics and Structuring

Structure follows strategy, and not vice versa. Developing an appropriate strategy is crucial in determining not just the structure, but also the architecture of the fund platform. Adopting strategies for tapping different categories of global investors, including institutional investors and non-institutional investors (such as family offices and ultra-high net worth individuals) and on conformity with global benchmarks, such as the Institutional Limited Partners' Association (ILPA) Principles 3.0, the European Union's AIFMD that have been gaining prominence in the recent times. Strategic framework also needs to be developed for incorporation of best practices on rights and liabilities of different counterparties, LP negotiations and drafting of various fund terms including key person provisions, currency exchange related issues and removal provisions.

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

After the OECD issued its report on Action Plan on BEPS, there has been an increased pressure to ensure observance of key tax principles like demonstrating substance, establishing tax resident status and transfer pricing principles. Tax authorities in several mature financial centers are adopting substance over form approach. The implementation of the GAAR allows Indian tax authorities to re-characterize transactions on grounds of lack of commercial substance among other things. This has prompted a shift while structuring funds to concentrate several aspects constituting 'commercial substance' in the same entity. So, unless specific investors require 'feeder' vehicles for tax or regulatory reasons, an attempt is being made to pool LPs in the same vehicle that invests in the foreign portfolio.

Mauritius, Netherlands, Singapore, Luxembourg, and the GIFT City in IFSC are being favorably considered while structuring India funds or funds with India allocation.

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

Documentation

Once a decision has been taken on the optimum structure for the fund, the same has to be carefully incorporated in the fund documents including the charter documents for the fund entity, the private placement memorandum, the shareholders' agreement, the share subscription or contribution agreement, the investment management agreement, the investment advisory agreement, etc. SEBI has issued a circular mandating AIFs to adhere to a template PPM ensuring that a minimum standard of disclosure is made available in the PPM. While SEBI has provided guidance on certain key terms in the template PPM, in particular, one would need to keep in mind the potential "permanent establishment" and association of persons (AoP) risk while drafting the fund documents. We also provide strategic inputs on various fund terms including key person provisions, currency exchange related issues and removal provisions. We also assist the client in developing structures for warehousing and co-investment.

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

Additionally, we also interact with other intermediaries involved with respect to an AIF such as the Trustees and the Merchant Bankers to file the PPM to SEBI as per the recent SEBI (AIF) (Fourth Amendment) Regulations, 2021 dated August 13, 2021 and modalities issued subsequently.

Advisory

In addition to preparing the necessary fund documents, we also advise the fund on the local registration requirements. Domestic funds may register themselves with SEBI pursuant to which they are required to comply with certain investment restrictions and other prescribed conditions. Domestic funds are also accorded pass-through status for Indian tax purposes upon the fulfilment of certain conditions. It is not mandatory for offshore funds to register with SEBI. However, there are certain benefits available to offshore funds that register with SEBI as 'foreign venture capital investors' ("**FVCI**") such as flexibility in entry and exit pricing, exemption from the lock-in period required when the portfolio company becomes public effectively allowing the FVCI to exit the investment immediately after the portfolio company is listed, exemption from takeover code in respect of the shares, "Qualified Institutional Buyer" status, etc. Further, with respect to funds seeking to participate in the secondary markets, apart from drafting of the information memorandum which is circulated to the investors of such a fund, we have also advised and assisted them in obtaining registration as FPIs. We also advise funds on a day to day basis from an Indian tax and regulatory perspective in relation to the execution of ODIs including P-notes.

LP Negotiations

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

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

Tax expertise: Sponsor and Carry Structuring

Being the pioneers of funds industry in India, we were also the early identifiers of tax issues with respect to the funds industry. We have represented and argued in several landmark cases before Authority for Advance Rulings (“**AAR**”), different High Courts and also the Supreme Court of India contributing to the development of tax jurisprudence in fund management industry — illustratively, *Aberdeen Institutional Commingled Funds, LLC, Nicholas Applegate, Azadi Bachao Andolan, General Pension Electric Trust etc.*

We have developed technical expertise in formulating tax efficient structures both for offshore and domestic funds in light of the recent shift of focus from form to substance under the ITA. In view of the recent changes in the tax treaties and the introduction of the GAAR and POEM provisions in the ITA, the architecture of a fund becomes more critical than the structure. Our understanding of tax treaties also enables us to advise clients on selection of appropriate jurisdictions for setting up feeder vehicles. With the development of GIFT City, our efforts are constantly dedicated to develop the most efficient and futuristic fund structure for our clients.

With an increasing industry demand for a skin-in-the-game, GPs of India focused funds have also begun exploring different innovative structures for employee GP commitment and carry structuring. We have also developed significant expertise in carry structuring not only for domestic funds but also for offshore funds comprising of India GPs and employees. Carry structuring involves a careful analysis of both regulatory and tax laws applicability on certain aspects, while looking at the jurisdiction of residence and taxation of the ultimate carry recipients and also the proportionality of investment in the fund vehicle by such recipients as employee GP commitment.

Global Project Management

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

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Nishith Desai is the founder of the research-based strategy driven international law firm, Nishith Desai Associates with offices in Mumbai, Silicon Valley, Bangalore, Singapore, Mumbai–BKC, New Delhi, Munich and New York. Nishith himself is a renowned international tax, corporate, IP lawyer researcher, published author and lecturer in leading academic institutions around the world. He specializes in Financial Services sector and assisted Government of Mauritius and Government of India in establishment of their offshore financial centers.

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

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Parul is Co-head, International tax and Fund Formation Practices at Nishith Desai Associates with over 20 years of experience. She is a Chartered Accountant, a Certified Public Accountant and an advocate. She focuses primarily on international taxation and Fund Formation practice areas including cross border investments and VC / PE funding structures. She has advised various PE clients with respect to their portfolio business operations restructuring, including advice on M&A transactions, spin offs and group reorganisation strategies. She was previously a partner in the Financial Services and M&A Tax Practices at a Big Four accounting firm.

Parul has been recognised by International Tax Review World Tax 2013 guide. She has also been listed in The Legal500 Directory and has been recognized as one of the Leading Women Leaders in Tax 2016 and in 2017 by International Tax Review. She was also part of a special Committee set up by Securities and Exchange Board of India to evaluate the changes to the AIF Regulations related to Angel Funds.

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Nandini Pathak is a Leader in the Investment Funds practice at Nishith Desai Associates and is actively involved in the firm's thought leadership on the VC and PE side. With a strong focus on VC / PE funds, she has advised several international and domestic clients on legal, regulatory and tax issues, fund governance and fund economics best practices and negotiations with various participants at the fund formation stage. She frequently interacts with the securities regulator and custodians. Her expertise includes tax efficient structuring for India focused funds as well as investor negotiations.

With her practice base on the fund formation side, she also regularly advises clients on the regulatory front including securities laws and exchange control laws. She believes in thought leadership through knowledge sharing, and frequently authors publicly available analysis on relevant topics in the investment funds industry. Nandini holds a B.A., LL.B. (hons). degree from Jindal Global Law School, and has recently (in 2019) been recognized as a 'Distinguished Alumni Award for Exemplary Accomplishments in Professional Service / Work' by her alma mater. She has recently completed her LL.M. (Corporate and Finance Law) from Jindal Global Law School, her alma mater.

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Prakhar Dua is a Leader of the firm's Financial Services & Regulatory Practice and Co-Head of the firm's Foreign Portfolio Investment (FPI) Practice Group. He specializes in securities and foreign exchange laws, with special focus on offshore hedge funds making investments in Indian listed and unlisted space. His expertise lies in FDI / FPI structuring, investment advisers and research analyst regulations, overseas investment laws, regulatory framework for stock broking and trading, and other SEBI and RBI related rules and regulations.

Prakhar frequently interacts with the officials at SEBI and RBI and has been a thought leader by playing a key role at the firm in making policy and legal recommendations to SEBI on various regulatory topics. He also often authors articles on contemporary regulatory subjects and issues, and has been published in forums, such as the Bombay Stock Exchange Brokers' Forum Views Magazine and the National Law Review. You can find him regularly quoted in newspapers and articles, such as Business Standard, Economic Times, Financial Express and Reuters.

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Radhika Parikh heads the Nishith Desai Associates GIFT City practice. She is also a Leader in the Fund Formation practice at Nishith Desai Associates with a strong focus on PE / VC Funds. She has advised both international and domestic clients on legal, regulatory and tax issues, and best practices for fund governance and fund economics. As head of the GIFT City practice, Radhika has developed an expertise in fund formation in GIFT City. She has also been involved in setting up of innovative structures under the Regulatory Sandbox at GIFT City.

Radhika also frequently interacts with IFSCA officials, and has actively been involved in policy making by working closing with several committees and working groups launched by IFSCA on various regulatory issues including the "Working Group for the Development of non-Resident Individual Business and Ease of Registration" which aims to facilitate greater participation from non-residents into financials services a products offered from GIFT City. She is also a Leader in the Private Client practice and works extensively with advising multi-jurisdictional families on both their family and business structures from an estate planning and succession perspective both in India and GIFT City.

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Dr. Dhruv Janssen-Sanghavi is the Co-Head of the International Tax and International Tax Litigation practices at Nishith Desai Associates, and leads the firm's European operations from the Netherlands. He is widely published, and is acknowledged as an expert in tax treaty interpretation. He is the recipient of the 2013 IBA Scholarship for Tax Matters and the 2017 IFA President YIN Scientific Award.

Dr. Janssen-Sanghavi received his Advanced LLM in International Tax Law from Leiden University (2011) and defended his doctoral thesis "Structural Issues in the Income Tax Treaty Network — Towards a Coherent Solution" at Maastricht University, where he was an Assistant Professor of International Tax Law and Policy. Apart from being a practitioner, Dr. Janssen-Sanghavi teaches at a number of universities around the world, and contributes regularly to the work of the United Nations Committee of Experts on International Tax Matters.

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Glossary of Terms

Term	Explanation
AAR	Authority for Advance Ruling, Ministry of Finance, Government of India
AC	Authorised Company
ADGM	Abu Dhabi Global Market
ADIA	Abu Dhabi Investment Authority
AIF	Alternative Investment Fund as defined under the SEBI (Alternative Investment Funds) Regulations, 2012
AIFMD	Alternative Investment Fund Managers Directive
AIF Regulations	SEBI (Alternative Investment Funds) Regulations, 2012
AIPAC	Alternative Investment Policy Advisory Committee
AML	Anti-Money Laundering
AUM	Assets under management
AOP	Association of Persons
BACO	Best Alternative Charitable Option
BEPS	Base Erosion and Profit Shifting
BIPA	Bilateral Investment Promotion and Protection Agreements
BIS	Bank for International Settlements
CBDT	Central Bureau of Direct Taxes, Department of Revenue, Ministry of Finance, Government of India
CBLO	Collateralized Borrowing and Lending Obligations
CCD	Compulsorily Convertible Debentures
CCPS	Compulsorily Convertible Preference Share
Companies Act	The Companies Act, 1956 and/or the Companies Act, 2013 (to the extent as may be applicable)
COR	Certificate of Registration
CSR	Corporate Social Responsibility
CTA	Covered Tax Agreements
DDP	Designated Depository Participant
DDT	Dividend Distribution Tax
DFIs	Development Financial Institutions
DFSA	Dubai Financial Services Authority
DI Regulations	Foreign Exchange Management (Debt Instruments) Regulations, 2019
DIFC	Dubai International Financial Centre
DTAA	Double Taxation Avoidance Agreement
ECB	External Commercial Borrowing
EEIG	European economic interest groupings
ESG	Environment, Social and Governance policies
FATCA	Foreign Account Tax Compliance Act

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Glossary of Terms

FATF	Financial Action Task Force
FATF Release	Jurisdictions under Increased Monitoring
FCCB	Foreign Currency Convertible Bond
FCPA	Foreign Corrupt Practices Act
FDI/ FDI Policy	Foreign Direct Investment / Consolidated Foreign Direct Investment Circular of 2017
FEMA	Foreign Exchange Management Act, 1999
FII	Foreign Institutional Investor
FII Regulations	SEBI (Foreign Institutional Investors) Regulations, 1995
FIPB	Foreign Investment Promotion Board, Department of Economic Affairs, Ministry of Finance, Government of India
FMV	Fair Market Value
FPI	Foreign Portfolio Investor
FPI Regulations 2019	SEBI (Foreign Portfolio Investors) Regulations, 2019
FSC	Financial Services Commission, Mauritius
FSRA	
FVCI	Foreign Venture Capital Investor
FVCI Regulations	SEBI (Foreign Venture Capital Investors) Regulations, 2000
FTS	Fees for Technical Services
GAAR	General Anti-Avoidance Rules
GBC-1	Category 1 Global Business (GBC–1) License
GIFT City	Gujarat International Finance Tech-City
GIFT IFSC	International Financial Services Centre at GIFT City
GIIN	Global Impact Investing Network
GIIRs	Global Impact Investing Rating System
GPs	General Partners (Fund Managers)
GST	Goods & Services Tax
GoI	Government of India
JOBS Act	Jumpstart Our Business Startups Act
IC	Investment Committee
ICDR Regulations	SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009
IFSC	International Financial Services Centers
IFSCA	International Financial Services Centres Authority
IFSCA Act	International Financial Services Centres Authority Act, 2019
Indian Rupee or "INR" or "Rs."	The currency of Republic of India
InvIT	Infrastructure Investment Trust registered with SEBI under the SEBI (Infrastructure Investment Trusts) Regulations, 2014
IOSCO	International Organization of Securities Commissions
IP	Intellectual Property

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IPO	Initial Public Offer
IRIS	Impact Reporting & Investment Standards
ITA	Income-tax Act, 1961
ITA Rules	Income Tax Rules, 1962
KYC	Know Your Customer
LoB	Limitations on Benefits
LLP	Limited Liability Partnership
LLP Act	Limited Liability Partnership Act, 2008
LPAC	Limited Partners' Advisory Committee
LPs	Limited Partners (Fund Investors)
LRS	Liberalised Remittance Scheme
MAT	Minimum Alternate Tax
MIM	Multiple Investment Management
Minimum Investment Amount	INR 10 million
MLI	Multilateral Instrument
NAV	Net Asset Value
NCD	Non-convertible Debentures
NDI Rules	Foreign Exchange Management (Non-debt Instruments) Rules, 2019
NRI	Non-Resident Indian
OCB	Overseas Corporate Body
ODI	Offshore Derivative Instrument
ODI Regulations	Foreign Exchange Management (Transfer or Issue of any Foreign Security) Regulations, 2004
OECD	Organisation for Economic Co-operation and Development
Onshore Fund	Domestic Pooling Vehicle
Operational Guidelines	Operational Guidelines for FPIs, DDPs and EFIs
OEIC	Open-ended Investment Company
ODI	Offshore Derivative Instrument
Offshore Fund	Means a pooling vehicle established outside India
OTT	Over-The-Top
P-notes	Participatory notes
PAN	Permanent Account Number
PCC	Protected Cell Companies
PE	Private Equity
PPM	Private Placement Memorandum
P-Notes	Participatory Notes
POEM	Place of Effective Management
PPT	Principal Purpose Test

Protocol	Protocol signed between India and Mauritius to amend the Mauritius India Double Taxation Avoidance Agreement
QFI	Qualified Foreign Investor
RBI	Reserve Bank of India
REITs	Real Estate Investment Trusts
RE Funds	Real Estate Funds
RoC	Registrar of Companies
RTA	Registrar to an issue / share transfer agent
SCRA	Securities Contracts (Regulation) Act, 1956
SEBI	Securities and Exchange Board of India
SEBI Act	Securities and Exchange Board of India Act, 1992
SEC	U.S. Securities and Exchange Commission
SGD	Singapore Dollars
SITA	Singapore Income Tax Act
SMEs	Small and Medium-sized Enterprises
SPCs	Segregated Portfolio Companies
SPV	Special Purpose Vehicle
TDS	Tax Deducted at Source
TRC	Tax Residency Certificate
TISPRO Regulations	Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2017
UN	United Nations
USD	US Dollars
VC	Venture Capital
VCC	Variable Capital Companies
VCF	Venture Capital Fund
VCF Regulations	SEBI (Venture Capital Funds) Regulations, 1996
VCPE	Venture Capital and Private Equity
VCU	Venture Capital Undertaking
2015 Circular	Circular no. 4 of 2015

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Choice of Jurisdiction for Setting up an India-Focused Fund

There are several factors that inform the choice of jurisdiction for setting up a pooled investment vehicle such as the jurisdiction of investors, the investment profile and focus, the residential status of the GPs etc.

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

The government is working towards easing the norms for effective mobilization of the domestic pool of investors in India (consisting of institutional investors like banks, insurance companies, mutual funds and high net worth individuals). The AIPAC reports[1] have also recommended unlocking domestic capital pools for providing fund managers an access to domestic pools as this investor class currently constitutes approximately 10% of the total VCPE invested in India annually. In fact, the fourth AIPAC Report has also listed 'expanding the existing domestic capital pools' as one of three imperative pillars for scaling up the industry to its next phase of growth.[2]

The Finance Act, 2021, had introduced a regime to provide tax neutrality in case of relocation of foreign funds to IFSC. Such amendment has made relocation from another country to IFSC tax neutral i.e. the transfer of capital asset by an 'original fund' (from a tax treaty jurisdiction) to a 'resultant fund' in IFSC. However, mere tax neutrality is not a sufficient incentive to attract capital into an international financial center — the core issue is that the regulatory landscape should be at par (or ahead of) global best practices. This shift has started to take place in the GIFT City with the promulgation of the FM Regulations; which has induced an inflow of capital and business into GIFT in the recent past. As of writing we've observed four investment managers relocating / opening branches in GIFT City — signaling a brighter future for the Indian international financial centre.[3] The 'relocation' is exempt from tax, subject to certain conditions. The details of this regime have been covered below.

I. Why Offshore Investors Are Pooled Outside India

India follows source-based taxation on capital gains and taxes thereon may not be creditable in the home jurisdiction of the offshore investors. Accordingly, offshore structures are used for offshore investors to invest into India to avoid double taxation on the same income stream. Further, if the offshore investors are pooled outside India, the requirement to obtain a Permanent Account Number ("**PAN**") card and filing of tax returns will only be on the Offshore Fund, as opposed to each of the offshore investors (in case of direct participation of such investors in an onshore pooling vehicle).

1 The report was issued on December 01, 2016 and can be accessed at: https://www.sebi.gov.in/sebi_data/attachdocs/1480591844782.pdf.
Our memo on AIPAC I (dated January 20, 2016) can also be accessed at: https://www.nishithdesai.com/SectionCategory/33/Funds-Hotline/12/40/FundsHotline/5187/1.html.

2 Final AIPAC report (dated July 18, 2023) available at: https://space.levo.so/WGLBUT82/6993214868693381492.pdf.

3 Rajesh Bayani, GIFT City gains traction: Avendus fourth firm to get nod for setting up AIF, Business Standard: https://www.business-standard.com/article/markets/gift-city-gains-traction-avendus-fourth-firm-to-get-nod-for-setting-up-aif-121090400054_1.html.

From a global perspective, it may be noted that the Indian Government has terminated its bilateral investment treaties with fifty-eight countriesin 2017 — including 22 EU countries. The absence of such treaties which may provide investors an access to several reliefs, including fair and equitable treatment, protection against expropriation, reparability of capital, an efficient dispute resolution framework and other rights and reliefs can cause investor hesitation. Nevertheless, investments made prior to 2017 may be protected under the erstwhile bilateral investment treaties.[4]

Offshore investors are preferably pooled in jurisdictions which have a Bilateral Investment Promotion and Protection Agreements ("**BIPA**") with India, which may provide investors an access to several reliefs, including fair and equitable treatment, protection against expropriation, reparability of capital, an efficient dispute resolution framework and other rights and reliefs. Further, India based structures with foreign participation which are not Indian managed and sponsored may require regulatory approvals, compliance with pricing norms and may be subject to performance conditions in certain sectors.[5] India does not have BIPA with all countries.

II. Why Onshore Investors Are Pooled in India

Resident investors prefer onshore structures for the following reasons:

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

   The OI Rules have completely overhauled the framework for overseas investment by resident individuals. The OI Rules *inter-alia* permits resident individuals to make overseas investment by way of overseas direct investment ("**ODI**") in an operating foreign entity which is not engaged in financial services activity and which does not have subsidiary or step-down subsidiary where the resident individual has control in the foreign entity. Therefore, the ability of resident individuals to directly make investment in an offshore fund has been restricted. Having said this, the OI Directions provide that investments (including sponsor commitments) in units of any investment fund overseas, duly regulated by the regulator for the financial sector in the host jurisdiction, shall be considered as overseas portfolio investment ("**OPI**"). Therefore, it may be possible to take a view that resident individual LPs are permitted to make OPI investments (ie. less than 10% shareholding, without control) in an offshore fund, if such fund is duly regulated in its host jurisdiction.

b. Paragraph 2 of Schedule 2[6] of the "OI Rules" stipulates certain conditions to be met by Indian entities engaged in financial services when making investments in a foreign entity[7] directly or indirectly engaged in financial services activities (including fund or fund management vehicles). The conditions include, *inter-alia*, (i) that the Indian entity should have earned net profits during the preceding three financial years (Covid-19 years, i.e. 2020–21 and 2021–22 may be excluded); (ii) that it is registered with or regulated by a financial service regulator in India; and (iii) that it has obtained approval from the concerned regulatory authorities, both in India and abroad, for venturing into such financial service activity.

4 India overhauls its investment treaty regime, Financial times: https://www.ft.com/content/53bd355c-8203-34af-9c27-7bf990a447dc.

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

6 https://incometaxindia.gov.in/Documents/Provisions%20for%20NR/FEM-Overseas-Investment-Rules-2022.htm.

7 As defined under rule 2(h) of the OI Rules.

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Further, an Indian entity which does not undertake financial services in India is permitted to invest in foreign entities that are directly / indirectly undertaking financial services activities (except banking and insurance) provided that the Indian entity has posted net profits during the preceding three financial years.

It is to be noted that all overseas investment by an Indian entity is subject to a ceiling of 400% of the Indian entity's net worth (by means of overseas direct investment).

c. Under a domestic fund structure, in most cases (especially for Category I or II AIFs), the fund vehicle (typically a trust entity registered with SEBI as an AIF) is not to be taxed on any income that is earned from the investments. The income earned is taxable in the hands of the investors when the AIF distributes the same to the investors. Further, the characterization of income in their hands is the same as that realized/ distributed by the investee company to the fund.

By contrast, if distributions were to be received in the form of dividend or interest from an Offshore Fund structure, the Indian resident investors would typically have to recognize the distribution as 'income' and as a result, could be taxed in India (at the time of receipt).

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

A. Mauritius

India has received FDI amounting to USD 167 billion (approximately) from Mauritius between April, 2000 – September, 2023.[8] Between April, 2000 and September, 2023, FDI from Mauritius accounted for 25.47% of the total FDI received by India.[9] During the FY 2022–23, India attracted USD 6.13 billion in FDI from Mauritius.[10] The bilateral trade between the countries dipped to USD 6.13 billion in FY 2022–23 from USD 9.3 billion in FY 2021–22.[11] Accordingly, in order to strengthen and enhance the trade and economic cooperation, Mauritius and India have signed Comprehensive Economic Cooperation and Partnership Agreement (CECPA), a kind of free trade pact.[12]

The Mauritian Financial Services Commission ("**FSC**") issued its first 'Anti-Money Laundering and Countering the Financing of Terrorism Handbook', designed to assist licensed financial institutions to adopt a 'more effective, risk-based and outcome-focused approach' in January, 2020. The Handbook offers financial institutions guidance on applying national measures to combat, *inter-alia*, money laundering and terrorist financing. On February 21, 2020, the FATF has issued a list of 'Jurisdictions under Increased Monitoring' commonly known as 'the grey list' which included Mauritius alongside 17 other jurisdictions.[13] Consequently, it was also included (along with 11 other countries) on the European Union's revised list of high-risk countries that have 'strategic deficiencies in their AML-CFT framework'.

8 https://dpiit.gov.in/sites/default/files/FDI_Factsheet_September_2023.pdf.

9 https://dpiit.gov.in/sites/default/files/FDI_Factsheet_September_2023.pdf.

10 Ibid.

11 https://dpiit.gov.in/sites/default/files/FDI_Factsheet_September_2023.pdf.

12 https://economictimes.indiatimes.com/news/economy/foreign-trade/india-inks-fta-with-mauritius-the-1st-with-an-africannation/articleshow/81165898.cms?utm_source=contentofinterest&utm_medium=text&utm_campaign=cppst.

13 https://www.fatf-gafi.org/publications/high-risk-and-other-monitored-jurisdictions/documents/increased-monitoring-february-2020.html.

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The EU 'blacklisting' applied as of 1 October 2020. After inclusion in the list, FDI inflow from Mauritius fell from USD 8.24 billion in 2019–20 to USD 6.13 billion in 2022–23.[14]

Following its listing, Mauritius made a high-level political commitment to the FATF to address the strategic deficiencies identified. A committee headed by the Mauritius Prime Minister was assembled to accelerate implementation of its action plan[15] and secure removal from the FATF list by September 2021. Building on the regulatory and policy announcements, and following the work undertaken by the competent authorities in Mauritius, the FATF, at its June 2021 Plenary Session, endorsed the substantial and expeditious progress made by Mauritius to consolidate the jurisdiction's AML/CFT regime. Due to this, on October 23, 2021 by an official order, FATF announced the removal of Mauritius from the "FATF" grey list.[16] Subsequently, in January 2022, the European Commission confirmed the removal of Mauritius from the list of High-Risk Third Countries after finding no deficiencies in the AML/CFT framework of Mauritius.[17]

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

The India-Mauritius double taxation avoidance agreement ("**DTAA**") underwent a change through the protocol signed between India and Mauritius on May 10, 2016 ("**Protocol**"). Prior to the Protocol, the India-Mauritius DTAA included a provision that exempted a resident of Mauritius from Indian tax on gains derived from the sale of shares of an Indian company. The Protocol however, gave India a source based right to tax capital gains which arise from alienation of shares of an Indian resident company acquired by a Mauritian tax resident (as opposed to the previous residence -based tax regime under the India-Mauritius DTAA). However, the Protocol had provided for grandfathering of investments and the revised position became applicable to investments made on or after April 01, 2017. In other words, all existing investments up to March 31, 2017 had been grandfathered and exits / shares transfers in respect of such investments beyond this date would not be subject to capital gains tax in India. Additionally, the Protocol introduced a LoB provision which shall be a pre-requisite for a reduced rate of tax[18] (50% of domestic tax rate) on capital gains arising during a two-year transition period from April 01, 2017 to March 31, 2019.

The modification on capital gains taxation is limited to gains arising on sale of shares. This ensures continuity of benefit to other instruments and also provides much needed certainty in respect of the position of the India-Mauritius DTAA. However, despite this, transactions related to the India-Mauritius DTAA continue to be closely scrutinised by tax authorities in India.[19]

The sale of debentures continues to enjoy tax benefits under the India-Mauritius DTAA. That, coupled with the lower withholding tax rate of 7.5% for interest income earned by Mauritius investors from India, comes as big boost to debt investments from Mauritius. Prior to the Protocol, interest income arising to Mauritius investors from Indian securities / loans were taxable as per Indian domestic law. The rates of interest could go as high as 40% for rupee denominated loans to non-FPIs.

14 https://dpiit.gov.in/sites/default/files/FDI%20Factsheet%20December%2C%202021.pdf.

15 With a view to enhancing the effectiveness of the AML/CFT measures and pursuant to Mauritius' action plan, several working groups were constituted at a national level to tackle the deficiencies identified in the jurisdiction's AML/CFT regime.

16 Jurisdictions under Increased Monitoring — October 2021, FATF available at: https://www.fatf-gafi.org/publications/high-risk-and-other-monitored-jurisdictions/documents/increased-monitoring-october-2021.html.

17 https://www.fscmauritius.org/media/119941/fsc-communiqu%C3%A9-delisting-from-high-risk-final.pdf.

18 This benefit shall only be available to such Mauritius resident who is (a) not a shell/conduit company and (b) satisfies the main purpose and bona fide business test.

19 Several MNCs under IT scanner for deals done via Mauritius Cos: https://economictimes.indiatimes.com/news/economy/policy/several-mncs-under-it-scanner-for-deals-done-via-mauritius-cos/articleshow/88419639.cms?utm_source=contentofinterest&utm_medium=text&utm_campaign=cppst.

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The Protocol amended the DTAA to provide for a uniform rate of 7.5% on all interest income earned by a Mauritian resident from an Indian company. The withholding tax rate offered under the India-Mauritius DTAA is significantly lower than those under India's treaties with Singapore (15%) and Netherlands (10%). This should make Mauritius a preferred choice for debt investments into India, going forward.

Further, the Protocol introduced Article 26A to the India-Mauritius DTAA. It provided that India and Mauritius shall lend assistance to each other in the collection of revenue claims. It allowed for Mauritius authorities to enforce and collect taxes of Indian revenue claims, as if such claims were its own, upon a request from Indian revenue authorities. Currently, in relation to MLI, Mauritius has not included India in its definitive notification, accordingly, India-Mauritius DTAA is not considered a CTA. In case Mauritius notifies India-Mauritius DTAA as CTA, there could be a significant change in tax positions from investments made through the Mauritius route and its impact on fund structuring would have to be determined accordingly.

On a separate note, the FSC had introduced domestic substance rules to be satisfied by Mauritius based GBC-1 entities incorporated after January 01, 2015.The substance rules were amended vide circulars issued by the FSC on October 12 and 15, 2018 to be effective from January 01, 2019.[20] Further, as part of the amendments brought by the Finance Act, 2018, Category 1 and Category 2 Global Business licenses will no longer be issued by FSC from January 01, 2019. Instead, new licenses namely the Global Business Corporation ("**GBC**") and Authorised Company ("**AC**"), were introduced by the FSC. The license requirements stipulate core income generating activities to be carried out by the GBC namely: (i) employing, either directly or indirectly, a reasonable number of suitably qualified persons to carry out the core activities; and (ii) having a minimum level of expenditure, which is proportionate to its level of activities. While determining the same, the FSC will take into consideration the nature and level of core income generating activities conducted (including the use of technology) by the GBC. The FSC also provided indicative guidelines for determining what would constitute as "a reasonable number of suitably qualified persons" and "a minimum expenditure which is proportionate to its level of activities". Further, in order to qualify for tax holidays under the Mauritius Income Tax Act, the FSC also stipulated that the licensees would require to possess a physical office and also specified the minimum number of employees which should be resident in Mauritius and also minimum amount of annual operating expenditure that should be incurred in Mauritius or assets to be under their management depending on the type of office.

The FSC on October 12, 2021, published a draft Variable Capital Companies ("**VCC**") Bill which was passed on April 12, 2022 ("**VCC Act**"). The VCC Act aims to provide a legal framework for the incorporation, conversion, structure, operation and termination of VCCs in Mauritius. The introduction of VCCs was first announced as part of the National Budget Speech 2020–2021 in June and is intended to further enhance the competitiveness of the financial services sector and diversify the product base of the Mauritius International Financial Centre (IFC). This new corporate structure will increase the competitiveness of Mauritius for alternative and flexible fund structures and propel the country to be an equivalent jurisdiction for incorporating funds.[21] Please note that further details pertaining to the Mauritius VCC is provided at **Annexure III: Certain Mauritius and Singapore Structures.**

20 https://f.datasrvr.com/fr1/118/86693/GBC_Circular_Substance.pdf.

21 https://www.fscmauritius.org/media/112460/communiqu%C3%A9-vcc-bill.pdf.

B. Singapore

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

During April 2022 – September 2023, India has received approximately USD 22 billion as FDI from Singapore.[22] India and Singapore are poised to see enhanced economic cooperation as well as an increase in trade and investment flows. This is well reflected from the fact Singapore was one of the top source of FDI into India for the third consecutive financial year, accounting for about 33 % of FDI inflows during April 2022 – September 2023.[23] Singapore has also launched the Variable Capital Companies (“**VCC**”) framework on January 14, 2020, to allow set up of investment funds across traditional and alternative strategies marking a significant chapter in propelling Singapore as an international fund management and domiciliation hub, VCCs provide fund managers with greater flexibility on the domiciliation of extensive range of investment funds. The provision of operational flexibility and cost savings has become an enticing factor for the Indian fund managers to set up offshore fund in the VCC form, giving Singapore a distinct advantage which in turn will lead to the development of the overall fund management industry in Singapore. Please note that further details pertaining to the Mauritius VCC is provided at **Annexure III: Certain Mauritius and Singapore Structures**.

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

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

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

22 https://dpiit.gov.in/sites/default/files/FDI_Factsheet_September_2023.pdf.

23 https://dpiit.gov.in/sites/default/files/FDI_Factsheet_March_23.pdf.

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

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

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

Making the GAAR applicable to companies that meet the requirements of a LoB clause is likely to adversely impact investor sentiment. Further, India-Singapore DTAA has been notified as a CTA and accordingly, the LoB clause contained in Article 24A of the India-Singapore DTAA would be superseded by the PPT. The PPT provides that no benefit under the tax treaty shall be granted if it is reasonable to conclude that obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit. However, there is a carve-out for granting such treaty benefits if availing such benefits is in accordance with the object and purpose of the relevant provisions of the tax treaty. Demonstration of commercial substance would be imperative to claim benefits under the India-Singapore DTAA. In this regard, the recent judgement of the Hon'ble Delhi High Court in favor of the Blackstone Group is set bolster investor (especially foreign investors) sentiments with regards to investing in India.[24] In the instant matter, the Hon'ble Delhi High Court stated that *"it is a fundamental rule of international taxation that every nation has a sovereign right to impose tax on the global income of its residents and on income that accrues or arises within its territorial limits", and that the "respondent's [income tax department's] attempt in seeking to question the TRC is wholly contrary to the Government of India's repeated assurances to foreign investors."* while holding that the tax residency certificate is the only evidence required under the law to be eligible for the benefits conferred under the India-Singapore DTAA.

C. Ireland

Ireland is a tax-efficient jurisdiction when investment into the Indian company is in the form of debt or convertible debt instrument. Interest, royalties and fees for technical services ("**FTS**") arising in India and paid to an Irish resident may be subject to a lower withholding tax of 10% under the India-Ireland DTAA. This is a significant relief from the withholding under Indian domestic law which can be as high as 42% for interest. India-Ireland DTAA has also been notified as a CTA and therefore, the PPT will need to be satisfied for availing benefits of the India-Ireland DTAA. India has received FDI amounting to USD 1.3 billion (approximately) from Ireland between April, 2000 – September, 2023.[25]

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

24 Blackstone Capital Partners (Singapore) VI FDI Three Pte Ltd vs ACIT; Neutral Citation Number 2023/DHC/000634.

25 https://dpiit.gov.in/sites/default/files/FDI_Factsheet_September_2023.pdf.

However, the changes introduced by the protocols to the India-Mauritius and India-Singapore DTAA on taxation of interest income (as summarized above) make Mauritius and Singapore favorable choice of jurisdictions even for debt funds. The costs of setting-up in Mauritius or Singapore are likely to be less expensive than Ireland.

D. Netherlands

With its robust network of income tax treaties, Netherlands is an established international fund domicile. Over the course of time, i.e. from April 2000 – September, 2023, Netherlands has contributed 6.98% of the FDI inflows into India — translating into a cumulative amount of approximately USD 45.6 billion.[26]

In the context of inbound investments to India, Netherlands emerges as an efficient jurisdiction for making portfolio investments. Post-Brexit, Britain is no longer part of the common market, and distributions are likely to suffer double taxation, which was relieved through the various EU freedoms and the Parent-Subsidiary Directive. Most Dutch people speak English fluently allowing for ease of communication. The Central European Timezone and ease of mobility it provides between continents, the Netherlands provides an efficient communications and physical bridge between India and the US. Its absence from any black or grey lists, and given its stable legal and political regimes, enables the Netherlands to emerge as a front runner for fund formation.

From a tax perspective, the India-Netherlands tax treaty provides relief from economic double taxation by ensuring that capital gains are exempt from tax in India in certain scenarios, arising both from direct as well as indirect transfers. Gains arising to a Dutch resident arising from the sale of shares of an Indian company to non-resident buyer would not be taxable in India. However, such gains would be taxable if the Dutch resident holds more than 10% of the shares of the Indian company in case of sale to Indian residents. Even though the eligible holding is capped, the same structure works well for FPIs, who are restricted to participate (whether directly or indirectly or synthetically through ODIs) to less than 10% of the paid-up capital of an Indian company. In some cases the capital gains may also qualify for the participation exemption in the Netherlands. Important to note that India-Netherlands DTAA has also been notified as a CTA and therefore, the PPT will need to be satisfied for availing benefits of the India-Netherlands DTAA.

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

In the case of KSPG Netherlands,[27] it was held that sale of shares of an Indian company by a Dutch holding company to a non-resident would not be taxable in India under the India-Netherlands DTAA. It was further held that the Dutch entity was a resident of the Netherlands and could not be treated as a conduit that lacked beneficial ownership over the Indian investments. The mere fact that the Dutch holding company was set up by its German parent company did not imply that it was not eligible to benefits under the India-Netherlands DTAA.

26 https://dpiit.gov.in/sites/default/files/FDI_Factsheet_September_2023.pdf.

27 [2010] 322 ITR 696 (AAR).

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

E. Abu Dhabi Global Market

The Abu Dhabi Global Market ("**ADGM**") is an international financial center located in the capital of the United Arab Emirates. With its common law application, business-friendly ecosystem, and proximity to investor / investing hubs – AGDM has rapidly risen within the ranks of fund jurisdictions, with a total of 130 funds being managed by ADGM fund managers.[28]

ADGM's Financial Services Regulatory Authority ("**FSRA**") acts as the regulatory body in the investment funds space and regulates the fund manager who seek to undertake collective investment activities in the region. FSRA regulates funds and fund managers setting up shop in the ADGM wherein domestic fund managers who seek to offer fund management services are required to obtain the category 3C asset manager license[29] whereas foreign fund managers are allowed to manager passport their funds to ADGM provided that they are from a recognized jurisdiction.[30] It is to be noted that a fast-track process has been provided for fund managers (exclusively undertaking fund management business) seeking to apply for the 3C. Additionally, an authorized fund manager is permitted to offer the units of a foreign fund in ADGM. Tabulated below are the different funds that may be started by a fund manager in ADGM.

Particulars[31]	Public Funds	Exempt Funds	Qualified Investor Funds
Minimum Subscription	No Minimum	USD 50,000	USD 500,000
Maximum Unit Holders	No Maximum		
Regulatory Oversight	High	Medium	Low
Offer	General public	Private placement to professional clients[32]	Private placement to professional clients
Marketing	File prospectus with the regulator	Prospectus to contain mandatory statement[33]	Prospectus to contain mandatory statement[34]
Sponsor commitment	Not applicable		

28 The Ideal Location for Asset Management Firms, ADGM: https://www.adgm.com/asset-management#:~:text=A%20total%20number%20of%20funds,VC)%20and%20public%20equity%20focused.

29 The minimum capital requirement for a category 3C license is USD 250,000 however the actual figure shall be contingent on the projected annual expenditure.

30 https://www.adgm.com/documents/publications/en/adgm-investment-funds.pdf.

31 https://www.adgm.com/documents/publications/en/adgm-investment-funds.pdf.

32 The criteria to be classified as a professional client are specified under Rule 2.4.1 of Conduct of Business Rulebook: https://en.adgm.thomsonreuters.com/rulebook/conduct-business-rulebook-cobs-ver13301122.

33 Rule 9.5.3, ADGM Fund Rules.

34 Ibid.

In addition, there are both corporate and non-corporate forms of fund vehicles for fund managers to choose from in ADGM such as open / closed investment company, limited liability partnership, investment trust, or a protected / investment cell company. Further, the ADGM area also provides flexibility with respect to structuring wherein a fund may be structured as a SPV, restricted scope company, or a general partner SPV. Lastly, it is to be noted that FSRA permits both umbrella funds and master-feeder structures.

Nevertheless, it is to be noted that the UAE, including the ADGM, is currently is in the list of countries that are actively working with the FATF to address strategic deficiencies in their regimes to counter money laundering, terrorist financing, and proliferation financing, commonly known as the "FATF Grey List".[35]

It is to be noted that the marketing of domestic funds is subject to certain marketing restrictions including, without limitation, the provision of a prospectus (not required for a qualified investor fund), the contents of such prospectus should be prepared as per the applicable law, and the making of a mandatory statement.[36] In contrast, foreign funds should ensure, without limitation, that the units of such funds are offered to retail clients only if such offer is permitted in the fund's home jurisdiction, the current prospectus (in English and with adequate disclosures) of the fund is provided, and the fund manager (or the authorized person) has office present in ADGM.

In accordance with the UAE "**Economic Substance Regulations**", [37] fund managers operating out of ADGM are required to meet the economic substance requirements and submit the relevant reports / notifications to the Ministry of Finance electronically. In contrast, ADGM investment funds are exempt from the purview of meeting such economic substance unless they are self-managed. The test to determine whether economic substance is met is as follows:

i. the entity undertakes investment fund management, or any other core income generating activity (as defined in the Economic Substance Regulations), in UAE. It may be noted that such core income generating activities may be outsourced subject to certain terms and conditions;

ii. the investment fund management business is directed and managed in UAE. To meet the threshold of 'directed and managed' the fund manager should ensure that:

    a. the board of the fund management entity physically meeting in UAE and such board members physically present in UAE constitute the required quorum;

    b. the board meeting minutes and the records of the fund manager are kept within UAE;

    c. the directors have the necessary expertise and knowledge to discharge the duties of the board.

35 United Arab Emirates, FATF: https://www.fatf-gafi.org/en/countries/detail/%C3%89mirats%20arabes%20unis.html.

36 Rule 9 of the Fund Rules; available at: https://en.adgm.thomsonreuters.com/sites/default/files/net_file_store/ADGM1547_9602_VER08040723.pdf.

37 Cabinet of Ministers Resolution No. 57 of 2020; available at: https://www.adgm.com/documents/operating-in-adgm/ongoing-obligation/economic-substance/new_cabinet_resolution_no_57_of_2020_revoking_cabinet_resolution_no__31_of_2019.pdf.

Read with Ministerial Decision No. 100 of 2020; available at: https://adgm.com/documents/operating-in-adgm/ongoing-obligation/economic-substance/ministerial-decision-100-of-2020--esr-guidance-and-relevant-activities-guide-issued-19-august-2020-e.pdf.

iii. with respect to the investment fund management business, the fund manager should ensure the following:

a. an adequate number of qualified full-time employees are physically present in UAE. It may be noted that a specific number of employees is not mandated in consideration of the fact that different businesses would require a different number of employees depending on its size and relevant activity;

b. there is adequate operating incurred within UAE. For similar reasons as above, a specific threshold has not been mandated;

c. there are adequate physical assets in UAE.

Further, it is to be noted that the India-UAE DTAA provides that gains from alienation of shares in an Indian company may be taxed in India. The sale of debentures continues to enjoy tax benefits under the India-UAE DTAA. Further, the India-UAE DTAA provides for a lower withholding tax rate of 12.5% for interest income earned by UAE investors from India, which is lower than the tax rate applicable under the Indian treaties with Singapore (15%). India-UAE DTAA has also been notified as a CTA and therefore, the PPT will need to be satisfied for availing benefits of the India-UAE DTAA.

F. Dubai International Financial Centre

Since its establishment in 2006, the Dubai International Financial Centre (“**DIFC**”) has emerged as one among the top 10 international financial centers. This ascent has been on the tailwinds of years of stable existence, common law application, and its ability to act as a window into the MENASA region while tapping into the investor base spread across the Middle East.

The DIFC follows a similar fund regime as the ADGM wherein funds are divided into the categories of public fund, exempt fund, and qualified investor fund — with substantially similar characteristics as its counterparts in the ADGM. Likewise, fund managers in the DIFC are permitted to market the units of foreign funds provided that they are in compliance with the rules prescribed by the market regulator, which is the Dubai Financial Services Authority (“**DFSA**”).

In the DIFC, both the fund and the fund manager are regulated entities wherein a fund may be set up as a public fund, exempt fund, qualified investor fund, or a specialist fund (Sha’ria fund, Hedge fund, property fund etc.). It is to be noted that a person needs to be a licensed fund manager to manage a fund in the DIFC, to obtain such a DIFC license, the applicant is required to demonstrate that it has the capability to manage the proposed fund in addition to meeting certain eligibility requirements prescribed for the manager’s board / senior management. Further, the DIFC permits fund managers who are registered in an ‘acceptable jurisdiction’[38] to establish and manage a DIFC fund without registering themselves with the DFSA. However, such a foreign fund manager shall have to subject itself to DIFC laws and jurisdiction of DIFC Courts[39] and appoint a DFSA-licensed fund administrator / trustee to undertake certain key functions such as investor-relations and regulatory liaison.

38 FUNDS-in-the-DIFC-Sep-14-2014.pdf (dfsa.ae): https://www.dfsa.ae/application/files/4815/8220/1483/FUNDS-in-the-DIFC-Sep-14-2014.pdf.

39 DIFC Courts, available at: https://www.difccourts.ae/.

With respect to marketing of funds, the marketing of both DIFC and foreign funds are contingent on relevant disclosures in the prospectus. However, foreign funds also need to ensure that it meets one of the following criteria:

- It is regulated in a DFSA Recognized Jurisdiction or meets such alternative criteria as prescribed by the DFSA; or It is recommended to an investor in light of the investor's investment objectives and circumstances; or
- The fund has a maximum investor limit of 100 professional clients who adhere to the minimum subscription limit of USD 50,000. Further, the fund should not be marketed by way of public offer.

It is to be noted that only DFSA-licensed firms authorized to carry out the either (i) advising on financial products or credit; or (ii) arranging credit or deals in investment are permitted to market foreign funds in / from the DIFC.

G. GIFT City

Set-up with a view to onshore financial services transactions with an Indian nexus carried out by both overseas branches / subsidiaries of Indian financial institutions and overseas financial institution, the Gujarat International Finance Tec-City ("**GIFT City**" or "**GIFT**") has observed an uptick in the participation of businesses within its funds industry — especially with India-focused funds. As India's first international financial center, GIFT City aims to develop a world class smart city that becomes a global financial hub under the aegis of International Financial Services Authority ("**IFSCA**") viz. the end-to-end regulatory body in GIFT.

The IFSC is a single-window clearance body, i.e. to regulate all matters relating to GIFT in addition to several dispensations and incentives to businesses relocation to GIFT City. For instance, the ITA provides several incentives to units located in IFSC, *inter-alia* including 100% tax holiday on business income under Section 80LA, reduced minimum alternate tax, concessional withholding tax on interest income, exemption from capital gains tax on transfer of specified securities etc. In September 2020, the Taxation and Other Laws (Relaxation and Amendment of Certain Provisions) Act, 2020 provided certain tax incentives for Category-III AIFs located in the IFSC to encourage relocation of foreign funds to the IFSC. Further, from a foreign exchange perspective, any financial institution or branch of a financial institution set up in the IFSC is treated as a person resident outside India. A financial institution or branch of a financial institution is required to conduct business in foreign currency other than Indian Rupees (INR), whether with a resident or otherwise.

The investment funds framework in GIFT City is governed under the FM Regulations which classifies as the fund managers into three categories — Authorised FME, Registered FME (non-retail), and Registered FME (non-retail). Based on the category under which the FME is registered, the FM Regulations further provide three categories of scheme that can be launched by the respective FME as per the proposed investment objective and strategy. The schemes that may be launched by a FME are venture capital scheme, restricted scheme (non-retail), and restricted scheme (retail) with increasing regulatory oversight in the order provided.

Accordingly, with the introduction of the FM Regulations, the regulatory regime for funds in GIFT City has completely changed from the SEBI regulatory regime which is being followed in India. In this regard, we have summarized the changes in the way GIFT Fund and Domestic AIFs are regulated below:

SN	Particulars	GIFT Funds	Domestic AIFs
1	**Regulations**	FM Regulations	AIF Regulations
2	**Regulated Entity**	Manager entity is registered and regulated by IFSCA	The Fund is registered with SEBI
3	**Leverage**	Permitted to engage in leverage activities	Not allowed to engage in leverage
4	**Diversification**	Not applicable	Category I and II AIFs are prohibited from investing more than 25% in a single company whereas a category III AIF may not invest more than 10% of its investable funds in a single portfolio company
5	**Overseas Investments**	Freely permitted invest outside India	Subject to SEBI approval and an industry-wide limit of USD 1500 million
6	**Segregated Portfolio**	Permitted	Not permitted
7	**Key Person Requirements**	Have to meet the prescribed professional and experience criteria	

Structural Alternatives for India-Focused Funds

I. Structuring India Focused Offshore Funds

PE and VC funds typically adopt one of the following modes when investing into India: (1) direct investment in the Indian portfolio company; (2) direct or indirect investment in an Indian investment fund vehicle; or (3) co-investment along-side the domestic fund vehicle directly in the Indian portfolio company: and (4) investment through an AIF set-up in IFSC. We explore all models in the brief below.

II. Foreign Investment Regime

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

The RBI is given primary authority to regulate capital flows through the FEMA. With the promulgation of Finance Act 2015, the power to classify and regulate permissible capital account transactions involving non-debt instruments was transferred to the Central Government whereas debt instruments remained with the RBI. This re-allocation of powers was implemented when on October 17, 2019, the Central Government notified the NDI Rules repealing TISPRO Regulations.

The primary routes for foreign investment into India are the (a) FDI[1] route, (b) FVCI[2] route, and (c) FPI[3] route.

A. Pure Offshore Structure

A pure offshore structure is typically used for investing primarily into India where there is no intent to pool capital at the domestic (i.e. India) level and the entire portion of the GP economics is intended to be extracted overseas, without any Indian beneficiaries. The Offshore Fund manager, to the extent that it intends to make investments into India, may engage an India based advisory team to provide non-binding investment advice pertaining to suitable India opportunities.

1 This refers to investment through capital instruments by a person resident outside India in an unlisted Indian company; or in 10%or more of the post issue paid-up equity capital on a fully diluted basis of a listed Indian company. While the RBI allows capital account transactions, these are subject to the NDI Rules. Thus, 'direct' investments by the offshore fund vehicles / SPVs (SPV would need to comply with the provisions and restrictions stipulated under the NDI Rules.

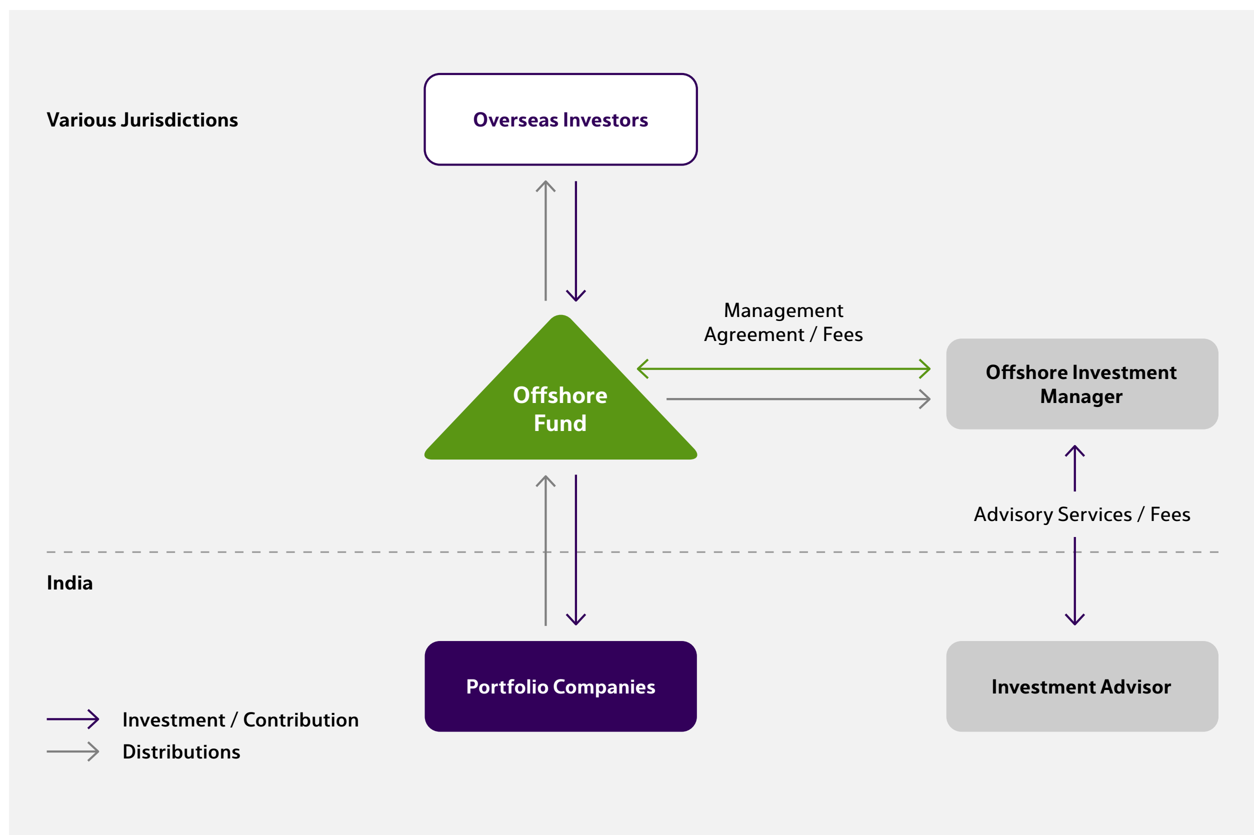
2 Given that the FVCI regime has been developed to attract venture capitalists, there are certain incentives attached to being recognised as one. This accordingly requires registration and approval from the regulators (SEBI and RBI). While granting approval to an FVCI, certain restrictions and conditions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

3 The FPI Regulations, 2014 classified FPIs into three categories based on their perceived risk profile. The FPI route as such is the preferred route for foreign investors who want to make portfolio investments and trade in Indian listed stocks on the floor of the stock exchange.

Under this structure, a pooling vehicle (Offshore Fund) is set up in an offshore jurisdiction. Offshore investors commit capital to the Offshore Fund which in turn makes investments into Indian portfolio companies (under one or more of the inbound investment regimes mentioned above) as and when investment opportunities arise.

A pure offshore structure may also be used for strategies with a diversified geographical coverage, where India may be one of the pockets. In such structures, depending on certain variables, Indian resident individuals may also allocate commitments into the Offshore Fund.

The following diagram depicts a pure offshore structure:

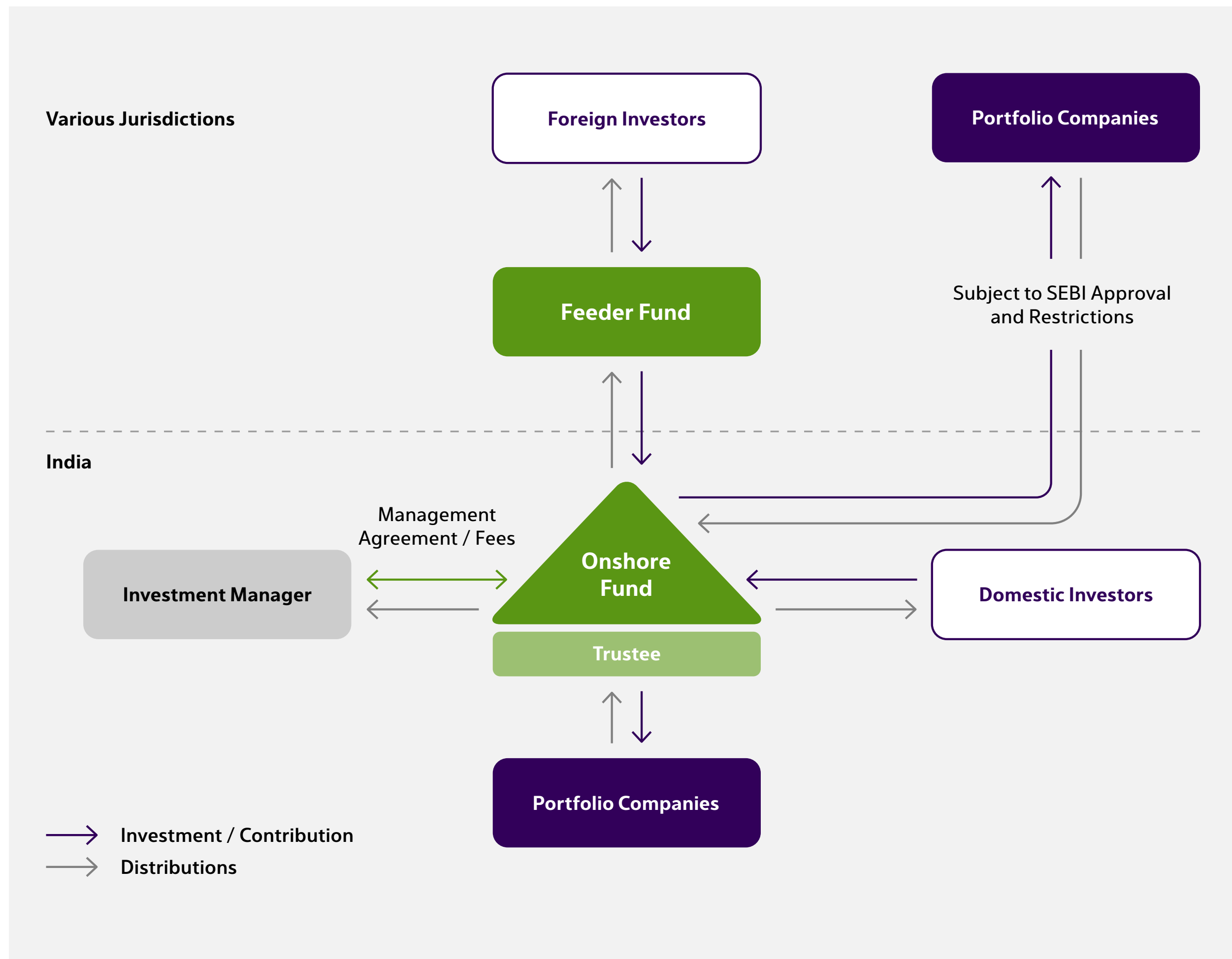


B. Unified Investment Structure

Under this structure, an AIF set up as a trust or limited liability partnership (“**LLP**”) or company (i.e., the (“**Onshore Fund**”) is formed in India. The domestic investors directly contribute to the Onshore Fund whereas overseas investors pool their monies in an offshore feeder vehicle (“**Feeder**”) which, in turn, invests primarily in the Onshore Fund. The Onshore Fund is registered with SEBI under the AIF Regulations.

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

The following diagram depicts a typical unified investment structure:



Favorable Reasons for a Unified Structure

a. **Non-applicability of foreign investment restrictions:** Under the unified structure, investments made by the Onshore Fund into Indian portfolio companies with the capital contributions received from the Feeder or any other foreign investors is not subject to any FDI related restrictions, if the manager and sponsor of the Onshore Fund are India Owned and Controlled[4], [5]. Therefore, the restrictions placed on foreign investments such as FDI Policy related restrictions including (a) sector specific caps (b) choice in instruments being limited to equity shares, fully, compulsorily convertible debentures and fully, compulsorily and mandatorily convertible preference (c) optionality clauses being subject to conditions (d) pricing guidelines, etc. shall not be applicable to the investments made in India through the unified platform (which would have been otherwise applicable in respect of investments directly made by the Feeder in Indian opportunities).

4 The sponsor / investment manager may be deemed to be foreign owned and controlled if (i) more than 50% of its ownership is held by persons not resident in India or foreign citizens / entities or (ii) if it controlled by a foreign entity.

For the above definition, 'control' shall include the right to appoint majority of the directors or to control the management or policy decisions exercisable by a person or persons acting individually or in concert, directly or indirectly, including by virtue of their shareholding or management rights or shareholders agreements or voting agreements or in any other manner.

5 The sponsor / investment manager may be deemed to be Indian owned and controlled if (i) more than 50% of its ownership is held by Indian entities / individual(s) and (ii) if it controlled (as defined above) by an Indian entity / individual(s).

b. **Consolidation of corpus:** A unified structure allows aggregation of assets-under-management across both the Feeder and Onshore Fund level. A larger corpus at the Onshore Fund level will help tap more capital from those LPs whose commitments are linked to the corpus of the Onshore Fund and allow the manager to evaluate larger deals as the portfolio concentration requirements can be met using the larger aggregate pool at the Onshore Fund level. In this regard, it is important to understand the differences between pooling offshore investors directly into the Onshore Fund versus a unified structure. There is a consolidation of corpus in both the cases, however, there are other reasons for pooling offshore investors in an offshore vehicle (i.e. unified structure) which are summarized below:

   i) In case of investment by offshore investors in the Onshore Fund, each offshore investor may be required to obtain a PAN from Indian income tax authorities and file income tax returns in India;

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

c. **Tax pass-through and DTAA eligibility:** Category I and Category II AIFs have been accorded tax pass through status under the ITA, i.e. the income received by a unit-holder through the Onshore Fund will be chargeable to income-tax in the same manner as if it were the income arising to such unit-holder directly from the Indian investments by the unit-holder.[6] Accordingly, the tax liabilities of the Feeder should remain the same (as would be for direct investments) under the unified structure. The protocols to the India-Mauritius DTAA and India-Singapore DTAA give India the right to tax capital gains arising from the transfer of equity shares. Despite the changes introduced by the protocols, Mauritius and Singapore continue to be favorable jurisdictions from a tax perspective with respect to non-equity investments as Mauritius and Singapore would continue to have the right to tax capital gains arising from the transfer of such investments. Further, the lower withholding tax rate of 7.5 % introduced by the Protocol on interest income earned by Mauritius resident from Indian companies provides Mauritius a competitive advantage for debt investments in India as compared to other jurisdictions.

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

   With amendments brought about by the Finance Act, 2015 (the "**2015 Act**") in relation to the criteria for determining the tax residence of companies incorporated outside India, a foreign company should not be a tax resident of India in a particular financial year if the company's POEM in that financial year is not located in India. POEM has been defined to mean "a place where key management and commercial decisions that are necessary for the conduct of the business of an entity as a whole are, in substance, made". The provisions in relation to POEM are applicable from the financial year 2016–17.

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

C. Co-investment / Parallel Investment Structure

A co-investment structure is adopted where the commercial expectation is to raise separate pools of capital for domestic investors and for offshore investors as well as to extract carry outside India.

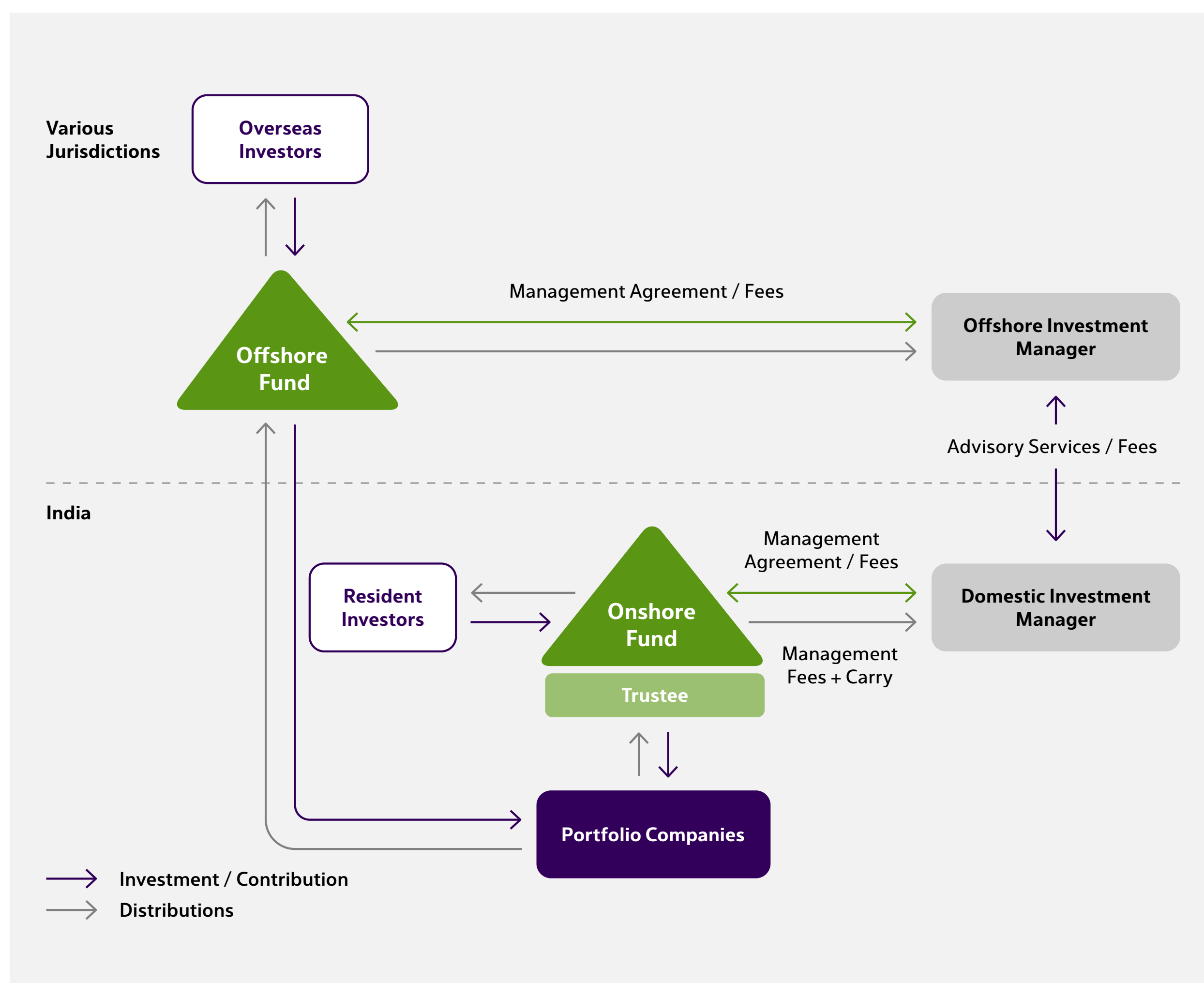
6 S. 115UB read with s. 10(23FBA), s. 10(23FBB) and s. 194LBB of the ITA.

Accordingly, separate pooling vehicles will need to be set up in India (i.e. Onshore Fund) and in an offshore jurisdiction (Offshore Fund). The Offshore Fund and the Onshore Fund typically have separate management structures. The Onshore Fund is managed by an India-based investment manager which entity may provide recommendations on investment opportunities to the management of the Offshore Fund on a non-binding basis. Typically, the co-investment ratio between the Offshore Fund and the Onshore Fund is the ratio of their undrawn capital commitments.

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

Certain tax risks exist in such structures as there is a possibility of the Onshore Fund and the Offshore Fund being taxed together in India as an 'association of persons' ("**AOP**") and thus, suffer disproportionately higher tax rates. However, the Indian tax authorities have so far not challenged any co-investment structures on such grounds. Further, due to the CESTAT ruling upholding levy of service tax on carried interest, there is an increased interest in exploring co-investment structures as significant amount of carried interest can be extracted outside India depending upon commercial considerations.

The following diagram depicts a typical co-investment structure:



D. AIF Established in IFSC

The GoI is encouraging investments through IFSC with the objective of *inter-alia* onshoring the fund management industry to India. Prior to the establishment of IFSCA in 2020, SEBI had introduced operating guidelines for setting up AIFs in IFSC in 2015 and 2018, which were amended up to August 2020. While section 18 of the Special Economic Zone, Act, 2005 originally allowed SEBI to prescribe guidelines for units in IFSCs, the IFSCA Act, 2019 (through section 13 read with section 33) amends the SEBI Act, 1992 and the Securities Contract (Regulation) Act, 1956 ("**SCRA**") to take away the power of SEBI under section 18 of the SEZ Act, 2005. Section(s) 13 and 33 of IFSCA Act, 2019 came into force on October 01, 2020. However, the aforementioned guidelines continued to be the applicable law as IFSCA had not notified any regulations to supersede the same.

Accordingly, the AIF Regulations except all amendments made by SEBI to the AIF Regulations after October 01, 2020 were applicable to AIFs in IFSC. The status quo was shifted with the introduction of the FM Regulations which rendered the AIF Regulations (and the abovementioned SEBI guidelines) inapplicable in IFSC from its effective date (i.e. May 19, 2022).

The recently introduced FM Regulations streamline the regulatory framework around management of pooling vehicles (as financial products) such as venture capital schemes and other alternative investment funds in IFSC such that the manager operating such products is required to obtain registration with IFSCA rather than registering the financial products each time. Once an AIF manager is registered with IFSCA, it is permitted to launch a fund within 21 days of filing the private placement memorandum ("**PPM**") of the fund with IFSCA (and incorporating all observations of IFSCA received pursuant to such filing), or even through a green channel without having to wait for IFSCA's comments in case it is a fund with only accredited investors[7] or a venture capital scheme.

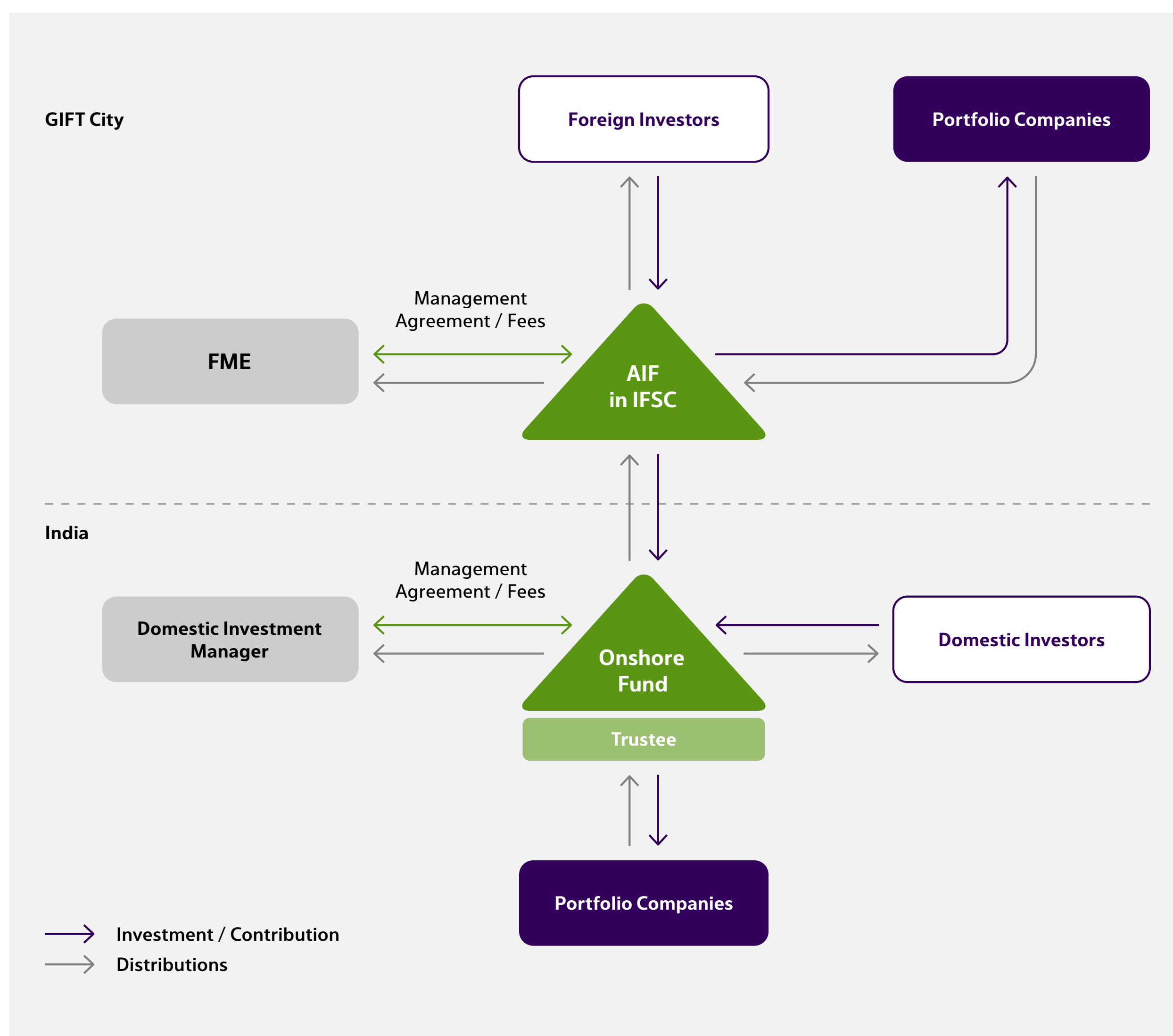
Several benefits have also been provided to AIFs in IFSC. These benefits *inter-alia* include exemption from GST on management fees, permission to borrow funds or engage in leveraging activities subject to fulfillment of certain conditions and co-investment in a portfolio company through a segregated portfolio.

Further, certain amendments have also been made to the regulatory and taxation framework to facilitate relocation of offshore funds to GIFT City. For instance, the requirement of continuing interest by the manager or sponsor has been made voluntary in case of relocation of offshore funds to IFSC, tax neutrality has been provided to such relocation etc.

A Category-I/ II AIF regulated under the FM Regulation has also been granted a tax pass-through status. It is to be noted that several nuances are involved in structuring of investment through AIFs in IFSC as they are considered as persons resident outside India from foreign exchange perspective, while being considered to be resident of India for tax purposes.

7 The criteria for qualifying as an accredited investor has been provided under Annexure 8 of Master Circular for AIFs (SEBI/HO/AFD/PoD1/P/CIR/2023/130) dated July 31, 2023.

The following diagram represents a typical structure of an AIF in IFSC (unified structure):



It is to be noted that the FME, as provided in the above diagram, may be structured as an LLP or a company or may be a branch / subsidiary of an existing India manager.

III. New Overseas Investment Rules

The GoI, along with the RBI, has released the **OI Rules**, the ((OI Regulations, and ((OI Directions (collectively the OI Rules, OI Regulations and the OI Directions read as the "**OI Framework**") in an attempt to streamline the foreign exchange regime in India.

The OI Framework has defined OPI in the negative as to include investments that do not qualify as ODI. Therefore, OPI should include investment of less than 10% in equity capital of listed foreign entity without control. Further, the OI Rules have provided clarity on round-tripping concerns by permitting overseas investment by resident Indians, subject to certain conditions, into the IFSC.

As compared to the erstwhile regime wherein only Indian entities registered with the relevant regulatory authority were permitted to make ODI under approval route, presently, Indian entities regulated by a financial services regulator is permitted to make ODI under the automatic route. In this regard, it can be noted that AIF managers are merely regulated by SEBI and not registered with SEBI under the AIF Regulations.

Under the present regime an Indian entity undertaking financial service activities would be required to, *inter-alia*, obtain approvals from the Indian and overseas regulator when investing into entities that are engaged in financial services and aren't located in the IFSC ("**NOC**"). Additionally, a non-financial service Indian entity would be required to have net profits for previous three financial years to invest into a non-IFSC foreign entity engaged in financial services (other than banking and insurance companies) ("**Profitability Criteria**"). In this regard, certain dispensation have been made available for ODI into IFSC entities, viz:

a. The approval / NOC is deemed to be given for an investment by an Indian entity engaged in financial services activity into IFSC if the NOC is not decided within a period of 45 days from date of application;

b. The Profitability Criteria is not applicable for Indian entities not engaged in financial services activity making investments into IFSC entities that are not engaged in banking or insurance activity.

The NOC has imbued much needed time efficiencies into the Indian ecosystem especially in respect of the Indian fund managers who had to wait for both SEBI and IFSCA NOCs before remitting funds to their IFSC manager entity. Nevertheless, a relaxation of three year profitability criteria is currently needed to ensure that the Indian funds ecosystem is supportive of emerging fund managers. As it stands, emerging GPs often do not have a three year track record. This further increases the attractiveness of IFSC for Indian GPs looking to set up offshore funds as compared to foreign jurisdictions such as Mauritius or Singapore for which the Profitability Criteria must be met. For example, a family office in India (which is an Indian entity) can now remit funds to the IFSC in order to set up a Family Investment Fund under the FM Regulations and such family office would not need to meet the Profitability Criteria.

Liberalised Remittance Scheme

RBI updated its master directions on Liberalized Remittance Scheme ("**LRS**") pursuant to the promulgation of the OI Framework. Presently, subject to the OI Framework, the LRS permits Indian residents to undertake (ODI and (OPI as permissible capital account transactions.

The OI Framework defines ODI as any investment in an unlisted foreign entity, irrespective of the shareholding or whether such acquisition is coupled with control over the foreign entity. Investments of less than 10% (without control) in an unlisted foreign entity, which might have earlier fallen under the head of OPI, would now be categorized as ODI. Further, resident Indian individuals are not permitted to make ODI in a financial services entity outside India, except where such foreign entity is situated in IFSC and subject to certain conditions. Having said that, Indian individuals can make OPI in an investment fund duly regulated by the financial sector regulator in the host jurisdiction. The issue that arises in this regard is that in certain jurisdictions, it is the fund manager that is regulated and not the fund.

The above restriction may raise issues for General Partnerships (“**GPs**”) with funds that are not required to be registered or regulated in their home jurisdictions and seek to pool in money from Indian resident individuals.

The issue is heightened for existing funds that have already secured commitments from Indian residents. However, in a situation wherein there is a comfort that a foreign fund is ‘duly regulated,’ then a view may be taken that resident individuals may make OPI investments into such funds. A similar view may also be taken in the context of carry structures where GPs may be able to make OPI into a regulated offshore fund; however, it may not be possible to structure such carry through the investment manager anymore.

Interestingly, under the new OI framework, Indian resident individuals, and listed / unlisted Indian entities may make investments into IFSC funds under the OPI route.

Alternative Investment Funds in India

I. Introduction

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

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

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

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

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

II. Alternative Investment Funds

Subject to certain exceptions, the ambit of the AIF Regulations is to regulate all forms of vehicles set up in India for pooling of funds on a private placement basis. To that extent, the AIF Regulations read with the master circular for AIFs ("**AIF Master Circular**")[1] provide the bulwark within which the Indian fund industry is to operate.

1 Master circular for AIFs, SEBI circular SEBI/HO/AFD/PoD1/P/CIR/2023/130 dated July 31, 2023.

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

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

b. is not covered under the Securities and Exchange Board of India (Mutual Funds) Regulations, 1996, Securities and Exchange Board of India (Collective Investment Schemes) Regulations, 1999 or any other regulations of the Board to regulate fund management activities.[2]

III. Choice of Pooling Vehicle

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

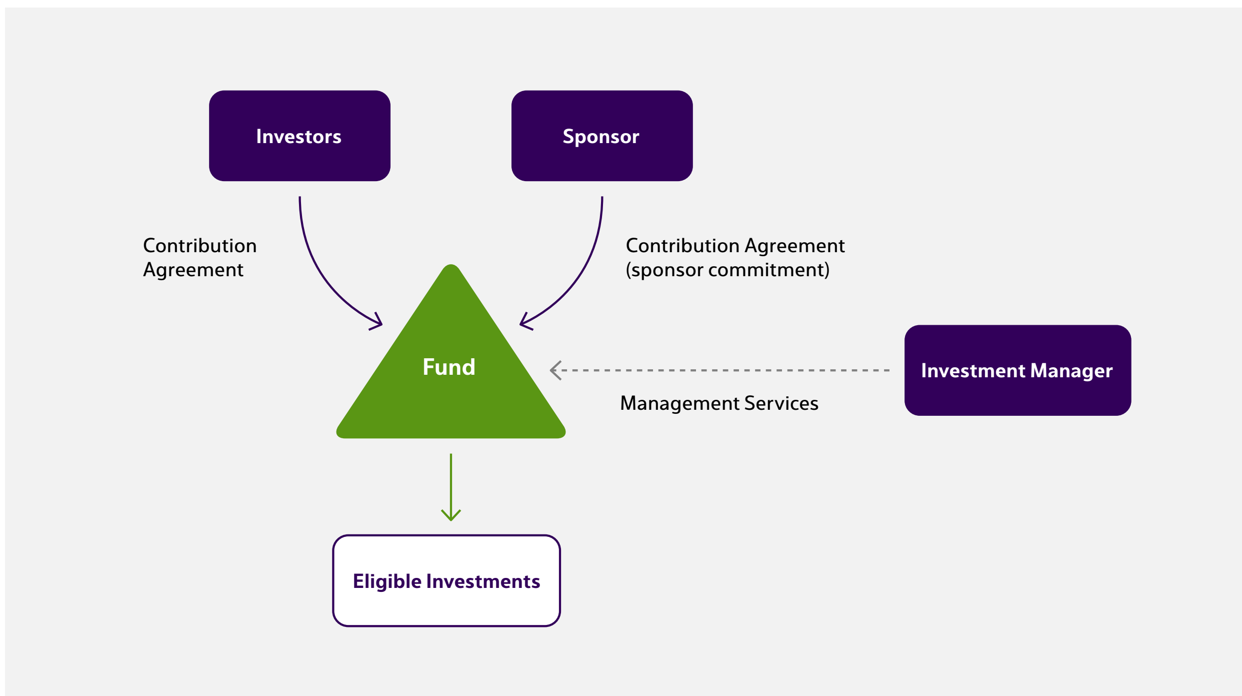
Issue	Trust	Limited Liability Partnership	Company
General	The person who reposes or declares the confidence is called the "author of the trust";[3] the person who accepts the confidence is called the "trustee"; the person for whose benefit the confidence is accepted is called the "beneficiary"; the subject matter of the trust is called "trust property"; the "beneficial interest" or "interest" of the beneficiary is the right against the trustee as owner of the trust property; and the instrument, if any, by which the trust is declared is called the "instrument of trust"/ "indenture of trust"	An LLP is a hybrid form of a corporate entity, which combines features of an existing partnership firm and a limited liability company (i.e. the benefits of limited liability for partners with flexibility to organize internal management based on mutual agreement amongst the partners). The functioning of an LLP is governed by the LLP agreement. LLP are registered under the Limited Liability Act, 2008	A Company can be incorporated under the Companies Act, 2013. The control of the company is with board of directors who are elected by the shareholders. Separate classes of securities could be issued to different shareholders that shall determine their rights and obligations (as distinct from other classes) from both, the 'voting' perspective as well as from a 'distribution' perspective. The class structure, however, would need to be in compliance with Companies Act, 2013, as and when all relevant sections thereof are brought into effect.
Entities Involved	The Settlor: The Settlor settles a trust with an initial settlement. Terms of the indenture of trust ("**Indenture**") shall administer the functioning of the trust ("**Trust**"). The Trustee: The Trustee is in charge of the overall administration of the Trust and may be entitled to a trusteeship fee.	**Partner**: A 'partner' represents an investor in the fund. To that extent, a partner has an obligation to fund its 'commitment' to the fund and is entitled to distributions based on fund documents (being the LLP Agreement in this case). As per section 5 of the LLP Act, 2008, only an individual or a body corporate is eligible to be a partner in an LLP.	**Shareholders**: Shareholders hold the shares of the company and are granted special privileges depending on the class of shares they own **Directors**: Directors have a fiduciary duty towards the company with respect to the powers conferred on them by the Companies Act, 2013 and by the Memorandum of Association and Articles of Association of the company.

2 SEBI (AIF) Regulations, 2012, Section 2 (1)(b).

3 Commonly referred to as a 'settlor'

	The Trustee may also appoint an investment manager, who in turn manages the assets of the Trust and the schemes / funds as may be launched under such Trust from time to time. The Contributor: The contributor is the investor to the Trust (the Fund) and makes a capital commitment under a contribution agreement.	**Designated Partner**: Though the expression 'designated partner' is not explicitly defined, however, on a plain reading of the LLP it is understood that such 'designated partner shall be the person responsible and liable in respect of the compliances stipulated for the LLP.	They are trustees in respect of powers of the company that are conferred upon them, for instance, powers of (a) issuing and allotting shares; (b) approving transfers of shares; (c) making calls on shares; and (d) forfeiting shares for non-payment of call etc. They must act bona fide and exercise these powers solely for the benefit of the company.
Management of entities	The Trustee is responsible for the overall management of the Trust. In practice this responsibility is outsourced to an investment manager pursuant to an investment management agreement.	The LLP relies on the Designated Partner in this respect. In practice, this responsibility may be outsourced to an investment manager pursuant to an investment management agreement.	The board of directors manages the company involved. In practice this responsibility is outsourced to an investment manager pursuant to an investment management agreement.
Market Practice	Almost all funds formed in India use this structure. The regulatory framework governing trust structures is stable and allows the management to write its own standard of governance.	Only a few funds are registered under this structure. The Registrar of Companies ("**RoC**") does not favor providing approvals to investment LLPs.	There are no clear precedents for raising funds in a 'company' format.

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



IV. Classification of AIFs

Category I AIF	Category II AIF	Category III AIF	Specified Funds
Category I AIFs are funds with strategies to invest in start-up or early stage ventures or social ventures or SMEs or infrastructure or other sectors or areas which the government or regulators consider as socially or economically desirable. Under the AIF Regulations, the following funds are designated as sub-categories of Category I AIFs – venture capital funds, SME funds, social impact funds, infrastructure funds and such other AIFs as may be specified. In September 2013, SEBI introduced 'angel investment funds' as a sub-class of the venture capital fund sub-category. Recently, SEBI has added Special Situation Funds ("**SSFs**") as a new sub-category under Category I AIFs.[4] that invest in 'special situation assets',[5] in accordance with its investment objectives and such SSF may act as a 'resolution applicant' under IBC. Category I AIFs are generally perceived to have positive spillover effects on the economy and therefore, SEBI, the GoI or other regulators may consider providing incentives	Category II AIFs are funds which cannot be categorized as Category I AIFs or Category III AIFs. These funds do not undertake leverage or borrowing other than to meet day-to-day operational requirements and as permitted in the AIF Regulations. AIFs such as private equity funds or debt funds for which no specific incentives or concessions are given by the GoI or any other regulator are included in the Category II AIF classification.	Category III AIFs are funds which employ complex or diverse trading strategies and may employ leverage including through investment in listed or unlisted derivatives and units of other AIFs. AIFs such as hedge funds or funds which trade with a view to make short-term returns or such other funds which are open ended and for which no specific incentives or concessions are given by the Government of India or any other regulator are included in the Category III AIF classification.	SEBI has recently introduced a Corporate Debt Market Development Fund as a specific fund not falling under the aforementioned categories. The Corporate Debt Market Development Fund has been established by the market regulator with the express purpose of making investments into eligible corporate debt securities from specified debt-oriented schemes of mutual funds during periods of market dislocation.[6]

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

4 SEBI (Alternative Investment Funds) (Amendment) Regulations 2022 ("Amendment Regulations"), as further supplemented by a circular dated January 27, 2022.

5 Special situation assets include (i) stressed loans available for acquisition in terms of Reserve Bank of India (Transfer of Loan Exposures) Directions, 2021 ("Transfer Directions") or as part of a resolution plan approved under IBC; (ii) Security receipts issued by ARCs; (iii) Securities of investee companies (a) whose stressed loans available for acquisition in terms of Reserve Bank of India (Transfer of Loan Exposures) Directions, 2021 Transfer Directions or as part of a resolution plan approved under IBC; (b) against whose borrowings, security receipts have been issued by an ARC; (c) whose borrowings are subject to corporate insolvency resolution process under Chapter II of IBC; (d) who have disclosed all the defaults relating to the payment of interest/ repayment of principal amount on loans from banks / financial institutions; and (iv)Any other asset/security as may be prescribed by SEBI from time to time.

6 Vide the SEBI (AIF) (Second Amendment) Regulations, 2023.

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

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

   Co-investment in an investee company by a manager or sponsor or a co-investor should not be on more favourable terms than those offered to the AIF and the terms of exit from the Co-investment in an investee company including the timing of exit shall be identical to the terms applicable to that of exit of the AIF.[7] Further, the AIF Regulations require that the any co-investment opportunity offered to the investors of the AIF shall be facilitated through a Co-investment Portfolio Manager as specified under the Securities and Exchange Board of India (Portfolio Managers) Regulations, 2020 ("**PMS Regulations**"). In other words, the Manager will be required to apply for registration with SEBI as a Co-investment Portfolio Manager.

b. Only a specific percentage of the investable funds (25% for Category I and II AIFs and 10% for Category III AIFs[8]) can be invested in a single investee company. For a Category I or Category II AIF, the sponsor or the manager is required to have a continuing interest of 2.5% of the corpus of the fund or INR 50 million whichever is lower and in the case of a Category III AIF, a continuing interest of 5% of the corpus or INR 100 million whichever is lower. The following is the list of general investment conditions applicable to all AIFs:

   i. AIFs are not permitted to invest in associates or units of AIF managed or sponsored by its manager, sponsor or associates of its manager of sponsor without the approval of 75% of investors by value of their investments in the AIF;[9] and

   ii. The un-invested portion of the investable funds and divestment proceeds of the AIF pending distribution to unit holders may be invested in liquid mutual funds or bank deposits or other liquid assets of higher quality such as Treasury bills, Triparty Repo Dealing and Settlement, Commercial Papers, Certificates of Deposits, etc.

V. Key Investment Conditions and Restrictions for AIFs

A. Continuing Interest

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

7 The proviso is applicable for co-investment made from 08-12-2021.

8 It is to be noted that large value funds for accredited investors (Category I / II) may invest up to 50% in a single investee company whereas a Category III large value fund for accredited investors may invest up to 25% in a single investee company.

9 SEBI | Securities and Exchange Board of India (Alternative Investment Funds) (Second Amendment) Regulations, 2021: https://www.sebi.gov.in/legal/regulations/may-2021/securities-and-exchange-board-of-india-alternative-investment-funds-second-amendment-regulations-2021_50089.html

INR 5 million whichever is lower. Further, the sponsor or the manager (as the case may be) is required to disclose its investment in an AIF to the investors of the AIF.

It is interesting to note that, for an AIF set up in GIFT City, unlike the AIF Regulations, the 'skin-in-the-game' (or FME contribution) requirement under the FM Regulations for venture capital schemes and restricted schemes (including Special Situation Funds) depends on the target corpus ("**TC**") of the scheme, and is capped as depicted below.

	TC < USD 30 million	TC >= USD 30 million
Close-ended	2.5% of TC up to 10% of TC	USD 750,000 up to 10% of TC
Open-ended	5% of TC up to 10% of TC	USD 1,500,000 up to 10% of TC

The TC of a scheme is estimated by the GP in its PPM and other offering documents. The exact raising of the entire TC cannot be guaranteed due to both internal (first time GP, no track record) and external (macro-economic issues, global pandemic, political upheaval) factors which may only be estimated. Accordingly, this provision creates a large scope for confusion among industry participants.

B. Minimum Corpus and Investment

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

The AIF Regulations do not permit an AIF to accept an investment of less than INR 10 million ("**Minimum Investment Amount**") from any investor unless such investor is an employee or a director of the AIF or an employee or director of the manager of the AIF in which case the AIF can accept investments of a minimum value of INR 2.5 million. However, such requirement of Minimum Investment Amount is not applicable for Accredited Investors investing in any AIFs. The AIF Master Circular has specifically clarified that in case of an open-ended AIF, the first lump-sum investment received from an investor should not be less than the Minimum Investment Amount.[10] Further, in case of partial redemption of units by an investor in an open-ended AIF, the amount of investment retained by the investor should not fall below the Minimum Investment Amount.[11]

10 CIR/IMD/DF/14/2014.

11 Id.

C. Qualified Investors

The AIF Regulations permit an AIF to raise funds from any investor whether Indian, foreign or non-resident through the issue of units of the AIF. An AIF may accept the following as joint investors for the purpose of investment of not less than one crore rupees:[12]

i. an investor and his/her spouse

ii. an investor and his/her parent

iii. an investor and his/her daughter/son

With respect to the above investors, not more than 2 persons shall act as joint-investors in an AIF. In case of any other investors acting as joint investors, for every investor, the minimum investment amount of INR 10 Million shall apply. Joint investors shall mean where each of the investor contributes towards the AIF.

D. Accredited Investors

SEBI has notified the SEBI (Alternative Investment Funds) (Third Amendment) Regulations, 2021 on August 03, 2021. The amendment introduced the criteria for certain investors in an AIF to be identified as Accredited Investors. A deemed status of being an Accredited Investor is provided to (i) Central and State Governments; (ii) any developmental agencies set up under the aegis of the Central and State Governments; (iii) any funds set up by the Central Government or the State Governments; (iv) qualified institutional buyers4; (v) Category I Foreign Portfolio Investors; (vi) sovereign wealth funds; and (vii) multilateral agencies and any other entity as may be specified by SEBI. Since these entities are deemed to be Accredited Investors, it is not incumbent on them to obtain any certification of accreditation from an Accreditation Agency.

E. Maximum Number of Investors

The AIF Regulations caps the maximum number of investors for an AIF (other than for angel funds) at 1,000. In case of AIFs setup in IFSC, the FM Regulations provide for a maximum of (i) 50 investors for a venture capital scheme; and (ii) 1000 investors for a restricted scheme.

F. Tenure

While Category I and Category II AIFs can only be closed-end funds (which, according to SEBI, indicates that their tenure needs to be ascertained upfront), Category III AIFs can be open-ended. The AIF Regulations prescribe a minimum tenure of 3 years for Category I and Category II AIFs. SEBI vide the AIF Master Circular, clarified that the tenure of any scheme of the AIF shall be calculated from the date of declaration of the first closing of the scheme. Further, the tenure of any AIF can be extended only with the approval of 2/3rd of the unitholders by value of their investment in the AIF.

12 Circular no. CIR/IMD/DF/14/2014 dated June 19, 2014.

The SEBI (Alternative Investment Funds) (Third Amendment Regulations) ("**SEBI AIF (Third Amendment) Regulations, 2021**") allow AI Funds to extend the tenure beyond two years subject to the terms of the contribution agreement, other fund documents and conditions specified by SEBI from time to time.

G. Diversification Requirements

Category I / II AIFs are not allowed to invest more than 25% of the investable funds in a portfolio company directly or through units of other AIFs. However, Category I / II LVFs for AIs are permitted to invest up to 50% of its investable corpus on a portfolio company directly or through units of other AIFs.

Further, Category III AIFs are not allowed to invest more than 10% of the investable funds in a portfolio company directly or through units of other AIFs. Similarly, category III LVFs for AIs are permitted to, directly or indirectly, invest up to 25% of its investable funds in a single portfolio company.

H. Permissible / Eligible Investments

Investments from / to Associates

Via the Second Amendment (as defined below), SEBI has now mandated investment managers to obtain the consent of 75% of investors by value of their investment in the AIF when buying / selling investments, from / to (a) associates;[13] (b) AIFs / schemes that are managed / sponsored by the investment manager or the sponsor; or (c) an investor who has contributed a minimum of 50% of the concerned scheme's / AIF's corpus.

It is to be noted that investors holding 50% of the scheme's / AIF's corpus may not vote for approving such conflicted transactions. With respect to availing services of associates, disclosure to investors regarding the fee being paid to associates has been mandated.

Investing in Other AIFs

It is to be noted that AIFs seek to invest in units of other AIFs ought to have a covenant in this regard in their PPM.[14] Further, AIFs which have been authorized to invest in units of other AIFs by their fund documents are not permitted to offer their units to other AIFs for subscription.[15]

This prohibition has been put in place by the regulator so as to ensure that AIF diversification norms are not breached and as the regulator can thoroughly monitor the AIF landscape to ensure investor protection.

13 As per AIF Regulations, associate means a company or a limited liability partnership or a body corporate in which a director or trustee or partner or Sponsor or Manager of the AIF or a director or partner of the Manager or Sponsor holds, either individually or collectively, more than 15% of its paid-up equity share capital or partnership interest, as the case may be.

14 Regulation 11(2) of the AIF Regulations.

15 Regulation 15 (1)(da) of the AIF Regulations.

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Temporary Investments

The AIF Regulations permits Investment Managers to invest the un-invested portion of investable funds and divestment proceeds (pending distribution) in liquid assets such as Treasury bills, Triparty Repo Dealing, bank deposits, Commercial Papers, and Certificates of Deposits. However, it is to be noted that the same is limited till (i) the un-invested funds are to be deployed as per the AIF's investment objective or (ii) the divestment proceeds are due distribution as per the AIF's distribution waterfall.

Additionally, it may be noted that Temporary investment proceeds and restructuring proceeds are typically expected by investors to be kept outside the waterfall / hurdle calculation and distributed only to LPs in their inter-se ratio of holdings.

Investments from Regulated Entities

The RBI has directed banks and NBFCs to not make investments in any AIFs that has downstream investments either directly or indirectly in a debtor company of the bank. The notification[16] aims to address concerns relating to possible evergreening through this route. The move is also expected to impact the fund flows to AIFs. The debtor company for this purpose mean any company to which the Regulated Entities (RE) currently has or previously had a loan or investment exposure anytime during the preceding 12 months. The notice also states that if a Bank / NBFC is already invested in an AIF which makes a downstream investment in any such debtor company, then the bank shall liquidate its investment in the AIF within 30 days from the date of such downstream investment by the AIF or the 30-day from date of issuance of the notification, as applicable.

I. Specific Restrictions on Different Categories of AIFs

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

Category I AIFs	i. Category I AIFs shall invest in investee companies or venture capital undertakings or in special purpose vehicles or in limited liability partnerships or in units of other AIFs specified in the Regulations. ii. A Category I AIF can simultaneously invest in investee companies as well as the units of other AIFs provided the information about such combination of strategies is conspicuously disclosed in the PPM of the investing AIF and the with the prior consent of at least two-third of the total unitholders of such AIF by value. iii. Category I AIFs shall not borrow funds directly or indirectly or engage in leverage except for meeting temporary funding requirements for more than thirty days, on not more than four occasions in a year and not more than 10% of its investable funds. iv. Category I AIFs shall invest not more than 25% of the investable funds in an investee company directly or through investment in the units of other AIFs, provided that, AI Funds of Category I and II, may invest up to 50% of its investable funds in an investee company. Further, SSFs are permitted to invest 100% of its investable funds in a single special situation asset. v. Category I AIFs under the Venture Capital Fund ("VCF") sub-category were mandatorily required to invest at least two-thirds (66.67%) of the total investable funds in (i) unlisted equity shares or equity-linked instruments of a VCU; or (ii) in companies listed or proposed to be listed on a Small and Medium Enterprise exchange or Small and Medium Enterprise segment of an exchange. This requirement has been changed to investing 75% of the total investable funds in the abovementioned avenues.17 In addition to the above, other investment restrictions applicable on the residual portion of the investable funds (i.e. one-third of the total investable funds) of the VCF have been done away with.

16 https://rbidocs.rbi.org.in/rdocs/Notification/PDFs/NT9051F8256D79234D5FA6D4E4CBD029E16D.PDF.

17 SEBI (AIF)(Fourth Amendment) Regulations, 2018.

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	vi. Category I AIFs under the sub-category SSFs, are required to invest in stressed assets such as (i) stressed loans available for acquisition in terms of RBI (Transfer of Loan Exposures) Directions, 2021 or as part of a resolution plan approved under Insolvency and Bankruptcy Code, 2016; (ii) security receipts issued by Asset Reconstruction Companies; (iii) securities of companies in distress; (iv) any other asset/security as may be prescribed by SEBI from time to time. SSFs shall not accept investments from any other AIF other than a SSF. Any investment by a SSF in the stressed loan acquired under clause 58 of the Master Direction – Reserve Bank of India (Transfer of Loan Exposures) Directions, 2021 as amended from time to time shall be subject to lock-in period as may be specified by SEBI. In addition to these investment conditions, the AIF Regulations also prescribe a set of investment conditions in respect of each sub-category of Category I AIFs.
Category II AIFs	i. Category II AIFs shall invest primarily in unlisted investee companies or in units of other AIFs as may be specified in the placement memorandum; ii. Category II AIFs can simultaneously invest in investee companies as well as the units of other AIFs provided the information about such combination of strategies is conspicuously disclosed in the PPM of the investing AIF and the with the prior consent of at least two-third of the total unitholders of such AIF by value; iii. Category II AIFs shall not borrow funds directly or indirectly or engage in leverage except for meeting temporary funding requirements for more than thirty days, on not more than four occasions in a year and not more than 10% of its investable funds; iv. Category II AIFs shall invest not more than 25% of the investable funds in an investee company directly or through investment in the units of other Alternative Investment Funds, provided that, AI Funds of Category I and II, may invest up to 50% of its investable funds in an investee company; v. Category II AIFs may engage in hedging subject to such guidelines that may be prescribed by SEBI; vi. Category II AIFs may enter into an agreement with a merchant banker to subscribe to the unsubscribed portion of the issue or to receive or deliver securities in the process of market making under Chapter XB of the ICDR Regulations; and vii. Category II AIFs shall be exempt from Regulations 3(1) and 3(2) and 4 of the Insider Trading Regulations in respect of investments in companies listed on SME exchange or SME segment of an exchange pursuant to due diligence of such companies. This is subject to the further conditions that the AIF must disclose any acquisition / dealing within 2 days to the stock exchanges where the investee company is listed and such investment will be locked in for a period of 1 year from the date of investment.
Category III AIFs	i. Category III AIFs may invest in securities of listed or unlisted investee companies or derivatives or complex or structured products; ii. Category III AIFs may deal in 'goods' received in delivery against physical settlement of commodity derivatives whereby 'goods' refers to those notified by the Central Government under Section 2 (bc) of the Securities Contracts (Regulation) Act, 1956 and forming the underlying of any commodity derivative; iii. Funds of category III AIFs may invest in the units of Category I and Category II AIFs; iv. Category III AIFs shall invest not more than 10% of the investable funds in one investee company directly or through investment in the units of other Alternative Investment Funds, provided that AI Funds of Category III may invest up to 20% of investable funds in an investee company; v. In case of such investments made by a Category III AIF, the investment limit of ten per cent may be calculated as either of the investable funds or the net asset value of the scheme and in case of such investment made by AI Funds, investment limit of twenty per cent may be calculated as either of the investable funds or the net asset value of the scheme, subject to the conditions specified by the SEBI from time to time; vi. Category III AIFs engage in leverage or borrow subject to consent from investors in the fund and subject to a maximum limit as may be specified by SEBI; and vii. Category III AIFs shall be regulated through issuance of directions by SEBI regarding areas such as operational standards, conduct of business rules, prudential requirements, restrictions on redemption and conflict of interest.
Specified Funds	i. The corporate debt market development fund may only make investments into eligible corporate debt securities from the SEBI-specified debt-oriented schemes of mutual funds during periods of market dislocation. Such periods of market dislocation will be determined by SEBI; ii. The abovementioned securities may only be purchased by the CDMD Funds at a fair value and not at distressed prices. And such securities are to be held until maturity or reversal of market dislocation; iii. The maximum tenure of the CDMD Fund, subject to SEBI approved extensions, is 15 years; iv. The units of the CDMD Fund may not be listed on any stock exchange; v. Asset management companies (as defined under SEBI (Mutual Funds) Regulations, 1996 and specified debt-oriented schemes of mutual funds are permitted to invest into the CDMD Fund.

VI. Overseas Investments by AIFs

As per a circular dated October 1, 2015 issued by SEBI and, as amended by the AIF Master Circular, an AIF may invest in equity and equity-linked instruments of off-shore VCUs, subject to certain conditions mentioned in the circular such as an overall aggregate limit of USD 1,500 million for all AIFs and VCFs registered under the SEBI (Venture Capital Funds) Regulations, 1996 and the guidelines stipulated by the RBI in this respect. The overall limit of USD 1,500 million would be renewed / replenished upon exits by AIFs of their previous overseas investments, to the extent of the original investment made, thereby, freeing the limit for further overseas investment. Overseas investments may only be made up to 25% of the investable funds of the concerned AIF. The AIF Master Circular clarifies that an offshore VCU means a foreign company whose shares are not listed on any of the recognized stock exchange in India or abroad. Such an investment by an AIF requires prior approval from SEBI.

Further the AIF, has to ensure that such overseas investee companies are (i) situated in a country whose securities market regulator is a signatory to the International Organization of Securities Commission's Multilateral Memorandum of Understanding (Appendix A Signatories) or a signatory to the bilateral Memorandum of Understanding with SEBI and (ii) are not in incorporated in a country identified in the public statement of Financial Action Task Force (FATF) as:

- a jurisdiction having a strategic Anti-Money Laundering or Combating the Financing of Terrorism deficiencies to which counter measures apply; or
- a jurisdiction that has not made sufficient progress in addressing the deficiencies or has not committed to an action plan developed with FATF to address the deficiencies.

The allocation of investment limits would be done on a 'first come-first serve' basis depending on availability in the overall limit of USD 1,500 million, and in case an AIF fails to make the allocated investment within a period of 6 months from date of approval, SEBI may allocate such unutilized limit to another applicant. However, SEBI has recently reduced the period of validity of such allocated investment limits from 6 months to 4 months.[18] Nevertheless, this reduced timeline is only applicable for approvals granted by SEBI post August 04, 2023.

VII. Key Features

A. Private Placement

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

18 Validity period of approval granted by SEBI to AIFs and VCFs for overseas investment, SEBI circular SEBI/HO/AFD/PoD/CIR/P/2023/137, dated August 04, 2023.

B. Documentation

Standardized PPM

The SEBI vide its circular dated Feb 06, 2020 (now covered under the AIF Master Circular) introduced template (s) for PPM, subject to certain exemptions, and mandatory performance benchmarking for AIFs with provisions for additional customized performance reporting. While the circular leaves ample scope for the parties to give additional information, the mandatory template provides for two parts:

a. Part A — section for minimum disclosures, and

b. Part B — supplementary section to allow full flexibility to the Fund in order to provide any additional information, which it deems fit.

The AIF Master Circular has specified two distinct templates, one for Category I and II AIFs and the other for Category III AIFs.

However, SEBI has exempted Angel Funds and AIFs/Schemes in which each investor commits to a minimum capital contribution of INR 70 crores (USD 10 million or equivalent, in case of capital commitment in non-INR currency) from the aforementioned compliances. This exemption is also extended to the AI Funds given that investment by each Accredited Investor in an AI Funds is equal to or more than INR 70 crores.

Audit of PPM

In order to ensure compliance with the terms of PPM, the AIF Master Circular 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.

The findings of the audit, along with corrective steps, if any, shall be communicated to the Trustee or Board or Designated Partners of the AIF, Board of the Manager and SEBI. Such audit of compliance shall be conducted at the end of each Financial Year and the required parties have to be informed within six months from the end of the Financial Year.[19]

However, SEBI has exempted Angel Funds and AIFs/Schemes in which each investor commits to a minimum capital contribution of INR 70 crores (USD 10 million or equivalent, in case of capital commitment in non-INR currency) from the aforementioned compliances. This exemption is also extended to the AI Funds given that investment by each Accredited Investor in an AI Funds is equal to or more than INR 70 crores. Furthermore, the requirement of audit of compliance with terms of PPM shall not apply to AIFs which have not raised any funds from their investors.

19 Circular No.: SEBI/HO/IMD/DF6/CIR/P/2020/99, dated Jun12, 2020.

C. Co-Investments

SEBI has recently introduced amendments to the AIF Regulations, 2012 and PMS Regulations on November 9, 2021. As per the amendments, "Co-investment" means an investment made by a Manager or Sponsor or investor of Category I and II AIFs in investee companies where such Category I or Category II AIF make investment, provided that Co-investment by unit holders of the AIF shall be through a Co-investment Portfolio Manager as specified under the PMS Regulations. The amendments also provide that the manager shall not provide advisory services to any investor other than the clients of the Co-investment Portfolio Manager as specified in the PMS Regulations, for investment in securities of investee companies where the AIF managed by it makes investment. Further, the terms of Co-investment in an investee company by a Manager or Sponsor or co-investor, shall not be more favourable than the terms of investment of the AIF. Further, the terms of exit by a Manager or Sponsor or co-investor from an investee company including the timing of exit shall be identical to the terms applicable to that of the AIF.

D. Liquidation

AIFs set up as trust can be wound up in the following situations:

a. when the tenure of AIF or schemes launched by AIF is over;

b. if the trustee is in the opinion that winding up of AIF is in interests of LPs;

c. if 75% of LPs by value of their investments pass a resolution for winding up of AIF

d. if SEBI so directs in interest of LPs.

AIF is required to liquidate its assets and distribute proceeds (net of liabilities) to LPs, within one year from the date of intimation of winding up of AIF to SEBI and LPs.

Recently, due to market conditions, certain AIFs have not been able to liquidate its assets upon expiry of its tenure. SEBI has amended the AIF Regulations to provide the following:

- AIFs may (i) sell unliquidated investments to a new scheme of same AIF i.e. liquidation scheme or (ii) make in-specie distributions to the investors, in each case, subject to the approval of 75% investors by value.
- Lack of investor approval shall cause unliquidated investments to be mandatorily distributed in-specie.
- Investments shall be written off if an investor is not willing to accept in-specie distribution.
- Value of sale to the liquidation scheme or value of in-specie distribution of such unliquidated investments shall be added to the manager's track record and communicated to performance benchmarking agencies.

In this regard, it ought to be noted that the market regulator has provided for a bidding process wherein the investment manager is required to arrange for at least 25% of the value of the AIF / scheme's unliquidated investment as bids. Such valuation is to be undertaken by two independent valuers and should be disclosed to the investors in such AIF / scheme. The failure of raising the aforementioned 25% bid amount shall hinder the formation of a liquidation. In contrast, the successful raise of such 25% bid amount shall cause the investment manager to utilize such amount to provide an exit to any dissenting investors; any remaining sums should be utilized to provide a pro rata exit to continuing investors. It is to be noted that such bidding procedures shall also be applicable to in-specie distribution of unliquidated investments.

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Additionally, SEBI has disallowed evergreening of AIF by stipulating that (i) liquidation schemes are not permitted to extend their tenure or sell its unliquidated investments to another liquidation scheme, and (ii) AIFs have to mandatorily distribute units of any liquidation scheme held by it upon the expiration of its tenure / extended tenure — thus preventing the units of a liquidation scheme from being carried over to another liquidation scheme.

Transfer of unliquidated portfolio to a new 'liquidation scheme' may cause capital gains tax implications in hands of investors in case of transfer from AIF / scheme to a liquidation scheme. In such instances, the period of holding and cost of investment for the investor may be considered from its date of holding units in liquidation scheme.

E. AIF Policies

AIFs are generally required to maintain policies on conflict management, investments, compliance, valuation and anti-money laundering. AIFs have increasingly started including policies on environmental, social and governance considerations.

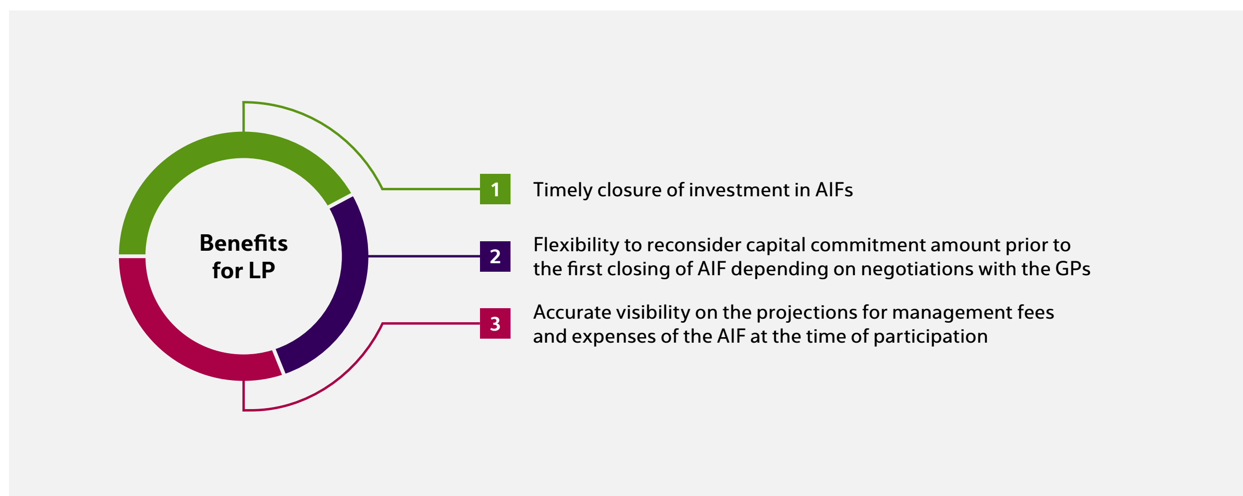
F. Lifecycle Timelines

SEBI has recently[20] mandated AIFs (or schemes therein) to calculate the starting point for their tenure from the date of first close (instead of final closing) and declare first closing within 12 months from SEBI taking their PPM on record. SEBI has also provided that in case where first close of AIF / schemes is not declared within the aforesaid timelines, the AIF shall be required to file a fresh application for launch with SEBI by paying requisite fee.

Originally, the AIF Regulations were silent with respect to calculation of tenure. In 2015, the AIF Regulations were amended to provide for calculation of tenure from date of its launch (which was considered as the day of final closing). Subsequently, SEBI noted that due to lack of clarification on determination of final closing, linking tenure to final closing was problematic as final closing was a moving date. This often left the tenure of AIFs vulnerable and susceptible to extensions.

20 Guidelines for AIFs for declaration of first close, calculation of tenure and change of sponsor/manager or change in control of sponsor/manage, SEBI Circular No. SEBI/HO/AFD-1/PoD/P/CIR/2022/155, November 17, 2022.

The below figure elaborates the benefits of this change for LPs:



G. Dematerialization of Units

SEBI has mandated dematerialization of AIF units for all new schemes going forward and existing schemes in the manner tabulated below.

Corpus / Particulars	Dematerialization of all Units Issues	Issuance Only in Dematerialized Form
≥ INR 5000 million	By October 31, 2023	November 01, 2023 onwards
< INR 5000 million	By April 30, 2024	May 01, 2024 onwards

It is to be noted that SEBI has clarified, via its circular dated June 21, 2023,[21] that AIFs whose tenure end prior to April 30, 2024 need not under the dematerialization of their units. Furthermore, as the transfer of AIF units continue to be governed under the fund documents, the depositaries have been directed by SEBI to seek the approval of the Investment Manager prior to effecting any such transfer.

AIF Units represent the beneficial interests of such investors in the AIF. The Finance Act, 2021 brought AIF Units under the definition of 'securities' under the Securities Contracts (Regulation) Act, 1956.

SEBI had, in its consultation paper for this proposal, observed that despite the depositaries having laid down procedures for dematerialisation of units pursuant to the above, most AIF Units are not dematerialised. The arguments favouring dematerialisation include ease of monitoring of AIF investments by investors as well as managers and reduced risk of damage and forgery.

21 Issuance of units of AIFs in dematerialised form, SEBI circular no. SEBI/HO/AFD/PoD1/CIR/2023/96, June 21, 2023.

SEBI has now provided guidelines for dematerializing/crediting units in cases where investors haven't provided demat account details via its circular dated December 11, 2023.[22] As per the said circular the Investment Manager hall continue to reach out to existing investors to obtain their demat account details and credit the units issued to them to their respective demat accounts.

In this regard, AIF industry and depositories shall adopt implementation standards as formulated by the pilot Standard Setting Forum for AIFs (SFA) along with the two depositories, in consultation with SEBI. Further, the units already issued by schemes of AIFs to existing investors who have not provided their demat account details, shall be credited to a separate demat account named "Aggregate Escrow Demat Account". Such account shall be opened by AIFs for the sole purpose of holding demat units of AIFs on behalf of such investors.

Further, new units to be issued in demat form shall be allotted to such investors and credited to the Aggregate Escrow Demat Account. As and when such investors provide their demat account details to the AIF, their units held in Aggregate Escrow Demat Account shall be transferred to the respective investors' demat accounts within 5 working days.

SEBI has mandated the process in the manner tabulated below:

Details	Schemes with corpus ≥ INR 500 crore as on Oct 31, 2023	Schemes with corpus < INR 500 crore as on Oct 31, 2023 and schemes launched after Oct 31, 2023 irrespective of corpus
Investors who have provided their demat account details	Units issued after Oct 31, 2023, shall be in demat form and credited only to investors demat accounts.	Units issued after April 30, 2024, shall be in demat form and credited only to investors demat accounts.
Investors who have not provided their demat account details	For investors on-boarded prior to Nov 01, 2023, units shall be credited in Aggregate Escrow Demat Account temporarily, till investors provide their demat account details.	For investors on-boarded prior to May 01, 2024, units shall be credited in Aggregate Escrow Demat Account temporarily, till investors providetheir demat account details.
Completionof creditof demat units to a. demat accounts of investors who have provided demat account details and b. Aggregate Escrow Demat Account, for those who have not provided demat account details	Latest by Jan 31, 2024	Latest by May 10, 2024

22 Credit of units of AIFs in dematerialized form, SEBI circular no. SEBI/HO/AFD/PoD1/CIR/2023/186, December 11, 2023.

VIII. GP Considerations

A. Reporting Obligations

Under the AIF Regulations, all AIFs are required to ensure transparency and disclosure of information to investors.[23] AIFs are required to provide at least on an annual basis, within 180 days from the year end, reports to investors including the information as prescribed in the AIF Regulations.

Further, the Fund shall submit a quarterly report to SEBI in accordance with SEBI Circular dated July 29, 2013 (now covered under the AIF Master Circular) on a quarterly (if leverage is not undertaken) and monthly (if leverage undertaken) basis within 7 calendar days from the end of the quarter / month (as the case may be). SEBI has revised the format in which such report must be submitted vide the circular No. SEBI/HO/AFD/SEC -1/ P /CIR/2023/0155, dated September 14, 2023.

At the end of a financial year, the manager must prepare a compliance test report (**"CTR"**) on compliance with AIF Regulations and circulars issued there under in the format as specified in the AIF Master Circular. The CTR has to be submitted to the Trustee and Sponsor within thirty (30) days from the end of the financial year and the Trustee/Sponsor can intimate any observations/comments on the CTR to the manager within thirty (30) days from the receipt of the CTR. Within fifteen (15) days of receipt of such observations / comments, the manager will make necessary changes in the CTR and submit its reply to the Trustee / Sponsor.

Further, with a view to providing relevant information to investors about the various activities pertaining to AIFs, an Investor Charter as provided by SEBI in the AIF Master Circular , which has to be disclosed in the PPM of each new scheme.

B. Code of Conduct

SEBI by way of an amendment to the AIF Regulations dated May 5, 2021 has provided for AIFs, the key management personnel, trustee, trustee company, directors, designated partners or directors of the AIFs, to abide by the Code of Conduct inserted in the Fourth Schedule of the AIF Regulations. In addition to this, the manager and the trustee or trustee company or board of directors or designated partners of the AIF are jointly required to formulate detailed policies and procedures in order to ensure compliance of the various obligations of the fund.

C. Material Changes

The AIF Master Circular provides that in case any 'material change' to the fund structure, is said to have arisen in the event of (1) change in sponsor or manager of the AIF, (2) change in control of the sponsor or manager of the AIF, (3) material changes to the placement memorandum — (i) term of the fund, (ii) investment strategy, (iii) increase in fees and charges, (4) winding up of the fund / scheme prior to expiry of tenure, investor consent needs to be obtained.

23 Regulation 22 of the AIF Regulations.

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There are increasing examples of acquisitions of fund management businesses by international and domestic acquirers. The AIF Master Circular becomes especially relevant in navigating the regulatory landscape for achieving such commercial transactions. Care must also be taken to ensure a proper diligence of the proposed target, not just from a company perspective, but also from a legal, regulatory and tax perspective vis-à-vis the fund manager by the target.

D. Audit

In accordance with the SEBI (AIF) (Second Amendment) Regulations, 2023 the AIF Regulations now require AIF's to value their portfolio in accordance with the SEBI (Mutual Funds) Regulations, 1996 or the valuation guidelines endorsed by any AIF industry association.[24] Further, the AIF Regulations stipulates that the AIF manager shall be responsible for the AIF's true and fair valuation and the appointment of an independent valuer.[25]

Interestingly, AIF managers are now allowed to deviate[26] from the concerned AIF's policies and procedures of valuation in situations wherein such policies do not result in a fair valuation; provided that the AIF manager provides the rationale for such deviation to the investors. Further, the SEBI circular dated June 21, 2023,[27] clarifies that that:

i. Any change in the methodology / approach for valuation of AIF portfolio will be construed as a material change significantly influencing the decision of the investor to continue to be invested in the AIF.[28]

ii. AIF managers are now required to disclose the following as part of changes in PPM to be submitted annually to SEBI and its investors:

- Details of changes in the valuation methodology and approach, if any, for valuation of each asset class of the scheme of the AIF;
- Details of changes in accounting practices/policies, if any, of the investee company and the scheme of the AIF; and
- Details of impact of the aforesaid changes in terms of valuation of the investments of the scheme of the AIF.

24 An AIF industry association is an association which has a minimum of 33% of AIFs as its members.

25 The independent valuer shall:

a) Not be an associate of the manager or sponsor or the trustee of the AIF;

b) It shall have at least 3 years of experience in valuation of unlisted securities; and

c) It shall either be (i) a valuer registered with the Insolvency and Bankruptcy Board of India and be a member of Institute of Chartered Accountants of India or Institute of Company Secretaries of India or Institute of Cost Accountants of India or CFA Institute; or (ii) it is a holding or subsidiary company of a credit rating agency registered with SEBI.

26 At each asset level, in case there is a deviation of more than 20% between two consecutive valuations or a deviation of more than 33% in a financial year, the manager is required to inform the investors the rationale for the same.

27 Standardised approach to valuation of investment portfolio of AIFs, SEBI circular no. SEBI/HO/AFD/PoD/CIR/2023/97, June 21, 2023.

28 SEBI circular No. CIR/IMD/DF/14/2014 dated June 19, 2014 and SEBI Circular No. CIR/IMD/DF/16/2014 dated July 18, 2014.

The AIF Regulations mandate that an AIF's books of accounts should be annually audited by a qualified auditor.[29] Presently, the AIF Regulations does not define the term 'qualified auditor' however SEBI vide its recent circular on the standardised approach to valuation[30] has laid down the eligibility criteria for independent valuers; wherein the following has been specified:

i. An associate of the investment manager / sponsor / trustee may not be the independent valuer;

ii. An experience threshold of three years in valuing unlisted securities has been specified; and

iii. Such valuer is also to fulfil any of the following criteria:

   a. is a valuer registered with Insolvency and Bankruptcy Board of India and has membership of Institute of Chartered Accountants of India or Institute of Company Secretaries of India or Institute of Cost Accountants of India or CFA Institute; or

   b. is a holding company or subsidiary of a Credit Rating Agency registered with SEBI; or

   c. fulfills any other criteria as may be specified by SEBI from time to time.

Further, the SEBI mandates AIFs to conduct a legal audit of its PPM to ensure compliance with the template PPM. This legal audit is to be conducted by either an internal or external auditor / legal professional. It is to be noted that the sections of the PPM pertaining to 'Risk Factors', 'Legal, Regulatory and Tax Considerations' and 'Track Record of First Time Managers' are not mandatorily subject to this legal audit.[31]

E. Performance Benchmarking

SEBI has also introduced mandatory benchmarking of the performance of the AIFs and the AIF industry and a framework for facilitating the use of data collected by Benchmarking Agencies to provide customized reports. Any association of AIFs ("**Association**"), which in terms of membership, represents at least 33% 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.

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.

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 AIF.

In the PPM, as well as in any marketing or promotional or other material, where past performance of the AIF is mentioned, the performance versus benchmark report provided by the benchmarking agencies for such AIF/Scheme shall also be provided.

29 Regulation 20 (14) of the AIF Regulations.

30 Standardised approach to valuation of investment portfolio of AIFs, SEBI circular SEBI/HO/AFD/PoD/CIR/2023/97 dated June 21, 2023.

31 Disclosure Standards for Alternative Investment Funds (AIFs), SEBI Circular: SEBI/HO/IMD/DF6/CIR/P/2020/24, February 05, 2020.

In any reporting to the existing investors, if performance of the AIF/Scheme is compared to any benchmark, a copy of the performance versus benchmark report provided by the Benchmarking Agency shall also be provided for such AIF/scheme. SEBI has also issued the Operational Guidelines in this regard.[32]

Additionally, the AIF Master Circular, has specified that AIFs may request such Benchmarking Agencies for customized performance reports subject to the (i) consent of the AIFs, whose data are required for such customized performance report and (ii) terms and conditions, including without limitation, fees decided mutually between the Benchmarking Agencies and the concerned AIF.

Further, it may be noted that investment managers are also required to intimate Benchmarking Agencies in instances where there is a transfer of unliquidated investments to a liquidation scheme, in specie distribution of unliquidated investments, or a write off unliquidated investments. In instances where the investment manager arranges bids for such unliquidated investments, such value shall be taken into account for performance benchmarking. In instances where the investment fails to secure the requisite bid amount, a notional value of INR 1 shall be taken into account. Whereas a complete write off of unliquidated investments shall cause the Benchmarking Agencies to record the value of such investments as nil.

With the intent to ensure that GPs promptly report their portfolio valuations to Benchmarking Agencies, GPs are required to ensure that:

a. a specific timeframe for providing audited accounts by portfolio companies to the AIF is included in the investment agreement with such portfolio companies, so as to enable AIFs to report valuation based on audited data of portfolio companies as on March 31 to performance benchmarking agencies within the specified timeline of six months; and
b. valuation based on audited data of portfolio companies is reported to performance benchmarking agencies only after the audit of books of accounts of the AIF (in accordance with regulation 20(14) of AIF Regulations).

F. Ring-Fencing of Assets and Schemes

As per the extant AIF Regulations, AIFs may launch multiple investment schemes under a single registration with SEBI. Generally, each of these schemes has its own group of investors and investment portfolio. As a matter of industry practice, AIFs obtain separate Permanent Account Numbers (i.e. the Indian tax identification number) from the income-tax department for each of the schemes even if they are setup under a single AIF. There were no specific provisions in the AIF Regulations recognizing the need for ring-fencing and segregation of assets between schemes of an AIF unlike in the case of mutual funds where the trustees and asset management companies are required to ensure that the assets and liabilities of each scheme are segregated and ring-fenced from other schemes of the mutual fund. The absence of such provisions often led to uncertainty among AIF participants (GPs and LPs alike), with respect to protection of assets of one scheme of an AIF from any liability which may arise from other schemes of the same AIF.

32 https://www.sebi.gov.in/sebi_data/commondocs/feb-2020/ann_4_p.pdf.

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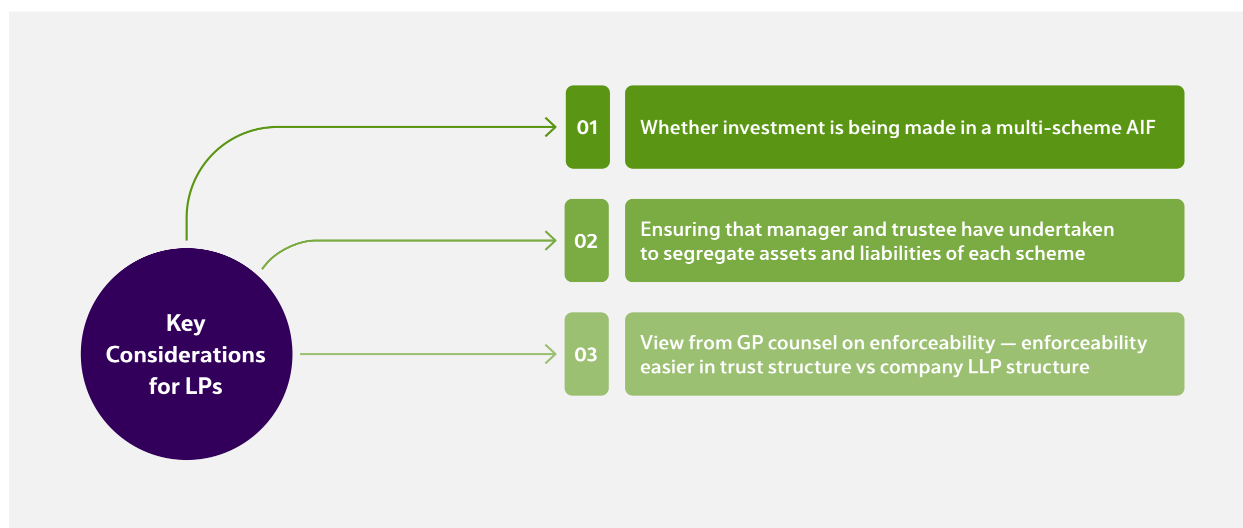
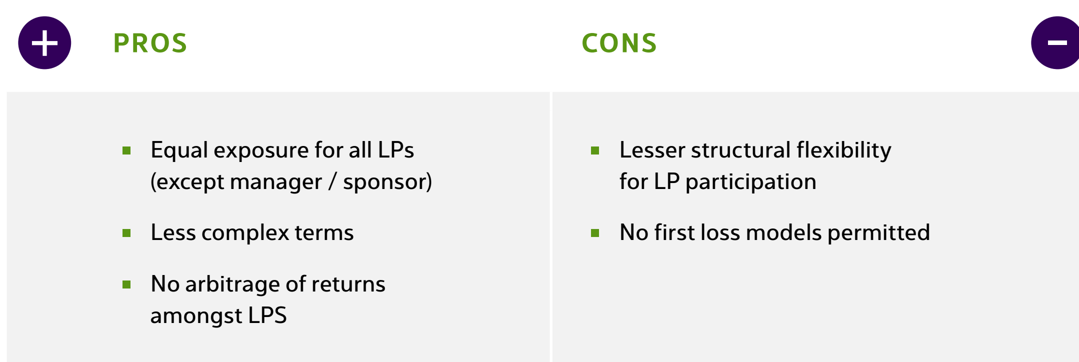
SEBI has now mandated *inter-alia* the managers of AIFs to ensure that the assets and liabilities of each scheme are kept separate and that the bank and securities accounts for each scheme are also segregated and ring-fenced.



G. Restrictions by SEBI on Priority Distribution Models

SEBI has taken note of some AIFs adopting a distribution model where one class of investors (other than sponsor/manager) share losses in the AIF disproportionately vis-à-vis other classes of investors/unit holders (such as structured debt models) ("**Priority Distribution Waterfall**"). While SEBI had earlier provided that the sharing of loss by the sponsor/manager shall not be less than pro rata to their holding in the AIF vis-à-vis other unit holders,[33] there is no explicit restriction on use of Priority Distribution Waterfall model. SEBI for the time being has prohibited AIFs from using such models. SEBI is consulting with the AIPAC and other stakeholders on the issue. Please refer to ***Section 10*** of this research paper for further information on Priority Distribution Waterfalls.



33 Guidelines on disclosures, reporting and clarifications under AIF Regulations, SEBI circular No. CIR/IMD/DF/14/2014, June 19, 2014.

H. Foreign Investment in AIFs

The NDI Rules defines an 'Investment Vehicle' to, inter-alia, mean an AIFs governed by the AIF Regulations. The NDI Rules permits a person resident outside India, other than a citizen of Bangladesh or Pakistan or an entity incorporated in Bangladesh or Pakistan, to invest in units of an Investment Vehicle, in the manner and subject to the terms and conditions specified in Schedule VIII of the NDI Rules.

The NDI Rules lay down certain terms and conditions governing investments in such Investment Vehicles in the manner as follows:

- A person resident outside India who has acquired or purchased units in accordance with Schedule VIII may sell or transfer in any manner or redeem the units as per regulations framed by Securities and Exchange Board of India or directions issued by the Reserve Bank.
- An Investment Vehicle may issue its units to a person resident outside India against swap of capital instruments of a SPV proposed to be acquired by such Investment Vehicle.
- Investment made by an Investment Vehicle into an Indian entity shall be reckoned as indirect foreign investment for the investee Indian entity if the sponsor or the manager or the investment manager (i) is not owned and not controlled by resident Indian citizens; or (ii) is owned or controlled by persons resident outside India.

Provided that for sponsors or managers or investment managers organized in a form other than companies or LLPs, Securities and Exchange Board of India shall determine whether the sponsor or manager or investment manager is foreign owned and controlled.

'Control' of the AIF is expected to be in the hands of sponsors and managers, with the general exclusion to others. In case the sponsors and managers of the AIF are individuals, for the treatment of downstream investment by such AIF as domestic, sponsors and managers should be resident Indian citizens.

Further, SEBI via a circular dated December 9, 2022,[34] has clarified that AIFs may raise funds from any investor by issue of units subject to the following conditions:

a. Foreign investor of the AIF is a resident of the country whose securities market regulator is a signatory to the International Organization of Securities Commission's Multilateral Memorandum of Understanding or a signatory to the bilateral Memorandum of Understanding with SEBI.
b. The investor (or its underlying investor contributing at least 25% of its corpus / having control) is not mentioned in the UN Security Council Sanctions List and is not resident in the country identified in the public statement of Financial Action Task Force as:
    - jurisdiction having a strategic Anti-Money Laundering or Combating the Financing of Terrorism deficiencies to which counter measures apply; or
    - a jurisdiction that has not made sufficient progress in addressing the deficiencies or has not committed to an action plan developed with the FATF to address the deficiencies.

It is to be noted that the foregoing conditions are also applicable to investors who have already been on-board into an AIF (or a scheme therein). No further drawdowns shall be made with respect to an investor who fails to meet the above conditions until the investor again meets the said conditions.

34 Foreign investment in Alternative Investment Funds(AIFs), SEBI circular No. SEBI/HO/AFD-1/PoD/P/CIR/2022/171, December 09, 2022.

I. Management and Governance of AIFs

The AIF Regulations have laid down twin conditions (experience requirement[35] and professional qualification[36]) to be satisfied by the key investment team of an AIF manager. The twin conditions may be satisfied by the same individual. Recently, SEBI has revised this requirement to provide that the AIF manager is required to meet a certification requirement as opposed to the experience requirement.

The certification requirement obligates at least one key investment team member of the AIF manager to obtain the relevant certification specified by SEBI. It is to be noted that the certification requirement is an continuous obligation wherein the key personnel would be required to renew the certification upon expiration of its validity. An unintended outcome of this change would be that seasoned managers who have been managing AIFs and similar products for a while may need to sit for an examination in order to be considered eligible as AIF managers. It is also to be noted that this certification requirement would also be applicable to the AIF's compliance officer.

SEBI has increased its vigilance on the governance of AIFs. In 2019, the AIF Regulations were amended to regulate investment committee (**"ICOM"**) members of a decision-making ICOM by the manager. These regulations are not aligned with global best practices. ICOM members are domain / industry experts and may not be qualified to review every decision of the AIF against internal policies of the AIF, which they are now required to do.

LPs have generally negotiated fund documents to include provisions around liability of ICOM members, manner of enforcement of claims (through trustee for AIFs which are trusts), inclusion in the director and officer insurance policy and expense caps for operations.

The table below summarizes the current provisions with respect to the responsibilities and liabilities of AIF manager and ICOM members.[37]

Parameter	AIF Manager	ICOM Members
Disclosure in PPM	Details of Manager and key management personnel of Manager to be provided in PPM.	Details of ICOM members to be disclosed in PPM. External members can be on boarded on the ICOM whose names are not disclosed in PPM only with consent of 75% of LPs.
Compliance with Code of Conduct	Liable to comply	Liable to comply
Decisions of AIF	AIF Manager responsible for every decision of AIF including ensuring that decisions are in compliance with AIF Regulations and terms of fund documents.	Not liable
Internal Policies of AIF (as Depicted in Features of an AIF)	AIF Manager responsible for ensuring decisions of AIF are in compliance with internal policies of AIF.	ICOM members responsible for ensuring decisions of AIF are in compliance with internal policies and procedures of the AIF (which are required to be in compliance with the AIF Regulations). Waiver from aforesaid can be obtained by LVFs from LPs.

35 At least one key personnel is required to have a minimum experience of five years in the fund / wealth / portfolio management industry.

36 At least one key personnel is required to have the necessary professional qualification as prescribed by SEBI.

37 Regulation 20 of AIF Regulations.

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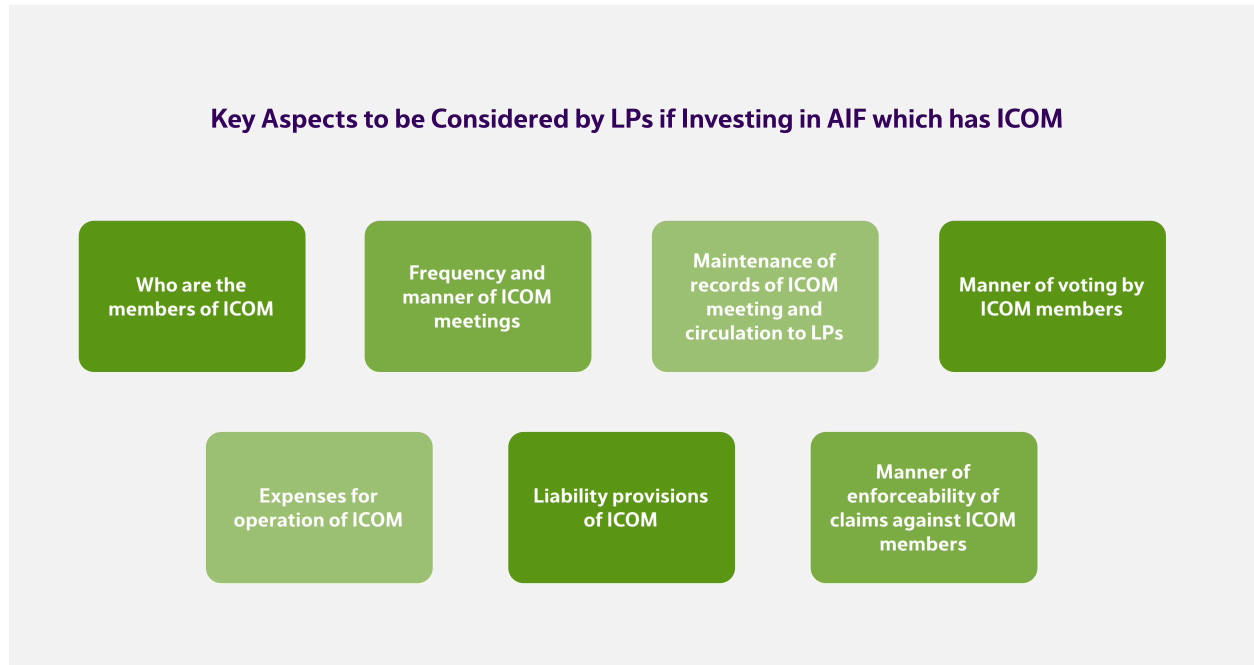
Important to note that SEBI is currently seeking clarification from RBI with respect to applicability of downstream investment rules to investment made by AIFs whose ICOM consists of external members who are not 'resident' Indian citizens.[38]



AIFs may also set up an LP Advisory Committee to inter-alia clear conflicts, review extension requests, waiver of defaults, divergence from investment limits, valuation policy, material variation in investment process, extraordinary expenses incurred by the manager and consider cure for cause or key person events.

Membership to the LP Advisory Committee is offered by the manager on the basis of size of such LP's investment and / or its strategic value to the AIF. Each member gets one vote on the committee, and typically decisions are made on the basis of simple-majority. Some LPs, who are not eligible for membership or conservative about taking up any liabilities associated with such membership seek a non-voting observer seat on the committee.

The LP Advisory Committee's meeting and travel costs with expressed caps are borne by the AIF. Members of the committee do not (i) exercise binding authority; (ii) have powers of management of the AIF; and (iii) owe fiduciary duties to other investors or the AIF or the manager.

J. Direct Plan for Schemes of AIF and Trail Model for Distribution Commission in AIFs

SEBI has now mandated direct plan for AIFs and trail model for distribution commission in AIFs.[39] Investors who allocate towards AIFs through SEBI registered intermediaries (like investment advisors or portfolio managers) may incur two kinds of fee, i.e. the advisory or portfolio management fee and the AIF distribution fee.

38 Processing of applications for registrations of AIFs and launch of schemes, SEBI Circular No SEBI/HO/IMD/DF6/CIR/P/2020/209, Oct 22, 2020.
39 SEBI Circular SEBI/HO/AFD/PoD/CIR/2023/054 dated April 10, 2023.

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SEBI's intent is to prevent such investors from a double whammy on the same capital. In this regard, SEBI has mandated AIFs to have an option of 'Direct Plan' for its investors which shall not entail any distribution or placement fee. SEBI has also mandated AIFs to ensure that investors who approach the AIF through a SEBI registered intermediary which is separately charging the investor any fee (such as advisory fee or portfolio management fee), are on-boarded via Direct Plan only. SEBI has removed the requirement for issuance of higher number of units to investors investing into the AIF via the direct plan.

SEBI has also mandated AIFs to disclose distribution fee/placement fee, if any, to the investors of AIF/scheme of AIF at the time of on-boarding. SEBI has provided for adoption of a trail model of distribution[40] wherein Category I and Category II AIFs may pay up to 1/3rd of total distribution /placement fee to distributors upfront and rest on equal trail basis over the tenure of the fund.

SEBI has clarified that the aforesaid provisions shall be complied with for investors on-boarded in AIFs/ schemes of AIFs from May 01, 2023 onwards.

K. USD-INR Hurdle Rates

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

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

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

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

40 In a trail model of distribution fees is paid every year until the investment is withdrawn instead of being upfront at the time of investment being made.

IX. Considerations

A. Co-Investments

GP co-investments: GPs expected to share figures pertaining co-investments to ensure that there is no adverse selection. To address 'cherry-picking', GPs may only be permitted to co-invest on a lock-step basis or subject to an overall / annual cap.

LP co-investments: Clarity to be provided in advance as to whether LPs invest directly or via a co-investment fund. Fund documents to lay down how and when co-investment opportunities are offered to LPs. GP to make disclosure pertaining to the allocation of co-investment opportunities and expense sharing between the fund and LPs.

B. Accredited Investor

The AIF Regulations prescribe a general set of investment restrictions that are applicable to all AIFs and further prescribe a specific set of investment restrictions that are applicable for each category of AIFs. SEBI is authorized to specify additional criteria or provide relaxations.

In this regard, SEBI vide an amendment dated August 03, 2021 introduced large value funds for accredited investors ("**AI Funds**") which are offered relaxation from certain requirements of the AIF Regulations. Such AI Funds are classified as funds in which each investor (other than the Manager, Sponsor, employees or directors of the AIF or employees or directors of the Manager) is an accredited investor and invests not less than INR 70 crores.

An Accredited Investor is any person who is granted a certification of accreditation by an Accreditation Agency, which for this purpose can be a subsidiary of a recognised stock exchange or a subsidiary of a depository, or any other entity as may be specified by SEBI. Certain financial parameters are required to be satisfied to grant the Accredited Investor status to such entity or individual.

X. Taxation of Alternative Investment Funds

A. General

Scope of Income Chargeable to Tax, Residential Status and Rates of Tax

Under the ITA, the scope of income chargeable to tax in India is determined on the basis of the residential status of the person earning the income. The Indian tax year runs from April 01 until March 31. An Indian tax resident is liable to tax in India on its worldwide income whereas non-residents are liable to tax only on India-source income 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.

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Residential Status and Taxability in India

As per the provisions of the ITA, a company would be considered a resident of India if (a) it is an Indian company; or (b) its POEM, in that year, is in India. Further, it is provided that for this purpose, the POEM would be the place where the key management and commercial decisions that are necessary for the conduct of the business of the entity as a whole are, in substance made.

Benefits under the Double Taxation Avoidance Agreement (if any)

Under Section 90(2) of the ITA, if a non-resident is resident in a country with which India has a DTAA, they would be taxable according to the provisions of the DTAA or the ITA, whichever is more beneficial to them.

Relief under a DTAA should normally be available as long as the non-resident is a resident and a separate legal person under the laws of its country of residence and is liable to tax under its laws. Sections 90(4) and 90(5) require a non-resident claiming treaty relief to:

a. Furnish a valid Tax Residency Certificate ("**TRC**") issued by the government of its home country; and

b. Provide certain additional information, as may be prescribed from time to time, in Form 10F.

At present, the following details are required to be provided by a non-resident claiming relief under a DTAA:

a. Status of the claimant i.e., individual, company, firm etc.;

b. Nationality or country of incorporation;

c. Claimant's tax identification number in the country of residence and in case there is no such number, a unique number on the basis of which the claimant is identified by the Government of the country of which he claims to be a resident;

d. Period for which the residential status, as mentioned in the TRC, is applicable; and

e. Claimant's address outside India, during the period for which the TRC is applicable.

The taxability of such income of the non-resident investors, in the absence of benefits under the DTAA, would be as per the provisions of the ITA. Also, the taxability of the income of the non-resident investors, from a country with which India has no DTAA, would be as per the provisions of the ITA. Further, the taxability under the DTAA depends of the provisions under the applicable treaty to the non-resident investor.

B. Taxation of Funds Registered as Category I or Category II AIFs

Tax Pass-through Status of the AIFs

The taxability of Category I and Category II AIFs (collectively, the "**investment funds**") is governed by Section 10 (23FBA), Section 10 (23FBB), Section 194LBB and Section 115UB (Chapter XII — FB, *Special Provisions Relating to Tax on Income of Investment Funds and Income Received from such Funds*) of the ITA.

Investment fund is defined under clause (a) of the Explanation 1 to Section 115UB of the ITA inter-alia as any fund established or incorporated in India in the form of a trust or a company or a LLP or a body corporate which has been granted a certificate of registration as a Category I or a Category II AIF and is regulated under the AIF Regulations or regulated under the FM Regulations.[41]

The ITA provides that any income accruing or arising to, or received by, a unit-holder of an investment fund out of investments made in the investment fund shall be chargeable to income-tax in the same manner as if it were the income accruing or arising to, or received by such person, had the investments made by the investment fund been made directly by the unit-holder.[42] In other words, the income of a unit-holder in an investment fund will take the character of the income that accrues or arises to, or is received by the investment fund.

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

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

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

Taxation of Unit Holders of AIF

i. If the income from securities at the AIF level is not characterized as PGBP in the hands of the AIF, then such income would be taxable in the hands of the unit holders of the AIF as under:

   a) The income would be chargeable to tax in the hands of the unit holders in the same manner as if it were the income accruing or arising to, or received by, such unit holder had the investments made by the AIF been made directly by such unit holder. However, the Central Board of Direct Taxes ("**CBDT**") vide its Circular No. 14/2019 dated July 03, 2019 has clarified that the income in the hands of non-resident investor from offshore investments routed through Category-I / Category-II AIFs shall not be liable to tax in India, being a deemed direct investment made outside India by such non-resident investor;

   b) The income paid or credited by the AIF would be deemed to be of the same nature and in the same proportion in the hands of the unit holders as if it had been received by, or had accrued or arisen to, the AIF;

   c) The income accruing or arising to, or received by, the AIF, during the financial year, if not paid or credited to the unit holders would be deemed to have been credited to the account of the unit holders on the last day of the financial year in the same proportion in which such unit holders would have been entitled to receive the income had it been paid in that year;

   d) Once the income is included in the total income of the unit holders in a year, on account of having been accrued or arisen in the said previous year, it would not be included in the total income of such person in the year in which such sum is actually paid to the unit holders by the AIF;

41 Explanation 1 to Section 115UB of the ITA . 20.Explanation 1 to Section 115UB of the ITA.

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

e) Where the AIF incurs any losses (other than business losses), such losses will also be allocated to the unit holders and will be available for set-off against other gains that they may have and will be allowed to be carried forward by them, in case they do not have other taxable gains. However, such losses will not be available for offset to unit holders if such loss has arisen in respect of a unit which has not been held by the unit holders for a period of at least 12 (twelve) months;

f) Business losses incurred by the AIF will be retained at the level of the AIF and not be available for offset to unit holders; instead, such losses must be offset by the AIF against subsequent business income, if any

ii. As stated above, in case the income of the AIF is characterized as PGBP, the same shall be taxable in the hands of the AIF at the maximum marginal rate and such income would be exempt from tax in the hands of the unit holders of the AIF.

In case, the exemption under section 10(23FBA) is denied to the investment fund, then the income of the such fund should be subject to tax as per the general principles of taxation of trusts under sections 161 to 164 of the ITA.

The taxation of gains realized on disposition of the securities of portfolio companies would depend on the characterization of the AIFs activities. In principle, the AIF could either be regarded as being engaged in the business of buying and selling securities or as an investor investing, rather than trading, in securities. The CBDT has, vide circulars and notifications, laid down the following principles in respect of characterization of income arising on sale of securities:

a) In respect of income arising from sale of listed shares and securities which are held for more than 12 (twelve) months, the taxpayer has a one-time option to treat the income as either PGBP or capital gains and the option once exercised, is irreversible.[43]

b) Gains arising from sale of unlisted shares are characterized as capital gains, irrespective of the period of holding of such shares, except in cases where (i) the transaction is considered to be sham or not genuine, or (ii) corporate veil is lifted or (iii) the transfer is made along with control and management of the underlying business. In such cases, the CBDT has stated that the Indian tax authorities would take an appropriate view based on the facts of the case.[44]

c) The CBDT has clarified that the third exception i.e. where the transfer of unlisted shares is made along with control and management of the underlying business, will not be applicable in case of transfer of unlisted shares by Category-I and Category-II AIF registered with the SEBI.[45]

Withholding Tax Obligation of Portfolio Companies

In terms of Section 197A(1F) of the ITA and the notification issued by the CBDT, any income (other than income under head PGBP) received by investment funds would be exempted from TDS by portfolio companies. This should be helpful in case of interest / coupon payouts by portfolio companies to such funds. Previously, it was administratively difficult for investors to take credit of the TDS withheld by portfolio companies.

43 Circular No. 6 of 2016 dated February 29, 2016.

44 Order F.No.225/12/2016/ITA.II dated May 2, 2016.

45 Order F.No.225/12/2016.II dated January 24, 2017.

Withholding Tax Obligation of AIFs

As per Section 194LBB of the ITA, in case of resident unit holders, the AIF would be required to deduct tax at the rate of 10% on any income, which is eligible for tax pass-through, at the time of credit of such income to the account of the unit holders or at the time of payment of such income to the unit holders, whichever is earlier.

Further, in case of non-resident unit holders, the AIF would be required to deduct tax at the rates in force i.e. the rates specified in the Finance Act of the relevant year or rates specified in the applicable the DTAA entered into between India and the country of residence of such non-resident; provided no taxes shall be withheld in case of any income which is not chargeable to tax under the ITA.

C. Taxability of Carried Interest

Recently, a ruling by the Bangalore bench of the CESTAT has created significant uncertainty on the nature of VCFs / AIFs set-up as trusts from a tax perspective. While the CESTAT decision pertains to the erstwhile service tax regime, it is likely to have an impact under the GST and income-tax regime on all pooling vehicles in general.

The Bangalore CESTAT inter-alia held that a VCF set-up as a trust is a separate legal entity and upheld the levy of service tax on carried interest distributed by the VCF, equating it to performance fee earned by the management company ("**Ruling**").[46] The Ruling dealt with 31 appeals relating to ICICI Econet Internet and Technology Fund and 10 other funds ("**Appellants**") and regarding tax demands covering the period from 2005–2006 to 2011–2012.

The CESTAT held that the VCFs would be treated as juridical persons distinct from its beneficiaries for the purpose of taxation. The CESTAT also held that the VCFs (set up as trusts) violated the principle of mutuality by carrying out commercial activities and using discretionary powers to benefit a certain class of investors. The CESTAT noted that the said trusts made provisions to act in a manner beyond the interest of the contributors, such as the payment of huge amounts as performance fee and carried interest to the Investment Manager or their nominees.

On whether service tax is leviable on carried interest, the CESTAT found that carried interest is neither interest nor return or investment instead a portion of consideration for services rendered by the Appellants. The CESTAT observed that the said trusts have been floated for drawing contributors and to facilitate them to earn profits. Any amount retained by the said trusts out of the income that is otherwise distributable to the contributors would constitute a fee for the services rendered. The CESTAT found that the fund structure enabled the investment manager and their nominees to receive huge amounts as performance fee and in the guise of carried interest, benefitting the recipients at the expense of the subscribers, and avoiding the taxes arising from such payment.

The Ruling has resurfaced the concerns regarding characterisation of carried interest as business income (instead of capital gains). Internationally rules for taxation of carried interest are evolving, while no clarification / guidance has been released by the government in this aspect currently, it is imperative for India to adopt an approach in line with global best practices. Having said this, it will also be essential for managers to revisit their structures and documentation.

46 Service Tax Appeal No 2900 of 2012 with others.

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D. Taxability of Sovereign Wealth Funds

With the intent to encourage long term stable capital participation from sovereign wealth funds (**"SWFs"**) and to replace government spending in the creation of infrastructure assets, the Finance Act, 2020 inserted Section 10(23FE) to the ITA exempting any income of 'specified persons' in the nature of dividend, interest or long-term capital gain arising from certain specified investments made on or after April 1, 2020 but on or before the March 31, 2024 and held for at least 3 years.

In this regard, 'specified person' (to whom exemption has been extended) includes the following:

a. wholly owned subsidiary of Abu Dhabi Investment Authority (**"ADIA"**) which:
   - is a resident of the United Arab Emirates; and
   - makes investment, directly or indirectly out of the fund owned by the Government of Abu Dhabi

b. a foreign SWF which satisfies the prescribed conditions;

c. a foreign pension fund which satisfies the prescribed conditions (including any pension fund specified by the Central Government)[47].

Section 10(23FE) provides that such investments shall be made in the form of debt or share capital or unit, in the following:

a. a business trust (registered as InvIT or REIT); or

b. company or enterprise carrying on the business of developing, operating or maintaining any infrastructure facility (as defined in explanation to Section 80-IA(4)(i)2 of the ITA) or as may be otherwise notified;

c. Category I or Category II of AIF (having not less than 50% investment in an InvIT or a company / entity referred to in item (b) or (d) or (e) herein).

d. domestic company, set up and registered on or after the April 1, 2021, having at least 75% investments in one or more of the companies entities referred to in item (b) above; or

e. a non-banking financial company registered as an Infrastructure Finance Company[48] or in an Infrastructure Debt Fund, a non-banking finance company,[49] having minimum 90% lending to one or more of the companies or enterprises or entities referred to in item (b) above.

The CBDT, vide a notification (44/2020/F. No. 370142/24/2020-TPL) dated 6th July, 2020, widened the scope of 'infrastructure' for the purpose of claiming income tax exemption under Section 10 (23FE) of the ITA. The Notification has extended the benefits of the exemption to the sovereign wealth funds and pension funds on their investment in infrastructure sector.

The Finance Act, 2021, *inter alia*, inserted the seventh proviso to section 10(23FE) to provide that in case the SWF or pension fund has loans or borrowings, directly or indirectly, for the purposes of making the investment in India, such fund shall be deemed to be not eligible for exemption under section 10(23FE).

47 In exercise of the powers conferred under section 10(23FE) of the ITA, the Central Government has specified several pension funds (illustrative list including MIC Redwood 1 RSC Limited, (Dubai), 2452991 Ontario Limited (Canada), OMERS Administration Corporation (Canada), BCI IRR India Holdings Inc (Canada), Indo-Infra Inc. (Canada), Government Employees Superannuation Board (Australia), 2726247 Ontario Inc (Canada)) as a 'specified person' for purposes of section 10(23FE) subject to the fulfillment of conditions specified in the respective notifications.

48 As referred to in notification number RBI/2009-10/316 issued by the RBI.

49 As referred to in the Infrastructure Debt Fund — Non-Banking Financial Companies (Reserve Bank) Directions, 2011.

E. Taxation of Category III AIFs

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

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

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

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

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

The Bangalore Income Tax Appellate Tribunal in the case of DCIT v. India Advantage Fund –VII[50] held that income arising to a trust where the contributions made by the contributors are revocable in nature, shall be taxable at the hands of the contributors. The ruling comes as a big positive for the Indian fund industry. The ruling offers some degree of certainty on the rules for taxation of domestic funds that are set up in the format of a trust by regarding such funds as fiscally neutral entities. Globally, funds have been accorded pass through status to ensure fiscal neutrality and investors are taxed based on their status. This is especially relevant when certain streams of income maybe tax free at investor level due to the status of the investor, but taxable at fund level. Funds, including AIFs that are not entitled to pass through status from a tax perspective (such as Category III AIFs) could seek to achieve a pass-through basis of tax by ensuring that the capital contributions made by the contributors is on a revocable basis).

F. Taxation on Relocation of an AIF to IFSC

SEBI has released a circular allowing one-time off-market transfer of securities by an FPI to the IFSC (**"2021 Circular"**).[51] This 2021 Circular will allow relocation of foreign funds (set-up as FPIs) to set up Category-III AIFs in IFSC. The FM Regulations provide that the requirement of continuing interest by the FME shall be voluntary in case of relocation of offshore funds to IFSC.

50 ITA No.178/Bang/2012.

51 SEBI circular no. SEBI/HO/FPI&C/P/CIR/2021/0569 dated June 01, 2021.

The Finance Act, 2021 amended several provisions of the ITA to facilitate the relocation of offshore funds to the IFSC in a tax neutral manner both for the offshore fund as well as investors. Such provisions are applicable where the assets of the 'original fund' are 'relocated' to a 'resultant fund' in GIFT City. For this purpose, the ITA defines the term 'original fund', 'relocation' and 'resultant fund' as under:

Original fund: Original fund means a fund establish outside India which collects funds from its members for investing such funds for their benefit and fulfills the following conditions:

a) the fund is not a person resident in India;
b) the fund is a resident of a country with which India has a tax treaty;
c) the fund and its activities are subject to applicable investor protection regulations in the country where it is established or incorporated; and
d) fulfils such other conditions as may be prescribed

Resultant fund: Resultant fund means a fund established or incorporated in India in the form of a trust or a company or a limited liability partnership, which:

a) has been granted certificate of registration as a Category I or Category II or Category III AIF and is regulated by SEBI or IFSCA; and
b) is located in IFSC

Considering that under the FM Regulations, the FME (not the AIF) will be registered, above definition may have to be amended to ensure that tax neutrality is available in case of relocation of funds to IFSC.

Relocation: Relocation means a transfer of assets of the original fund, or of its wholly owned special purpose vehicle, to a resultant fund on or before March 31, 2023 where consideration for such transfer is discharged in the form of share or unit or interest in the resulting fund to:

a) shareholder or unit holder or interest holder of the original fund in the same proportion in which the share or unit or interest was held by such shareholder or unit holder or interest holder in such original fund, in lieu of their shares or units or interests in original fund; or
b) The original fund, in the same proportion as referred in sub-clause (i), in respect of which share or unit or interest is not issued by resultant fund to its shareholder or unit holder or interest holder.

Essentially, relocation will encompass transfer of assets of an offshore fund (say in Mauritius or Delaware) to an AIF in IFSC the consideration of which would be discharged by way of a swap. The swap will include proportionate issuance of units by the AIF in IFSC to either the unit holders of the offshore fund in lieu of units held in the offshore fund or to the offshore fund (in case where share or unit or interest is not issued by AIF in IFSC to shareholder or unit holder or interest holder of offshore fund).

G. Other Benefits on Relocation

Pursuant to the Finance Act, 2021, the ITA has also been amended to provide the following provisions for ensuring tax neutrality of relocation:

a) Exemption from capital gains tax on capital gains arising from transfer of capital asset in a relocation by the offshore fund to the AIF in IFSC. This provision essentially seeks to exempt capital gains tax arising on transfer of shares of Indian companies and other Indian securities held by an offshore fund to an AIF in IFSC. The ITA levies capital gains tax on gains arising on transfer of shares or securities of an Indian company. In absence of this exemption transfer of shares or securities of an Indian company by an offshore fund to AIF in IFSC pursuant to relocation would have been subject to tax in India;

b) Exemption from capital gains tax on capital gains arising from transfer by a shareholder / unit holder, in a relocation, of capital asset being share / unit held by him in the offshore fund in consideration for share / unit in the resultant fund. This provision seeks to exempt the transfer at the shareholder level from capital gains tax on account of indirect transfer provisions;

c) Exemption from capital gains tax on capital gain income arising or received by a non-resident investor or a specified fund, on account of transfer of shares of an Indian company by the AIF in IFSC or specified fund which were acquired by the AIF in IFSC or specified fund pursuant to relocation and where the capital gains on such shares were not been chargeable to tax had the relocation not taken place. This provision seeks protect grandfathered investments of offshore fund. It ensures that the outcome for the non-resident investor remains the same whether the exit from Indian company takes place by the offshore fund or the AIF in IFSC;

d) Cost of acquisition of shares of an Indian company acquired by the AIF in IFSC upon the relocation is deemed to be the cost of the previous owner i.e. cost base of shares of Indian company in hands of offshore fund is available to AIF in IFSC;

e) Cost of acquisition of units of the AIF in IFSC acquired by the unit holders on relocation of the offshore fund is deemed to be the cost of the previous owner;

f) The period of holding of shares of an Indian company acquired by the AIF in IFSC upon the relocation is deemed to be include the period for which the shares of the Indian company were held by the offshore fund;

g) The period of holding of units of AIF in IFSC acquired by the unit holders upon the relocation is deemed to be include the period for which such unit holders held the units of the offshore fund;

h) Section 79 has also been amended to allow the Indian company the benefit of set off and carry forward of loss to the extent the change in shareholding has taken place on account of relocation;

i) Lastly, corresponding changes have also been made to the provisions of Section 56(2)(x) to ensure that the AIF in IFSC or the unit holders of the offshore fund are not subject to tax on account of the swap transaction.

Fund Formation in Gift City

FM Regulations

Recently, IFSCA has notified the FM Regulations, which seeks to change the manner of fund formation in the IFSC. The FM Regulations regulate the fund manager, instead of the fund, by providing a single unified registration to the Fund Management Entities ("**FME**"), managing different schemes (ie. funds). The FME may seek registration under any of the three categories, viz, Authorised FME, Registered FME (non-retail) and Registered FME (retail). The three categories follow a risk based approach for supervision and to facilitate FMEs to undertake activities dealing with sophisticated investors with ease. The FM Regulations allow Authorised FMEs to manage venture capital schemes and family investment funds, whereas Registered FME (Non-Retail) are allowed to manage restricted schemes (in the nature of CAT I, CAT II, and CAT III AIFs), in addition to schemes managed by Authorised FMEs. Registered FMEs (Retail) are permitted to manage all schemes, retail as well as non-retail. In addition to the categories of FMEs, the FM Regulations specify the types of schemes which the FME can launch and manage. These schemes are, *inter alia*, venture capital schemes, restricted schemes (non-retail), restricted schemes (retail), and special situation funds.

The FM Regulations also require up to three key managerial personnel ("**KMPs**") be appointed by an FME, depending on the type of FME. A principal officer must be appointed by all the three categories of FMEs, a compliance and risk manager must be appointed by both Registered FME (Non-Retail) and Registered FME (Retail), whereas a fund manager must be appointed by a Registered FME (Retail). The FM Regulations require that the KMPs to be based out of the IFSC and that the proposal on the portfolio composition is also made by persons based in the FME's office in the IFSC. Professional qualification and experience requirements of the KMP have also been provided.

Further, the FM Regulations provide that advertisements shall be as per the advertisement code specified in the FM Regulations. The FM Regulations define advertisement in an inclusive manner, thereby, increasing the risk of inadvertent non-compliance. For example, during a roadshow, investors may seek information about past performance of the manager. Such communications by the manager may come under the ambit of advertisement as defined under the FM Regulations.

Trends In Private Equity

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

As discussed briefly earlier, given the issues associated with the levy of service tax on extraction of carried interest in India in unified structures and risk of being considered as AOP, co-investment structures have now emerged as a preferred choice for structuring India focused funds. There is also an increased participation from DFIs in India focused funds, including unified structures. Accordingly, some global benchmarks need to be followed when designing the structure and calibrating the fund documents including the governance, fiduciary aspects and adherence to ESG policies and AML policies. With one or more DFIs or sovereign investors in the mix, the fund terms continue reflecting a more LP tilt in balance even for fund managers raising a series III or a series IV fund.

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

The overseas fund could directly invest in India based opportunities or adopt a co-investment structure (i.e. the offshore fund invests alongside the Indian fund in eligible investment opportunities). The FDI Policy will however be applicable to investments made directly by an offshore fund in India. An optimum structure should reconcile the investment strategy, team economics and LP preferences.

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

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

Trending Fund Terms

A. Carry Mechanism

The total distribution to GPs (catch-up plus remaining share in profits) in the waterfall is known as 'carried interest' or 'additional return'. Typically, managers are entitled to 15%–20% carried interest on the entire profit of the AIF (i.e. distributions net of capital) where catch-up is involved. If there is no catch-up, the manager participates in profits of the AIF after hurdle (i.e. distributions net of capital and hurdle).

Carry clawback provisions also included to recover carried interest payments made in excess of distribution to LPs in certain situations like removal of manager, failure to cure KPE etc. This is considered a theoretical provision in whole-fund distribution models.

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Escrow mechanisms adopted to hold retention amounts from carried interest to honor clawback if such a situation arises.

B. Distribution Waterfall

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

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

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

C. Giveback

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

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

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

D. Voting Rights

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

E. Commitment Period / Tenure

Raising period (i.e. from first closing to final closing) is expected to be not longer than 18 months (including a 6-month extension). However, during COVID, there was a general consensus among LPs and GPs that the AIF may require a longer raising period. Equalization or catch-up contribution applies to subsequent closing investors in order to maintain proportionate exposure in the active portfolio of all LPs in the AIF as of any given date. GPs also charge an equalization premium amount or compensating contribution to subsequent LPs for the time value of money of existing LPs, however this amount may be waived with LP consent or LP Advisory Committee consent.

Commitment period (or the period of portfolio construction calculated from first closing) is expected to remain less than 2/3rd of the tenure of the fund (including extensions). The remaining period is for exits.

While no outer limit is given in the AIF Regulations for tenure, it is typically kept between 10–12 years (including extensions) for venture capital and private equity funds, whereas it is kept as 20-30 years for infrastructure and real estate funds which yield only in the later years. LVFs are permitted to extend tenure beyond two years subject to fund documents,[1] whereas, AIFs not permitted to extend tenure beyond two years.[2]

F. Leveraging

Category I Alternative Investment Funds are barred from directly or indirectly indulging in leverage / borrowings as per the Securities and Exchange Board of India (AIF) Regulations, 2012. The sole exception to this prohibition on leverage / borrowings is the usage of the same to meet temporary funding requirements for a maximum of period of thirty days and four times a year provided that the same is within 10% of the AIF's investable funds.

1 Proviso to regulation 13 (5) of AIF Regulations.

2 Regulation 13 (5) of AIF Regulations.

However, category III AIFs are permitted to engage in leverage / borrow provided that such AIFs receive investor consent and is within the permissible limit viz twice the net asset value of the concerned Category III AIF.[3], [4] Further, category III AIFs are to disclose the following to its investors and SEBI:

- information regarding the overall level of leverage employed;
- level of leverage arising from borrowing of cash;
- level of leverage arising from position held in derivatives or in any complex product; and
- main source of leverage in the fund.

It is to be noted that such leverage disclosures are to be made in the format specified by SEBI in the AIF Master Circular.

G. Side Letter

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

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

In the template PPM provided under the AIF Master Circular, SEBI has prescribed that investors be informed of any side letters that have been entered into by the Fund. It also prescribes that certain rights such as rights related to preferential exit from AIF, contribution to indemnification, contributor giveback and drawdowns (except as per the provision for 'excuse and exclusion') cannot be offered under the Side Letter to any investor.

H. Identification of Key Persons

LPs prefer to identify senior personnel in addition to the founders as key persons in the fund documents to avoid concentration risk and promote institutionalization of the GP. A point system has also gained popularity where senior and junior personnel are allotted certain points, and their departure leads to loss of points for the AIF manager. Upon total points going beyond a specified floor, a KPE is triggered.

Requires key person to devote reasonable business time to activities of AIFs. GPs request to carve out attention towards existing funds / prior funds from this requirement.

3 105 Regulation 18 (c) of AIF Regulations.

4 106 Clause 5.2.3 of the AIF Master Circular.

KPE may lead to the suspension of commitment period until a cure is given, termination upon failure to cure, removal of the GP, or in severe cases — even termination of the fund. Proposal for cure by the GP is time-bound and subject to satisfaction of the LPs / LP Advisory Committee.

I. Closing Adjustments

Generally, LPs prefer that the AIFs have certain provisions pertaining to closing adjustments to be made when a new investor is admitted to the fund at any closing subsequent to the first closing. We generally observe that subsequent investors to a fund are treated in a manner that they are deemed to have invested in the fund prior to first close, i.e., as though such investors had participated in all drawdowns of the fund until date. Any amount to be contributed by new investors for the aforementioned treatment shall be collected by the fund and distributed to the existing fund and the investment manager (as applicable). Further, at the discretion of the investment manager, the new investors may also be required to pay additional premiums if an existing investment of the fund has significantly increased in valuation.

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

J. Excuse Rights

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

Despite the minimum information required to be disclosed under the Template PPM, SEBI has observed that there is *"inconsistency and lack of adequate disclosure with respect to certain industry practices".* Thus, SEBI has now stipulated certain specific conditions wherein LPs may be excluded from contributing capital— the same are as follows:

a) based on the opinion of a legal professional/legal advisor, confirms that such LP's participation in the investment opportunity would be in violation of the applicable law or regulation; or

b) if the LP is also an AIF, or any other investment vehicle, such investor may be partially excused or excluded from participation in an investment opportunity, to the extent of the contribution of the said fund/ investment vehicle's underlying investors who are to be excused or excluded from such investment opportunity. the investment manager shall record the rationale for such excuse or exclusion along with the supporting documents, if any; or

c) as part of contribution agreement (or such similar agreement), the LP had disclosed to the investment manager that, their participation in such investment opportunity would be in contravention to their internal policy. The investment manager shall ensure that terms of contribution agreement with the LP include reporting of any change in the disclosed internal policy, to the investment manager, within fifteen days of such change; or\

d) if the investment manager is satisfied that the participation of such LP in the investment opportunity would lead to the AIF being in violation of applicable law or regulation or would result in material adverse effect on the AIF. The investment manager shall record the rationale for such exclusion, along with the documents relied upon, if any.[5]

K. GP Removal

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

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

Further, it is also being observed that many LPs require the Manager to take haircuts on carry even when the Manager is removed for no cause.

L. Management Fee

Manager remunerated by the AIF for providing management services; management fee typically used by manager to cover its own overhead expenses such as rent, salaries and other operational costs.

Charged as (i) 1.5%–2% of capital commitment during commitment period; and (ii) 1.5%–2% of net invested capital post expiry of commitment period. No fee charged to sponsor or manager unless it is a third-party sponsor. If tenure is extended, LPs expect fee to be charged on the basis of an annual budget presented by the GP and approved by the LPs (typically 75% by value) or LP Advisory Committee rather than as a percentage of net invested capital.

New fund managers expect to charge fees on the corpus throughout the life because the structure and team is new. Anchor LPs expect a lower management fees among other rights through a different class of units. Since different LPs may have different fee structures, drawdowns for fees are done independently for each LP rather than in the ratio of their capital commitments or unfunded capital commitments. Non-defaulting LPs are not required to contribute towards shortfall due to defaulting LPs for fees.

5 Guidelines with respect to excusing or excluding an investor from an investment of AIF, SEBI circular SEBI/HO/AFD-1/PoD/P/CIR/2023/053, dated April 10, 2023.

- Front loading (i.e. charging bulk of management fee in initial years) gaining popularity. Frequency of charging may differ — generally, charged on quarterly in advance basis.
- GST either (i) entirely borne by AIF (typically in case of venture capital funds); (ii) shared between the AIF and the manager such that up to a cap (say, 18%) will be borne by the AIF but any excess will be borne by the manager.
- Offset against any other fees received by the manager or its affiliates from portfolio companies.
- Split between feeder and master in unified structures such that the overall exposure of feeder LPs does not go beyond the agreed caps.
- If a successor fund is launched during the commitment period of the current fund and fee starts being charged therefrom, the fee for the current fund is reduced from a percentage of the commitments to percentage of the net invested capital.
- GPs retain discretion to waiver or defer payment of management fees. Fee consequences on GP removal, suspension of commitment period, key-person event is discussed subsequently.

M. Expenses

Expenses of an AIF may be broadly categorized as fund expenses and non-fund expenses. Non-fund expenses include all those expenses which are not chargeable to the fund such as the expenses to the Investment Manager such as overhead / administrative expenses of the Investment Manager (salaries / wages of its employees).

On the contrary, fund expenses encapsulated all the expenses that are chargeable to the fund such as set-up costs, placement and distribution costs (if any), and operating expenses. The PPM template specified by SEBI obligates the manager to disclose the caps (wherever applicable) on various expenses that may be charged to the fund.

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Provided upon request only

N. Fund Economics

SN	Fund Term	Market best practices
1	**Distribution Waterfall** Provides manner of allocation of profits between LPs/ GPs	▪ European whole fund model adopted more commonly than a deal-by-deal waterfall. Where many investors are involved (higher potential for excuse and default) or different classes of units have different expense exposures, ratio of distribution adopted is determined on the basis on the inter-se ratio of LPs in amounts utilized for investments generating such distribution proceeds. ▪ A typical distribution waterfall (i) first requires a return of capital contribution; (ii) second, a hurdle return (typically USD-basis 8% or INR-basis 10-12% post tax basis) to LPs; (iii) third, a GP catch-up (100% or even 50% in some cases); (iv) fourth, splitting of the residual proceeds between the LPs and the GP (typically 80:20). Alternatively, there may be a staggered waterfall, where step (iv) is followed until a specific performance benchmark of the AIF (say, 30% IRR). For distributions of remaining proceeds thereafter, a re-catchup is done for the GP, and the remaining proceeds are distributed between GPs and LPs (more in favor of the GP, say 75:25 or 70:30). ▪ Some waterfalls do not adopt a catch-up approach, which is considered more LP friendly. ▪ Temporary investment proceeds and restructuring proceeds are typically expected by LPs to be kept outside the waterfall / hurdle calculation and distributed only to LPs in their inter-se ratio of holdings. ▪ In debt fund structures, recurring income undergoes a separate waterfall (with its own carry structure, but typically without hurdle) than the exit income so that the GP is kept incentivized. However, in exit income distributions, such recurring income distributions to LPs are included towards calculation of their hurdle. ▪ Distributions to the sponsor of an AIF are subject to the continuing interest obligation, such that their minimum sponsor commitment amount is retained by the AIF until its last distribution. ▪ Even in case of in-specie distributions, the steps and ratio of the waterfall are to be followed.
2	**Calculation of IRR** Method of calculating the hurdle / preferred return	▪ Start date for calculation is due date in the drawdown or date of actual contribution, whichever is later. LPs are not benefitted for advancing their contributions in terms of start-date of the IRR. ▪ XIRR function in Microsoft Excel may be used for calculation of IRR. It may be also be calculated as a weighted average. ▪ Unutilized amounts which are returned within 45 calendar days from drawdown are excluded from IRR calculations, but any unutilized amounts beyond this period would lead to the clock ticking on IRR.

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O. LP Liabilities

SN	Fund Term	Market Best Practices
1	**Default**	▪ LPs are typically given a default notice / cure period (e.g., 7 calendar days) on default in payment before they are declared 'defaulting investors'. Institutional LPs disallow the GPs in their side letters from calling them defaulters without good faith discussions with LPs. ▪ Upon failure to cure and being declared defaulters, GPs are entitled to impose penalties on such LPs which could be both financial (e.g., 18% interest on default) and non-financial (e.g., forfeiture of units, exclusion from voting, compulsory exit, removal from LP Advisory Committee). Non-defaulting LPs may want to buy out such defaulting LPs' interests at a discount (e.g., 25%). Managers retain discretion to waive or reduce default consequences. LPs expect such waivers to be subject to LP Advisory Committee review. ▪ Breach of representations or confidentiality by LPs could also lead to a default. ▪ Non-defaulting LPs like to limit their excess exposure to deals on account of default by certain LPs to 15-20% of their original commitment amount. ▪ In master-feeder structures, or for other LPs which are pooling vehicles themselves, such feeder or LPs are considered defaulters only to the extent of their own investors defaulting.
2	**Tax Indemnity**	LPs are typically required to extend personal indemnity for any adverse tax implications arising on the AIF, trustee or manager solely due to such LP's conduct or omission. For example, an LP may undertake to the manager that it is not subject to certain taxes whereas the tax authorities may take a view subsequently that the LP is indeed subject to those taxes and may hold the trustee and / or the manager accountable for payment and penalties.
3	**LP Giveback**	▪ LP giveback protects the AIF from its post-termination liabilities (tax and non-tax including indemnification obligations). Under this, LPs and GP are required to return distributions in the reverse order of the waterfall to make good the AIF for such liabilities (except in case of bad acts of the manager or trustee such as fraud, gross negligence or willful misconduct). ▪ Time period of LP giveback is pegged to the relevant statutory timeline. ▪ Generally, capped at the lower of actual distributions or 25% of capital commitments. ▪ LP giveback should only be triggered upon the GP exhausting all other avenues to meet fund liabilities. ▪ The trust which obtains AIF registration is generally kept alive even after expiry of AIF tenure to keep aside reserves for potential liabilities up to the statutory period of limitations.

P. Governance Related Terms

Governance provisions in fund documents are heavily negotiated between the LPs and GPs. Key provisions are provided below:

S No	Fund Term	Market Best Practices
1	**Timelines**	▪ Raising period (i.e. from first closing to final closing) is expected to be not longer than 18 months (including a 6-month extension). However, during COVID, there was a general consensus among LPs and GPs that the AIF may require a longer raising period. Equalization or catch-up contribution applies to subsequent closing investors in order to maintain proportionate exposure in the active portfolio of all LPs in the AIF as of any given date. GPs also charge an equalization premium amount or compensating contribution to subsequent LPs for the time value of money of existing LPs, however this amount may be waived with LP consent or LP Advisory Committee consent. ▪ Commitment period (or the period of portfolio construction calculated from first closing) is expected to remain less than 2/3rd of the tenure of the fund (including extensions). The remaining period is for exits. ▪ While no outer limit is given in the AIF Regulations for tenure, it is typically kept between 10-12 years (including extensions) for venture capital and private equity funds, whereas it is kept as 20-30 years for infrastructure and real estate funds which yield only in the later years.
2	**Key Person Event (“KPE”)**	▪ LPs prefer to identify senior personnel in addition to the founders as key persons in the fund documents to avoid concentration risk and promote institutionalization of the GP. A point system has also gained popularity where senior and junior personnel are allotted certain points, and their departure leads to loss of points for the AIF manager. Upon total points going beyond a specified floor, a KPE is triggered. ▪ Requires key person to devote reasonable business time to activities of AIFs. GPs request to carve out attention towards existing funds / prior funds from this requirement. ▪ KPE may lead to the suspension of commitment period until a cure is given, termination upon failure to cure, removal of the GP, or in severe cases – even termination of the fund. ▪ Proposal for cure by the GP is time-bound and subject to satisfaction of the LPs / LP Advisory Committee.
3	**Removal of Manager**	▪ No fault removal on basis of 75% LP consent (by value); ▪ Fault removal (simple-majority by value) on occurrence of cause events such as fraud, willful misconduct etc. by AIF manager or its directors / employees; ▪ Haircut on management fee and carried interest for fault. No haircut on management fee (in fact, 6 months’ fees is advanced to the manager) and reduced haircut on carried interest for no fault removal.

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Q. Conflict of Interest and Resolution

Conflict of interest provisions have become a priority focus area for regulators across the globe, especially in relation to deal-flow allocation, expense sharing, co-investment and affiliate transactions.

SN	Conflict points	Market Best Practices
1	**Successor Funds**	▪ LPs seek to limit GP's ability to raise funds with a similar investment thesis during the fund's commitment period or until at least 70% of current fund's corpus is utilized for investments or reserved for identified investments. ▪ GPs tend to exclude funds with different strategies from the scope / ambit of successor funds. ▪ For GPs with good track-record, LPs expect a right of first offer for committing into such successor funds.
2	**Exclusivity and Deal Flow Allocation**	▪ LPs seek explicit disclosure pertaining to the allocation of investment opportunities between the funds managed by the GP. ▪ GPs request for pro rata allocation between multiple funds under their management with identical investment strategies, whereas LPs insist on deal-flow exclusivity for their fund.
3	**GP Co-investments**	▪ GPs expected to share figures pertaining co-investments to ensure that there is no adverse selection. ▪ To address 'cherry-picking', GPs may only be permitted to co-invest on a lock-step basis or subject to an overall / annual cap.
4	**Affiliate Transactions**	▪ Consent of LP advisory committee may be mandated for cross transaction between affiliates. ▪ Fund documents to lay down specific procedures pertaining to warehousing of investments. ▪ GP to disclose services offered to the fund / portfolio entities to the LP advisory committee and fee for the same should be charged on an arm's length basis.
5	**LP Co-investments**	▪ Clarity to be provided in advance as to whether LPs invest directly or via a co-investment fund. ▪ Fund documents to lay down how and when co-investment opportunities are offered to LPs. ▪ GP to make disclosure pertaining to the allocation of co-investment opportunities and expense sharing between the fund and LPs.

Recently, SEBI has mandated that an AIF shall not buy or sell investments, except with the approval of 75% of investors by value of their investment in the AIF, from or to (i) associates; (ii) other AIFs managed or sponsored by the same manager, sponsor or their associates; or (iii) an investor who has committed to the extent of more than 50% of the corpus of the scheme of AIF. From a conflict disclosure and mitigation perspective, AIF managers were already making these disclosures in the placement memorandum and going to their investor advisory committees for conflict clearance. The requirement of obtaining 'affirmative consent' may be too burdensome. If the placement memorandum provides an appropriate disclosure, then investors' consent should be deemed as having been provided. For example, warehoused investments would typically be bought from an associate and should not require any investor consent. The manager acquires such investments even prior to the first closing in the interests of investors.

A recommendation in this regard is to allow a deemed consent mechanism, wherein if the consent of the investors is not received within a certain time period (say 30 days), it would be deemed that the investor has consented to such transfer.

R. Dispute Resolution

LPs and GPs (like any other commercial counterparts) prefer to have arbitration as a method of dispute resolution in the fund documents. However, pursuant to the Supreme Court decision in case of Vimal Shah and Ors. v. Jayesh Shah and Ors[6] enforcement of arbitration provisions for AIFs set up as trusts is not certain.

The AIF Regulation expressly provides AIFs the ability to lay down procedures (including by way of arbitration) to address disputes provided that such procedure is mutually agreed by all the parties involved.[7] Nevertheless, in the interest of avoiding protracted litigation on account of enforceability issues, the governing law provision of the Indenture of Trust should specifically prioritize arbitration over any other legal proceedings if permitted under applicable law.

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6 Civil Appeal No.8164 OF 2016; The Hon'ble Supreme Court has held that (i) an arbitration clause in a trust deed does not qualify as written agreement evidencing an arbitration agreement and (ii) that there exists an implied bar under the Indian Trusts Act, 1882 rendering disputes pertaining to a trust incapable of being referred to a private arbitration. Although the Vimal Shah judgement pertained to a family trust and not an AIF, the decision has led to some investor discomfort.

7 It may be argued that as special law takes precedence over a general legislation, i.e. the AIF Regulations should take precedence over the Indian trusts act, 1882.

Fund Documentation

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

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

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

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

I. At the Offshore Fund Level

A. Private Placement Memorandum / Wrapper

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

B. Constitution

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

C. Subscription Agreement

The subscription agreement is an agreement that records the terms on which an investor will subscribe to the securities / interests issued by an offshore fund. The subscription agreement sets out the investor's capital commitment to the fund and also records the representations and warranties made by the investor to the fund. This includes the representation that the investor is qualified under law to make the investment in the fund.[1]

D. Advisory Agreement

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

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

II. At the Onshore Fund Level

A. Private Placement Memorandum

AIF Regulations require that a concerned fund's PPM should contain all material information about the AIF, including details of the manager, the key investment team, targeted investors, fees and other expenses proposed to be charged from the fund, tenure of the scheme, conditions or limits on redemption, investment strategy, risk factors and risk management tools, conflicts of interest and procedures to identify and address them, disciplinary history, terms and conditions on which the manager offers services, affiliations with other intermediaries, manner of winding up the scheme or the AIF and such other information as may be necessary for an investor to make an informed decision as to whether to invest in the scheme of an AIF.[2]

SEBI has now directed fund managers to add by way of an annexure to the placement memorandum, a detailed tabular example of how the fees and charges shall be applicable to the investor and the distribution waterfall for AIFs.[3] In addition, the AIF Master Circular mandates that (i) investor charter; and (ii) data on investor complaints received against AIFs and each of their schemes and redressal status thereof shall be disclosed by all AIFs in a format as prescribed in the AIF Master Circular.

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

2 Regulation 11 of the AIF Regulations, 2012.

3 Paragraph 2(a)(i) of the SEBI Circular CIR/IMD/DF/14/2014.

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AIFs should also include disciplinary actions in its PPM.[4] It has been clarified by SEBI that AIFs should also include a disciplinary history of the AIF, sponsor, manager and their directors, partners, promoters and associates and a disciplinary history of the trustees or the trustee company and its directors if the applicant for AIF registration is a trust.[5]

Any changes made to the PPM submitted to SEBI at the time of the application for registration as an AIF must be listed clearly in the covering letter submitted to SEBI and further to that, such changes must be highlighted in the copy of the final PPM.[6] In case the change to the PPM is a case of a 'material change' (factors that SEBI believes to be a change significantly influencing the decision of the investor to continue to be invested in the AIF), said to arise in the event of (1) change in sponsor / manager, (2) change in control of sponsor / manager, (3) change in fee structure or hurdle rate which may result in higher fees being charged to the unit holders), existing unit holders who do not wish to continue post the change shall be provided with an exit option.[7] Further, such material changes to the PPM, shall be intimated to investors and SEBI on a consolidated basis, within 1 month of the end of each financial year.

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

While global investors prefer excluding the PPM from being an 'applicable fund document' to investors, SEBI expects the manager to ensure that each of the investors has read and agreed to the terms in the PPM. Also, as explained above, SEBI primarily reviews the PPM to grant registration as an AIF to the applicants. This often becomes a matter of concern during LP-GP negotiations. Unless a waiver has been taken, the AIF shall abide by the template form of the PPMs as discussed in detail in the previous section.

B. Indenture of Trust

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

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

4 Regulation 11(2) AIF Regulations.

5 Paragraph 2(a)(ii) of the SEBI Circular CIR/IMD/ DF/14/2014Regulation.

6 Paragraph 2(b)(i) of the SEBI Circular CIR/IMD/DF/14/2014.

7 Paragraph 2(b)(iv)(a) of the SEBI Circular CIR/IMD/DF/14/2014.

C. Investment Management Agreement

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

D. Contribution Agreement

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

SEBI also requires that the terms of the Contribution Agreement should be in alignment with the terms of the PPM and should not go beyond the same.

III. Investor Side Letters

It is common for some investors to ask for specific arrangements with respect to their participation in the fund. These arrangements are recorded in a separate document known as the side letter that is executed by a specific investor, the fund and the investment manager. Typically, investors seek differential arrangements with respect to management fee, distribution mechanics, participation in investment committees, investor giveback, etc. An investor may also insist on including a 'most favoured nation' (“**MFN**”) clause to prevent any other investor being placed in a better position than itself. An issue to be considered is the enforceability of such side letters unless it is an amendment to the main contribution agreement itself.

SEBI has, as stipulated in the AIF Master Circular, made it mandatory for the PPMs to provide for various disclosures. Some of them include disclosure of whether any side letters shall be offered, the criteria for offering differential rights (quantitative/qualitative/both), list of commercial / non-commercial terms on which differential rights may be / may not be offered. SEBI also mandated for the PPM to include a declaration to the effect that the terms of the side letters shall not alter the rights of other investors.

IV. Agreements with Service Providers

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

V. Applicability of Stamp Duty

The amendments to the Indian Stamp Act, 1899 (w.e.f. from July 01, 2020) have made provision for the payment of stamp duty on issuance and transfer of securities (other than debentures). The definition of 'securities' to be perused for this provision has to be borrowed from the Securities Contracts (Regulation) Act, 1956 ("**SCRA**") and will also include any other instrument as declared by the Central Government. While prior to the introduction of this provision, the AIF units were not considered 'securities' as per the SCRA, the SEBI recently issued a circular[8] (now covered under the AIF Master Circular) to this effect thus bringing the AIF units within the purview of the said amendment. Furthermore, the Department of Economic Affairs also released a set of FAQs to clarify this aspect.

Hence, as per the amendment, issuance of AIF units will now attract a stamp duty of 0.005% of the value of units excluding charges such as management fee, GST etc. Transfer of units on delivery basis will attract a stamp duty of 0.015% whereas transfer on a non-delivery basis will attract a stamp duty of 0.003% on the transfer consideration. It is noteworthy that the redemption of units shall not require payment of stamp duty. With the dematerialization of AIF units the applicable stamp duties on the issuance and transfer of such units shall now be payable to depositories as opposed to being paid to Registrar to an issue/share transfer agent ("**RTA**").[9]

In the interim, the non-dematerialized AIF units (till the compulsory dematerialization) shall have their applicable stamp duties collected by a RTA.

8 https://www.sebi.gov.in/legal/circulars/jun-2020/collection-of-stamp-duty-on-issue-transfer-and-sale-of-units-of-aifs_46983.html.

9 Section 9A of the Stamp Act.

Hedge Funds

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

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

The FPI Regulations 2014 were recently overhauled to render effect to the recommendations of the HR Khan Committee. This section deals with eligible participants under the FPI Regulations, 2019 the range of investment and hedge strategies that may be adopted and the scope of dealing with contract notes (swaps and offshore derivative instruments, i.e. ODIs).

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

Onshore Hedge Funds (Category Funds)

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

While the general characteristics of Category III AIFs have been discussed previously, it is important to stress on certain key aspects. The AIF Regulations provide that Category III AIFs may engage in leverage or borrow subject to consent from the investors in the fund and subject to a maximum limit specified by SEBI.

A. Suspension of Redemptions

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

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

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

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

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

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

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B. Leverage Guidelines

SEBI limits the leverage that can be employed by any scheme of a fund to two times (2x) the after deducting the value of investments in units of the Investee AIFs from the net asset value ("**NAV**")[1] of the of the total portfolio investment held by such fund. The leverage of a given scheme is calculated as the ratio of total exposure of the scheme to the prevailing NAV of the fund. While calculating leverage, the following points should be kept in mind:

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

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

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

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

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

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

1 SEBI circular no. SEBI/HO/IMD-I/DF6/P/CIR/2021/584, dated June 25, 2021.

Fund Governance

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

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

I. Investment Manager

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

II. Investment Committee and Advisory Board

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

The functions of the IC typically include review of (1) transactions that are proposed by the investment manager, (2) performance, risk profile and management of the investment portfolio and (3) to provide appropriate recommendations to the investment manager (4) ensuring compliance with the Code of Conduct of the AIF as prescribed in the PPM and other constitutive documents of the AIF.

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

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

Sophisticated LPs insist on a robust decision-making process whereby an investment manager will refer investment and / or divestment proposals along with any due diligence reports in respect of such proposals to an investment committee comprising representatives of the GP. The investment committee has traditionally been authorized to take a final decision in respect of the various proposals that are referred to it. The committee is also empowered to monitor the performance of investments made by the fund a view to limiting the quantum of expenses that are paid by the fund, LPs insist on putting a cap on expenses. The cap is generally expressed as a percentage of the size of the fund or as a fixed number can become a debatable issue depending on the investment strategy and objective of the fund.

GPs often try to negotiate for annual caps for operating expenses, given the long tenure of VC/PE funds and the difficulty in ascertaining the appropriate cap for the entire tenure upfront; whereas, LPs prefer a cap for the entire tenure to be disclosed upfront in the fund documents. If an annual cap method is chosen, LPs often seek the right to be consulted before setting the annual cap by GPs. Separately, as a measure of aligning interests, LPs insist that allocations made from their capital contributions towards the payment of expenses should be included while computing the hurdle return whereas the same should not be included while determining management fee after the commitment period.

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

However, SEBI from time to time gives feedback on such provisions. For example, SEBI vide its notification dated October 19, 2020 ("**2020 Notification**") had statutorily provided for the constitution of an Investment Committee ("**ICOM**") by the IM. It also provided that the members of the ICOM would be severally and jointly liable for the investment decisions and compliance of the AIF Regulations as well as the governing documents of the AIF. As the notification tried to fasten responsibility for legal compliances on the ICOM which is primarily responsible for the commercial decision of the AIF, the funds' industry reacted negatively to the notification. To address the concerns of the stakeholders, SEBI released another notification in January 2021 ("**Amendment Notification**"). This Amendment Notification introduced a mechanism to obtain a waiver from the requirements and responsibilities outlined in the 2020 Notification. The waiver mechanism allows the AIFs in which each investor other than the AIF Manager, sponsor, employees, or directors of the AIF or employees or directors of the AIF Manager, has committed to invest not less than INR 70 crore and has furnished a waiver to the AIF in respect of compliance with the said clauses, in the manner as specified by SEBI. Currently, SEBI has stipulated that the ICOM members shall ensure that their decisions are also in compliance with the policies and procedures of the AIF. ICOM members may not be jointly liable with AIF managers due to the amendments; however, SEBI seems to have retained regulatory authority over such members.

The above changes reflected the market regulators' continual approach to strike a balance between accountability of the AIF managers towards the investors and the flexibility such managers would need to effectively run their operations. Moreover, these measures have resulted in increased investor protection by ensuring transparency and accountability of the concerned personnel.

III. Aspects and Fiduciaries to be Considered by Fund Directors

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

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

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

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

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

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

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

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

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

Further, in India, the recent case of RBI & Ors v. Jayantilal N. Mistry & Ors.[1] the Supreme Court of India considered the meaning of the term 'fiduciary,' and held that it referred to a person having a duty to act for the benefit of another (a 'duty of loyalty'), showing good faith and candour ('duty of care'), where such other person reposes trust and special confidence in the person owing or discharging the duty. The court took the view that the term 'fiduciary relationship' is used to describe a situation or transaction wherein one-person (the beneficiary) places complete confidence in another person (the fiduciary) in regard to his affairs, business or transaction(s). The term also referred to a person who held a thing in trust for another (the beneficiary). The fiduciary is expected to act in confidence and for the benefit and advantage of the beneficiary, and to employ good faith and fairness in dealing with the beneficiary or with things belonging to the beneficiary. In the aforesaid case, the court held that "...RBI has no legal duty to maximixe the benefit of any public sector bank, and thus there is no relationship of 'trust' between them." [2]

In a relevant case, HMRC v Holland[3] it was observed that the fact that a person is consulted about directorial decisions, or asked for approval, does not in general make him a director because he is not making the decision.

1 AIR 2016 SC 1.

2 Ibid.

3 122 3. [2010] 1 WLR 2793.

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

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

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

A. At the Fund Formation Stage

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

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

B. During the Fund's Tenure

i. Appointment of Service Providers

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

ii. Agenda

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

iii. Actions Outside Board Meetings

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

iv. Decision Making Process

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

v. Minutes

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

vi. Remuneration

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

vii. Conflict of Interest

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

The rulings discussed confirm that a fund's board has duties cast on it and the 'business judgment rule' may ensure that liability is not shielded in all cases. There are certain non-delegable functions for the directors to discharge on an on-going basis and none are more paramount than reviewing of the fund's performance, portfolio composition and ensuring that an effective compliance program is in place. These functions require action 'between' board meetings and not only 'during' board meetings.

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

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IV. KPE Governance

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

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

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

V. Grievance Redressal

In accordance with SEBI circular No. CIR/OIAE/1/2014 dated December 18, 2014, the AIF, as a SEBI registered intermediary, is required to register with the SEBI Complaints Redress System (SCORES) platform within one month from the date of registration as an AIF. All disputes shall be resolved on the SCORES platform.

Further, in accordance with the AIF Master Circular, details of investor complaints received against AIF and its redressal status thereof must be disclosed in the PPM as a separate section.

Recently, SEBI has introduced a mandatory an online dispute resolution (“**ODR**”) mechanism vide its circular dated July 31, 2023[4] (“**ODR Circular**”) (as amended from time to time).[5]

4 Online Resolution of Disputes in the Indian Securities Market; Circular No. SEBI/HO/OIAE/OIAE_IAD-1/P/CIR/2023/131.

5 The ODR Circular has been amended by the Corrigendum cum Amendment to Circular dated July 31, 2023 on Online Resolution of Disputes in the Indian Securities Market [SEBI/HO/OIAE/OIAE_IAD-1/P/CIR/2023/135] dated August 04, 2023.

The major aspects pertaining to ODR that is specifically addressed by the ODR circular are depicted below:

Vide the ODR Circular, SEBI seeks to streamline and expand the scope of the currently existing alternative dispute resolution (“**ADR**”) mechanisms in place by enabling an online mode of conducting conciliation and arbitration for resolution of disputes arising in the Indian Securities Market. The scope of the ODR framework is tabulated hereunder.

SN	Party I	Party II	Disputes Covered
1	Investors / Clients (or holders on account of nominations or transmission being given effect to)	Listed companies (including their registrar and share transfer agents)	a. Arising of Party II's activities in the securities market; or b. Unresolved issues of any service request / service related complaints
2	Investors / Clients (or holders on account of nominations or transmission being given effect to)	Intermediaries / regulated entities in securities market specified under Schedule A of the ODR Circular[6] ("**Schedule A Market Participants**")	
3	Institutional or corporate clients	Intermediaries / regulated entities in securities market specified under Schedule B of the ODR Circular[7] ("**Schedule B Market Participants**") (collectively, "Market Participants")	
4	MIIs	Constituents of the MIIs	Disputes that are contractual in nature with specific exclusion of disputes/appeals/reviews/ challenges pertaining to the regulatory, enforcement role and roles of similar nature played by MIIs[8]

6 Schedule A Market Participants:
1) AIFs – Fund managers
2) CIS – Collective Investment management company
3) Depository Participants
4) Investment Advisors
5) InvITs – Investment Manager
6) Mutual Funds – AMCs
7) Portfolio Managers
8) Registrars and Share Transfer Agents
9) REITs – Managers
10) Stock brokers

7 Schedule B Market Participants:
1) Clearing Corporations and their constituents
2) Credit Rating Agency and rating clients
3) Custodians and their clients/FPIs
4) Debenture Trustees and issuers
5) Designated Depository Participant and their clients/FPIs
6) KYC Registration Agency and their clients/intermediaries
7) Merchant Banker and issuers
8) Mutual Funds and Mutual Fund Distributors
9) Proxy Advisory and their clients
10) Proxy advisors and listed entities
11) Registrars and Share Transfer Agents and their clients
12) Research Analyst and their clients
13) Stock brokers and their Authorised Persons
14) Trading Members and Clearing Members
15) Vault Managers and beneficial owners

8 Such disputes shall be covered under the ODR framework at a future date (as specified by SEBI).

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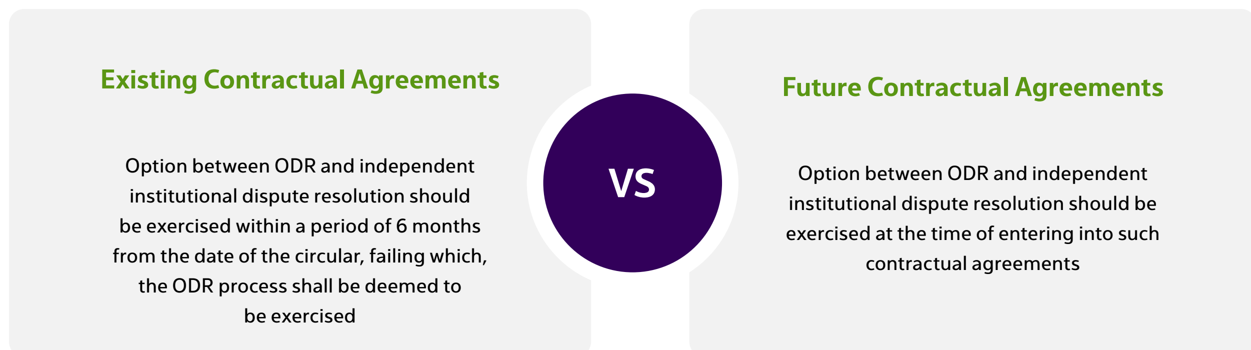
Further, institutional / corporate clients are provided the liberty to chose between the ODR mechanism as specified in the ODR Circular or any independent institutional mediation, conciliation and / or online arbitration institution in India. Furthermore, the ODR circular also sheds light on dispute resolution mechanism to be adopted in the current and future contracts between institutional / corporate clients and Schedule B Market Participants — the same is captured in the diagram below.

The ODR Circular lays specific emphasis on 'matters that pertain to activities in the securities market'. Although the circular does not provide an indicative / exhaustive list of the same, the phrase may be reasonably interpreted to mean matters that are related to securities market and are directly regulated by a statute. This specificity to matter ensures that there is greater autonomy for investors (especially sophisticated investors) as contractual agreements entered into between investors and Market Participants / Listed Companies fall outside the purview of the ODR framework. For example, in the context of Alternative Investment Funds (**"AIFs"**)— while the obligations of an AIF manager under the AIF regulations may be a cause of action under the ODR framework, a dispute arising out of a contribution agreement[9] may not be a valid cause of action under the ODR framework.



Additionally, the inclusion of service related complaints within the scope of ODR greatly expands the ambit of the ODR framework. In furtherance of the same, the ODR Circular provides an indicative list of causes that are covered under 'service related complaints'. [10] By including service related complaints within the ambit of ODR, SEBI has ensured that aggrieved investors have access to a seamless dispute resolution method for miscellaneous grievances such as include non-receipt/ delay of account statement, technological issues, etc.

9 Contractual agreement between the trustee, AIF manager and the investor for the latter to subscribe to units of an AIF.

10 Service related complaints shall include non-receipt/ delay of account statement, non-receipt/ delay of bills, closure of account/branch, technological issues, shifting/closure of branch without intimation, improper service by staff, freezing of account, alleged debit in trading account, contact person not available, demat account transferred without permission etc.

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For ease in implementation of the mechanism under the ODR Circular, the market regulator has obligated MIIs to establish an ODR portal. This ODR portal is to provide for the necessary infrastructure to undertake the ODR process as laid down under the ODR Circular. Herein, the MIIs are to ensure the following:

i. The ODR framework is facilitated through independent ODR institutions ("**ODR Institutions**") empaneled with them in accordance with the Arbitration and Conciliation Act, 1996, and other applicable laws;

ii. ODR shall be in the form of online conciliation and / or online arbitration by harnessing audio-video technologies, presided by qualified conciliators and / or arbitrators;

iii. SEBI specified norms of empanelment and continuing obligations of ODR Institutions are adhered to;

iv. Allocation of disputes to ODR Institutions is in accordance with the ODR Circular; and

v. The ODR Portal has connectivity with-

   a. the SEBI Complaint Redress System ("**SCORES**") platform;

   b. SEBI intermediary portals; and

   c. ODR Institutions for the purpose of conducting the discussed activities.

Further, all listed companies and Market Participants are to roll themselves on the ODR Portal by execution of online agreements with MIIs and ODR Institutions. It may be noted that SEBI SCORES portal / SEBI intermediary portal credentials may also be used on the ODR Portal. Additionally, the process of ODR, as is to be followed by investors / clients, has been summarized in the diagrammatic representation below.

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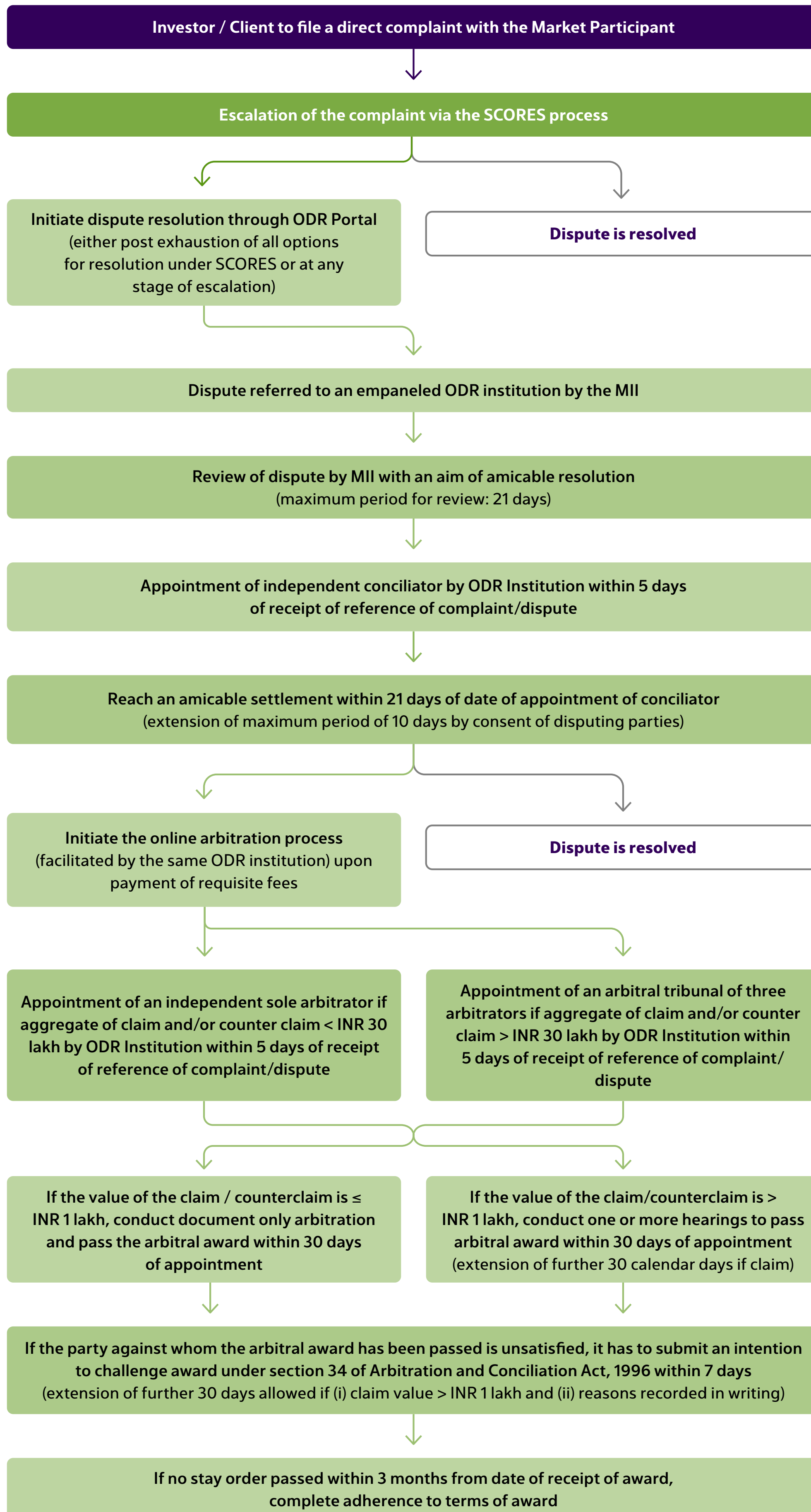

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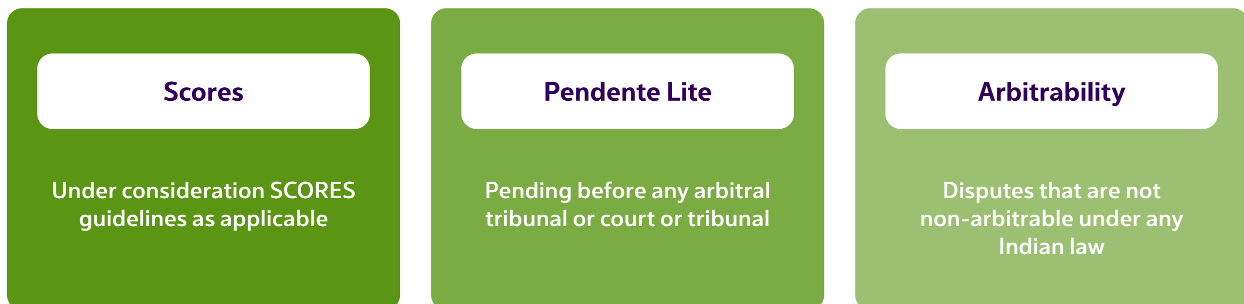
The above flow chart highlights the crucial aspects of the ODR process wherein it may be observed that the ODR Circular systematically provides for two alternative dispute resolution methods for grievance redressal, one being conciliation, failure of which shall result into stage two being arbitration, the strict timelines therein ensure timely redressal of the complaints.

Additionally, it is to be noted that in situations where the claim is not resolved at the stage of conciliation, the conciliators are required to ascertain the claim value of the dispute and notify the concerned parties, ODR Institutions and MIIs of the same. Further, please refer to diagram below capturing the list of complaints/ disputes that may not be accepted by ODR institutions.[11]



Moreover, in order to deter frivolous applications by Market Participants against investors, SEBI has put in place certain additional requirements that have to be met by Market Participants who are initiating actions under ODR, viz. as follows:

11 Non-arbitrability to include instances wherein moratorium under the Insolvency and Bankruptcy Code is in operation due to the insolvency process or if liquidation or winding up process has been commenced against the Market Participant)

It is to be noted that if the Market Participant fails to deposit 100% of the admissible claim value with the relevant MII shall result in online arbitration not being initiated and may result in the fit and proper status of the Market Participant getting revoked. This penalty of the Market Participant losing its 'fit and proper' person status is quite onerous as it shall be unable to provide its services in the Indian securities market without a fit and proper declaration. Nevertheless, Market Participants may seek to initiate action(s) against investors wherein the latter have failed to adhere.

VI. Stewardship Code

In recognition of the stewardship responsibilities undertaken by institutional investors like AIFs to their clients, SEBI (in 2019) released the SEBI Stewardship Code with a view to bolster corporate governance and improve investor protection. As of April 01, 2020, all categories of AIFs are expected to follow the SEBI Stewardship Code with respect to their investments in listed equities. The principles that form a part of the SEBI Stewardship Code are distilled hereunder.

A. Policies on Stewardship Responsibilities to be Formulated

Institutional investors are mandated to put in place a comprehensive policy pertaining to their stewardship policies. This policy is to specify how the institutional investor shall fulfill its responsibilities such as that of monitoring investments and engaging with portfolio companies. Any outsourcing of stewardship functions ought to be highlighted in the policy with mechanisms put in place to ensure that they are properly and diligently exercised.

It is to be noted that this stewardship policy is to be updated periodically and publicly disclosed (including on the entity's website). Further, this policy is also to contain training manual/policy for personnel to familiarize themselves with the underlying principles of stewardship.

B. Conflicts of Interests

Detailed guidelines for identifying and managing conflicts of interests are to be covered by a conflict of interest policy wherein the entity's interests are subordinated to that of the client / beneficiary's. This policy is to mandatorily (i) identify situations where conflict of interest may reasonably arise and (ii) put in place mechanisms to address such identified conflicts. It is to be noted that this conflict of interest policy is to be updated periodically and publicly disclosed.

C. Monitor Investee Investments

Institutional investors are to lay down a policy on continuous monitoring of their investee companies. This policy ought to cover important aspects such as risk factors and investee performance. The policy may lay out differentiated levels / areas / mechanisms of monitoring in respect of different investments, even excluding active involvement with small / specific investments by way of express disclaimers in the policy.

It is to be noted that this policy should specifically provide for (i) levels of monitoring for different investee companies, (ii) areas of monitoring focus, and (iii) situation which may attract insider trading provisions and mechanisms put in place to be in compliance of insider trading regulations.

D. Interventions into Investee Companies

Situations that call for active intervention in the investee companies and the manner thereof ought to be specifically provided for in a separate policy. The policy should also provide for back-testing of situations where the institutional investors actively intervened. The policy may provide for differentiated levels of intervention depending on the severity of the surrounding circumstances (the same needs to be disclosed).

E. Voting Activity

A voting policy is to be drafted by institutional investor to ensure that the interests of clients / beneficiaries are protected. Such a policy is to cover critical aspects such as (i) voting mechanisms, (ii) internal guidelines on voting procedures, (iii) disclosure of voting with rationale, and (iv) disclosures pertaining to voting advisory services such as proxy voting (if applicable).

F. Periodic Reporting

Institutional investors are to periodically communicate to their clients / beneficiaries as to how the stewardship responsibilities have been fulfilled by them as per the policies that have been put in place. The same ought to be easy-to-understand and disclosed in the following manner:

i. Report on the entity's website as to the implementation of every principle at periodic intervals or separate reports for each principle at different periodicities; or

ii. Report to be annexed with the annual communications made to the clients / beneficiaries.

In a nutshell, as a part of their governance requirement, fund managers in India are required to draft a comprehensive stewardship policy which shall include:

a. Conflict of interest policy;

b. Personnel training policy;

c. Conflict of interest policy;

d. Investment monitoring policy;

e. Interventions policy; and

f. Voting policy.

VII. New Orders

SEBI as the AIF market regulator constantly undertakes inspections and commences enforcement actions wherever necessary to ensure that its vision of investor protection is safeguarded. In furtherance of the same, we have summarized orders / directions issued by SEBI in few matters below:

a) **Extension of fund life beyond the term specified in fund documents:** Upon inspection of a VCF, SEBI noted that the VCF had not liquidated its investment despite the expiry of the fund term (and extensions).

Response of VCF to show cause notice issued by SEBI:

- *Inability to liquidate attributed to investment climate.*
- *Investment Manager has not charged management fees from 2014.*
- *Distressed sale would result in erosion of value. Third party consultants recommended to gradually offload investments in the interest of investors.*
- *Investment Manager continued to make efforts to liquidate investments gradually — 83% of capital contributions were returned to LPs.*

Upon examination of the matter, SEBI directed the VCF *inter-alia* to ensure that the VCF is wound up by providing exit to its LPs within a maximum period of 3 months from the date of its order.[12] SEBI also noted the following:

- Liquidation of the assets of VCF within the prescribed timeline was not impossible but was economically unfeasible. Avoidance of loss could not be a valid ground for not complying with the mandatory obligation prescribed under VCF Regulations
- The PPM contained disclosures of adequate and material risk factors and the investors in VCF were sophisticated. Thus, it was reasonable to infer that they had invested in the VCF knowing very well the associated risks involved in a real estate scheme and were aware that there was a possibility of loss.
- In the absence of any provision in law or any customary/market practice, it may not be an appropriate interpretation of the law to state that a scheme that had invited investors to invest in the fund promising it to have a definite lifespan, could be permitted to continue to exist in perpetuity only on the ground that any exit that may be provided to the unit holders, may not be profitable to them at the time of their exit.

SEBI also specified the manner of providing exit to LPs including the manner of valuation of liquidated investments. In addition, SEBI restrained the directors of investment manager from accessing the securities market by issuing prospectus, offer document or advertisement soliciting money from the public in any manner, either directly or indirectly, for a period of 1 year from the date of its order.

12 In the matter of Urban Infrastructure Venture Capital Fund, WTM/SM/AFD-1/AFD-1-SEC/20965/2022-23.

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b) **Non-compliance with 'fit and proper' criteria:** SEBI passed an order against the sponsor and a director of an investment manager of an AIF in a separate action for violating SEBI norms. Subsequently, SEBI initiated proceedings against the AIF to ascertain whether its sponsor and director of its investment manager complied with the fit and proper person criteria as laid down by the SEBI (Intermediaries) Regulation, 2008 ("**Intermediaries Regulations**").

> *Response to show cause notice issued by SEBI:*
>
> - *The AIF shall not raise funds until the aforementioned separate action has reached finality at the Hon'ble SAT.*
> - *In the instance wherein the SAT decides against the sponsor and the director, then, the AIF would restructure its management to ensure that persons not meeting the criteria of 'fit and proper' person would be excluded.*
>
> *It was subsequently intimated to SEBI that the contravening director had resigned from the investment manager of the AIF and was no longer associated with the AIF.*

Upon examination of the matter, SEBI directed that the AIF's sponsor could not be considered a 'fit and proper person' in terms of Regulation 4(f) of the AIF Regulations read with Schedule II of Intermediaries Regulations and, therefore, the AIF's certificate of registration be cancelled.[13] In the instant matter, SEBI also opined that:

- SEBI registered intermediaries are required to continuously meet the threshold of 'fit and proper' person throughout validity of their registration/ the period they are associated with the securities market.
- A qualifying criterion for meeting the 'fit and proper' person requirement is absence of any conviction or restraint orders. However, a restraint order (an order not to access the securities market for a specified period) was in place against the sponsor.

SEBI also directed the fund/investment manager/trustee to not intake any new clients; to liquidate any investments and return the same to investors within a period of three months; and to file a compliance report to SEBI within a period of three months.

c) **Settlement order with SEBI:** adjudication proceedings were initiated against an AIF, its investment manager, and concerned employees/directors for the multiple alleged violations of the AIF Regulations (examples, certain LPs had not invested the minimum mandated minimum amount of INR 1 crore, AIF failing to liquidate its investments as per the timelines provided under the AIF Regulations, Failure of the AIF to register itself with the Central KYC Registry as per SEBI timelines etc.)

13 In the matter of Life Fund, WTM/MPB/EFD-1-DRA-4/ 64 /2019.

The AIF made a settlement application to SEBI under Section 15JB of the SEBI Act. Upon review by SEBI, the matter was settled upon payment of certain penalties by the AIF and its compliance officer (collectively amounting to ~ GBP 83,000).[14]

d) Violation of multiple provisions of the AIF Regulations: pursuant to a SEBI investigation, it was *prima facie* revealed that an AIF and its fund manager were in violation of multiple provisions under the AIF Regulations (example, granting of loans to portfolio companies, investing > 25% in one portfolio company etc.).

Response by AIF to show cause notice issued by SEBI:

- *Loans extended by the AIF would fall within the ambit of investment under the AIF Regulations and the same was disclosed in the PPM.*
- *The AIF had not made any investments in excess of 25% of its committed corpus with the sole exception of one. Further, it noticees conveyed its difficulty as to continuously maintained this 25% threshold.*
- *The investment limit mentioned in the PPM was merely indicative.*
- *The AIF had substantially complied with the decision of its investment committee.*
- *The continuing interest by the sponsor / investment manager was not maintained as sponsor cum manager's share was distributed back to it pursuant to a distribution from AIF.*

Additionally, the noticees requested clarity on how to maintain the sponsor's continuing interest and provide proportionate distribution of capital of all fund investors (including the sponsor).

Upon examination of the matter, SEBI directed that levy of multiple penalties (to the extent of INR 30 lakh) for aforesaid violations.[15] Further, SEBI also noted that:

- The AIFs PPM clearly indicates that investment in the form of loan to various companies are permitted and, thus, the allegation that investments were not made in compliance with the AIF Regulations do not stand.[16]
- Regarding the obligation of investing a maximum of 25% of the investable funds into a single portfolio company, it was opined that practical complexities faced by the AIF cannot override statutory requirements.
- The AIF manager is required to carry the AIF's activities in accordance with its PPM and any deviation therein may result in adversely affecting investor's interest.
- Deviations from the specified investment strategy / investment limit specified in the PPM may adversely affect investor's interest.
- The failure of the sponsor to maintain the continuing interest cannot be excused as the AIF Regulations expressly provides for the same.

14 In the Matter of Peninsula Brookfield India Real Estate Fund, AIF & Pen Brook Capital Advisors Private Limited & Ors, Settlement Order Nos. SO/MC/HP/2021-22/6448-49 and SO/MC/HP/2021-22/6451-57.

15 In Respect of: Srei Multiple Asset Investment Trust & Srei Alternative Investment Managers Limited, 2017 SCC OnLine SEBI 136.

16 Please note that pursuant to amendment in AIF Regulations, it is now clear that Category II AIFs cannot grant loans.

e) **Cancellation of certificate of registration of AIF:** Recently, SEBI has recommended cancellation of certificate of registrations of 8 AIFs on account on non-compliance with AIF Regulations and failure to file periodic reports.[17]

f) **In the matter of Life Fund**[18]

In this matter, SEBI had passed an order against Neesa Technologies Limited ("**NTL**") and its directors for violating SEBI norms pertaining to fund-raising via non-convertible debentures. However, it was observed that the sponsor of Life Fund (an AIF) Mr. Sanjay Gupta and a shareholder/director of Life Fund's investment manager Mr. Girishchandra Mukundram Baluni were among the directors of NTL who were affected by the SEBI order.

Due to AIF's status as an intermediary, it (along with its key personnel) has a continuing obligation to meet the 'fit and proper person' criterion as laid down by SEBI. In the light of the same, SEBI initiated proceedings against the AIF to ascertain whether its sponsor and director of its investment manager complied with the fit and proper person criteria as laid down by the SEBI (Intermediaries) Regulation, 2008 ("**Intermediaries Regulations**"). A designated authority appointed by SEBI recommended that the AIF's certificate of registration be cancelled. In furtherance of the same, SEBI issued a show cause notice under regulation 28 (1) of the Intermediaries Regulation requesting the AIF to show cause as to why the recommended action should not be taken.

Life Fund responded to this show cause notice by stating that (i) the AIF shall not raise funds until the aforementioned NTL action has reached finality at the Hon'ble SAT and (ii) the AIF would restructure its management to ensure that persons not meeting the criteria of 'fit and proper' person would be excluded. It is also to be noted that during this time, Mr. Baluni had resigned from the AIF's investment manager.

Nevertheless, upon examination of the matter, SEBI directed that the AIF's sponsor could not be considered a 'fit and proper person' in terms of Regulation 4(f) of the AIF Regulations read with Schedule II of Intermediaries Regulations and, therefore, the AIF's certificate of registration be cancelled. SEBI underscored the fact that (i) registered intermediaries are required to continuously meet the threshold of 'fit and proper' person throughout validity of their registration/ the period they are associated with the securities market and (ii) a qualifying criterion for meeting the 'fit and proper' person requirement is absence of any conviction or restraint orders, however, a restraint order (an order not to access the securities market for a specified period) was in place against Mr. Gupta.

g) **Show Cause Notice under Regulation 27(1) of the SEBI (Intermediaries) Regulations, 2008 in respect of Enquiry conducted against Investmaxima Trust (Noticee)**[19]

Further, SEBI has been observed to initiate enforcements actions against AIFs that are non-compliant with the disclosure requirements laid down under regulation 28 of the AIF Regulations.

17 SEBI/ HO/EFD1/DRA4/ P/ OW/ 2022/ 58497/1 dated November 21, 2022.

18 In the matter of Life Fund, WTM/MPB/EFD-1-DRA-4/ 64 /2019.

19 Show Cause Notice under Regulation 27(1) of the SEBI (Intermediaries) Regulations, 2008 in respect of Enquiry conducted against Investmaxima Trust (Noticee), SEBI/HO/EFD1/DRA4/P/OW/2022/58497/1, November 21, 2022.

Recently, SEBI has recommended the cancellation of the certificate of registration of eight AIFs for failing to meet their regulatory reporting requirements — namely, Quant First Alternate Investment Trust, IREO Advantage Fund I, Paranjape Plustus Fund 1, Saveda Venture Capital Fund, SRS Alternative Investment Fund, GSF Venture Capital Fund, Investmaxima Trust and Golden Bird AIF.[20]

In the present matter, SEBI had initiated enquiry proceedings against the aforementioned eight AIFs for failing to meet their reporting requirements under the AIF Regulations and various SEBI circulars wherein it was observed that the AIFs were not filing periodic reports to SEBI. Subsequently, the same was communicated to AIFs by SEBI on multiple occasions but remained unanswered. Therein, SEBI initiated an enforcement action against the said AIFs and appointed a designated authority under the Intermediaries Regulations — up on which a show cause notice was sent to the AIFs.

The twin issues grappled with SEBI in this matter is (i) whether the AIFs were in violation of regulation 28 of the AIF Regulations and the AIF Master Circular; and (ii) whether the AIFs were liable for actions under the SEBI Act if found non-compliant. Upon due examination of matter, it was observed by SEBI that the eight AIFs were indeed non-compliant with the reporting requirements under the AIF Regulations and it the cancellation of their AIF registrations were recommend. In forwarding this recommendation, SEBI also noted that:

- Citing issues with the intermediary portal (through which reports to SBEI ought to be filed) shall not shield an AIF against its reporting obligations in situations wherein such technical issues were observed after the receipt of the show cause notice;
- Among the eight AIFs, only one indicated an intent to operationalize its AIF activities, for which the AIF manager had stated that it would file a settlement application so as to not attract the cancellation of AIF registration. However, it was observed that no valid settlement application had been filed;
- All eight AIFs were dormant and had not commenced their activities. Nevertheless, SEBI stated that the reporting requirements extends to all AIFs and the non-commencement of AIF activities will not act as a bar against the reporting requirements; and
- AIFs are required to commence their AIF activities within a reasonable time period despite the fact that the AIF Regulations does not stipulate a specific time frame.

Herein fund managers should ensure that robust reporting mechanism are put in place as a part of their fund governance standards so as to not run afoul of the AIF Regulations. An order that calls for the cancellation of AIF registration can have a huge impact on the AIF as it may not be able to immediately seek re-registration due to its non-fulfillment of the 'fit and proper person' criteria.

h) **Final Order in respect of India Infrastructure Fund II, Global Infrastructure Partners India Private Limited and IDBI Trusteeship Services Limited**[21]

Upon an on-site inspection by SEBI of the Fund, managed by Global Infrastructure Partners India Private Limited ("**Investment Manager**"), it was noticed that the Fund had pledged 24% of its portfolio companies' securities in order to assist the portfolio companies in securing larger loans.

20 Investmaxima Trust-Show Cause Notice dated November 21, 2022 in the matter of Non-compliance of SEBI (AIF) Regulations, 2012: https://www.sebi.gov.in/enforcement/unserved-summons-notices/apr-2023/investmaxima-trust-show-cause-notice-dated-november-21-2022-in-the-matter-of-non-compliance-of-sebi-aif-regulations-2012_70478.html.

21 Final Order in respect of India Infrastructure Fund II, Global Infrastructure Partners India Private Limited and IDBI Trusteeship Services Limited, QJA/KS/AFD-1/AFD-1-SEC/27020/2023-24, May 31, 2023.

In the light of this irregularity with respect to the AIF Regulations, SEBI issued a show cause notice ("**SCN**") with the primary allegations being:

i. That the Fund violated the AIF Regulations by indirectly indulging in leverage by means of pledging the shares of its portfolio companies;

ii. IDBI Trusteeship Services Limited ("**Trustee**") had failed to ensure that the Fund was in compliance with the AIF Regulations; and

iii. By exposing the investors of the Fund to such leverage, the Trustee and the Investment Manager ran afoul of the AIF Code of Conduct.

The noticees, i.e., the manager, trustee, and the fund provided a joint response to the SCN, inter alia, stating that the trust deed empowered the fund to pledge securities of the portfolio company, the fund did not undertake any leverage as the charge was created at the portfolio company level, the SEBI format for leverage disclosure does not mandate the disclosure of pledging the shares of portfolio companies, the fund gained no undue benefit from the transaction, and the pledging of securities was in the interest of the investors.

Nevertheless, SEBI found the noticees to be in violation of the AIF Regulations by holding that the pledging the shares of the portfolio companies amounted to leverage as the term 'indirectly' present in the AIF Regulations were broad enough to cover situations wherein the AIF was merely a party to leverage transactions — it need not be expressly prohibited. Further it was noted that the manager exposed the investors to a risk of default at the portfolio company level even though disclosure were provided in the trust deed. Furthermore, it was observed by the regulator that the covenants in the fund documents were subject to the law and could not, in any instance, override the AIF Regulations.

However, it is to be noted that as no monetary hardship was caused to the investors and as the offence was not of a repetitive nature, no monetary penalties were levied on any of the noticees.

Proposed and Recent Amendments

SEBI has recently issued four consultation papers that propose restrictions on various aspects of AIFs, such as priority distribution waterfalls, pari passu rights for LPs, and limitations on borrowings by AIFs. The consultation papers also discuss new governance norms, including the appointment of custodians for all AIFs and the requirement to issue all securities of portfolio entities in dematerialized form. SEBI has invited public comments and feedback on these consultation papers.

The Consultation Papers are as follows:

I. Proposal with Respect to Pro-rata and Pari Passu Rights of LPs of AIFs ("Consultation Paper I")

In Consultation Paper I, SEBI argues that maintaining pro-rata distribution for LPs has always been expected of AIFs even though it may not have been expressly stated.

SEBI has observed that certain AIFs adopt a distribution waterfall wherein one or more class(es) of LPs (referred to as "**Junior Class**"), share(s) loss disproportionately higher as compared to other class(es) of LPs (referred to "**Senior Class**"). This is usually done by compensating the Senior Class for the loss out of residual capital of the Junior Class (in a loss scenario), and by distributing to the Senior Class first until their hurdle rate is met and then distributing the remaining amounts to the Junior Class (in a profit scenario) ("**Priority Distribution Model" or "PD model**").

As per SEBI, Priority Distribution Model pose the following risks:

- Evergreening of loans — Regulated lenders are taking advantage of the regulatory arbitrage available due to lack of an express prohibition on disproportionate sharing of losses by LPs. The relevant AIFs are structured in a manner that a regulated lender subscribes to the Junior Class units thereby taking a haircut or loss on its returns from the AIF. The expected loss on the loan portfolio at the time of structuring (haircut) appears to be used to determine the size of investment by the regulated lender in the AIF, as a Junior class LP. The LPs of the Senior class invest to the extent of perceived fair market value of the assets acquired by AIF from the regulated lender. The AIF invests in NCDs of the borrower companies with the understanding that funds so received by them shall be used to repay the loans extended to them by the regulated lender. This way the regulated lender is able to replace the loan portfolio in its books with the amount repaid by the borrower company and remaining as investments in the units of the AIF.
- Conflict of interest — As PD Models are intended to cater to the risk appetite of different set of LPs investing in the same portfolio entities, such models can create conflict of interest issues.
- Potential for mis-selling — SEBI also noted that during the financial crisis of 2008 there was rampant mis-selling of collateralised debt obligations (CDOs) as different tranches of CDOs based on the risk appetite of an LP were subscribed to. However, as the LPs failed to accurately asses the potential risk, when the value of CDOs plummeted, LPs alleged mis-selling.

In the light of such concerns, SEBI via its Circular dated November 23, 2022 (now covered under the AIF Master Circular applied an interim injunction on AIFs which have adopted PD model from making fresh investments or accepting any fresh capital, until SEBI adopts a view on the matter.

SEBI then appointed a working group to suggest whether PD models of distribution can affect pro-rata distribution rights of LPs. The working group recommended that PD model should not be entirely prohibited and should only be applicable in cases where the evidence of misuse is actually found. The working group also recommended measures to mitigate potential conflict and / or mis-selling. However, SEBI held a contradictory view and has provided arguments against the recommendations of the working group.

In the Consultation Paper I, emphasising on the principles of fair and equitable treatment, SEBI has proposed that all LPs of the AIF/scheme shall be treated equally with respect to their economic rights in the Fund i.e., no differential economic rights shall be provided to any LP (excluding economic rights with respect to hurdle rate of return, performance linked fee/additional return and management fees).

The scope of economic rights is not defined other than the clarity around exclusions as mentioned above. It could be considered that differential terms in respect of (i) drawdown timeline; (ii) compensatory contribution; (iii) co-investment rights etc. are economic rights.

The drawdown timeline for different LPs typically depends on the internal policies and administrative compliances required for remitting funds. If the due-date of the drawdown or the date for beginning of the IRR of each LP (other than defaulters) is kept the same, then the difference in timeline for an LP should not be prejudicial to the economic interest of other LPs. In an AIF where many LPs are retail LPs / individual LPs, the manager may prefer taking the funds upfront, instead of going through a longer route of issuing drawdown notices.

Additionally, differential co-investment rights should not have any impact on the economic rights of other LPs. The proposal to ensure that the rights of the LPs are pari passu is only with respect to the rights in the AIF, co-investments rights are with respect to a separate investment in its own capacity by the LP instead of investment via the AIF.

II. Consultation Paper on Strengthening Governance Mechanisms of AIFs (“Consultation Paper II”)

SEBI has concluded based on investment reports submitted by AIFs that temporary borrowings by AIFs are being utilized for purposes other than meeting operating expenses, including making portfolio investments.

In an attempt to bridge the divide between the provisions of the AIF Regulations and the industry, SEBI has proposed permitting AIFs to utilize borrowings to meet the shortfall in drawdowns while making investments in a portfolio company. SEBI has also prescribed certain conditions to this permission, which are:

- the amount so borrowed shall not exceed 10% of the investment proposed to be made in the portfolio company;
- the cost of such borrowing shall be charged only to the LP that has delayed or defaulted on their drawdown payment, thus causing the shortfall;
- the AIF may borrow only once to meet the shortfall with respect to a specific LP;
- the AIF must disclose the intent to borrow to make up for any shortfall in drawdowns, in the Private Placement Memorandum (“**PPM**”);

- the Investment Manager ("**Manager**") shall disclose the details of the borrowing such as amount borrowed, terms of borrowing and repayment to all LPs of the AIF / scheme, and
- the borrowings must not be used to schedule different drawdown timeline for different LPs.

Additionally, SEBI has proposed a cooling-off period of 30 days between two periods of permissible leverage. We note that borrowing more than 10% of the investment proposed to be made in a portfolio investment shall be permitted in cases where existing LPs are interested in buying the units of a defaulting investor provided that appropriate safeguards as well as comfort letters are obtained from such defaulting LPs that they shall return the monies to such LPs.

Further, while it is noted that the cost of borrowings shall be borne by such LP who has defaulted on its drawdown payment, practically a defaulting contributor is unlikely to be able to bear such costs. In cases where some units are already issued, the same could be cancelled by the AIF. In other cases, the non-defaulting LPs may take up the costs to an extent while the remaining is allocated to the Manager.

To fully realize the objective of easing the monitoring and administration of AIFs by stakeholders and enhancing transparency in governance, SEBI has proposed to mandate all AIFs to hold instruments / securities of their investments only in dematerialized form excluding cases where dematerialization is not available for the instrument / security.

In respect of existing investments made by AIFs in investee companies where the AIF or AIFs together have a controlling interest, SEBI has proposed that such investments shall be held in the dematerialized form. SEBI views the benefits of demateralization as outweighing the costs and administrative compliances of requiring the existing portfolio investments to be reissued in demat form. SEBI via its board meeting dated November 25, 2023[1] has now approved that any fresh investment made by an AIF, beyond September 2024, shall be held in dematerialised form. Further, it has been approved that the existing investments made by AIFs shall be exempted from the said requirement, except in cases where (a) Investee company has been mandated under applicable law to facilitate dematerialisation of its securities; and (b) Investments where the AIF, on its own, or along with other SEBI registered intermediaries/entities which are mandated to hold their investment in dematerialised form, has control in the investee company. In addition to the above, the said requirement shall not be applicable for investments held by (a) Liquidation schemes of AIFs; (b) schemes of an AIF whose tenure (not including permissible extension of tenure) ends within one year from the date of issuance of necessary notification in this regard; and (c) schemes of an AIF which are in extended tenure as on the date of issuance of the notification.

In light of the independent monitoring and additional services provided by custodians, SEBI proposed to extend the mandate of appointing a custodian to Category I and II AIFs that have a corpus of less than INR 500 crores. The Manager of the Fund shall ensure that the custodian appointed by the AIF is not an associate of the Manager / sponsor / trustee of the AIF. Further, custodians shall also be responsible for monitoring investments of AIFs with regard to investment conditions and other related requirements under the AIF Regulations. SEBI via its board meeting dated November 25, 2023[2] has now approved such proposal. AIFs may appoint a custodian who is an associate of manager or sponsor of the AIF, subject to conditions similar to those prescribed under SEBI (Mutual Funds) Regulations, 1996 for permitting related party of sponsor of a Mutual Fund to act as its custodian.

1 https://www.sebi.gov.in/media-and-notifications/press-releases/nov-2023/sebi-board-meeting_79337.html.

2 https://www.sebi.gov.in/media-and-notifications/press-releases/nov-2023/sebi-board-meeting_79337.html.

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While AIs have been provided certain flexibilities in general, the LVF also benefits from having a contributor pool comprised exclusively of AI. One such flexibility pertains to the maximum permissible extension of tenure. Currently, LVFs are permitted to extend their tenure beyond the two-year limit applicable to close-ended AIFs. However, based on regulatory filings made with SEBI, it has been observed that 79% of close-ended LVF schemes have provided for a maximum tenure extension of 2 years, subject to the consent of two-thirds of the LPs by value.

The muted utilization of the perpetual fund tenure coupled with the availability of alternatives such as selling unliquidated investments to a new scheme of the same fund, or distributing the unliquidated investments in-kind subject to the consent of 75% of LPs by value – has led to a need to align the extension of tenure of LVFs with that of other AIFs.

SEBI has proposed permitting LVFs to extend their tenure up to four years, subject to approval of two-thirds of LPs by value. It can be noted that the industry has been awaiting a sub-category of Category I or Category II AIFs which are permitted to exist in perpetuity which shall not necessarily be large value funds of accredited investors.

SEBI has observed, based on the quarterly reports filed by AIFs, that many AIFs are still holding their Certificate of Registration despite having no fund raising or investment activity in their schemes for several years. This may lead to the following issues:

- Inflated number of AIF registrations,
- Consumption of regulatory resources in monitoring inactive AIFs,
- Potential for misuse in unauthorized fund raising,
- Compliance cost for inactive AIFs,
- Difficulty in tracing inactive AIFs and initiating enforcement action.

SEBI noted that various market intermediaries are required to renew their registrations with SEBI in three-year or five-year intervals including portfolio managers, registered investment advisers and research analysts, as well as infrastructure investment trusts and real estate investment trusts.

Along similar lines, SEBI has proposed mandating AIFs to pay a renewal fee equal to 50% of the registration fee for the AIF, for every block of 5 years, within 3 months before the expiry of the said block.

We note that this requirement for renewal of registration by existing and well operational AIFs is highly onerous. SEBI, under its AIF Master Circular, has already prescribed the requirement to conduct the first closing of the AIF within 12 months from the date of SEBI taking the PPM on record, it further requires refiling of the application in the prescribed Form – A along with fees in case the timelines are not adhered to by the applicant AIF. Further, AIFs are also required to submit quarterly and annual reports to SEBI including no. of LPs, no. of portfolio investments, percentage of corpus invested etc. Despite presence of such elaborate checks to look through the operations of the AIFs, such renewal shall only add to extra costs and administrative hurdles for the AIFs, thereby reducing the ease of doing business in India.

III. Consultation Paper on the Status of AIF as a Qualified Institutional Buyer ("QIB") ("Consultation Paper III")

In common parlance, QIBs are considered to be large institutional investors who possess the acumen to evaluate, invest and manage the risks of their investments in the capital market. Keeping this in mind, SEBI, under the ICDR Regulations provides various benefits and flexibilities with respect to investment in the capital market.

Consultation Paper III reviews the status of QIB provided to AIFs, VCFs, and foreign venture capital investors[3] and seeks to make a carve-out to ensure that AIFs with 50% or more contribution contributed by a single LP / LPs of the same group[4] be exempt from being categorized as QIBs. The carve-out has been specified by the market regulator to ensure that entities, who would not themselves qualify as QIBs, do not pool together capital via AIFs to be considered a QIB.

3 Consultation paper on the proposal to review QIB status of AIFs, VCFs and foreign venture capital investors, Reports for Public Comments, May 19, 2023.

4 'Same group' shall include relatives and related parties as defined in the Companies Act, 2013.

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International Tax Considerations

I. Association of Persons (AOP) Risk

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

II. Taxation of Indirect Transfers

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

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

The indirect transfer provisions were introduced in the ITA as a knee-jerk reaction to the Supreme Court's decision in the Vodafone International Holdings.[2] The retrospective amendments introduced by the Finance Act, 2012 effectively negated the decision of the Supreme Court wherein the Court had held that offshore transfer of shares was not liable to tax in India.

The Finance Act, 2012 retrospectively amended Section 9(1)(i) of ITA by adding Explanation 5 clarifying that an offshore capital asset would be considered to have situs in India if it substantially derived its value (directly or indirectly) from assets situated in India. However, the Finance Act, 2012 did not define the word 'substantially'. Subsequently, Finance Act, 2015 introduced Explanations 6 and 7 to Section 9(1)(i) to specify the situations to which Explanation 5 would apply.

1 Section 5(2) of the ITA.

2 Vodafone International Holdings BV v. Union of India (2012) 6 SCC 613.

Threshold Test on Substantiality and Valuation

The ITA, pursuant to amendment by the Finance Act, 2015, provides that the share or interest of a foreign company or entity shall be deemed to derive its value substantially from the assets (whether tangible or intangible) located in India, if on the specified date, the value of Indian assets (i) exceeds the amount of INR 100 million; and (ii) represents at least 50% of the value of all the assets owned by the company or entity. The value of the assets shall be the Fair Market Value ("**FMV**") of such asset without reduction of liabilities, if any, in respect of the asset.[3]

The CBDT notified rules prescribing the method of computation of FMV of assets (Rule 11UB), computation of income attributable to such assets in India (Rule 11UC) and reporting requirements under the indirect transfer provisions (Rule 114DB).[4] Broadly, Rule 11UB in relation to computation of FMV of assets prescribes the adding back of liabilities that were deducted while calculating the FMV through internationally accepted methods of valuation. As stated above, the indirect transfer tax should apply if the total asset value of the Indian assets is above the aforementioned thresholds without taking into account any deduction on the basis of existing liabilities. Rule 11UB prescribes separate rules and methods with respect to each asset class such as listed shares, unlisted shares, interests in a partnership and other capital assets in India and slightly different valuation rules for similar assets held abroad.

The FMV of shares of unlisted Indian companies[5] will be as determined by a merchant banker or an accountant in accordance with any internationally accepted valuation methodology for valuation of shares on an arm's length basis as increased by the liability, if any, considered in such determination. The methodologies for computing the value of all the assets of a foreign entity are also prescribed in Rule 11UB.[6]

i. Date for Determining Valuation

Typically, the end of the accounting period preceding the date of transfer shall be the specified date of valuation. However, in a situation when the book value of the assets on the date of transfer exceeds by at least 15%, the book value of the assets as on the last balance sheet date preceding the date of transfer, then the specified date shall be the date of transfer.

ii. Apportionment 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.

iii. Exemptions

The ITA, pursuant to amendment by the Finance Act, 2015, provides for situations where indirect transfer provisions shall not be applicable.

3 Explanation 6 to Section 9(1)(i) of the ITA.

4 Notification No. 55 of 2016, dated June 28, 2016.

5 Rule 11UB(3) of the ITR.

6 Rule 11UB(6) of the ITR.

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

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 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, at any time during twelve months preceding the date of transfer:

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 transactions of a similar nature.

iv. Other Clarifications on Applicability of Indirect Transfer Provisions

a. Distribution of Dividends

The indirect transfer tax provisions raise critical concerns for an organization which seeks to take exposure to an Indian entity through an intermediary holding vehicle. Not only at the time of exit, but there is also a risk of taxation when cash is up-streamed by way of redemption of shares of the holding company that are held by the parent company.

However, the CBDT through Circular No. 4 of 2015 had clarified that a distribution of dividends by an offshore company with underlying assets deriving substantial value from India would not result in a tax liability under the indirect transfer provisions since it does not have the effect of transfer of any underlying assets located in India.

b. Applicability on Investments by FPIs/ AIFS

The Finance Act, 2017 brought changes to clarify that the indirect transfer tax provisions shall not be applicable to an asset or capital asset that is held directly / indirectly by way of investment in a Category I or Category II FPI[7] under the FPI Regulations 2014. Further, due to the recategorization of categories of FPIs under the FPI Regulations 2019, the Finance Act, 2020 exempted the applicability of indirect transfer tax provisions to Category I FPIs under the FPI Regulations 2019.

The clarifications were implemented retrospectively from FY starting April 1, 2012, and therefore would help bring about certainty on past transactions that have been entered into by Category I and Category II FPI entities (under FPI Regulations 2014)/ Category I FPIs (under FPI Regulations 2019).

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

7 Proviso to Explanation 5 to Section 9(1)(i).

v. Reporting Requirement

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

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

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

vi. Removal of Retroactive Application of Indirect Transfer Provisions

Recently, the Indirect Transfer provisions were amended by the Taxation Laws (Amendment) Act, 2021 ("**2021 Act**") to remove the retrospective application of such Indirect Transfer provisions. The 2021 Act makes following changes in the Indirect Transfer provisions:

An embargo on future tax demands: The 2021 Act provides that the indirect transfer provisions would not apply to income accruing or arising as a result of an indirect transfer undertaken prior to May 28, 2012. The 2021 Act has added a proviso to Explanation 5 to section 9(1)(i) of the ITA for non-application of indirect transfer provisions on (i) assessments or reassessments initiated under specified sections, (ii) orders passed enhancing a tax assessment or reducing a refund and (iii) orders passed deeming a person to be an assessee-in-default for not withholding taxes in respect of indirect transfers prior to May 28, 2012.

- **Nullification of tax demands raised:** The 2021 Act also provides that demands raised for indirect transfers of Indian assets made prior to May 28, 2012 shall be nullified, subject to fulfilment of the following conditions[8] by the person in whose case such demand has been raised:
    - withdrawal or an undertaking for withdrawal of appeal filed before an appellate forum or a writ petition filed before a High Court or the Supreme Court of India;
    - withdrawal or an undertaking for withdrawal of any proceedings for arbitration, conciliation or mediation initiated by such person such as under a bilateral investment treaty; and
    - furnishing of an undertaking waiving their rights to seek or pursue any remedy or any claim in relation to such income whether in India or outside India.
- **Refund of amounts paid:** The 2021 Act also provides that the Government shall refund the taxes paid in cases where the application of indirect transfer provisions is being withdrawn due to fulfilment of the conditions mentioned above. However, no interest, cost or damage shall be paid by the Government on such refund of taxes.

8 On August 28, 2021, the Government has notified the draft rules for public consultation to specify the conditions to be fulfilled and the process to be followed to give effect to the amendment made by the 2021 Act.

III. General Anti-Avoidance Rule (GAAR)

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

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

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

The CBDT has issued clarifications on implementation of GAAR provisions in response to various queries received from the stakeholders and industry associations. Some of the important clarifications issued are as under:

i. Where tax avoidance is sufficiently addressed by the LOB clause in a tax treaty, GAAR should not be invoked.

ii. GAAR should not be invoked merely on the ground that the entity is located in a tax efficient jurisdiction.

iii. GAAR is with respect to an arrangement or part of the arrangement and limit of INR 30 million cannot be read in respect of a single taxpayer only.

The Supreme Court ruling in McDowell & Co. Ltd. CTO[9] stated that under the Indian tax laws, even while predominantly respecting legal form, the substance of a transaction could not be ignored where it involved sham or colorable devices to reduce an entity's tax liabilities.

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

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

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

9 McDowell & Co. Ltd. CTO 154 ITR 148.

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A. Non-arm's Length Dealings

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

B. Misuse or Abuse of the Provisions of the Act

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

C. Lack of Commercial Substance

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

D. Non-Bona Fide Purpose

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

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

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

IV. Business Connection / Permanent Establishment Exposure

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

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What constitutes permanent establishment?

Management teams for India focused Offshore Funds are typically based outside India as an onshore fund manager enhances the risk of the fund being perceived as having a PE in India. Although DTAAs provide for the concept of a permanent establishment in Article 5 (as derived from the OECD and United Nations ("**UN**") Model Convention), the expression has not been exhaustively defined anywhere. The Andhra Pradesh High Court, in CIT v. Visakhapatnam Port Trust,[10] held that:

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

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

What tantamounts to business connection in the context of an Offshore Fund?

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

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

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

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

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

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

10 CIT v. Visakhapatnam Port Trust 144 ITR 146.

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

The conditions given under Section 9A are as follows: — (i) the fund must not be a person resident in India; (ii) the fund must be a resident of a country with which India has entered into an agreement under Section 90(1) or 90A(1) of the ITA or is established or incorporated or registered in a country or a specified territory notified by the GoI in this behalf; (iii) investment in the fund by persons resident in India should not exceed 5% of the corpus of the fund; provided that for the purposes of calculation of the said aggregate participation or investment in the fund, any contribution made by the eligible fund manager during the first three years of operation of the fund, not exceeding twenty-five crore rupees, shall not be taken into account; (iv) the fund and its activities are subject to investor protection regulations in the country in which it is incorporated or resident; (v) the fund must have minimum twenty five members, who are not connected persons; (vi) any member of the fund along with connected persons should not have any participation interest in the fund exceeding 10 %; (vii) the aggregate participation interest of ten or less members along with their connected persons in the fund, should be less than 50% (viii) the fund should not invest more than 20%. of its corpus in any single entity; (ix) the fund should not make any investment in its associate entity; (x) the monthly average of the corpus of the fund should not be less than INR 1 billion; provided that if the fund has been established or incorporated in the previous year, the corpus of fund shall not be less than INR 1 billion at the end of a period of twelve months from the last day of the month of its establishment or incorporation. Nevertheless, this provision shall not be applicable in case of the year in which the fund is wound up; (xi) the fund should not carry on or control and manage, directly or indirectly, any business in India; (xii) the fund should not engage in any activity which will constitute business connection in India; (xiii) the remuneration paid by the fund to the fund manager should be not less than the arm's length price. The conditions (i) to (xiii) may not be applicable to eligible fund managers located in IFSC and have commenced its operations on or before 31st March of 2024.

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

Section 9A also requires an 'eligible fund manager' in respect of an eligible investment fund to means any person who is engaged in the activity of fund management and fulfils the following conditions, namely (a) the person is not an employee of the eligible investment fund or a connected person of the fund; (b) the person is registered as a fund manager or an investment advisor in accordance with the specified regulations; (c) the person is acting in the ordinary course of his business as a fund manager; (d) the person along with his connected persons shall not be entitled, directly or indirectly, to more than twenty per cent of the profits accruing or arising to the eligible investment fund from the transactions carried out by the fund through the fund manager. The Finance Act, 2019 amended one of the conditions for availing safe harbour under section 9A by removing the requirement for the eligible fund manager to receive an arm's length remuneration for performing the fund management activity and replacing it with a minimum fee to be prescribed by the CBDT. On December 5, 2019 CBDT had released draft notification to amend Rule 10V of the IT Rules for public comments and inputs and the amendments have now been notified through Income Tax (Amendment) Rules, 2020 ("**Notification**"). The Notification introduces new rules on remuneration for fund managers to qualify for safe harbour under section 9A.[11]

11 Notification No G.S.R. 315(E) dated May 27, 2020.

In case where the eligible investment fund is a registered Category I FPI which has obtained such registration due to its status as an endowment fund, a sovereign wealth fund, a Government, a university, an appropriately regulated entity (banks, insurers, managers, advisers etc.) under the relevant provisions as described in the Notification, the amount of remuneration for the eligible fund manager shall be at least 0.10% of AUM. As per the recent amendment to the ITA, it has been provided that the conditions mentioned above in (a) to (d) shall not be applicable on eligible fund managers located in IFSC and have commenced its operations on or before the 31st day of March, 2024.

In other cases (i.e. other than for Category I FPIs of the kind explained above), the amount of remuneration for the eligible fund manager is required to be at least:

i. 0.30% of AUM; or

ii. 10% of profits derived by the fund in excess of the specified hurdle rate, where the fund manager is entitled only to remuneration linked to the income or profits derived by the fund; or

iii. 50% of management fee, where the fee is shared with another fund manager reduced by operational expenses.

The Notification also allows for the CBDT to approve a lower remuneration to be charged if the eligible investment fund is able to satisfy CBDT.

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

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

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

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

V. Angel Tax

Angel tax to seeks to tax consideration received by private companies (in which the public are not substantially interested) on the sale of its shares that are in excess of its fair market value (“**FMV**”). Such excess consideration would be taxable under the head of ‘income from other sources.’ For example, if the FMV of companies share is INR 100 but the same was sold for INR 250, the excess consideration of INR 150 would be taxed as income from other sources.

Prior to March 31, 2023, angel tax was solely applicable to considerations received from resident Indian investors, however, the purview of the same has now been expanded to include foreign investment, thus, deterring the foreign inflow of capital into startups.

Nevertheless, Category I and II AIFs (either registered with SEBI or regulated by IFSCA) are not subject to such angel tax — increasing the attractiveness of the pooled vehicle for foreign investors.

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Annexure I

Sector Focused Funds

I. Social Impact Funds

A. Introduction

Even Under the AIF Regulations, a social impact fund is defined as, "an alternative investment fund which invests primarily in securities, units or partnership interest of social ventures or securities of social enterprises and which satisfies the social performance norms laid down by the fund". Typically, social impact funds tend to be impact funds which predominantly invest in sustainable and innovative business models. The investment manager of such fund is expected to recognise that there is a need to forecast social value, track and evaluate performance over time and assess investments made by such funds.

B. Characteristics of Social Impact Funds

Social impact funds tend to be different from VC funds or PE funds not just in the investments that they make, but also in the nature of commitments that they receive from their limited partners / investors.

The following is a list of some of the characteristics that a social impact fund may expect to have:

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

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

C. Tools to Measure Social Impact

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

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

D. Laws Relating to Social Impact Funds Investing into India

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

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

- Requirement to have at least 75% of their investable funds[1] invested in unlisted securities or partnership interest of 'social ventures' or in units of social ventures or in securities of social enterprise;[2] the amount of grant that may be accepted by the fund from any person shall not be less than ten lakh rupees.[3] Accredited Investors are permitted to contribute an amount lower than the prescribed minimum amount as a grant to such social impact funds.[4]
- Allowed to receive grants (in so far as they conform to the above investment restriction) and provide grants. Relevant disclosure in the placement memorandum of the fund will have to be provided if the social impact fund is considering providing grants as well; and it is also allowed to receive muted returns.

II. Media & Entertainment Funds

A. Media Funds — An Introduction

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

In current times, when demand for high quality films and media products has increased, such pooling platforms play the role of providing organized financing to various independent projects or work alongside studios and production houses. A unique feature is the multiple roles and level of involvement that the fund manager can undertake for the fund and its various projects. Further, with the rise in the amounts invested in OTT platforms, which are subscription based there has been increased interests of the VC Firms in investing in such OTT Platforms.

B. Media Funding Models

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

In terms of risk mitigation, the slate financing model works better than a specific project model owing to risk-diversification achieved for the investor. Apart from typical equity investments, film funds may additionally seek debt financing pursuant to credit facilities subject to compliance with local laws e.g., in the Indian context, debt financing by Offshore Fund may not work.

1 As defined under section 2(p) of the AIF Regulations, 2012.
2 Regulation 16(4) of the AIF Regulations 2012.
3 Ibid.
4 SEBI (Alternative Investment Fund) (Fourth Amendment) Regulations, 2018.

C. Risks and Mitigating Factors

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

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

D. Life Cycle of a Film Fund

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

- Domestic and international theatrical release of the film;
- Domestic and international television markets; and
- Merchandizing of film related products, sound track releases, home video releases, release of the film on mobile platforms, and other such online platforms.

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

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

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

E. Sources of Income of a Film Fund and Tax Treatment

Distributorship Arrangements

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

Lock Stock and Barrel Sale

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

Use of an Appropriate Intermediary Jurisdiction

Fund vehicles have historically been located in investor friendly and tax neutral jurisdictions. The unique nature of film funds adds another dimension i.e. intellectual property (“**IP**”) while choosing an appropriate jurisdiction. Generally, an IP friendly jurisdiction is chosen for housing the intellectual property of the fund or specific project. Further, since considerable amount of income earned by the fund may be in the form of royalties, a jurisdiction that has a favourable royalty clause in its DTAA with the country of the distributor may be used. This assumes greater importance because the royalty withholding tax rate under the ITA is 10%.

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

F. Role of Services Company

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

G. Role of the Fund Manager

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

III. Special Situation Funds

A. Introduction

SEBI in an attempt to address the stressed assets woes of the banking and finance industry has recently introduced SSFs as a new sub-category of AIF called Special Situation Fund under Category I AIFs under the AIF Regulations. SSFs are defined as Category I —AIFs that invest in 'special situation assets' in accordance with its investment objectives and such SSF may act as a 'resolution applicant' under the IBC.

Given that AIFs manage and raise privately pooled funds from sophisticated investors who are open to high-risk investments, they can effectively serve as a source of risk capital to deal with the issue of stressed loans. Such a move is expected to bring in a new set of investors in the stressed asset space and create a more efficient market for buying distressed assets.

Prior to the introduction of SSFs, AIFs were only permitted to invest in debt by way of investment in debt securities and were prohibited from lending. Therefore, the AIFs currently tend to invest in distressed assets through investing in securities of stressed companies and Security Receipts ("**SRs**") issued by Asset Reconstruction Companies ("**ARCs**").

B. Special Situation Assets

Notably, Category I AIFs invest, *inter alia*, in sectors which the Government or regulators consider as socially or economically desirable and which are generally perceived to have positive spillover effects on the economy. Further, SEBI or Government or other regulators in India might consider providing incentives or concessions to such AIFs. SSFs are allowed to invest in special situation assets which include-

- Stressed loans available for acquisition in terms of Reserve Bank of India (Transfer of Loan Exposures) Directions, 2021 ("**Transfer Directions**") or as part of a resolution plan approved under IBC;
- Security receipts issued by ARCs;
- Securities of investee companies (i) whose stressed loans available for acquisition in terms of Transfer Directions or as part of a resolution plan approved under IBC; (ii) against whose borrowings, security receipts have been issued by an ARC; (iii) whose borrowings are subject to corporate insolvency resolution process under Chapter II of IBC; (iv) who have disclosed all the defaults relating to the payment of interest /repayment of principal amount on loans from banks / financial institutions; and
- Any other asset/security as may be prescribed by SEBI from time to time.

With the introduction of such provisions, SSFs will be able to provide much needed capital to companies in distress, which are unable to function optimally and generate value for stakeholders due to over-leveraging, but may have potential of a turnaround.

C. Key Features of SSFs

- No investment concentration limits: SEBI has exempted the SSFs from the diversification norms as applicable under the AIF Regulations thereby allowing SSFs to invest up to 100% of their investable funds in a single special situation asset. Unlike asset reconstruction companies, an SSF, is not subject to limits for restructuring support finance.
- SSFs can set up specific schemes targeting specific special situations asset. In order to provide adequate capital for revival of the distressed company, SEBI has mandated that the SSFs should have a minimum corpus of INR 100 crores with a minimum commitment of INR 10 crores from each investor (AIs can commit a minimum of INR 5 crores).
- SSFs are allowed to invest in units of other SSFs, however it is prohibited from investing in (i) associates; (ii) SSFs managed or sponsored by the same manager/ sponsor or associates; or (iii) units of non-SSF AIFs; (iv) overseas investments.
- SEBI while providing for SSFs to acquire stressed loans has effectively barred acquisition of stressed loans from individual lender since Clause 58 of the Transfer Directions contemplates acquisition of loans only pursuant to a resolution plan as approved by the lenders under the Reserve Bank of India (Prudential Framework for Resolution of Stressed Assets) Directions, 2019.
- Stressed loans acquired by SSF in terms of Clause 58 of the Transfer Directions are subject to a minimum lock-in period of six months. However, the lock in period shall not be applicable in case of recovery of the stressed loan from the borrower. Moreover, in order to ensure that there is no regulatory arbitrage in respect of the due diligence requirements mandated for ARCs, SSFs acquiring the stressed loans are required to comply with the same initial and continuous due diligence requirements for its investors, as those mandated by for ARCs.
- SEBI by permitting SSFs to act as a 'resolution applicant' under the IBC has provided for a way through which the SSF can acquire the debt as well as securities, including shares of stressed companies undergoing a corporate insolvency resolution process under the IBC. Considering that investment in Special Situation Assets would require extensive monitoring and managerial support from the SSFs, such provisions allow the SSFs to provide a complete exit to the lenders and control the revival of the stressed company, without any restriction on investment concentration.

Annexure II

Summary of Tax Treatment for Mauritius, Singapore, and Netherlands Based Entities Participating in Indian Oppurtunities

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

Parameter	Mauritius	Singapore	Netherlands
General			
Eligibility to DTAA benefits	A person is considered a resident of Mauritius for relief under the DTAA, as long as it is liable to tax in Mauritius by reason of domicile, residence or place of management. The Indian tax authorities issued a Circular (789 of 2000) stating that a TRC issued by the Mauritius tax authorities constitutes sufficient proof of residence in Mauritius and entitlement to DTAA relief. The landmark decision of the Indian Supreme Court in Union of India v. Azadi Bachao Andolan,[1] upheld the validity of the aforesaid Circular 789.[2]	The management and control of business of the pooling vehicle must be in Singapore. Tax resident companies are eligible for DTAA benefits subject to (as a practical matter) being able to obtain a TRC from the Inland Revenue Authority of Singapore.	The management and control of business of the pooling vehicle must be in Netherlands. Tax resident companies are eligible for DTAA benefits subject to (as a practical matter) being able to obtain a TRC from the Dutch tax authorities.

1 [2003] 263 IT 707 (SC).

2 Following this case, a number of cases have confirmed DTAA benefits for Mauritius based investors including: Dynamic India Fund I (AAR 1016/2010 dated July 19, 2012); DDIT v. Saraswati Holdings Corporation [(2009) 111 TTJ 334]; In re, E*Trade Mauritius Limited [(2010) 324 ITR 1 (AAR)]; In re, Castleton Ltd [(2012) 348 ITR 537]; Zaheer Mauritius v. DIT [(2014) 270 CTR (Del) 244]; D.B.Zwirn Mauritius Trading [(1997) 228 ITR 268]; HSBC Bank (Mauritius) Ltd. v. DCIT [(2018) 96 taxmann.com 544 (Mumbai –Trib.)].

However, certain Courts have also taken contrary views specifically challenging the beneficial ownership of shares of the Indian company by the Mauritian taxpayer and alleging that the transaction of acquisition of shares of Indian company was a colourable device and an impermissible tax avoidance arrangement for deriving DTAA benefit ["AB" Mauritius, In re AAR No. 1128 of 2011]. With the revision of the India-Mauritius DTAA, and introduction of anti-abuse rules, courts in India have also been challenging the availability of treaty benefits for investments dating prior to April 1, 2017. Recently, the Mumbai bench of the Authority for Advance Rulings in Bidvest [In Re: Bid Services Division (Mauritius) Ltd. 2020 (2) TMI 1183] rejected capital gains tax benefit under Article 13(4) of the India–Mauritius DTAA to a Mauritian entity, on sale of shares of an Indian joint venture company.

Annexure II

Parameter	Mauritius	Singapore	Netherlands
Substance Requirements	The GBC would be required to carry out the core income generating activities: (i) employing, either directly or indirectly, a reasonable number of suitably qualified persons to carry out the core activities; and (ii) having a minimum level of expenditure, which is proportionate to its level of activities. Further, while determining whether the activities constitute as core income generating activities, the FSC will take into consideration the nature and level of core income generating activities conducted (including the use of technology) by the GBC. Under the Protocol, India shall tax capital gains arising from the sale of shares acquired on or after April 01, 2017 in a company resident in India with effect from financial year 2017-18.	The India-Singapore DTAA itself states the Substance requirement. Subsequently negotiated protocol to the India-Singapore DTAA requires that the Singapore entity must not be a shell or a conduit entity. A shell / conduit entity is the one which has negligible or nil business operations or has no real and continuous business activities that are being carried out in Singapore. A Singapore resident is deemed not to be a shell or conduit if it is listed on a recognized stock exchange or if its annual operational expenditure is at least SGD 200,000 per year in the two years preceding to the transfer of shares which are giving rise to capital gains. (The term "annual expenditure" means expenditure incurred during a period of twelve months. The period of twenty-four months shall be calculated by referring to two blocks of twelve months immediately preceding the date when the gains arise.) Accordingly, if the affairs of the Singapore entity are arranged with the primary purpose of taking benefit of capital gains relief, the benefit may be denied even if the Singapore entity is considered to have commercial substance under the GAAR provisions or incurs annual operational expenditure of SGD 200,000.	i. At least half of the total number of directors and other persons with decision-making power should qualify as a tax resident in the Netherlands ("Dutch Resident Directors"). ii. Dutch Resident Directors should have the required professional knowledge to properly perform their duties. iii. The duties of the board include decision-making in respect of transactions to be entered into by the company, on the basis of the own responsibility of the company and within the ordinary course of group involvement, and a proper handling of the transactions entered into. iv. Cooperative ("Coop") avails of qualified employees for proper implementation and registration of the transactions to be entered into by it. v. The management decisions should be taken in the Netherlands. vi. The main bank accounts of Coop shall be maintained in the Netherlands. vii. The bookkeeping of Coop has to be conducted in the Netherlands. viii. The Coop has to have an office space available, located in the jurisdiction of establishment, for the duration of at least 24 months. ix. Salary costs of at least (gross) EUR 100,000 per year has to be incurred by the Coop.
MLI	Mauritius has not included India in its definitive notification, accordingly, India-Mauritius DTAA is not considered a CTA. In case Mauritius notifies India-Mauritius DTAA as CTA, there would be a significant change in tax positions from investments made through the Mauritius route.[3]	India-Singapore DTAA notified as CTA. Preamble of India-Singapore DTAA modified to include clear statement of intent. LoB contained in Article 24A superseded by PPT, which will need to be satisfied to avail benefits.[4]	India-Netherlands DTAA notified as CTA. Preamble of India-Netherlands DTAA modified to include clear statement of intent. LoB contained in Article 24A superseded by PPT, which will need to be satisfied to avail benefits

3 From news reports, it appears that India and Mauritius may bilaterally re-negotiate the India-Mauritius DTAA to adopt the minimum standards emanating from the MLI: https://www.business-standard.com/article/markets/talks-on-to-adopt-beps-minimum-standards-in-tax-treaty-mauritius-minister-120051800772_1.html

4 The other specific tests under the LoB in Article 24A of the India-Singapore DTAA relating to shell / conduit companies not being entitled to benefits, minimum expenditure requirements etc. will continue to be applicable as they are not incompatible with the PPT.

Annexure II

Parameter	Mauritius	Singapore	Netherlands
Tax Implications under the Relevant DTAA			
Dividends	Taxable at rate of 5%, if Mauritian shareholder is beneficial owner holding directly at least 10% share capital of Indian company; otherwise 15%.[5]	Taxable at rate of 10%, if the Singaporean shareholder is a company being beneficial owner of at least 25% share capital of Indian company; otherwise 15%.[6]	Taxable, at the rate of 10%, if the Dutch shareholder is a company being beneficial owner of share capital of Indian company.[7]
Capital Gains	No local tax in Mauritius on capital gains. Till April 1, 2017, Mauritius residents were not taxed in India on gains resulting from the transfer of shares in an Indian company. After April 1, 2017 post amendment of India-Mauritius DTAA: i. No tax on capital gains on alienation of shares acquired by Mauritian residents before April 1, 2017.[8] ii. 50% of applicable Indian tax rate on capital gains arising to Mauritian residents from alienation of shares between April 1, 2017 to April 1, 2019, subject to PPT and LoB rule.[9] The LoB rule states that a shell / conduit company[10] shall not be entitled to the concessional tax rate under Article 13(3B). Capital gains arising on alienation of shares acquired by Mauritian residents after April 1, 2019 are taxable in India.[11]	No local tax in Singapore on capital gains (unless characterized as business income). Till April 1, 2017, Singapore residents were not taxed in India on gains resulting from the transfer of shares in an Indian company. After April 1, 2017 post amendment of India-Singapore DTAA: i. No tax on capital gains on investments made by Singapore residents before April 1, 2017, subject to PPT and LoB rule.[12] ii. 50% of applicable Indian tax rate on capital gains arising to Singapore residents from alienation of shares between April 1, 2017 to April 1, 2019, subject to PPT and LoB rule.[13] The LoB rule states that a shell / conduit company[14] shall not be entitled to the benefits under points i. and ii. above. Capital gains arising on alienation of shares acquired by Singapore residents after April 1, 2019 are taxable in India.[15]	Exemption from Indian capital gains tax if a Dutch shareholder holds: a) less than 10% in an Indian company; b) in case of the sale of shares to a non-Indian resident purchaser; or, (c) as a corollary from a group restructuring. Non-exempt Long –term capital gains taxed at the rate of 10% (excluding surcharge and cess). No Limitation of Benefits Clause. (limit the ability of third country residents to obtain benefits under the DTAA). Indirect transfer tax exemption available.

5 Article 10(2) of India-Mauritius DTAA.

6 Article 10(2) of India-Singapore DTAA.

7 Article 10(2) of India-Netherlands DTAA.

8 Article 13(3A) of India-Mauritius DTAA.

9 Article 13(3B) read with Article 27A of India-Mauritius DTAA.

10 A shell /conduit company is defined to mean any legal entity falling within the definition of resident with negligible or nil business operations or with no real and continuous business activities carried out in that Contracting State. Article 27A of India-Mauritius DTAA also elaborates cases wherein an entity will be deemed or will not be deemed to be a shell / conduit company.

11 Article 13(4) of India-Mauritius DTAA.

12 Article 13(4A) read with Article 24A of India-Singapore DTAA.

13 Article 13(4C) read with Article 24A of India-Singapore DTAA.

14 Article 24A of India-Singapore DTAA elaborates cases wherein an entity will be deemed or will not be deemed to be a shell / conduit company.

15 Article 13(4B) of India-Singapore DTAA.

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Annexure II

Parameter	Mauritius	Singapore	Netherlands
Interest	7.5%, subject to satisfaction of beneficial ownership test.[16]	10 % of the gross amount of the interest if such interest is paid on a loan granted by a bank carrying on a bona fide banking business or by a similar financial institution (including an insurance company); 15%, subject to satisfaction of beneficial ownership test.[17]	10%, subject to satisfaction of beneficial ownership test.[18]

Tax Implications if the Non-resident Investor is not Eligible to Claim Benefits under the Relevant DTAAs

Capital Gains	Nature of Securities	Short-term Capital Gains	Long-term Capital Gain
	Sale of listed equity shares on the floor of the recognized stock exchange (Securities Transaction Tax paid)	**15%**	**10%** without foreign exchange fluctuation benefit (capital gains in excess of INR 0.1 million)
	Sale of other listed securities	**40%**	**10%** without indexation benefit
	Sale of unlisted shares and securities	**40%**	**10%** without foreign exchange fluctuation benefit

16 Article 11(2) of India-Mauritius DTAA.

17 Article 11(2)(b) of India-Singapore DTAA.

18 Article 11(2) of India-Netherlands DTAA.

Annexure III

Certain Mauritius and Singapore Structures

I. Singapore VCC

Introduced under the Variable Capital Companies Act 2018 in 2020 (“**Singapore VCC Act**”), the Singapore VCC has introduced a segregated portfolio company structure to the Singaporean investment funds industry. A VCC is a separate legal entity that is empowered to hold property under its own name and may be constituted with a single member / shareholder.[1] Unlike an AIF, which has to wind up on the termination of underlying trust, a VCC is a perpetual vehicle that may be used to pool investments until wound up in accordance with the Singapore VCC Act.

Similarly, a VCC is required to have at least one director (who is ordinarily resident in Singapore) to undertake its management functions[2] as it is the board of directors of the VCC that constitutes its management. Further, the shares in of a VCC denotes the investor’s the right to receive distribution in accordance with the constitution of the VCC (and any letter agreements entered by and between the investment manager and the investor). As opposed to traditional companies, VCCs are permitted to pay dividends from its capital base and a VCC is permitted to repurchase / redeem its own share in accordance with its constitution.[3]

It is to be noted that a VCC may not be its own manager, i.e., it should not be currently possible to incorporate a self-managed VCC. A VCC requires a fund manager who is appropriately licensed by MAS to undertake fund management activities and is based in Singapore.[4] Further, similar to the treatment of private trusts in India, a VCC’s register of members is not open for public inspection.

Importantly, the sub-funds under a VCC are not considered a separate legal entity and therefore MAS has mandated the ring-fencing of the assets and liabilities of each sub-fund wherein the asset(s) of a sub-fund may not be utilized to service the liabilities of another. Nevertheless, there is a remote risk of non-recognition of this statutory ring-fencing in instances of multi-jurisdictional disputes.

Lastly, from a tax perspective, the VCC (including its sub-funds) shall be viewed as a single taxable entity with the entire income of the VCC being chargeable to tax at the corporate tax rate of 17% (unless other beneficial provisions apply). In this regard, it may be noted that dividends paid to the shareholders of the VCC are not liable to tax in Singapore.

1 Section 17A of the Singapore VCC Act
2 Section 48 of the Singapore VCC Act
3 Section 34 of the Singapore VCC Act
4 Section 46 of the Singapore VCC Act

II. Mauritius VCC

Introduced by the Variable Capital Companies Act 2022 ("**Mauritius VCC Act**"), the Mauritius VCC largely resembles its Singaporean counterpart with certain key exceptions such as each sub-fund being a separate legal entity.[5] The important factors to note in relation to a Mauritius VCC are as follows:

1. It is empowered to have both open-ended and close-ended schemes under the same fund umbrella.
2. Each sub-fund is permitted to have different fund managers and have differing investing strategies.[6]
3. The Mauritian tax code has been amended to restrict the tax authorities from cutting across sub-funds to meet tax obligations. Likewise, there is also general statutory ring-fencing available to the VCC preventing external creditor from accessing the asset of another sub-fund to meet the liabilities of another.[7]
4. Subject to certain conditions, the sub-funds of the VCC are permitted to cross invest in each other.[8]
5. VCCs may also have SPVs under it as opposed to only having sub-funds.[9]
6. Flexibility has been provided to the VCC to file consolidated returns or to file separate returns in respect of each sub-fund.[10]

It is to be noted that a VCC, regardless of the number of sub-funds under it, requires only a single Global Business License to commence operation.

5 Section 8 of the Mauritius VCC Act.

6 Section 12 of the Mauritius VCC Act.

7 Section 11 of the Mauritius VCC Act.

8 Section 14 of the Mauritius VCC Act.

9 Section 9 of the Mauritius VCC Act.

10 Section 24 of the Mauritius VCC Act.

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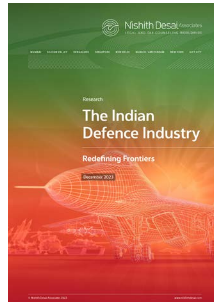

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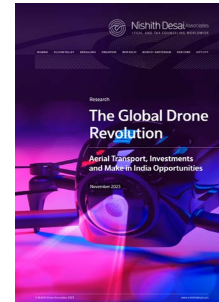

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Fund Formation: Attracting Global Investors

Global, Regulatory and Tax Environment Impacting India Focused Funds

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