

Report submitted by Alternative Investment Policy Advisory Committee

1. To solicit the comments/views from public on suggestions pertaining to the report submitted by Alternative Investment Policy Advisory Committee.

Background:

2. SEBI had constituted a standing committee 'Alternative Investment Policy Advisory Committee' (AIPAC) under chairmanship of Shri. N. R. Narayan Murthy in March 2015. AIPAC has submitted its first report to SEBI with various recommendations stated therein.

Public Comments:

3. In order to take into consideration the views of various stakeholders, public comments are solicited on the said report as placed at Annexure. Comments may be emailed on or before **February 10, 2016**, to **aif@sebi.gov.in** or sent by post, to:-

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Bandra (East), Mumbai - 400 051*

4. Comments/ suggestions may be provided in the format given below:

Name of entity / person / intermediary/ Organization			
Sr. No.	Clause No.	Suggestions	Rationale

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The Alternative Investment Policy Advisory Committee Report

31 December, 2015

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Preface

Alternative Investment Funds (AIFs) play a vital role in India's economy. As engines of economic growth, they contribute significantly to nation building. They provide long-term and high-risk capital to a wide variety of ventures at all stages of their evolution, creating stability and entrepreneurial capability. This includes risk capital in the form of equity capital for pre-revenue stage companies, early and late stage ventures, growth companies that wish to scale their operations, and even companies facing distress. AIFs help incubate innovative ideas and invest in a broad array of sectors ranging from e-commerce, hospitals, tech ventures, education ventures, and industrial and infrastructure projects. The capability capital also ensures well-run and well-governed businesses. There is unanimity in the recognition that AIFs are a critical part of a robust and lively capital market.

In the light of this vital role, the Securities and Exchange Board of India (SEBI) has taken several progressive measures since 1996 to promote Alternative Investment Funds. SEBI's most recent initiative was the enactment of the SEBI Alternative Investment Fund Regulations, 2012 and subsequent amendments. Considering the developing nature of India's AIF market, considerable advances in regulation are needed to promote the supply of risk capital in a prudent fashion. Accordingly, SEBI established the Alternative Investment Policy Advisory Committee (AIPAC). The Terms of Reference of the Committee are to advise SEBI in the following areas:

- (i) the further development of the alternative investment and startup ecosystem in India;
- (ii) the removal of hurdles that might hinder the development of the alternative investment industry;
- (iii) issues which need to be taken up with other regulators for the development of the alternative investment industry; and
- (iv) any other issue relevant to the alternative investment industry and development of the start-up eco-system in India.

The Committee comprises 21 members. The Committee has met four times since its inception in March, 2015. In its initial phase the Committee decided to focus on four central areas. These include reforms in the fields of taxation, development of domestic capital pools in India, attracting overseas managers onshore in India, and the categorization of Alternative Investment Funds in SEBI's regulatory regime. This first report addresses these four areas, and recommendations are founded on core underlying principles.

As the field of Alternative Investment Funds has a wide canvas, the Committee will meet again to discuss and make recommendations in other areas like the novel instrument of crowd-funding, business development companies and related topics

It is evident that the Government of India and regulators have embarked on a reform-oriented approach and there is significant momentum. The recommendations in this report are, therefore, timely. I welcome further reviews and comments from other industry players and stakeholders of the AIF industry.

I do hope that policymakers will embrace the proposed reforms. To assist policymakers, the precise wordings of suggested amendments and draft notifications have been included in the report.

I sincerely thank all those who worked tirelessly and have spared their valuable time from their regular duties to help craft the recommendations and prepare this report. In particular, I wish to thank SEBI and its staff for providing its invaluable guidance and support at various stages of this report.

N.R. Narayana Murthy
Chairman, AIPAC
Founder, Infosys

Alternative Investment Policy Advisory Committee (AIPAC)

List of Members

Sr. No.	Name	Organization & Designation	Capacity
1.	Shri. N.R. Narayana Murthy	Founder, Infosys Ltd.	Chairperson
2.	Shri. N. S. Vishwanathan	ED, Reserve Bank of India	Member
3.	Shri. Ashish Kumar	Director, CBDT, Ministry of Finance	Member
4.	Shri. Nikhil Varma	Deputy Secretary, DEA, Ministry of Finance	Member
5.	Shri. Sanjay Nayar	Chairman, Indian Private Equity & Venture Capital Association (IVCA), Member & CEO, KKR India Advisors Pvt. Ltd.	Member
6.	Shri. Saurabh Srivastava	Founder, Indian Angel Network	Member
7.	Shri. Ajay Piramal	Chairman, Piramal Group	Member
8.	Shri. Devinjit Singh	MD, The Carlyle Group, India	Member
9.	Shri. Manish Chokhani	Chairman, TPG Growth India	Member
10.	Shri. Gautam Mehra	Partner, PwC India	Member
11.	Shri. Akshay Mansukhani	Partner, Malabar Investments	Member
12.	Shri. Mani Iyer	Director, Incube Ventures Pvt. Ltd.	Member
13.	Shri. Abid Hassan	COO, Mobile ID, Startup Village Fund	Member
14.	Shri. K.E.C Rajakumar	MD & CEO, Ascent Capital Advisors	Member
15.	Shri. Sudhir Sethi	Founder Chairman & MD, IDG Ventures India, iSPIRT Foundation	Member
16.	Shri. Sunil Godhwani	Chairman and MD, Religare Enterprises Limited	Member
17.	Shri. Gopal Srinivasan	Chairman and MD, TVS Capital Funds Limited	Member
18.	Shri. Manish Kejriwal	Managing Partner, Kedaara Capital Advisors LLP	Member
19.	Shri. Arvind Mathur	President, Indian Private Equity & Venture Capital Association (IVCA)	Member
20.	Shri. Ananta Barua	ED, SEBI	Member
21.	Smt. Barnali Mukherjee	CGM, SEBI	Member Secretary

Acknowledgements

This report of the Alternative Investment Policy Advisory Committee (AIPAC) has been made possible with the support and contributions of many individuals.

The Committee would like to gratefully acknowledge the valuable support of SEBI and the contribution of its professionals – S. Raman, Naveen Kumar Gupta, Nila Khanolkar, Dharmendra Jain and several other SEBI staff who helped convene the meetings of AIPAC. The Committee also acknowledges the efforts and the contribution of, Abhishek Laximinarayan, Sheetal Bhat, Vikram Bohra, Subramaniam Krishnan, Siddharth Shah, Bharat Anand, Joyjyoti Misra, Nishith Desai, Richie Sancheti, Vivek Pandit, Padmaja Ruparel, Ritesh Pandey, Rohan Rai, Tejash Gangar and Varzavand Batliwala.

The McKinsey & Company Report – *Indian Private Equity: Route to Resurgence, June 2015*, has been an invaluable background source.

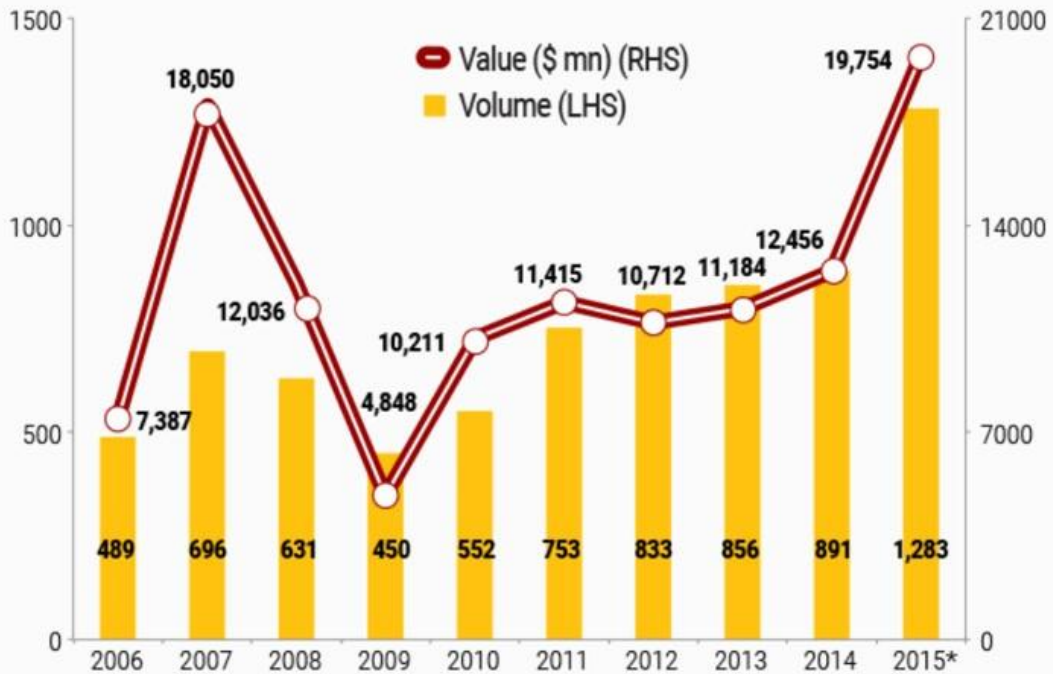
Four sub-committees were formed to address the topics of : the Rationalisation of AIF Categories, Tax Policy, Unlocking Domestic Capital Pools and Promoting Onshore Fund Management, chaired by Sanjay Nayar, Gopal Srinivasan, Saurabh Srivastava and K.E.C. Rajakumar, respectively. Special thanks are extended to the sub-committees and their Chairmen.

Introduction to the Alternative Investment Fund Industry

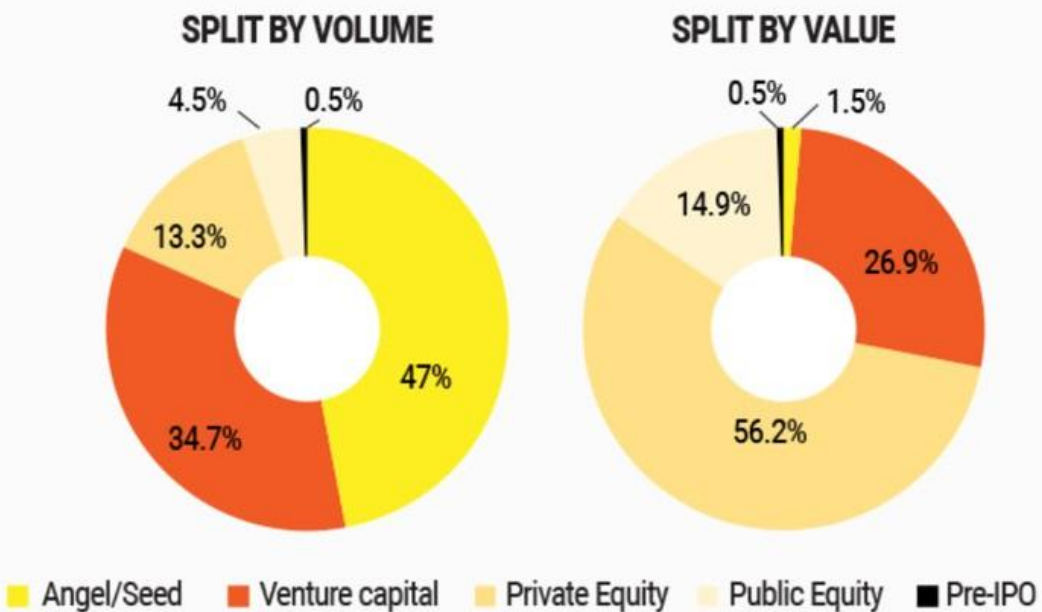
- 1.1 Enterprises are risky ventures. They cannot only be financed by traditional sources of debt, such as banks. They need access to sufficient amounts of stable, long-term, risk capital, which are angel capital, venture capital and private equity, collectively referred to as Alternative Investment Funds. Venture capital and angels provide equity capital to new ventures and nurture and mentor the management of portfolio enterprises. As the capital needs of a growing venture rise, it seeks private equity which adds value in several ways, such as improving governance processes, providing access to networks and helping scale the enterprise.
- 1.2 A distinguishing characteristic of both venture capital and private equity is that they add strategic value and enhance the internal proficiencies of enterprises, thus being regarded as invaluable 'capability capital'. The distinction between venture capital and private equity has become blurred as they have become 'stage agnostic' with both forms of capital providing capital to a wide range of enterprises at different stages of their development.
- 1.3 The venture capital and private equity industry has contributed considerably to India's economic growth. Between 2001 and 2015, venture capital and private equity of more than \$103 billion was invested in Indian companies. These investments were made in more than 3,100 companies across 12 major sectors, including those critical for the country's development. The enterprises have ranged from start-ups to mature, mid-size companies. A significant portion of these investments have been made by global fund managers operating India-focussed offshore funds, global fund managers operating in India and Indian fund managers operating offshore funds, in the form of foreign direct investment (FDI).

RISING TO A RECORD

PE & VC investments touched an all-time high in 2015.



Type of deals in 2015*



Source: VC Circle

- 1.4 The Government recognizes that start-ups have always been the engine of progress. The star businesses of today, were once start-ups. The digital age has created a fertile new environment for start-ups. The Government also wishes to create the eco-system in which start-ups can mushroom and thrive. Venture capital, private equity and angel capital are vital elements in this eco-system. Accordingly, reforming the AIF regulatory framework for venture capital, private equity and angel capital will play a key role in making a success of the start-up policy.
- 1.5 The risk appetite of this asset class has helped shape several new industries, such as mobile telecommunications, information technology services, social media and ecommerce. Portfolio companies of venture capital and private equity funds have contributed significantly to India's economic development through outcomes such as :
- a) **Stronger Job Creation Record:** Venture capital and private equity have helped accelerate job growth. In the five years following initial investment, companies backed by private equity grew direct employment faster than companies not backed by private equity.
 - b) **Superior Financial Performance:** In the two years following initial investment, revenues of portfolio companies grew 28% more than revenues of companies not backed by venture capital and private equity in a comparable period. In addition, their profits were stronger.
 - c) **Greater Export Earnings:** Venture capital and private equity investors focused on building capabilities in their portfolio companies, resulting in increased export earnings. This strategy also helped reduce risks associated with volatility of domestic growth and currency rate changes.
 - d) **More Acquisitive and Global Mind-set:** In the sample set, 80% of the companies participated in their first cross-border M&A only after receiving venture capital or private equity funding. Venture capital and private equity fund managers shared their experience, knowledge and networks to help companies acquire strategic partners.
 - e) **Superior Corporate Governance and Higher Tax Contribution:** Portfolio companies of venture capital and private equity funds generally improved their corporate governance. Private companies with revenues less than INR 7.5 billion linked to VC/PE contributed 18.8% of the corporate tax receipts for companies of a similar size, more than 13.1% of total revenue within this group.

- 1.6 To foster venture capital and private equity as a source of risk capital for entrepreneurs and innovation, the Government of India enacted the Securities and Exchange Board of India (Venture Capital Funds) Regulations, 1996 (VCF Regulations). Later, SEBI introduced a comprehensive legal framework in the form of SEBI (Alternative Investment Funds) Regulations, 2012 (AIF regulations), repealing and replacing the erstwhile SEBI (Venture Capital Funds) Regulations, 1996.
- 1.7 Alternative investment funds (AIFs) are defined in Regulation 2(1)(b) of SEBI (Alternative Investment Funds) Regulations, 2012. AIFs refer to privately pooled investment funds, which are not covered by any regulation of SEBI governing fund management, nor come under the direct regulation of other sectoral regulators in India. AIFs have been divided into three categories in the SEBI (Alternative Investment Funds) Regulations, 2012. AIFs include venture capital funds, private equity funds, debt funds, infrastructure funds, social venture funds amongst others. AIFs include funds which employ diverse or complex trading strategies in the secondary markets in the securities of listed companies. These latter funds account for less than 10% of the AIF investments made.
- 1.8 Venture capital and private equity funds with fund managers domiciled in India and which were registered with SEBI post 2012, are now classified as AIFs and come within the ambit of the AIF regulations. These funds also include those in which offshore capital has been invested.

India: Alternative Investment Funds by Category (As of September 2015)

Category	Commitments raised (Rs. crores)	Funds raised (Rs. crores)	Investments made (Rs crores)	No. of AIFs
Category I				
Infrastructure Fund	6875.69	1970.25	1350.08	8
Social Venture Fund	600.52	259.52	216.65	3
Venture Capital Fund	1382.39	798.48	487.85	36
SME Fund	135.00	123.79	20.03	8
<i>Category I Total</i>	8993.60	3152.04	2074.61	55
Category II	14375.71	8079.29	6792.38	87
Category III	2162.79	1568.88	896.43	26
Grand Total	25532.10	12800.21	9763.42	167

1.9 AIFs with domestic capital have only invested \$850 million in the first 3 quarters of 2015. The recent amendments for Foreign Direct Investment (FDI) in AIFs (most importantly the exemptions from all sectoral FDI caps and conditions for downstream investments by India-sponsored and managed AIFs), is expected to see a dramatic shift in the quantum of investments made by AIFs, potentially translating into a total commitment of \$8-10 billion that will make it to Indian shores, considering the amount of foreign capital deployed to date by India-based fund managers. Accordingly, the recommendations in this report become even more relevant and critical.

Introduction to the Report and Executive Summary

The Purpose of the Report

- 2.1.1. India's economic environment is positive and is going through a period of accelerated growth and innovation. Long-term and stable risk capital is much needed for development to meet the demands of a large population in a competitive and modernizing world. Reforms to promote AIFs in these propitious conditions are well justified as they can significantly increase this steady source of long-term risk capital. With the rising demand for sizable amounts of capital to be invested in India, the AIF industry has a critical need to increase the pool of talented India-based Fund Managers with access to a better and larger deal flow i.e. a strong pipeline of investment opportunities in India.
- 2.1.2. Considering the developing nature of India's AIF market, many advances in the regulatory framework are needed to promote the supply of risk capital in a prudent fashion. Accordingly, the Securities & Exchange Board of India (SEBI) established the Alternative Investment Policy Advisory Committee (AIPAC).
- 2.1.3. The purpose of the first AIPAC Report is to recommend wide-ranging reforms which India needs to institute in order to create a favourable climate for building a sound alternative investment eco-system in India. The Committee has worked with a solution - finding approach and has evolved recommendations that would help create: a favourable tax environment for investors; unlock domestic sources of venture capital and private equity and other funds for AIFs; enable and encourage onshore fund management in India; and reform the AIF Regulatory regime to facilitate and optimise investments by AIFs.
- 2.1.4. The Committee has taken cognizance of a range of stakeholders and has tried to evolve a 'win-win' solution. For the Government, this would result in robust direct and indirect tax collections, creation of more jobs, and acceleration of GDP growth. For SEBI, all alternative assets would come under its supervision; equity markets would be able to attract a greater supply of stable risk capital; and sound portfolio companies in a wide range of economic sectors and established and budding entrepreneurs will be able to attract equity capital to meet their start-up costs, capital expenditure and operating needs.

Fundamental Principles Underlying the Recommendations

2.1.5. The recommendations of the Committee are founded on **core best practice principles** as discussed below:

a. Ease of doing business is important

India needs to maintain the recent momentum to improve ease of doing business. Cumbersome regulations are hurdles on the start-up and growth of businesses in India as well as in the effective functioning of Alternative Investment Funds which provides much-needed long-term capital to enterprises. Ease of doing business creates a conducive business environment, reduces risk aversion and lowers the cost of doing business resulting in an increased inflow of capital to support new and existing businesses. Ease of doing business increases investor confidence enabling AIFs to provide stable risk capital to a larger universe of portfolio companies more effectively and in greater amounts. This leads to a robust platform, innovation in indigenous technologies, provides jobs, and generates revenue which could be ploughed back for growth and expansion. Nation-building through wealth and job creation in the economy, benefits society, being the end goal of simplifying business regulations.

b. Fund managers have the role of “Prudent Men”

Best practice for fund managers is to follow the Prudent Man rule (outlined below), and it is in the interest of the AIF industry to adhere to it. The Prudent Man Rule requires that each investment be judged on its own merit and provides the standard in accordance to which a fiduciary is expected to operate.

The Prudent Man Rule

The Prudent Man Rule first came into being in the seminal 1830 Massachusetts court formulation, *Harvard College vs. Amory*. The original rule stated that:

“A fiduciary must discharge his or her duties with the care, skill, prudence and diligence that a prudent person acting in a like capacity would use in the conduct of an enterprise of like character and aims.”

The rule was formally set forth in the Employee Retirement Income Security Act of 1974 (ERISA) in the US. Section 404 of the Act. The fiduciary standard is comprised of 5 separate standards, including

- a) **Duty of Loyalty:** A fiduciary must discharge his duties solely in the interest of plan participants. Thus, the fiduciary must avoid conflicts of interest when managing plan assets
- b) **Exclusive Purpose Rule:** A fiduciary must discharge his duties for the exclusive purpose of providing benefits or defraying reasonable expenses only. The plan must not pay excessive compensation to its investment and service providers.
- c) **Duty of Care:** A fiduciary must discharge his duties with the “care, skill, prudence and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like chapter with like aims.” This standard of care is also known as the “prudent expert” standard
- d) **Duty to Diversify:** A fiduciary must diversify the plan’s investments so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so
- e) **Duty of Obedience:** A fiduciary must discharge his duties in accordance with the documents and instruments governing the plan insofar as they are consistent with governing laws.

Fund managers for AIFs in India are required to follow the guidelines set in the Prudent Man Rule, giving them an empowering framework; with the assumption that there will be serious consequences for non-compliance.

c. Adopt global best practices, and where necessary, innovate the “next” (best) practice

Alternative investment funds are still an evolving sector in the Indian financial services landscape. The recommendations in this report are based on the core principle of adopting global best practices and where required, innovating the ‘next’ best practice. These recommendations are framed with the view that every next practice created is not just a global gold standard, but is also

innovative and based on careful thought and consideration. A few examples of 'Next Practices' from this report are:

- Securities Transaction Tax (STT)- based taxation for listed equities,
- tax pass-through for retail investors in mutual funds
- the concept of accredited investors,
- simplified investment manager framework,
- tax efficient Employee Stock Option Plans (ESOPs), yet tax neutral,
- recognition of new market participants such as Family Offices, amongst others.

India must attempt to develop the next best practice for the AIF industry.

d. Clarity, consistency, and certainty in tax policies

In countries where alternative investments have been immensely successful, a clear and consistent policy framework has been a significant enabler, and this includes a stable tax regime. These criteria – clarity, certainty and consistency in policy – impact the growth of the venture capital and private equity ecosystem, and the funds' ability to attract capital and provide efficient, tax-adjusted returns. For example, funds are pooling vehicles for their investors, and the universally applicable principle is of a single-level of taxation in the hands of investors, also known as limited partners (LPs). In a globalized world, where countries compete for capital, the success of alternative investments in the medium to long-term depends on India's tax policy for alternative investments being globally competitive.

e. Harmonisation and consistency across different regulators

It is vital that the recommendations of the Committee are coherently coordinated and harmonized across different regulators such as the Reserve Bank of India (RBI), the Central Board of Direct Taxes (CBDT), the Ministry of Finance, the Ministry of Corporate Affairs and others. For AIFs to work seamlessly, they need to be treated equally and on par by all stakeholders and regulators.

f. AIFs should at least have parity with public market funds in tax policies

Investments in venture capital and private equity funds are risky, commonly illiquid, and relatively longer term in nature. Accordingly, venture capital and private equity funds should, at the very least, have a tax regime that is on par with that applicable to investors in public markets.

Summary of Recommendations

- 2.1.6. The four chapters that follow focus on the four forces that will drive the progress and contribution of the AIF industry.

I. Creating a Favourable Tax Environment

- 2.2.1. The tax recommendations are aimed at bringing about ease of doing business ensuring neutrality, clarity, consistency and certainty in the tax policy; helping increase the confidence of investors, fund managers and entrepreneurs; and establishing parity in tax policies between alternative investments and public market investments.

- 2.2.2. Once implemented, the recommendations will help attract significantly more capital from offshore and Indian investors into Indian private equity and venture capital, including SEBI-regulated Alternative Investment Funds.

- i. **Make Tax Pass-Through Work Effectively:** The tax pass through system of taxation of AIFs ensures that investors do not pay more tax than they would, had they made the investments directly themselves. AIFs are simply vehicles that pool the savings of investors for professional fund management over a long-term period. Accordingly the pass-through method should be made to work flawlessly with simplicity. This requires the immediate implementation of the following:
- a) The exempt income of AIFs should not suffer tax withholding of 10%.
 - b) Exempt investors should not suffer withholding tax of 10%.
 - c) Investment gains of AIFs should be deemed to be 'capital gains' in nature.
 - d) The tax rules applicable to 'investment funds' in Chapter XII-B of the Act should be extended to all categories of AIFs.
 - e) Losses incurred by AIFs should be available for set-off to their investors.
 - f) Non-resident investors should be subject to rates in force in the respective Double Tax Avoidance Agreements.
- ii. **Eliminate Deemed Income:** It is important to recognize the basic principle that investments made in portfolio companies are capital contributions and not the income of the portfolio company. Similarly, the income of an AIF arises only when it receives dividend or interest income during the holding period, or realises capital gains at the time of exit. In order to be consistent with these principles, AIFs and portfolio companies should be exempted from section 56(2)(viiia) and 56(2)(viiib), respectively, of the Income-tax Act, 1961 (the Act).

- iii. **Clarify Indirect Transfers:** Overseas investors in India-centric fund vehicles should not be subject to the indirect transfer provisions of the IT Act when they transfer their investments in an India-centric vehicle to another investor. This provision creates a perverse incentive for investors to prefer investments in multi-country regional funds whose exposure to India is less than 50% rather than funds which invest the majority of their capital in India.

Since the objective is to attract more offshore investors in dedicated India-centric private equity and venture capital fund vehicles which invest all their investible capital in India, it is recommended that CBDT should clarify that investors in the holding companies or entities above Eligible Investment Funds (EIFs) investing in India, are not subject to the indirect transfer provisions.

- iv. **Make Safe-harbour Effective for Managing Funds from India:** Currently most fund managers of offshore funds manage their investments from offshore locations rather than from India. This is a disadvantage to both them and India. The fund managers lose the benefit of being close to the Indian private equity and venture capital deal flow i.e. the pipeline of investible ventures. India loses the employment and tax revenue benefits of a large India-based fund management industry and larger related volumes of long-term and stable private equity and venture capital inflows.

In order to attract significant amounts of foreign capital by having fund managers based in India, it is important that their operations in India are not treated as permanent establishments under DTAA's. In order to provide them a safe-harbour, the Government has enacted section 9A of the Income Tax Act.

The feedback is that the provisions of s.9A are not sufficiently effective in providing a fool-proof safe harbour to onshore India-based managers of offshore private equity and venture capital funds. This report recommends changes in conditions in s.9A relating to: investor diversification, control or management of portfolio companies, tax residence, arm's length remuneration of fund managers and annual reporting requirements.

- v. **Make Foreign Direct Investment in AIFs Work Efficiently:** The Government's policy to permit foreign direct investment in SEBI-registered AIFs is a welcome measure. To make this policy work

effectively it is recommended that the Government clarify the rules for investment by non-resident Indian investors in AIFs on a non-repatriation basis; eliminate ambiguity to enable non-resident Indians (NRIs) to invest in AIFs using funds in their rupee NRO accounts; provide for Tax Deduction at Source on distribution of income to non-resident investors in AIFs in accordance with DTAA tax rates in force; grant permission to LLPs to act as sponsors and/or managers of AIFs; and the relaxation of Indian tax compliance obligations for non-resident investors in AIFs.

- vi. **Securities Transaction Tax (STT)**: This report recommends the introduction of STT for private equity and venture capital investments, including SEBI-registered AIFs and has parity with the taxation of investments in listed securities. Given the high risk and relatively illiquid and stable nature of private equity and venture capital, it needs to at least be treated at par with volatile, short-term public market investments for taxation.

We recommend the government adopt a roadmap for AIF taxation based on the STT framework. In the interim, the CBDT should immediately clarify that exempt income flowing through AIFs does not suffer any withholding tax and make the necessary amendments to make pass-through work effectively.

It is recommended that the Government Introduce STT at an appropriate rate on all distributions (gross) of AIFs, investment, short-term gains and other income and eliminate any withholding of tax. After STT, income from AIFs should be tax free to investors.

- 2.2.3. While all recommendations need to be implemented, the two critical reforms that would greatly advance and simplify the tax framework are: a) tweaking 'Safe Harbour' norms; and b) implementing the Securities Transaction Tax (STT) approach to taxation of investments and distributions by Indian AIFs. *Next Practices: India should at least be the global best practice and advance further by introducing "NEXT PRACTICES". Recommendations in this category are:*

- i. Deduction for investments in angel funds/ social venture funds;
- ii. Allow management expenses for venture capital and private equity investments to be capitalized as 'cost of improvement';

- iii. Taxation upon 'sale' and reduced taxation rates for unlisted shares acquired via ESOPs/employee incentive schemes;
 - iv. Clarify tax rate of 10% on long term capital gains to be applicable on transfer of shares of private limited companies ;
 - v. Taxation of convertible preference shares/ debentures based on the holding period reckoned from the date of investment rather than the date of conversion;
 - vi. AIFs to be permissible investments of charitable and religious trusts ;
 - vii. Taxation on conversion/ transfer of Global Depository Receipts issued against permitted securities (other than listed shares) ; and
 - viii. Service tax in respect of capital raised by an AIF from overseas investors. A clarification should be provided that investors in funds are the service recipients of the services provided by a fund manager/ service provider.
- The proposed amendments to the Income Tax Act have been included in this report wherever possible.

II. Unlocking Domestic Capital Pools

- 2.3.1. India has an urgent need to unlock domestic capital pools for investment as private equity and venture capital. This is due to factors such as:
- i. **Large Capital Needs:**-Given that India is large economy, it needs to invest sizeable volumes of long-term capital every year to help create jobs across the nation, build new infrastructure, and become innovative in addressing challenges while being globally competitive.
 - ii. **Risk Aversion of Traditional Forms of Finance:**-In a rapidly growing economy that is encouraging entrepreneurship, and where start-ups, and medium and large enterprises have a rising need for risk capital across various stages – start up, growth, listing and recovery - traditional funding sources have a limited ability and are constrained by risk aversion.
 - iii. **Public Capital Markets have limited funds and are volatile:**-A dynamic entrepreneurial eco-system requires strong and stable capital flows and substantial equity infusion. The public capital markets can only cater to a small part of this need and are subject to market volatility.
- 2.3.2. Fund Managers need access to capital both from domestic and foreign pools. Several important capital pools– pensions, insurance, DFIs and banks, as well as pools of charitable institutions – need appropriate risk-adjusted returns. AIFs provide their corpuses with significant returns when prudently managed in a favourable economic environment.

- 2.3.3. There is, therefore, a critical need to unlock other domestic pools of capital as identified in this report because such pools currently constitute only approximately 10 % of the total private equity and venture capital invested in India annually.
- 2.3.4. This chapter recommends wide-ranging reforms to help unlock diverse domestic sources, such as domestic pension funds, insurance companies, charitable endowments, banks, the concept of accredited investors and others which have the capacity to provide significant amounts of long-term risk capital.

III. Promoting Onshore Fund Management

- 2.4.1. An ideal tax and regulatory framework for AIFs should aim for India-focused funds pooled or domiciled in India and fund managers, who manage these funds to operate locally. This model of localizing funds and their management is followed by developed economies resulting in a thriving AIF industry.
- 2.4.2. Proactive measures need to be taken to attract fund managers to India due to the beneficial impact on the Indian economy and the creation of a robust eco-system to boost entrepreneurship, job creation and GDP growth.
- 2.4.3. This scenario is only possible if there is a level playing field between fund managers domiciled in India and those located offshore, which is clearly not the case in India currently. The policy framework needs to change, and the operational freedom of domestic AIFs needs to be enhanced.
- 2.4.4. The Committee has evolved a set of recommendations that would enable and encourage onshore fund management, and has taken cognizance of all stakeholders. The two vital reforms that would greatly help the cause are a) tweaking 'Safe Harbour' norms and b) implementing a Securities Transactions Tax (STT) approach to taxation on investments and distributions by Indian AIFs which has worked effectively for several years in the case of Foreign Portfolio Investors. In the interim it is recommended that the authorities should clarify, on an immediate basis, that exempt income flowing through AIFs should not suffer any withholding tax.
- 2.4.5. The modification of safe-harbour rules proposed in this report is a result of feedback that India has not reaped the benefits of the current safe-harbour rules. Accordingly, the industry has not gone down this route primarily on account of the existing tax law not being conducive.
- 2.4.6. These suggestions are transformative and would be hugely beneficial and should be implemented on a priority basis.

- 2.4.7. The chapter titled 'Promoting Onshore Fund Management' provides numerical examples of the tax impact of the withholding tax approach and the STT approach to illustrate the benefits of the latter. It shows that the withholding tax regime creates undue hardships and is inconsistent with the need for ease of business. On the other hand, the suggested STT regime will simplify taxation of AIFs.
- 2.4.8. Greater operational freedom for India-domiciled AIFs will attract more offshore capital into them. Such freedom requires a disclosure-based approach to regulation. In addition, there needs to be greater flexibility in the regulations such as for investing in offshore companies.
- 2.4.9. The chapter also shows that venture capital and private equity portfolio companies are major sustainable tax generators, not the venture capital and private equity funds in themselves.

IV. Reforming the AIF Regulatory Regime

- 2.5.1. In order to sustain the continued growth of the AIF industry, the path ahead requires reforms in the enabling regulatory framework for AIFs. While most regulatory efforts have rightly focused on protecting minority shareholder interests and improving compliance, there has been limited direct regulatory effort focused on the private equity and venture capital industry itself.

There have been considerable developments recently, for example the pass-through approach introduced in the Union Budget 2015 and the Reserve Bank of India's AIF investment policy liberalising investments in AIFs. Sustained reforms in a few areas could further grow the industry. These include a current and rationalised approach, an awareness of merging boundaries of different pools, a consistent and simple framework harmonized across regulators, and a sharply defined clarity on investment boundaries.

The Committee's recommendations cover:

- i. Regulation of fund manager and not the fund
 - ii. Minor amendments to existing AIF regulations to include 'growth' in the definition of venture capital funds under Category I AIFs
 - iii. Classification of Category III AIFs
- 2.5.2. The report clearly indicates the road ahead through specific recommendations supported by underlying principles, best practices, and the much larger vision of economic growth which shapes and sustains the quality of human lives.

The Way Forward

Alternative Investment Funds bring significant benefits to the economy. If the regulatory issues are streamlined, AIFs can attract large capital flows to potentially reach a size of as much 2% of the GDP. The Committee believes that, as the way forward, it is vital for this report to be widely disseminated to key regulatory agencies for consideration and implementation, garnering support for the framework laid down by the Standing Committee.

III

Creating a Favourable Tax Environment

- 3.1.1. In the context of the contribution of Alternative Investment Funds in India's economic growth story, and given the current positive economic sentiment, the country's AIF industry has a real opportunity to make a greater impact on the Indian economy. For this to happen, the route ahead requires an enabling tax regulatory framework to ensure the continued growth of the industry.
- 3.1.2. Alternative Investment Funds (AIFs) as an asset class will need recognition as a distinct investment class, much the same way as investments from Foreign Portfolio Investors and Foreign Direct Investment are recognized as carrying unique attributes. While the last few months (including the Union Budget 2015) have seen developments on many policy fronts, there are a few areas where tax regulations could further help forge a resurgent path ahead for the industry.

3.2 Tax Recommendations

The Committee's tax recommendations are based on fundamental best practice principles described in the introduction to this report. The recommendations focus on four key areas:

- A. Make the tax pass-through system work flawlessly in a simple manner for complete “clarity”, “certainty” and “consistency”; provide exemption to AIFs from section 56(2)(viiia) and 56(2)(viiib) of the Income-tax Act, 1961 (the Act); and clarify indirect transfer provisions for funds/ investors;
- B. Attract significant amounts of stable, long-term foreign capital:
 - into India-focused foreign funds by providing a safe harbour to onshore managers of offshore funds
 - by making Foreign Direct Investment in AIFs work efficiently.
- C. Given the high risk and relatively illiquid nature of capital from the venture capital and private equity sector, it needs to at least be treated at par with volatile, short-term public market investments for taxation. We recommend the Government adopt a roadmap for AIF taxation based on the STT framework.
- D. India should at least be the global best practice and be followed by the world for “NEXT PRACTICES”.

The recommendations in each list are broadly in order of their priority. These recommendations, if implemented in their entirety, would go a long way in making India more attractive for alternative investments and for the growth of a robust Alternative Investment Fund industry. Wherever possible, our suggested amendments of the Income Tax Act, corresponding to our recommendations, have been provided in the last section of this Chapter

A. Make the tax pass-through system work flawlessly in a simple manner for complete “clarity”, “certainty” and “consistency”, provide exemption to AIFs from section 56(2)(viiia) and 56(2)(viiib) of the Act and clarify indirect transfer provisions for funds/ investors.

Summary of recommendations:

- I Make the concept of tax pass-through for AIFs effective
 - a) The exempt income of AIFs should not suffer tax withholding of 10%.
 - b) Investment gains of AIFs should be deemed to be ‘capital gains’ in nature.
 - c) The tax rules applicable to ‘investment funds’ in Chapter XII-B of the Act should be extended to all categories of AIFs.
 - d) Losses incurred by AIFs should be available for set-off to its investors.
- II Investments by AIFs should be exempt from provisions of Section 56(2)(viiia) and 56(2)(viiib) of the Act.
- III Indirect transfer provisions should be clarified to be not applicable to gains from transfer of shares or interest of the holding companies/entities above eligible investment funds (EIFs) investing in India.

A.I a) Elimination of the Requirement for Tax Deduction on Exempt Income

1.1 The Act has a provision (Section 194LBB of the Act) relating to deduction of tax at source on the income arising for the investor from an investment fund, which requires the investment fund to deduct tax at source (TDS), at the time when it pays income to the investor, or credits the same to the account of the investor.

1.2 The technical interpretation of the Act leads to, *inter alia*, the following, which misaligns the investor’s tax liability and the tax withholding by the investment fund:

- Tax withholding on exempt income streams – such as dividend income [Section 10(34)] and specified long-term capital gains [Section 10(38)] payable by the AIF to its investors.
- Tax withholding on entities which are exempt from tax – income of certain prescribed entities are exempt under Section 10 the Act, e.g., corporations established for the welfare and economic upliftment of ex-servicemen. In future, provident funds, gratuity funds, superannuation funds, etc., could become investors in AIFs. All these funds are exempt from tax on their investment income / gains.
- Applicability of withholding tax on credit / distribution of income paid / payable to non-resident investors eligible for beneficial provisions of a double tax avoidance agreement (DTAA).

1.3 Tax withholding in the above scenarios would lead to deferment of realization of income / gains for the investors, as they will need to claim the tax withheld in their respective income-tax returns as refunds (where they do not have sufficient tax liability to otherwise absorb the excess tax withheld by the AIF). As such, collection of withholding tax in such cases would not increase the revenues of the Government and result in the Government incurring interest costs for the period the tax is not refunded to the taxpayers.

1.4 The provisions of Section 197 of the Act provide an opportunity to the assessee to apply for a certificate allowing deduction of income-tax at lower rates, or no deduction of income-tax. However, such a certificate can be applied only in case of withholding requirements prescribed under certain sections of Chapter XVII of the Act. The list of such sections mentioned as part of Section 197(1) does not include section 194LBB. The absence of Section 194LBB as part of Section 197(1) will lead to unintentional hardships to investors who could otherwise have obtained nil or lower withholding tax certification under Section 197 of the Act.

Recommendations

A] Resident investors in AIF

1. The requirement to deduct tax at source should not apply vis-à-vis accrual/ distribution of income to investors exempt from tax under the Act irrespective of its nature and source.
2. The requirement to deduct tax at source should not apply to income exempt from tax under the Act. For example, if the income earned by the AIF is dividend on which the company paying the dividend has paid dividend distribution tax, which is exempt from tax under the Act, the accrual/ distribution of such dividend should not be subject to tax deduction at source.
3. The requirement to deduct tax at source should be in accordance with the provisions of Chapter XVII-B (Deduction at source) of the Act for the type of income credited/ distributed to the investors.

B] Non-resident investors in AIF

1. Tax deduction at source on accrual/ distribution of income to non-resident investors eligible for beneficial taxation provisions under an applicable DTAA will be on the basis of the DTAA or domestic tax law provision, whichever is more beneficial to the investor.
2. Resident and non-resident investors in AIFs should have the ability to obtain a NIL/ reduced tax withholding certificate under section 197, subject to conditions in the said section.
3. From a reporting perspective, the withholding tax return to be filed by the AIF could capture the details of the income distributed to ensure that the relevant data is captured.

A.I b) Characterization of Gains of an AIF

- 1.1 Traditionally, the issue of characterization of exit gains (whether taxable as business income or capital gains) has been a subject matter of litigation with the tax authorities. There have been judicial pronouncements on whether gains from transactions in securities should be taxed as “business profits” or as “capital gains”. However, these pronouncements, while laying down certain guiding principles, have largely been driven by the facts and circumstances of each case.

- 1.2 The intention of the SEBI (AIF) Regulations, 2012 is to promote investments. As per the extant regulatory framework, a SEBI registered AIF is a privately pooled investment vehicle which collects funds from investors for investing in accordance with the defined investment policy for the benefit of its investors.
- 1.3 Category I and II AIFs predominantly invest in unlisted investee entities with a medium to long-term investment horizon (typical holding periods would range from 2-5 years). The investments by AIFs are made out of funds collected from their investors; their ability to borrow is severely restricted under the SEBI (AIF) Regulations.
- 1.4 The current tax code for AIFs could lead to unintended litigation on characterization of income at AIF level. Given the intent of SEBI (AIF) Regulations is not to allow carrying on of business, there is no need to provide for taxation of business income at the AIF level.
- 1.5 It is pertinent to note that, given the activity of an AIF, it can earn only capital gains income, interest income and dividend income. Historically, funds have been making investments in investee companies as an investment activity and not business activity. The primary objective of an AIF is to make investments and provide much needed capital to entrepreneurs. Therefore, income earned by an AIF from its investment activity cannot be characterized as business income.
- 1.6 The regulatory framework of FDIs / FPIs and AIFs is similar, which allows such entities to make investment in securities. Therefore, any income earned by an AIF should be characterized as capital gains.
- 1.7 Further, since the issue on characterization of gains from an investment activity as “capital gains” or “business profits” is also relevant for offshore private equity funds, it should be provided that investments made by an eligible investment fund (as defined in the Section 9A(3)) shall be deemed to be a “capital asset” under the Act.

Recommendations

The provisions relating to taxability of business income earned by AIF at the AIF level should be deleted.

It should be deemed that income earned by the AIF should be taxable under the head “capital gains” or “income from other sources” and not “business income”.

- 1.8 It is our understanding that one of the concerns expressed by the tax administration, in connection with providing a deemed characterization of gains derived by Category II AIFs, is that the SEBI (AIF) Regulations are far less prescriptive on investment conditions applicable to Category II AIFs, i.e. the regulations only stipulate that a Category II AIF shall invest primarily in unlisted investee companies or in units of other AIFs, as may be specified in the placement memorandum.
- 1.9 As an adjunct to the above recommendation, we would recommend consideration of the following:

Recommendations

- Amend the definition of “venture capital fund” in Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012 in the Definitions section, Clause 2(z) -

“venture capital fund” means an Alternative Investment Fund which invests primarily in unlisted securities of start-ups, emerging or early-stage or growth venture capital undertakings mainly involved in new products, new services, technology or intellectual property right based activities or a new business model

- Amend the definition of “Category I Alternative Investment Fund” in Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012, Clause 3(4)(a) -

A.I c) Extension of Tax Pass-through to all categories of AIFs

- 1.1 The Finance Act 2015 (FA 2015) introduced a special tax regime for Category I and II AIFs by the insertion of a new chapter, i.e. Chapter XII-

B in the Act. The amendments to the Act conceptually attempt to provide a “pass-through” tax status to Category I and II AIFs for the income earned (except for business income).

- 1.2 However, the “pass-through” tax status has not been accorded to Category III AIFs.
- 1.3 AIFs are vehicles set-up to pool investments from various investors and to invest across different asset classes using different investment strategies. The income that is sought to be taxed is the income of the investors. The taxation of an income, or the taxpayer itself, should not change, merely because an investor decides to use a professional asset manager to make investment decisions for him vis-à-vis directly making those investment decisions himself. Further, the manner of taxation should also not change, where an investor invests in an AIF, instead of investing in his own name, using a SEBI registered portfolio manager.
- 1.4 In any case, it is clear that irrespective of the investment strategy, the policy of the Government is to have one-level tax in terms of the income arising from / to the AIF – i.e., either the AIF will be taxed or the investor, but not both (on the basis that usually the AIF is a trust).
- 1.5 The class of investors that make investments in AIFs are generally high net worth and taxpaying investors, so a question of tracking those investors should not generally arise.
- 1.6 Category III AIFs introduced a product that was hitherto not available in the Indian financial sector. A clear tax code for taxation of such AIFs based on the pass-through tax principle will be critical for the success of this product in the medium to long-term.

Recommendations

The tax rules applicable to “investment funds” in Chapter XII-B of the Act should be extended to all categories of AIFs with suitable modifications to eliminate the distinction between the tax treatment of business income and income under other heads in the hands of the AIF / its investors. As such, given that, under the pass-through tax principle, the taxation of income derived by the AIF would, in the hands of the investor, assume the same character had the investor made the underlying investments directly, there should be no revenue loss to the Government on account of this recommendation.

A.I d) Pass-through Tax Status Extended to Net Losses at AIF level to the Investor

- 1.1 Conceptually, pooling vehicles are formed for the following two benefits:
 - a. To engage experienced professionals to invest savings;
 - b. To achieve economies of scale.

Thus, investors who invest could have chosen to invest in target companies of their own accord.

- 1.2 Tax implication thus plays an important role for the investor to choose one form over the other. The above-mentioned benefits will be of no relevance if the tax impact on investing through AIF is higher.
- 1.3 Under the AIF Regulations, Category I and II AIFs are closed-ended funds and the tenure of a specific fund / scheme is determined at the time of its launch. Typically, an AIF’s tenure would not exceed 10 years from its launch. Based on the provisions, where Category I and II AIFs incurs net losses on investments towards the end of its lifecycle, or has unabsorbed losses, which cannot be utilised by the AIF, such losses would lapse. The investors would in this scenario be taxed on an amount that would be greater than the “real” taxable income derived by them from their investment in the AIF, causing the AIF alternative becoming unattractive to an investor vis-a-vis direct investments.
- 1.4 Further, it could be provided that in case of transfer (excluding transactions which are not regarded as transfer under section 47 of the Act) of units by the investors in the AIF, the net loss proportionate to the units transferred shall not be passed on to the investors.

Recommendations

As such, a pass through tax regime should not distinguish between gains and losses. Therefore, similar to the pass through for net income, net losses incurred by all the categories of AIFs, under any head of income, should also be allowed to be passed on to the investors.

A.II Exemption for AIFs from (a) Section 56(1)(viib) on issue of shares at a value higher than fair market value and (b) Section 56(2)(viiia) on purchase of shares at a value lower than fair market value (FMV)

- 2.1 Section 56(2)(viiia) of the Act provides that where shares are purchased at a value lower than FMV of a company, not being a company in which public are substantially interested, then the difference is taxed in the hands of the purchaser.
- 2.2 Section 56(2)(viib) of the Act provides that where a company, not being a company in which public are substantially interested, issues shares at a consideration which exceeds the FMV of such company, then the difference is taxed as income in the hands of the issuing company.
- 2.3 Currently, these provisions 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.
- 2.4 Presently, Section 56(2)(viib) of the Act provides specific exemption for companies where the consideration for issue of shares is received from inter alia Venture Capital Funds (VCFs) and AIF. Further, while such an exclusion has been provided to VCFs in respect of Section 56(2)(viib), these benefits have not been extended to Section 56(2)(viiia).
- 2.5 Further, AIFs, being institutional investors, hold a fiduciary responsibility to invest in transactions on an arm's length basis, and given that they are subject to SEBI oversight and have investor reporting obligations, it would be reasonable to assume that the price for acquisition / subscription is determined on a sound basis, considering all factors associated with the investee companies' and sector's past performance and future potential.

Recommendation

All AIFs and their investee companies should be exempted from the rigor of Sections 56(2)(viia) and 56(2)(viib) of the Act.

A.III Clarify indirect transfer provisions for funds/ investors

- 3.1 Gains from an offshore vehicle wherein the Indian assets represent at least 50% of the value of all the assets is subject to tax in India. India-centric offshore funds by design have more than 50% Indian assets and therefore are subject to ambiguity on taxation.
- 3.2 In a multi-layered structure, the gains can be subject to indirect transfer tax at multiple levels.
- 3.3 Globally, there is a practice of providing liquidity to limited partnerships (LPs) by facilitating secondary transfers (for example – an LP buying the stake of another LP in a fund which has more than 50% Indian assets). In such case, the gains on sale of stake by an LP can be subject to indirect transfer tax.

Recommendation

Indirect transfer provisions should be clarified to be not applicable to gains from transfer of share or interest of the holding companies/entities above EIFs investing in India

- B. Attract significant inflows of foreign capital:
 - I. Into India-focused foreign funds by providing a safe harbour to onshore managers of those funds; and
 - II. by making FDI in AIF work efficiently.

Summary of Recommendations

- I. Attract large amount of foreign capital into India-focused foreign funds by providing a safe harbour to onshore managers of offshore funds:-
 - a) The requirement of the fund to be a “tax resident” of a foreign country should be changed to a requirement of the fund being “established” or “set-up” or “incorporated” or “registered” in such country.
 - b) Due to various commercial reasons (discussed in detail in subsequent paragraphs), investor diversification related conditions should be deleted. Alternatively, exclusions could be provided for applying the investor diversification related conditions.
 - c) The determination of fund management fees to be at arm’s length will involve a lot of subjectivity. Therefore, the condition of fund management fees to be at arm’s length should be deleted.
 - d) Investment diversification conditions restrict the ability of the funds to make significant minority investments (say more than 20%) or make controlled acquisitions. Furthermore, it restricts the ability of the funds to set- up offshore subsidiaries to invest in India – these subsidiaries may be required to ring fence the investment risk of a specific investment or to get a co-investor for a specific investment
 - e) It should be clarified that offshore funds shall not be regarded as carrying on business in India merely because of the activities they perform to protect their shareholding in investee entities.
 - f) Safe harbour under Section 9A of the Act should not be denied only on account of non-furnishing of the prescribed statement within 90 days, even when the fund qualifies as an eligible investment fund and the fund manager qualifies as an eligible fund manager.
- II. Attract large amount of foreign capital by making Foreign Direct Investment (FDI) in AIF work efficiently
 - a) Promoting FDI in AIFs:
 - i. Investment by non-resident investors in AIFs on a non-repatriation basis; and
 - ii. TDS on distribution of income to non-resident investors in AIFs to be in accordance with DTAA tax rates

- iii. Permit LLPs, including Indian owned and managed LLPs, to act as sponsors/ managers to AIFs
 - iv. Relax Indian tax compliance obligations for non-resident investors in AIFs
- b) Resolve ambiguity around investment by non-resident investors into AIFs

B.I Attract large amounts of foreign capital into India-focused foreign funds by providing a safe harbour to onshore managers of offshore funds

1.1 The FA 2015 seeks to encourage fund managers managing “eligible investment funds” to be based in India without such activity being regarded as a business connection / place of effective management of the eligible investment fund in India.

1.2 The definition of an “eligible investment fund” is onerous which requires compliance of several conditions, such as:

- a) Tax residency of the fund
- b) Investor diversification
- c) Remuneration to investment managers
- d) Investment diversification
- e) Carrying on any business in India, or from India
- f) Reporting requirements

a) Tax Residency of the fund

We understand that the backdrop of this condition is to enable the tax authorities to gain access to information, through the tax treaty and information exchange agreements, about investors investing in India through these funds, should a need arise. This is therefore critical from a legislative perspective.

While the requirement is appreciated, the condition of the investment fund being a tax resident need not be a pre-requisite for the following reasons:

- i. There are many instances where a fund may not qualify as a tax resident of a country on account of domestic tax laws or legal framework; the global structure of funds has been based on applicable legal and

regulatory frameworks. Such funds do not avail tax treaty benefits in terms of capital gains, and pay full tax on capital gains earned by them in India.

To give some examples - large pension funds or mutual funds from USA or SICAVs (open ended collective investment schemes) from Luxembourg are generally not regarded as residents of the respective countries because of the respective domestic tax law.

- ii. The removal of the trigger of “residence” should not impact India’s ability to collect required information under the applicable tax treaty / information exchange agreements. In this context, it is important to note that typically the Article relating to jurisdiction in any information exchange agreement entered into by India provides that *“information shall be exchanged in accordance with this Agreement without regard to whether the person to whom the information relates is, or whether the information is held by, a resident of a Contracting Party”*.

Similarly, the relevant Article on Exchange of information in India’s tax treaties typically provides that *“the exchange of information is not restricted by Article 1”*; Article 1 provides that the tax treaty shall apply to persons who are residents of one or both of the Contracting States.

Recommendation

The requirement of the fund to be a “tax resident” of a foreign country shall be changed to a requirement of fund being “established” or “set-up” or “incorporated” or “registered” in such country.

For reasons discussed above, we believe that our recommendation addresses the concern of the fund management industry without compromising on the administration’s requirement to access the information by India tax and government authorities

b) Investor diversification

Firstly, we believe the management of funds in India should not lead to a differential tax treatment for investors merely because some of those funds managed are diversified, and some are not.

Further, there are many instances where the fund managers wish to manage a small set of investors who could provide them with relatively large pools of capital to manage. The following are illustrative situations of providing good cases for management of offshore funds in India, but where the diversification of investor base may not be relevant:

- Management of a large global family office.
- Management of a part of the funds allocated by a large investor (e.g. sovereign wealth fund or a pension fund) to be managed by a domestic fund manager.
- Global propriety funds of development and other financial institutions (like banks and insurance companies) being managed by domestic asset managers in India.
- New fund managers looking at raising commitments may be able to achieve diversification only after they have established a reasonable track record.
- All new funds could have anchor investors who would clearly hold more than 5% of the total holding. These anchor investors are critical for the success of the fund managers.
 - The diversification may be achieved over multiple fund closings but the asset management has to start immediately from first closing of the fund.

There are many domestic asset managers who wish to manage global pools of capital but who may not be able to meet diversification related conditions given the regulatory restrictions in marketing and distribution of the financial products in various jurisdictions.

Recommendations

Given the constraints discussed above, it is appropriate to delete the diversification related conditions.

Alternatively, exclusions/ changes could be provided for applying the diversification related conditions. An illustrative list of exclusions/ changes is provided below:

- The diversification conditions should be applied only after the fund makes a final closing, or alternatively these should not be applied for the initial three years of setting-up.
- One should consider direct and indirect investors – there could be more investments from investors like fund of funds or institutional investors having several beneficiaries/ members.
- Diversification rules should not be applicable where a majority of the investors comprise of institutional investors like sovereign wealth funds, large pension funds, banks, etc.
- There should be exclusion for anchor investors – these could mean initial two or three investors in the fund.
- The SEBI, after a lot of industry deliberation, has prescribed categories and types of funds that can invest in India and conditions attached to the same. The existing regulatory framework to allow foreign investments either under the FPI Regulations or FVCI Regulations is comprehensive, and there are detailed monitoring mechanisms to track the quality of investors and the sectors in which the investment flows. Hence the funds that are eligible to be registered as foreign portfolio investors or foreign venture capital investors should be excluded from the applicability of diversification rules.
- Lastly, the diversification rules used by SEBI for FPIs are robust and well understood by the industry in terms of implementation. Our recommendation is to merely align the requirements of diversification under the Act and the FPI Regulations.

c) Remuneration to investment managers

Ordinarily where the eligible investment fund and the eligible fund manager are unrelated or unconnected, there is no reason to believe that the fund management fees will not be at arm's length.

In cases where they are related or connected persons (or to put it differently, associated enterprises), the payment of fund management fees to the eligible

fund manager has to be computed in accordance with the arm's length principle under the provisions relating to transfer pricing in the Act.

A determination of fees being in accordance with an arm's length principle could involve lots of factors including demand and supply, experience and track record of the eligible fund manager, investment strategy, and size of the funds that are being allocated to respective eligible fund managers.

In other words such a determination of fees to be at arm's length will involve a lot of subjectivity, and it is possible that the tax payers and tax authorities have a different point of view on what constitutes an arm's length price. Any challenge by the tax authority could result in an uncertainty on the tax liability of eligible investment funds, on account of the risk of them being regarded as resident in India or carrying on operations in India.

Recommendation

Therefore the condition of fund management fees to be at arm's length may serve no purpose, and should be deleted.

d) Investment diversification

This provision restricts the ability of the funds to make significant minority investments (say more than 20%) or make controlled acquisitions.

Furthermore, it restricts the ability of the funds to set-up offshore subsidiaries to invest in India – these subsidiaries may be required to ring fence the investment risk of a specific investment or to get a co-investor for a specific investment.

Recommendation

In backdrop of the aforesaid commercial requirements, this condition should be deleted.

e) Carrying on any business in India or from India

At times, offshore Private Equity funds (especially buyout funds) acquire a controlling stake in the investee companies. Further, in other cases also, where the fund has acquired a minority stake, the fund may have minority interest

protection rights, which could be viewed as resulting in “control” over the business of the investee company in India.

Recommendation

It should be clarified that offshore funds shall not be regarded as carrying on business in India merely because of the activities they perform to protect their shareholding in investee entities.

f) Reporting requirements

Sub-section (5) of Section 9A of the Act, provides that every eligible investment fund is required to furnish a statement containing information relating to the fulfilment of the prescribed conditions and other relevant information, within 90 days from the end of the financial year.

Further, Section 271FAB of the Act provides that failure to furnish the aforesaid statement within the time prescribed under Section 9A of the Act could result in a penalty of Rs. 500,000.

Recommendation

It is important to clarify that non-compliance with the provisions of this sub-section (i.e. if the statement is not furnished within 90 days) should not result in denial of Safe Harbour under Section 9A of the Act, even when the fund qualifies as an eligible investment fund, and the fund manager qualifies as an eligible fund manager.

B.II Attract large amount of foreign capital by making Foreign Direct Investments (FDI) in AIF work efficiently

The RBI notification permitting foreign investment in AIFs reflects the ‘Make in India’ initiative for the fund management industry. Substantial benefits have been offered for an AIF that is sponsored / managed by Indian resident citizen or entities under their control. Few minor tweaks could attract substantial capital through this route

a) Promoting FDIs in AIFs

- i. Investment by non-resident investors in AIFs on a non-repatriation basis

- ii. TDS on distribution of income to non-resident investors in AIFs to be in accordance with DTAA tax rates
 - iii. Permit Indian owned and managed LLPs to act as sponsors/ managers to AIFs
 - iv. Relax Indian tax compliance obligations for non-resident investors in AIFs
- b) Resolve ambiguity around investment by non-resident investors into AIFs under NRO route

a) Promoting FDIs in AIFs

- The RBI notification permitting foreign investment in AIFs reflects the 'Make in India' initiative for the fund management industry
- Substantial benefits have been offered for an AIF that is sponsored / managed by Indian resident citizens or entities under their control
- Few minor tweaks could attract substantial capital through this route

Recommendation

- Permit investment by non-resident Indians in AIFs on a non-repatriation basis through appropriate amendments in the Foreign Exchange Management Act, 1999
- TDS on accrual/ distribution of income to non-resident investors in AIFs to be in accordance with DTAA tax rates (refer point AI a) above for proposed amendment)
- Permit Limited Liability Partnerships (LLPs), including those which are Indian-owned and controlled, to act as sponsors/ managers to AIFs
 - Manner of determining ownership / control of LLPs has now been defined
- Relax Indian tax compliance obligations for non-resident investors in AIFs where tax has been fully discharged through TDS

b) Resolve ambiguity around investment by non-resident investors into AIFs

Remove ambiguity around investment by NRIs into AIFs under NRO route by changes to the Foreign Exchange Management (Transfer or Issue of Security by a Person Resident outside India) Regulations 2000 ("TISPRO")

Recommendations

- Amend the language of Regulation 2 of the Schedule 11 to clarify to include payments made through NRO account in addition to NRE and FCNR to be eligible for investments under this Schedule.
- An amendment may also be carried out in Regulation 2(2) of Schedule 5 of the TISPRO to include 'units of Investment Vehicles' in addition to other securities such as government securities, units of domestic mutual funds, etc.
- Include a separate proviso in both Schedule 5 and Schedule 11 to state that any investment by NRI in the units of Investment Vehicle under the non-repatriation route shall be treated as domestic investment for the purpose of foreign ownership

C. Given the high risk and relatively illiquid nature of capital from the venture capital and private equity sector, it needs to at least be treated at par with public market investments for taxation. We recommend the government adopt roadmap for AIF taxation based on a Securities Transaction Tax (STT) framework.

Summary of committee's recommendations

- I. Introduce STT at an appropriate rate on all distributions (gross) of AIFs, investment, short-term gains and other income and eliminate any withholding of tax. After STT, income from AIFs should be tax free to investors

C.I Long term roadmap for STT based approach for AIFs

- 1.1 Currently no taxes are being paid by foreign investors on account of their investment through DTAA jurisdiction. Even when taxes are being paid, there is a limited amount being collected due to indexation, loss-setoffs and other exemptions being claimed.
- 1.2 The current tax regime is also not very well understood by foreign investors and has led to numerous litigations with tax authorities. To facilitate the pooling of foreign funds in India, foreign investors should be provided simple straight-forward tax laws that they are comfortable with.

- 1.3 STT was introduced in 2004 to:
- replace the long term capital gains tax on securities traded on the floor of the stock exchange
 - shore up revenue from stock transactions and to create a level playing field for all participants in the stock market
 - simplify the tax treatment on transaction in securities leading to a significant reduction in litigation
- 1.4 As a long-term approach to align taxation of AIFs and other forms of collective investment vehicles, an STT approach may be considered. This approach would
- Eliminate tax arbitrage and hence, attract more capital in AIFs
 - Simplify tax administration of AIFs and reduce revenue compliance gaps
 - Ease of operations – pave the way for VCPE funds to domicile in India
 - Discourage ‘treaty shopping’ – development of local financial hubs
- 1.5 If STT is implemented and Withholding Taxes are removed, tax authorities can directly collect a significant amount of taxes on the investments/distributions made by AIFs.
- 1.6 STT approach will reduce tax disputes and enable smooth collection of taxes.
- 1.7 Post STT, distributions are tax free to investors in funds i.e. LPs.
- 1.8 India can significantly move up in World Bank Group rating on “Ease of Paying Taxes” (current ranking is 156 out of 189 economies).

Recommendations

- Introduce STT at an appropriate rate on all distributions (gross) of AIFs, investment, short-term gains and other income and eliminate any withholding of tax. After STT, income from AIFs should be tax free to investors
- Venture capital and private equity funds have a complete audit trail. The audit trail and full information on investments/distributions to be provided to tax authorities

D. India should at least be the global best practice and be followed by the world for “NEXT PRACTICES”

Summary of Recommendations

- I. Investors in SEBI regulated angel/ venture capital funds should be provided an incentive in the form of a tax deduction of up to 50% of the investment amount.
- II. Allow management expenses for venture capital and private equity investments to be capitalized as ‘cost of improvement’
- III. Taxation upon ‘sale’ and reduced taxation rates for unlisted shares acquired via ESOPs/employee incentive schemes
- IV. Clarify tax rate of 10% on long term capital gains (LTCG) to be applicable on transfers of shares of private limited companies. There is a need to align the treatment of capital gains for listed and unlisted companies, both on holding period and tax breaks. AIF and Angel Investments are typically long term and typically create new enterprises and jobs. Yet they operate under less favourable terms than Mutual Funds. AIFs should not pay higher taxes than paid by FPIs or Domestic Institutional Investors (DIIs) who pay STT and DDT as preferred route to STCG and LTCG.
 - a) AIF investments held for a year must qualify as LTCG to encourage investment in risk capital that creates new ventures, jobs, and encourages entrepreneurship.
 - b) Current rate of 20% tax with 3 year holding is punishing for AIFs backing an entrepreneur.
 - c) AIFs have huge reputational risks amongst others, and can be relied upon for full compliance.
 - d) 0% LTCG regime must apply to all SEBI registered AIFs.
 - e) Foreign PE Funds structure their investments to achieve this anyway, so this will level the playing field and bring domestic funds on par.

To streamline tax collections, custodians of AIFs can be mandated to collect STT rates that are paid by FPIs and DIIs.

- V.
 - a) The tax law should expressly provide an exemption for conversion of preference shares into equity shares.
 - b) In determining the holding period of equity shares in the context of investment in convertible preference shares / debentures, the tax law should provide for inclusion of the period of holding of convertible preference shares/ debentures (pre-conversion).

- VI. Permit charitable and religious trusts to invest in AIFs
- VII. Taxation of Global Depository Receipts (GDRs) issued against permitted securities (other than listed shares):
 - Introduction of a specific regime for taxation of GDRs issued under the new scheme;
 - Transfer of GDRs from one non-resident to another should not be regarded as a taxable transfer;
 - Transfer by way of conversion of GDR into the underlying security should not be regarded as a taxable transfer.
- VIII. Service tax abatement on service fees in respect of funds raised by an AIF from overseas investors

D.I Tax deduction for investors in SEBI regulated angel/ social venture funds¹

- 1.1 Many start-ups do not make profits in the initial years, but have potential to grow rapidly in a short time frame. Due to the lack of adequate track record/ assets and other factors access to funds from banks and financial institutions becomes a challenge.
- 1.2 Such budding businesses require financial backing to help them achieve their goals. Angel funds bridge the gap and not only provide finance but also mentor and nurture these businesses and empower them to achieve new heights. The concept of angel funding is still at a nascent stage in India. There are pockets of angel investors who invest in small business directly without any formal platform.
- 1.3 Recognition and promotion of early stage investors in angel funds is critical, and providing them a conducive environment will encourage them to channel more funds to the Indian entrepreneurs, and behind them FDI/ overseas monies will flow.
- 1.4 Most government around the world (UK, USA, Singapore, etc.) provide incentives such as recognition, tax credits up to 50%, tax pass-through LLP structures to enable a large group of individual angels to invest together, and the Indian government should provide the same. This will help create a large base of investors in angel funds. The importance of angel funds is evidenced by the fact that in a typical year in the US,

¹ The recommendations stated here are *in sync* with the recommendations given in the Report of The Committee on Angel Investment & Early Stage Venture Capital – June 2012

angels invest around US\$25bn in around 50,000 companies and venture capital funds invest about the same in about 5,000 companies. In India, we have under 1,000 angel investors, investing barely \$20mn

- US provides accredited investor/ angel investors to write off their losses against their gains
- UK provides the Enterprise Incentive Scheme and the Small Enterprise Incentive Scheme providing angel investors to write off losses up to 50%
- Singapore's Angel Investors Tax Deduction Scheme is a tax incentive which aims to stimulate business angel investments into Singapore-based start-ups and encourage more angel investors to add value to these.

We have provided a summary of the tax deduction schemes for angel funds/ investors available in some foreign countries as an Annexure.

- 1.5 Social venture capital is a form of investment funding that is usually funded by a group of social venture capitalists, who achieve a reasonable gain in financial return while delivering social impact to the world. There are various organizations, such as venture philanthropy companies and non-profit organizations that deploy a simple venture capital strategy model to fund non-profit events, social enterprises, or activities that deliver a high social impact or a strong social cause for their existence.
- 1.6 As part of effort of the Indian Government to support social ventures from a grassroots level to deliver positive social and environment impact, a special tax deduction/ relief should be designed to encourage more social investments from investors to support social enterprise.

Recommendation

Investors in SEBI regulated angel funds should be provided a tax deduction of up to 50% of the investment amount. Suitable safeguards to mitigate misuse of the provision by non-financial investors / relatives of the promoter / promoter group can be considered.

D.II Inclusion of the concept of ‘accredited Investors’

- 2.1 AIF regulations currently require an investor to invest at least Rs. 1 crore in an AIF. This is to ensure that only sophisticated investors invest in such AIFs considering the risk involved in such investments.
- 2.2 Globally, however, the concept of “accredited investors” is used wherein an investor who has a certain minimum income or asset or net worth is considered to be an accredited investor, and can make such investments. Such investors are usually self-certified, for instance in countries like USA. (Refer Annexure 2 for U.S. law on “accredited investors”).

Recommendation

- In line with the global practice, it is proposed that the individuals who satisfy the following conditions should be recognized as accredited investors:
 - a. Capable of identifying potential investments and their underlying risks;
 - b. Possess sufficient financial sophistication to take on the risks associated with the offerings; and
 - c. Have a sound financial track record i.e. reported total income (including exempt income) exceeding Rs. 50 lakhs annually in three assessment years immediately preceding the assessment year in which the investment is proposed to be made.
- Further, it is also proposed to link the Permanent Account Number (PAN) of the investor in the electronic database of revenue authorities with the total income (including exempt income) of the investor in a manner such that it is easier to determine whether the investor qualifies as an accredited investor.
- Further, in the chapter titled “Unlocking Domestic Pools of Capital for the Alternative Investment Industry” in this report, it is proposed that the concept of “Accredited Investors” currently prevalent in the AIF Regulations for “angel funds” should also extend (with such modifications as may be appropriate) to all AIFs.

D.III Allow management expenses for AIF investments to be capitalized as ‘cost of improvement’

- 3.1 A formal reading of the Act only allows costs related to the acquisition of securities to be treated as capitalized expenses as they relate to the actual acquisition of the title to the share. Costs in relation to the disposal of the capital asset are allowed to be deducted as ‘cost of transfer’ from the sale consideration.
- 3.2 Venture capital and private equity investors spend a significant amount of time working closely with unlisted businesses to manage and improve the investment. Currently, there is no provision for capitalizing expenses related to the management and improvement of the capital asset during the holding period of the security.
- 3.3 This means in effect that investors have to write off the management fees as expenses, which means that they are not available to be offset against capital gains that may eventually result from the investment. In case of foreign LPs, these costs are allowed to be capitalized overseas (US model) and thus, this issue is particularly relevant to domestic LPs and domestic GPs.
- 3.4 The issue is further exacerbated by the fact that management expenses (typically in the range of 2% of managed funds) are also subject to service tax. Assuming a 10 year hold period for a VCPE investment, 2% management fees annually, and mark-ups on management fees of 20% and 14% for transfer pricing and service tax – the amount to be capitalized is considerable $(10 \text{ yrs} \times 2 \% \times 1.20 \times 1.14) = 27\%$ of initial cost of investment. This cost currently has to be written off and cannot be offset against the capital gains that it produces.

Recommendation

Option 1: Allow expenditure capital in nature towards improvement of the capital asset be capitalised as “cost of improvement”.

Option 2: Allow a standard deduction of 3% of cost of acquisition of capital asset irrespective of the actual expenditure incurred

D.IV Taxation upon sale, and reduced taxation rates for unlisted shares acquired via ESOPs/employee incentive schemes

- 4.1 There are two severe tax events that occur upon exercise of options granted to founders and early employees of VCPE companies.
- 4.2 First, the employee is subject to tax at the time of exercise of option – i.e. this tax is payable immediately even if the employee has not sold the share in that tax period. The magnitude of the tax is calculated on the notional gain between the acquisition price of the share (option strike price) and the “FMV” at the time of exercise. In other words, the employee becomes liable for a significant cash tax for exercise of options amounting to a notional non-cash gain.
- 4.3 Secondly, the nature of such gains is considered as salary or perquisite. This means that the employee may be payable for ordinary income tax (30+%, calculated as per the marginal income tax rate) for the notional gains calculated above – which will be a substantial amount in a successful company.
- 4.4 *Rather perversely, this means that 1) the tax rate suffered by employees (with option vesting periods of 4+ years) is generally higher than 2) the tax rate suffered by their investors who hold the investment for 3+ years which in turn is greater than 3) the tax rate suffered by investors who subscribe to shares in the IPO or “Offer for sale” and hold for 1+ years. The relevant rates are 1) ordinary income i.e. 30+% vs. 2) long term capital gains tax on unlisted sales i.e. 20% after indexation vs. 3) long term capital gains tax on listed sales i.e. 0%.*

Recommendations

1. Tax incidence should arise in the year of the sale of shares (not the year of exercise of the option); and
2. Profit made on sale of shares should be treated as capital gains (vs. the treatment as a portion of the gains as salary, or perquisite, thereby attracting ordinary income tax)

Best Practice:

Developed economies have come up with defined rules under which early employees can:

1. Be eligible for “Entrepreneur’s Relief”, and other reduced tax rates for founders and early employees
2. Defer the payment of tax until sale (and not exercise) for approved ESOP plans.

In the US, for statutory stock options², the individual does not have to pay ordinary income tax (nor employment taxes) on the difference between the exercise price and the FMV of the shares issued at exercise. Instead, if the shares are held for 1 year from the date of exercise and 2 years from the date of grant, then the profit (if any) made on sale of the shares is taxed as long-term capital gain. Long-term capital gain is taxed in the U.S. at lower rates than ordinary income.

In the UK, a tax-advantaged share option scheme called the Enterprise Management Incentive (EMI) has been designed for smaller companies. A company may grant options under a defined plan to selected employees provided that certain qualifying conditions are met:

- There is no tax charge on the exercise of an EMI option providing it was granted at market value.
- If the company’s share price has increased in value between the time of grant and exercise, the uplift is not charged to Income Tax.
- There is a Capital Gains Tax (CGT) charge when the employee disposes of his shares and proceeds exceed the market value at the date of the grant of the option.
- The minimum holding period is only 12 months (including the period that the option was held).

In addition, entrepreneurs may be eligible for “Entrepreneurs’ Relief”, meaning a reduced rate of capital gains tax, if:

- The entrepreneur is selling all or part of his or her business as a sole trader or business partner - including the business’s assets after it closed (assuming they have owned the business for more than a year.
- The individual is selling shares in a company where they have at least 5% of shares and voting rights and they are an employee or director of the company.

² Usually granted to employees under a defined employee stock option plan and subject to certain restrictions (must be granted to current employees, at an exercise price greater or equal to the FMV of the underlying stock at the time of the grant and subject to holding period restrictions).

D.V Clarify tax rate of 10% on long term capital gains to be applicable on transfer of shares of private limited companies

- 5.1 Section 112(1)(c) of the Act provides a concessional tax rate of 10% on long term capital gains earned from transfer of unlisted securities in the hands of the non-residents
- 5.2 However, the manner in which the term 'unlisted securities' has been defined in the Act leads to the unintentional consequence of the 10% concessional tax rate not being applicable to long-term gains on transfer of shares of private limited companies
- 5.3 Given that a significant portion of investments by VCPE funds in India are in private limited companies, the recommendation will ensure that the intended beneficiaries actually benefit from the tax provisions

Recommendation

- Amend the definition of the term 'securities' in Explanation (a) to section 112(1) of the Act to include shares of private limited companies

D.VI a Period of holding for shares received on conversion of preference shares / debentures

- 6.1 The FA 2015 amended the definition of a short-term capital asset to include unlisted shares held for a period of less than 36 months. Also, in cases where the investment in convertible preference shares / debentures is held for more than 36 months, the gains on sale of equity shares received on conversion of the preference shares / debentures *may* be considered as short term capital gains, unless the equity shares are sold 36 months after the date of conversion.
- 6.2 The above results in additional tax on long terms investors, since before the amendment the gains were considered as long term capital gains provided the period of holding was more than 12 months.
- 6.3 In case of equity shares received on conversion of convertible preference shares/ debentures, the cost of acquisition of equity shares is calculated with reference to the cost of acquisition of preference shares / debentures. Hence, for determining the holding period of equity shares, the period of holding convertible preference shares / debentures should also be considered.

Recommendation

In the context of preference shares / debentures, where conversion is not a taxable event, the period of holding of the equity shares should be considered from the date of acquisition of such convertible securities, and not from the date of allotment of the equity shares. This could be achieved by amending the definition of short term capital asset under Section 2(42A) of the Act to provide for inclusion of the period of holding of convertible preference shares / debentures (pre-conversion) in computing the period of holding of converted equity shares.

D. VI b Conversion of preference shares into equity should be exempt from the definition of “transfer”

- 6.1 Venture capital and private equity funds prefer to use convertible preference shares / debentures over equity shares, since these instruments provide the investor the flexibility to link the formulae for conversion into equity shares with the performance of the company on a pre-defined date in the future. In such cases, the conversion typically happens 12 to 18 months prior to the “offer for sale” or an “Initial Public Offer” event. Other commercial factors also drive such investors to initially structure their investment in the form of a convertible instrument.
- 6.2 Typically, the total holding period of the investment is in the range of 3 to 5 years, i.e. the investments are long term in nature.
- 6.3 A question that arises in these situations is whether the act of conversion of preference shares into equity shares would be regarded as a “transfer” under section 2(47) of the Act, and thus be liable for capital gains taxation in the hands of the shareholders, or whether the capital gains would arise only when the shares, after conversion, are sold or otherwise transferred.
- 6.4 Based on a Circular [dated 12 May 1964 (F. No. 12/1/64-IT (AI))] issued to all Commissioners of Income-Tax, which is binding on the Department, judicial precedents and the provision in tax law for considering cost of equity shares (post conversion of preference shares into equity shares) as the cost of convertible preference shares pre-conversion at the time of transfer of equity shares, conversion of preference shares to equity shares should not amount to “transfer” under the Act, and therefore, it should not trigger capital gains tax.

- 6.5 Further, the Act exempts any transfer by way of conversion of bonds or debenture, debenture-stock, or deposit certificates in any form, of a company into shares or debentures of that company from tax.

Recommendation

Based on the above, to provide certainty and mitigate litigation risk, it is recommended to expressly provide an exemption for conversion of preference shares into equity shares.

D.VII Permit charitable and religious trusts to invest in AIFs

- 7.1 Charitable and religious trusts have been in existence in India for many decades. These are established for several purposes including building hospitals, educational institutions and the promotion of various social causes. These institutions are regulated under a variety of laws. Prudent cash flow and expenditure management of these organizations requires investing in a diversified set of assets.
- 7.2 Educational endowments are a good example of the importance of these trusts. The returns from a professionally -managed and diversified investment portfolio can be used to finance the cost of Professor Chairs, purchase of modern laboratory equipment, provide scholarships to high-calibre, needy students and many other desirable purposes. In this manner, trusts make a significant contribution to society. Hence, they should be brought into the mainstream investment eco-system and should form part of India's financial system's regulatory mind-set
- 7.3 Similar organizations in other countries invest a portion of their assets in VCPE industry. For example, the respected Yale Endowment has over a 30 per cent asset allocation to VCPE investments
- 7.4 Charitable Trusts have long term funds for which AIFs are well matched

Recommendations

- AIFs should be an eligible asset for investment by charitable and religious trusts.
- Amend section 11(5) of the Act and Rule 17C of the Income-tax Rules, 1962 (the Rules) to permit charitable trusts to invest in AIFs.
- Charitable trusts with INR 25 crores or more of assets under management (AUM) should have an investment committee, a chief investment officer and an appropriate compliance function.
- Section 80G - charitable and religious trusts should be permitted to invest up to 10% of their AUM in AIFs

D.VIII Taxation on conversion/ transfer of Global Depository Receipts (GDR) issued against permitted securities (other than listed shares)

8.1 GDRs allow the foreign investors to invest in Indian companies without worrying about the trading practices, accounting rules, or cross-border transactions. GDRs offer most of the same corporate rights, especially voting rights, to the holders of GDRs that investors of the underlying securities enjoy. GDRs are liquid because supply and demand can be regulated by creating or cancelling GDR shares. The Depository Receipts Scheme, 2014 (New Scheme) permits an Indian company, listed or unlisted, private or public, or any other issuer or person holding permissible securities to issue or transfer permissible securities to a foreign depository for the purpose of issuance of depository receipt. The underlying securities can be debt instruments, shares or units etc.

8.2 The main benefit to GDR issuance to the company is increased visibility in the target markets, which usually garners increased research coverage in the new markets; a larger and more diverse shareholder base; and the ability to raise more capital in international markets.

8.3 As derivatives, depository receipts can be created or cancelled depending on supply and demand. The ability to create or cancel depository shares keeps the depository share price in line with the corporate stock price, since any differences will be eliminated through arbitrage.

8.4 Further, GDRs are permitted to be held and transferred by both residents and non-residents. However, recently, the tax benefits under

the Act have been restricted to GDRs issued against ordinary shares of listed companies including exempting transfer of GDRs outside India by a non-resident (NR) to another NR and conversion of “deposit certificates” in any form of a company into shares or debentures of that company from tax.

8.5 Thus, there is a clarification required to address the taxability on transfer of GDRs outside India by a NR to another NR and conversion of GDR issued against permitted securities (other than listed shares) under the Act.

8.6 In this context, it would be relevant to note that the Sahoo Committee report, pursuant to which the New Scheme was issued, recommended that the issue and transfer of (all) permitted GDRs prior to conversion into local securities should not be taxable in India.

Recommendation

It is recommended that a specific regime be introduced as regards taxation of GDRs issued under the New Scheme. This would provide the much needed clarity on taxation of foreign investors.

It would be important to clarify that the transfer of GDRs from one non-resident to another should not be regarded as a “transfer” for the purpose of chargeability of capital gains tax.

In addition, it should be clarified that transfer by way of conversion of GDR into the underlying security will not be regarded as a taxable “transfer”.

D.IX Service tax abatement on service fees in respect of funds raised by an AIF from overseas investors

9.1 In India, the taxation of services is presently governed under the provisions of Chapter V of the Finance Act, 1994 (service tax legislation). Further, the Goods & Services Tax (GST) legislation is proposed to be implemented in India in 2016. GST shall be a tax levied in India on the supply of goods and services. The taxing principle under the present service tax legislation is expected to continue under the proposed GST legislation, i.e. taxation based on destination of supply.

- 9.2 Under the present service tax legislation, services whose place of supply (determined in terms of the relevant rules) is in India are subject to service tax at 14%.
- 9.3 Further, services provided by service providers located in India to service recipients located outside India can qualify as exports and be treated as zero-rated services, subject to the fulfilment of the following prescribed conditions cumulatively:
- Service provider is located in India
 - Service recipient is located outside India
 - Service should not be an exempted service, as per the service tax legislation
 - Place of supply of service should be outside India in terms of the relevant rules
 - Payment of services is received by service provider in convertible foreign exchange
 - Service provider and recipient should be separate legal entities. and not merely different establishments of the same legal entity
- 9.4 A fund is, in essence, the pooling in of the contributions of its investors for the purpose of investment and therefore does not have any distinct entity apart from its investors. However, for the purpose of levy of service tax in India, a fund is viewed as a distinct person. Accordingly, under the present service tax legislation, services provided by a fund manager (and other service providers) to a fund located in India are taxable, irrespective of the location of its investors.
- 9.5 It is relevant to note that in such a scenario, the taxing principle of service tax, i.e. consumption-based taxation, is not being met in respect of overseas investors. This is on account of the fact that the Fund is considered for determination of the consumption of the services provided by the fund manager, whereas the actual effective consumption of the said services is by the investors and not the fund.
- 9.6 If the principle of effective consumption were to be followed, the services to the extent of the investments made by the overseas investors would be outside the purview of service tax in India, as the place of supply of the said services is outside India, i.e. the location of the effective service recipient (overseas investors). Further, the said services shall also qualify as exports and be treated as zero rated services as all of the conditions prescribed for the export qualification are being met in essence, for e.g., the fee for asset management

services is provided from the very pool of investments made by the investors which includes contribution made by the overseas investors in convertible foreign exchange. Therefore, the condition of receipt of consideration in convertible foreign exchange is, in principle, being met in the present case.

Recommendation

A clarification should be provided that investors in funds are the service recipients of the services provided by a fund manager/ service provider.

Relaxation to be provided in terms of the conditions for export qualification to be fulfilled by fund managers/ service providers in respect of service provided to overseas investors wherein all conditions for export qualification are in essence being met. With the recent announcement that foreign investment would be permitted in SEBI regulated AIFs, this relaxation would be a critical factor in foreign investors' choice of a domestic fund manager vs. a foreign fund manager.

Annexure 1

Suggested Amendments to Implement the Tax Recommendations

A. Make the tax pass-through system work flawlessly in a simple manner for complete “clarity”, “certainty” and “consistency”, provide exemption to AIFs from section 56(2)(vii a) and 56(2)(vii b) of the Act and clarify indirect transfer provisions for funds/investors.

A.1 a) Elimination of the Requirement for Tax Deduction on Exempt Income.

Proposed Amendment

*‘194LBB. (1) Where any income, other than that proportion of income which is of the same nature as income referred to in clause (23FBB) of Section 10, is payable to a unit holder, **being a resident**, in respect of units of an investment fund specified in clause (a) of the Explanation 1 to Section 115UB, the person responsible for making the payment shall, at the time of credit of such income to the account of payee or at the time of payment thereof in cash or by issue of a cheque or draft or by any other mode, whichever is earlier, deduct income-tax thereon at **the rates in force**.*

Provided that nothing contained in this sub-section shall apply in respect of

- credit or payment of any income exempt under section 10 of the Act; or*
- any income credited or paid by an investment fund to any person in whose case income, irrespective of its nature and source is not chargeable to tax under the Act; or*
- any income credited or paid by an investment fund in which case deduction at source is not provided under the provisions of Chapter XVII-B (Deduction at source) of the Act*

*(2) Where any income is payable to a unit holder, **being a non-resident (not being a company) or a foreign company**, in respect of units of an investment fund specified in clause (a) of the Explanation 1 to section 115UB, the person responsible for making the payment shall, at the time of credit of such income to the account of payee or at the time of payment thereof in cash or by issue of a cheque or draft or by any other mode, whichever is earlier, deduct income-tax thereon at the rates in force.*

Provided that nothing contained in this sub-section shall apply in respect of

- credit/ distribution of any income exempt under section 10 of the Act or*
- any other income credited/ distributed by an investment fund to any person in whose case income, irrespective of its nature and source is not chargeable to tax under the Act.*

197. (1) Subject to rules made under sub-section (2A), [where, in the case of any income of any person [or sum payable to any person], income-tax is required to be deducted at the time of credit or, as the case may be, at the time of payment at the rates in force under the provisions of Sections 192, 193, 194, 194A, 194C, 194D, 194G, 194H, 194-I, 194J, 194K, 194LA, 194LBB and 195, the Assessing Officer is

satisfied that the total income of the recipient justifies the deduction of income-tax at any lower rates or no deduction of income-tax, as the case may be, the Assessing Officer shall, on an application made by the assessee in this behalf, give to him such certificate as may be appropriate.

(Draft)

[TO BE PUBLISHED IN THE GAZETTE OF INDIA, EXTRAORDINARY, PART II, SECTION 3, SUB-SECTION (ii)]

GOVERNMENT OF INDIA
MINISTRY OF FINANCE
DEPARTMENT OF REVENUE
(CENTRAL BOARD OF DIRECT TAXES)

NOTIFICATION NO. /2016
New Delhi, Dated-____, 2016

S.O. (E).- In exercise of the powers conferred by sub-section (1 F) of section 197A of the Income-tax Act, 1961 (43 of 1961), the Central Government hereby notifies that no deduction of tax under Chapter XVII of the said Act shall be made on the payments or credits of the nature specified in section 194LBB of the said Act received by any of the following:

a) (Refer Appendix enclosed below)

b)

c)

2. This notification shall come into force from the date of its publication in the Official Gazette.

[F. No.____]

(_____)

Under Secretary to the Govt. of India

(Draft Appendix)

- (21) *any income of a research association for the time being approved for the purpose of clause (ii) or clause (iii) of sub-section (1) of section 35:*
- (23A) *any income (other than income chargeable under the head "Income from houseproperty" or any income received for rendering any specific services or income by way of interest or dividends derived from its investments) of an association or institution established in India having as its object the control, supervision, regulation or encouragement of the profession of law, medicine, accountancy, engineering or architecture or such other profession as the Central Government may specify in this behalf, from time to time, by notification in the Official Gazette:*
- (23AA) *any income received by any person on behalf of any Regimental Fund or Non-Public Fund established by the armed forces of the Union for the welfare of the past and present members of such forces or their dependants;*
- (23AAA) *any income received by any person on behalf of a fund established, for such purposes as may be notified by the Board in the Official Gazette, for the welfare of employees or their dependants and of which fund such employees are members*
- (23AAB) *any income of a fund, by whatever name called, set up by the Life Insurance Corporation of India on or after the 1st day of August, 1996 or any other insurer under a pension scheme,—*
(i) to which contribution is made by any person for the purpose of receiving pension from such fund;
(ii) which is approved by the Controller of Insurance or the Insurance Regulatory and Development Authority established under sub-section (1) of section 3 of the Insurance Regulatory and Development Authority Act, 1999 (41 of 1999), as the case may be.
- (23B) *any income of an institution constituted as a public charitable trust or registered under the Societies Registration Act, 1860 (21 of 1860), or under any law corresponding to that Act in force in any part of India, and existing solely for the development of khadi or village industries or both, and not for purposes of profit, to the extent such income is attributable to the business of production, sale, or marketing, of khadi or products of village industries:*
- (23BB) *any income of an authority (whether known as the Khadi and Village Industries Board or by any other name) established in a State by or under a State or Provincial Act for the development of khadi or village industries in the State.*
- (23BBE) *any income of the Insurance Regulatory and Development Authority established under sub-section (1) of section 3 of the Insurance Regulatory and Development Authority Act, 1999 (41 of 1999);*
- (23BBF) *any income of the North-Eastern Development Finance Corporation Limited, being a company formed and registered under the Companies Act, 1956 (1 of 1956):*
- (23BBG) *any income of the Central Electricity Regulatory Commission constituted under sub-section (1) of section 76 of the Electricity Act, 2003 (36 of 2003);*
- (23BBH) *any income of the Prasar Bharati (Broadcasting Corporation of India) established under sub-section (1) of section 3 of the Prasar Bharati (Broadcasting Corporation of India) Act, 1990 (25 of 1990);*
- (23C) *any income received by any person on behalf of—*
(i) the Prime Minister's National Relief Fund; or
(ii) the Prime Minister's Fund (Promotion of Folk Art); or
(iii) the Prime Minister's Aid to Students Fund; or

- (iiiia) the National Foundation for Communal Harmony; or
 [(iiiiaa) the Swachh Bharat Kosh, set up by the Central Government; or
 (iiiiaaa) the Clean Ganga Fund, set up by the Central Government; or]
 (iiiab) any university or other educational institution existing solely for educational purposes and not for purposes of profit, and which is wholly or substantially financed by the Government; or
 (iiiac) any hospital or other institution for the reception and treatment of persons suffering from illness or mental defectiveness or for the reception and treatment of persons during convalescence or of persons requiring medical attention or rehabilitation, existing solely for philanthropic purposes and not for purposes of profit, and which is wholly or substantially financed by the Government.
 [Explanation.—For the purposes of sub-clauses (iiiab) and (iiiac), any university or other educational institution, hospital or other institution referred therein, shall be considered as being substantially financed by the Government for any previous year, if the Government grant to such university or other educational institution, hospital or other institution exceeds such percentage of the total receipts including any voluntary contributions, as may be prescribed, of such university or other educational institution, hospital or other institution, as the case may be, during the relevant previous year]; or
 (iiiad) any university or other educational institution existing solely for educational purposes and not for purposes of profit if the aggregate annual receipts of such university or educational institution do not exceed the amount of annual receipts as may be prescribed; or
 (iiiiae) any hospital or other institution for the reception and treatment of persons suffering from illness or mental defectiveness or for the reception and treatment of persons during convalescence or of persons requiring medical attention or rehabilitation, existing solely for philanthropic purposes and not for purposes of profit, if the aggregate annual receipts of such hospital or institution do not exceed the amount of annual receipts as may be prescribed; or
 (iv) any other fund or institution established for charitable purposes which may be approved by the prescribed authority, having regard to the objects of the fund or institution and its importance throughout India or throughout any State or States; or
 (v) any trust (including any other legal obligation) or institution wholly for public religious purposes or wholly for public religious and charitable purposes, which may be approved by the prescribed authority, having regard to the manner in which the affairs of the trust or institution are administered and supervised for ensuring that the income accruing thereto is properly applied for the objects thereof;
 (vi) any university or other educational institution existing solely for educational purposes and not for purposes of profit, other than those mentioned in sub-clause (iiiab) or sub-clause (iiiad) and which may be approved by the prescribed authority; or
 (via) any hospital or other institution for the reception and treatment of persons suffering from illness or mental defectiveness or for the reception and treatment of persons during convalescence or of persons requiring medical attention or rehabilitation, existing solely for philanthropic purposes and not for purposes of profit, other than those mentioned in sub-clause (iiiac) or sub-clause (iiiiae) and which may be approved by the prescribed authority:

- (23D) *subject to the provisions of Chapter XII-E, any income of—*
- (i) *a Mutual Fund registered under the Securities and Exchange Board of India Act, 1992 (15 of 1992) or regulations made thereunder;*
 - (ii) *such other Mutual Fund set up by a public sector bank or a public financial institution or authorized by the Reserve Bank of India and subject to such conditions as the Central Government may, by notification in the Official Gazette, specify in this behalf.*
- (23EE) *any specified income of such Core Settlement Guarantee Fund, set up by a recognized clearing corporation in accordance with the regulations, as the Central Government may, by notification in the Official Gazette, specify in this behalf:*
- (25) (i) *interest on securities which are held by, or are the property of, any provident fund to which the Provident Funds Act, 1925 (19 of 1925), applies, and any capital gains of the fund arising from the sale, exchange or transfer of such securities;*
- (ii) *any income received by the trustees on behalf of a recognized provident fund;*
 - (iii) *any income received by the trustees on behalf of an approved superannuation fund;*
 - (iv) *any income received by the trustees on behalf of an approved gratuity fund;*
 - (v) *any income received—*
 - (a) *by the Board of Trustees constituted under the Coal Mines Provident Funds and Miscellaneous Provisions Act, 1948 (46 of 1948), on behalf of the Deposit-linked Insurance Fund established under section 3G of that Act; or*
 - (b) *by the Board of Trustees constituted under the Employees' Provident Funds and Miscellaneous Provisions Act, 1952 (19 of 1952), on behalf of the Deposit-linked Insurance Fund established under section 6C of that Act;*
- (25A) *any income of the Employees' State Insurance Fund set up under the provisions of the Employees' State Insurance Act, 1948 (34 of 1948);*
- (26BB) *any income of a corporation established by the Central Government or any State Government for promoting the interests of the members of a minority community.*
- (26BBB) *any income of a corporation established by a Central, State or Provincial Act for the welfare and economic upliftment of ex-servicemen being the citizens of India.*
- (44) *any income received by any person for, or on behalf of, the New Pension System Trust established on the 27th day of February, 2008 under the provisions of the Indian Trusts Act, 1882 (2 of 1882);”*

A.1 d) Pass-through Tax Status Extended to Net Losses at AIF Level to the Investor

Proposed Amendment

Section 115UB

(2) Where in any previous year, a person, being a unit holder of an investment fund, transfers the units to another person (excluding transfers referred to in section 47) and the net result of computation of total income of the investment fund [without giving effect to the provisions of clause (23FBA) of Section 10] is a loss under any head of income and such loss cannot be or is not wholly set-off against income under any other head of income of the said previous year, —

- ~~(i) such loss shall be allowed to be carried forward and it shall be set-off by the investment fund in accordance with the provisions of Chapter VI; and~~
~~(ii) such loss shall be ignored for the purposes of sub-section (1).~~

A.II Exemptions of AIFs from a) Section 56(1)(viib) on issue of shares at a value higher than fair market value and (b) Section 56(2)(viiia) on purchase of shares at a value lower than fair market value (FMV)

Proposed Amendment

Section 56(2)(viiia)

Provided that this clause shall not apply to any such property received by an investment fund

Explanation: For the purpose of this section —
the expression “Investment Fund” shall have the meaning assigned to it in clause (a) of the Explanation 1 to Section 115UB

Section 56(2)(viib)

Provided that this clause shall not apply where the consideration for issue of shares is received—

- (i) by venture capital undertaking from a venture capital company or a venture capital fund;
(ii) from an investment fund; or
~~(iii)~~ (iii) by a company from a class or classes of persons as may be notified by the Central Government in this behalf

Explanation: For the purpose of this clause —
the expression “Investment Fund” shall have the meaning assigned to it in clause (a) of the Explanation 1 to Section 115UB

B.1 Attract large amount of foreign capital into India-focussed foreign funds by providing a safe harbour to onshore managers of offshore funds.

B.1 a) Tax Residency of the Fund

Proposed Amendment

Section 9A

(3)(b) the fund is ~~a resident of~~ established or set-up or incorporated or registered in a country or a specified territory with which an agreement referred to in sub-section (1) of [Section 90](#) or sub-section (1) of [Section 90A](#) has been entered into.

B.1 b) Investor Diversification

Proposed Amendment

Amend section 9A(3)(e) as follows

The fund has a minimum of ~~twenty five~~ **ten** members who are, directly or indirectly, not connected persons

Following proviso to Section 9A(3)(e) should be inserted-

Provided that the conditions specified in clauses (a) to (m) shall not apply to:

i) entities registered as FPIs or FVCI under the applicable SEBI regulations; ii) where a majority of the investors comprise of institutional investors like sovereign wealth funds, large pension funds, banks, etc.

iii) A fund in the initial three years of setting-up or date of final closing for receiving investor monies whichever is earlier

Section 9A(3)

*(f) any member of the fund along with connected persons shall not have any participation interest, directly or indirectly, in the fund exceeding ~~ten~~ **forty-nine** percent*

Provided that if the fund has an institutional investor who holds more than forty nine percent participation interest, then this condition shall be deemed to be satisfied if such institutional investor itself satisfies the condition in clause (e) of sub-section (3) of Section 9A.

Section 9A(3)

~~*(g) the aggregate participation interest, directly or indirectly, of ten or less members along with their connected persons in the fund, shall be less than 50 per cent;*~~

~~*(n) the fund is a broad based Fund*~~

~~*Provided that if the broad based fund has an institutional investor who holds more than forty nine per cent of the shares or units in the fund, then such institutional investor must itself be a broad based fund.*~~

(9) For the purposes of this section,—

~~*(f) “Board Based Fund” shall mean a fund, established or incorporated outside India, which has at least twenty investors, with no investor holding more than forty-nine per cent of the shares or units of the fund.*~~

B.I c) Remuneration to Investment Managers

Proposed Amendment

Section 9A(3)

~~(m) the remuneration paid by the fund to an eligible fund manager in respect of fund management activity undertaken by him on its behalf is not less than the arm's length price of the said activity~~

B.I d) Investment Diversification

Proposed Amendment

Section 9A(3)

~~(h) the fund shall not invest more than 20 per cent of its corpus in any entity~~

B.I e) Carrying on any business in India or from India

Proposed Amendment

Section 9A(3)

Insertion of Proviso to clauses (k) and (l): Provided that the offshore funds shall not be regarded as carrying on business, or said to have business connection in India, merely because of the activities they perform to protect their shareholding in investee entities.

B.I f) Reporting Requirements

Proposed Amendment

Proviso to Section 9A(5)

Provided that the non-furnishing of the statement or any information within 90 days does not result in denial of the safe harbour

B.II Attract large amounts of foreign capital by making Foreign Direct Investments (FDI) in AIF work efficiently

B.II b) Resolve ambiguity around investment by non-resident investors into AIFs

Proposed Amendment

Amend Regulation 2 of the Schedule 11 as follows:

*The payment for the units of an Investment vehicle acquired by a person resident or registered / incorporated outside India shall be made by an inward remittance through the normal banking channel including by debit to an **NRO or NRE** or an FCNR account.*

Insert proviso below Regulation 2 of the Schedule 11 as follows:

Provided that any investment by non-resident Indian in the units of Investment Vehicle under the non-repatriation route shall be treated as domestic investment for the purpose of foreign ownership.

Amend Regulation 2(2) of the Schedule 5 as follows:

*A Non-resident Indian may, without any limit, purchase on non-repatriation basis dated Government securities (other than bearer securities), treasury bills, units of domestic mutual funds, units of Money Market Mutual Funds in India, **units of Investment Vehicle** or National Plan/ Savings Certificates.*

Insert proviso below Regulation 2(2) of the Schedule 5 as follows:

Provided that any investment by non-resident Indian in the units of Investment Vehicle under the non-repatriation route shall be treated as domestic investment for the purpose of foreign ownership.

C. Given the high risk and relatively illiquid nature of the capital from VCPE sector, it needs to at least be treated at par with public market investments for taxation. We recommend the government adopt roadmap for AIF taxation based in STT framework.

C.I Long term roadmap STT based approach for AIFs

Proposed Amendments

Amendment 1

I. Distributions by AIFs to be treated as a taxable transaction liable to STT

Amendments required in the Finance Act 2004 (Chapter VII):

Amending the Chapter VII of Finance (No. 2) Act, 2004 to include distribution from Investment Funds as a taxable transaction in securities:

Definitions

- A) In section 97 of the Finance (No.2) Act, 2004, insert the following definition as sub-section (1):
“Investment Fund” shall have the meaning assigned to it in clause (a) of the explanation to section 115UB of the Income-tax Act, 1961”
- B) In section 97 re-insert the current sub-section (1) defining Appellate Tribunal as sub-section (1A)
- C) In section 97 of the Finance (No. 2) Act, 2004,—
in sub-section 13, after sub-clause (b), the following sub-clauses shall be inserted:
*“(c) purchase of a unit in an Investment Fund
(d) any distribution made on sale or redemption of a unit in an Investment Fund”
(d) any distribution made otherwise by an Investment fund”*

Charge of STT

D) In section 98 of the Finance (No. 2) Act, 2004, in the Table, after serial number 7 and the corresponding entries thereto, the following shall be inserted, namely:—

Sl. No.	Taxable Securities Transaction	Rate	Payable by
(1)	(2)	(3)	(4)
“8	<i>(a) Purchase of an unit of an Investment Fund</i>	<i>_ percent</i>	<i>Purchaser</i>
	<i>(b) Distribution of income representing long term capital gains, made to an unit holder by an Investment Fund on redemption or otherwise</i>	<i>_ percent</i>	<i>Unit holder</i>
	<i>(c) Distribution of income other than long term capital gains, made by an Investment Fund on redemption or otherwise</i>	<i>_ percent</i>	<i>Unit holder</i>

	<i>(d) Sale of an unit of an Investment Fund being a long term capital asset, to any person other than the Investment Fund in which such units are held</i>	<i>_ percent</i>	<i>Seller</i>
	<i>(e) Sale of an unit of an Investment Fund being a short term capital asset, to any person other than the Investment Fund in which such units are held</i>	<i>_ percent</i>	<i>Seller</i>

Value of taxable securities transaction

E) In section 99 of the Finance (No.2) Act, 2004, after sub-clause (b) insert the following clauses -

“(ba) in the case of purchase of units of an Investment Fund, the price at which such units are purchased;

(bb) in the case of distribution on account of redemption of units of an Investment Fund, such amounts as are distributed to the unit holder including the principal amount redeemed;

(bc) in the case of distribution by an Investment fund other than the distribution referred in clause (bb) above, the amounts so distributed to the unit holder;

(bd) in the case of sale of units of an Investment Fund by the unit holder to any person other than the Investment Fund in which such units are held, the price at which such units are sold”

Collection and Recovery of STT

F) In section 100 insert the following sub-section (2B) after sub-section (2A)

“The prescribed person in the case of every Investment Fund shall collect the securities transaction tax from every person who purchases or sells or redeems the unit of an Investment Fund”

Recognized stock exchange or Investment Fund or Mutual Fund to furnish prescribed return

G) In sub-section (1) of section 101 - insert the following words after the words “every recognized stock exchange” –

“Prescribed person in the case of every Investment Fund”

Amendment 2

On treating the transactions of investment in and distribution from an Investment Funds liable to STT, any distribution made by the AIF should be totally exempt from tax

Exempting the income from Investment Fund under section 10 of the Act:

In Section 10 of the IT Act, after clause (38), the following clause shall be inserted, namely:-

“(38A) any distribution received by an assessee, being a unit holder of an Investment fund referred to in Explanation to section 10(23FBA), either on redemption or otherwise and where such distribution is chargeable to securities transaction tax under Chapter VII of the Finance (No. 2) Act, 2004.

(38B) any income received by an assessee, being a unit holder of an Investment fund referred to in Explanation to section 10(23FBA), on sale of units in an Investment Fund to any person other than the Investment Fund in which such units are held and where such sale is chargeable to securities transaction tax under Chapter VII of the Finance (No. 2) Act, 2004.”

Other consequential amendments:

Amending the period of holding in the securities held in and by an Investment Fund

In sub-section 42(A) of the IT Act, insert the following proviso after the second proviso-

“Provided further that in the case of share or other securities of a company (not being a share listed in a recognised stock exchange) held by an Investment Fund or a unit of an Investment Fund specified under clause (23FBA) of section 10 the provisions of this clause shall have effect as if for the words "thirty-six months", the words "Twelve months" had been substituted”

In Section 10 of the IT Act, 1961 (IT Act)-

Amend clause (23FBA) as follows:

any income of an investment fund ~~other than income chargeable under the head “Profits and gains of business or profession.”~~

Delete clause (23FBB).

Amending Section 115UB

In Section 115UB of the IT Act, after sub-section (7), the following sub-section shall be inserted, namely:-

“(8) Nothing contained in sub-sections (1) to (7) shall apply to any distributions by an Investment fund, where the distribution from such an Investment Fund is chargeable to securities transaction tax under Chapter VII of the Finance (No. 2) Act, 2004”

Avoiding the needless Tax Deduction at Source by Investment Funds (Section 194LBB)

In Section 194LBB of the Act, the first paragraph shall be numbered as sub-section (1) and after sub-section (1) so numbered, the following sub-section shall be inserted, namely:-

“(2) Nothing contained in sub-section (1) shall apply to distributions by an Investment fund, where such distribution is chargeable to securities transaction tax under Chapter VII of the Finance (No. 2) Act, 2004”

D. India should at least be the global best practice and be followed by the world for “NEXT PRACTICES”

D.I Tax deduction for investors in SEBI regulated angel/ social venture funds

Proposed Amendment

For the purpose of Chapter VI, the following section should be inserted-

Section 80CCH - In computing the total income of an assessee, there shall be deducted 50% of the investment amount in SEBI regulated angel / social venture funds in the previous year.

Explanation –

SEBI regulated angel / social venture fund means any fund established or incorporated in India, in the form of a trust, or a company, or a limited liability partnership, or a body corporate which has been granted a certificate of registration as a Category I Alternative Investment Fund – angel / social venture capital and is regulated under the Securities and Exchange Board of India (Alternative Investment Fund) Regulations, 2012, made under the Securities and Exchange Board of India Act, 1992.

D.II Inclusion of the concept of “accredited investors”

Proposed Amendment

Section 56(2)(viib)

Provided that this clause shall not apply where the consideration for issue of shares is received—

by venture capital undertaking from a venture capital company or a venture capital fund;

or

by an investment fund; or

by an accredited investor; or

~~(iii)~~(iv) by a company from a class or classes of persons as may be notified by the Central Government in this behalf

Explanation:

“Accredited Investors” includes individuals or HUFs, company, a firm, an association of persons or a body of individuals whether incorporated or not, a local authority and every artificial juridical person who reports a total income (including exempt income) exceeding Rs 50 lakhs annually in immediately three assessment years preceding the assessment year in which the investment is made.

D.III Allow management expenses for AIF investments to be capitalized as “cost of improvement”

Proposed Amendment

Option 1: Where expenditure capital in nature towards improvement of the capital asset is to be capitalized as “cost of improvement”

Modify section 55 (1)(b)(1)(ii) of the Act to read as under:

“in any other case, means all expenditure of a capital nature incurred in making any additions or alterations ‘*or improvement*’ to the capital asset by the assessee after it became his property, and, where the capital asset became the property of the assessee by any of the modes specified in sub- section (1) of] section 49, by the previous owner, but does not include any expenditure which is deductible in computing the income chargeable under the head....”

Notification required

“Improvement expenditure” for a capital asset would include expenditure of a capital nature in relation to:

- *Management Advisory*
- *Legal and Professional*
- *Administrative expense directly identifiable to capital asset*

Option 2: Allow a Standard deduction of 3% of cost of acquisition of capital asset irrespective of the actual expenditure incurred

Suggested modification:

Section 48: Mode of computation.

8. The income chargeable under the head “Capital gains” shall be computed, by deducting from the full value of the consideration received or accruing as a result of the transfer of the capital asset the following amounts, namely :—

(i) expenditure incurred wholly and exclusively in connection with such transfer;

(ii) the cost of acquisition of the asset and the cost of any improvement thereto:

(iii) a sum equal to three per cent of the cost of acquisition of the asset where asset is in the nature of securities of an unlisted company or units in a mutual fund/AIF

D.IV Taxation upon sale, and reduced taxation rates for unlisted shares acquired via ESOPs/ employee incentive schemes

Proposed Amendment

Option 1: Delete (vi) of section 17(2) which reads as

17. For the purposes of [Sections 15](#) and [16](#) and of this section,—

(2) “perquisite” includes—

~~*(vi) the value of any specified security or sweat equity shares allotted or transferred, directly or indirectly, by the employer, or former employer, free of cost or at concessional rate to the assessee.*~~

Option 2: Specify criteria to identify start-up entities and approve stock option plans for eligible companies

Modify Section 17(2)(vi) as

(vi) the value of any specified security or sweat equity shares *excluding security under an approved stock option plan* allotted or transferred, directly or indirectly, by the employer, or former employer, free of cost or at concessional rate to the assessee.

D.V. Clarify tax rate of 10% on long term capital gains to be applicable on transfer of shares of private limited companies

Proposed Amendment

The term ‘securities’ in Explanation (a) to section 112(1) of the Act, should be defined as under:

“shares, scripts, stocks, bonds, debentures, debenture stock, warrants, units or other securities of like nature issued by a private company, public company, any other body corporate and includes other securities as specified in Section 2(h) of Securities Contracts (Regulation) Act, 1956”

D.VIa Period of holding for shares received on conversion preference shares/debentures

Proposed Amendment

This will require insertion of following clause in Section 2(42A):

Explanation 1.—(i) In determining the period for which any capital asset is held by the assessee—

(hf) in the case of a capital asset, being equity share obtained on conversion of preference shares/ debentures in an Indian company, there shall be included the period for which such convertible preference shares/ debentures (pre-conversion) were held by the assessee;

D.VIb Conversion of preference shares into equity should be exempt from the definition of “transfer”

Proposed Amendment

This will require amendment to the following section:

47(x) - any transfer by way of conversion of preference shares, bonds or debentures, debenture-stock or deposit certificates in any form, of a company into shares or debentures of that company

D.VII Permit charitable and religious trusts to invest in AIFs

Proposed Amendment

After point (viii) of Rule 17C of the Rules, the following shall be inserted:

(ix) - Investment by way of acquiring units in an Investment Fund as defined in clause (a) of the explanation to section 115UB of the Income-tax Act, 1961

D.VIII Taxation on conversion/ transfer of Global Depository Receipts (GDR) issued against permitted securities (other than listed shares)

Proposed Amendment

This will require amendment to Section 115ACA(3) as follows:

Explanation: For the purposes of this section,

"Global Depository Receipts" means any instrument in the form of a depository receipt or certificate....issued to non-resident investors against the issue of–

*(i) ordinary shares of issuing company, **being a company listed on a recognized stock exchange in India***

(II) or foreign currency convertible bonds of issuing company;

Angel Investors

A. USA

Small Business Investment Corporation (SBIC) under the U.S. Government's Small Business Administration Programme³

- ▶ Operates as a fund-of-funds to supplement the flow of private venture capital and long term funds for financing growth, expansion and modernization of small businesses.
- ▶ It invests up to 75% of a downstream VC fund's capital, subject to a maximum of US\$108 million.
- ▶ SBIC has invested up to US\$ 18 billion so far.

B. Israel

The Government of Israel has played both a direct and indirect role in the growth of entrepreneurship and innovation. It has funded incubators as well as venture funds, while creating an environment conducive for entrepreneurship. One of the factors from a tax perspective is:

- ▶ Non-Israeli investors in a VCF are exempt from capital gains tax, subject to certain conditions
- ▶ Tax treaties with 40 nations to avoid double taxation

C. Singapore

Singapore – Angel Investors tax deduction scheme

Overview

- ▶ Tax incentive to stimulate angel investment into Singapore based new ventures
- ▶ Applies to approved angel investors who commit a minimum of Rs. 37 lakhs (US\$80K)
 - Tax deduction of up to 50% of investment amount
 - Holding period of 2 years
 - Subject to max of Rs. 93 lakhs (US\$200K)

³ Indian Angel Network research

Criteria

- ▶ Not applicable to investments made via corporations, trusts, institutionalised funds and other investment vehicles
- ▶ Criteria for angels: must have either
 - Early stage investment experience or
 - Experience as a serial entrepreneur or senior management professional
- ▶ Criteria for investee company: must be
 - Private limited or
 - Incorporated in Singapore for no more than 3 years

D. New Zealand

New Zealand Seed Co-investment Fund (SCIF)

Overview

- ▶ Managed by New Zealand Venture Investment Fund Ltd (NZVIF)
- ▶ “Aims to enhance the development of angel investor networks, stimulate investment into innovative start-up companies and to increase capacity in the market for matching experienced angel investors with new, innovative start-up companies.”

Features

- ▶ The Government has made available Rs. 147 crore (US\$31M) to make investments alongside “approved co-investors”/ angel groups over a period of 12 years;
- ▶ Investments are made in a 50/50 ratio with an expected investment period of 5-6 years;
- ▶ Total investment per co-investment partner limited to Rs. 14.8 crore (US\$3.2M) and each investment per investee company limited to max of Rs. 93 lakhs (US\$200K).

Annexure 3

USA: Accredited Investors

Under the Securities Act of 1933, a company that offers or sells its securities must register the securities with the SEC, or find an exemption from the registration requirements. The Act provides companies with a number of exemptions. For some of the exemptions from registration requirements of federal securities laws, a company may sell its securities to what are known as "accredited investors.

The federal securities laws define the term "accredited investor" in Rule 501 of Regulation D as:

1. A bank, insurance company, registered investment company, business development company, or small business investment company;
2. An employee benefit plan, within the meaning of the Employee Retirement Income Security Act, if a bank, insurance company, or registered investment adviser makes the investment decisions, or if the plan has total assets in excess of US\$5 million;
3. A charitable organization, corporation, or partnership with assets exceeding US \$5 million;
4. A director, executive officer, or general partner of the company selling the securities;
5. A business in which all the equity owners are accredited investors;
6. A natural person who has individual net worth, or joint net worth with the person's spouse, that exceeds US\$1 million at the time of the purchase, excluding the value of the primary residence of such person;
7. A natural person with income exceeding US\$200,000 in each of the two most recent years, or joint income with a spouse exceeding US\$300,000 for those years and a reasonable expectation of the same income level in the current year; or a trust with assets in excess of US\$5 million, not formed to acquire the securities offered, whose purchases a sophisticated person makes.

IV

Unlocking Domestic Capital Pools

- 4.1.1 In India, a mere 10-15% of equity capital required by start-ups, medium enterprises and large companies is funded from domestic sources. The remaining 85 to 90% is sourced from overseas. This is in contrast to the U.S. and China where domestic sources fund 90% and 50% respectively, of the venture capital and private equity needs of enterprises.
- 4.1.2 Traditional funding sources, such as banks and non-bank financial companies, are constrained by risk-aversion, which limits their ability to supply risk capital. Hence, there is a vital need to unlock other domestic pools of capital identified in this paper. The nature of these pools is such that they are well-suited to assuming the risks and rewards of venture capital and private equity at all stages of the entrepreneurial life-cycle.
- 4.1.3 Availability of domestic capital for venture capital funds is almost negligible, except for SIDBI which is constrained by RBI from contributing more than 15% of a fund's corpus. This is detrimental, as more domestic capital will enable India to attract more global capital. Domestic capital typically takes higher early-stage risk and can therefore energize the start-up eco-system.
- 4.1.4 The purpose of this chapter is to recommend a set of wide-ranging reforms that India needs to institute, which will help unlock domestic sources of Angel Capital, Venture Capital and Private Equity, collectively referred to as capital, or Alternative Investment Funds. More specifically, this chapter recommends a set of measures that will help increase the flow of capital through Alternative Investment Funds regulated by the Securities and Exchange Board of India (SEBI). Alternative Investment Funds (AIFs) include funds raised to invest in infrastructure assets, start-ups, social ventures, growing companies and, to a limited extent, funds investing with complex strategies.

4.2 **General Recommendations for all Domestic Capital Pools**

This chapter makes recommendations across different categories of investors/ investment vehicles in order to meet the risk capital needs at different stages of an enterprise.

The objective of greater domestic funding of AIFs entails the measures outlined in this chapter including the following:

- I. Regulators such as the Reserve Bank of India and the Insurance Regulatory & Development Authority may be requested to consider measures that would encourage institutions regulated by them to invest in the AIF asset class.
- II. Institutions that have chosen to invest in equities should be encouraged to dedicate a part of their corpus to AIFs. They can emulate the path that allowed banks to set up mutual funds and attract foreign partners into related asset management companies, thereby bringing in more capital and talent. These entities can create step down subsidiaries, which could register with SEBI as AIF and explore JVs with local/global partners with professional expertise.
- III. All banks, pensions, provident funds, insurance companies and charitable endowments which invest in equities must create an internal management system to prudently manage increased exposure to public/private equities which entails:
 - appointing an Investment Officer,
 - creating a fully constituted Investment Committee, and
 - utilizing a minimum of 2-5% of the corpus or annual contribution of that amount in SEBI approved Category 1 AIF
- IV. Increasing investment limits for banks and insurance companies in AIFs from the current 10% limit to 20% of the total corpus of an AIF (up to 25% permitted for Social Venture Funds - SVFs).
- V. For banks, such investments should be treated as priority sector investments and need not impact the banks' capital market exposure.
- VI. Permitting charitable or religious funds to invest in SEBI-registered SVFs.

Recommendations in this chapter cover the following domestic sources of capital:

- A. Pension Funds
- B. Charitable and Religious Trusts
- C. Insurance Companies
- D. Banks
- E. Accredited Investors
- F. Limited Liability Partnerships (LLPs)
- G. Single Family Offices
- H. NRIs
- I. Foreign Venture Capital Investors (FVCIs)
- J. Initial Public Offerings (IPOs)
- K. Angel Investments

A. Pension Funds

- 4.3.1 Pension funds have long-term liabilities which need to be matched by long-term assets. They need to invest in a broadly diversified set of asset classes. In the U.S., pension funds began to invest in private equity and venture capital in the late 1970s. Subsequently, pension funds in Europe, Japan, Malaysia, Singapore, South Africa and many other countries began to allocate a portion of their investible funds in private equity and venture capital.
- 4.3.2 The paradoxical situation in India is that while leading overseas pension funds invest in Indian private equity and venture capital, domestic Indian pension funds have not yet begun to invest in Indian private equity and venture capital opportunities. In several countries, pension funds are the dominant source of capital for such private equity and venture capital funds. The Government of India has taken the progressive step to establish a regulatory authority called the Pension Fund Regulatory Development Authority (PFRDA). The PFRDA's publication titled '**Report of the Committee to Review Investment Guidelines for National Pension System Schemes in the Private Sector**'⁴ has recommended investment in private equity and venture capital.

Recommendations

- I. Domestic pension funds in India, including those managed/ regulated by PFRDA (National Pension System-NPS) and the Employee Provident Fund Organization (EPFO), should allocate up to 3% of their assets to AIF by 2017, rising to 5% by 2020, as they gain more experience.
- II. Implement a 'prudent investor regime', i.e. establish an institutional architecture comprising of trained investment teams, including Chief Investment Officers, and Investment Committees for AIF investing by mid-2016. The investment function should include an investment committee and investment monitoring staff and an appropriate investment process. This should include an investment advisory committee consisting of persons with expertise and experience in investments.

Justification

- I. Diversification of investments requires exposure to a broad array of asset classes, including AIFs.

⁴ <http://pfrda.org.in/myauth/admin/showimg.cshtml?ID=682>

- II. Global Best Practice: The Collier Institute of Private Equity (London School of Economics) study **'The Extent and Evolution of Pension Funds' Private Equity Allocations'**⁵ shows that on average pension funds allocate 5% of assets under management (AUM) to private equity and venture capital.

B. Charitable and Religious Trusts

- 4.4.1 Charitable & religious Trusts have been in existence in India for many decades. These are established for several purposes including building hospitals, educational institutions and the promotion of various social causes. These institutions are regulated under a variety of laws. Prudent cash flow and expenditure management of these organizations requires investing in a diversified set of assets.
- 4.4.2 Educational endowments are a good example of the importance of these trusts. The returns from a professionally-managed and diversified investment portfolio can be used to finance the cost of Professor Chairs, purchase of modern laboratory equipment, provide scholarships to high-calibre, needy students and many other desirable purposes. Trusts make a significant contribution to society and hence should be brought into the mainstream investment eco-system and be part of India's financial system's regulatory mind-set.
- 4.4.3 Similar organizations in other countries invest a portion of their assets in private equity and venture capital. For example, the respected Yale Endowment has an over 30% asset allocation to private equity.
- 4.4.4 While returns on any asset class can fluctuate up and down, the following quote from the Stanford Endowment has relevance for private equity and venture capital:
- 4.4.5 "During fiscal 2014, U.S. public and private equity markets, particularly venture capital, delivered strong returns as the low-interest-rate environment and ongoing economic recovery provided support," said John Powers, CEO of the Stanford Management Company, Annual Report, 2014.

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<http://www.lpeq.com/Portals/0/Assets/PDFDocuments/MarketResearch/THE%20EXTENT%20AND%20EVOLUTION%20OF%20PENSION%20FUNDS'%20PRIVATE%20EQUITY%20ALLOCATIONS%20-%20FIRST%20RESEARCH%20REPORT%20UNDER%20THE%20ADVEQ%20APPLIED%20RESEARCH%20SERIES.pdf>

4.4.6 Similarly, Yale, in a statement said that its highest returning asset class over the past decade was venture capital at an average annual gain of 18%. *Source: Bloomberg.*

Recommendations

- I. AIFs should be an eligible asset for investment by Charitable and Religious Trusts.
- II. To be tax exempt, currently Charitable and Religious Trusts can only invest in instruments specified in Section 11 (5) of the Income Tax Act. Hence, amend Section 11(5) of the Income Tax Act and Rule 17C to permit Charitable Trusts to invest in AIFs.
- III. Charitable Trusts with Rs. 50 crores or more of AUM should have an Investment Committee, a Chief Investment Officer and an appropriate compliance function.
- IV. S.80G Charitable and Religious Trusts should be permitted to invest up to 10% of their AUM in AIFs.

Justification

- I. The eligible investment list was previously amended during 1983-89, when AIFs were not in existence.
- II. Charitable Trusts have long term funds for which AIFs are well matched.
- III. Asset Diversification: Currently allowed to invest in only a select list of asset classes is permitted but not AIFs.
- IV. Prudence: To manage the investment function prudently, larger Charitable Trusts must be required to have Investment Committees.

C. Insurance Companies

4.5. Insurance companies have long-term liabilities. There is also a time gap between receipt of premiums and the payment of claims. This gives rise to a substantial pool of long-term capital. Some progress has been achieved in diversifying the eligible assets for investments by insurance companies. The current status shows that further reforms are needed.

The current investment situation vis-à-vis private equity and venture capital can be characterized as follows:

- IRDA, in August, 2013, permitted Insurance Companies to invest in Category 1 & 2 AIFs but placed low limits on AIF Investments: Life Insurance - 3 % and General Insurance-5%.
- An operational hurdle is that AIF investments are categorised as ‘Unapproved Investments’ requiring Board Approval in addition to Investment Committee Approval.
- Another important hurdle is that Insurance companies are not allowed to invest in Fund-of-Funds (FOFs). FOFs are a common investment medium for all types of institutions. They are also subject to SEBI regulation.

Recommendations

- I. Enable investments in all types of Category 1 & 2 AIFs as well as unlevered Category 3 AIFs.
- II. AIF investments should fall in the ‘Approved Category’ to enable investment approval by Investment Committees, rather than Boards, subject to internal prudential guidelines.
- III. Increase the maximum exposure for Life Insurance Companies to AIFs from 3% to 5% and to 10% by 2020 for both Life and General Insurers.
- IV. Permit investment in Fund-of-Funds (FOFs).

Justification

These recommendations are justified on the following grounds:

- I. Insurance Companies have long-term liabilities, which make AIF a suitable long-term asset class.
- II. Internal processes should be streamlined to enhance investments.
- III. General Insurers are already permitted a higher allocation of 5%, and the allocation for life insurers should have parity. FOFs are a legitimate investment category for making AIF investments since there is an added layer of due diligence by the FOF Fund Manager.

D. Banks

- 4.6.1 There is a sound rationale for banks to allocate a prudent amount of their funds to private equity. Firstly, while banks have access mainly to short-term resources, they also have access to longer-term funds. Secondly, banks have a strategic rationale for investing in private equity and venture capital. This is primarily to find potential banking clients from the portfolio companies of funds in which they have invested.

- 4.6.2 “Between 1983 and 2009, 30% of all U.S. private equity investments (representing over US\$700 billion of transaction value) were sponsored by the Private Equity arm of a large bank. In the aftermath of the 2008 financial crisis, the passing of the 'Volcker Rule' as part of the Dodd-Frank Act required banks to limit their exposure to Private Equity and Hedge Funds to no more than 3% of their Tier 1 capital”.⁶
- 4.6.3 Banks as guardians of depositors’ savings, need to institute risk management safeguards to ensure prudent investing in private equity and venture capital funds.
- 4.6.4 SVF invest primarily in securities or units of social ventures / enterprises thus satisfying social performance norms laid down by the fund. The overall returns of SVF are at two levels, the absolute financial returns which could be marginally muted (i.e. lower than the returns expectations for similar investments), and returns in the form of formation of social capital which is of very high importance to the inclusive growth of the economy.

Recommendations

- I. Lower the risk weight attached to investments in AIFs and increase investment limits for banks from 10% to 20% of the total corpus of an AIF (and to 25% for SVFs).
- II. AIF investments, where the investment objectives are consistent with the needs of the priority sector, should be treated as priority sector investment and not impact the bank's capital market exposure.

Justification

- I. Strategic Benefits: Successful portfolio companies of AIFs can become bank clients.
- II. Risk Management: Investing in AIFs is a risk management tool because they are professionally managed and have a diversified portfolio which is regularly monitored by an external fund manager for value-addition.

⁶ COMBINING BANKING WITH PRIVATE EQUITY INVESTING

Lily Fang, Victoria Ivashina & Josh Lerner, at
<https://www.insead.edu/facultyresearch/faculty/personal/lfang/research/documents/5.CombiningBankingandPEInvesting.pdf>

E. Accredited Investors

- 4.7.1 Not all investors have the capacity, or the risk tolerance for investing in AIFs because they are illiquid, unlisted and closed-ended investment vehicles. Given that SEBI has already introduced the concept of 'Accredited Investors' (AI) in the AIF Regulations for Angel Funds, the concept could be made applicable to all other categories of AIFs with such modifications as may be appropriate. The criteria for AIs may also be based on past tax assessments indicating net worth and annual cash flows being over a defined threshold as is the case in the U.S.
- 4.7.2 Accredited investors should not be required to register with SEBI. AIF Regulations currently require an investor to invest at least Rs. 1 crore in an AIF. This is to ensure that only sophisticated investors invest in such AIFs considering the risk involved in such investments.
- 4.7.3 Globally, instead, the concept of 'Accredited Investors' is applied where an investor who satisfies a certain minimum income, or asset, or net worth thresholds is considered to be an accredited investor and can make such investments. Such investors are usually self-certified, for instance, in countries like USA (Refer Annexure 2 for U.S. law on 'accredited investors').

Recommendations

In line with global practice, it is proposed that the individuals who satisfy the following conditions should be recognised as Accredited Investors:

- I. Capable of identifying the potential investments and its underlying risks.
- II. Possess sufficient financial sophistication to take on the risks associated with the investment offerings.
- III. Have a sound financial track record, i.e. reported total income (including exempt income) exceeding Rs 50 lakhs annually in three assessment years immediately preceding the assessment year in which the investment is proposed to be made.
- IV. It is also proposed to link the Permanent Account Number (PAN) of the investor in the electronic database of the revenue authorities with the total income (including exempt income) of the investor in a manner such that it is easier to determine whether the investor qualifies as an Accredited Investor.

- V. Since the VCF Regulations have been superseded by the SEBI (AIF) Regulations, a similar exemption should be extended to Category I AIF and Category II AIF.

Justification

- I. The concept of Accredited Investors will simplify the process of determining who are eligible investors in AIFs and will be a factor in ease of doing business; and
- II. It will ensure that investors who regard themselves as capable of identifying the risks consistent with their risk tolerance and capacity, consider investing in AIFs.

F. Limited Liability Partnerships (LLPs)

4.8.1 The AIF industry will be more in touch with, and more in tune with the issues of India if a significant fraction of pooled funds are domiciled, structured and raised in India. The current level of domestic investment in AIFs is very low, leading several AIFs not to raise money in India at all. This is very different in a country such as the US, where LLPs are the typical structure for establishing AIFs.

4.8.2 Currently, the Registrar of Companies (RoC) does not allow LLPs to be set up with “investment” in the objects section of the charter documents. The RBI also does not oversee LLPs as they are not companies, even though there are well-defined rules of when a Company is required to register with RBI. The requirement, then, is to cultivate more sophisticated limited partners (LPs) in India, and bring them on the same level playing field as foreign LPs. and formally allow (under Registrar of Companies) proprietary domestic capital to set up an LLP as an investment vehicle.

Recommendation

- I. 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.

Justification

- I. This is essential as it allows a large LP to manage all their costs, gains, losses and risk exposures tax efficiently in one place (across several India investments, for example), while still ensuring that tax disputes do not flow upwards and outwards to their other global activities.
- II. An LLP is the ideal investment vehicle as (i) it is a body corporate from a legal and tax perspective and (ii) it offers one layer of taxation for all partners. Being a body corporate, it also allows the LLP to invest some multiple of its net worth overseas (albeit only in actively managed investments) in a regulated manner as prescribed by RBI.

G. Single Family Offices

- a. Following the liberalization of the Indian economy in 1991, new, professional and established entrepreneurs have created new ventures by harnessing their technical and managerial prowess as well as India's human resource talent. This has created lakhs of jobs and helped grow India's export earnings. At the same time, the value of the assets of successful entrepreneurs has grown manifold. Given their success in India, these entrepreneurs have been willing to deploy and invest their resulting wealth in India.

4.9.2 The primary sources of the entrepreneurial wealth are earnings gained from operating entrepreneurial ventures and from the sale of businesses to other parties i.e. liquidity events. The combined wealth of such successful entrepreneurs is a significant source of domestic capital that can potentially be invested in AIFs. This wealth needs to be prudently invested for inter-generational transfers, and at the same time invested in ventures that benefit the Indian economy, create jobs and promote innovation and creativity.

4.9.3 Some of the ventures of these entrepreneurs have been funded by private equity and venture capital funds. Accordingly, they have a good understanding of the Alternative Investment Fund asset class comprising of venture capital, private equity and social venture funds.

4.9.4 Two important characteristics of entrepreneurial wealth are:

Firstly, being inter-generational in nature, such wealth can be invested in illiquid, long-term asset classes such as venture capital and private equity.

Given the risk-loving nature of the entrepreneurs who created this wealth, they are willing to invest a part of this pool of capital in venture capital and private equity.

Secondly, being entrepreneurs themselves, they have the capability to add value to venture capital and private equity portfolio companies by providing mentorship, business management ideas as well as introductions to their business networks which can contribute in a major way to the success of the portfolio companies of AIFs.

The investment activity of entrepreneurially-created wealth is increasingly managed by Single or Multi-Family Offices. This represents a substantial domestic pool of capital for which the regulatory framework should provide various investment avenues, including AIFs.

Recommendations

- I. Single Family Offices to be allowed to register specified investment vehicles as Qualified Institutional Buyers (QIBs)
- II. Specifically state that Family Offices and dedicated state funded vehicles can be registered AIFs

Justification

- I. Over the past 20 years, several entrepreneurs have established family offices to manage their funds in a diversified and sophisticated way. Their capital needs to be mobilized for investment and development in as many ways as possible. This is similar to the evolution of the venture capital and private equity industry in the United States.
- II. These Family Offices are not recognized as having institutional status, and consequently cannot participate in particular kinds of domestic transactions (e.g. QIP except via retail book) though they can add substantial value alongside AIFs and FVCIs.

H. Non-Resident Indians (NRIs)

4.10.1 Non-Resident Indians have a natural affinity to India. Unlike most other foreign investors, they have additional reasons to invest in India. These include the natural desire to engage with the motherland, utilise personal and business networks in the homeland, take advantage of local language skills and make a contribution to India's businesses and institutions by way

of transfer of knowhow and technical knowledge gained abroad, added innovation, employment and provide mentorship.

- 4.10.2 In recognition of these attributes, the Government of India has from time to time enunciated policies and priorities to attract the savings of NRIs. This section of the report highlights the policy measures needed to attract long-term savings of NRIs into SEBI-regulated Alternative Investment Funds.
- 4.10.3 NRIs have two types of savings for investment in India. These are repatriable funds, i.e. savings which are permitted by RBI to be taken out of India. The other type of savings are non-repatriable funds which cannot be taken out of India.
- 4.10.4 Two issues need to be addressed to provide clarity for NRI investment in AIFs. One relates to the use of NRO funds and the other to the Consolidated FDI Policy, dated 12th May, 2015

Recommendations

- I. Non-Resident Ordinary Accounts: The RBI Notification dated 16th November, 2015 permits NRIs to invest in AIFs using their FCNR and NRE accounts. As there is no mention of NRO accounts in the notification, it is recommended that clarification needs to be provided by RBI that NRIs can make investments in AIFs using funds lying in their NRO accounts.
- II. Section 2.1 of the Consolidated FDI Policy should include a definition of an Alternative Investment Fund in the same manner as it has defined venture capital fund in clause 2.1.42.
- III. Para 3.2.4 of the Consolidated FDI Policy permits investment in venture capital funds structured as trusts. Similarly, in order to enable investment in AIFs through the trust structure, para 3.2.4 should be suitably amended.

Justification

- I. Balances lying in NRO accounts of NRIs are permitted for investment in the stock market under the Portfolio Investment Scheme (PIS) as well as in Mutual Funds. The suggested amendment will help to remove any ambiguity around investment by NRIs into AIFs under the NRO route.

Investment by NRIs (as well as entities majority-owned by NRIs as per Press note 12) investing through the NRO route is to be treated as domestic investment and thus when such entities make an investment in AIF through the NRO route such AIF should not be treated as having foreign investment and be subjected to downstream investment conditions, even if the manager or the sponsor are foreign owned and controlled.

- II. In the Consolidated FDI Policy, the definition of AIFs should be provided as currently there is no mention of Alternative Investment Funds (AIFs) in the Consolidated FDI Policy dated 12th May, 2015.

The trust structure of AIF's should also be permitted for investment through the automatic route. Paras 3.2.3 and 3.2.4 of the FDI policy have different and inconsistent policies depending on the structure of a fund, namely whether a fund is set up as a company or as a trust. These policies should be harmonised. Specifically, the policy is more burdensome if a fund is established as a trust because the policy then mandates that FIPB approval is required, when for ease of business, it ought to be under the automatic route.

- III. NRIs are a natural and mostly professional, pool of investors to attract. Ease of doing business will be considerably enhanced if the automatic route is made applicable.
- IV. Offer NRIs a wider array of investible instruments, including AIFs.
- V. Additional long-term savings of NRIs could be attracted into AIFs which will help grow long-term investments into a wide variety of sectors in which AIFs invest.
- VI. Currently, under the Foreign Exchange Management (Transfer or Issue of Security by a Person Resident outside India) Regulations, 2000 (TISPRO Regulations), investment by NRIs on non-repatriation basis is dealt with separately under Schedule 4 Press Note 7 of 2015, dated 3 June, 2015 issued by DIPP, Ministry of Commerce states that, for purposes of FDI Policy, investment by NRIs under Schedule 4 of FEMA (TISPRO) Regulations will be deemed to be domestic investment at par with investments made by residents.

I. Foreign Venture Capital Investors (FVCIs)

FVCI are mainly overseas pension funds, endowment fund, sovereign wealth funds and insurance companies. They are permitted to invest in India under the FVCI regime, which has been in existence for the past 15 years.

FVCI is principally governed by three sets of regulations:

- I. SEBI registers Foreign Venture Capital Investors (FVCIs) and regulates investments by FVCIs in India under SEBI (Foreign Venture Capital Investors) Regulations, 2000 (FVCI Regulations). FVCIs are investors incorporated and established outside India investing primarily in venture capital undertakings in India either directly or through venture capital fund(s)/alternative investment funds.
- II. RBI through Schedule 6 of the Foreign Exchange Management (TISPRO) Regulations, 2000, also regulates the flow of capital through the FVCI route. Infrastructure is one among 10 sectors in which RBI has permitted investment under the FVCI route.
- III. The Consolidated FDI Policy requires FVCI investors to obtain specific approval of the Government for each investment in an AIF.

Benefits of FVCI

- I. FVCI are covered in this report because they are potentially a large source of long term capital. As on 30 September 2014, there were 197 FVCI registered with SEBI with a cumulative capital of Rs. 42,2776 crore. Further FVCI investment in the infrastructure sector as on 30th September 2014 amounted to more than Rs. 20,000 crore i.e. nearly half of the total cumulative net investment by FVCIs in India. Major investment by FVCI in the infrastructure sector is in power, telecom, roads, bridges, and urban infrastructure.
- II. FVCI and AIFs are interlinked in that FVCI investors should be able to invest in AIFs which are regulated by SEBI. As many FVCIs are highly experienced venture capital and private equity investors, their direct presence in an Indian AIF has a positive demonstration effect. Such FVCI investment in AIFs, will be a source of confidence amongst domestic investors who have limited experience in these asset classes. This, in turn, will help attract domestic investors, including pension funds, into AIFs as well as assist in the growth of domestic fund managers. Ultimately, the pool of domestic capital for domestic investment through AIFs will rise thereby making available more stable capital for domestic enterprises.

- III. Private equity and venture capital are long-term stable capital. In recent years, they have been the only form of long term capital available to start-ups or growth companies, or infrastructure projects. This is potentially a significant source of capital for ventures and projects in India and India should have a regulatory framework that makes it easy for FVCIs to invest in India. Unlisted companies do not have access to the stock market, but can raise capital from FVCIs.
- IV. This form of capital is vital to make a success of India's 'Make in India' program. Ultimately, the development and growth resulting from FVCI leads to greater employment in portfolio companies.
- V. FVCI investors require the highest standards of corporate governance in portfolio companies which is consistent with the objectives of various regulators like SEBI, RBI and the various Ministries.

The FVCI regime has been in existence for 15 years. Market participants are now familiar with the procedures involved. Hence, it should continue with further improvements in the regulatory landscape covering FVCI. FVCI investment should be welcomed in all categories of AIFs. All AIF categories are regulated by SEBI and have the necessary checks and balances.

Reforms Needed in the FVCI Regime

a) Choice of Investment Structures to be liberalized

Several FVCIs are a part of large substantial pools of capital running into billions of dollars. It is quite normal for various arms to employ different investment strategies and deal and fund formation structures. FVCIs should be permitted to invest in AIFs via any structure, namely trusts, LLPs, company or body corporate which they consider suitable.

Across the world a variety of fund formation structures have been employed to channel private equity and venture capital for decades. All these methods of fund formation should also be available in India, thereby making India a jurisdiction, which is investor, including FVCI, friendly.

b) Sector Restrictions to be liberalized

It is recommended that restrictions placed by RBI limiting FVCI investments to only 10 sectors should be removed. The rationale for this is that almost every significant sector of the Indian economy is in need of private equity

and venture capital and hence a wide array of sectors should be accessible to FVCI investors. This is consistent with the 'Make in India' policy. If the Government so wishes, there can be a small negative list but this should be very narrow so that significant long term stable capital flows are not restricted, but instead should be welcomed.

c) Continuation of benefits under the current framework

The existing benefits offered to FVCIs should continue. This was also suggested by the June, 2013 K M Chandrashekhar Committee report titled 'Rationalisation of Investment Routes and Monitoring of Foreign Portfolio Investments'.

The rationale is principally twofold:

Firstly, any perception that the country is backing down on previous arrangements may not be viewed favourably amongst the domestic and global investment community. This may ultimately hurt the investee companies, which need long term capital.

Secondly, the benefits are not of a tax nature, and hence have no adverse effect on the tax revenues of the country. On the other hand, a more liberal FVCI regime would help attract more capital, leading to more growth at the investee company level ultimately leading to higher tax revenues to the nation.

The Pricing Benefit: FVCIs may acquire by purchase or otherwise or sell shares/convertible debentures/units or any other investment held by it in the VCUs or VCFs or schemes/funds set up by the VCFs at a price that is mutually acceptable to the buyer and the seller/issuer.

A price which is mutually acceptable to a buyer and a seller is ultimately the basis of a sound valuation. Such valuations are usually backed by a formal valuation analysis of the two parties. Accordingly this system of valuation applied to FVCI should continue.

d) Automatic Route

Given the benefits of FVCIs highlighted above, the FDI policy should allow investment vide an automatic route, subject to compliance with SEBI's AIF regulations.

e) FDI policy to permit FVCI investment under the 'automatic route'

Recommendations

- I. A general permission should be provided under the FDI Policy enabling investments by FVCI in all AIFs (including AIFs set up as trusts) under the 'automatic route'.
- II. Remove RBI's 10 sector restrictions.
- III. Institute a single-stage approval of FVCI at the level of SEBI-approved Designated Depository Participant (DDP) on behalf of SEBI as is the case with FPIs.
- IV. The existing benefits offered to FVCIs should continue. This was also suggested by the June 2013 K M Chandrashekar Committee report titled 'Rationalisation of Investment Routes and Monitoring of Foreign Portfolio Investments'.

Justification

- I. FVCIs are a large pool of offshore capital, which can boost the Indian fund management industry. Alignment: Many FVCIs would prefer to invest in a domestic AIF since local investors have 'skin in the game'. The presence of FVCIs will also be a confidence booster for domestic investors of AIF. Potential increase in employment in several sectors. Single-stage approval by DDPs will substantially ease the doing of business by FVCIs in India.
- II. Risk capital is needed not just by 10 sectors but by almost every sector of the Indian economy.

J. Initial Public Offerings (IPOs)

IPO treatment for AIFs

Most IPOs have a restricted allocation for equity mutual funds. Furthermore, mutual funds are currently allowed to anchor an IPO, even if the lead manager is a group company. As per SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009, SCHEDULE XI (point 10(k)), neither the merchant bankers nor any person related to the promoter/promoter group/merchant bankers can apply under anchor Investor category in a public issue. The only exception given by SEBI is for mutual fund entities related to merchant banker.

Recommendations

- I. Allow all AIFs to get an allocation in an IPO.
- II. AIFs to be allowed to anchor an IPO, even if the lead manager is a group company.

Justification

- I. Providing equal treatment for AIFs with mutual funds will allow for greater capital flows in to AIFs.
- II. Investing a proportion of committed capital in listed companies is common in the global private equity and venture capital industry.
- III. Since AIFs are professional investors, their anchor investors in IPOs will provide confidence to other investors.
- IV. AIFs are long-term investors, which may limit price volatility post-IPO.

K. Angel Investments

1. Recognition and promotion of early stage investors such as angel investors / venture funds is critical, and providing them a conducive environment will encourage them to channel more funds to Indian entrepreneurs and behind them, FDI / overseas monies will flow.

At the very early / start up stage of a venture, equity investment is the riskiest and most critical source of funding. Angel Investors are successful entrepreneurs who are willing to invest their own savings in such risky ventures and also help start-up ventures with mentoring, strategic and operational inputs, and providing access to their business networks are the first and most critical investors in a start-up enterprise.

2. Most governments around the world (UK, USA, Singapore, etc.) provide incentives such as recognition, tax credits up to 50%, tax pass-through LLP structures to enable a large group of individual angels to invest together. The Government of India should provide the same.

This will help create a large base of angel investors. The importance of angel investors is evidenced by the fact that in a typical year in the USA, angels invest around US\$25 billion in around 50,000 companies and VCs invest about the same in about 5000 companies. In India, we have under 1000 angel investors, investing barely \$20 million.

- U.S. allows accredited investor angel investors to write off their losses against their gains.
- UK provides the Enterprise Incentive Scheme and the Small Enterprise Incentive Scheme allowing angel investors to write off losses up to 50%.
- Singapore's Angel Investors Tax Deduction Scheme is a tax incentive which aims to stimulate business angel investments in Singapore-based start-ups and encourage more angel investors to add value to these.

3. Angel Funds

SEBI has done an admirable job of trying to solve the problems created by Section 56 (2) (vii b) of the Income Tax Act which taxes investment in a company made above the Fair Market Value by creating a new category of AIF Category I for Angel Groups. While not optimal (angel groups are not regulated anywhere in the world), this route can be utilized by angel groups with the below recommended changes.

- i. The stipulation that angel investors must remain invested in a company for a minimum of 3 years should ideally be removed (AIF Category 1 Funds do not have it) or at least be brought down to one year, if at all a minimum holding period is required.

This is onerous and, in fact, counterproductive for the investee company's interests as many companies that receive angel investments (especially those that are doing well) need more money within 12 to 24 months. Most VCs who are willing to make larger investments insist that they clean out the earlier shareholding and buy out the angel investors as they do not want the clutter of 30 or 40 angel investors to deal with. The other source of capital is from corporates (investment or acquisition) who also want to buy out the angels for the same reason. This 3 year lock in may, therefore, deny a company the funds it desperately needs and that would be detrimental to its interests.

Angel Investors, on their part, would like to exit when they can, and then invest in the next start up. Most of them have a certain amount of money earmarked for angel investments and if they cannot exit their current holdings, they will not invest in new companies. This lock in will therefore be counterproductive to the objective of breeding more start-ups.

Also, exiting angel investments is a difficult and delicate affair and lockins will make the process sub-optimal for investors. Such liquidity and circulation of capital can also be facilitated if the investments of some angels are acquired by other angels in the same group, depending on their interests and financial capabilities.

If there are compelling reasons why this lock in provision cannot be removed entirely or reduced to one year, then an alternative route would be to insert a proviso to regulation 19F(3) of the AIF Regulations as follows:

Provided that an angel fund could transfer its investment before the completion of the three year lock-in period to:

- any SEBI registered fund;
- any overseas fund/investor which is either an appropriately regulated entity;
- an overseas fund whose investment manager or parent company is appropriately regulated;
- a strategic buyer being a body corporate, incorporated in India or overseas: and
- any other investor in the angel fund.

Explanation: For the purposes of this clause, an overseas fund / investor shall be considered to be "appropriately regulated" if it is regulated or supervised by a market regulator or the banking regulator of the concerned overseas jurisdiction.

- ii. The provision that each angel investor needs to invest Rs. 25 lakh over 3 years should be allowed for the life of the fund, or at least raised to 5 years for the following reasons:
 - This will be impractical because though an investor may wish to do so, he may be unable to do so as the network /angel group may simply not be able to offer sufficient number of investment opportunities in the angel investor's area of interest.
 - Also, most angel groups rules allow investors to share the investment on a *pari passu* basis. Therefore, an individual member may make a number of investments but, because they tend to be over 30 or 40 investors in each investment, he may not reach Rs. 25 lakh in 3 years.
 - There would be periods when there would not be enough opportunities due to reasons of macro-economic outlook. Slow growth economic trends do not provide a conducive environment for high growth companies.
- iii. The provision that the angel fund needs to invest a minimum of Rs. 50 lakhs in a company should be brought down to Rs. 25 lakh, as this will encourage start-ups.
- iv. AIF Regulations be amended to allow a scheme to have a maximum of 200 investors.

Currently, no scheme of the angel fund shall have more than 49 angel investors. This provision was inserted to be in-line with the Companies Act, 1956 wherein, over 50 investors in a company would make it deemed public. Since this provision has been changed in the Companies Act, 2013 to 200 shareholders, we would

request that the AIF Regulations be amended to allow a scheme to have a maximum of 200 investors.

- v. The provision that angel funds shall invest only in venture capital undertakings which have been incorporated during the preceding three years from the date of such investment. This should be modified to allow at least 10% of the angel fund's portfolio investments to be companies that may be more than 3 years old.

Often an investee company comes up with a new idea or product after 3 years of its incorporation but the entrepreneurs don't set up a new company for the new idea/product to avoid incurring additional costs and do it within the existing company (this is also because closing a company is a very tiresome and complex process). In such a situation, an angel fund shall not be able to invest in such idea/product, which is a detrimental regulation.

It is, of course, assumed that this clause shall not restrict a further investment in the same company, if the first investment has taken place as per norms.

- vi. Angel funds should also be allowed to invest in overseas venture fund undertakings, the same percentage of their corpus as other AIF I categories.

Angel Investors who invest at the highest risk level of a venture fund risk mitigate their investments through various means. One way of spreading the risks is by investing across geographies. We would recommend that similar to other venture funds under Category I, angel funds should also be allowed to invest the same percentage of their corpus in overseas venture fund undertakings as in venture funds. The venture should ideally have an India connection.

Private Placements of Small Ventures

Rule 14(2)(c) of Chapter III of the Companies Act, 2013 states that a private placement shall not be for an investment size of less than INR 20,000 of the face value of the securities ("**Minimum Investment Size**"). Issuance of shares with a high face value is unduly onerous for start-up companies, is entrepreneur unfriendly and forces a start-up to issue Rs.20, 000 worth shares at par to any investor, when the investor is willing to pay a premium.

Recommendations

- a. The process should be simplified. For example, the requirement of issuing an “offer letter” for a preferential issue should be done away with at least for private companies, as in any case persons who invest in a private company would conduct their due diligence since there is no free market for the securities of a private company unlike a listed company.
- b. To comply with the above, companies need to increase their authorised capital which entails unnecessary expense to companies.
- c. The minimum investment size requirement serves no purpose and instead just adds an unnecessary restriction/compliance requirement for companies desirous of raising capital. It should be deleted.

Promoting Onshore Fund Management in India

A. Introduction

- 5.1 Currently, approximately 95% of venture capital and private equity capital is contributed by overseas investors, and given the paucity of a domestic investor pool, overseas investors will continue to be major contributors to venture capital and private equity in the foreseeable future. The majority of overseas investors (98% of total foreign VCPE capital) and their venture capital and private equity fund managers prefer to domicile their funds in countries with stable and favourable tax and regulatory regimes on fund management.
- 5.2 Offshore funds typically invest in Indian companies through India's Foreign Direct Investment (FDI) or the Foreign Portfolio Investor (FPI) routes rather than establishing domestic funds domiciled in India. This is because their FDI and FPI regimes are considered to be far more consistent in contrast to the changing tax and regulatory regimes specific to VCPE Funds in India. Since such fund vehicles are domiciled offshore, they do not fall in the ambit of SEBI's regulatory regime for Alternative Investment Funds.
- 5.3 The majority of offshore venture capital and private equity funds are managed by fund managers located outside India. The key question is why is the current regulatory and tax regime driving more than 95% of venture capital and private equity fund managers overseas and causing more than 95% of the India focused VCPE funds to be domiciled overseas. This is because, albeit inadvertently, the current regulatory and tax regime is severely disadvantageous to fund managers domiciled in India, resulting in the exodus of the fund management industry to foreign shores.
- 5.4 The two major factors which have led to this situation are (i) the lack of tax clarity and (ii) severe restrictions on the operational freedom of fund managers domiciled in India. These reasons are critical to the extent that it puts the economics of an entire fund under peril, if domiciled in India. Therefore, fund managers who would have otherwise preferred to domicile in India, have been forced to setup their operations overseas.
- 5.5 India needs to create a level playing field between fund managers domiciled in India and those located offshore, which is not the case in India currently. A level playing field will help India realize the multiple benefits of attracting VCPE fund managers to India.

B. Tax Clarity

- 5.6 An ideal tax and regulatory framework should have features which enable India focused fund vehicles to be pooled or located in India and fund managers, who manage these funds, to operate locally. This model of funds and their management established in local jurisdictions is common among developed economies. This, in turn, contributes to a thriving venture capital and private equity industry. More to the point, many progressive economies have proactively taken measures to attract venture capital and private equity managers to their host jurisdictions for the obvious reasons of the beneficial impact on their economies – creation of a robust eco-system to boost entrepreneurship, creation of jobs and increased GDP growth.
- 5.7 The suggestions and recommendations made in this chapter are easily implementable, transformative in nature and should trigger the growth of a vibrant venture capital and private equity industry in India. These can lead to benefits to India in the shape of growth in annual tax revenues for the exchequer. Accordingly, the recommendations should be implemented on a priority basis. Transformative steps which would encourage venture capital and private equity funds to be domiciled in India would be to:
- a. Create parity between Indian regulations and those offshore and with their respective double taxation avoidance agreements (DTAA).
 - b. Allow foreign investment from international limited partners directly into domestic alternative investment funds (AIFs) by bringing changes to the foreign exchange regulations (FDI policy/FEMA) and the policy on tax deducted at source.
 - c. Create a level playing field between the fund managers domiciled in India and those located offshore, which is not the case in India currently.
 - d. Enable more foreign funds to be domiciled in India and brought under the purview of SEBI by ensuring clear policies and their consistent application over the entire life of fund vehicles. The STT based regime has been in vogue for a decade in India and is a time-tested method of taxation, which ensures easy and efficient collection of taxes at source. STT reduces the compliance burden on the funds to a great extent and ensures upfront collection of taxes to the revenue. STT could be levied on both entry as well as exit from Funds. STT would also reduce the scrutiny burden of the revenue authorized and consequent reduction in the litigation.

- e. Prior to the introduction of an STT regime, as an interim measure, it is recommended that CBDT immediately clarifies that exempt income flowing through AIFs should not suffer any withholding tax.
- f. Amend the safe-harbour norms for ease of doing business

5.8 The committee has worked with a solution-finding approach and has evolved a set of recommendations that would enable and encourage onshore fund management. The two must-do items that would greatly help the cause are a) tweaking 'Safe harbour' norms and b) implementing the STT approach to taxation on investments / distributions by Indian AIFs.

5.9 In making its recommendations, the committee has taken cognizance of all the stakeholders and has tried to evolve a 'win-win' solution. For the Government, this would result in robust direct/indirect tax collections, creation of more jobs, and acceleration of GDP growth. For SEBI, all alternative assets would come under its supervision; equity markets would be able to attract stable and deeper investment base. SEBI would be the key enabler of increasing domestic participation in venture capital and private equity, and there would be complete oversight on any systemic risk possibilities. For the tax authorities, the STT approach to taxation is superior to the 'tax pass-through' approach and would result in less litigation while still maximizing tax revenues and availability of full audit trail.

5.10 The government should attract as much venture capital and private equity capital into India as possible, by creating enabling regulations. One of the key benefits of such capital inflows for India would be higher tax revenues for the government. To put the revenue generation potential of venture capital and private equity capital in perspective and help policy makers in the Revenue Department take a macro-view while formulating/evolving tax policies governing this asset class, the committee analysed the various sources of revenue.

5.11 The study clearly indicates that the potential for generating the largest amount of revenue lies at the portfolio level i.e. with venture capital and private equity backed companies and not at the venture capital and private equity fund vehicle or fund managers themselves. Thus, it is estimated that VCPE backed portfolio companies could potentially generate 85% of taxes on a recurring basis annually. Fund managers could generate 10% of recurring

taxes annually, and the remaining 5% from venture capital and private equity funds in the form of non-recurring capital gains tax over a fund life of 10 -12 years.

- 5.12 Simple, litigation-free tax regime through levying Securities Transaction Tax (STT) on investments and distributions of AIFs can be a game changer in enabling localization of funds and their management in India. The STT approach envisages that AIFs will discharge the tax liabilities of overseas Limited Partners (LPs) and distributions made to foreign LPs if tax free. A tax regime where tax filing and payment obligations of foreign investors are discharged by domestic AIFs will provide comfort to large foreign LPs and enable them to boost their allocation of capital to Indian AIFs. More than 95% of investors in Indian VCPE asset class are overseas investors who do not have any business activity in India apart from investing in India-focused VCPE funds. A simple unambiguous tax regime, akin to the STT approach, will persuade them to directly participate in Indian AIFs, and is clearly the ideal tax framework to facilitate the participation of foreign LPs in AIFs domiciled in India.
- 5.13 Following the major policy initiative of the Government to “Make in India”, a suitable policy framework would enable venture capital and private equity funds to “Manage in India”. Also, it makes tremendous economic sense to attract the fund management industry onshore by crafting an appropriate regulatory framework. Taking cognizance of this, the current government has, with best intentions, attempted to correct certain anomalies by introducing “Safe Harbour Provisions”. However, the benefits under these new provisions are available upon satisfying several stringent and impractical conditions by the venture capital and private equity industry.
- 5.14 Since these issues strike at the very survival of fund managers and the viability of venture capital and private equity funds, unless the current Safe Harbour Provisions in section 9A of the Income Tax Act are amended to address these issues clearly and with certainty, fund managers are not expected to shift their operations to India. By tailoring “Safe Harbour Provisions” to the special characteristics of venture capital and private equity funds, the conditions can be created for fund managers to shift their operations to India. This can lead to benefits to India in the shape of growth in annual tax revenues for the exchequer. The proposed amendments in the safe-harbour regime are contained in the chapter titled ‘Creating a Favourable Tax Environment’.

C. Operational Freedom for Domestic AIFs

5.15 Approach to Investor Protection:

The other major challenge that any fund manager looking at domiciling in India faces is the extent of operational freedom they have always enjoyed operating offshore. Such investors protect their interests by embedding the principle of 'alignment of interests' in stringent contractual arrangements with fund managers. The regulatory framework in India should aim to achieve parity with the level of operational freedom available to fund managers in international markets in order to increase the inflow of private equity in India.

5.16 Piggyback on Conditions Negotiated by Sophisticated Offshore Investors:

An emerging domestic-investor-base in India is keen on co-investing with large and global institutional investors in domestic Alternative Investment Funds. Encouraging domestic participation in the venture capital and private equity asset class is also a stated objective of the Government. If the current AIF regulations provide provisions for large sophisticated domestic investors to piggyback on the same protections negotiated by sophisticated offshore investors, SEBI could be the key enabler of promoting domestic participation in this key long term asset class.

5.17 Disclosure-based Approach:

In the case of venture capital and private equity funds that only raise capital from sophisticated offshore/large domestic investors, a disclosure-based approach should take precedence over investor protection. To manage systemic risk, regulators should be able to clearly monitor and seek appropriate disclosures. Such an approach to regulating AIFs where investor protection is the responsibility of sophisticated investors themselves, whereas disclosures and monitoring is the central focus of the regulator is prevalent in developed economies.

5.18 Parity in Operational Freedom for Domestic Fund Managers with Offshore Managers:

To encourage fund managers to relocate to India, SEBI needs to evolve a regulatory framework that imparts the same operational freedom to onshore fund managers that is available to offshore fund managers, while not compromising on its mandate. If such a framework is evolved, the majority of

venture capital and private equity capital that is currently not under the ambit of SEBI will come under it, thereby allowing SEBI to exercise better oversight of this asset class.

5.19 Offshore Portfolio Companies:

It has been observed that of late some Indian promoters prefer to domicile their companies in offshore jurisdictions (externalizing ownership). This trend is being observed in the technology and e-commerce space. The benefits of such offshore domiciliation are IP protection, ability to attract global venture capital, and the ability to list in international markets such as NASDAQ, NYSE, and AIM. These markets have greater depth and pools of capital, which enable large IPOs, including billion dollar IPOs to be absorbed by international investors. Currently, venture capital funds which are structured offshore have the flexibility to invest in offshore structured portfolio companies. AIFs need parity in this regard.

5.20 As per the current procedure followed by SEBI, an AIF can invest up to 25% of the corpus in overseas entities provided an 'India connection' is established between the offshore entity and an India entity. India focused funds domiciled offshore can invest in offshore entities without any such regulatory permission from SEBI. Also, high quality deals have high competition among the funds and AIFs regulated by SEBI should be able to compete with offshore funds in capturing these high quality deals. In view of this, the 'India connection' requirement has to be liberalized and also the fact that AIFs are domiciled in India and regulated by SEBI prove the India connection. Eventually, this will pave the way for Pan-Asia focused funds to be pooled as AIFs in India similar to the manner in which funds are pooled offshore.

5.21 It is recommended that AIFs be provided the freedom- like India-focused offshore funds to invest in offshore portfolio companies / entities to the extent of 25% of the corpus of an AIF (currently provided by SEBI) or 50% of the offshore component of the corpus of the AIF, whichever is higher. SEBI's requirement of 'Indian connection' should be liberalized. Investment from an AIF in itself should be regarded as satisfying this criteria.

D. Withholding Taxes on Income Distributed By AIFs – Undue Hardship

The Finance Act, 2015 brought in significant amendments in relation to Category I and II Alternative Investment Funds (AIFs). The amendments took into consideration

the long-standing demands of the industry to extend the pass-through status to AIFs. However, the amendments also introduced a tax deduction at source (TDS) of 10 % on income distributed by the Funds to its investors. While the intent of the said TDS provisions seem to be to ensure collection of taxes at source, it is important to understand the issues arising and its effect on investors.

1. Gross versus Net Income

As per section 194LBB of the Income-tax Act, 1961 (IT Act), wherein any income, other than income in the nature of profits and gains of business or profession is payable to a unit holder of Category I and II AIFs, then such income shall be subject to TDS at the rate of 10% at the time of credit of such income to the account of the payee, or at the time of payment, whichever is earlier.

The term “Income” has been defined under Section 2(24) to include profits and gains from business or profession, dividends, capital gains etc.

The language of the section is ambiguous and does not explicitly state whether the taxes need to be deducted at source on gross amounts distributed by the Funds, or on net income chargeable to tax. A plain reading would suggest that the withholding taxes should apply on net income chargeable to tax as the definition of income refers to income computed under the respective heads of income such as a capital gains, profits and gains from business or profession etc. However, in the absence of an explicit clarification, AIFs are in a quandary to decide on whether to deduct on gross or net distributions.

2. Exempt Income

The TDS provisions also pose a unique problem on exempt income such as long term capital gains under section 10(38) of the IT Act and Dividends under section 10(34) of the IT Act distributed by AIFs. The cardinal principal of taxation is that there should be no tax on income which is exempt. Any application of TDS provisions on such exempt income would make the exempt income suffer taxes, albeit temporarily. The taxpayer would be free to claim a refund of such taxes ultimately. However, until the refund is claimed and processed, the exempt income would have suffered a tax of 10%.

Similarly, the taxpayer himself may be eligible to claim exemption under specific provisions of the IT Act or the Double Taxation Avoidance Agreements (DTAA) namely, pension funds, offshore tax residents etc. However, the withholding tax provisions do not provide any exception to taxpayers who are exempt from taxes,

thus leading to a scenario wherein, the taxpayer will have to resort to claiming refund of the taxes deducted at source by filing a return of income.

AIFs are permitted to invest in the units of other AIFs. If a Category I or II AIF invests in another Category I or II AIF, then, the same income may be subject to withholding taxes twice.

3. The adverse tax impact of charging withholding taxes on exempt income has been detailed in the table below

Considering the hypothetical case of an AIF with assets under management of Rs. 1000 crore which results in a gain of Rs. 700 crore over a period of 6 years. (1.7x is average multiple), the table below captures the adverse tax impact of withholding tax:

Exhibit 5.1: Withholding Taxes Higher than Actual Tax

S. No.	Particulars	Net Income Basis	Gross Income Basis
1	Initial investment	1,000	1,000
2	Total realisation after 6 years	1,700	1,700
3	Investment break up		
	a) Investment in listed companies	400	400
	b) Investment in un-listed companies	300	300
	c) Investment in un-listed companies	300	300
4	Realisation on exits		
	a) from listed exits of 3(a)	750	750
	b) from exits of 3(b)	650	650
	c) from exits of 3(c)	300	300
	d) Total	1,700	1,700
5	Book Gains from exits		
	a) from 3(a)	350	350
	b) from 3(b)	350	350
	c) from 3(c)	0	0
	d) Total	700	700
6	TDS made under Section 194LBB @ 10 percent on 5(d)	70	
7	TDS made under Section 194LBB @ 10 percent on 4 (d)		170
8	Capital Gains as per IT Act		
	a) from 3(a)	Exempt	Exempt
	b) from 3(b) considering indexed cost 50%	200	200
9	Actual tax as per Income Tax @20%	10	10
10	Tax refund (7) – (9) being excess deduction	60	160

Indian Rupees in Crores

It may be noticed from the above, that the fund manager would deduct TDS under section 194LBB at 10 % on whole of the income distributed of Rs.1, 700 crores, rather than the taxable income of Rs. 50 crores, taking a conservative view, considering the rigorous penal consequences and prosecution for non-compliance of TDS provisions under section 276B and 201 of the IT Act.

Even if the fund manager were to deduct TDS under section 194LBB at 10 % on the whole of the book income of Rs. 700 crores, the TDS would be significantly higher by Rs. 60 crores as against the actual tax liability.

Hence, the fund manager will end up deducting taxes (about 6 times more than what is actually required) leading to tax refunds for the investors. Further, this affects the fund's distribution to its investors and diluting the IRR.

4. Limited life of AIF

Typically, AIFs are setup with limited life of 8 – 10 years. Where the AIF withholds taxes as detailed above, a significant amount of the taxes paid would be blocked as refund claims which may extend beyond the life time of the AIF, thus causing undue hardship to the AIF and its investors.

5. Lower withholding of tax

The IT Act provides for a mechanism under section 197 whereby, the Assessing Officer upon application by the assessee, issues a nil withholding / lower withholding certificate. However, the certificate under this section can be issued only towards withholding under specified section which does not include section 194LBB of the Act. Even if the section were to be amended, the process of obtaining a nil withholding / lower withholding certificate would itself be cumbersome to the investors as each investor will have to apply and obtain a certificate and the Fund will have to administer the distributions differently for each and every investor.

6. Implications of withholding tax by foreign entity when it buys assets of AIF

It may be noted that, in the case of the unlisted exits made by AIFs, the acquirer in most cases will be a foreign entity and as a precautionary measure, such foreign entity withholds tax from the sale proceeds. This, in turn, affects the fund's distribution to its investors and causes substantial stress on the IRR as the investor which is computed on the basis of cash flows.

Recommendations

- Based on the above analyses, it is recommended that the withholding tax on distributions made by the Fund be abolished, since the investors are subject to tax directly on the income so distributed.
- The AIF regulations prescribe minimum investment by each investor and a vast majority of the investors are sophisticated / accredited investors such as banks, insurance companies, high net worth individuals etc. Where the TDS provisions cannot be abolished, the following proposition could be considered:
 - The sophisticated / accredited investors could be excluded from the applicability of TDS based on a self-declaration of their status and taxability of the income distributed by the Fund in their hands;
 - Non-resident investors who are already subject to the rigour of section 195 could be excluded from the applicability of section 194LBB of the Act; and
 - Provide clarification that the TDS will apply only on net income that is chargeable to tax in the hands of the investors after considering the benefits under applicable DTAA.
- As depicted in Exhibit 5.1 above, it may be noted that the taxes deducted at source is higher than the actual tax in any scenario. Consequently, as an alternative, the TDS rate can be reduced to 2% of the net book income instead of the current rate of 10 per cent.
- Alternatively, the current Venture Capital Fund / AIF tax regime could be replaced with a Securities Transaction Tax (STT) based regime. The STT based regime has been in vogue for a decade in India and is a time tested method of taxation which ensures easy and efficient collection of taxes at source. STT reduces the compliance burden on the Funds to a great extent and ensures upfront collection of taxes to the Revenue. STT could be levied on both entry as well as exit from Funds. STT would also reduce the scrutiny burden of the revenue authorized and consequent reduction in the litigation.

E. Securities Transactions Tax (STT) Method of Taxation

– A New Approach

The tax treatment of Venture Capital Funds (VCFs) and Alternative Investment Funds (AIFs) (collectively referred to as 'Funds') has had a chequered history. The tax treatment of investments made by VCF and Private Equity Funds [now categorized as Alternative Investment Funds (AIF)] has drifted away from a stable non-

controversial regime to a complex, litigation prone regime. The complexity and the issues involved in the tax regime has discouraged the fund managers from setting up Indian pooled funds i.e. funds domiciled in India. To address the issues, we suggest an alternative approach which entails the levy of a Securities Transaction Tax (STT).

The STT method of taxation has various advantages. It ensures the timely collection of taxes at source; reduces the compliance burden on the tax payers; reduces the need for scrutiny of tax returns filed by taxpayers and should raise tax revenues. Consequently, the STT method of taxation is a compelling proposition which addresses the concerns of the VCF / AIF industry. Summarized below are the implications under the current tax regime as well as the proposed STT regime.

Implications – Fund	Implications – Investors	Implications – Revenue Authorities
<u>Current Tax Regime</u>		
<ul style="list-style-type: none"> • Onerous and ambiguous on provisions relating to Tax Deduction at Source (TDS) • Ambiguity on whether TDS needs to be made on gross or net income; whether TDS has to be made on income chargeable to tax i.e., exclude exemption income from the ambit of TDS. • Funds required to issue / file <ul style="list-style-type: none"> - Return of income - Form 64A and 64B detailing the income distributed by the Fund. 	<ul style="list-style-type: none"> • Investors have to file a return of income and claim refund irrespective of whether such income is taxable or not. • Blocked TDS claim on exempt income creates unnecessary stress on the working capital. • Increased scrutiny may lead to increased scope for litigation as to taxability of capital gain even though such gains may be protected under the Double Taxation Avoidance Agreements (DTAA). 	<ul style="list-style-type: none"> • Increased scrutiny of returns filed by the Fund and the Investors of income and TDS adds to the administrative burden of the revenue authorities in scrutinizing returns containing exempt income. • Administering tax credits and ensuring that the Form 26AS credits match with the credits claimed by the investors, adds to the existing reconciliation of mismatches between TDS claims and Form 26AS.

Implications – Fund	Implications – Investors	Implications – Revenue Authorities
<p>- Quarterly TDS returns</p> <ul style="list-style-type: none"> • Investors would suffer TDS on all income distributed by the Fund, thereby resulting in tax on exempt income as well. Refund claims of the investors would be blocked until the refund is paid thereby resulting in a sub-optimal return on capital on investments from the Fund. • Scope for litigation on account of ambiguity in the law. • Administrative inconvenience for the Funds as they would need to continue to exist for the purpose of realizing refund claims and completing assessment proceedings notwithstanding the fact that most funds are setup with a limited life. 		<ul style="list-style-type: none"> • Revenue leakage on account of interest on refunds which was never to be charged. • Increase in litigation leading to poor tax collection and inefficient utilization of tax authorities in fighting tax battles.

Proposed STT Regime		
<ul style="list-style-type: none"> • STT could be levied on entry as well as exit from the Funds resulting in increased tax collection. • Improves ease of doing business since filing returns and claiming refunds would not be needed. 	<ul style="list-style-type: none"> • Investors receive tax free income as the income would have suffered STT at the source itself. • Scrutiny of return of income filed by the investors would reduce to a great extent on account of exemption thereby reducing the compliance burden of the investors. 	<ul style="list-style-type: none"> • The STT method ensures timely collection of tax at source. • Interests of Revenue is protected and considering the average return on investment, levy of STT would be beneficial resulting in higher levy of taxes (refer Exhibit 5.4).

Implications – Fund	Implications – Investors	Implications – Revenue Authorities
<ul style="list-style-type: none"> • Reduces compliance burden to a significant extent as compliance will be reduced to STT alone, and filing an exempt income return (if prescribed). • Reduced compliance increases the ease of doing business. • Funds are not blocked in the form of refunds thereby ensuring returns are not sub-optimal to the investors. 	<ul style="list-style-type: none"> • No working capital stress as funds would not be blocked as refunds. • The STT regime would ensure that there is no scope of litigation. 	<ul style="list-style-type: none"> • Upfront collection of taxes on entry and collection of taxes as well as on exit, irrespective of whether the investment has generated income chargeable to tax. • Enables Revenue to collect taxes on a wider tax base which would include exempt as well as taxable income. • No assessment of investors' income and consequently significant reduction in litigation.

Background

- 5.22 While the AIFs have been providing the much needed risk capital, the tax and regulatory environment in which they operate is increasingly becoming more and more complex and litigation prone. In comparison, the tax treatment of Foreign Portfolio Investor (FPI) investments has been moving towards certainty. For instance, the clarification brought about in the treatment of income earned by FPIs, that it will be treated as capital gains, and the recent clarifications on applicability of Minimum Alternate Tax (MAT) to FPI have gone a long way in providing certainty to FII investors. Contrast this with the tax treatment of income earned by SEBI-registered VCFs and AIFs. The regime moved from a simplistic treatment of exempting all income earned by VCFs to restricting the exemption to only income from investment in limited sectors, and, from there, again reintroducing the exemption to income from portfolio investments. Recently, the tax regime for Category I and II AIF were introduced whereby income of the AIF in the nature of profits and gains from business were to be taxed in the hands of the Fund only, and income in the nature of capital gains and other sources was to be taxed in the hands of the investors. Further, the income distributed by the Funds were subject to a tax withholding of 10 %.
- 5.23 In addition to the complexities surrounding the withholding and tax treatment of domestic investors, foreign investors have also been facing the heat in the form of stringent scrutiny of relief / benefits under Double Taxation Avoidance Agreements.
- 5.24 All of the above have been slowly discouraging fund managers from setting up Indian-pooled i.e. India-domiciled Alternative Investment Funds, and to instead pool capital outside India for investing in India through the Foreign Direct Investment (FDI) route. The investments under the FDI route are not subject to any of the above restrictions.
- 5.25 In light of the above, we have detailed below some of the key issues relating to the current tax treatment of AIFs and their investors, along with recommendations to alleviate the concerns.

1. Current tax treatment of Alternative Investment Funds Domiciled in India

Under the current tax regime, tax pass-through status has been provided to all Category I and II AIFs for income other than Profits and Gains from Business &

Profession (PGBP). Income of the nature of capital gains and Income from other sources are exempt in the hands of AIF and are taxable in the hands of the unit holder / investors directly.

Foreign investors are generally taxable at normal tax rates subject to treaty benefits, asunder:

- 20% Long term capital gains; and
- 40 % (foreign company)/ 30 % for short term capital gains

However, a significant amount of foreign investments are made from countries with benefits under the DTAA.

Resident investors are liable to tax like any other assessee:

- 20% – Long term capital gains
- 30% –Short term capital gains

Income distributed by AIF to the unit holders / investors is subject to withholding at the rate of 10 %.

2. Issues under the current treatment

Under Section 194LBB of the Act, any income distributed by the Fund is subject to Tax Deduction at Source (TDS) at the rate of 10 %.

Implications for the Fund

- Determination of TDS: The TDS provisions are ambiguous on whether the TDS needs to be made on gross or net income; whether TDS has to be made on income chargeable to tax i.e., exclude exempt income from the ambit of TDS. This ambiguity in the law, fear of prosecution and penal consequences would make the fund managers turn conservative and deduct taxes on gross income, irrespective of whether such income is chargeable to tax or not. The conservative treatment by the fund managers could lead to absurd situations, wherein income earned by the Fund, which is in the nature of Dividend and Long term Capital Gains, would be exempt from tax whereas the same income would suffer TDS at the rate of 10% upon distribution to the investors.
- Tax Compliance: The tax related compliance requirement of Funds has not been reduced over the years. The Fund is still required to file the return of income, and, in addition, is required to submit Form 64A and 64B detailing the income distributed by the Fund. This is in addition to the additional

requirement of submitting TDS returns on income distributed by the Fund, which is otherwise not required to be done by other assessees.

- Blockage of Refund Claim: On account of TDS on all income distributed by the Fund, irrespective of whether such income is chargeable to tax or not, investors are left with no option but to claim the TDS as a refund by filing a return of income. This means the refund claim would be blocked until the refund is paid, thereby resulting in a sub-optimal return on capital.
- Litigation Risk: The above ambiguities could lead to situations where the revenue may differ from the interpretations adopted by the Funds, leading to litigation.
- Inconsistency with Fund Life: In addition, the Fund would need to continue its existence, notwithstanding the fact that most funds are setup with a limited life, on account of completing of assessment and litigation proceedings and realization of refunds.

Implications for Investors

- Compliance Burden Hurts Ease of Business: Investors have to file a return of income and claim refund irrespective of whether such income is taxable or not.
- Working Capital Stress: Blocked TDS claim on exempt income creates unnecessary stress on the working capital.
- Litigation Risk: Increased scrutiny may lead to increased scope for litigation as to taxability of capital gain even though such gains may be protected under the Double Taxation Avoidance Agreements.

Implications for the Revenue Authorities

- Administrative Burden: Increased scrutiny of returns filed by the Fund and the investors towards income and TDS adds to the administrative burden of the Revenue authorities for scrutinizing returns containing exempt income;
- Reconciliation Mismatch: Administering tax credits and ensuring that the Form 26AS credits match with the credits claimed by the investors adds to the existing reconciliation of mismatches between TDS claims and Form 26AS;

- Revenue Leakage due to Interest Cost: Revenue leakage on account of interest on refunds, which was never to be charged; and
- ~~Litigation Risk:~~ Increase in litigation leading to poor tax collection and inefficient utilization of tax authorities in fighting tax battles.

3. Need of the Hour

It is imperative that the existing uncertainties on the tax treatment are removed and a stable and non-controversial tax regime is prescribed. While revenue authorities could try and remove the uncertainties by issuing clarifications and continue with the existing tax regime, it may not be possible to completely eliminate the uncertainties and administrative difficulties unless until the tax treatment is completely revamped. The revenue authorities could therefore consider the following alternative manner of taxing the income earned by the Funds.

4. Securities Transaction Tax (STT) – A Time Tested Approach

This section shows that there is a compelling case for a Securities Transaction Tax regime in the case of venture capital and private equity funds.

STT was introduced in 2004 to replace the long-term capital gains tax on securities traded on stock exchanges. The objective of introducing STT was to increase revenue from stock transactions and to create a level playing field for all participants in the stock market. The revenue potential of STT was one of the key drivers of the introduction of STT as the tax was payable irrespective of whether any income arose from it or not. In addition, the STT regime simplified the tax treatment on transaction relating to stocks to a significant extent. Thus leading to a significant reduction in litigation relating to securities transactions on the stock market.

The revenue authorities could therefore consider implementing a STT tax structure in the case of VC/PE because of the several benefits associated with it. It ensures:

- a) the timely collection of taxes at source, thereby ensuring minimal leakage;
- b) lowers the burden faced by revenue authorities associated with the scrutiny of income tax returns as such income is exempt;
- c) reduces litigation to a great extent consequent to its structure; and
- d) enhances the ease of implementation and monitoring.

A non-adversarial STT regime has the following benefits:

a) For the Fund

- Funds would be required to collect and remit the STT to the Revenue authorities. STT could be levied on entry as well as exit from the Funds.
- STT reduces the hassle of filing returns and claiming refunds.
- It reduces the compliance requirement to a significant extent as compliance will be reduced to STT alone and filing an exempt income return (if prescribed).
- No further compliance required.
- Reduced compliance increases the ease of doing business.
- Funds are not blocked in the form of refunds thereby ensuring returns to investors are not impacted due to the gap between paying tax and receiving returns.

b) For investors

- Investors receive tax-free income as the income would have suffered STT at the source itself.
- The burden of compliance on investors is significantly reduced as investors will not be required to file returns. Even where investors are required to file returns with respect to the income from the Funds, such return would be limited to the disclosure of exempt income only.
- The scrutiny of return of income filed by investors would reduce to a great extent due to exemption thereby reducing the compliance burden of the investors.
- No working capital stress as funds would not be locked in the form of refunds.
- The STT regime would ensure there is no scope of litigation.

c) For the revenue authorities

Collection from investors and remittance of STT to the Government by the Fund on every redemption of units ensures timely collection of tax at source. Since the mechanism is similar to tax deduction at source, the interests of the Revenue are protected.

- Assured tax collection to the Revenue authorities, as tax would be collected upfront on entry as well as on exit, irrespective of whether

the investment has generated income chargeable to tax.

- No revenue leakage as the tax will be levied upon entry as well as exit. Since the STT would be levied on the gross amount, Revenue will be assured of taxes. Further, since STT is a tax collected at source, the Revenue would be able to collect taxes on a wider tax base of income which would include exempt as well as taxable income. The potential growth in the economy is only going to increase the amount of capital being invested through venture capital & private equity funds, consequently, a STT based tax regime should help the Revenue authorities in higher and more efficient collection of taxes. Accordingly, there could be a significant jump in revenue.
- No assessment of investors' income and consequently significant reduction in litigation.

5. Securities Transaction Tax (STT) approach is already in vogue

The STT approach of taxation compliance has been in vogue in India for a decade. The Finance Act 2015 has extended the applicability of STT to Business Trusts (Infrastructure Investment Trust and Real Estate Investment Trust registered under SEBI) as well thereby exempting the investors on gains from these trusts. The following table (see Exhibit 5.2) summarizes the tax compliance required by various entities paying STT.

Exhibit 5.2: Current Rates of Securities Transaction Tax

Entity	Compliance
1. Business Trusts (REIT and IIT)	<ul style="list-style-type: none"> • Pay 0.2% STT on redemption of units (as per Section 98 of the Finance Act, 2004, Chapter VII) • Any long term gains exempt in the hands of investors u/s 10(38) of the Income Tax Act, 1961
2. Equity Linked Mutual Funds	<ul style="list-style-type: none"> • Pay 0.001% STT on redemption of units (as per Section 98 of the Finance Act, 2004, Chapter VII) • Any long term gains exempt in the hands of investors u/s 10(38) of the Income Tax Act, 1961 • Millions of investors are paying STT and no further compliance is expected from them

3. Stock Exchanges (in case of listed equity shares)	<ul style="list-style-type: none"> • Pay 0.1% STT on purchase and sale of shares by investors (as per Section 98 of the Finance Act, 2004, Chapter VII)
	<ul style="list-style-type: none"> • Any long term gains exempt in the hands of investors u/s 10(38) of the Income Tax Act, 1961 • Millions of investors are paying STT and no further compliance is expected from them • In case of non-resident investors, the onus of ensuring remittance of proper tax (if any) is on the banker.

6. Securities Transaction Tax (STT) on Alternative Investment Funds - Suggested Approach

Given that the current STT model of taxation is a time tested one, we have suggested below (see Exhibit 5.3) an indicative STT structure for taxation of AIFs.

Exhibit 5.3: Indicative Rates on STT on Alternative Investment Funds

Upon investment / purchase of units	<ul style="list-style-type: none"> • 0.25% of the amount invested / purchased
Upon Redemption	<ul style="list-style-type: none"> • Where the income distributed represents income from long term capital assets being securities held for 24 months or more (12 months or more in the case of FPI), 0.25% of the income so distributed • Where the income distributed represents income in the nature of profits and gains from business or profession, short term capital gains or income from other sources 1% of the income so distributed.

<p>Upon secondary transfer of units of the AIFs</p>	<ul style="list-style-type: none"> • Where the units are held for 24 months or more (12 months or more in the case of FPI), 0.25% of the transfer consideration • Where the units are held for less than 24 months (12 months in the case of FPI), 0.5% of the transfer consideration <p>The onus to discharge STT would be on the Fund. Fund would be required to collect STT from the buyer as well as the seller and deposit the same to the Government.</p>
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Rationale for the levy of 0.25% STT

- Incremental Revenue Collection: Levy of STT should result in incremental collection of taxes to the Revenue considering that it is levied on gross amounts and is collected irrespective of whether there is a gain or not, i.e., even in the case of losses, the STT would still be levied.
- The majority of the investments are made by non-resident investors who derive benefits under Double Taxation Avoidance Agreement, and which constitutes close to 90% of the capital invested into AIFs. Consequently only 10% of the gains made are taxable in India.
- Upfront Collection of Revenues: A significant portion of the STT is collected upfront upon investment itself.
- Overseas investors who constitute a significant portion of the investor base in AIFs typically lose about 3 – 4 % of gains on account of exchange rate fluctuation, thus resulting in gains which are lesser by 20% – 25%, as compared to resident investors.
- STT is Time-Tested: The levy of STT is a tested concept and has been recently levied on business trusts (Investment Trusts and Real Estate Investment Trusts registered with SEBI) as well. Transactions of sale of unlisted units of a business trust under an offer for sale are subject to STT at the rate of 0.2%.
- Higher Suggested Rate: Accordingly, the proposed rate of 0.25% upon entry and exit appears to be reasonable. It may also be noted that the STT rate on mutual funds is currently restricted to sale of units with a significantly lower rate of 0.001% as compared to the rate being proposed on the AIFs.
- Higher Tax Collection as Proposed STT Applicable at 3 points: Considering that the levy of STT would be both on entry, exit as well as secondary transfers, the levy of STT should result in higher tax collections.

We have, in the table below (see Exhibit 5.4), illustrated the net incremental tax collection due to the levy of STT assuming an average historical return of 1.7x on the capital invested – as compared to that under a capital gains tax mechanism.

The above advantages, when clubbed with the fact that the revenue will not be required to pay interest on the refunds due to the investors, makes a compelling case for the levy of STT.

Exhibit 5.4: Net Incremental Collection of Tax due to STT

Investment	Amount in INR Crores		
Initial Investment (A)	1000		
Return on investment over 5 years 0.7x of	700		
Total	1700		

Book Income	(i) Gross	(ii) Cost of Acquisition (% of A)	(iii) Net
Long term capital gains - 90% = (C)	1530	900	630
Short Term Capital Gains - 10% = (D)	170	100	70
Indexation benefit - 50% of cost - [(C (ii))]=(E)	450		
Capital Gains under the Income-tax Act			
Long term Capital Gains - [C (iii) - (E)] = (F)	180		
Short Term capital gains - [D(iii)] = (G)	70		
Split of Taxable and Non-taxable Investors	(i) %	(ii) Long Term	(iii) Short
Exempt Investors - Non-resident investors availing treaty benefits and exempt entities = (H)	90%	162	63
Taxable Investors = (I)	10%	18	7
Tax Rates	(i) Normal		

Current			
Withholding tax rate = (J)	11.54%		
Long term capital gains tax rate = (K)	23.07%		
Short term capital gains and other income tax rate = (L)	34.61%		
Proposed STT			
Upon Investment (M)	0.25%		
Upon exit - Long term (N)	0.25%		
Upon exit - Short term and Other Income	1.00%		
Tax Computation			
Withholding tax on income distributed = (B) x [(J) = (P) @ current rate	80.75		
Capital Gains Tax			
Long term Capital Gains Tax (10% being taxable investors) - [(ii) x (K)] = (Q)	4.15		
Short term Capital Gains Tax (10% being taxable investors) - [(iii) x (L)] = (R)	2.42		
Total (Q) + (R) = (S)	6.58		
STT			
Upon Investment - (A) x (M) = (T)	2.50		
Upon Redemption			
Long term capital gains - Gross - [(C) (i) x (N)] = (U)	3.83		
Short term capital gains - Gross - [(D) (i) x (O)] = (V)	1.70		
Total STT (T+U+V) = (W)	8.03		
Net Incremental Tax Collected by Revenue (S - W) = (X)	1.45		

Conclusion

5.26 Flagship Initiatives of the Government of India such as 'Make in India' and 'Digital India' have the potential to create significant industrial growth, increase employment, trade and innovation. However, these initiatives are also capital intensive and require huge participation from the private sector. A robust VC / PE eco-system would assist in providing the capital needed by the private sector and help fund the seed and growth sectors of the economy.

5.27 The increase in VC /PE Funds would surely have a domino effect on the economy. This would result in a positive cascading effect on the tax revenues of the country, in the form of indirect taxes on transactions such as VAT and GST and taxes on the profits earned by corporations. A simpler and certain tax regime for venture capital & private equity funds would go a long way in extending the reach and scale of such funds in India.

F. Venture capital and private equity backed portfolio companies - not the Funds - are major sustainable tax generators: Illustration

5.28 A Venture Capital / Private Equity (VCPE) fund per se is not a major tax generating entity and it is through portfolio companies that venture capital and private equity funds generate robust tax realisation for the government.

5.29 To illustrate this point, take the example of a typical VCPE fund with a corpus of INR 10 Billion. Most often **90% of the fund corpus would be raised from overseas investors who enjoy DTAA (Double Taxation Avoidance Agreement) benefits offshore and other such jurisdictions.** The remaining 10% of the corpus would be raised from Indian investors. The majority of the income earned by VCPE funds is long-term capital gains (LTCG). LTCG is exempt in the case of listed securities and is taxed at the rate of 20% in the case of unlisted securities after netting off long term capital losses. Such LTCG is taxed in the hands of Indian investors who form an insignificant proportion of the overall VCPE investment in India, while 90% of the investors who are foreign investors do not pay taxes on capital gains in view of DTAA benefits.

5.30 Assuming the Fund achieves a multiple of 2.2 overall and 50% of the exits are through the listed route, **the total tax revenue from a Fund with a corpus of INR 10 Billion is merely INR 12 crore over the life of the Fund which is typically 8 - 10 years** as illustrated below: (see Exhibit 5.5)

Exhibit 5.5: Capital Gains Tax Revenue from an AIF

Particulars	Amounts in INR crores	Notes
Fund Corpus	1000	(A)
Overall exit multiple	2.2	(B)
Total amount realised from exits	2200	(C)=(A)*(B)
Total long term capital gains (LTCG) for the Fund	1200	(D)=(C)- (A)
% of LTCG from exits of listed securities	50%	

% of LTGG from exits of unlisted securities	50%	(E)
% of overseas investors covered under DTAA	90%	
% of domestic investors		
Total LTCG subject to tax in India	60	(G)=(D)*(E)*(F)
Tax on long term capital gains at 20%	12	(G)*20%

Though a VCPE fund per se is not a major tax generating entity, VCPE funds help create and grow their portfolio investee companies which are taxable entities that can sustain growth in tax revenues - both direct and indirect taxes - for several years.

5.31 To illustrate the actual impact that a VCPE fund has on increasing tax realisation on a sustainable basis, we present the following example of a portfolio investee company that the Fund invests in. It is assumed that a fund with a corpus of INR 10 Billion will make twenty investments of INR 50 crore each. Each portfolio company has the potential to grow revenues and profits 2.5 - 3X over a four to five year horizon. We illustrate below (see Exhibit 5.6) the growth trajectory of a typical VCPE funded company and the revenue potential for the government, both from direct and indirect taxes.

Exhibit 5.6: Revenue Potential of a Venture Capital / Private Equity Portfolio Company

INR Crore	Year 1	Year 2	Year 3	Year 4	Year 5	Ref	Assumption
Revenue	150	250	350	400	450		
Indirect Tax (Excise Duty)	12	20	28	32	36	(A)	8% of revenue
Salary costs	7.5	12.5	17.5	20	22.5		5% of revenue
Profit Before Taxes	12	20	28	32	36		8% of revenue
Direct Taxes	3.96	6.6	9.24	10.56	11.88	(B)	33% of PBT
PAT	8.04	13.4	18.76	21.44	24.12		5% of revenue
TDS on Salaries	1.5	2.5	3.5	4.0	4.5	(C)	20% of salaries
Total revenue for government	17.5	29.1	40.7	46.6	52.4	(A)+(B)+(C)= 186.3	

5.32 In the above example, **the total tax revenue (both direct and indirect taxes) for the government is Rs. 186 crore from one portfolio company over a five year period.** Apart the illustration above, there are several other revenue streams for the government such as service tax, TDS on other payments, VAT,

state-level taxes, taxes imposed by local authorities and dividend distribution tax which are also paid by these companies. VCPE investors act as a catalyst in placing their portfolio companies on a high growth trajectory which will in turn enables them to raise debt, expand operations, and thus generate profits and employment. **Increased tax realisations are a natural outcome of this transformation.**

5.33 Assuming that 50% of the Fund's portfolio companies, (i.e. 10 portfolio companies out of the 20 portfolio companies) are successful and achieve similar growth as illustrated in the example above, **the total revenue potential for the government from a Rs. 10 Billion Fund's portfolio companies could be to the tune of Rs. 1,863 crore over a five year period, extrapolating the same assumptions. If a fund with INR 10 Billion corpus can create such a multiplier effect on tax revenues, the positive role of VCPE funds in sustainable tax realisations for the government is perfectly well established.** It should be noted that about **US\$ 100 Billion of VCPE investment has happened in India between 2001 and 2014. With this magnitude of investment, the contribution from this industry for boosting tax revenues on a sustainable basis needs to be appreciated.**

5.34 Given the fact that tax realisations from the VCPE industry comes not from the funds themselves, but from their portfolio companies, the request made by the VCPE industry for restoring_ the '**pass-through**' status for all the categories of AIF is justified. It needs to be understood that this request has been made for better clarity and for avoidance of double taxation. Unlike other funds such as mutual funds, hedge funds etc., VCPE funds have a limited number of institutional investors (typically less than 35) and given that there is a robust audit trail for all transactions, there is no scope for losing track of these income streams and thereby taxes from the Fund.

5.35 The above study proves the point that VCPE funds per se are not major tax generating entities whereas the portfolio investee companies backed by funds are robust tax generating entities on a sustainable basis. Based on the establishment of a clearer tax regime for VCPE industry, vast pools of capital can be attracted to India, which has the potential to generate sustainable tax realisation through portfolio companies as illustrated in this chapter.

G. Suggested Amendments to Income Tax Act to Simplify Taxation of AIFs

Summary of Proposal for Implementing STT

- 5.36 Investment Funds, like mutual funds, pool savings from investors and invest such capital in accordance with a stated investment criteria. A simplified regime for taxation of investors in mutual funds has significantly helped in the growth of that industry, with minimal issues and litigation. A similar regime could provide great impetus to the growth of Alternative Investment Funds.
- 5.37 Presently, there is significant difference in the way income is taxed in the hands of the investors of Mutual Funds and Investment Funds. In the case of Mutual Funds (long-term equity oriented), the redemptions are liable to Securities Transaction Tax (STT) and the net income is exempt in the hands of the investors. However, in the case of Alternative Investment Funds, even though the units are held for a very long duration, the income is taxable in the hands of investors.
- 5.38 Experience suggests that STT has been useful in not only easing the applicable tax regime but also reduced tax litigation. To harmonise the taxation of Mutual Funds and Alternative Investment Funds, and to simplify the taxation compliance of the investor as well as the Alternative Investment Funds, it is proposed to bring Alternative Investment Funds under the ambit of STT.
- 5.39 In short, the investors of the Investment Fund will be made liable to pay STT on the distribution made by the Investment Fund to the investors, and consequently, such distributions should be exempted from tax in the hands of the investors.

Recommendation 1

Distributions by AIF to be treated as a taxable transaction liable to STT

Amendments required in the Finance Act 2004 (Chapter VII):

Amending the Chapter VII of Finance (No. 2) Act, 2004 to include distribution from Investment Funds as a taxable transaction in securities:

Definitions

- A) In Section 97, of the Finance (No. 2) Act, 2004, insert the following definitions as sub section (1) :

“Investment Fund” shall have the meaning assigned to it in clause (a) of the explanation to Section 115UB of the Income Tax Act, 1961”

B) In Section 97, re-insert the current sub-section (1) defining Appellate Tribunal as sub-section (1A)

C) In Section 97 of the Finance (No. 2) Act, 2004:

In sub-section 13, after sub-clause (b), the following sub-clauses shall be inserted:

“(c) purchase of a unit in an Investment Fund

(d) any distribution made on sale or redemption of a unit in an Investment Fund

(d) any distribution made otherwise by an Investment Fund”

Charge of STT

D) In Section 98 of the Finance (No. 2) Act, 2004, in the Table, after serial number 7 and the corresponding entries thereto, the following shall be inserted, namely:

Sl. No.	Taxable Securities Transaction	Rate	Payable by
(1)	(2)	(3)	(4)
“8	(a) Purchase of an unit of an Investment Fund	0.25%	Purchaser
	(b) Distribution of income representing long term capital gains, made to an unit holder by an Investment Fund on redemption or otherwise	0.25%	Unit holder
	(c) Distribution of income other than long term capital gains, made by an Investment Fund on redemption or otherwise	1%	Unit holder
	(d) Sale of an unit of an Investment Fund being a long term capital asset, to any person other than the Investment Fund in which such units are held	0.25%	Seller
	(e) Sale of an unit of an Investment Fund being a short term capital asset, to any person other than the Investment Fund in which such units are held	1 %	Seller

Value of taxable securities transaction

E) In Section 99 of the Finance (No.2) Act, 2004, after sub-clause (b) insert the following clauses :

- “(ba) in the case of purchase of units of an Investment Fund, the price at which such units are purchased;
- (bb) in the case of distribution on account of redemption of units of an Investment Fund, such amounts as are distributed to the unit holder including the principal amount redeemed;
- (bc) in the case of distribution by an Investment Fund other than the distribution referred in clause (bb) above, the amounts so distributed to the unit holder;
- (bd) in the case of sale of units of an Investment Fund by the unit holder to any person other than the Investment Fund in which such units are held, the price at which such units are sold”

Collection and Recovery of STT

- F) In Section 100 insert the following sub-section (2B) after sub-section (2A)

“The prescribed person in the case of every Investment Fund shall collect the securities transaction tax from every person who purchases or sells or redeems the unit of an Investment Fund”.

Recognised Stock Exchange or Investment Fund or Mutual Fund to furnish prescribed return

- G) In sub-section (1) of Section 101 - insert the following words after the words “every recognised stock exchange” –

“Prescribed person in the case of every Investment Fund”

Recommendation – 2

On treating the transactions of investment in and distribution from an Investment Funds liable to STT, any distribution made by the AIF should be totally exempt from tax

Amendments required in the Income Tax Act, 1961 (IT Act)

Exempting the income from Investment Fund (AIF) under section 10 of the IT Act:

- A) In Section 10 of the IT Act, after clause (38), the following clause shall be inserted, namely:-

“(38A) any distribution received by an assessee, being a unit holder of an

Investment Fund referred to in Explanation to Section 10(23FBA), either on redemption or otherwise and where such distribution is chargeable to Securities Transaction Tax under Chapter VII of the Finance (No. 2) Act, 2004.

(38B) any income received by an assessee, being a unit holder of an Investment Fund referred to in Explanation to Section 10(23FBA), on sale of units in an Investment Fund to any person other than the Investment Fund, in which such units are held and where such sale is chargeable to Securities Transaction Tax under Chapter VII of the Finance (No. 2) Act, 2004.”

Other Consequential Amendments

Amending the period of holding in the securities held in and by an Investment Fund

In sub-section 42(A) of the IT Act, insert the following proviso after the second proviso-

“Provided further that in the case of share or other securities of a company (not being a share listed in a recognised stock exchange) held by an Investment Fund or a unit of an Investment Fund specified under clause (23FBA) of Section 10, the provisions of this clause shall have effect as if for the words "thirty-six months", the words "twelve months" had been substituted.”

Avoiding redundant exemptions in section 10 of the IT Act

In Section 10 of the IT Act, 1961 (IT Act)-

- (a) for clause (23FBA), the following clause shall be substituted, namely:- “(23FBA) any income of an Investment Fund;

Explanation: For the purposes of this clause, the expression “Investment Fund” shall have the same meaning as assigned to it in clause (a) of the Explanation 1 to Section 11UB.”

- (b) clause (23FBB) shall be omitted:-

Avoiding the MAT effect on foreign companies (Section 115JB)

In Section 115JB of the IT Act, in sub-section (2), in Explanation 1-

“(C) any distributions from an Investment Fund, where such distribution is

chargeable to Securities Transaction Tax under Chapter VII of the Finance (No. 2) Act, 2004”

(a) after sub-clause (B) of clause (ii d), the following sub-clause shall be inserted, namely:-

“(C) any distributions from an Investment Fund, where such distribution is chargeable to Securities Transaction Tax under Chapter VII of the Finance (No. 2) Act, 2004”

Amending Section 115UB

In Section 115UB of the IT Act, after sub-section (7), the following sub-section shall be inserted, namely:-

“(8) Nothing contained in sub-sections (1) to (7) shall apply to any distributions by an Investment Fund, where the distribution from such an Investment Fund is chargeable to Securities Transaction Tax under Chapter VII of the Finance (No. 2) Act, 2004.”

Avoiding the needless Tax Deduction at Source by Investment Funds (Section 194LBB)

In Section 194LBB of the IT Act, the first paragraph shall be numbered as sub-section (1) and after sub-section (1) so numbered, the following sub-section shall be inserted, namely:-

“(2) Nothing contained in sub-section (1) shall apply to distributions by an Investment Fund, where such distribution is chargeable to Securities Transaction Tax under Chapter VII of the Finance (No. 2) Act, 2004.”

VI

Reforming the AIF Regulatory Regime

6.1 India's capital market regulator, the Securities and Exchange Board of India (SEBI), notified the Alternative Investment Funds (AIF) Regulations, 2012 (AIF Regulations) in May 2012. The regulatory philosophy was⁷:

- Create a structure where a regulatory framework is available for all shades of private pools of capital or investment vehicles, so that such funds are channelized in the desired space in a regulated manner without posing systemic risk.
- Make clear the distinction among the various types of private pooled investment vehicles of institutional or sophisticated investors, to allow the Government/ regulators to tailor- make concessions / relaxations that may be desirable for various types of individual kinds of funds.
- Provide a framework as a deterrence for fraud and unfair trade practices, and to minimise conflicts of interest.
- Provide for the private placement of units of alternate investment vehicle, rather than through public offerings.
- Define the duties of a fund manager to the fund investors as be largely shaped by fund documents that are subject to negotiation between the fund and its investor.
- Settlement of disputes, if any, were to be settled through mediation, conciliation or arbitration.

6.2 The AIF Regulations paved the way for various forms of AIF with many new asset classes and investment strategies made possible in a collective investment vehicle. For instance, for the first time in India, a hedge fund strategy in a collective investment vehicle was permitted. The success of the AIF Regulations is reflected in the number of registrations granted; as on 31 March 2015, 135 registrations had been granted by SEBI⁸. Recent changes enacted in the Indian tax framework for AIFs specifically and the funds industry generally, coupled with the announcement in the Union Budget 2015 that the Government would permit foreign investment in AIFs⁹, should give further fillip to this sector.

⁷ http://www.sebi.gov.in/cms/sebi_data/attachdocs/1337601524196.pdf

⁸ The numbers of registrations reflect the number of AIFs that have been granted approval. The AIF Regulations permit a registered AIF to launch schemes from time to time without seeking separate registration.

⁹ The corresponding policy framework is yet to be notified

Principles Underlying Our Recommendations

In making recommendations, the following principles have been considered:

1. Current and Rationalised Approach

The approach to regulate pooling vehicles, including AIFs, should be consistent, current and rationalised to reflect the current global and Indian scenario. It should encourage emerging development trends that can shape the future of the Indian economy.

2. Merging of Boundaries in AIFs

The distinction between venture capital and private equity funds has blurred, especially in the new economy start-ups in India. Investments in the e-commerce sector reflect this trend.

3. Consistent and Simple Framework

The framework should be simple and consistent for the industry to follow and most importantly, be harmonised across the regulators, viz. SEBI, Central Board of Direct Taxes (CBDT), Department of Economic Affairs/ Financial Services and the Reserve Bank of India.

4. Clarity

Sharper definitions on investment boundaries for private equity funds would help CBDT rules, especially in relation to non-business vs. business income, as a key administrative issue in fund taxation.

Recommendations

recommendations in light of the above principles are detailed below.

1. Regulate the Fund Manager and not the Fund

- 1.1 The origin of the Indian fund industry can be traced back to 1964 when the Indian government, with a view to augment small savings within the country and to channelise these savings to the capital markets, set up the Unit Trust of India.
- 1.2 Owing to new and innovative methods of raising funds from retail investors, there was a need to bridge the regulatory gap on fund raising, which led to the introduction of the SEBI (Mutual Fund) Regulations, 1993 (MF Regulations). Further, to provide tailor-made boutique/customised investment management services to the investors, SEBI (Portfolio Manager) Regulations, 1993 (PMS Regulations) were notified.
- 1.3 To foster venture capital as a source of funding new entrepreneurs and technology, the Government of India took a policy initiative and announced the SEBI (Venture Capital Funds) Regulations, 1996 (VCF Regulations).
- 1.4 Later, SEBI introduced a comprehensive legal framework in the form of SEBI (Alternative Investment Funds) Regulations, 2012 (AIF regulations), repealing the VCF Regulations and acknowledging the sector's demand to allow fund managers the flexibility to design fund products to cater to wider investor demand and risk appetites. This would provide targeted concessions to certain funds, as well as to bring within the ambit of regulation, a range of domestic pooling vehicles.
- 1.5 In 2013, the SEBI (Investment Adviser) Regulations (IA Regulations) were introduced to regulate investment advisors who provide investment advice to retail and institutional investors in India. This regulation was brought into effect primarily to safeguard the interests of Indian investors.
- 1.6 The concurrent prevalence of multiple sets of guidelines and the requirements of different regulations have led to a complex regulatory regime for a fund or a fund manager in India. Therefore, there is a need to harmonise and consolidate

all the above regulations, within the framework of SEBI, to create one regulation which shall:

- reduce the multiplicity of regulations from a fund manager perspective;
- achieve simplicity, uniformity and consistency in the regulatory regime;
- provide flexibility to managers to customise product offerings for sophisticated institutional and accredited investors; and
- protect retail investors.

Recommendations:

1. The various regulatory bodies in offshore jurisdictions have formulated regulations to govern the fund manager instead of the fund as it is. The fund manager who makes investment decisions that could pose risks to the investors, markets and the economy (Refer Annexure). A study needs to be undertaken to formulate fund manager regulations based on the regulations prevalent in other countries.
2. Repeal the following regulations and introduce a regulatory framework / policy to govern the fund manager such that the fund manager is responsible for all the investment activities of the client (individual or fund):
 - SEBI (Portfolio Manager) Regulations, 1993
 - SEBI (Alternative Investment Funds) Regulations, 2012 and
 - SEBI (Investment Adviser) Regulations, 2013

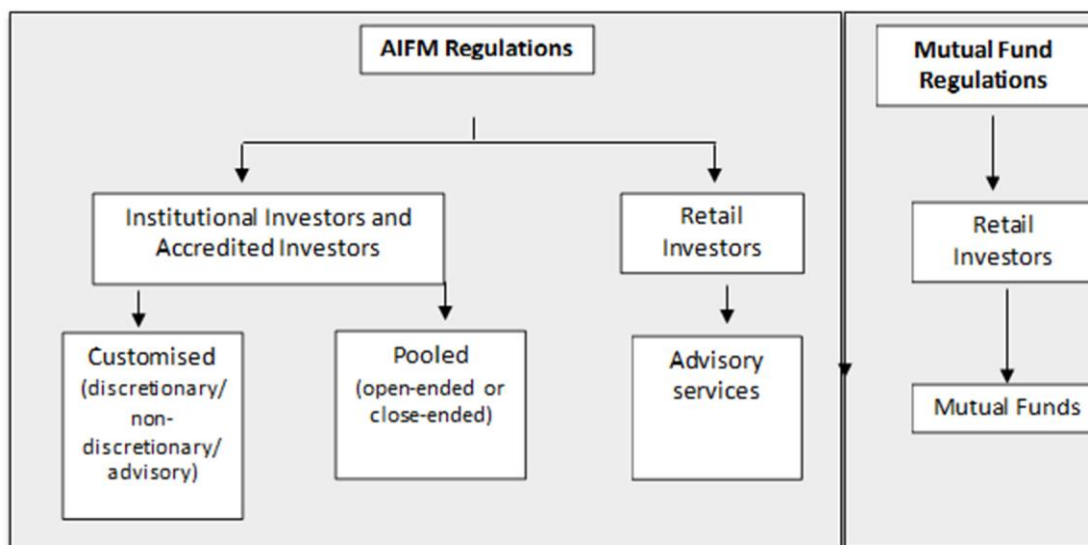
A new “Securities and Exchange Board of India (Alternative Investment Fund Managers) Regulations” (AIFM Regulations) could replace all the above Regulations.
3. A registered Investment manager under the AIFM Regulations can provide discretionary or non-discretionary investment advisory/ management services to investors who could be an individual/ a group of individuals or to funds whether open-ended/ close-ended or clients seeking customized products.

4. The Investment Manager will have specific capitalization requirements, which could provide for sub-categories based on the nature of the AIFM's business (i.e. discretionary, non-discretionary, customized or collective investments).
5. The funds raised by registered investment manager will follow the SEBI guidelines and notify SEBI under an appropriate reporting framework.
6. Angel Funds/ networks and social venture funds should be separately categorised since they have social venture angle which would benefit the society as a whole. The AIFM Regulations will empower SEBI to recognize Angel Funds/ networks other categories of funds which may require special incentives in future. Reference should be made to the recommendations on Angel investing/Funds in the Chapter titled 'Unlocking Domestic Capital Pools' in this report.
7. It is recommended to introduce the concept of accredited investors. Globally, the concept of 'accredited investors' is applied wherein an investor who has a certain minimum income, or assets, or net worth, is considered to be an accredited investor and can make such investments without triggering regulations that apply to fund offerings to retail investors.
8. The Chapter on tax in this report recommends the concept of accredited investors in relevant tax provision. An Accredited Investor is defined to include:

"Individuals or HUFs, company, a firm, an association of persons or a body of individuals whether incorporated or not, a local authority and every artificial juridical person who report a total income (including exempt income) exceeding Rs 50 lacs annually in immediately three assessment years preceding the assessment year in which the investment is made."

The diagram of the resultant regulatory framework, should the aforesaid recommendations be adopted, is as follows:

EXHIBIT: AIFM Regulations Structure



The above recommendation will require comprehensive regulations to address all the current issues of the industry without taking away the current tax framework as analysed and proposed in the chapter on tax in this report.

Thus, we recommend that the above changes to the regulatory framework should follow extensive consultations between SEBI, CBDT and market participants, and should necessarily be preceded by a comprehensive tax code to deal with tax issues and concerns that may arise to funds, fund managers and investors in such product offerings.

2. Minor Amendments in the AIF Regulations, 2012

It is recommended that the definition of “venture capital fund” in Category I AIF is amended to include funds that invest in growth stage ventures. The rationale and justification for including growth stage venture funds in the definition of “venture capital fund” in Category I is as follows:

- 2.1 The trend has now become for a private equity fund to invest in companies at various stages ranging from early stage to further developmental stages of growth. Funds are mandated to operate flexibly from early stage to growth and back. Hence some fund managers may find it appropriate to categorise the fund as a “venture capital fund” while still investing in growth, if they accept all the restrictions as specified for Category I AIFs.

2.2 By including growth in the definition of a “venture capital fund”, a larger quantum of capital shall flow into both early stage and further developmental stages because of the diversification across various stages of a company’s development, which is in line with the Government’s start-up promotion policy.

2.3 The McKinsey report released by the Minister of State for Finance on 1st July, 2015, titled *India Private Equity: Route to Resurgence*; has identified an array of benefits to the Indian economy from growth-oriented private equity investments.

According to the report, the benefits include:

- A stronger job creation record of PE portfolio companies
- Superior financial performance
- Greater export earnings
- More acquisitive and global business
- Better corporate governance and higher tax contribution

It is amply clear from evidence supporting the report, that growth investments are socially and economically desirable.

2.4 Finally, growth investing plays a critical role in the case of early stage companies. For example, as early-stage companies with good potential may run out of cash, a stage-agnostic fund can step in directly, or indirectly through their other portfolio companies to provide much needed capital for a start-up to continue pursuing its strategy for eventual take-off.

From a categorization perspective, and in view of the above study and current global private equity and venture capital trends, there is merit in including growth investing in the definition of “venture capital fund” in Category 1 AIF.

Recommendation

Amend the definition of “venture capital fund” in Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012 in the Definitions section, Clause 2(z) -

“venture capital fund” means an Alternative Investment Fund which invests primarily in unlisted securities of start-ups, emerging or early-stage or growth venture capital undertakings mainly involved in new products, new services, technology or intellectual property right based activities or a new business model

Amend the definition of “Category I Alternative Investment Fund” in Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012, Clause 3(4)(a) -

“Category I Alternative Investment Fund” which invests in start-up or early stage or growth ventures or social ventures or SMEs or infrastructure or other sectors or areas which the government or regulators consider as socially or economically desirable and shall include venture capital funds, SME Funds, social venture funds, infrastructure funds and such other Alternative Investment Funds as may be specified;

3. Classification of Category III AIF

3.1 Currently, Category 3 AIF encompasses all public market investments that employ a diverse range of investment philosophies and strategies. Broadly this category of AIF includes two types of funds, one with a long term orientation that makes investments based on detailed fundamental research and the other that aims to make short term returns through use of quantitative research, leverage and complex trading strategies. All such funds are regulated through issuance of directions related to operational standards, conduct of business rules, prudential requirements, restriction on redemption and conflict of interest etc.

-

3.2 There is a large appetite amongst investors for investment opportunities in, and fund managers to organize collective pools for investing in, listed companies. This market is currently being tapped under portfolio management services which effectively get all the Institutional/ High net-worth individual investors to invest in various opportunities in public markets without a formal fund platform. Today, such an arrangement gives the desired tax outcome (i.e. single level taxation etc.) to the investors.

Recommendations

We recommend sub-categorization in Category III AIFs as follows:

- a. Category III Subcategory A for an AIF which primarily invests in public markets and does not employ leverage including through investment in listed or unlisted derivatives (except for the purpose of hedging the investments) and is long-term oriented with a minimum life of 3 years. Further, the AIF should invest 66% of its investible funds in equity or equity-linked instruments of the investee company and not more than 33% in the debt instruments of such investee company.
- b. Category III Subcategory B for 'Complex Trading Fund': funds which employ diverse or complex trading strategies and may employ leverage including through investment in listed or unlisted derivatives.

Justification

To encourage a fund platform which can target investors other than retail investors, like the one discussed above, to be folded into the AIF regime, there is a need to identify such funds which invest solely in listed securities with no leverage or derivative exposure, as a separate sub-category with AIF Category III.

This classification will segregate a diverse range of strategies under the Category 3 umbrella into two distinct buckets based on investment horizon, underlying securities and investment objectives. This will further aid in matching investors with appropriate strategies.

This option would not require significant tax administration consultation for implementation.

3.3 Ten Percent Restriction of Investible Funds

Chapter III of the SEBI (Alternative Investment Funds) Regulations, 2012 ('Regulations') Clause 15(d) of Chapter III states that Category III Alternative Investment Fund shall invest not more than ten percent of the investible funds in one Investee Company. Such definition prescribes various Investment Conditions and Restrictions which needs to be adhered to while making investments by an Alternate Investment Fund ('AIF'). The term "investible funds" is defined under Chapter I, clause 2(p) as corpus of the Alternative Investment Fund net of estimated expenditure for administration and management of the fund. Further the term corpus is defined

under Chapter I, clause 2(h) as the total amount of funds committed by investors to the AIF by way of a written contract or any such document as on a particular date.

Recommendation

Amend the ten percent restriction of 'investible funds' in one Investee Company to reference the 'market value' of such securities at the time of investment.

Justification

It is prudent if the limit is calculated on the market value of the portfolio as on the date of investment. Going by the literal interpretation, the aforesaid limit is to be monitored on the corpus which is defined as the initial amount committed by the investors and not on the market value of the portfolio.

For example, if the Fund has raised a corpus of Rs.100 crore during the allotment, the value of which has increased to Rs.150 crore due to market movement, under current regulations the limit of 10% will be applied on the initial amount raised i.e. Rs.100 crore whereas, since the market value of investments of the portfolio of the scheme is Rs.150 crore as on the date of investment.

The Way Forward

The above recommendations, if implemented, would encourage more investments in the economy through the AIF route providing the capital needed for the sustained growth of the economy. We believe the Indian market is ready for an overhaul in the AIF Regulations as discussed in our section 1 above. If, for any reason this is not immediately implemented, then SEBI, in harmony with CBDT, could carry out the above recommendations in a phased manner as follows:

- The last recommendation i.e. adding 'growth' in the definition of 'venture capital fund' in Category I AIFs and the classification of unlevered public-markets-focused funds into a separate sub-category under Category III AIF, could be implemented immediately as it is a minor amendment to the existing AIF Regulations.
- The second recommendation i.e. categorisation of AIFs based on whether the securities are listed/ unlisted and leveraged funds could be visited only if the first recommendation i.e. regulating the fund manager is regarded as a measure to be adopted in the medium-term.

Regulating the Fund Manager: Global Practices

Various regulatory bodies in offshore jurisdictions have formulated regulations to govern the fund manager instead of the fund as it is the fund manager who makes investment decisions that could pose risks to the investors, markets and the economy. To illustrate:

- The G-30 Report recommends that —"Managers of private pools of capital that employ substantial borrowed funds should be required to register with an appropriate national regulator (...). The regulator of such managers should have authority to require periodic regulatory reports and public disclosures of appropriate information regarding the size, investment style, borrowing, and performance of the funds under management".
- The European Parliament and Council has come out with a Directive on Alternative Investment Fund Manager (AIFM) such as Hedge Funds, Private Equity Managers, etc. The salient features of the directives are:
 - A legally binding authorisation and supervisory regime for all AIFM managing AIF in the European Union, irrespective of the legal domicile of the AIF managed with few exceptions.
 - To operate in the European Union, all AIFM will be required to obtain authorisation from the competent authority of their home Member State.

An overview of the AIFM Directive has been provided in Annexure 5.

- Under the Private Fund Investment Advisers Registration Act of 2010 (The Act), enacted as part of the Dodd Frank Wall Street Reform and Consumer Protection Act, 2010 (C P Act 2010), Investment Advisers to private funds including hedge funds and private equity funds are required to register with the SEC unless they qualify for one of the exemptions provided such as advisers to Venture Capital Funds, smaller advisers (advising to private funds with AUM less than USD 150 million), foreign private fund advisers, family offices etc.
- In the IOSCO Consultation Report on Hedge Funds Oversight (June 2009), the IOSCO Task Force suggests that progress towards a consistent and equivalent approach of regulators to hedge fund managers should be a high priority. The Task Force recommends that regulatory oversight for hedge funds should be risk based, focused particularly on the systemically important and/or higher-risk hedge fund managers.

Alternative Investment Fund Managers Directive (AIFMD): Overview

Scope

- The AIFMD regulates AIFMs; it does not regulate AIFs directly.
- The main provisions of the directive only apply where the AIFM manages assets of €100 million or more. A higher threshold of €500 million applies to AIFMs that do not use leverage and have a five year lock-in period for their investors.
- The AIFMD creates a number of exemptions for managers and funds which would otherwise fall within the broad definitions contained in the AIFMD, including holding companies; institutions for occupational retirement provision or pension fund managers; employee participation and employee savings schemes; and securitisation special purpose entities.

Minimum Capital Requirements

Internally managed or self-managed funds are required to have €300,000 in initial capital and external managers of one or more funds must have at least €125,000, increasing on a sliding scale to a maximum of €10 million according to the total value of assets under management.

Leverage

- The AIFM must set a maximum level of leverage for each AIF it manages. The AIFM must comply with this maximum at all times and must be able to demonstrate to its Regulator that the levels set are reasonable.
- The Regulator will assess the risks which the use of leverage employed by the AIFM could entail and may impose limits on the level of leverage that an AIFM may employ, or other restrictions on the management of the AIF.

Delegation

- An AIFM must notify its Regulator if it chooses to delegate any of its functions.
- The AIFM must be able to objectively justify the entire delegation structure and will have to review the services provided by each delegate on an ongoing basis.

- It may only delegate its portfolio and/or risk management functions to regulated entities; where this condition cannot be satisfied, delegation is subject to the prior authorisation of the Regulator.

Valuation

- The valuation function may be carried out by the AIFM itself, or it may appoint an external valuation agent.
- Where the AIFM decides to carry out the valuation function itself, it must ensure that the process is functionally independent from the portfolio management and remuneration functions of the AIF, and that adequate measures are put in place to mitigate conflicts of interest.
- Where an external valuer is appointed, the AIFM must be able to demonstrate that the delegation is to an external valuer that is professionally recognised, can furnish professional guarantees and has been appointed pursuant to the AIFMD delegation provisions.

Depositary Provisions

- An AIFM must appoint a single depositary in respect of each AIF it manages.
- An AIFM cannot act as a depositary. A prime broker acting as a counter party to an AIF may not act as a depositary unless it has functionally and hierarchically separated the performance of its depositary functions from its tasks as prime broker and any potential conflicts of interest are properly identified, managed, monitored and disclosed to the AIF investors.

Reporting Requirements

- The AIFMD makes provision for disclosure to investors, both prior to and after their initial investment.
- The directive provides a detailed list of matters to be disclosed to investors, including but not limited to a description of the investment strategy and objectives of the AIF.
- The disclosure and reporting requirements under the AIFMD can be split into three groups, these being initial disclosures to investors, ongoing disclosures to investors and information required to be reported to regulators.

Suggested Non-Tax Amendments

List of Suggested Non-Tax Amendments

- I. Insurance Companies: Investment in AIFs
- II. Banks: Investment in AIFs
- III. Angel Funds
- IV. Non Resident Indians : Investment in Units of Investment Vehicle
- V. LLPs : Investment objective
- VI. Overseas Investment by AIFs
- VII. Investment Manager : AIFs as Anchor Investors in IPOs
- VIII. Single Family Offices : Qualified Institutional Buyer
- IX. LLPs as Fund Managers and Sponsors
- X. AIFs with no Foreign Investment
- XI. Investment by NRI in AIF from NRO Account

Non-Tax Amendments

S.No	Current Law	Suggested Changes	Rationale																								
I. <u>Investment by insurance companies in AIFs</u>																											
1.	<p>As per circular no. IRDA/F&I/CIR/INV/172/08/2013 issued by the Insurance Regulatory and Development Authority of India (IRDA) on August 23, 2013, (2013 IRDA Circular) life insurance companies and general insurance companies are permitted to invest in Category I AIFs and Category II AIFs. Such investment is currently subject to the following limits:</p> <table border="1" style="width: 100%; border-collapse: collapse;"> <thead> <tr> <th style="text-align: center;">Type of Insurer</th> <th style="text-align: center;">Overall Exposure to Venture Funds and AIFs put together</th> <th style="text-align: center;">Exposure to Single AIF/Venture Fund</th> </tr> <tr> <th style="text-align: center;">(a)</th> <th style="text-align: center;">(b)</th> <th style="text-align: center;">(c)</th> </tr> </thead> <tbody> <tr> <td style="text-align: center;">Life Insurance Company</td> <td style="text-align: center;">3% of respective Fund</td> <td> 10% of AIF/Venture Fund size or 20% of Overall Exposure as per (b), whichever is lower. The above 10% limit shall be read as 20% in case of Infrastructure Fund </td> </tr> <tr> <td style="text-align: center;">General Insurance Company</td> <td style="text-align: center;">5% of Investment Assets</td> <td> 10% of AIF/Venture Fund size 20% of overall Exposure as per (b), whichever is lower. The above 10% limit shall be read as 20% in case of Infrastructure Fund. </td> </tr> </tbody> </table>	Type of Insurer	Overall Exposure to Venture Funds and AIFs put together	Exposure to Single AIF/Venture Fund	(a)	(b)	(c)	Life Insurance Company	3% of respective Fund	10% of AIF/Venture Fund size or 20% of Overall Exposure as per (b), whichever is lower. The above 10% limit shall be read as 20% in case of Infrastructure Fund	General Insurance Company	5% of Investment Assets	10% of AIF/Venture Fund size 20% of overall Exposure as per (b), whichever is lower. The above 10% limit shall be read as 20% in case of Infrastructure Fund.	<p>IRDA should issue a circular modifying the 2013 IRDA Circular to effectuate the following:</p> <p>Investment by life insurance companies and general insurance companies should be subject to the following limits</p> <table border="1" style="width: 100%; border-collapse: collapse;"> <thead> <tr> <th style="text-align: center;">Type of Insurer</th> <th style="text-align: center;">Overall Exposure to Venture Funds and AIFs put together</th> <th style="text-align: center;">Exposure to Single AIF/Venture Fund</th> </tr> <tr> <th style="text-align: center;">(a)</th> <th style="text-align: center;">(b)</th> <th style="text-align: center;">(c)</th> </tr> </thead> <tbody> <tr> <td style="text-align: center;">Life Insurance Company</td> <td style="text-align: center;">3%—5% of respective Fund</td> <td> 10%-20% of AIF/Venture Fund size or 20% of Overall Exposure as per (b), whichever is lower. The above 10%-20% limit shall be read as 20% in case of Infrastructure Fund </td> </tr> <tr> <td style="text-align: center;">General Insurance Company</td> <td style="text-align: center;">5% of Investment Assets</td> <td> 10%-20% of AIF/Venture Fund size 20% of overall Exposure as per (b), whichever is lower. The above 10%-20% limit shall be read as 20% in case of Infrastructure Fund. </td> </tr> </tbody> </table>	Type of Insurer	Overall Exposure to Venture Funds and AIFs put together	Exposure to Single AIF/Venture Fund	(a)	(b)	(c)	Life Insurance Company	3% —5% of respective Fund	10%-20% of AIF/Venture Fund size or 20% of Overall Exposure as per (b), whichever is lower. The above 10%-20% limit shall be read as 20% in case of Infrastructure Fund	General Insurance Company	5% of Investment Assets	10%-20% of AIF/Venture Fund size 20% of overall Exposure as per (b), whichever is lower. The above 10%-20% limit shall be read as 20% in case of Infrastructure Fund.	<p>In order to provide greater access to domestic capital for AIFs and to increase the investment opportunities available to Indian institutional investors, the limits on investment in AIFs by insurance companies should be increased from 10% to 20% of the total corpus of an AIF.</p>
Type of Insurer	Overall Exposure to Venture Funds and AIFs put together	Exposure to Single AIF/Venture Fund																									
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2.	<p>The IRDA Circular also mentions the following:</p> <p><i>“Insurers are also not permitted to invest in AIFs, which has the nature of Funds of Funds and Leverage Funds.”</i></p>	<p>IRDA should issue a circular to delete the prohibition on insurance companies from investing in Funds of Funds. Further, the circular should also clarify the definition of ‘Leveraged Funds’. The circular should bring about the following changes:</p> <p><i>“Insurers are also not permitted to invest in AIFs, which has the nature of Funds of Funds and Leverage Funds. The term ‘Leveraged Funds’ shall mean AIFs that have engaged in leverage for the purpose of carrying out investments and not AIFs that undertake short term borrowing as permitted under the SEBI (Alternative Investment Funds) Regulations, 2012”</i></p>	<p>The removal of prohibition on investment in Funds of Funds will ensure greater risk mitigation and diversification. Further, the scope of the term ‘Leveraged Funds’ should be clarified to exclude from its ambit funds that undertake short term borrowing as per the AIF Regulations.</p>																								
3.	<p>Section 27A of the Insurance Act, 1938, (“Insurance Act”) read along with Regulation 3 of the IRDA (Investment) Regulations, 2000, (“Insurance Investment Regulations”) provides that in case of any investments by life insurance companies and general insurance companies, for investments that are not categorized as an ‘Approved Investment’ under the Insurance Act and Insurance Investment Regulations, require the consent of all the directors of the board of directors of the life insurance company or the general insurance company, as the case may be.</p>	<p>Clause (b) of Schedule I of the Insurance Investment Regulations should be amended to include the following in the list of Approved Investments:</p> <p><i>“Investments in Alternative Investment Funds registered under the SEBI (Alternative Investment Funds) Regulations, 2012 and as specified by IRDA”.</i></p>	<p>This will ensure that for making any investments in AIFs, as permitted by the IRDA, the insurance companies will not be required to obtain the prior approval of its board of directors.</p>																								

II. Investment by banks in AIFs			
4.	<p>Paragraph 1.3 of circular RBI/2006-2007/113 DBOD.No.BP.BC.27/21.01.002/2006-2007 issued by the Reserve Bank of India (“RBI”) on August 23, 2006, (“Prudential Guidelines Circular”) read with paragraph 3 of the master circular on ‘Para-banking activities’ issued by the RBI on July 1, 2015, (“RBI Master Circular on Para Banking Activities”) specifies that the investment by banks in venture capital funds (“VCFs”) is subject to the following limits:</p> <p><i>“...investments in VCFs in the form of equity/units etc. will also be subjected to the limits stipulated vide para 3 of RBI Master circular on Para Banking Activities in terms of which the investment by a bank in a subsidiary company, financial services company, financial institution, stock and other exchanges should not exceed 10 per cent of the bank’s paid-up capital and reserves and the investments in all such companies, financial institutions, stock and other exchanges put together should not exceed 20 per cent of the bank’s paid-up capital and reserves.”</i></p>	<p>The RBI should issue a circular to specify the following and amend the Prudential Guidelines Circular:</p> <p><i>“...investments in VCFs and AIFs in the form of equity/units etc. will also be subjected to the limits stipulated vide para 3 of RBI Master circular on Para Banking Activities in terms of which the investment by a bank in a subsidiary company, financial services company, financial institution, stock and other exchanges should not exceed 1020 per cent of the bank’s paid-up capital and reserves and the investments in all such companies, financial institutions, stock and other exchanges put together should not exceed 20 per cent of the bank’s paid-up capital and reserves.”</i></p>	<p>In order to provide greater access to domestic capital for AIFs and to increase the investment opportunities available to Indian institutional investors, the limits on investment in AIFs by banks should be increased from 10% to 20% of the bank’s paid-up capital. This will enable banks to invest larger amounts into AIFs.</p>
5.	<p>Paragraph 5 of the Prudential Guidelines Circular specifies the following:</p> <p><i>“Banks should obtain prior approval of RBI for making strategic investment in VCFs i.e. investments equivalent to more than 10% of the equity/unit capital of a VCF”.</i></p>	<p>The RBI should issue a circular to specify the following and amend the Prudential Guidelines Circular:</p> <p><i>“Banks should obtain prior approval of RBI for making strategic investment in VCFs i.e. investments equivalent to more than 10%-20% of the equity/unit capital of a VCF”.</i></p>	<p>In order to provide greater access to domestic capital for AIFs and to increase the investment opportunities available to Indian institutional investors, the limits on investment in AIFs by banks should be increased from 10% to 20% of the corpus of the AIF. This will enable AIFs to accept larger contributions from banks that are willing to commit larger portions.</p>
6.	<p>Paragraph 1.1 of the Prudential Guidelines Circular specifies the following:</p> <p><i>“All exposures to VCFs (both registered and unregistered) will be deemed to be on par with equity and hence will be reckoned for compliance with the capital market exposure ceilings (ceiling for direct investment in equity and equity linked instruments as well as ceiling for overall capital market exposure).”</i></p>	<p>The RBI should issue a circular to specify the following and amend the Prudential Guidelines Circular:</p> <p><i>“All exposures to VCFs (both registered and unregistered) and AIFs engaged in investments in priority sectors will be treated as-at par with priority sector lending deemed to be on-par with equity and hence will not be reckoned for compliance with the capital market exposure ceilings (ceiling for direct investment in equity and equity linked instruments as well as ceiling for overall capital market exposure).”</i></p> <p>Regulations providing for investments by banks in priority sectors (through instruments other than securitised assets) should also be implemented. Investments by banks in AIFs or SVFs or in funds engaged in sectors which have been classified as ‘priority sectors’ by the Reserve Bank of India under the Master Circular on Priority Sector Lending should be considered as ‘priority sector investments’.</p>	<p>Excluding investment in AIFs from the category of capital market exposure will ensure that the investments in AIFs is not consolidated while calculating the banks’ capital market exposure. This in turn will enable banks to make more investments into AIFs.</p>
7.	<p>Paragraph 1.2.9 of the Master Circular on Prudential Norms for classification, valuation and operation of investment portfolio by Banks states as follows:</p> <p><i>“Bank’s investment in unlisted non-SLR securities should not exceed 10 per cent of its total investment in non-SLR securities as on March 31, of the previous year, and such investment should comply with the disclosure requirements as prescribed by SEBI for listed companies. As there is a time lag between issuance and listing of securities, investment in non-SLR debt securities (both primary and secondary market) by banks where the security is proposed to be listed on the Exchange(s) may be considered as</i></p>	<p><i>“Bank’s investment in unlisted non-SLR securities should not exceed 10-20 per cent of its total investment in non-SLR securities as on March 31, of the previous year, and such investment should comply with the disclosure requirements as prescribed by the SEBI for listed companies. As there is a time lag between issuance and listing of securities, investment in non-SLR debt securities (both primary and secondary market) by banks where the security is proposed to be listed on the Exchange(s) may be considered as investment in listed security at the time of making investment. However, if such security is not listed within the period specified, the same will be reckoned for the 10-20 per cent limit specified for unlisted non-SLR securities. In case</i></p>	-

	<p>investment in listed security at the time of making investment. However, if such security is not listed within the period specified, the same will be reckoned for the 10 per cent limit specified for unlisted non-SLR securities. In case such investments included under unlisted non-SLR securities lead to a breach of the 10 per cent limit, the bank would not be allowed to make further investment in non-SLR securities (both primary and secondary market) as also in unrated bonds issued by companies engaged in infrastructure activities till such time bank's investment in unlisted non-SLR securities comes within the limit of 10 per cent."</p>	<p>such investments included under unlisted non-SLR securities lead to a breach of the 10-20 per cent limit, the bank would not be allowed to make further investment in non-SLR securities (both primary and secondary market) as also in unrated bonds issued by companies engaged in infrastructure activities till such time bank's investment in unlisted non-SLR securities comes within the limit of 10-20 per cent. Notwithstanding anything to the contrary contained herein, investments by banks in social venture funds (SVFs) will be permitted up to a maximum limit of 25 per cent of the bank's total investment in SVFs, as on March 31, of the previous year.</p>	
III. <u>Angel Funds</u>			
8.	<p>Regulations 19F(3) of the Securities and Exchange Board of India (Alternative Investment Fund), 2012 ("AIF Regulations") states:</p> <p>"Investment by an angel fund in the venture capital undertaking shall be locked-in for a period of three years."</p>	<p>SEBI should amend the said regulation to reduce the lock-in period. The revised regulation may read as follows:</p> <p><i>"Investment by an angel fund in the venture capital undertaking shall be locked-in for a period of three years one year."</i></p> <p>Alternatively, if the current lock-in were to continue, SEBI may consider easing transfer restriction during the lock in period.</p> <p><i>"Investment by an angel fund in the venture capital undertaking shall be locked-in for a period of three years."</i></p> <p><i>Provided, during the lock-in period as specified above, the angel fund may transfer a whole or part of its investment in an investee company to another SEBI registered fund; or an overseas investor (including a body corporate, whether incorporate in India or abroad); or an investor in the angel fund.</i></p> <p><i>Provided however, in case of such transfer, the shareholding of the angel fund transferred shall be subject to a lock-in for a period of three years from the date of such issue of such security."</i></p>	-
9.	<p>Regulation 19D(3) of the AIF Regulations states:</p> <p>"Angel funds shall accept, up to a maximum period of three years, an investment of not less than twenty five lakh rupees from an angel investor."</p>	<p>Regulation 19D(3) may be amended as follows:</p> <p><i>"Angel funds shall accept, up to a maximum period of three-five years, an investment of not less than twenty five lakh rupees from an angel investor."</i></p>	<p>The proposal seeks to extend the time duration during which an angel fund may drawdown capital commitments from its investors. The removal of this restriction will provide flexibility to angel fund in line with flexibility available with all other categories of AIFs.</p>
10.	<p>Regulation 19F(2) of the AIF Regulations states:</p> <p>"Investment by an angel fund in any venture capital undertaking shall not be less than fifty lakh rupees and shall not exceed five crore rupees."</p>	<p>SEBI should amend the said regulation to read as follows:</p> <p><i>"Investment by an angel fund in any venture capital undertaking shall not be less than fifty-twenty five lakh rupees and shall not exceed five crore rupees."</i></p>	<p>Decreasing the minimum amount that can be invested by an angel fund will assist in providing flexibility to the angel fund in terms of its investment strategy, while also creating an opportunity for diversification of its portfolio</p>
11.	<p>Regulation 19E(4) of the AIF Regulations states:</p> <p>"No scheme of the angel fund shall have more than forty-nine angel investors."</p>	<p>The Regulation may be amended as follows:</p> <p><i>"No scheme of the angel fund shall have more than forty-nine-one thousand angel investors."</i></p>	<p>The purpose of the amendments is to expand the avenues of fund-raising available to the funds and bring the same in line with provisions as applicable to other category/ sub-classes of AIFs.</p>
12.	<p>Regulation 19F (1) (a) of the AIF Regulation states:</p>	<p>SEBI may consider diluting such requirement by introducing either of the following amendment to the said regulation:</p>	

	<p><i>“Angel funds shall invest only in venture capital undertakings which: (a) have been incorporated during the preceding three years from the date of such investment;”</i></p>	<p><i>“Angel funds shall invest only in venture capital undertakings which: (a) have been incorporated during the preceding three years from the date of such investment; Provided however, not more than ten per cent of the investible funds of the angel fund may be invested in venture capital undertakings which have been incorporated for a period of more than 3 years from the date of such investment. Provided further, the restriction laid down in the preceding above shall not apply in case of follow on investment by the angel fund in a venture capital undertaking in which it has made or has existing investments.”</i></p>	<p>This change seeks to provide flexibility to angel funds in terms of available investment opportunities in early stage ventures.</p> <p>This change is sought to provide angel funds the flexibility to invest in existing portfolio entities to preserve, protect or enhance the value of such existing investments in such portfolio entities</p>
13.	-	<p>SEBI may consider introducing the concept of ‘accredited investor’ within the AIF Regulations. SEBI may consider including the following clause (aa) in Regulation 2(1): The following scope may be considered:</p> <p><i>“accredited investors” include (i) a natural person whose net worth, either individually or jointly with the investor’s spouse exceeds INR [2,00,00,000] (excluding the value of the investor’s primary residence and indebtedness thereon up to the gross value of such residence, except that if the amount of such indebtedness outstanding at the time of investor’s admission to the angel fund exceeds the amount of such indebtedness outstanding 60 days before such time, other than as a result of the acquisition of the primary residence, the amount of such excess shall be included as a liability in the determination of investor’s net worth), or whose income in the in the [two] most recent years is in excess of INR [•], or joint income with the investor’s spouse is in excess of INR [•] and has a reasonable expectation of reaching the same income level in the current year, and (ii) a corporation / entity whose net worth exceeds INR [•]. For the purpose of determine the net worth of a corporation / entity, net worth shall mean the aggregate value of the paid up equity capital (in case of company) or capital contributions by partner (in case of a limited liability partnership or partnership) or [aggregate value of the corpus] (in case of a trust/benefit plan) [plus free reserves] excluding reserves created out of revaluation reduced by the aggregate value of accumulated losses and deferred expenditures not written off including miscellaneous expenses not written off”</i></p>	<p>Internationally, ‘accredited investors’ have been recognised as a separate category of non-institutional investors.</p> <p>Recognising a separate category of accredited investors will give angel funds access to a number of sophisticated investors.</p> <p>The concept of accredited investors suggested here is based on the standards followed in other jurisdictions, such a United States, Singapore, etc.</p>
IV. <u>Investments by NRIs</u>			
14.	<p>Regulation 2 of Schedule 4 of TISPRO Regulation currently states:</p> <p><i>“Subject to paragraph 1, a Non-resident Indian or an Overseas Corporate Body may, without any limit, purchase on non-repatriation basis, shares or convertible debentures of an Indian company issued whether by public issue or private placement or right issue.”</i></p>	<p>The regulation may be amended to read as follows:</p> <p><i>“Subject to paragraph 1, a Non-resident Indian or an Overseas Corporate Body may, without any limit, purchase on non-repatriation basis, shares or convertible debentures of an Indian company issued whether by public issue or private placement or right issue or unit of Investment Vehicle.”</i></p>	-
15.	<p>Regulation 2(2) of Schedule 5 of TISPRO Regulation currently states:</p> <p><i>“A Non-resident Indian or an Overseas Corporate Body may, without limit, purchase on non-repatriation basis, dated Government securities (other than bearer securities), treasury bills, units of domestic mutual funds, units of</i></p>	<p>It is recommended that that the Schedule be amended to read as follows:</p> <p><i>“A Non-resident Indian or an Overseas Corporate Body may, without limit, purchase on non-repatriation basis, dated Government securities (other than bearer securities), treasury bills, units of domestic mutual funds, , units of</i></p>	-

	Money Market Mutual Funds in India, or National Plan/Savings Certificates”	Money Market Mutual Funds in India, or National Plan/Savings Certificates, or units of investment vehicles.”	
16.	Schedule 4 of the FEMA (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2000 provides for the purchase and sale of shares/ convertible debentures by a Non-resident Indian on non-repatriation basis.	It is recommended that a new paragraph 2A be added to Schedule 4 to read as follows: “Subject to Paragraph 1, a non-resident Indian may, without limit, purchase or subscribe to equity shares or convertible securities or warrants of an alternative investment fund registered with SEBI, subject to such conditions as may be prescribed.”	
V. <u>LLPs: Investment</u>			
17.	<p>Section 56, Limited Liability Partnership Act, 2008:</p> <p><i>“A private company may convert into a limited liability partnership in accordance with the provisions of this Chapter and the Third Schedule.”</i></p> <p>Third Schedule, Limited Liability Partnership Act, 2008:</p> <p><i>“On receiving the documents referred to in paragraph 3, the Registrar shall, subject to the provisions of this Act and the rules made thereunder, register the documents and issue a certificate of registration in such form as the Registrar may determine stating that the limited liability partnership is, on and from the date specified in the certificate, registered under this Act: Provided that the limited liability partnership shall, within fifteen days of the date of registration, inform the concerned Registrar of Companies with which it was registered under the provisions of the Companies Act, 1956 (1 of 1956) about the conversion and of the particulars of the limited liability partnership in such form and manner as the Central Government may prescribe”</i></p> <p>Rule 39, Limited Liability Partnership Rules, 2009 (“LLP Rules”):</p> <p><i>“(1) For the purposes of the Third Schedule, an application shall be made in the form provided in Part A of Form 18 together with the statement of shareholders in format provided in Part B of Form 18 along with the fee as mentioned in Annexure “A”.</i></p> <p><i>(2) The Registrar shall, on conversion of any private company into a limited liability partnership shall issue a certificate of registration under his seal in Form 19.</i></p> <p><i>(3) For the purposes of para 4 of the Third Schedule, the limited liability partnership shall inform the Registrar about conversion of private company into limited liability partnership in Form 14A.”</i></p> <p>Declaration, Part B, Form 18, LLP Rules:</p> <p><i>“I state as under:</i></p> <p><i>(iii) that all the applicable clearances, approvals or permissions for conversion of the company into a limited liability partnership from any other authority/authorities have been obtained”</i></p> <p>RBI directive:</p> <p>At the time of conversion of Investment Company into LLP, RBI has directed the Registrar of Companies to take on record a “No Objection Certificate” from RBI, since the proposed LLP would be dealing with investment activities.</p>	<p>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</p>	<p>The RBI is unwilling to give NOC to Investment Companies as they would be out of the purview of supervision of RBI. However, the advantage of having an LLP structure as an LLP may be noted below:</p> <ol style="list-style-type: none"> 1. LLP being a separate assessable entity, the assessment by the tax authorities will be limited to the LLP and would not individually affect the partners interest; 2. Being body corporates, they have more flexibility in undertaking overseas investments as compared to a trust or individual.

VI. Overseas Investments by AIFs			
18.	<p>Under Regulation 15(1)(a), AIF Regulations: <i>“Alternative Investment Fund may invest in securities of companies incorporated outside India subject to such conditions or guidelines that may be stipulated or issued by the Reserve Bank of India and the Board from time to time”</i></p> <p>Clause B(c)(v), SEBI Circular CIR/IMD/DF/7/2015 dated 1 October 2015:</p> <p><i>“Such investments shall not exceed 25% of the investible funds of the scheme of the AIF”</i></p>	<p>We propose the following amendments:</p> <p>Clause B(c)(v), SEBI Circular CIR/IMD/DF/7/2015 dated 1 October 2015:</p> <p><i>“Such investments shall not exceed 25% of the investible funds of the scheme of the AIF or 50% of the offshore component of the investible funds of the AIF, whichever is higher”</i></p> <p>Corresponding amendments should be made under Regulation 15(1) of the AIF Regulations.</p>	<p>AIFs need the freedom like their India-focused offshore funds (Mauritius etc.) to invest in these offshore entities to the extent of 25% of the corpus of the AIF (currently provided by SEBI) or 50% of the offshore component of the investible funds of the AIF, whichever is higher</p>
VII. Investment Manager as Anchor Investor (AIF-IPO)			
19.	<p>Item 10(k), Part A, SCHEDULE XI, SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009:</p> <p><i>“Neither the merchant bankers nor any person related to the promoter/ promoter group/ merchant bankers in the concerned public issue can apply under Anchor Investor category. The parameters for selection of Anchor Investor shall be clearly identified by the merchant banker and shall be available as part of records of the merchant banker and shall be available as part of records of the merchant banker for inspection by the Board.”</i></p> <p>Regulation 2(1)(c), SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009</p> <p>anchor investor <i>“means a qualified institutional buyer who makes an application for a value of ten crore rupees or more in a public issue made through the book building process in accordance with these regulations”</i></p>	<p>Item 10(k), Part A, SCHEDULE XI, SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009:</p> <p><i>“Neither the merchant bankers nor any person related to the promoter/ promoter group/ merchant bankers in the concerned public issue can apply under Anchor Investor category. Provided, however, any person related to the promoter/ promoter group/ merchant bankers in the concerned issue in their capacity of an investment manager to an Alternative Investment Fund or a fund manager of a mutual fund and whose activities are segregated from the activities of the concerned merchant banker, promoter or promoter group can apply under Anchor Investor category. The parameters for selection of Anchor Investor shall be clearly identified by the merchant banker and shall be available as part of records of the merchant banker for inspection by the Board.”</i></p>	<p>In case of a public issue, an AIF qualifies as an anchor investor, so long as its manager is not a person related to the promoter group or the merchant bankers.</p> <p>Investment managers of AIFs and fund managers of mutual are regulated entities and pursuant to their respective SEBI regulations, their management activities are segregated from other management and marketing departments of a related entity.</p> <p>The permission to the mutual fund managers and AIF investment managers will provide greater flexibility to the AIFs and mutual funds to apply under Anchor Investor category, considering there are stringent regulations in to monitor activities of the AIFs and mutual funds.</p>
VIII. Single Family Offices			
20.	<p>Regulation 2(zd)(i) ICDR Regulations – ‘qualified institutional buyer’ means: <i>“a mutual fund, venture capital fund, Alternative Investment Fund and foreign venture capital investor registered with the Board”</i></p>	<p>We propose the following amendments:</p> <p><i>‘qualified institutional buyer’ means “a mutual fund, venture capital fund, Alternative Investment Fund and foreign venture capital investor registered with the Board or a single family office with assets under management exceeding Rupees fifty crore and whose assets are managed by a dedicated officer who is registered with the Board as an investment adviser”</i></p>	<p>To provide flexibility to single family offices to invest as a qualified institutional buyer for investing in initial public offerings</p>

SI No	Provision of the RBI Notification No. FEMA.355/2015-RB dated 16 November 2015 (“Notification”)	Current Interpretation	Proposed Amendment	Rationale
IX: LLPs as Fund Managers or Sponsors				
21.	<p><u>Proviso to Item 4, Schedule 11, Notification</u></p> <p><i>Provided that for sponsors or managers or investment managers organized in a form other than companies, SEBI shall determine whether the sponsor or manager or investment manager is foreign owned and controlled.</i></p> <p><u>Explanation 1 to Item 4, Schedule 11, Notification</u></p> <p><i>Ownership and control is clearly determined as per the extant FDI policy. AIF is a pooled investment vehicle. ‘Control’ of the AIF should be in the hands of ‘sponsors’ and ‘managers/investment managers’, with the general exclusion of others. In case the ‘sponsors’ and ‘managers/investment managers’ of the AIF are individuals, for the treatment of downstream investment by such AIF as domestic, ‘sponsors’ and ‘managers/investment managers’ should be resident Indian citizens. As ownership and control cannot be determined in LLP under the extant FDI policy, a LLP shall not act as sponsor or manager/ investment manager.</i></p>	<p>The Explanation 1 to Item 2, Schedule 11 states that on account of difficulty in determination of control and ownership in case of a LLP, the LLPs shall not be permitted to act as a sponsor or manager of an AIF. This implies a complete ban on an AIF from having an investment manager or the sponsor as a LLP.</p>	<p><u>Amendment to Proviso to Item 4, Schedule 11, Notification –</u></p> <p><i>Provided that for sponsors or managers or investment managers organized in a form other than companies and LLPs, SEBI shall determine whether the sponsor or manager or investment manager is foreign owned and controlled.</i></p> <p><u>Explanation 1 to Item 4, Schedule 11, Notification</u></p> <p><i>Ownership and control is clearly determined as per the extant FDI policy. AIF is a pooled investment vehicle. ‘Control’ of the AIF should be in the hands of ‘sponsors’ and ‘managers/investment managers’, with the general exclusion of others. In case the ‘sponsors’ and ‘managers/investment managers’ of the AIF are individuals, for the treatment of downstream investment by such AIF as domestic, ‘sponsors’ and ‘managers/investment managers’ should be resident Indian citizens. As ownership and control cannot be determined in LLP under the extant FDI policy, a LLP shall not act as sponsor or manager/ investment manager.</i></p>	<p>The Press Note No. 12 (of 2015), amending the FDI Policy was issued on 24 November 2015. The Press Note provides clarity on the aspect of “ownership”¹⁰ and “control”¹¹ under the FDI Policy.</p> <p>On account of clarity to the ownership and control of LLPs provided subsequent to the Notification, this proposal for amendment will align the provisions of TISPRO, with the FDI Policy.</p>

¹⁰ For the purpose of “ownership” Para 2.1.28 of the amended FDI Policy now provides – “A Limited Liability Partnership will be considered as owned by resident Indian citizens if more than 50% of the investment in such an LLP is contributed by resident Indian citizens and/or entities which are ultimately ‘owned and controlled by resident Indian citizens’ and such resident Indian citizens and entities have majority of the profit share”

¹¹ For the purpose of “control” Para 2.1.7 of the amended FDI Policy now provides – “For the purposes of Limited Liability Partnership, ‘control’ will mean right to appoint majority of the designated partners, with specific exclusion to others, have control over all the policies of the LLP”

X: AIFS with "No Foreign Investment"				
22.	<p><u>Clause (10) of Regulation 5, TISPRO</u> =</p> <p><i>A person resident outside India (other than an individual who is citizen of or any other entity which is registered/ incorporated in Pakistan or Bangladesh), including an Registered Foreign Portfolio Investor (RFPI) or a non-resident Indian (NRI) may acquire, purchase, hold, sell or transfer units of an Investment Vehicle, in the manner and subject to the terms and conditions specified in Schedule 11.</i></p>	<p>This provision seems to include the restrictions of "downstream investment" etc. as detailed in Schedule XI to AIFs that do have any foreign investment.</p>	<p><u>Clause (10) of Regulation 5, TISPRO –</u></p> <p><i>A person resident outside India (other than an individual who is citizen of or any other entity which is registered/ incorporated in Pakistan or Bangladesh), including an Registered Foreign Portfolio Investor (RFPI) or a non-resident Indian (NRI) may acquire, purchase, hold, sell or transfer units of an Investment Vehicle, in the manner and subject to the terms and conditions specified in Schedule 11.</i></p> <p><i>Explanation 1: The provisions of Clause (10) of Regulation 5 shall not be applicable to AIFs which do not have any foreign investment and where the sponsor, manager or investment manager is an entity which is foreign owned or control.</i></p> <p><i>Explanation 2: Contribution in an AIF made by a Sponsor which is a foreign owned and controlled entity to meet the regulatory requirement prescribed under relevant regulations, shall not be treated as foreign investment in an AIF, for the purpose of Clause (10) of Regulation 5.</i></p>	<p>In order to provide uniform rights and liabilities to all AIFs which have investments from only Indian resident contributors, the amendment to the Regulation, by way of Explanation 1, is provided.</p> <p>The rationale for removal of the Sponsor (as in Explanation 2) is on account of the role of the Sponsor as a passive investor, who is not involved in the management of the AIF.</p>

XI: AIF Investment by NRIs from NRO Accounts"				
23	<p>The following two amendments to the Foreign Exchange Management (Transfer or Issue of Security By A Person Resident Outside India) Regulations 2000 ("TISPRO" ISPRO following two amendments to the Foreign Exchange Management (Transfer or Issue of Security B</p>	<p>It is unclear whether investment by NRIs through the NRO route will be governed by the new Schedule 11 as there may not be inward remittance involved in that case. So clarity is needed if this will be governed by this new Schedule 11 or Schedule 5 of the TISPRO regulations.</p>	<ol style="list-style-type: none"> 1. Amend the language of Regulation 2 of the Schedule 11 to clarify to include to payments made through NRO account in addition to NRE and FCNR to be eligible for investments under this Schedule. 2. An amendment may also be carried out in Regulation 2(2) of Schedule 5 of the TISPRO to include rough NRO account in additives' in addition to other securities such as government securities, units of domestic mutual funds, etc. 3. Separate proviso be added under Schedule 5 and Schedule 11 to state as follows: <i>Provided any investment made by an NRI or an foreign entity in which majority of the interest is owned by NRIs in the Units of an Investment Vehicle through its NRO account shall not be treated as foreign investment in such Investment Vehicle.</i> 	<p>NRIs are a very relevant class of investors in the alternative space.</p> <p>Investment by NRIs (as well as entities majority owned by NRIs as per Press note 12) investing through the NRO route is to be treated as domestic investment and thus when such entities make an investment in AIF through the NRO route such AIF should not be treated as having foreign investment and be subjected to downstream investment conditions, even if the manager or the sponsor are foreign owned and controlled.</p>

Abbreviations

AIF	Alternative Investment Fund		
AI	Accredited Investor	IT Act	Income Tax Act, 1961
AIFM	Alternative Investment Fund Manager	LACS LTCCG	One Lac = 100 Thousand Long-term Capital Gains Tax
AIFMD	Alternative Investment Fund Manager Directive	LP LLP	Limited Partner Limited Liability Partnership
AIPAC	Alternative Investment Funds Policy Advisory Committee	OCI PIO PFRDA	Overseas Citizen of India Person of Indian Origin Pension Fund Regulatory Development Authority
AUM	Assets under Management		
CBDT	Central Board of Direct Taxes	PE	Private Equity
CCD	Compulsorily Convertible Debentures	VC VCF	Venture Capital Venture Capital Fund
CCPS	Compulsorily Convertible Preference Shares	EIF FCNR	Eligible Investment Fund Foreign Currency Non-Resident bank account
Crore	1 Crore = 10 million = 100 Lakhs	NR	Non-resident
DDT	Dividend Distribution Tax	NRI	Non-resident Indian
DTAA	Double Tax Avoidance Agreement	NRE	Non-Resident External bank account
DII	Domestic Institutional Investor	NRO	Non-Resident (Ordinary) bank account
ESOP	Employee Stock Option Plan	RBI	Reserve Bank of India
FA	Finance Act	REIT	Real Estate Investment Trust
FDI	Foreign Direct Investments	IIT	Infrastructure Investment Trust
FEMA	Foreign Exchange Management Act	SEBI	The Securities Exchange Board of India
FMV	Fair Market Value	SEC	Securities & Exchange Commission
FOF	Fund-of-Funds		
FPI	Foreign Portfolio Investor	STCG	Short-term Capital Gains Tax
FVCI	Foreign Venture Capital Investors	STT SVF	Securities Transaction Tax Social Venture Funds
GDR	Global Depository Receipt	TISPRO	Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India)
GP	General Partner		
GST	Goods & Services Tax		
HUF	Hindu Undivided Family		Regulations 2000
IRDA	Insurance Regulatory & Development Authority	TDS QIP QIB	Tax Deducted at Source Qualified Institutional Placement Qualified Institutional Buyer