THE ALTERNATIVE INVESTMENT POLICY ADVISORY COMMITTEE

AIPAC ONE – FINAL REPORT

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PREFACE

The Alternative Investment Fund (AIF) industry in India has been evolving at a rapid pace and channeled over ₹1.5 lakh crore in funds into Indian ventures in financial year 2017-18. As of March 2018 over 400 AIFs are already registered with the Securities & Exchange Board of India, with commitments raised of ₹1.65 lakh crore.

The industry is glad to note that private equity and venture capital investments in India have breached new records recently with Q1 2018 turning out to be the second-best quarter in four years. We are also grateful to note that the Government is fully cognizant of the special role played by this industry in fostering entrepreneurship and has taken commendable measures to reform the tax and regulatory regime to enable the scaling up of AIFs. The industry earned a special mention from the Honorable Finance Minister in the Budget speech, with the speech recognizing the need for an innovative and special developmental regulatory regime for the industry.

With Indian AIFs making rapid strides in attracting investors, the next policy imperative would be to expand the domestic pool of AIF assets and to onshore assets that are currently managed from offshore destinations, so that the spinoff benefits from the AIF revolution can flow to the Indian economy.

It is critical to note that while India's AIF industry has grown at a scorching pace in the last few years, investments at ₹1.5 lakh crore in CY17 are at less than a third of the ₹5 lakh crore raised by venture capital and growth stage funds in China. India being the best-placed on growth among the emerging markets is now at a crossroads where both reforms and capital infusion are much-needed.

The proposals contained in this AIPAC ONE - FINAL REPORT of the Alternative Investment Policy Advisory Committee (AIPAC) report actively address the concerns of the industry on this front and push for more reforms that can contribute to measurable successes.

The business environment and outlook for AIFs remains very positive. An important emerging trend is the rising optimism and participation of domestic investors in this vehicle. This report is an attempt to build on the progress made pursuant to the first three reports, on the overarching theme of 'Onshoring the Offshore Capital Pools'. This is the need of the hour. Presently, an overwhelming majority of AIFs investing in India choose to locate their management and administration functions outside the country, leading to lost opportunities for the local economy. This report covers in detail, the need for an internationally competitive tax and regulatory framework for AIFs which can act as an incentive for the funds to operate from India. Fair and consistent taxation for Category III funds has been sought too.

The watershed Goods and Services Tax has just completed one year and the government has tried to make sure that the taxation process is seamless. It has also addressed the concerns of the industry and taken corrective steps, signifying it is open to suggestions and ideas. GST has certain implications on asset managers in India. This report covers GST implications for AIFs in detail and suggests the changes required to make Indian investments more attractive to overseas investors.

Domestic institutional investors are seeing a sizeable expansion in investing capacity and need to be encouraged to channel funds into the AIF asset class. This report recommends on how large government institutions can be encouraged to channel a proportion of their investible surplus into domestic funds. Given the special role played by angel investors in nurturing start-ups, the report covers a simplified structure for angel investments. It makes a strong argument for allowing CSR investments in social impact funds and creating a government Fund-Of-Funds structure for sector-agnostic investments.

It is important to mention that this report has relied considerably on a collaborative approach with the AIF industry and is the result of several deep conversations with various stakeholders to assess the issues and challenges faced. AIPAC members continue to be open to further feedback and additional suggestions will be welcomed.

SEBI has played an invaluable role in the preparation of successive editions of this report by contributing their considerable expertise on the subject matter. I thank their leadership and staff for the insights provided. I sincerely thank all the AIPAC members and market participants who have made an invaluable contribution to making this report complete and for burning midnight oil to prepare this in-depth report.

Thank you once again.

N.R. Narayana Murthy, Chairman
Alternative Investment Policy Advisory Committee

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Terms of reference of the Alternative Investment Policy Advisory Committee:

i. To advise SEBI on issues related to the further development of the alternative investment and start-up ecosystem in India.

ii. To advise SEBI on any hurdles that might hinder the development of the alternative investment industry under its purview.

iii. To advise SEBI on any issues which need to be taken up with other regulators for development of the alternative investment industry.

iv. Any other item relevant to alternative investment industry and development of the start-up ecosystem in India.

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Finally, we thank Vinati Dev for editing, producing and integrating the contents of all AIPAC reports in a common thread consistent with the terms of reference of AIPAC.

As this report was being written, India surpassed France to become the world's sixth largest economy. Key macro indicators also suggest that India is now firmly on a growth path. Both the National Council for Applied Economic and CRISIL have projected a 7.5% growth rate in 2018 – 2019. The International Monetary Fund has predicted India's growth at 7.4% in 2018 and 7.8 % in 2019, respectively. While there are several drivers of this growth, including reforms undertaken by the Government of India (GoI) and Securities Exchange Bureau of India (SEBI), Alternative Investment Fund's (AIF) that includes private equity (PE), venture capital (VC), and angel investors, have made a significant positive contribution to this growth story.

Indeed, over the last fifteen years, AIFs have provided nearly ₹10 lakh crore of risk capital to Indian businesses, funding several major investments across sectors. These have been as diverse as industrial, retail, healthcare, digital consumer, and banking, financial services and insurance (BFSI). Registered AIFs in India have more than doubled over the past couple of years. Currently, there are 402 registered AIFs in India. AIFs have also been a significant contributor to overall fund-raising in the Indian market and have helped raise ₹33,150 crore in 2017, more than double their 2016 total.1 Some of the most well-known AIF funded brands include, but are not limited to, Bharat Forge, TVS Logistics Services Limited, Fab India, Café Coffee Day, Mankind, Medanta, Flipkart, Ola, Paytm, Snapdeal, RBL Bank and Spandana.

The Honorable Finance Minister, Shri Arun Jaitley, has even highlighted the need for developing an enabling policy regime for AIFs. In his 2018 Budget Speech, the Minister stated,

"Venture capital funds (VCFs) and the angel investors need an innovative and special developmental and regulatory regime for their growth. We have taken a number of policy measures including launching ''Start-Up India'' program, building very robust alternative investment regime in the country and rolling out a taxation regime designed for the special nature of the VCFs and the angel investors. We will take additional measures to strengthen the environment for their growth and successful operation of alternative investment funds in India."

May 2018 itself, witnessed 52 PE investments worth about ₹27,230 crore ($4 Billion); 20 VC investments worth about ₹596 crore ($88 million). In addition, super angels and angel networks made 9 investments – the largest was of the amount ₹28 crore ($4.2 million).

Cognizant of this positive role of AIFs, GoI and the regulators, notably the SEBI, have already enabled 27 policy changes to unleash the full potential of AIFs. These changes have been well received by the AIF industry and by the international investor community. A 2017, Global Limited Partner Survey of the Emerging Markets Private Equity Association (EMPEA), indicated India's attractiveness as investment destination. The survey of 106 limited partners, amongst 34 countries,

[1] http://www.bain.com/publications/articles/india-private-equity-report-2018.aspx

ranked India as the number one destination in 2017. In previous years, India's rankings were: 2nd in 2016, 4th in 2015, 8th in 2014 and 9th in 2013.

There is a clear evidence that the progressive reforms undertaken by the GoI and the SEBI have already created a positive environment for investment and positioned India as an attractive investment destination. However, in order to sustain this success, and achieve the highest potential of AIFs as an instrument to catalyze India's economic growth, the existing AIF-related tax and regulatory must be revisited to include important incremental changes in tax and regulations currently governing AIFs. These changes have the potential to pivot India into a preferred investment destination. Given, capital will continue to gravitate towards the most enabling tax and regulatory regimes around the world, it is imperative for India to maintain the momentum and even gain an edge, by unleashing reforms in a proactive and time-bound manner.

SEBI has published that the current AIF commitments raised inflow investments stand at ₹1.65 lakh crore in domestic ventures, which in turn amount to approximately 1% of India's GDP. Additional reforms, however, can result in AIFs achieving their full potential. This can be done by making ₹5 lakh crore in annual domestic investments, while onshoring an additional ₹5 lakh crore of foreign funds within 5 years. Were India to achieve this, AIFs value would amount to 2% of GDP and would have a cascading impact on entrepreneurship and job creation.

Globally, China and the United States, stand as evidence of the critical role of AIFs in a country's economic growth. In China, the venture capital and private equity industry is already seen as a key driving force behind its economic growth, job creation, innovation as well as entrepreneurial success. In the second quarter of 2018, Chinese start-ups accounted for 47% of the world's venture capital funding and have surpassed North America in fundraising.

In the United States, the Jumpstart Our Business Startups Act (JOBS Act) is also a case in point. JOBS Act recognises the role of AIFs and was intended to encourage funding of small businesses in the United States by easing many of the country's securities regulations. The act was passed with bipartisan support, and signed into law by former President Barack Obama on April 5, 2012. Visionary in its approach, JOBS Act, also known as the CROWDFUND Act, created a way for companies to use crowd funding to issue securities, something that was not previously permitted in the United States.

Research has also shown that private equity-backed companies created more jobs and paid higher wages and salaries as well as prioritized spending on research and development versus non-private equity backed ones [2]

In India, thus doubling or tripling AIFs has the potential to enable Indian businesses to innovate, grow and create jobs. Indeed, unleashing AIF's potential is critical for the success of Startup India,

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[2]http://www.bain.com/publications/articles/social-economic-impact-of-private-equity-in-china.aspx

a flagship initiative of the GoI, focused on building a strong ecosystem for nurturing innovation, entrepreneurship, and generating large-scale employment opportunities.

This report presents a set of recommendations from the AIF industry which serves as a reference point for policymakers to bring about holistic, system-wide changes to the design of the regulations that will enable AIFs to achieve their highest potential as a key driver of India's economic growth.

CHAPTER II – Executive Summary

Alternative Investment Funds (AIFs) have been the largest source of risk capital to Indian businesses in the last fifteen years, contributing more than ₹10 lakh crore in capital flows over this period. As per the SEBI data, AIFs now channel ₹1.65 lakh crore annually into Indian ventures, thus emerging as the key drivers of economic growth, innovation and job creation. This has been enabled by as many as 27 proactive policy changes from the SEBI, GoI and the key regulators since 2014.

In his 2018 Budget speech, the Honorable Finance Minister, Shri Arun Jaitley, had also highlighted the positive role played by AIFs in the economy and flagged the need for an innovative and special developmental and regulatory regime for the industry. This is a very positive and welcoming development.

While the authors of this report commend the GoI, the SEBI, and the regulators for the reforms already undertaken, they seek this opportunity to present a case for making incremental, but important regulatory and tax changes that are critical for the next phase of growth in the AIF industry.

It is pertinent to note that of the ₹1.65 lakh crore annual AIF investments in India, only 15% or ₹26,000 crore is pooled in India. Therefore, the Indian Private Equity & Venture Capital Association (IVCA) is of the view that for the industry to scale up to its next phase of growth, focusing on three-pillars is imperative. These pillars are a) Onshoring foreign capital and expansion of existing domestic capital pools b) Creating an internationally competitive tax framework to make India an attractive destination and c) Enabling a powerful full stack ecosystem allowing start-ups to thrive.

Thus, the main section of this report is divided into three chapters which address each of these pillars in depth.

Chapter III discusses the first pillar, i.e. onshoring of foreign pools and expanding domestic capital pools. Global VC/PE funds are now earmarking a sizeable share of their capital pie for India, but there is a lingering concern that over 85% of funds earmarked for India are still pooled in overseas jurisdictions. In order to bring this capital onshore, this report recommends a few changes.

A key suggestion is that AIFs with 100% foreign investment, which locate their fund management operations in India be exempted from GST to make managing in India more attractive. We also suggest that the upcoming IFSC be promoted as an attractive pooling jurisdiction to the international fraternity by clarifying the tax and regulatory regime for AIFs located in the centre. Given that the world over, pension funds and endowment trusts have been instrumental in the expansion of the AIF industry, the report recommends that the domestic institutions such as the National Pension System, Employees Provident Fund Organization and large charitable, religious and educational trusts (over ₹100 crore corpus) be allowed and actively encouraged to access AIFs.

Currently, AIFs managed by Indian banks, financial institutions and NBFCs are disadvantaged on managing in India due to restrictions based on foreign ownership at their parent listed level. The report recommends an appropriate ownership test for such India-listed entities to be able to raise funds domestically and also to manage in India.

Chapter IV discusses the creation of internationally competitive tax and regulatory framework that is required to make India an attractive destination for foreign fund managers and capital pool allocators. It highlights the best practices that can align India's AIF tax regime with competing destinations such as the US and China, currently the world's top destinations for AIF capital.

The first requirement is clarity on the tax treatment of the additional returns[3] made by the investment managers and/or sponsors of Indian AIFs. As a compensation for their knowledge and capital contributions, investment managers (sometimes also the sponsors) of AIFs receive a fixed fee[4] as a percentage of assets and additional returns by way of a variable share of portfolio gains. Currently, while the fixed fee is subjected to the GST and income tax, there is a lack of clarity on the taxation of additional returns. The proposal is that they be taxed as long-term capital gains, as they are an uncertain reward for taking the market risks.

The second is allowing set-off of fixed fee from returns, while reckoning the investor's gains from the AIF vehicle. AIFs typically incur 15-20% of the investor's capital commitments towards fees payable to investment managers and other costs. The suggestion is that the fixed fees paid to an AIF be capitalised as the cost of improvement, while computing the investor's tax liability on the AIF income.

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[3] Additional Returns = Carry Fee

[4] Fixed Fee = Management Fee

Three, the levy of GST on fund management and other services on AIFs receiving foreign capital, violates the principle of destination-based consumption tax that is central to the GST. We suggest that they be exempted from the GST as this adversely impacts the choice of domicile of AIFs as a pooling vehicle to raise foreign capital.

Four, presently profits made by Category I or Category II AIFs are passed through to the investors for tax purposes. But the net losses they make are retained at the fund level and usually lapse. This is conceptually flawed, given that the income earned by AIFs is passed through to investors. Therefore, we request a restoration of pass-through to investors for all net losses incurred by AIFs I/II, at the end of a fund's life.

Five, while there have been several tax measures to encourage Category I and Category II AIFs, Category III AIFs currently lack a distinct tax framework. This category is gaining popularity as an alternate method of investing in the public markets, but is subjected to double taxation and business income characterisation. The report recommends a well-defined fair and consistent taxation framework for this category.

Finally, Chapter V makes suggestions to develop a powerful ecosystem spanning angel investors and angel funds, venture funds, social impact funds and AIFs, to catalyze the start-up revolution in India.

First, it suggests a simplified accreditation framework for High Net Individuals (HNIs) to participate in startups and crowdfunding, taking cues from the US' JOBS Act. It recommends a fully digitized, time-bound accreditation process for HNIs investing in all high-risk assets through a Central KYC mechanism to be set-up under the Central Registry of Securitisation Asset Reconstruction and Security Interest (CERSAI). The conditions for angel tax exemptions need to be liberalized and the investors in angel funds broad-based.

Second, regulators can consider allowing CSR investments in social impact AIFs. Third, with the new National Infrastructure Fund (NIIF) structure in place, the report proposes that the NIIF branch out and consider formation of a sector agnostic Fund-of-Funds with a similar ownership structure.

The concluding Chapter VI presents a detailed list of recommendations and identifies the relevant stakeholders for their implementation and execution. These include the Department Of Economic Affairs and Revenue Department of the Finance Ministry, the Central Board of Direct Taxation, and SEBI. The authors hope that these recommendations will serve as a basis for consultations and result in the creation of a globally competitive AIF regulatory regime in India.

CHAPTER III – Expanding the Available Capital Pools

While giant steps have already been taken in opening the floodgates of capital to the AIF industry, a few incremental tweaks can help further augment the foreign as well as domestic capital pool available to managers in India.

A. Onshoring the Offshore Capital

Global VC/PE funds are now earmarking a rising share of their capital pie for India, but a lingering concern is that over 80% of the ₹6 lakh crore of funds earmarked for India are still pooled in overseas jurisdictions. In the past, this was due to the concessional tax rates for Mauritius and Singapore domiciled vehicles. But with these anomalies getting plugged, there is keen interest from foreign funds to create new AIF pools directly in India. But onshoring this capital pool calls for a few tax changes.

1). Exempt dollar capital from GST:

A key impediment that makes it unattractive for foreign funds to locate fund management operations in India is the 18% GST levied on fixed fees paid by AIFs, to their investment management company. Since there is no output GST liability on AIFs, this GST outgo becomes an incremental cost to be borne by investors with no input credit. For foreign investors in AIFs, this also violates principle of destination-based consumption tax.

In an asymmetric tax treatment, when AIFs pool their funds outside India, GST is not levied as this is treated as export of services. This actually creates incentives for foreign AIFs not to onshore their operations.

We recommend that AIFs with 100% foreign investment, which locate their fund management operations in India, should be exempt from GST. Where the entire investment in AIF is made by foreign investors, the services provided by the manager are completely consumed outside India. Thus, it would be logical to treat such transactions as 'export of services' and to levy a zero rate of GST. This would also be in keeping with the tax treatment of AIFs in competing markets.

2). Encourage AIFs in the International Financial Services Centre (IFSC):

Setting up of an IFSC in India has provided the GOI impetus to push global fund managers to re-locate to India, the GoI should also promote IFSC as a pooling jurisdiction to the global investor fraternity. However, despite GoI's best intent to promote India's IFSC, the extant regulatory and tax regime promoted for Funds poses challenges (such as certainty of regime, fund flow permissibility, investment route, etc.) which needs to be addressed in order to open doors for offshore funds. Where the above challenges are addressed, the IFSC shall result in primary capital inflow into India, incremental taxation revenues from additional businesses and importantly, job stimulation in the domestic market along with its related impact on the domestic consumption pattern. The following recommendations should be considered to overcome the regulatory and tax challenges faced currently:

Recommendations relating to Regulatory Regime for AIFs

Recommendation I:

The SEBI AIF Regulations provide a comprehensive regulatory regime for the setting up and functioning of AIFs in India. Given the familiarity of the existing fund houses in terms of prevailing AIF regime, the SEBI should clarify that the existing SEBI AIF Regulations will also apply to AIFs set up in an IFSC, subject to certain relaxations / modifications as may be notified.

Recommendation II:

SEBI IFSC Regulations should be amended to include 'Trust' as a recognised entity for clarity.

Recommendation III:

An AIF in IFSC should be permitted to invest into India under all the permissible investment avenues including FDI route. Further, participation in the capital of a Limited Liability Partnership incorporated in India should also be allowed. The SEBI and RBI should relax the guidelines for outbound investments by AIFs set up in an IFSC.

Recommendation IV:

The SEBI IFSC guidelines should be amended to allow a Sponsor / Manager of an existing AIF in India to act as a Sponsor / Manager for an AIF in IFSC. Further, the Investment Manager should be permitted to obtain investment advisory services from an entity setup outside IFSC.

Recommendation V:

Foreign Exchange Management (Foreign Currency Accounts By a Person Resident in India) Regulations, 2015should be amended to liberalize remittance transactions between the Sponsor / Manager's head office in India and its branch in the IFSC. In order to facilitate ease of doing business in the IFSC, certain conditions under the Foreign Exchange Management (Transfer or Issue of Any Foreign Security) Regulations, 2004 should be exempted.

Recommendations relating to Regulatory Regime for Investment Advisors

Recommendation VI:

The SEBI Investment Advisor Regulations provide a comprehensive regulatory regime for setting up and functioning of Investment Advisors in India. However, the current regime does not regulate investment advisors who exclusively advice foreign clients.

Further, where an existing Investment adviser (which is already registered with SEBI) proposes to advice foreign clients, this activity will be treated as unregulated and being an unregulated activity, the minimum capitalisation requirements under FEMA could apply to such an entity.

Given that IFSC is an offshore business platform, SEBI should permit and regulate Investment Advisors set up in IFSC exclusively providing service to foreign clients.

Recommendations relating to Taxation Regime for AIFs

Recommendation VII:
With a view to encourage offshore investment by a foreign investor through a fund set up in IFSC in India, any income earned through an offshore investment by an AIF in IFSC should be exempted from tax in India.

Recommendation VIII:
In order to encourage foreign investors to directly come into the IFSC without worrying about the hassle of Indian tax compliances, the foreign investors should be exempted from obtaining PAN and filing of tax return in India, in respect of any income distributed by an AIF in IFSC after deduction of tax at source.

Suggestions for regulating and encouraging setting-up of Alternative Investment Funds in International Financial Service Centre

Overview of an IFSC

- An IFSC caters to customers outside the jurisdiction of a country's domestic economy and deals with flows of finance, financial products and services across borders.
- Various countries like London, Singapore, Hong Kong, Dubai, etc. had developed an IFSC to provide international financial services to the customers outside their domestic jurisdictions and are continuing to benefit on large scales by functioning as global pioneers in the financial services market.
- Such IFSCs have created significant economic value for their domestic economy and have continued to remain successful on account of the following factors:
    - Availability of skilled personnel;
    - Suitable regulatory environment;
    - Corporate and personal tax regime;
    - Availability of business infrastructure;

    - Access to international financial markets; and
    - A fair business environment.
- According to Global LP's survey, India is seen as one of the most attractive emerging markets for allocating fresh commitments and offshore funds play a very important role in the financial market of the Indian economy.
- India possesses a strong tax and regulatory regime to manage its financial markets, a talent pool on par with global peers and the required infrastructure to offer facilities which are required to function as a pooling jurisdiction.
- The GoI had notified India's first IFSC in Gujarat at GIFT City and followed it with relevant tax/regulatory amendments to enable its functioning.
- Internationally, pooling vehicles have been set up in offshore jurisdictions which offer benefits identical to an IFSC.
- While the setting up of an IFSC in India has provided the GoI impetus to push global fund managers to re-locate to India, the GoI should also promote IFSC as a pooling jurisdiction to the global investor fraternity.
- From a taxation perspective, given the recent developments on tax treaty re-negotiations, Multi-lateral instruments, BEPS initiatives, the taxation regime in IFSC is quite well balanced and relatively on par (subject to certain issues) with other offshore regimes.
- However, despite GoI's best intent to promote India's IFSC, the extant regulatory and tax regime promoted for Funds poses challenges (such as certainty of regime, fund flow permissibility, investment route, etc.) which needs to be addressed in order to open doors for offshore funds.
- Where the above challenges are addressed, the IFSC shall result in primary capital inflow into India, incremental taxation revenues from additional businesses and importantly, job stimulation in the domestic market along with its related impact on the domestic consumption pattern.

Issues

Regulatory issues to be addressed for setting up AIFs in IFSC

I. *Clarity on applicability of existing SEBI AIF regulations to IFSC*

- The SEBI had issued specific guidelines governing the operation of capital markets in an IFSC on 27 March 2015.
- Chapter VI of the SEBI IFSC Guidelines deals with Funds [such as an AIF and MF] in an IFSC and stipulates eligibility criteria for investors, permissible avenues for investment and the currency involved.
- The aforesaid guidelines provide that various other requirements such as appointment of trustee, custodian, manager, minimum investment amount, minimum corpus of fund, disclosures, valuation norms, investment conditions, types of schemes, professional qualifications, etc., shall be as prescribed by SEBI.

- On 23 May 2017, the SEBI issued a circular[5]clarifying the investment conditions. However, SEBI has neither clarified other operational and regulatory aspects nor notified that the existing framework will apply.
- In this context, reference may be drawn to the SEBI AIF Regulations, which provide a comprehensive regulatory regime for the setting up and functioning of alternative investment funds in India, also addressing all the operational and regulatory requirements. SEBI AIF Regulations deal with the form of entity in which an AIF may be set up, various categories of AIFs, their investment strategies and conditions for investments, requirement for having a sponsor / manager including their rights and obligations, valuation norms, mechanism for dispute resolution and provide certainty on operating aspects (such as maintenance of records, submission of reports, winding up, etc.).
- Further, the Finance Act 2015 also introduced a special tax regime for taxation of such AIFs considering the above regulatory regime.
- Given the familiarity of the existing fund houses in terms of the prevailing AIF regime, the SEBI should clarify that the existing SEBI AIF Regulations will also apply to AIFs set up in an IFSC, subject to certain relaxations / modifications as discussed later in this document.

II. <u>Setting up an AIF as a Trust in IFSC to be provided by SEBI</u>

- Currently, guideline 2 (1)(d) in Chapter I of the SEBI IFSC Guidelines defines the term "financial institution" to include various types of entity types except a Trust.
- Further, the explanation to the above-mentioned guideline also provides that certain financial service players (governed by the SEBI) would be treated as financial institutions which include AIFs and MFs.
- Under the existing SEBI AIF Regulations, the preferred market practice is to set up an AIF / MF in the form of a Trust.
- However, the definition of financial institution as provided in the SEBI IFSC Guidelines does not include 'Trust', which is a deterrent for any new entrant into the IFSC.
- Given the preferred market practice in the existing regime, the inclusion of 'Trust' as a recognised entity type under the SEBI IFSC Guidelines will encourage existing players to establish / expand fund businesses in the IFSC.
- Further, it will also be a tried and tested entity model for any interested participant looking to set up operations in the IFSC.

III. <u>Investment avenues for AIFs in IFSC</u>

Inbound investments

[5]SEBI Circular No. SEBI/HO/MRD/DSA/CIR/P/2017/45 dated May 23, 2017

- Currently, offshore funds / investors invest in listed as well as unlisted securities in the Indian market through different foreign investment routes [i.e., through the FDI route, FPI route and the FVCI route].
- The SEBI IFSC Guidelines for Funds permits investment in the following:
    - Securities which are listed in IFSC;
    - Securities issued by companies incorporated in IFSC; and
    - Securities issued by companies belonging to foreign jurisdiction.
- Subsequently, the SEBI vide Circular No. SEBI/HO/MRD/DSA/CIR/P/2017/45 dated May 23, 2017, expanded the scope of permissible investments for AIFs in IFSC by allowing them to invest in the securities issued by companies incorporated in India subject to such conditions or guidelines that may be stipulated or issued by the RBI and GoI from time to time".

  Further, the Circular also stated that such investment by an AIF shall be through the FPI route.
- As per the SEBI (Foreign Portfolio Investors) Regulations, 2014 ("SEBI FPI Regulations"), any investment under the FPI route is permitted only in securities which are listed or to be listed on a recognized stock exchange in India (through primary and secondary markets).
- As a result of the above clarification, an AIF in IFSC may not be able to invest in unlisted securities (including shares of a private limited company and capital of a limited liability partnership) in the Indian market. This may limit an AIF's ability to attract offshore funds / investors.
- In order to ensure that AIF's in IFSC are treated on par with the offshore funds / investors with respect to the permissible investment avenues for making investments into India, an AIF in IFSC should be permitted to invest into India under all the permissible investment avenues including FDI route.
- Further, an AIF in IFSC should also be allowed to participate in the capital of a Limited Liability Partnership incorporated in India.

Outbound investments

- The SEBI vide circular[6]dated October 1, 2015 had issued 'Guidelines on overseas investments and other issues / clarifications for AIFs/VCFs' in which it had drawn reference to the RBI's A.P.(DIR Series) Circulars[7] which provide various guidelines / restrictions for outbound

[6] CIR/IMD/DF/7/2015
[7] A.P.(DIR Series) Circular No.48 dated December 09, 2014
A.P. (DIR Series) Circulars No. 49 and 50 dated April 30, 2007 and May 04, 2007 respectively

investments by AIFs in India. Further, the SEBI vide circular[8] dated July 3, 2018 has enhanced the limits for overseas investments by AIFs and VCFs.

- With a view to promote and encourage setting up of AIFs in IFSC for making outbound investments and bring them on par with offshore funds, the SEBI and RBI should relax the above guidelines for AIFs set up in an IFSC.

IV. *Sponsor and Manager of the AIF in IFSC*

- An AIF is promoted / formed by a Sponsor and is required to appoint a Manager to manage its investments and such Sponsor / Manager are required to meet certain prescribed conditions. Some key conditions have been elaborated below –
  - Fulfill criteria for been determined as a 'Fit and Proper' person under Schedule II to SEBI (Intermediaries) Regulations, 2008 read with clause 4(f) of the AIF regulations;
  - Possess adequate experience, with at least one key personnel having not less than five years of experience in advising or managing pools of capital or in fund or asset or wealth or portfolio management or in the business of buying, selling and dealing of securities or other financial assets and has relevant professional qualification as per clause 4(g) of the AIF regulations; and
  - Possess the necessary infrastructure and manpower to effectively discharge its activities as per clause 4(h) of the AIF Regulations.
- From an investor perspective, the performance of a Fund is driven by the Sponsor / Manager's expertise and an experienced Sponsor / Investment Manager helps investors in the following ways:
  - Discern the best strategy for Investments
  - Analyse status of finance, and assist in asset and stock selection
  - Monitor investments on an ongoing basis
  - Help gain maximum benefits from investments
  - Provide advice on investment areas
  - Handle investor decisions and investments with the utmost discretion
- From a practical perspective, it may be difficult for any new Sponsor / Manager being set up in the IFSC to meet the above requirements and attract investors for the AIF in IFSC. Further, there is no clarity regarding permissibility of obtaining investment advisory services by an Investment Manager from an entity set up outside IFSC.
- Hence, in order to retain the investors' confidence and also to meet the requirements of the regulatory regime, the SEBI IFSC Guidelines should be amended as follows:

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[8] SEBI/HO/IMD/DF1/CIR/P/2018/103/2018

- A Sponsor / Manager of an existing AIF in India should be permitted to act as a Sponsor / Manager for an AIF in IFSC by setting up a branch in IFSC; and
- A Sponsor / Manager of an existing AIF in India should be permitted to act as a Sponsor / Manager for an AIF in IFSC by incorporating a company / limited liability partnership in IFSC;

Further, the above should be considered as automatically approved by the SEBI.

- Further, the Investment Manager should be permitted to obtain investment advisory services from an entity setup outside IFSC

V. *Sponsor / Manager commitment*

- As required under the SEBI AIF Regulations, the Manager or Sponsor would be required to have a continuing interest in the corpus of the AIF in IFSC by way of investment, which shall be the lower of, two and half percent of the corpus or five crore rupees. In case of Category III AIFs, the continuing interest shall be not less than five percent of the corpus or ten crore rupees, whichever is lower.
- Considering the recommendations in para IV above, the Sponsor / Manager commitment to an AIF in IFSC may be satisfied under any of the following scenarios:
    - **Scenario 1** - Domestic Sponsor / Manager in India to set up a branch in IFSC and act as a Sponsor / Manager for an AIF in IFSC
    - **Scenario 2**–Domestic Sponsor / Manager in India to incorporate a company in IFSC and act as a Sponsor / Manager for an AIF in IFSC
- Since the domestic Manager / Sponsor shall qualify as a 'person resident in India', the Foreign Security Regulations shall apply.
- As per the Foreign Security Regulations, the following permissions have been given:
    - A 'person resident in India' may purchase / sell any foreign security subject to conditions specified in sub-regulation 4 of these regulations;
    - An Indian Party to make an investment in an entity outside India, engaged in financial services activities, subject to satisfaction of conditions specified in sub-regulation 7;
    - An Indian Party to make direct investment in a Joint Venture or Wholly Owned Subsidiary outside India subject to conditions specified in sub-regulation 6 other than those covered under sub-regulation 7.
- Given the above, the impact of the extant regulations and the suggestions thereto are discussed below for each scenario:

***Scenario 1**- Domestic Sponsor / Manager in India to act as a Sponsor / Manager for an AIF in IFSC by setting up a branch in IFSC*

- The branch of a Sponsor / Manager set up in an IFSC would be treated as a 'person resident outside India' under the FEMA IFSC regulations.
- Currently, Regulation 5 (B) of the Foreign Exchange Management (Foreign Currency Accounts By a Person Resident In India) Regulations, 2015 permits a company / firm in India to open, hold and maintain a foreign currency account with a bank outside India for the purpose of its overseas branch's operations subject to the following conditions:

  "A firm or a company or a body corporate registered or incorporated in India (hereinafter referred to as 'the Indian entity') may open, hold and maintain in the name of its office (trading or non-trading) or its branch set up outside India or its representative posted outside India, a foreign currency account with a bank outside India by making remittances from India for the purpose of normal business operations of the office/branch or representative;

  Provided that—

  (a) the overseas branch/ office has been set up or representative is posted overseas for conducting normal business activities of the Indian entity;

  (b) the total remittances made under this sub-Regulation by the Indian entity, to all such accounts in an accounting year shall not exceed

  (i) 15%of the average annual sales/ income or turnover of the Indian entity during the last two financial years or up to 25%of the net worth, whichever is higher, where the remittances are made to meet initial expenses of the branch or office or representative; and

  (ii) 10%of such average annual sales/ income or turnover during the last financial year where the remittances are made to meet recurring expenses of the branch or office or representative;

  (c) the overseas branch/ office/ representative shall not enter in any contract or agreement in contravention of the Act, Rules or Regulations made thereunder;

  (d) the account so opened, held or maintained shall be closed,

  (i) if the overseas branch/ office is not set up within six months of opening the account, or

  (ii) within one month of closure of the overseas branch/ office, or

  (iii) where no representative is posted for six months ...."

- In order to liberalize remittance transactions between the Sponsor / Manager's Head office in India and its branch in the IFSC, the Reserve Bank of India should amend the Foreign Exchange Management (Foreign Currency Accounts By a Person Resident In India) Regulations, 2015.

Scenario 2*- Domestic Sponsor / Manager in India to incorporate a Company in IFSC and act as a Sponsor / Manager for an AIF in IFSC*

- Any investment in a Joint Venture / Wholly owned subsidiary outside India by a person resident in India needs to be compliant with the Foreign Security Regulations.
- Specifically, the investment by the Domestic Sponsor / Manager in the Company, which is to act as the Sponsor / Manager of the AIF in the IFSC, shall need to be in compliance with conditions prescribed under sub-regulation 7 (reproduced below).

> *"****7. Investment in Financial Services Sector****
>
> *(1)Subject to the Regulations in Part I, an Indian party may make investment in an entity outside India engaged in financial services activities:*
>
> *Provided that the Indian party*
>
> > *i. has earned net profit during the preceding three financial years from the financial services activities;*
> >
> > *ii. is registered with the regulatory authority in India for conducting the financial services activities;*
> >
> > *iii. has obtained approval from the concerned regulatory authorities both in India and abroad, for venturing into such financial sector activity;*
> >
> > *iv. has fulfilled the prudential norms relating to capital adequacy as prescribed by the concerned regulatory authority in India.*
>
> *(2) any additional investment by an existing JV/WOS or its step down company in the Financial Services Sector shall be made only after complying with the conditions stipulated in*
> *sub-clause (1)."*

- In order to facilitate ease of doing business in the IFSC, the conditions under Regulation 7 of the Foreign Security Regulations should be exempted for the above investment by the Domestic Sponsor / Manager.

Regulatory issues to be addressed for setting up Investment Advisors in IFSC

VI. Clarity on applicability of existing SEBI (Investment Advisers)Regulations, 2013 to IFSC

- The SEBI had issued specific guidelines governing the operation of capital markets in an IFSC on 27 March 2015.
- Chapter I of the SEBI IFSC Guidelines provides broad objective and lays down the definition of "intermediaries" which includes a reference to Investment Advisers. However, the guidelines do not specifically provide operating guidelines for Investment Advisers in IFSC.

- Given the familiarity of the prevailing investment advisory regime, the SEBI should clarify that the existing SEBI (Investment Advisers) Regulations, 2013 will also apply to investment advisers set up in an IFSC, subject to certain relaxations / modifications.

VII. *Regulating advisory services to foreign clients*

- As per clause (i) of para 4 of the existing SEBI(Investment Advisers) Regulations, 2013 SEBI has exempted any person, who provides investment advice exclusively to clients based out of India, from obtaining any registration.
- In accordance with the provisions of the said clause, an investment advisor setup in IFSC rendering services exclusively to clients based out of India will not require any registration with the SEBI and hence be unregulated.
- Since such investment advisors would be unregulated, they will not be considered as an IFSC unit and further might not enjoy the confidence of the global investment funds and may not be in a position to compete with global peers. Hence it may be necessary to ensure that such investment advisors are regulated in order to provide them with sufficient credibility to solicit global investment funds.
- Per Regulation 16 of the FEMA (Transfer or Issue of Security by A Person Resident outside India) Regulations, 2017, minimum capitalisation requirements could apply to any domestic Indian advisory entity proposing to undertake advisory services to foreign clients.
- Also, the tax incentives associated with IFSC units will not be available and the special status of being treated as a 'Person resident outside India' will not be applicable.
- Therefore, investment advisors in IFSC should be regulated with specific conditions laid down for their eligibility.

Tax issues to be addressed for setting up an Alternative Investment Funds in International Financial Services Centre ('IFSC')

VIII. *Exemption from tax for any income earned by an offshore investor from offshore investments made through a Fund in IFSC*

- Indian tax laws follow source based taxation, where in any income earned by a non-resident is taxable in India, if such income is –
    - Received or deemed to be received in India; or
    - Accrues or arises or is deemed to accrue or arise in India.
- Accordingly, any income earned by a foreign investor from an investment made in an offshore jurisdiction through a fund set up in IFSC is taxable in India. (For example, any income earned by a US investor from making investment in Korean market through an AIF / company set in IFSC would be taxable in India.)

- However, if a similar transaction is undertaken through a fund set up in offshore jurisdiction (For e.g., Singapore then any income earned by a US investor from making investment in Korean market through a fund set up in Singapore), the income may not be subject to any tax in Singapore.
- Such an unfavorable tax treatment, may act as a hindrance for global fund managers to set up a fund i.e. pooling vehicle in an IFSC.
- Given the above, with a view to encourage offshore investment by a foreign investor through a fund set up in IFSC in India, any income earned through such a transaction should be exempted from tax in India.

IX. <u>Relaxation from filing return of income and obtaining PAN number for offshore investors in an AIF in IFSC</u>

- Currently, Category I and II AIFs have been provided tax pass through status for capital gains under the Indian income tax laws. However, while distributing any income to its investors, an AIF is required to withhold taxes at the applicable rates based on the jurisdiction of the investor and remit such taxes to the Government of India.
- Further, the Indian income tax laws also require the unit holders to obtain tax registration (i.e. to obtain PAN) and disclose such income by filing of a RoI in India.
- In a way, collection of tax revenue is met by the above withholding requirement in the hands of the AIF resulting in no tax revenue leakage for the GoI.
- The need to obtain tax registrations and filing of a RoI by the unit holder requires an investor to go through the rigours of compliances in India. While this approach may be required for the domestic market, an IFSC regime should be more investor friendly in terms of compliance requirements.
- Hence, in order to encourage foreign investors to directly come into the IFSC without worrying about the hassle of Indian tax compliances, the Government of India should exempt the foreign investors from obtaining PAN number and filing of tax return in India, in respect of any income distributed by an AIF in IFSC after deduction of tax at source.
- However, where such foreign investor earns any other income from India, such foreign investor should be subject to the above compliances.

<u>Rationale</u>

About International Financial Centre

- An International Financial Centre caters to customers outside the jurisdiction of a country's domestic economy and deals with flows of finance, financial products and services across borders such as:

- Fund-raising services for individuals, corporations and governments;
- Asset management and global portfolio diversification undertaken by pension funds, insurance companies and mutual funds;
- Wealth management;
- Global tax management and cross-border tax liability optimization, which provides a business opportunity for financial intermediaries, accountants and law firms;
- Global and regional corporate treasury management operations that involve fund-raising, liquidity investment and management and asset-liability matching;
- Risk management operations such as insurance and reinsurance; and
- Merger and acquisition activities among trans-national corporations.

- Such International Financial Centre's benefit from a low burden of regulation and prove extremely attractive for offshore investors / funds as they are driven by lighter regulatory requirements, world class infrastructure, ease of doing business rather than the perceived tax benefits.
- The world has witnessed the growth of international financial hubs such as London, New York, Hong Kong, Singapore and Dubai.

An International Financial Service Centre in India

- Currently, Indian economy is one of the fastest growing economies in the world and has been considered one amongst the most attractive destinations for foreign investment.
- India has a diversified financial services sector undergoing rapid expansion, both in terms of strong growth of existing financial services firms and new entities entering the market. The sector comprises commercial banks, insurance companies, non-banking financial companies, co-operatives, pension funds, mutual funds and other smaller financial entities.
- India's financial service sector currently[9] –
    - Employs over 4 million people and likely to grow around 10-11 million by 2020;
    - Represents around 5% of the GDP and will grow to 15% by 2020;
    - Estimated market capitalisation of over US$ 300 billion and likely to grow over US$ 1600 billion by 2020.
    - Offers distinct kinds of opportunities across several product markets
- Considering the above potential, the GoI had notified India's first IFSC at GIFT City, Gandhi Nagar, Gujarat followed by regulatory and tax notifications for enabling its functioning.

[9] http://giftgujarat.in/documents/GIFT-Corporate-Presentation.pdf

- The IFSC in Gujarat has been set up in a Special Economic Zone hosting world class infrastructure, facilities and has two International Stock Exchanges operating round the clock to cater to the global market.
- Given India's commitment to the Organization for Economic Cooperation and Development's 'G20 Base Erosion and Profit Shifting' Project, the GoI aims to promote its IFSC as a global financial services hub with minimal tax arbitrage vis-à-vis its domestic and other global markets.
- While the promotion and development of the IFSC is in the GOI's priority list, the current regulatory regime promoted for Funds has in-built regulatory restrictions which needs to be addressed in order to open doors for offshore funds.
- In specific, the current regulatory regime for AIFs in IFSC is very restrictive and offers investment in limited products/sectors. Considering the issues highlighted above in background and with a view to have a suitable regulatory regime for offshore investors / funds to set up an AIF in IFSC for making inbound as well as outbound investment, the following recommendations along with suggested amendments/clarifications need to be implemented.
- Further, the existing regime for Investment Advisers needs to be expanded to regulate advisers to advice foreign clients from the IFSC.
- Such amendments/clarifications will contribute to the overall success of IFSC and Indian economy by attracting fund managers to set up AIFs (funds) in IFSC and attract foreign investors.

Proposed Recommendations

I. *Clarity on applicability of existing SEBI AIF regulations to IFSC*

- In order to establish a suitable and robust regulatory regime for AIFs operating in IFSC, SEBI should extend the existing SEBI AIF Regulations to AIFs in IFSC subject to certain relaxations / modifications as discussed in the following paragraphs.
-

Suggested Amendments:

- It is recommended to insert the following Explanation under clause 2(b), before the proviso, of the SEBI AIF Regulations, 2012:

"Explanation: For the purpose of this clause –

i) the term Alternative Investment Fund shall include an Alternative Investment Fund set up in an International Financial Services Centre;

ii) "International Financial Services Centre" shall have the same meaning as assigned to it in clause (q) of section 2 of the Special Economic Zones Act, *2005."*

- Further, it is also recommended to insert the following proviso under clause 3(1) of Chapter II of the SEBI AIF Regulations:

  "Provided further that this regulation shall apply to an alternative investment fund set up in an International Financial Services Centre, as modified by the Securities and Exchange Board of India (International Financial Services Centres) Guidelines, 2015, amended from time to time."

II. *Setting up an AIF as a Trust in IFSC to be provided by SEBI*

- The inclusion of 'Trust' as a recognised entity type under the SEBI IFSC guidelines will encourage existing players to establish / expand Fund businesses in the IFSC.

Suggested Amendments:

The SEBI (International Financial Services Centres) Guidelines, 2015 - Guideline 2(1)(d) under Chapter I may be amended as follows:

"

(d) financial institution shall include:

(i) a company;

(ii) a firm;

(iia) a trust;

(iii) an association of persons or a body of individuals, whether incorporated or not; or

(iv) any artificial juridical person, not falling within any of the preceding categories engaged in rendering financial services in securities market or dealing in securities market in any manner.

Explanation ...."

III. *Investment avenues for AIFs in IFSC*

- Currently, offshore funds / investors invest in the listed as well as the unlisted securities[10] in the Indian market through FDI route, FPI route or FVCI route.
- Considering the above, in order to ensure that AIF's in IFSC are treated on par with the offshore funds / investors with respect to the permissible investment avenues for making

[10] including interests in limited liability partnerships

investments into India, an AIF in IFSC should be permitted to invest into India under all the permissible investment avenues.

- Further, an AIF in IFSC should also be allowed to participate in the capital of a Limited Liability Partnership incorporated in India.
- Considering the above, specific amendments should be made in the regulations to expand the available investment products for an AIF set up in IFSC.

Suggested Amendments:

SEBI Impact

Clause 22 (3) of SEBI (International Financial Services Centres) Guidelines, 2015 should be amended and read as follows:

"Any alternative investment fund or mutual fund operating in IFSC shall be permitted to invest in the following:

a. Securities which are listed in IFSC;
b. Securities issued by companies incorporated in IFSC;
c. Securities issued by companies incorporated in India or companies belonging to foreign jurisdiction; and
d. Capital of limited liability partnerships incorporated in India;
subject to such conditions or guidelines that may be stipulated or issued by the Reserve Bank of India and Government of India from time to time."

~~*Further, it is clarified that such portfolio manager, alternative investment fund or mutual fund shall invest in India through the foreign portfolio investor route.*~~

Such alternative investment fund or mutual fund shall obtain registration, where necessary, under the Securities and Exchange Board of India (Foreign Portfolio Investors) Regulations, 2014."

Further, it is clarified that the Circular No. CIR/IMD/DF/7/2015 dated /1 October 2015 issued by the Board on 'Guidelines on overseas investments and other issues / clarifications for AIFs/VCFs' shall not apply to an AIF set up in an IFSC."

FEMA Impact

The following proviso needs to be inserted in Regulation 26 of the Foreign Exchange Management (Transfer or issue of Foreign Security) Regulations, 2004:

"Provided that nothing contained in this regulation shall apply to an AIF set up in an IFSC."

IV. Sponsor and Manager of the AIF in IFSC

- Considering the regulatory requirements for Sponsor / Manager discussed in paragraph IV of the background section, the SEBI IFSC Guidelines should be relaxed to permit a Sponsor / Manager of an existing AIF in India to act as a Sponsor / Manager of an AIF in IFSC by setting up a branch or a company in the IFSC. Further, the Investment Manager shall be permitted to obtain investment advisory services from an entity set up outside IFSC.

Suggested Amendments:

It is recommended to insert the following clause 22.7and 22.8 in Chapter VI – Funds of the SEBI (International Financial Services Centres) Guidelines, 2015:

"22.7 The Sponsor / Manager of an Alternative Investment Fund in IFSC shall be in compliance with the provisions of this clause -

a) A Sponsor / Manager of an Alternative Investment Fund in India may act as a Sponsor / Manager of an Alternative Investment Fund set up in the IFSC by –

i) setting up a branch in the IFSC; or

ii) incorporating a company in the IFSC

subject to any guidelines, regulations issued by the Reserve Bank of India from time to time.

b) In other cases, such a Sponsor / Manager shall need to incorporate a company or limited liability partnership in the IFSC.

22.8 The Manager of an Alternative Investment Fund in IFSC may obtain advisory services from an entity set up outside IFSC."

V. Sponsor / Manager commitment

- Further to the discussions in the background section IV of this document, the following amendments could be made to the relevant Foreign Exchange Management Regulations.

***Scenario 1**- Domestic Sponsor / Manager in India to act as a Sponsor / Manager for an AIF in IFSC by setting up a branch in IFSC*

To liberalise remittance of fund by the Sponsor/Manager in India to its branch in IFSC, the Reserve Bank of India should amend the Foreign Exchange Management (Foreign Currency Accounts By a Person Resident in India) Regulations, 2015 to specifically permit such remittances.

Suggested Amendments:

- It is recommended to amend clause (B) of Regulation 5 of the Foreign Exchange Management (Foreign Currency Accounts By a Person Resident In India) Regulations, 2015 by inserting the following clause (iii) under clause (b) to the first proviso as follows::

"(iii) Nothing contained in clause (i) and (ii) above shall apply to any remittance made to the branch, which is a Sponsor / Manager of an Alternative Investment Fund in an International Financial Services Centre."

***Scenario 2**- Domestic Sponsor / Manager in India to incorporate a Company in IFSC and act as a Sponsor / Manager for an AIF in IFSC*

Suggested Amendments:

It is recommended to amend sub-regulation 7 of the Foreign Exchange Management (Transfer or issue of Foreign Security) Regulations, 2004 by inserting the following proviso after clause (2) as follows:

"Provided that nothing contained in clause 1) and 2) above shall apply to any investment made by a person resident in India in a company or limited liability partnership, incorporated in an International Financial Services Centre, to act as a Sponsor / Manager for an Alternative Investment Fund in such centre."

VI. *Clarity on applicability of existing SEBI (Investment Advisers) Regulations, 2013 to IFSC*

- In order to establish a suitable and robust regulatory regime for Investment Advisers in IFSC, SEBI should extend the existing SEBI Investment Advisers to investment advisers in IFSC subject to certain relaxations / modifications as discussed in the following paragraphs.

Suggested Amendments:

- It is recommended to insert the following Explanation under clause 2(m), of the SEBI (Investment Advisers) Regulations, 2013:

  "Explanation: For the purpose of this clause –

  iii) the term investment adviser shall include an investment adviser set up in an International Financial Services Centre;

  iv) "International Financial Services Centre" shall have the same meaning as assigned to it in clause (q) of section 2 of the Special Economic Zones Act, 2005."

- Further, it is also recommended to insert the following proviso under clause 3(1) of the SEBI AIF Regulations:

"Provided further that this regulation shall apply to an investment advisor set up in an International Financial Services Centre, as modified by the Securities and Exchange Board of India (Investment Advisers) Regulations, 2013, amended from time to time."

VII. Regulating investment advisory services to foreign clients

- In order to ensure credibility of investment advisers set up in IFSC, the investment advisers in IFSC should be appropriately regulated by SEBI.

Suggested Amendments:

- It is recommended to insert the following proviso under clause 4(i), of the SEBI (Investment Advisers) Regulations, 2013:

"Provided further that nothing contained in this clause shall apply to an investment adviser set up in an International Financial Services Centre."

VIII. *Exemption from tax for any income earned by an offshore investor from offshore investments made through a Fund in IFSC*

- In order to treat an AIF set up in an IFSC on par with a fund, i.e. a pooling vehicle set up in an offshore jurisdiction, and encourage offshore investments by a foreign investor through a fund set up in an IFSC in India, any income arising from such investments should be exempted from tax in India.

Suggested Amendments:

It is recommended to insert the following proviso in section 5(2) of the Income-tax Act, 1961

"Provided that in the case of a non-resident, being an unit holder in an Alternative Investment Fund set up in an International Financial Services Center in India, the income referred to in sub-section (2) above, shall not include any income, to the extent, derived from any investment made by such Alternative Investment Fund outside India.

Explanation 3.- For the purpose of this proviso, an Alternative Investment 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 and is regulated under the Securities and Exchange Board of India (Alternative Investment Fund) Regulations, 2012 and Securities and Exchange Board of India (International Financial Services Centres) Guidelines, 2015made under the Securities and Exchange Board of India Act, 1992 (15 of 1992).

IX. *Exemption from filing return of income and obtaining PAN number for offshore investors in an AIF in IFSC*

- In order to encourage foreign investors to directly come into the IFSC without worrying about the hassle of Indian tax compliances, the Government of India should exempt the offshore investors from obtaining PAN number and filing of tax return in India, in respect of any income distributed by an AIF in IFSC after deduction of tax at source.

Suggested Amendments:

A. *Exemption from obtaining Permanent Account Number*

It is recommended to issue the following notification pursuant to powers conferred in clause (d) to sub-section (8) of section 139A of the Income-tax Act, 1961

SECTION 139A OF THE INCOME-TAX ACT, 1961 –EXEMPTION FOR INVESTORS IN AN ALTERNATIVE INVESTMENT FUND SET UP IN AN INTERNATIONAL FINANCIAL SERVICES CENTRE

NOTIFICATION NO. S.O. _(E) [NO. XXX—201X (F. NO. __-__-__-__)], DATED XX-XX-201X

In exercise of the powers conferred by clause (d) to sub-section (8) of section 139A of the Income-tax Act, 1961 (XX of 1961), the Central Government hereby specifies that the requirement to obtain a permanent account number shall not apply in respect of the following class or classes of persons, namely:

(a) a non-resident, not being a company, or
(b) a foreign company

which earns income only from investments made in an Alternative Investment Fund set up in an International Financial Services Centre.

B. *Exemption from filing Return of Income*

It is recommended to insert the following sub clause (iv) in clause (a) of sub-section (1) in section 115A of the Income-tax Act, 1961

"(iv) income received in respect of units, purchased in foreign currency, of an Alternative Investment Fund set up in an International Financial Services Centre;"

3). Non-applicability of GST to long-term gains of Investment Managers/Sponsors:

In an AIF structure, investors are akin to 'sleeping' partners contributing higher capital, while the Sponsor and/or the Investment Manager acts as a 'working partner'. Investment returns earned by the AIF are usually split between investors and the Sponsor. The distributions to the Sponsor should therefore be viewed as return on investment and taxed as capital gains, rather than under GST.

B. Tapping domestic institutions

The world over, institutional investors such as pension funds and endowment trusts have been instrumental in the expansion of the AIF industry, given their staying power. Educational endowments such as Yale for instance, have a 30%allocation to VC/PE funds. In India, banks, insurers and the National Pension System have been permitted to invest in AIFs. With domestic investor interest in capital markets taking wing, this appears to be an opportune time to encourage higher participation in AIFs from other domestic institutions, such as charitable trusts and the EPFO.

1). Encouraging investments by charitable trusts, EPFO:

World over, institutions such as pension funds and endowment trusts have been instrumental in the expansion of the AIF industry, given their staying power (Yale has a 30%allocation to VC/PE funds). In India, banks, insurers and the NPS have been permitted to invest in AIFs. With investor interest in capital markets taking wing, this appears to be an opportune time to encourage higher participation in AIFs from other domestic institutions.

Charitable, religious and educational trusts are looking to deploy significant capital outside conventional low-return avenues. The AIF vehicle is ideally suited to such investors. We suggest that large charitable, religious trusts and educational trusts (over ₹100 crore) be permitted to invest upto 10% of their assets in AIFs. The EPFO can also be enabled to invest in AIFs in line with PFRDA regulations.

2). Replicate SIDBI model:

The SIDBI fund of funds for encouraging start-ups has done a commendable job in catalyzing capital commitments for Indian startups. It has invested ₹1,418 crores in 46 AIFs, which has in turn helped them attract 4.5X that capital (₹6,432 crores) from other investors. These investments have incrementally employed 4,180 people. The only suggested tweak is a more long-term budgeting framework for SIDBI fund of funds, given that drawdowns happen over 4-5 years. The SIDBI model also deserves to be replicated by others such as NIIF, which can take up a fund of funds for private equity.

3). Enable listed Permanent Capital Vehicles in AIFs:

SEBI is currently working on regulations for a new category of special investment vehicles termed as Permanent Capital Vehicles (PCVs) that will pool permanent capital from private investors to provide capital to small and mid-market companies. Presently, these vehicles are envisaged mainly to provide debt funding to mid- market firms. Progressively, the scope of PCVs may be expanded to allow for other strategies, such as providing very long-term equity funding. Enabling the listing of these vehicles will enable capital formation. An accredited investor framework can be used to screen participation in these funds.

4) Managing Alternative Investment Funds in India – Foreign Ownership Test

I. Introduction: Need for Liberalisation

1. Indian fund managers and sponsors are disadvantaged due to the level of foreign ownership at their parent listed level. The current rules issued by the Reserve Bank of India largely mean that Indian Financial services sponsors like ICICI and HDFC--pioneers of India's Alternative Investment Fund industry - will face restrictions in managing foreign pools of capital in Indian domiciled AIFs. This would, clearly, be counterproductive to managing in India.

2. In furtherance of the Government's intent to attract foreign investment in Indian investment vehicles, the Reserve Bank of India, in the TISPRO Regulations notified on 7th November 2017 inter alia have allowed foreign investment in Indian regulated investment vehicles (including Alternative Investment Funds or AIFs).

3. The Regulations provides that downstream investments i.e. investments in portfolio companies by AIF's shall be regarded as foreign investment if neither the Sponsor nor the Manager nor the Investment Manager is Indian 'owned and controlled'. In other words, if the Sponsor or the

Manager or the Investment Manager is not Indian 'owned and controlled', the entire downstream investment by the AIF will qualify as foreign investment and be subject to the restrictions on foreign investments.

4. The above rule creates significant challenges for many AIFs which are sponsored and managed by Indian banks, Non-Banking Financial Companies, or holding companies of such financial institutions, which are listed on recognized stock exchanges in India. In many such cases, given the significant level of Foreign Portfolio Investors' (FPIs) ownership, the institutions fail to meet the criteria of being Indian owned and controlled. Consequently, the investments made by AIFs sponsored by such institutions or their subsidiaries have to comply with the rules applicable to foreign investment.

II. Recommendation for an Appropriate Ownership Test

5. In view of the fact that financial institutions, fund managers and sponsors have been active in raising capital in AIFs and have successfully raised significant capital from domestic and foreign investors it is necessary that no hurdles be placed in their future fund managing and raising efforts.

6. It is recommended that a more appropriate test to determine ownership be provided for sponsors and fund managers that belong to a group that is listed on Indian stock exchanges.

7. It is recommended that the ownership test be defined on the following lines:

Test of Ownership: Foreign Portfolio Investors acquire small percentage stakes in listed companies and are passive investors exercising no control on their investee companies. Accordingly, while determining the foreign ownership in widely held listed companies (or their direct or indirect subsidiaries), the stake held by Foreign Portfolio Investors (FPIs) should be excluded i.e. foreign ownership should be computed based on the composition of domestic investment and foreign investment made under the Foreign Direct Investment (FDI) route, only. A 'widely held' listed company should be considered to be one where no single foreign (non FPI) shareholder along with his/its affiliates has a shareholding exceeding 10%.

By way of an illustration, where an Indian listed company has a shareholder composition comprising 50% FPI investors, 24% FDI investors and balance 26% domestic investors, the Indian listed company should be treated as Indian owned so long as no single FDI investor along with his/its affiliates has a shareholding exceeding 10%.

III. Rationale & Justification

8. The rationale and justification for making the proposed changes are:

(i) Promotion of fund raising efforts by experienced AIFs. Many of the fund managers and sponsors affected have mobilized substantial amounts of domestic and international capital. This experience is beneficial to India as the fund managers and sponsors are geared to raising significant amounts of much-needed long term capital in the future as well. Accordingly, it is vital that the regulatory framework does not pose any hurdles in their future fund raising efforts;

(ii) Policy of Liberalisation: A more liberal regime is needed given that private equity and venture capital is long-term capital. The Government has liberalised its policies in several areas. Enunciating the recommended test of ownership will be consistent with the liberalization trend in India. The reform will be very well received internationally and domestically by fund managers and limited partners ultimately leading to greater flows of international and domestic capital to India; and

(iii) The Government Applies an Ownership Test which is similar in the Insurance Sector: There should be parity between the ownership test in RBI's TISPRO norms and the one covering the insurance sector. The Government has already provided for a similar ownership test, which correctly excludes the shareholding of Foreign Portfolio Investors, in determining the ownership of insurance companies. Regulation 11 of the **Insurance Regulatory and Development Authority (Registration of Indian Insurance Companies) Regulations, 2000**, and the related Explanation which was added by IRDA subsequently to address the issues faced by the entities whose parents were foreign owned by virtue of high FPI participation.

"11. Manner of calculation of twenty six percent equity capital held by a foreign company.—

(1) For the purposes of the Act and these Regulations, the calculation of the holding of equity shares by a foreign company either by itself or through its subsidiary companies or its nominees (hereafter referred to as foreign investor) in the applicant company, shall be made as under and shall be aggregate of:-

i. the quantum of paid up equity share capital held by the foreign company either by itself or through its subsidiary companies or nominees in the applicant company;
ii. the quantum of paid up equity share capital held by other foreign investors, non-resident Indians, overseas corporate bodies and multinational agencies in the applicant company; and
iii. the quantum represented by that proportion of the paid up equity share capital to the total issued equity capital of an Indian promoter company mentioned in sub-clause (i) of clause (g) of regulation 2 held or controlled by the category of persons mentioned in sub-clauses (i) and (ii) of this sub regulation.

Explanation: For purposes of calculation referred to above, account need not be taken of the holdings of equity in an Indian promoter company held by foreign institutional investors, other than the foreign promoters of the applicant and their subsidiaries and nominees, and Indian mutual funds to the extent the investment of foreign institutional investors and Indian mutual funds are within the approved limits laid down by the Securities and Exchange Board of India under its rules, regulations or guidelines issued from time to time.

(2) Every insurer who has been granted registration under the Act shall, within 15 days of the end of every quarter, furnish to the Authority a statement indicating changes exceeding 1% of the issued capital in the holding of the shares in his company and those of the promoter……………."

Draft Notification for Amendments in TISPRO Regulations, 2017

It is recommended that Explanation to para 4 of Schedule 8 of the TISPRO Regulations, 2017, should be amended as follows: Explanation 1: For purposes of determining level of foreign ownership of the Sponsor or the manager or investment manager of an AIF referred to above, account should not be taken of the holdings of equity in an Indian promoter company of such Sponsor or the manager or investment manager which is held by foreign institutional investors or foreign portfolio investors or non-resident Indians under the portfolio investment scheme unless these shares are held by the foreign promoters of the applicant and their subsidiaries and nominees, and Indian mutual funds to the extent the investment of foreign institutional investors and Indian mutual funds are within the approved limits laid down by the Securities and Exchange Board of India under its rules, regulations or guidelines issued from time to time.

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.

While determining the foreign ownership in widely-held listed companies (or their direct or indirect subsidiaries) including a banking company as defined under the Banking Regulation Act, 1949, the stake held by Foreign Portfolio Investors (FPIs) should be excluded i.e. foreign ownership should be computed based on the composition of domestic investment and foreign investment made under the Foreign Direct Investment (FDI) route, only. A 'widely held' listed company should be considered to be one where no single foreign (non FPI) shareholder along with his/its affiliates has a shareholding exceeding 10%.

Explanation 2: The extent of foreign investment in the corpus of the Investment Vehicle will not be a factor to determine as to whether downstream investment of the Investment Vehicle concerned is foreign investment or not."

5) Sector agnostic fund-of-funds (NIIF) through participation of Development Finance Institutions

The National Investment and Infrastructure Fund (NIIF) was envisaged as a medium to infuse capital in the Indian Infrastructure sector in partnership with private/ foreign capital.

The domestic and international investors have shown tremendous interest with commitments already received from few sovereign wealth funds.

With NIIF structure in place, the organization is in a position to replicate the same and initiate forming more such funds. As India lacks a sovereign wealth fund, the NIIF structure shows government's commitment to investment in critical areas. Along with Infrastructure, many other sectors have a considerable appetite to absorb the investments and grow.

We duly propose, NIIF to branch out and consider formation of a sector agnostic Fund-of-Funds on similar ownership structure with participation to invest from Sovereign Wealth Funds and Development Finance Institutions (DFIs).

Forming such a fund would add credence to the Fund-Of-Funds strategy and pave way for the sector to setup more such funds in the future and in turn aid job growth and economic development.

CHAPTER IV – Internationally Competitive Tax & Regulatory Frameworks

Recent policy changes have made the global investing fraternity well aware of India's entrepreneurial talent, and sparked considerable investment interest in home-grown ventures. The next logical step should be to put in place a globally competitive tax and regulatory framework that can attract top-of-shelf Fund managers(called as Investment Managers by SEBI, and General Partners or GPs, internationally) and Capital Pool managers (called as Limited Partners, or LPs, internationally) to the AIF industry, who act as skilled resource-allocators on behalf of investors. Investment managers are, after all, a critical conduit to a thriving start-up ecosystem as they direct valuable capital into the most deserving and profitable ventures, so that investors can ultimately earn healthy portfolio returns, which is critical to make future fund flows continue systematically. Internationally, the United States of America and China have a sophisticated and competitive tax framework for private equity/ venture capital funds. A snapshot of the private equity/ venture capital tax regime prevailing in USA and China is provided in Annexure 1. An internationally competitive tax and regulatory framework will aid to make India a preferred destination in the alternative investment space. While the tax regime has been progressively simplified to encourage AIFs in India, there remain some critical areas to be set right.

[A] Distinct taxation for long-term gains (additional returns) to Investment Manager/Sponsor

Direct Tax Implications

Typically, in an AIF structure, investors are akin to 'sleeping' or 'dormant' partners contributing higher capital, while the Sponsor and/or Manager acts as a 'working partner' contributing knowledge capital that is in the nature of sweat equity, as well as risk capital. The investment manager (who is sometimes also the Sponsor) receives compensation by way of a fixed fee which is a percentage of assets under management. But the primary profits of the investment manager come from the additional returns - a variable share of the gains earned by the investment managers from the direct participation in the AIF once an agreed level of performance is reached.

Now, while the fixed fee to the Investment manager/ sponsor is rightly subject to GST as well as applicable income tax on business profits, there exists no formal guidance on the taxation of the additional returns component. Based on an analysis of the global practice followed for taxation of additional returns to manager/ sponsor entities, we understand that in the USA, such share of additional returns is taxed as long-term capital gains, when the underlying investment is held for a minimum three years. Similar rules apply in China.

Further, it is relevant to note that the additional returns take the same form as the underlying nature of the fund's income. As such based on the type of the fund, it would logically assume the characteristic of being "capital gains" or "interest" or "dividend", etc. Since the additional returns are typically payable only at the time of an exit event, where the fund receives" capital gains" income, the additional returns payable by the fund should retain the same character.

Accordingly, it is recommended that, the distribution of additional returns to the

Recommendation: Taxation of additional returns as capital gains.

It is recommended that the following clarification could be issued in relation to taxability of additional returns earned by investment managers and its employees etc.

Additional returns arising to an investment manager of a VCF / AIF through direct participation in the units of the VCF / AIF shall be treated as capital gains, if under the arrangement -

(a) theadditional return is to, or may, arise only if—

(i) thereis income for a period on the investments, or on particular investments, made for the purposes of the scheme, or

(ii) there is income arising from a disposal of the investments, or of particular investments, made for those purposes,

(b) the amount of the additional returns which is to, or may, arise is variable, to a substantial extent, by reference to those returns, and

(c) returns to external investors are also determined by reference to those returns.

Sponsor/Investment Manager should therefore be taxed as capital gains.

Indirect Tax Implications

1. Distribution of profit

In an AIF structure, investors are akin to 'sleeping' partners contributing higher capital, while the Sponsor and/or Manager acts as a 'working partner' contributing knowledge capital that is in the nature of sweat equity, as well as risk capital.

For fund management services, the Sponsor and/or Manager receive compensation by way of a fixed fee which is a percentage of assets under management. For the sweat equity/risk capital element, the Sponsor and/or Manager are entitled to additional returns –usually a variable share of the gains that the portfolio delivers over and above a base rate of return contractually indicated to investors.

The distribution of additional returns to the Sponsor/investment Manager is more in the nature of return on investment made by the investment manager. It should therefore be taxed as capital gains.

In the case of a partnership firm or LLP, the levy of GST is not attracted on distributions of profits by such partnership firm, or LLP, to its partners. Globally as well, distribution of profits by partnership firm or LLP to its partners is outside the purview of VAT/GST.

Further, globally, from an income-tax perspective, profits distributed in the hands of general partners are generally taxable in their hands as capital gains, being a return on investment earned by the fund, as shared between limited partners and the fund's general partner.

In the USA, such share of additional returns is taxed as long-term capital gains, when the underlying investment is held for a minimum three years. Similar rules apply in China. Similarly, investment Managers/Sponsors AIFs should have certainty on this profit share not being taxed under GST.

Recommendation:
1. A clarification be issued stating that GST is not applicable on distribution of share in income or profits to the Sponsor/investment manager

2. Joint GST liability of directors

a. Under various Indian laws, directors of companies have the obligation and liability to ensure that the companies are compliant with the obligations under various laws. The

Government has recognised and exempted a certain category of directors i.e. nominee or non-executive directors who are not involved in the day-to-day functioning of companies, from these obligations and related liabilities. These carve-outs are most relevant for AIFs. This is because in order to protect the interest of their investors, AIFs frequently appoint their nominees as non-executive directors on the Board of portfolio companies.

b. Section 89(1) of the CGST Act casts joint and several liability on all directors of a private limited company which defaults in the payment of tax, interest or penalty. Such liability is however not triggered, if the director proves that the non-recovery of taxes, interest or penalty cannot be attributed to any gross neglect, misfeasance or breach of duty on his part.

c. Nominee or non-executive directors, who merely represent the interest of a shareholder or his/her appoint or, are also covered by the provision of section 89(1) of the CGST Act. It is submitted that nominee, or non-executive, directors of AIFs are merely engaged in a stewardship role and do not participate in the day-to-day activities or management of companies.

d. The Companies Act, 2013 is a good example of a carve-out from liability for non-executive directors. It is pertinent to note that the definition of 'officer in default' as per section 2(60) of the Companies Act, 2013, viz persons who shall be liable for penalty or imprisonment in the case of any contravention by the company, does not include non-executive directors, unless such non-executive director is aware of such contravention by virtue of receiving any proceedings of the Board, or participation in such proceedings without objecting to them, or where such contravention had taken place with his consent or connivance.

e. Additionally, section 149(12) of the Companies Act, 2013 states that the non- executive director shall be liable under the Companies Act, 2013, only in respect of acts of omission or commission by a company which has occurred with his knowledge, attributable through Board processes, and with his consent or connivance, or where such non-executive director has not acted diligently.

Recommendation:

1. Nominee and non-executive directors appointed by AIFs on the boards of their portfolio companies be excluded from implications of the provisions of section 89(1) of the CGST Act

[B] Allow set-off of fixed fees from returns

Direct Tax Implications

1. Typically, a VCF / AIF would incur 15-20% of the investors' capital commitments towards fees payable to the investment manager, bankers, advisers, lawyers, accountants, administrators, and other service providers. Therefore, the amount actually invested by the VCF / AIF stands reduced by this amount and only 80-85% of the investor's capital commitments are actually invested in portfolio investments. Commercially, the investor's gain on their investment is net of all expenses incurred by the VCF / AIF.

2. The main income stream of a VCF / AIF that makes investment in equity/ equity linked securities is gains on sale of investments. The Act provides for a mechanism for computation of income under the 'capital gains' head. As per the provisions of the Act, capital gains/losses are to be computed by reducing from the sale consideration:
   - the cost of acquisition of the asset transferred;
   - the cost of any improvement thereto; and
   - any expenditure incurred wholly and exclusively in connection with the transfer of the asset.

3. Currently, there is no provision for capitalizing investor capital commitments incurred towards fees payable to the investment manager in relation to the investment management activities and other service providers either at the investor level or VCF/ AIF level. The income (including capital gains) is calculated at the level of VCF/AIF and distributed to the investors. This leads to investors paying taxes on an amount higher than their real gains from VCF/AIF investments.

4. In effect, the investors are not able to offset the expenses against income/gains that may eventuallyresultfromtheinvestmentleadingtoanincongruenceinthegainscommercially derived by the investors (net of expenses) and gains treated as taxable (gross of expenses).

5. Given below is an illustration on the impact of significant costs not being factored in while computing capital gains tax liability of investors:

Sr. No.	Particulars		Amount (₹)	Amount (₹)
(A)	Capital contribution by investor		100	
(B)	Fixed fees and other expenses incurred by AIF		20	

(C)	Amounts invested by AIF		80	
(D)	Amounts received on sale of investment by AIF		165	
(E)	**Gain on Investment (Gross)**	(D) – (C)		**85**
(F)	**Net Gain**	(E) – (B)		**65**
	Tax payable (as per the existing provisions)	**(E)*20%**		**17**

From the above illustration, it is observed that on a capital contribution of ₹100 by the investor

- Investor realizes a surplus (income and gains) of ₹65
- Taxable base however is ₹85
- Investment management expenses of ₹20 are a dead loss

To summarize, the current scheme of taxation for the AIFs / investors results in inconsistency in the commercial gains of the investors and the amount on which the investors are required to discharge taxes. This entails higher tax implications on the investors. Correcting this anomaly would align the Indian tax system with the tax regimes of mature markets such as USA and China, where operational expenses and fees are allowed to be set-off before reckoning taxable income from investors.

Recommendation: Deduction of Expenses

Proposed Amendment

Introduction of clause (ad) in section 55(2)

55(2) for the purposes of section 48 and 49, “cost of acquisition”

(ad) of the capital asset, being shares and securities held by the investment fund,with respect to each of the unit holders of the investment fund, shall mean share of the unit holder in

(i) aggregate of the purchase price of the capital asset; and

(ii) the contractually agreedfixedfee incurred by the investment fund from date of acquisition of the capital asset to the date of transfer of the capital asset by the investment fund in proportion to (i) above.

“Contractually agreed fixedfee” shall mean the annual fixed fee agreed to the paid by a unit holder as a percentage of his capital contribution to the investment fund as per the terms of the agreement entered into between the investment fund and the unit holder.

Explanation – For the purpose of this clause

(i) “investment fund” shall have the same meaning as assigned to it in clause (a) of Explanation 1 to section 115UB

(ii) “venture capital fund” shall have the meaning assigned to it under clause (23FB) of section 10

Indirect Tax Implications

Fixed fees and other expenses incurred by AIFs

i. The levy of GST on fund management and other services received by AIFs, may adversely impact the choice of domiciliation of AIFs as a pooling vehicle to raise foreign capital. The hurdles faced by the AIF asset class are summarised below:

   a. The taxing principle under the erstwhile service tax legislation continues under the new GST regime, i.e. GST is a destination-based consumption tax. Accordingly, GST is not levied on services consumed outside India which are regarded as export of services.

   b. A domestic AIF, in essence, represents a common pool of contributions made by its investors and therefore, should not be viewed as a distinct entity separate from its investors. Recognising the ‘pooling’ concept, the Income-tax law has accorded ‘pass-through status’ to Category I and Category II AIFs such that income is taxed, as if investments were made directly by investors. This, in essence, represents the taxing principle of managing and taxing AIFs.

c. Under the GST regime, as in the previous service tax regime, there is no concept of 'pass through', and the services provided by fund managers and other service providers to AIFs are liable to GST. Since AIFs are only a pooling vehicle and do not provide any service, there is no output GST liability on AIFs. Hence, AIFs are not able to obtain any benefit of input credits. Consequently, the GST paid on fund fixed fees and other input services, becomes an incremental cost to be borne by investors.

d. In the context of foreign investors, this, in effect, violates the taxing principle of destination-based consumption tax, because the services rendered by a service provider to AIFs are ultimately for the benefit of its underlying investors who include foreign investors as well. The services rendered to an AIF are effectively consumed outside India to the extent that there are foreign investors in a domestic AIF.

e. On the other hand, if a foreign investor makes a direct investment in a start-up or a growth portfolio company, he is not subject to service tax or GST liability. GST is also not applicable on fees and expenses for services provided by an overseas fund manager to an offshore pooling vehicle for investment in India, but which is domiciled outside India.

f. Accordingly, the current GST framework encourages offshore Funds to be domiciled/remain offshore, instead of onshore in India. Consider a simple example of an India- domiciled AIF where all its investors are foreign investors. The AIF receives services which would generally be liable to GST at the rate of 18%. The India- domiciled AIF would not be eligible to claim a refund of such input GST. On the other hand, in a similar situation, if the pooling vehicle for investing in India, would be formed and domiciled offshore, then the services provided to such an offshore pooling vehicle would be regarded as export of services and would not be subject to GST. Accordingly, the service provider would be eligible to claim a refund of GST paid on any input services.

g. With such asymmetric tax treatment, foreign venture capital or private equities are effectively encouraged to pool money overseas, rather than in India. Global venture capital or private equity funds are now earmarking a rising share of their pie for India, but over 80% of this ₹5 lakh crore is still pooled in foreign jurisdictions.

h. The Government has progressively liberalized the foreign exchange regime by permitting foreign investments in domestic AIFs to encourage the conduct of asset management within India. Similarly, it has introduced safe harbour provisions in the income-tax law, recognizing the role of asset managers abroad and to facilitate their relocation to India. The Government is also making significant efforts to rationalise the safe harbor provisions, making it convenient for the fund managers to re-locate to India, especially in the case of India-focused funds. The levy of GST on domestic AIFs in which foreign investors have invested may, on the contrary, discourage such initiatives. The government has been increasingly giving impetus to provide more clarity and certainty to the investor community and is trying to maintain consistency in the implementation of tax and regulatory laws. Exemption from GST to domestically-domiciled AIFs which have foreign investors, would provide much needed tax clarity to investors in AIFs, bringing certainty on tax outcomes and ensure greater consistency in extending export-related incentives.

ii. There are six principal benefits of domestic formation and domiciliation of AIFs in India with foreign investors:

a. When an offshore investor invests through an overseas fund domiciled outside India, the investment remains contingent till it is actually invested in the country. On the other hand, in a India-domiciled AIF structure, once an offshore investor commits the investment to a domestic AIF, the foreign pool of capital is effectively 'earmarked' and 'locked' for investment in India for the entire life of the AIF;

b. The investment commitments, typically being long term in nature, spur investments and economic activity in the country, leading to the growth of portfolio companies and meet the investment needs of the Indian economy;

c. The resultant growth of portfolio companies is also consistent with the larger 'Make in India' initiative of the Government;

d. Growth of private equity investments accelerates employment opportunities in the Indian economy. These employment opportunities fit well with the Government's initiative of 'Skill India';

e. Companies with private equity investments are also more diligent in ensuring good corporate governance leading to greater investor confidence; and

f. Internationally, countries like Singapore are recognized as well developed asset management hubs. India competes with such countries for domiciling funds and fund managers, especially India-focused funds and fund managers. On indirect taxes, Singapore provides benefits in the form of GST rebate to asset managers and thus, mitigates the effective tax cost. GST exemption to India-domiciled AIFs could encourage fund managers to re-locate to India.

Recommendation:

1. AIFs with 100% investor commitments from offshore (excluding domestic sponsor contributions) which locate their fund management operations in India, should in any case be subject to a zero rate of GST, as the investment management service in their case is entirely an export of a service.

2. With a view to encouraging on-shoring of funds, the Centre can even explore a zero rate of GST for AIFs that source over 50%of their funds from foreign investors.

3. Where an AIF derives part of its investment commitments from overseas, may be subjected to pro-rated GST, or lower GST rates depending on the dollar component.

[C] Restore pass-through of losses

Direct Tax Implications

I. **Net losses incurred by AIFs are not available to investors and may lapse if not set-off by the AIF**

1. Investors in AIFs could have chosen to directly invest in portfolio companies of their own accord. Conceptually, pooling vehicles are formed to derive two advantages; (a) to engage experienced professionals for investment management; and (b) to achieve economies of scale.

2. Tax implications play an important role for the investor to choose one form of investing over the other i.e. pooling vehicle vs. direct investing. An efficient tax system for AIFs should ensure that an investor in a pooling vehicle should have the same (or better) tax outcome in comparison with direct investment with the objective of driving investor preference towards professional fund management. Should investors suffer extra tax as a result of investing in an AIF vis-à-vis direct investment that would serve as a disincentive for investment in an AIF.

3. The present tax regime for Category I and II AIFs provides for pass-through of income earned by the AIF, however net losses in a year are retained at the fund level, and are not passed on to the investors. Typically, an AIF's tenure would be 8-10 years from its launch. Practically, it is observed that in a fund, usually the profitable investments of the fund are first sold, while the relatively lesser performing investments may be sold towards the end of the fund's life.

4. Based on the current provisions of the Act and the sequence of exits, practically, where Category I and II AIFs incur net losses on investments towards the end of their life or have unabsorbed losses, which cannot be utilized by the AIF, such losses would lapse. The investors would in this scenario also be taxed on an amount that would be greater than the "real" income derived by them from their total investment in the AIF. For an investor who has committed capital to an AIF and remained invested in the AIF for its full tenure, there is little legal/ commercial justification for being denied the offset of losses incurred on the AIFs investments.

5. In case of an AIF (Category I or II) with a tenure of 8 years, we have provided below an illustration depicting the tax treatment of losses under the present regime and under the recommended tax regime:

Year	Particulars	Amount	Tax Treatment under	Tax Treatment under

		(₹)	Existing Tax Regime	Recommended Tax Regime
1	Investment 1 Investment 2	100 120		
2	Investment 3	150		
7	Investment 2 sold	250	Gain of ₹130 taxable in the hands of investor.	Gain of ₹130 taxable in the hands of investor.
8	Investment 1 sold Investment 3 sold	20 180	Loss of ₹(80) on Investment 1 set off against gain of ₹30 on Investment 3^. Balance loss of ₹ (50) will lapse.	Loss of ₹ (80) on Investment 1 set off against gain of ₹30 on Investment 3^. Balance loss of ₹(50) to be passed on to the investor.

^ In accordance with 'Chapter VI - Aggregation of Income and Set-off or Carry Forward of Loss' of the Act

Recommendation: Pass through of Net Losses

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 unlisted AIFs, under any head of income, should also be allowed to be passed on to the investors.

Proposed Amendment

115UB. (1) Notwithstanding anything contained in any other provisions of this Act and subject to the provisions of this Chapter, any income accruing or arising to, or received by, a person, being a unit holder of an investment fund, out of investments made in the investment fund, shall be chargeable to income-tax in the same manner as if it were the income accruing or arising to, or received by, such person had the investments made by the investment fund been made directly by him.

(~~2) Where in any previous year, 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, then,—~~

~~(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).~~

(3) The income paid or credited by the investment fund shall be deemed to be of the same nature and in the same proportion in the hands of the person referred to in sub-section (1), as if it had been received by, or had accrued or arisen to, the investment fund during the previous year ~~subject to the provisions of sub-section (2)~~.

(4) The total income of the investment fund shall be charged to tax—

(i) at the rate or rates as specified in the Finance Act of the relevant year, where such fund is a company or a firm; or

(ii) at maximum marginal rate in any other case.

(5) The provisions of Chapter XII-D or Chapter XII-E shall not apply to the income paid by an investment fund under this Chapter.

(6) The income accruing or arising to, or received by, the investment fund, during a previous year, if not paid or credited to the person referred to in sub-section (1~~), shall subject to the provisions of sub-section (2),~~ be deemed to have been credited to the account of the said person on the last day of the previous year in the same proportion in which such person would have been entitled to receive the income had it been paid in the previous year.

[D] Fair and consistent taxation for AIF Category III

While there have been several tax measures to encourage Category I and Category II AIFs, Category III AIFs currently lack a distinct tax framework. This category is gaining popularity among investors as an alternate method of investing in the public markets, with the funds raised growing by 250% in FY17. With complex trust taxation provisions applied to these AIFs on an ad-hoc basis, Category III AIFs are often subject to double taxation and business income characterization. The industry desires a clear tax regime for AIF III with one-level taxation.

Direct Tax Implications

<u>Proposed Separate Tax Regime for Category III AIFs: Investor-Level Taxation</u>

<u>Background of existing complications in the taxation of Category III AIFs</u>

1. The tax regime for Category I and II AIFs is based on the pass-through principle (except for business income). The current tax framework for AIF's does not extend 'tax pass through status' for Category III AIFs and there is no separate taxation code for Category III AIFs.

2. Category III AIFs primarily include funds that invest in securities with the objective of making long term or short-term capital gains. Typically, they are set up as trusts. Two of their features are:
   (i) Two set of portfolios are generally maintained by category III AIFs depending on the investment strategy, i.e. trading portfolio (complex derivative products) and investment portfolio (listed & unlisted securities); and
   (ii) The AIFs can be open ended or close ended

3. An AIF can be set up as a company, a limited liability partnership ('LLP') or a trust. The above characteristics lead to significant complexity under the current provisions of the Act since there is no specific tax regime or guidance on the taxation of Category III AIF and their investors. In the absence of a specific tax code, the AIF continues to be governed by the provisions generally applicable to a company, LLP or a trust.

4. Where a Category III AIF is set-up as a trust and is treated as 'indeterminate trust', it could get taxed under at maximum marginal rate and where the trust is treated as 'determinate trust', the income of the trust could be taxed either in the hands of the investors directly or in the hands of the trustee in a representative capacity for the investors. For a Category III AIF trust to qualify as a determinate, the beneficiaries should be expressly stated and identifiable as on the date of the trust deed; and their individual shares should be expressly stated and ascertainable as on

the date of the trust deed. Furthermore, if the Category III AIF is set-up as a LLP, the AIF would be subject to tax at entity level and the investors, being partners to the Fund, would be exempt from tax.

5. Further, there are no express provisions under the Act which provide that once the income arising at the trust level is assessed to tax in the hands of the trustee, it cannot be assessed again in the hands of the beneficiaries (investors). Further section 166 of the Act [which overrides the above regime of trust taxation i.e. sections 161 to 164 discussed above] provides that nothing can prevent the tax authorities to directly assess the beneficiaries (investors) of the Category III AIF trust for the income arising at the trust level or recover the tax arising on such income from them.

6. Additionally, there are no provisions in the Act which allows credit of tax paid by the trustee to the beneficiaries (investors) in the trust. Hence, there are clouds of doubts in relation to taxability of income distributed by the trust to its investors, by way of redemption or otherwise, and there is no assurance under the Act that the income which gets taxed at the trust level will not get doubly taxed in the hands of the investors when distributed.

<u>Rationale for proposed changes to the tax regime of Category III AIFs</u>

6. The rationale for the proposed tax regime is to provide clarity in the taxation for Category III AIFs. It will help promote the Government's objective of 'ease of doing business in India' and provide the required depth in Indian capital markets. Capital invested in Category III AIFs has increased rapidly in recent years and is expected to grow manifold in the coming years. This is because Category III AIFs serve the following vital functions in the capital markets:

   - risk management for investors;
   - hedging long positions in investments;
   - flexible and a wide range of investment strategies which meet the diverse needs of various investors, including institutions and high-net worth individuals;
   - stewardship role by potentially influencing the quality of corporate governance in portfolio companies;
   - lend greater sophistication to the capital markets; and
   - provide exits to other investment funds such as Category I and Category IIAIFs.

7. The lack of clarity in the taxation of Category III AIFs handicaps their growth and management as described below:

i. Clarity to foreign asset managers which setup open-ended hedge funds in offshore jurisdictions for investing in India under the FPI route are not handicapped by the uncertainty of taxation surrounding the domestic SEBI-registered Category III AIFs;

ii. There is complete certainty to FPIs with respect to the characterization of income. The regulatory framework for FPIs is similar to the regulatory framework for AIFs, with 'investment in securities' being the common factor. CBDT Circulars have been issued for providing certainty with respect to characterization of income on the transfer of securities (listed and unlisted). There is no clarity for short term capital gains arising from the transfer of listed securities unlike for FPIs;

iii. The uncertainty of taxation is also leading to the reduction of opportunities to domestic fund managers and professionals and in some cases leads to 'brain drain' to offshore jurisdictions, besides a narrowing of investment opportunities for domestic investors. Clarity and certainty in the taxation of Category III AIFs will provide a competitive edge to domestic fund managers and will improve the prospects of an appropriate risk-return profile of these pooled investment vehicles.

Recommendation: Implement an Investor-Level Taxation Regime for Category III AIFs

8. In an investor-level tax regime, investors of Category III AIFs shall pay tax on income/ gains arising from investment in units of Category IIIAIFs.

9. The features of the recommended investor-level regime for Category III AIFs are:

i. Short term capital gains on transfer of units (whether by way of redemption or otherwise) of equity-oriented investment fund to be taxed at the rate of 15%;

ii. Long term capital gains on transfer of units (whether by way of redemption or otherwise) of equity-oriented investment fund to be taxable at 10%;

iii. In case of transfer of units (whether by way of redemption or otherwise) of a Category III AIF (other than an equity oriented investment fund), short-term capital gains to be taxable at maximum marginal rate and long-term capital gains to be taxable at 20% (in case of residents) and 10% (in case of non-residents);

iv. Any income distributed by a Category III AIF out of income received by it (other than dividend income and income of the nature which is exempt under section 10) shall be taxable in the hands of investors as Income from Other Sources at applicable rates (~30%);

v. Cost step to be provided for the secondary purchase of units by the investors;

vi. All of the above tax on investors would be paid by way of TDS at the fund level;

vii. TDS to be deducted on dividend income distributed a Category III AIF at the rate of 10% in case of the applicable assesses.

viii. Category III AIFs shall not be subject to any tax on income / gains arising from their investments in underlying securities; and

ix. 'Equity oriented investment fund' means an investment fund, which has been granted a certificate of registration as a Category III Alternative Investment Fund and is regulated under the SEBI (AIF) Regulations 2012 made under the SEBI Act, 1992, who (i) in a case where the fund invests in the units of another fund which is traded on a recognized stock exchange in India,—
    (A) a minimum of ninety per cent of the total proceeds of such fund is invested in the units of such other fund; and
    (B) such other fund also invests a minimum of ninety per cent of its total proceeds in the equity shares of domestic companies listed on a recognized stock exchange in India; and
    (ii) in any other case, investible funds are invested in equity shares of domestic companies listed on a recognized stock exchange in India to the extent of more than sixty-five per cent of the total proceeds of such fund.

    Provided that the percentage of equity shareholding of the fund shall be computed with reference to the annual average of the monthly averages of the opening and closing figures.

10. The draft of the proposed amendments to be made under the Act for Category III AIFs are presented in the following boxes for consideration.

Proposed Amendments:

Section 2(14)

Capital Asset means –

*(a)*Property of any kind held by an assessee, whether or not connected with his business or profession;

(b) any securities held by a Foreign Institutional Investor which has invested in such securities in accordance with the regulations made under the Securities and Exchange Board of India Act,1992;

(c) any units issued by an investment fund

Explanation 2: For the purposes of this clause-

(a) the expression "Foreign Institutional Investor" shall have the meaning assigned to it in clause (a) of the Explanation to section 115AD;

(b) the expression "securities" shall have the meaning assigned to it in clause (h) of section 2 of the Securities Contracts (Regulations) Act, 1956 (42 of1956);

*(c)*the expression "investment fund" shall have the meaning assigned to it in the Explanation to clause (23DB) of section 10

Section 2(42A)

"short term capital asset" means a capital asset held by an assessee for not more than thirty-six months immediately preceding the date of its transfer:

Provided that in the case of a security (other than a unit) listed in a recognized stock exchange in India or a unit of the Unit Trust of India established under the Unit Trust of India Act, 1963 (52 of 1963) or a unit of an equity oriented fund or a unit of an equity oriented investment fund or a zero coupon bond, the provisions of this clause shall have effect as if for the words "thirty-six months", the words "twelve months" had been substituted:

Explanation 5. – For the purposes of this clause, the expression "equity oriented investment fund" shall have the meaning assigned to it in the Explanation to section 111B

Section 10(23DB)

Any income of an investment fund.

Explanation: For the purposes of this clause, 'investment fund' shall mean a fund which has been granted a certificate of registration as a category III Alternative Investment Fund 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 (15 of 1992)

Section 56

(2) In particular, and without prejudice to the generality of the provisions of sub-section (1), the following incomes, shall be chargeable to income-tax under the head "Income from Other Sources", namely: -

-

(ie) any income distributed by an investment fund; and

Explanation: For the purposes of this clause, the term *"investment fund"* shall have the meaning assigned to it in clause (23DB) of section 10.

Section 111B

(1) Where the total income of an assessee includes income chargeable under the head "Capital Gains", arising from the transfer capital asset, being a unit of an equity oriented investment fund, the tax payable by the assessee on the total income shall be the aggregate of-

(i) the amount of income-tax calculated on long-term capital gains arising from such capital asset at the rate of ten per cent;

(ii) the amount of income-tax calculated on such short-term capital gains arising from such capital asset at the rate of fifteen per cent; and

(iii) the amount of income-tax payable on the balance amount of the total income as if such balance amount were the total income of the assessee

Provided that in the case of an individual or a Hindu undivided family, being a resident, where the total income as reduced by such short term capital gains is below the maximum amount which is not chargeable to income-tax, then, such short term capital gains shall be reduced by the amount by which the total income so reduced falls short of the maximum amount which is not chargeable to income-tax and the tax on the balance of such short-term capital gains shall be computed at the rate of fifteen per cent.

(2) Where the gross total income of an assessee includes any short-term capital gains referred to in sub- section (1), the deduction under Chapter VI-A shall be allowed from the gross total income as reduced by such capital gains.

Explanation. - For the purposes of this section, the expression "equity oriented investment fund" shall mean an Investment Fund referred to it in the Explanation to clause (23DB) of section 10 and who

(i) in a case where the fund invests in the units of another fund which is traded on a recognized stock exchange, —

(A) a minimum of ninety per cent of the investible funds of such fund is invested in the units of such other fund; and

(B) such other fund also invests a minimum of ninety per cent of its investible funds in the equity shares of domestic companies listed on a recognized stock exchange; and

(ii) in any other case, investible funds are invested in equity shares of domestic companies listed on a recognized stock exchange to the extent of more than sixty-five per cent of the investible funds of such fund.

Provided that the percentage of equity shareholding of the fund shall be computed with reference to the annual average of the monthly averages of the opening and closing figures

Insertion of new section 194LBD

(1) Where any income is payable to a unit holder in respect of units of the investment fund, the person responsible for making the payment or distribution shall, at the time of payment or distribution thereof in cash or by issue of cheque or draft or by any other mode, deduct income-tax thereon at the following rates:

a. on the short-term capital gains ofthenaturereferredtoinsection111Battherateoffifteenpercent;
b. on the long-term capital gains of the nature referredtoinsection111Battherateoftenpercent;
c. on the income distributed by an investment fund other than income distributed by equity oriented investment fund referred to in Explanation to section 111B, at the rate of thirty per cent;
d. on the income arising on redemption of a long-term capital asset being a unit of an investment fund other than equity oriented investment fund, at the rate of twenty percent; and
e. on the income arising on redemption of a short-term capital asset being a unit of an investment fund other than equity oriented investment fund, at the rate of thirty per cent.
f. on the income in the nature of dividend, at the rate of ten percent to assessees chargeable to tax under section 115BBDA

Provided that where the payee is a non-resident (not being a company) or a foreign company, deduction of tax shall be made in respect of any income at the rates in force

Explanation – For the purposes of this section –

i. the expression "equity oriented investment fund" shall have the meaning assigned to it in the Explanation to section 111B
ii. the expression "investment fund" shall have the meaning assigned to it in the Explanation to clause (23DB) of section 10

Section 55

55(2) for the purposes of section 48 and 49, "cost of acquisition"

(ad) in case of a capital asset being units of an investment fund as defined in clause (23DB) of section 10, means the subscription price of such units of the investment fund, or the price paid on the secondary purchase of such units, as the case may be. *

**the procedure for intimation by the unit holder of secondary acquisition of units of the investment fund may be separately prescribed*

Section 196

Notwithstanding anything contained in the foregoing provisions of this Chapter, no deduction of tax shall be made by any person from any sums payable to –

(i) the Government, or

(ii) the Reserve Bank of India, or

(iii) a corporation established by or under a Central Act which is, under any law for the time being in force, exempt from income-tax on its income or

(iv) a Mutual Fund specified under clause (23D) of section 10,or

(v) an Investment Fund specified under clause (23DB) of section10,

where such sum is payable to it by way of interest or dividend in respect of any securities or shares owned by it or in which it has full beneficial interest, or any other income accruing or arising to it

[E] Other Tax Recommendations

I. Removal of distinction between "business income" and "non-business income" of AIF

1. Under the present tax regime for a Category I and II AIF, any income (other than business income) earned by the AIF is exempt in its hands and is chargeable to income-tax directly in the hands of the investors in the same manner as if it were the income accruing or arising to, or received by, such investor had the investments been made directly by the investor.

2. However, any business income, accruing or arising to or received by investors of the AIF, is exempt in the hands of the investors and taxed at MMR in the hands of the AIF.

3. An issue however arises with respect to characterization of income arising to the AIF into business income or non-business income.

4. 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. 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 (not permitted for investments).

5. It is pertinent to note that, given the activity of an AIF, it can earn only investment 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.

6. Even the regulatory framework under which AIFs invest only refers to the activity of investment in securities and not to the activity of carrying out any business activity i.e. the regulatory framework for AIFs entitle them to make investments in securities. It does not indicate that AIFs are managing/ controlling the business operations of such investee companies. Further, AIFs predominantly invest in unlisted investee entities with an intention only to earn financial income.

7. 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.

8. Traditionally, the issue of treatment of investment exit gains (whether taxable as business income or capital gains) had been a subject matter of litigation. There have been several 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 guiding principles, have largely been driven by the facts and circumstances of each case.

9. Circulars issued by the CBDT have to a large extent clarified the issue of treatment of gains on exit of investments. CBDT has issued Circular 6 of 2016 dated February 29, 2016 in respect of treatment of surplus arising on the transfer of listed shares/ securities with a view to reduce litigation and maintain consistency in approach. In the Circular, it is stated that:

- Where the assessee itself treats listed shares/securities as 'stock in trade', irrespective of the period of holding, income from transfer to be treated as business income; and
- In case of listed shares/securities held for more than 12 months period immediately preceding date of transfer, the tax authorities shall not dispute the stand taken by assessee of treating such income as capital gains. However, this stand once taken shall remain applicable in subsequent years also; and
- In all other cases, guidance under existing CBDT circulars shall apply.

10. The CBDT had issued an instruction dated 2 May 2016 clarifying that the income arising from transfer of unlisted shares will be treated as 'capital gains' irrespective of the period of holding except in the following situations where the Assessing Officer would take an appropriate view:

- the genuineness of transactions in unlisted shares itself is questionable;
- the transfer of unlisted shares is related to issue pertaining to the lifting of the corporate veil;
- the transfer of unlisted shares is made along with the control and management of underlying business

11. Further, the CBDT has issued a clarification No. F. No. 225/12/2016/ITA.II dated January 24, 2017 that the exception regarding transfer of unlisted shares along with 'control and management of the underlying business' would not be applicable to SEBI registered Category I AIFs and Category II AIFs.

12. While the aforesaid clarification puts to rest a long-drawn controversy, the characterization of following income is still pending clarification:

a. Sale of listed investments held for less than 12 months;
b. Sale of unlisted securities (other than shares);
c. Income arising from debt investments to an AIF that makes investments in debt securities

13. Given the above background and the pending clarifications, it is recommended it should be deemed that the income earned by a Category I or II AIF would be deemed to only be investment income giving rights to income under the head 'capital gains' or 'income from other sources' only. This would ensure that on a pass-through basis the characterization of income in the hands of the VCF / AIF would flow to the investors without being distinguished in any other manner. This would mitigate duality in taxation which creates an unnecessary risk for the VCF / AIF that may earn income of the nature outlined above.

Recommendation: Characterization of income

The provisions relating to the taxability of business income earned by an 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".

10(23FBA) - Any income of an investment fund ~~other than the income chargeable under the head "Profits and gains of business or profession";~~

~~(23FBB) any income referred to in section 115UB, accruing or arising to, or received by, a unit holder o fund, being that proportion of income which is of the same nature as income chargeable under the hea gains of business or profession".~~

Explanation.—For the purposes of clauses (23FBA) ~~and (23FBB)~~, the expression "investment fund" shall have the meaning assigned to it in clause (a) of the Explanation 1 to section 115UB;';

115UB. ~~**(4)** The total income of the investment fund shall be charged to tax—~~

~~(i) at the rate or rates as specified in the Finance Act of the relevant year, where such fund is a company or a firm; or~~

~~(ii) at maximum marginal rate in any other case~~

II. **Exemption for AIFs from (a) Section 56(2)(viib) on issue of shares at a value higher than fair market value and (b) Section 56(2)(x) on receipt of shares at a value lower than fair market value (FMV)**

1. Section 56(2)(x) of the Act provides that where any person received any shares and securities at a value lower than value of such shares or securities (as prescribed under Rules 11UA of the Income-tax Rules, 1961 ('the Rule')) ('11UA Value'), the difference is taxed in the hands of the recipient as other income. For the purpose of section 56(2)(x) of the Act,11UA Value is computed as the net asset value subject to certain adjustments (such as stamp duty value for immovable properties, market value for listed securities etc.,).

2. Further, section 56(2)(viib) of the Act provides that where a company, not being a company in which public are substantially interested, issues shares to a resident in India at a premium for a consideration which exceeds the value (as prescribed under Rule 11UA of the Rules) of such company, the difference is taxed as income in the hands of the issuing company. For the purpose of section 56(2)(viib) of the Act, 11UA Value is computed as the net asset value subject to certain adjustments (such as stamp duty value for immovable properties, market value for listed securities etc.,) or the discounted cash flow method.

3. At present,

   a. section 56(2)(x) of the Act is applicable to all, Category I, Category II and Category III AIFs; and

   b. section 56(2)(viib) of the Act provides exemption to companies issuing shares to venture capital funds registered under the erstwhile SEBI (VCF) Regulations and VCFs under Category I-AIF. Thus, it is applicable to all AIFs other than Category I AIF. Since Category III AIFs are not designed to invest in unlisted companies, section 56(2)(viib) of the Act may have limited applicability to Category III AIFs.

4. Section 56(2)(x) and section 56(2)(viib) of the Act are an extension of the anti-abuse provisions introduced under section 56 of the Act to plug the loop holes under the Act in relation to money laundering and prevent circulation of unaccounted money.

5. The Finance Act 2017 has also exempted various transactions having regulatory / NCLT oversight such as merger, demergers etc., which require prior approval for the NCLT be from the ambit of section 56(2)(x) of the Act. Further, it is also to be noted that section 56(2)(viib) of the Act applies to companies only when the shares are issued to residents – considering that

non-residents making investments in India are adequately regulated under the foreign direct investment policy ('FDI Policy') of the Government of India (which provides minimum pricing norms for foreign investments in India by non-residents).

6. VCFs / AIFs, being institutional investors, have a fiduciary responsibility to invest in transactions on an arm's length basis, and given that they are subject to the supervision of SEBI and have investor reporting obligations, it is reasonable to assume that the price for acquisition / subscription is determined on a reasonable basis, considering all factors associated with the investee companies' and sector's past performance and future potential. Further, the VCFs/ AIFs also have the obligation to disclose transactions with associated enterprises or where the VCF/ AIF, sponsor or investment manager has or likely to have conflict of interests. Further, the investment manager is also required to establish written policies and procedures to identify, monitor and appropriately mitigate conflict of interest situations and are required to abide by high level principles in deal with such situations. Additionally, the VCFs/ AIFs, sponsor and the investment manager are also required to comply with the 'fit and proper' criteria as prescribed by the SEBI.

7. Thus, the transactions entered into by AIFs can be assumed to be in compliance with the 11UA Valuations, even in the cases of conflict of interest and should not be subject to section 56(2)(x) of the Act and therefore, it is recommended that the VCFs/ AIFs should be exempted from the rigor of section 56(2)(x) and section 56(2)(viib) of the Act.

Proposed Amendment

56(2)(viib) - where a company, not being a company in which the public are substantially interested, receives, in any previous year, from any person being a resident, any consideration for issue of shares that exceeds the face value of such shares, the aggregate consideration received for such shares as exceeds the fair market value of the shares:

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

(*i*) by a venture capital undertaking from a venture capital company or a venture capital fund or an investment fund; or

(*ii*) by a company from a class or classes of persons as may be notified by the Central Government in this behalf.

Explanation.—For the purposes of this clause,—

(*a*) the fair market value of the shares shall be the value—

(*i*) as may be determined in accordance with such method as may be prescribed[9]; or

(*ii*) as may be substantiated by the company to the satisfaction of the Assessing Officer, based on the value, on the date of issue of shares, of its assets, including intangible assets being goodwill, know-how, patents, copyrights, trademarks, licenses, franchises or any other business or commercial rights of similar nature,

whichever is higher;

(*b*) "venture capital company", "venture capital fund" and "venture capital undertaking" shall have the meanings respectively assigned to them in clause (a), clause (b) and clause (c) of Explanation to clause (23FB) of section 10;

(c) "investment fund" shall have the meaning assigned to it in Explanation to section 115UB

56(2)(x) –

…

Provided that this clause shall not apply to any sum of money or any property received—

(*I*) from any relative; or

(*II*) to (IX)…

(*X*) from an individual by a trust created or established solely for the benefit of relative of the individual.

(XI) by an investment fund

Explanation.—For the purposes of this clause, the expressions "assessable", "fair market value", "jewellery", "property", "relative" and "stamp duty value" shall have the same meanings as respectively assigned to them in the *Explanation* to clause (*vii*) and "investment fund" shall have the meaning assigned to it in Explanation to section 115UBand shall also include

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 III Alternative Investment Fund 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 (15 of 1992).

III. Grant of pass- through status to liquidation trust set up after the tenure of AIF

1. VCFs and AIFs are regulated by the SEBI as per the SEBI VCF Regulations and SEBI AIF Regulations with regard to the set-up, registration, on-going compliance and conduct as well as winding up at the end its tenure.

2. Further, under the Act, a Category I and Category II AIF have been accorded pass-through status for the purpose of taxation and any income (other than business income) earned by such VCFs / AIF are exempt in their hands and is chargeable to income-tax directly in the hands of the investors in the same manner as if it were the income accruing or arising to, or received by, such investor had the investments been made directly by the investor.

3. It is being experienced that a VCF or AIF nearing the end of its tenure may not be able exit its entire portfolio of investments. In such a scenario, either,

   a. the VCF / AIF may be wound up at the end of its tenure and the pending investments may be settled in a liquidation trust; or

   b. the VCF / AIF may itself continue as a liquidation trust beyond its tenure as a VCF / AIF

4. Such liquidation trust will operate until the pending investments are sold and the assets are liquidated. The rights and liabilities of the investors, trustees and the investment manager would continue to be the same in the liquidation trust and the liquidation trust will distribute the returns from the pending investments as per the distribution waterfall that existed under the documents of the Fund.

5. The succession of a VCF / AIF by a liquidation trust may have the following implications under the Act:

   a. The liquidation trust may not be separately registered as a VCF / AIF (other than a Category III AIF) and therefore, may not have a pass through status. In such a case, the liquidation trust may have to rely on the principles of trust taxation which would create uncertainties of taxation for the investors, VCF / AIF (other than Category III AIF) as well as the investment manager.

   b. Succession of the VCF / AIF by the liquidation trust (in scenario (a) above) may, in absence of a specific provision, result in an unwarranted tax implications of a taxable transfer in the hands of (i) the VCF / AIF – in the form of transfer of investments to the liquidation trust and (ii) the investors to the VCF / AIF – in the form of extinguishment of the units of the VCF / AIF (for units in the new liquidation trust).

      The above transactions are pursuant to the provisions of the SEBI (VCF) Regulations and SEBI (AIF) Regulations as well as the normal trust laws in India. Thus, the succession of the

VCF / AIF is mere operation of law in terms of change in the pooling vehicle for the investments and should not be treated as transfer from VCF / AIF to the liquidation trust.

Further, these transactions are mere stop gap arrangements to liquidate the investments pending with the VCF / AIF at the end of their lives to mitigate distress situations and do not provide any immediate value in the hands of the unitholders by way of exchange of units of VCF / AIF for units of the liquidation trust. The rights, liabilities and obligations of each of the stakeholders of the VCF / AIF viz. the investors, trustees and the investment manager continue to remain the same in the liquidation trust.

c. Receipt of (i) shares and securities held by the VCF / AIF by the liquidation trust and (ii) units of the liquidation trust by the investors shall come within ambit of section 56(2)(x) of the Act, resulting in the tax implications. Having regard to the above discussions, considering that the succession of the VCF / AIF by a liquidation trust is merely an accommodating transaction, taxing the receipts of shares / securities and units in the hands of the liquidation trust and unitholders, respectively under section 56(2)(x) of the Act would be an unintentional consequence.

6. In order to avoid such uncertainties in tax implications and also to have a consistent approach – it is recommended that:

   a. the liquidation trust should be provided the same pass-through status as applicable to VCF / AIFs (applicable to VCF and Category I and II AIFs);

   b. The succession of the VCF / AIF by a liquidation trust should not be treated as a taxable in the hands of the VCF / AIF and the unit holders (applicable to VCF and Category I, II and III AIFs); and

   c. The receipt of shares / securities by the liquidation trust and the units of liquidation trust by the unit holders should be exempt from section 56(2)(x) of the Act (applicable to VCF and Category I, II and III AIFs).

Proposed Amendment

115U

Explanation 1 - For the purposes of this Chapter, "venture capital company", "venture capital fund" and "venture capital undertaking" shall have the meanings respectively assigned to them in clause (*23FB*) of section 10 and includes a liquidation trust.

Explanation 3 -

For the purpose of this section, a "liquidation trust" means a trust settled with the outstanding investments of venture capital fund pursuant to the winding up of the venture capital fund wherein the rights and liabilities of the investors, trustees and investment manager remain the same as in the venture capital fund to which such liquidation trust has succeeded.

115UB

Explanation 1.—For the purposes of this Chapter,—

(*a*) "investment 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 or a Category II Alternative Investment Fund 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 (15 of 1992) and includes a liquidation trust

(d) For the purpose of this section, a "liquidation trust" means a trust settled with the outstanding investments of investment fund pursuant to the winding up of the investment fund wherein the rights and liabilities of the investors, trustees and investment manager remain the same as in the investment fund to which such liquidation trust has succeeded.

47

Nothing contained in section 45 shall apply to the following transfers

(xx) Any transfer of a capital asset, being shares and securities, by an investment fund or a venture capital fund to a liquidation trust

(xxi) Any transfer by a unit holder of a capital asset being units of an investment fund pursuant to the succession of the investment fund or a venture capital fund to a liquidation trust

Explanation: For the purposes of clause (xx) and (xxi) above,—

(i) investment fund" shall have the same meaning as assigned to it in clause (a) of Explanation 1 to section 115UB and shall also include 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 III Alternative Investment Fund 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 (15 of 1992).

(ii) "venture capital fund" shall have the meaning assigned to it under clause (23FB) of section 10

(iii) "liquidation trust" shall have the meaning assigned to in clause (d) of Explanation 1 to section 115UB and Explanation 3 to section 115Uand shall also include a trust settled with the outstanding investments of a Category III alternative investment fund pursuant to the winding up of the investment fund wherein the rights and liabilities of the investors, trustees and investment manager remain the same as in the Category III alternative investment fund to which such liquidation trust has succeeded.

2(42A)

(hi) in case of a capital asset, being shares and securities, which becomes a property of the liquidation trust in consideration of a transfer referred to in clause (xx) of section 47, there shall be included the period for which the shares and securities held by the succeeded venture capital fund or investment fund.

(hj) in case of a capital asset, being units of a liquidation trust, which becomes the property of the assesse in consideration of a transfer referred to in clause (xxi) of section 47, there shall be included the period

Explanation: For the purposes of clause (hi) and (hj) above—

(i) "investment fund" shall have the same meaning as assigned to it in clause (a) of Explanation 1 to section 115UB and shall also include 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 III Alternative Investment Fund 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 (15 of 1992).

(ii) "venture capital fund" shall have the meaning assigned to it under clause (23FB) of section 10

(iii) "liquidation trust" shall have the meaning assigned to in clause (d) of Explanation 1 to section 115UB and Explanation 3 to section 115U and shall also include a trust settled with the outstanding investments of a Category III alternative investment fund pursuant to the winding up of the investment fund wherein the rights and liabilities of the investors, trustees and investment manager remain the same as in the Category III alternative investment fund to which such liquidation trust has succeeded.

49Where the capital asset became the property of the assessee

(iii)(e) under any such transfer as is referred to in clause (*iv*) or clause (*v*) or clause (*vi*) or clause (*via*) or clause (*viaa*) or clause (*viab*) or clause (*vib*) *or clause (*vic or clause (*vica*) or clause (*vicb*) or clause (*vicc*) or clause (*xiii*) or clause (*xiiib*) or clause (*xiv*) or clause (xx) or clause (xxi) of section 47
the cost of acquisition of the asset shall be deemed to be the cost for which the previous owner of the property acquired it, as increased by the cost of any improvement of the assets incurred or borne by the previous owner or the assessee, as the case may be

56(2)(x)
Provided that this clause shall not apply to any sum of money or any property received—

(IX) by way of transaction not regarded as transfer under clause (i) or 11clause (iv) or clause (v) or] clause (vi) or clause (via) or clause (viaa) or clause (vib) or clause (vic) or clause (vica) or clause (vicb) or clause (vid) or clause (vii) or clause (xx) or clause (xxi)of section 47; or

IV. Exemption under section 56(2)(x) of the Act to investors of VCF / AIF on the in-specie distributions made by VCF / AIF

1. The SEBI (VCF) Regulations as well as the SEBI (AIF) Regulations permit a VCF / AIF to make in-specie distributions of the shares of its portfolio companies to its investors, subject to approval of SEBI.

2. The in-specie distribution by the VCF / AIF may have the following implication under the Act:

   a. When an AIF would distribute shares to investors pursuant to an in-specie distribution, the investors would receive such shares without any additional payment and therefore, a possibility that the tax authorities could contend that the 11UA value of the shares received by the investors should be taxable in their hands as other income under section 56(2)(x) of the Act.

   Section 56(2)(x) of the Act is an anti-abuse provisions to plug the loop holes under the Act in relation to money laundering and prevent circulation of unaccounted money. Further the Finance Act, 2017 has exempted various transactions from the ambit of section 56(2)(x) of the Act which are already under regulatory oversight. As discussed, the in-specie distributions are made by the VCF / AIF, subject to approval of SEBI after having regard to the rights of the investors in the VCF / AIF and the valuation of the shares proposed to be distributed. Thus, the in-specie distribution by the VCF / AIF could be treated as having the required regulatory oversight.

   Furthermore, the in-specie distribution should be treated either,

   i. as distribution of pre-existing beneficial interest in a trust held by the investors; or

   ii. distribution in lieu of the extinguishment of the units the investors held in the VCF / AIF, the fair market value of which is determined by the underlying portfolio of securities held by the VCF / AIF. Since the 11UA valuation is based on book value of the assets (subject to certain adjustments) the fair market value of the portfolio of securities should, under normal circumstances, be higher than the 11UA value.

   d. The in-specie distribution may be treated as a taxable transfer in the hands of the investors – in the form of extinguishment of units in the VCF / AIF (for shares / securities).

   Considering the fact that the in-specie distribution is merely distribution of the pre-existing beneficial interest to the investors from a pooling vehicle, taxing them for unrealized gains may result in unintended hardship for the investors – specifically having regard to the fact that some of the investments would have appreciated substantially in value and in the absence of a real sale, the investors may not have adequate cash to pay of the tax liability.

3. Having regard to the above, it is recommended that receipt of shares / securities by the investors on in-specie distribution should be exempt from capital gains tax as well as section 56(2)(x) of the Act.

Proposed Amendment

47

Nothing contained in section 45 shall apply to the following transfers

(xx) Any distribution of capital asset, being shares and securities, by an investment fund to the unit holders.

Explanation: For the purposes of this clause "investment fund" shall have the same meaning as assigned to it in clause (a) of Explanation 1 to section 115UB and shall also include 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 III Alternative Investment Fund 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 (15 of 1992).

2(42A)

(hi) in case of a capital asset, being shares and securities, which becomes a property of the assessee in consideration of a transfer referred to in clause (xx) of section 47, there shall be included the period for which the shares and securities held by the succeeded VCF or investment fund.

Explanation: For the purposes of this clause

(i) *"investment fund" shall have the same meaning as assigned to it in clause (a) of Explanation 1 to section 115UB and shall also include 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 III Alternative Investment Fund 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 (15 of 1992).*
(ii) *venture capital fund" shall have the meaning assigned to it under clause (23FB) of section 10*

49Where the capital asset became the property of the assessee

(iii)(e) under any such transfer as is referred to in clause (*iv*) or clause (*v*) or clause (*vi*) or clause (*via*) or clause (*viaa*) or clause (*viab*) or clause (*vib*) *or clause (*vic or clause (*vica*) or clause (*vicb*) or clause (*vicc*) or clause (*xiii*) or clause (*xiiib*) or clause (*xiv*) or clause (xx) or of section 47
the cost of acquisition of the asset shall be deemed to be the cost for which the previous owner of the property acquired it, as increased by the cost of any improvement of the assets incurred or borne by the previous owner or the assessee, as the case may be

56(2)(x)

Provided that this clause shall not apply to any sum of money or any property received—

(IX) by way of transaction not regarded as transfer under clause (i) or 11clause (iv) or clause (v) or] clause (vi) or clause (via) or clause (viaa) or clause (vib) or clause (vic) or clause (vica) or clause (vicb) or clause (vid) or clause (vii) or clause (xx) of section 47; or

CHAPTER V – Enabling a full-spectrum ecosystem from angels to AIFs

In a welcome break from the past, the Government has taken a series of steps to ensure that start-ups and small firms occupy centre-stage in India's industrial growth. The Start-up India initiative launched last year has taken wing strongly. The DIPP has recognized over 8,100 startups till date, SIDBI has extended funding support to 24 AIFs to catalyse investments. Atal Innovation Mission has disbursed funds to over 940 schools to foster research labs, while the NITI Aayog is planning grants to as many as 21 incubators.

A vibrant funding ecosystem for startups should ideally feature a full spectrum of investors from angel investors to venture funds and companies. We recommend a couple of policy initiatives to enable this.

A). Framework for Accredited Angel investors:

Angel investors and their networks are an extremely important source of high-risk capital to very early stage ventures. In most countries, capital commitments by angel investors are wooed through tax breaks. In India though, start-ups receiving capital infusions from angel investors are liable to pay Angel Tax, on any consideration above 'fair market value'. While exemptions are available under Sec 56(2)(viib) of the IT Act, they are available only to recognised start-ups, subject to the fulfillment of onerous conditions by both the angel investor and the start-up.

In a recent notification, the DIPP has laid down clear guidelines for this tax exemption, doing away with uncertain interpretations. The qualifying criteria are: For the start-up - a ₹10 crore equity capital limit, for the investor - an average returned income of ₹25 lakh for three financial years or net worth of ₹2 crore in the preceding financial year, and a report from the merchant banker specifying the 'fair market value' of shares.

While we welcome DIPP's decision to clear the air on issue and accept the accredited investor regime proposed by the AIPAC expert committee, it is desirable that the onus of investor accreditation not be placed on the start-ups, given their limited bandwidth and resources. Instead, to promote ease of doing business, it would be best to implement a fully digitized, time-bound Digitally Accredited Qualified Investor (**DAQI**) process for screening angel investors under the auspices of the Central KYC, as logically proposed by the AIPAC committee.

The main objective of DAQI is to protect investors who may be unable to sustain economic risks of investing in Alternate Funds and also provide the industry with a readily available pool of sophisticated investors to which it can market its products.

In DAQI we propose to collate and authenticate financial health of investor in a central repository. DAQI also proposes to verify investor information for AML screening. Further basis the agreed upon accreditation methodology we propose to endorse the Investor as DAQI.

The perceived benefits are as listed below -

- Convenient for Investors to upload their documents in one place and reduces burden of constantly producing and verifying accredited investors for a new AIF
- Cost optimization, as DAQI introduces mutualisation of costs across multiple AIF's by facilitating inter-usability of DAQI records across the various AIF's
- AML screening at a central level

Engage more angels: SEBI's regulations cap the number of participants in Angel Funds at 200, should also ideally be reviewed, given that Category I & II AIFs allow upto 1,000 investors in a Fund. Such policy attention can result, in a controlled manner, encouraging crowd funding to catalyze start-ups.

B). Simplify conditions for Angel Tax exemptions

The Department of Industrial Policy and Promotion (DIPP) has taken several steps to improve Angel investment activity, to promote ease of doing business in India and accelerate the Startup India movement. The Angel networks are yet to take off and if we can address certain additional industry concerns particularly with respect to Angel Tax, it will certainly further boost the growth of budding Indian entrepreneurs - startups for whom the best route is Angel Investment given the time and mentorship Angel Investors provide and not just financial support vis-a-vis the Venture Capital Investors.

Recent update by the DIPP on Angel Tax, Angel industry concerns and IVCA's recommendations:

The DIPP issued a notification dated April 11, 2018, revising the definition of a start-up and prescribing certain forms and thresholds in order to claim benefits extended to eligible start-ups under section 80-IAC and section 56(2)(viib) of the Income-tax Act, 1961

The Indian Private Equity & Venture Capital Association raised certain industry concerns & recommendations in this regard highlighting the following:

- Elaborate and upgrade the startup definition: It is recommended to make this definition more objective so that the start-
- ups could prima facie evaluate whether they will be able to satisfy the definition or not. The condition for investors returned income for past three years or statement of wealth are very onerous conditions. To promote ease of doing business, it would be best to implement a fully digitised, time-bound accreditation process for screening angel investors under the auspices of the Central KYC (DAQI).
- Considering that a Category I and Category II AIF are SEBI registered investment vehicle and are also recognised at par with Category I Venture Capital Funds by various laws, exemption under

section 56(2)(viib) should also be extended to other categories of Category I and Category II AIFs.

Another concern for Angel Investors is Section 68 of IT Act, 1961 which states that any sum credited to the books of accounts of an assessee can be charged to tax if:

- The assessee is unable to explain the source of the credit
- The explanation is not to the satisfaction of the Assessing Officer

Whereas Section 56(2)(viib) and Section 68 were originally implemented to tackle money laundering, they have become a major concern for the startup world and Angel Investors by default. Here's a brief snapshot of angel investments in India.

The Angel investment activity has been constantly declining, part of the credit goes to the speculative environment due to mainly the angel tax hurdles and negative sentiment of the startups. The angel investment industry is maturing and a majority of this is being driven currently by seasoned IT industry leaders, entrepreneurs and angel networks but if we relax the angel tax regulations, it will open the doors for the untapped domestic pool of capital from Indias ultra HNHs* (refer below table), and many more investors which will massively improve the early stage investments, thus boosting entrepreneurship, employment & supporting the Startup India movement.

C). Broadbase Angel participation

A syndicate is a group of investors who pool their resources to invest in an investee company, typically a start-up. It basically allows investors ("Backers") to participate in a lead investor's ("Lead") deals11. Founded in 2010, AngelList LLC ("AngelList") operates a platform that allows start-ups to raise funds online12using a syndicate model. It serves as a mediator between start-ups looking to raise angel capital, Leads willing to identify and fund attractive start-ups, and Backers desirous of obtaining high returns on risky investments.

Under syndicate model, Lead identifies an investment opportunity and agrees to invest a certain amount (e.g. USD 250,000). The Lead personally invests a portion of the amount (e.g. USD 50,000) and offers the remaining (e.g. USD 200,000) to the syndicate[13.] They are typically current or former founders or professional technology early stage investors who invest on a part-time or full-time basis. The Lead is supported by other investors ("Backers") who pool in the remaining funds in syndicate. Backers are typically angel or accredited investors who have investable capital, a minimum net worth, risk appetite and investment background. They are typically investors who are able to bear the total loss of their capital contribution to an investment.

India does not have a set and separate framework to facilitate working of syndicates. A syndicate could however be set up within the existing framework that permits fund raising, albeit there are

[11]https://angel.co/help/syndicates/how-syndicates-work
[12]https://angel.co/help/general/about
[13]https://angel.co/help/syndicates/how-syndicates-work

certain issues from a regulatory perspective which need to be addressed. These have been discussed below.

D). Allowing CSR investments in non-profit dedicated Social impact AIFs:

Company law in India places a Corporate Social Responsibility (CSR) requirement on all companies meeting minimum net worth, turnover and profit criteria with these companies required to deploy 2% of their average net profits in approved CSR activities, which is estimated at ₹19,000 crores in FY 2019. The rules permit companies to undertake their own CSR activities in specified areas or contribute to government funds such as PM's Relief Fund.

The category of Social Venture Funds under Category I AIFs are readymade vehicles designed to make a social impact by taking up carefully-curated CSR projects, with strict controls such as periodic disclosures and external audits. We suggest that CSR rules in the Companies Act permit investments by companies in Social Venture Funds of Category 1 AIFs (Schedule VII of the Companies Act, 2013) to expand the pools of capital available to non- profit social entrepreneurs, which are section 8 companies. These funds can be allowed to recycle their capital through debt funding with the proceeds at the end of their life donated to the PM's Relief Fund or other social causes.

E) Data Disclosure by SEBI

AIF regulations make periodic reporting by all funds mandatory. Category I, II and III (without leverage) report on a quarterly basis. The Category III funds operating with leverage report on a monthly basis. It is recommended that a centralised body be created to report the performance metrics of funds on an aggregate basis (vintage year wise) by using the information obtained from the periodic reporting by AIFs to SEBI. This is because funds generate different returns at different stages of their maturity and different macro-economic conditions. Typically in the early stages of a fund, negative or low returns occur due to capital drawdowns and a portfolio that is yet to mature. Over time returns are higher when the mature portfolio starts generating returns and distributions are made. Consequently, PE/VC funds may be classified by the stage, industry and geographical region of the fund. This will enable performance of individual fund managers to be benchmarked relative to aggregate industry returns performance data.

The report recommends enhancements in the periodic- monthly or quarterly- reporting by AIFs to SEBI such that individual fund performance data can be captured which, in turn, can be used to create industry benchmarks. The following are recommended to be reported by a return dissemination central body:

a) Foreign & Rupee Component: For focusing on mapping of percentage allocation of domestic and foreign private capital allocation to AIFs.

b) Distribution of performance metrics: For each performance metric, the values for all the individual funds are calculated. Then the 10, 25, 50, 75 and 90 percentiles may be reported.

c) Pooled Values of IRR, TVPI, RVPI, DPI, Horizon returns: The pooled values of the above return measures are useful benchmarks against which the return of individual funds can be compared. These are calculated by simply aggregating the cash flows of all the funds that are considered in the benchmark. The metrics are calculated from the final cash flows on similar lines as the individual fund return measures are calculated.

d) Public Market Equivalent values: The public market equivalent (PME) is a popular benchmarking measure for private equity funds. The PME of the individual returns are calculated by mimicking a similar drawdown and distribution schedule of funds but which are invested in a public market ETF instead of the private fund.

CHAPTER VI – Recommendations for Implementation

1. Indirect Tax & GST Recommendations

S. No.	Proposed Recommendations		Regulatory Authority
1	GST on management services and	a. AIFs with 100% investor commitments from offshore (excluding domestic sponsor contributions) which locate their fund management	CBIC

	other expenses incurred by AIFs	operations in India, should in any case be subject to a zero rate of GST, as the investment management service in their case is entirely an export of a service. b. Considering the importance of venture capital and private equity capital, services rendered to an AIF should be chargeable to a lower rate of GST or pro-rated depending on the proportion of investments by foreign investors. c. Alternatively, investors in an AIF should be deemed to be service recipients and where the foreign investment in an AIF exceeds 50%, the services received by an AIF should be considered as export of services and thereby be liable for zero rate of GST.	
2	GST on distribution of profits to Sponsor/Manager	It should be clarified that GST is not applicable on distribution of share in income or profits to the sponsor/manager of AIF	CBIC
3	GST liability on directors in case of default by a private limited company	Joint liability under section 89(1) of the CGST Act on all directors should not be extended to nominee or non-executive directors, especially where the appointment or nomination is made by AIFs.	CBIC

<u>**Recommendation and proposed amendments: GST relating to AIFs**</u>

1. Recommendation: AIFs with 100% investor commitments from offshore (excluding domestic sponsor contributions) which locate their fund management operations in India, should in any case be subject to a zero rate of GST, as the investment management service in their case is entirely an export of a service.

   <u>Proposed Amendments</u>: A draft of the notification to be issued under the IGST Act to give effect to the above are set out as **Annexure 2**

2. Recommendation: Considering the importance of venture capital and private equity capital, services rendered to an AIF should be chargeable to a lower rate of GST or pro-rated depending on the proportion of investments by foreign investors.

Proposed Amendments: A draft of the notifications to be issued under the IGST Act and CGST Act to give effect to the above are set out as **Annexure 3**

3. Recommendation: Alternatively, investors in an AIF should be deemed to be the service recipients and where the foreign investment in an AIF exceeds 50%, the services received by an AIF should be considered as export of services and thereby be liable for zero rate of GST.

   Proposed Amendments: A draft of the notification to be issued under the IGST Act to give effect to the above are set out as **Annexure 4**

4. Recommendation: It should be clarified that GST is not applicable on distribution of share in income or profits to the sponsor/manager of AIF.

   Proposed Amendments: A draft of the notification to be issued under CGST Act to give effect to the above are set out as **Annexure 5**

5. Recommendation: Joint liability under section 89(1) of the CGST Act on all directors should not be extended to nominee or non-executive directors, especially where the appointment or nomination is made by AIFs.

   Proposed Amendments: Section 89(1) of the CGST Act could be amended as under:

   "Notwithstanding anything contained in the Companies Act, 2013, where any tax, interest or penalty due from a private company in respect of any supply of goods or services or both for any period cannot be recovered, then, every person who was a director, other than a Nominee/Non-executive Director appointed as a representative of a Fund, of the private company during such period shall, jointly and severally, be liable for the payment of such tax, interest or penalty unless he proves that the non-recovery cannot be attributed to any gross neglect, misfeasance or breach of duty on his part in relation to the affairs of the company."

2. Direct Tax and GST Recommendations

S No.	Proposed Recommendation		Regulatory Authority
1	Allow deduction of fixed fees incurred by the AIF	Fixed fees incurred by the AIF should be treated as 'cost of acquisition'	CBDT
2	Allow pass-through of Fund losses	Similar to the pass-through for net income, net losses incurred by unlisted AIFs, under any head of income, should also be allowed to be passed on to the investors.	CBDT

3	Fair and consistent tax regime for AIF III	A well-defined tax regime should be introduced for a Category III AIF.	CBDT
4	Removal of distinction between business income and non-business income	The provisions relating to the taxability of business income earned by an 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".	CBDT
5	Distinct taxation for long term gains (additional returns) to Investment Manager/Sponsor	To provide certainty on taxation of additional return paid to Investment Manager/ Sponsor, it should be clarified additional returns distributed to the Investment Manager/ Sponsor should be taxed under the head 'Capital gains'	CBDT
6	Exemption for AIFs from (a) Section 56(2)(viib) on issue of shares at a value higher than fair market value and (b) Section 56(2)(x) on receipt of shares at a value lower than fair market value	AIFs should be exempt from the provisions of issue of shares at a value higher than fair market value and on receipt of shares at a value lower than fair market value	CBDT
7	Grant of pass - through status to liquidation trust set up after the tenure of VCF/AIF	A liquidation trust set up after the life of the AIF should also be granted pass-through status as the AIF.	CBDT
8	Exemption under section 56(2)(x) of the Act to investors of VCF / AIF on the in-specie distributions made by VCF / AIF	Receipt of property on in-specie distribution by a VCF/ AIF should not be taxable in the hands of the investors	CBDT

9	GST on management services and other expenses incurred by AIFs	d. AIFs with 100% investor commitments from offshore (excluding domestic sponsor contributions) which locate their fund management operations in India, should in any case be subject to a zero rate of GST, as the investment management service in their case is entirely an export of a service. e. Considering the importance of venture capital and private equity capital, services rendered to an AIF should be chargeable to a lower rate of GST or pro-rated depending on the proportion of investments by foreign investors. f. Alternatively, investors in an AIF should be deemed to be service recipients and where the foreign investment in an AIF exceeds 50%, the services received by an AIF should be considered as export of services and thereby be liable for zero rate of GST.	CBIC
10	GST on distribution of profits to Sponsor/Manager	It should be clarified that GST is not applicable on distribution of share in income or profits to the sponsor/manager of AIF.	CBIC
11	GST liability on directors in case of default by a private limited company	Joint liability under section 89(1) of the CGST Act on all directors should not be extended to nominee or non-executive directors, especially where the appointment or nomination is made by AIFs.	CBIC
12	Encourage AIFs to locate in the IFSC	It is recommended to provide clarity on the below points: • Clarification regarding applicability of SEBI (AIF) regulations, 2012 to AIFs in IFSC • SEBI IFSC Regulations to include 'trust' as a recognized entity type • AIFs in IFSC be allowed to invest in India through any route, including FPI, FDI, FVCI route. Domestic investments and outbound investments must be permitted • without restrictions.	CBDT SEBI RBI

		• Sponsor / Manager of an existing AIF in India to be allowed to act as a Sponsor / Manager for an AIF in IFSC • Relaxations to Sponsors/Managers from certain regulations under FEMA • Exemption from tax for any income earned by an offshore investor, from offshore investments made outside India through an AIF in an IFSC; • Relaxation from filing return of income and obtaining a PAN number for offshore investors in an AIF in an IFSC	
13	Investment Advisors in IFSC	It is recommended that Investment Advisors servicing foreign funds are granted recognition in the IFSC in order to attract advisory talent and thereby encourage fund managers to migrate	SEBI

3. Recommendations on tapping domestic institutions

S. No.	Proposed Recommendations		Regulatory Authority
1	Tapping domestic Institutions	• Encouraging investments by charitable trusts, EPFO • Replicate SIDBI model • Enable listing of AIF	

4. Recommendations on Enabling a full-spectrum ecosystem from angels to AIFs

S. No.	Proposed Recommendations		Regulatory Authority
1	Accredited Angel investors - Engage more angels:	SEBI's regulations cap the number of participants in Angel Funds at 200, should also ideally be reviewed, given that Category I & II AIFs allow upto 1,000 investors in a Fund. Such policy attention can result, in a	SEBI

		controlled manner, encouraging crowdfunding to catalyse start-ups.	
2	Allowing CSR investments in non-profit dedicated Social impact AIFs	CSR rules in the Companies Act permit investments by companies in Social Venture Funds of Category 1 AIFs (Schedule VII of the Companies Act, 2013) to expand the pool of capital available to non- profit social entrepreneurs, which are section 8 companies. These funds can be allowed to recycle their capital through debt funding with the proceeds at the end of their life donated to the PM's Relief Fund or other social causes.	

ANNEXURES

Annexure 1: Snapshot of the private equity/ venture capital tax regime prevailing in USA and China

Transaction	US	China

Constitution of PE / VC Funds	• Typically, the PE / VC Funds in US are set-up as a Limited Partnership since they are not taxable entities for US income-tax purposes. • Limited partnerships constitutes limited partners ('LPs'), who are investors and general partners ('GPs') who control and manage the Fund. • Further, partnerships are preferred over Corporations (C Corp or S Corp), as they are more flexible for operating as PE / VC Funds. • C Corp is not a tax pass through entity, which creates a double taxation issue. C Corp is liable to pay full corporate tax on its profits and distributions/ remittance to shareholders are taxed again in the hands of shareholders. Hence, it is not a popular fund structure in the US. • S Corp is a pass-through entity, however, it has the following restrictions: (i) Cap on the number of investors - limited to 100, (ii) Nature of investors - only natural persons who are citizens or residents in the U.S. and (iii) may have only one class of shares	• Typically, the RMB Funds are set-up as limited partnership since they are not taxable entities under the Chinese tax law. • Like US, limited partnerships are preferred over corporations, as limited partnerships are flexible for operating as PE / VC Funds.
Taxation status of PE / VC Funds	• Limited partnership – No such restrictions as above and a "tax pass through" entity. • All the tax items like income, losses, expenses, deductions and credits are passed on its partners (limited and general partners) in their respective profit shares. The respective tax items are dealt with	• Corporation – Tax at the Fund level at 25% corporate tax rate • Limited Partnership – Pass through entity

	at the partner (investor) level based on the applicable rates of taxation for the individual cases.	
Taxation of income distributed to the investors	• As the Limited Partnerships are tax-pass through entities, respective tax items are dealt with at the partner (investor) level based on applicable rates of taxation for the individual cases. • Capital gains tax arises only if the distribution of capital exceeds the investors "cost basis". The cost basis initially is the funds contributed by the investor, but increases or decreases on redemptions, his shares of income accruals, additional investment etc.	• Investors / partners to pay income tax as per the respective tax rates applicable for any profits distributed by the Fund • Income from equity investments (dividend and interest) in qualified resident enterprises are generally exempt from corporate tax.
Allocation of income, expenses, deductions and credits	• Allocated to the partners (in case of limited partnership) in their respective profit share and taxed at the partner (investor) level based on the applicable rates of taxation. • Losses at the Fund level, allocable to the investors are allowed to be offset against their respective personal incomes. • The Limited Partnerships, however, are required to calculate these tax items, allocate them to partner's capital accounts, report them to partners and IRS.	• Proportionate share of the operation cost of the Fund and investment loss at the Fund level can be deducted from the taxable income of the investor.
Taxation on transfer / redemption of units	• Capital gains tax on transfer of interest in Funds; incoming investor (on secondary transfer by an existing investor) can get a 'tax	• Capital gains on equity transfer earned by partners from the limited partnership, is subject to

	basis step up' for his interest in the Fund, upon election made by the Fund to value its securities on the date of the transfer of interest to the incoming investor, on fair value basis.	income-tax in the hands of the individual partners at the rate of 5% to 35% (excessive progressive tax rates).

Annexure 2

Amendment to section 16 of IGST Act

(i) After sub-section 1(b) of Section 16, the following shall be added:

(c) supply of goods or services or both to an Alternative Investment Fund

(ii) After section 1 of 16, the following provisos shall be added:

Provided that the foreign investments in the Alternative Investment Funds shall be in accordance with the conditions prescribed in this regard.

(iii) After sub-section 3 of Section 16, the following explanation shall be added:

Explanation: for the purpose of sub section 1 (c) of section 16:

a. Alternative Investment Fund shall have the meaning assigned to it under Regulation 2(1)(b) of the Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012.

b. Foreign investment shall mean investment by non-resident entity/person resident outside India in accordance with Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2000.

Conditions to be prescribed to give effect; to sub section 1(c) of Section 16:

1. 100% of the total investments in the Alternative Investment Funds during the financial year, excluding domestic sponsor contributions, should be from foreign investors.

2. The Alternative Investment Funds must intimate in writing to the jurisdictional officer giving the proportion of investment in the Alternative Investment Funds from foreign investors within 90 days from the end of the financial year.

3. The acknowledged copy of the aforementioned intimation to be provided by the Alternative Investment Funds to Annexure to all its suppliers from whom it seeks to receive supplies at zero rate.

4. In case of unregistered Alternative Investment Funds, the filing of intimation and providing it to the supplier of goods or services or both should be done by the Manager/Sponsor as the case

Annexure 3

Notification under CGST Act

Government of India

Ministry of Finance

(Department of Revenue)

Notification No./2018-Central Tax (Rate)

NewDelhi, the_, 2018

G.S.R. (E).- In exercise of the powers conferred by sub-section (1) of section 9 of the Central Goods and Services Tax Act, 2017, the Central Government, on the recommendations of the Council, hereby makes the following amendments in the notification of the Government of India, in the Ministry of Finance (Department of Revenue), No.11/2017-Central Tax (Rate), dated the 28th June, 2017 published in the Gazette of India, Extraordinary, Part II, Section 3, Sub-section (i), *vide* number G.S.R. 673(E) dated the 28th June, 2017, namely:-

2. In the said notification, -

   (i) In Sr. no (15), Chapter 9971, after entry (v) in Column (3), the following entry shall be inserted, namely: -

Sr. No.	**Chapter, Section, Heading, Group or Service Code (Tariff)**	**Description of Services**	**Rate (%)**	**Condition**
(1)	**(2)**	**(3)**	**(4)**	**(5)**
15	9971	(v-a) Taxable supplies received by Alternative Investment Funds	2.5	1. More than 50% of the total investments in the Alternative Investment Funds during the financial year, excluding domestic sponsor contributions, should be from foreign investors.

				2. The Alternative Investment Funds must intimate in writing to the jurisdictional officer giving the proportion of investment in the Alternative Investment Funds from foreign investors within 90 days from the end of the financial year. 3. The acknowledged copy of the aforementioned intimation to be provided by the Alternative Investment Funds to all its suppliers from whom it seeks to receive supplies at zero rate. 4. In case of unregistered Alternative Investment Funds, the filing of intimation and providing it to the supplier of goods or services or both should be done by the Manager/Sponsor as the case may be, of such Alternative Investment Fund.

(ii) In para 4, after Sl No (x), the following explanation shall be inserted

(xi) Alternative Investment Fund shall have the meaning assigned to it under Regulation 2(1)(b) of the Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012

(xii) Foreign investment shall mean investment by non-resident entity/person resident outside India in accordance with Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2000.

(xiii) Taxable supplies provided by the Associate (in the capacity of a Manager) to the Alternative Investment Fund shall also be covered under Entry (v-a) in Sl No (15) of the table.

[F.No. / /2018-TRU]

(******)

Under Secretary to the Government of India

Notification under IGST Act

Government of India

Ministry of Finance

(Department of Revenue)

Notification No./2018-Integrated Tax (Rate)

NewDelhi, the_, 2018

G.S.R. (E).- In exercise of the powers conferred by sub-section (1) of section 5 of the Integrated Goods and Services Tax Act, 2017, the Central Government, on the recommendations of the Council, hereby makes the following amendments in the notification of the Government of India, in the Ministry of Finance (Department of Revenue), No.8/2017-Integrated Tax (Rate), dated the 28th June, 2017 published in the Gazette of India, Extraordinary, Part II, Section 3, Sub-section (i), *vide* number G.S.R. 673(E) dated the 28th June, 2017, namely:-

2. In the said notification, -

   (i) In Sr. no (15), Chapter 9971, after entry (v) in Column (3), the following entry shall be inserted, namely: -

Sr.No.	Chapter, Section, Heading, Group or Service Code (Tariff)	Description of Services	Rate(%)	Condition
(1)	(2)	(3)	(4)	(5)
15	9971	(v-a) Taxable supplies received by Alternative Investment Funds	5	1. More than 50% of the total investments in the Alternative Investment Funds during the financial year, excluding domestic sponsor contributions, should be from foreign investors. 2. The Alternative Investment Funds must intimate in writing to the jurisdictional officer giving the proportion of investment in the Alternative Investment Funds from foreign investors within 90 days from the end of the financial year. 3. The acknowledged copy of the

				aforementioned intimation to be provided by the Alternative Investment Funds to all its suppliers from whom it seeks to receive supplies at zero rate. 4. In case of unregistered Alternative Investment Funds, the filing of intimation and providing it to the supplier of goods or services or both should be done by the Manager/Sponsor as the case may be, of such Alternative Investment Fund.

(ii) In para 5, after Sl No (x), the following explanation shall be inserted

(xi) Alternative Investment Fund shall have the meaning assigned to it under Regulation 2(1)(b) of the Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012

(xii) Foreign investment shall mean investment by non-resident entity/person resident outside India in accordance with Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2000.

(xiii) Taxable supplies provided by the Associate (in the capacity of a Manager) to the Alternative Investment Fund shall also be covered under Entry (v-a) in Sl No (15) of the table.

[F.No. / /2018-TRU]

(******)

Under Secretary to the Government of India

Annexure 4

Amendment to section 16 of IGST Act

(i) After sub-section 1(b) of Section 16, the following shall beadded:

(c) supply of goods or services or both to an Alternative Investment Fund

(ii) After section 1 of 16, the following provisos shall be added:

Provided that the foreign investments in the Alternative Investment Funds shall be in accordance with the conditions prescribed in this regard.

(iii) After sub-section 3 of Section 16, the following explanation shall beadded:

Explanation: for the purpose of sub section 1 (c) of section 16:

a. Alternative Investment Fund shall have the meaning assigned to it under Regulation 2(1)(b) of the Securities and Exchange Board of India (Alternative InvestmentFunds) Regulations, 2012.

b. Foreign investment shall mean investment by non-resident entity/person resident outside India in accordance with Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2000.

c. Taxable supplies provided by the Associate (in the capacity of a Manager) to the Alternative Investment Fund shall also be covered under sub section 1(c) of Section 16.

Conditions to be prescribed to give effect; to sub section 1(c) of Section 16:

1. More than 50% of the total investments in the Alternative Investment Funds during the financial year, excluding domestic sponsor contributions, should be from foreign investors.

2. The Alternative Investment Funds must intimate in writing to the jurisdictional officer giving the proportion of investment in the Alternative Investment Funds from foreign investors within 90 days from the end of the financial year.

3. The acknowledged copy of the aforementioned intimation to be provided by the Alternative Investment Funds to Annexure to all its suppliers from whom it seeks to receive supplies at zero rate.

4. In case of unregistered Alternative Investment Funds, the filing of intimation and providing it to the supplier of goods or services or both should be done by the Manager/Sponsor as the case may be, of such Alternative Investment Fund.

Annexure 5

Amendment to Schedule III

After entry 6, the following entry shall be added:

7. Share in income or profits distributed by an Alternative Investment Fund to its Sponsor, Fund Manager, any employee of the Sponsor or Fund Manager or to any other person

Abbreviations

1	Act	Income Tax Act, 1961
2	AIF	Alternative Investment Fund
3	BEPS	Base Erosion and Profit Shifting
4	CBDT	Central Board of Direct Taxes
5	CBIC	Central Board of Indirect taxes and Customs
6	CGST Act	Central Goods and Services Tax Act, 2017
7	FDI	Foreign Direct Investment
8	FDI Policy	Foreign Direct Investment Policy
9	FEMA	Foreign Exchange Management Act, 1999
10	FMV	Fair Market Value
11	Foreign Security Regulations	Foreign Exchange Management (Transfer or Issue of Any Foreign Security) Regulations, 2004
12	FPI	Foreign Portfolio Investor
13	FVCI	Foreign Venture Capital Investor
14	GIFT City	Gujarat International Finance-Tec City
15	GoI	Government of India
16	GST	Goods and Services Tax
17	IFSC	International Financial Services Centre
18	IGST Act	Integrated Goods and Services Tax Act, 2017
19	JV	Joint Venture
20	MF	Mutual Funds
21	MOF	Ministry of Finance
22	NCLT	National Company Law Tribunal
23	PAN	Permanent Account Number
24	RBI	Reserve Bank of India
25	RoI	Return of Income
26	SEBI	Securities and Exchange Board of India
27	SEBI (AIF) Regulations	Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012
28	SEBI (VCF) Regulations	Securities and Exchange Board of India (Venture Capital Funds) Regulations, 1996
29	SEBI AIF Regulations	SEBI (AIF) Regulations, 2012
30	SEBI FPI Regulations	SEBI (FPI) Regulations, 2014

31	SEBI IFSC Guidelines	SEBI (IFSC) Guidelines, 2015
32	TDS	Tax Deducted at Source
33	VCF	Venture Capital Fund
34	WoS	Wholly owned subsidiary