

Funds Hotline

February 11, 2016

NARAYAN MURTHY COMMITTEE'S FIRST REPORT ON AIF POLICY: A MIXTURE OF IMMEDIATE FIXES AND LONG TERM RECOMMENDATIONS

1. In 2015, SEBI had set up the standing Alternative Investment Policy Advisory Committee ("**AIPAC**") under the chairmanship of Mr. Narayan Murthy. AIPAC released its first report on January 20, 2015 ("**Report**").
2. The Report lays down the roadmap for immediate improvements and long term progress of the alternative investment fund industry. The recommendations primarily deal with tax and regulatory reforms.
3. AIPAC suggests amendments to the Income Tax Act, 1961 to align the legislation with the commercial realities and the potential of private equity and venture capital sector. Major recommendations include:-
 - Removal of withholding tax for exempt investors and exempt streams of income;
 - Clarification that "indirect transfer" provisions are not applicable to offshore funds/ holding vehicles for investment funds;
 - Relaxation of norms laid down in safe harbor provisions for onshore fund managers under Section 9A.
 - Provisions permitted allocation of losses among investors at the end of fund's life.
 - Introduction of securities transaction tax as replacement to the existing tax regime for AIFs
4. The major suggestions on regulatory reforms include:-
 - Permission for religious and charitable trusts to invest in AIFs;
 - Single family offices should be given the status of pooling vehicles;
 - Introduction of "accredited investor" concept in India;
 - Liberalization of overseas investments for AIFs;
 - Explicit permission for LLPs to act as sponsor/manager must be granted for funds that are accepting foreign investments;
 - Inclusion of "growth funds" in the definition of "Venture Capital Funds" in the AIF Regulations.
 - Division of Category III AIFs in two sub-categories to distinguish trading funds from non-trading funds.

BACKGROUND

In 2012, SEBI took steps to completely overhaul the regulatory framework for domestic funds in India and introduced the Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012 ("**AIF Regulations**"). The AIF Regulations were introduced by SEBI with a view to recognize such pooling vehicles as a distinct asset class and to promote investment in start-ups and early stage companies. Further, the AIF Regulations were also aimed at rationalizing investment restrictions with the concessions and incentives that were made available.

Categories of funds: **Category I AIFs** encompass AIFs with a defined investment strategy focusing on Venture Capital Funds, Small and Medium Enterprises Funds, Social Venture Funds and Infrastructure Funds, which in SEBI's view, lead to "... positive spillover effects on the economy". **Category II AIFs** encompass AIFs that may not need any focused incentives. These would include private equity funds and debt funds, among others. **Category III AIFs** are used to set up an onshore hedge fund structure with prescribed levels of leverage.

In 2015, the Securities and Exchange Board of India ("**SEBI**") had constituted the Alternative Investment Policy Advisory Committee ("**AIPAC**" or the "**Committee**") under the chairmanship of Mr. Narayan Murthy. AIPAC is a standing committee that has been constituted with the objective to advise SEBI on measures to further development of the alternative investment and startup ecosystem in India and to highlight any hurdles that might hinder the industry's development.

The first report of the AIPAC was issued on January 20, 2016. Following is a brief summary of the issues highlighted by the Committee and the suggested changes.

OBJECTIVES

The report outlines the following objectives that its recommendations seek to achieve:-

1. Creating a favorable tax environment;
2. Unlocking domestic capital pools;

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3. Promoting onshore fund management; and

4. Reforming the AIF regulatory regime

SUMMARY OF THE REPORT

A. Creating a favorable tax environment:

The AIPAC is of the view that the AIF industry has a real opportunity to make a greater impact on the economy provided that AIFs as an asset class get recognition as a distinct investment class, much the same as foreign portfolio investment and foreign direct investment are recognized as carrying unique attributes. The Committee recommends the following changes to achieve the same:-

Recommendations:

(i) Exempt income of an AIF and exempt investors in an AIF should not suffer withholding tax

Section 194 LBB of the Income Tax Act, 1961 ("**Act**") deals with provisions related to withholding on income arising from an investment fund. The provision requires the investment fund to deduct tax at the rate of 10% of the net book income at the time of making distributions to the investor, or crediting the same to the account of the investor.

As a best case scenario, the Committee has recommended that Section 194LBB should be abolished. If the provision is continued, (1) exempt income must be excluded from its ambit, (2) the provision should exclude "accredited investors" which provide self-declaration, (3) provision should exclude non-resident investors as they are subject to requirements of Section 195, (4) clarify that it is applied on net income and not gross income and (4) reduce the rate to 2% of the net book income instead of 10%.

The report recommends that there should be no tax withholding on exempt income streams, entities that are exempt from income tax and distributions/credit to investors that can avail benefits under the relevant Double Taxation Avoidance Agreement ("**DTAA**"). This is an important reform that will go a long way in incentivizing foreign investors to invest in AIFs.

Further, the report also recommends that transactions covered under Section 194LBB should be eligible to obtain a nil withholding certificate under Section 197.

(ii) Investment gains of an AIF should be deemed to be "capital gains".

AIPAC has recommended that the income earned by an AIF should be taxable under the head "capital gains" or "income from other sources". This is important to remove the risk of the income being characterized as "business income". At present, funds (especially category III AIFs) face the risk of their income being characterized as business income due to the frequency of investment and exits. Further, an earlier amendment to the Act deems all income of a foreign portfolio investor ("**FPI**") to be "capital gains". This creates a mismatch in the applicable regulations and places onshore AIFs at a disadvantage over offshore funds.

(iii) Investments by AIFs should be exempt from provisions of Section 56(2)(viia) and 56(2)(viib)

Currently, Sections 56(2)(viia) and 56(2)(viib) apply to AIFs when they purchase shares of a closely held company, or to the investee company when they subscribe to shares of such a company. These are anti-abuse provisions that have been inserted into the Act to prevent transactions above or below fair market value.

However, at present Section 56(2) of the Act provides specific exemption for companies where the consideration for issue of shares is received from "venture capital funds" due to the special nature of the transactions. AIPAC has recommended that all AIFs and their investee companies should be exempted from the rigors of Sections 56(2)(viia) and Section 56(2)(viib).

(iv) Indirect transfer provisions

AIPAC has recommended that it should be clarified that the indirect transfer provisions under Section 9 of the Act are not applicable to gains from transfer of shares or interest of the holding companies/entities above investment funds investing in India. This is important as at present, there is uncertainty surrounding the transfer of shares of an investment fund investing into India due to the fact that most India focused funds have more than 50% of their assets situated in India. This makes them subject to a Section 9 scrutiny on indirect transfers.

(v) Overhaul of safe harbor provisions for onshore managers for India-focused foreign funds

By an amendment under Finance Act, 2015, safe harbor provisions were introduced under Section 9A of the Act. These provisions were introduced to encourage onshore fund management for offshore funds as they laid down that upon fulfillment of certain conditions, activities of the fund manager would be deemed to not have a "business connection" in India.

The safe harbor provisions under the Act have not been utilized by the fund management industry as they have been found to be too onerous. In order to improve the safe harbor provisions, the Committee has recommended various changes such as rationalization of the diversification requirements, allowing indirect investors to be counted while calculating the number of investors and removal of caps on the percentage of corpus that can be invested into a single investment. Most importantly, the Committee has sought clarity on the fact that a fund would not be regarded as carrying out business activities in India merely by the virtue of holding shares in various entities and subsequent measures taken to protect their interest therein.

(vi) Extension of "pass-through" status to all categories of AIFs and grant of pass-through status to net losses at AIF level

At present, "pass-through" status has been granted only to category I and category II AIFs. The Committee has recommended that "pass-through" status should be granted to category III AIFs as well. Globally, investment funds rely on a 'tax pass-through status' wherein the income of the investment fund is taxed directly in the hands of its investors, and not at the level of the fund itself. This provides fiscal neutrality to funds as it eliminates tax at the pool level while maintaining taxation at the investor level.

Further, AIPAC has recommended that net losses incurred at the end of a fund's lifecycle or has unabsorbed losses,

which cannot be utilized by the AIF should be allowed to be passed on to investors. The investors should then be allowed to offset other capital gains against such losses.

(vii) Long term roadmap for a Securities Transaction Tax based approach for AIFs

One of the major long term recommendations from the AIPAC is to introduce a Securities Transfer Tax ("STT") at an appropriate rate on all distributions (gross) of AIFs, investments, short-term gains and other income and eliminate any withholding of tax. The AIPAC was of the opinion that having regard to the level of risk taken by investors into an AIF, the investment should be treated at par with investment into listed securities. STT based taxation is already applied in case of transactions involving listed securities. After STT has been imposed at an appropriate rate, income from AIFs should not be subject to tax at the hands of investors. However, it must be noted that the imposition of STT would take away from the "pass-through" nature of taxation in category-I and category-II AIFs as it would lead to an additional and mandatory tax being imposed at the level of the AIF.

(viii) Proposed "next practices"

In addition to the immediate changes, AIPAC has recommended the following measures as "next practices" which have been positioned as measures that go beyond the existing "best practices" that are prevalent globally. Some important suggestions are as follows:-

1. SEBI regulated angel/venture capital funds should be provided with an incentive in the form of a tax deduction of up to 50% of the investment amount.
2. Management expenses for venture capital and private equity ("VC/PE") investments should be allowed to be capitalized as "cost of improvement" and should consequently be allowed to be deducted from the gain amount.
3. Taxation upon "sale" and reduced taxation rates for unlisted shares acquired via Employee Stock Ownership Plans ("ESOPs")/ employee investment schemes. Currently, tax is payable on the vesting of the ESOP which leads to an onerous situation where tax is payable for a non-cash gain.
4. Reduce tax rate on long term capital gains ("LTCG") applicable on transfer of shares of private limited companies to 10%. At present, such transfers are taxed at 20%. Further, the Committee has recommended that investment through an AIF must be incentivized with 0% LTCG regime.
5. Further, the Committee has recommended that investment held by an AIF for a year must qualify for taxation as LTCG. At present, shares of a private limited company need to be held for at least 3 years to qualify for taxation as LTCG.
6. There should be clarity that conversion of preference shares into equity shares should not amount to a "transfer" of shares under the Act.
7. Service tax abatement on service fees in respect of funds raised by an AIF from overseas investors. The AIPAC was of the opinion that the Act should look through to the investors in an AIF and consequently management fee charged from an overseas investor should be exempt from service tax as it should amount to export of services.

B. Unlocking capital pools:

The Committee identified that at present there are constraints on banks and NBFCs to supply risk capital as they are subject to risk management requirements. Hence, other domestic pools need to be identified as potential pools of domestic capital into AIFs. The AIPAC is of the view that more domestic capital would enable India to attract more global capital and the policy should incentivize institutions looking to make equity investments in India should consider the AIF route as a sound alternative and domestic capital is likely to take higher early-stage risk and can spur the start-up system in India.

The following potential domestic sources of capital have been identified by AIPAC:

1. **Pension Funds:** The latest Pension Fund Regulatory and Development Authority ("PFRDA") report recommends pension funds to (1) allocate up to 3% of their assets to AIF by 2017, rising to 5% by 2020; and (2) implement a prudent investor regime (trained investment teams, committees, officers).
2. **Charitable and religious trusts** should be allowed to invest in AIFs (through amendment in section 11(5) of the Act and Rule 17C of the Income Tax Rules, 1962 for at least up to 10% of their Assets Under Management ("AUM") in AIFs. They must also implement a prudent investor regime (trained investment teams, committees, officers). Alternatively, charitable or religious trusts should at least be allowed to invest in SEBI registered "social venture funds".
3. **Insurance companies:** (1) Allow investments in all types of AIFs (including unlevered Cat III), (2) AIF investments should fall under 'approved category' (no Board approval, only Investment Committee ("IC") approval subject to internal prudential guidelines), (4) increase maximum exposure to AIFs from 3% to 5%, and to 10% by 2020 and (5) permit investments in fund of funds.
4. **Banks:** (1) Increase investment limits for banks from 10% to 20% of the total corpus of an AIF; and (2) AIF investments by banks should be treated as 'priority sector investments'.
5. **Accredited investors:** AIPAC has recommended that the concept of 'accredited investors' in line with global practice be introduced – the reported total income of such investor should exceed INR 50 lakhs annually in three assessment years immediately preceding the assessment year in which the investment is proposed to be made along with other qualifications.
6. **Limited Liability Partnerships:** The Registrar of Companies should allow LLPs to be registered for the object of investment, provided that they self-certify that all the capital is contributed by the partners, and that they do not accept public deposits or use borrowed funds.
7. **Single Family Offices:** (1) Single family offices should be allowed to register specified investment vehicles as QIBs; and (2) Family offices and dedicated state funded vehicles can be registered as AIFs.

8. **NRIs:** (1) RBI should clarify that NRIs can invest in AIFs using their NRO accounts; (2) FDI Policy should include a definition of AIF and permit investments in trusts registered as AIFs.
9. **Foreign Venture Capital Investors:** (1) General permission should be given under the FDI policy for FVCI investments in AIFs under the automatic route; (2) Remove the 10 sector restriction that is currently applicable to FVCIs; (3) DDP approach for FVCI registration to ease the registration process which is extremely onerous at present; (4) Existing benefits offered to FVCIs should continue.
10. **Reforms for angel funds** – (1) Angel funds should not be required to remain invested in a company for a minimum of 3 years. If such a period is continued, it should be reduced to 1 year; (2) Requirement to invest INR 25 lakh over 3 years should be extended for the life of the fund or raised to 5 years; (3) minimum investment by an angel fund in a company should be brought down to INR 25 lakhs from INR 50 lakhs; (4) SEBI (Alternative Investment Funds) Regulations, 2012 ("**AIF Regulations**") should allow a scheme to have a maximum of 200 investors (as opposed to 49 at present) (5) Change the requirement of angel funds investing only in Venture Capital Undertakings ("**VCUs**") incorporated not more than 3 years ago to – at least 10% of the corpus being invested in VCUs which may be more than 3 years old (6) Angel funds should be allowed to invest in offshore VCUs (similar to other Cat 1 categories).

C. Promoting Onshore Fund Management:

The AIPAC identified that the current regulatory and tax regime is a key factor in driving VC/PE fund managers overseas and causes most India focused VC/PE funds to be domiciled overseas. The report suggests that (a) tax clarity on issues such as rationalization of withholding requirements under Section 194LBB (*as discussed in the section titled "creation of a favorable tax environment"* above); and (b) operational freedom of fund managers have a key role to play in promoting onshore fund management.

Operational freedom for domestic AIFs: AIPAC has recommended that the following measures must be taken to increase operational freedom for AIFs and to have a more robust system of investor protection:-

1. Strengthen the regulatory framework to address investor protection by promoting the principle of 'alignment of interests' between the manager and the investors.
2. Allow for piggyback rights to onshore investors on the rights negotiated by sophisticated offshore funds.

Overseas investments by AIFs – The AIF Regulations should allow for either 25% of the total corpus of the AIF (under an automatic route as opposed to the current policy of prior permission) or 50% of the offshore component of the corpus of the AIF to invest in overseas portfolio companies. The understanding of 'Indian connection' should be liberalized i.e. investment from an AIF in itself should be regarded as satisfying this criteria.

D. Reforming the AIF regulatory regime:

AIPAC has recommended a greater thrust on regulating the fund managers as opposed to the funds. The Committee has recommended that the existing SEBI (Portfolio Management) Regulations, 1993 ("**PMS Regulations**"), SEBI (Investment Advisers) Regulations, 2013 and AIF Regulations should be consolidated to a single Alternative Investment Fund Managers regulations ("**AIFM Regulations**"). As an alternative, the Committee has recommended that the following changes must be made to the AIF Regulations:-

1. Amend the definition of 'Venture Capital Fund' to include funds which invest in "growth stage ventures". Presently, "Venture Capital Funds" are entitled to benefits such as exemption from the minimum pricing requirements under Section 56(2)(viiia) and Section 56 (2)(viib) of the Act. The amendment to the definition has been suggested with the objective to extend "Venture Capital Fund" classification to private equity funds which invest in later stages of a company's life.
2. **Classify Category III AIFs into two sub-categories** – Category III AIFs should be classified into the following sub-categories (a) "**Sub-category (A)**" which will invest in public markets and not employ leverage including through investment in listed or unlisted derivatives (except for hedging) and is long-term oriented with a minimum life of 3 years. At least 66% of such AIF's investment must be in equity and at least 33% must be in debt; (b) "**Sub-category (B)**" for 'complex trading funds', i.e. funds which employ diverse or complex trading strategies and may employ leverage (including through investment in listed or unlisted derivatives). While the Committee did deal with the consequences of such classification, it seems likely that there will be relaxation of reporting requirements for the above mentioned sub-category (A) and it will also make it easier for an amendment to the Act providing for "pass-through" status to at least sub-category (A) of category III AIFs.
3. The 10% investment limit for portfolio companies should be referenced to the market value of units of the AIF instead of the investible funds or corpus.

ANALYSIS

The AIPAC report marks a welcome start for necessary dialogue that is required between the industry and the regulator. While the Report outlines emphasizes on specific changes required in the current regulatory framework for certain immediate changes, it is far sighted in its recommendations and contains various structural suggestions that would go a long way in enabling a thriving AIF platform in India.

A critical positive feature of the AIPAC is that it is constituted as a standing committee which will continue its work in other areas that affect the AIF industry. We hope that the Committee shall also monitor the implementation of its recommendations and consistently engage with the government and the industry to create a stable, secure and progressive regime for pooled investment structures in India.

– **Linesh Lalwani, Nandini Pathak & Richie Sancheti**
You can direct your queries or comments to the authors

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