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Analysing developments impacting business

AIF GIFT TO THE GIFT CITY

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India has witnessed an unprecedented growth in the domain of investment funds, at a global level. The Indian fund legal and regulatory regime has exhibited dynamic promptitude in accommodating a wide variety of investors and fund managers. Owing to such conducive investment conditions, there has been an increase in fund raising activity in India over the period of time. While most of the investment funds raising capital from offshore investors have typically been established in offshore financial hubs such as Singapore, Hong Kong, Mauritius, Cayman Islands etc. on account of the globally known financial services centers, India has attempted to align its fund industry with the global fund destinations by introducing International Financial Services Centre (**IFSCs**). These centers provide suitable regulatory regimes and create conducive business environment to increase capital flow and proffer vibrant investment avenues.

[GIFT City - A dive into the future](#)

Following the finance budget of 2015, certain regulations and guidelines were introduced to operationalize Gujarat International Finance Tec-City (**GIFT City**) in India under the Special Economic Zone Act, 2005, conceptualized as an IFSC to be at par with globally benchmarked financial centers. The *raison d'etre* of GIFT City is to facilitate those financial services in India that are presently carried on abroad or through offshore branches / subsidiaries of resident entities.

On March 27, 2015, the Securities and Exchange Board of India (**SEBI**) had issued the SEBI (International Financial Services Centers) Guidelines, 2015 (**IFSC Guidelines**) to facilitate foreign investment in India, by offering wide regulatory concessions and incentives to foreign investors.

[Revisiting IFSC AIFs under the IFSC Guidelines](#)

IFSC Guidelines permitted "*recognized entities*" registered with SEBI or registered / recognized with a foreign regulator, to organize or assist in organizing stock exchanges, clearing corporations or depositories and undertake any other financial services relating to securities market in IFSC. Alternative investment funds operating in IFSCs (**IFSC AIF**) are recognized financial institutions under the IFSC Guidelines and hence a "*recognized entity*" which may be established in IFSC.

Pursuant to some much-awaited regulatory and operational specifications that were eagerly sought by investment fund players waiting to set up AIFs in IFSCs, on November 26, 2018 SEBI introduced the "*Operating Guidelines for Alternative Investment Funds in International Financial Services Centres*" (**IFSC AIF Guidelines**).

Salient features of the IFSC AIF Guidelines read with the IFSC Guidelines

➤ *Applicability of the AIF Regulations*

The construct of the IFSC AIF Guidelines has been kept on the general framework of the AIF Regulations. The IFSC AIF Guidelines provide that all provisions of the AIF Regulations and the guidelines and circulars issued thereunder, are applicable to AIFs setting up/ operating in IFSC, their investors, sponsors, managers and other intermediaries as applicable. However, the provisions governing overseas investments by AIFs is not applicable to IFSC AIFs, offering them the flexibility in terms of their investment abroad. Further, IFSC AIFs are required to periodically report their activities, denominated in USD million, in accordance with the SEBI circular dated July 29, 2013, which is similar to the reporting requirements applicable to AIFs by SEBI.

➤ *Deemed foreign territory*

Under the Operational Guidelines on IFSCs dated March 31, 2015, it has been clarified that financial institutions and their branches set up in the IFSC that are permitted / recognised as such by the government or a regulatory authority are treated as persons resident outside India. Therefore, their transactions with a person resident in India are treated as transactions between a resident and non-resident and are subject to the provisions of Foreign Exchange Management Act, 1999 (FEMA). To this end, IFSC AIFs in the GIFT City, making investments in Indian securities would need to comply with the relevant FEMA norms.

One of the areas where clarity may be required would be whether by virtue of the investment manager being based in IFSC which is a 'deemed foreign territory', would the IFSC AIF be entitled to being treated as domestic pool as would be the case for other onshore AIFs under the current FEMA provisions.

➤ *Compliance requirements, conditions and restrictions:*

- **Broad Framework:** The general framework of AIFs in IFSCs shall be as prescribed under the provisions laid down under the SEBI (Alternative Investment Funds) Regulations, 2012 (**AIF Regulations**). The conditions for grant of registration, categories of AIFs and all other broad principles applicable to IFSC AIFs shall be as specified under the AIF Regulations.
- **Eligible investors:**
 - persons resident outside India;
 - non-resident Indians;
 - institutional investors resident in India who are eligible under FEMA to invest in offshore funds subject to permissible outward investment conditions; and
 - persons resident in India and eligible under FEMA to invest in offshore funds, having minimum net worth of USD 1,000,000 during the preceding financial year and subject to Liberalized Remittance Scheme (**LRS**) of the Reserve Bank of India (**RBI**).

It is to be noted that for Indian investors investing in an AIF set up in the IFSC, the same considerations applicable to an Indian investor investing in an offshore fund will be applicable. Hence, if such AIF is proposing to invest predominantly in Indian securities, then a prior approval of the RBI may be required before accepting any Indian investors in such an AIF.

However, considering that the funds are not leaving the shores of the country, RBI should be more favorably disposed to permitting such fund raising from residents, specially where the fund manager wishes to pool both domestic and offshore investors in a single AIF. Secondly, the sponsor being a resident would not only be obligated to invest in the IFSC AIF from a regulatory perspective but would also be expected by investors to have significant 'skin-in-the-game' in this regard. RBI should be sympathetic to this requirement and should allow flexibility for the sponsors to invest freely in IFSC AIF.

- Permissible investments: IFSC AIFs are permitted to invest in:
 - securities that are listed in IFSCs;
 - securities issued by companies incorporated in IFSCs;
 - securities issued by companies belonging to a foreign jurisdiction;
 - units of other IFSC AIFs; and
 - units of AIFs.

It has been clarified that IFSC AIFs may invest in India through the Foreign Venture Capital Investor (**FVCI**) route, the Foreign Direct Investment (**FDI**) route, in accordance with applicable FDI policy/ guidelines, and / or under the Foreign Portfolio Investment (**FPI**) route. This flexibility to invest under any of these investment routes should allow multi-strategy funds to organize themselves as an IFSC AIF and avail the benefits of the IFSC regime.

It would be necessary for SEBI to clarify that once registered as IFSC AIFs, there should be no separate FPI or FVCI license necessary from SEBI for such AIFs to invest in Indian securities. However, considering that these are offshore pools, any investments by Category III AIFs may be subjected to FPI conditionalities to the extent they invest in listed securities as is the case for onshore Category III AIFs with offshore monies.

- Minimum corpus: Each scheme of IFSC AIF must have minimum corpus of USD 3,000,000.
- Minimum investor commitment: Minimum investor commitment to IFSC AIF is USD 150,000, while the minimum capital commitment threshold for employees / directors of IFSC AIF or that of the manager of such IFSC AIF is USD 40,000.
- Manager / Sponsor Commitment: Minimum continuing interest of the manager / sponsor in (i) a Category I and Category II IFSC AIF must be 2.5% of the corpus of such IFSC AIF or USD 750,000, whichever is lower; and (ii) a Category III IFSC AIF is 5% of the corpus, or USD 1,500,000, whichever is lower.

There is a need for clarification as to whether a domestic sponsor or manager can act as such for IFSC AIF, if it desires to benefit from its 'Indian owned and controlled' status.

- Sponsor / Manager: Sponsor or manager of an existing AIF established under the AIF Regulations may act as the sponsor or manager of an IFSC AIF by (i) either setting up a branch in the IFSC for the same, or (ii) by incorporating a subsidiary in the nature of a company or a limited liability partnership in the IFSC.

However, a new sponsor or manager to be set up *de novo* in IFSC is required to be incorporated as a company or a limited liability partnership in the IFSC.

- Appointment of custodian: While Category I and Category II IFSC AIFs are required to appoint a SEBI registered custodian in case the fund corpus is more than USD 70,000,000; it is mandatory for Category III IFSC AIFs to appoint a SEBI registered custodian.
- Angel Funds: IFSC AIF Guidelines have laid down the following financial eligibility criteria for angel funds and investors:
 - Minimum corpus for angel funds is USD 750,000.
 - An individual investor must have minimum net tangible assets of USD 300,000 exceeding the value of principal residence; whereas for a body corporate, minimum net worth must be USD 1,500,000.
 - Minimum investor commitment for angel funds, for up to a maximum period of 5 years is USD 40,000.
 - Angel funds are permitted to invest in Indian venture capital undertakings having turnover of less than USD 3,750,000 (VCU), subject to the conditions laid down in the AIF Regulations, however, such VCUs must not be promoted / sponsored / related to an industrial group (with group turnover exceeding USD 45,000,000).
 - Minimum quantum of investment by an angel fund is USD 1,500,000.
 - Minimum continuing interest of manager / sponsor is 2.5% or USD 80,000, whichever is lesser and shall not be through the waiver of management fees.

➤ Set-up costs

A non-refundable application fee of USD 1,500 must be paid by prospective IFSC AIFs. The registration fee structure for different categories of IFSC AIFs, depending on their category, is as follows:

Category of IFSC AIF	Registration Fee
Category I IFSC AIF other than Angel Funds	USD 7,500
Category II IFSC AIF	USD 15,000
Category III IFSC AIF	USD 22,500
Angel Fund	USD 3,000

Further, the scheme fee for IFSC AIFs, other than angel funds, is USD 1,500 and the re-registration fee is USD 1,500.

➤ Who will be benefitted?

While the IFSC AIF regime is still new and yet to unfold, it appears to us that some categories of investors who may be benefitted through IFSC AIFs are:

- Traditionally most offshore feeder funds for domestic AIFs which have been established in overseas jurisdictions, can consider being established in IFSC, and can act as a feeder fund for the Indian AIF as an option. A clarification may be

expected in this regard as to whether these IFSC AIFs, that are treated as pass-through entities, would have their individual investors being subject to permanent account number compliances and other tax filing requirements.

- Offshore funds which traditionally were based in Mauritius, Singapore, and Cayman Islands, for investments into Indian assets under the FDI, FVCI and FPI routes, may have an option to explore IFSC AIF regime.
- Domestic and overseas fund managers setting up funds for investments outside India, which are raising commitments from overseas investors and / or Indian investors may also find the IFSC AIF regime attractive. Domestic and overseas fund managers who are setting up regional funds to invest in India and overseas can evaluate IFSC as an option.
- Offshore fund managers could use the IFSC vehicles as feeder funds to invest in offshore funds.

Taxation regime applicable to IFSCs

The (Indian) Income Tax Act, 1961 (IT Act), provides for a special tax regime in case of a Category I and Category II AIF, while taxation of a Category III AIF is governed by the general provisions of the IT Act. Since IFSC AIFs are also registered under the provisions of the AIF Regulations, they should be regarded as 'investment funds' for the purposes of the benefits provided to Category I and Category II AIFs under Sections 10(23FBA) and 115UB, wherein Category I and Category II AIFs have been accorded a tax pass through status with respect to income other than business income earned by such AIFs. In other words, such income (i.e. income other than business income) is chargeable to tax in the hands of the investors as if such investors had directly made the investments held by the AIFs. In case of IFSCs, the IT Act provides for certain beneficial provisions, however, these provisions are not specific to an IFSC AIF, which given the circumstances unique to AIFs especially those having a tax pass-through status, could give rise to ambiguity relating to availability of these incentives to an IFSC AIF.

We have discussed below, the key beneficial provisions available in relation to an IFSC under the IT Act, and the interplay between such provisions and the provisions governing taxation of an AIF as well as some potential areas of uncertainties:

➤ *Tax holiday provided under Section 80LA of the IT Act:*

A unit set up in an IFSC, is eligible for a tax holiday under Section 80LA of the IT Act in relation to income arising from its business (which it has been approved for setting up). The tax holiday is in the form of a deduction from income of a unit for an amount equivalent to:

- 100% of income for 5 years beginning with the year in which the permission or registration was obtained, and thereafter; and
- 50% of income for 5 next consecutive years.

- The scope of the aforesaid tax holiday deals with income of a 'unit' set up in an IFSC. Thus, in case of a Category I and Category II AIF which, owing to their tax pass-through status (in relation to their income other than business income) do not have any taxable income, clarity must be sought as to how the tax holiday will be availed by such AIFs.

- Similarly, some guidance will need to be provided in case of a Category III AIF which is set up as a trust and thereby taxable only in a representative capacity for and on behalf of the investors.
- Notably, the tax holiday is available in relation to income arising from the 'business' of a unit set up in an IFSC. Therefore, it is to be seen if the tax holiday will be available to AIFs not earning any 'business' income.
- Currently, it appears that only AIFs earning business income, for which the Category I and II AIFs lose their tax pass-through status and income is taxable at the AIF level, may benefit from the tax holiday.
- This would certainly benefit investment managers established in IFSC, wherein the management fee and other income of the manager will be exempt for the specified duration.

➤ Lower rate of Minimum Alternate Tax (MAT) and Alternate Minimum Tax (AMT)

In case of a company, being a unit located in an IFSC and deriving its income solely in convertible foreign exchange, MAT shall be chargeable at a concessional rate of 9% (plus applicable surcharge and cess) of the amount of its book / accounting profits (compared to the general tax rate of 18.5% applicable otherwise). MAT is payable when the tax payable under normal provisions is less than MAT.

Similarly, in case of a taxpayer other than a company, being a unit set up in an IFSC and deriving its income solely in convertible foreign exchange, AMT shall be chargeable at a concessional tax rate of 9% (plus applicable surcharge and cess) of the amount of adjusted income (compared to the general tax rate of 18.5% applicable otherwise). Like MAT, AMT is payable when the tax payable under normal provisions is less than AMT.

The aforesaid concessional tax rate of MAT / AMT would apply to income which is claimed as exempt under normal provisions owing to the aforementioned tax holiday under Section 80LA. Note that income other than business income of Category I and II AIFs is outside the purview of MAT / AMT.

➤ Exemption from Dividend Distribution Tax (DDT)

A company, being a unit set up in an IFSC, and deriving its income solely in convertible foreign exchange, is exempt from paying DDT (generally payable by a company at a rate of 20.56% of dividends distributed) at the time of distributing profits in the form of dividends.

This benefit should be available to all three categories of AIFs, if set up as a company.

➤ Exemption to non-resident from capital gains tax on transfer of certain securities

Any transfer of the following capital assets:

- Specified bonds or global depository receipts,
- Rupee denominated bonds of an Indian company, and
- Derivatives,

made by a non-resident on a recognized stock exchange set up in an IFSC, and where the consideration for such transfer is payable in foreign currency, is exempt from capital gains tax in India.

In a case where an AIF, being a resident of India, transfers such assets, it would need to be seen if the benefit of the aforesaid tax exemption will be allowed to the non-resident investors in the AIF on a pass-through basis.

➤ Exemption from Securities Transaction Tax (STT)

Transactions undertaken on a recognized stock exchange set up in an IFSC, and where the consideration is paid in foreign currency, are exempt from STT. However, beneficial rates of capital gains tax provided under the IT Act for transactions undertaken on a recognized stock exchange, which are generally available only if STT is paid on such transactions, shall be applicable to transactions undertaken on a recognized stock exchange set up in an IFSC, even though no STT is paid on the same.

"Gifts" in the IFSC AIF bounty- can IFSC AIFs replace offshore feeder funds yet?

The IFSC AIF regime offers certain encompassing benefits, which may have wide ramifications on fund structuring, including elimination of structuring complexity involving multiple jurisdictions for fund managers, however there are certain grey areas that need elucidation to understand the perceptible effects that IFSC AIFs will have on the Indian alternative investment space. Some of the ambiguities that warrant clarification from the regulators are:

- While the FPI route is available to IFSC AIFs, SEBI FPI Regulations, 2014 will need amendment to incorporate the provisions in relation to IFSC AIFs being 'deemed non-residents' investing through the FPI route.
- Clarity may be sought as to whether the investors in IFSC AIFs will be required to obtain a permanent account number and file tax returns in India, as this will be a major determinant in the race between offshore feeder funds and IFSC AIFs to the trophy of the most conducive investment regime.
- Regarding permissibility of obtaining investment advisory services by an investment manager from an entity set up outside India, it is to be seen whether the same would be regulated under the SEBI (Investment Advisor) Regulations.
- Clarity regarding permissibility of IFSC Category III AIFs investing in other Category III AIFs established in India is required for the fund of fund structures; as under the AIF Regulations, Category III AIFs are not permitted to invest in the units of other Category III AIFs.
- It is still to be seen whether a separate unified regulatory and licensing regime for IFSC AIFs, similar to other such global financial services centers, will be introduced.
- Lastly, absolute tax clarity on such structures is required to assess the extent of tax benefits offered by IFSC AIFs.

Conclusion

The IFSC AIF Guidelines introduced with the aim to provide a boost to the IFSC regime towards making it a hub for multifarious financial activities, including asset management.

IFSC, for all practical purposes is a 'deemed foreign territory' which would have the same ecosystem as offshore locations, but which is physically on Indian soil hence offering greater proximity and comfort to investors. Further, there may be a notable reduction in costs for setting up fund structures in IFSC as compared to setting up of offshore feeders. However, it can be hoped that the nebulous aspects arising in the operation of IFSC AIF regime on account of seeming incongruities and overlaps between IFSC AIF Guidelines and

general foreign exchange and taxation laws will be resolved, making IFSC AIF regime a utopia for the fund industry.

Whether or not fund managers prefer setting up shop using this route as opposed to traditional offshore channels such as Mauritius, Cayman Islands, Singapore etc. hinges on the extent of tax incentives provided by the Government of India. Considering the practical aspects of fund structuring and regulatory approval process in India, it is imperative that the IFSC AIF Guidelines consider the actual timelines in the setting up and operation of a typical AIF set up in India. Regardless, the future of IFSC AIFs in India rests on the success of GIFT City as a major financial hub in the years to come.

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