India's international financial services centre and family investment fund – the beginning of a new era

Shabnam Shaikh and Pranav Doshi

Globalisation has made the world a smaller place. The seamless availability of information regarding supernormal growth prospects in one place and an asymmetrical availability of capital in another put the market forces of demand and supply to work. However, the regulatory environment was not always as developed as the present day. At the risk of oversimplifying a complex issue, it can be said that the logistical hindrances created by the unavailability of adequate financial technology and uncertain legal and regulatory frameworks/implications marred the growth of developing countries on the one side and restricted the returns on capital on the other. This void has given birth to the concept of an International Financial Services Centre (IFSC).

What is an IFSC?

Let us imagine a hypothetical day at Amazon in its initial days. It has just set up its e-commerce platform and they are receiving orders. It is business as usual but one of their buyers, Mr A, has placed orders to purchase items from four different states and Mrs B (one of the sellers) has orders to deliver in four other states. It would be nothing but a logistical chaos where the end-to-end of one product is managed by just one person, ie picking up the product from the seller and going all the way to the buyer's state to deliver the same. Now multiply that chaos by millions of products, buyers and sellers. To add to this nightmare, remember the defective products, wrong size, 'that colour does not look as good in person' returns, and the horrors of delivering the cash proceeds back to the buyers (back when payment methods were not as organised).

To solve this problem, what does Amazon do? It's simple – a warehouse. Amazon establishes a central point where products, money and responsibilities change hands. Once all products, funds and manpower are pooled at one place the responsibilities are divided in the most efficacious manner, like deliveries would now be assigned area-wise and not product-wise. The pooling of things at one central point allows for the metaphorical disentanglement of wires that may otherwise remain intertwined.

But the problems do not end here – the warehouse now requires manpower and technology to enable the disentanglement (like maintaining inventory, sorting out items, managing the inflow and outflow of funds and so on), so Amazon develops and puts in place robust technology and efficient systems to manage this. The warehouse now has a lot of valuables in one place, so Amazon requires adequate insurance products to mitigate its risks. Further, to increase its profits, it also decides to sell its own products rather than just being an intermediary – so for this it needs adequate financial products for funding as well as hedging its risks.

Circling back to our question – what is an IFSC? It is a warehouse. An IFSC is a warehouse where funds from several countries (where there is excess capital) are pooled to be invested into several other countries (with the potential for supernormal returns). What sets apart IFSCs from other areas is generally: (i) a specialised regulatory and tax regime; (ii) advanced financial technology; and (iii) specialised manpower. Further, the abundance of capital in an IFSC naturally results in the availability of superior financial services and insurance products.

Today, who would not want to be the owner of a warehouse that Amazon is ready to move in to, develop and also pay good money for it. This is exactly the motivation behind India's development of its very own IFSC in the state of Gujarat – the Gujarat International Fin-Tec City (GIFT City).

Journey of India's very own financial services *warehouse* (albeit an advanced one) – GIFT City IFSC

The ideation of GIFT City IFSC originated from the recognition that a dedicated financial centre could contribute significantly to India's economic growth and position the country as a global financial powerhouse. In 2007, the then-Chief Minister of Gujarat and the current Prime Minister of India, Mr Narendra Modi, proposed the idea of establishing an IFSC in India. The intent was clear: to create a world-class financial hub that would attract global financial institutions, facilitate international trade, and provide a conducive environment for financial services.

The project gained momentum with the formation of a dedicated company, Gujarat International Finance Tec-City Co Ltd, in 2009 to oversee the development and operation of GIFT City.

Shabnam Shaikh Khaitan & Co 108.162.227.123 1_59_392 2024-04-04 13:22:08 Print

In 2012, GIFT City received approval as the country's first IFSC, marking a significant milestone. The government implemented various regulatory and tax reforms to attract international businesses and foster a competitive financial and regulatory ecosystem. India's financial services regulator (Reserve Bank of India (RBI)) and the capital markets regulator (Securities and Exchange Board of India (SEBI)) played pivotal roles in shaping the regulatory framework, ensuring compliance with international standards and fostering investor confidence. The government has also established the International Financial Services Centre Authority (IFSCA) as a unified regulator to fortify the regulatory landscape which would aid in fostering confidence among investors and market participants.

As of today, the GIFT City IFSC stands as a noteworthy testament to India's unwavering dedication to establishing a globally competitive financial hub. The city has attracted a diverse array of financial institutions, including banks, insurance companies, asset management firms, and stock exchanges. Notably, global players have chosen to establish their presence in GIFT City, capitalising on the advantages that are being offered on the regulatory and cost perspectives.

Family investment fund regime in GIFT City

Introduction

As noted above, globalisation has made the world a smaller place but the other effects are that it has promoted trade and commerce, which in turn has propelled economic growth and led to an abundance of high-net-worth individuals/families (HNIs/HNFs). The HNIs/HNFs have disposable income and have been proactively diversifying their investments across asset classes and countries around the world. Family offices as a concept was thus birthed to cater to the needs and requirements of HNFs/HNIs which meet their estate planning objective, ie to preserve and grow their wealth. In recent times, the IFSCs in Singapore and Dubai have been looked at as favourable foreign jurisdictions to set up family offices in light of the conducive business environment, tax incentives and access to international markets.

India has strict exchange control norms whereby the flow of money into and out of the country is not freely permissible. Thus, setting up of a family office in India by an Indian or overseas HNF, so as to undertake activities of investment and diversifying in various jurisdictions, was not easy and was in some scenarios impossible.

Against the backdrop of regulatory constraint, growth of HNIs/HNFs (and the need for providing investment avenues to such individuals and families), attracting foreign investment into India, tapping India's potential to provide world-class financial services to global customers and competing with global IFSCs, India introduced the family investment fund (FIF) regime via the IFSCA, which essentially allows for HNIs (whether in India or outside India) to set-up family offices that can make investments globally and across several asset classes.

In 2022, India introduced the concept of an FIF – a regime that formalised the family office structure. An FIF is essentially an investment fund in which contributions could be made by individuals of a single family and the companies owned by them. The interesting aspect of an FIF in GIFT City is that it is treated as a person resident outside India for the purposes of India's exchange control laws. While the exchange control laws do not normally permit investment in a foreign entity that is engaged in financial services, a specific carve-out has been made for FIFs in GIFT City. Further, such FIF (being a person resident outside India) can invest in assets globally without any restrictions that would otherwise have been placed under the Indian exchange control laws. Illustratively, an individual resident in India could acquire immovable property outside India only within his or her annual foreign remittance limits in a year, which is presently US$250,000. Further, while an Indian entity had no monetary limits, it could acquire the same only for the purposes of its business. However, in the case of an FIF in GIFT City, there are no restrictions placed on acquiring such an immovable property merely for the purposes of investment.

Globalisation has made the world a smaller place but the other effects are that it has promoted trade and commerce, which in turn has propelled economic growth and led to an abundance of high-net-worth individuals/families (HNIs/HNFs).

Shabnam Shaikh Khaitan & Co 108.162.227.123 1_59_392 2024-04-04 13:22:08 Print

An FIF is a self-pooling and self-managed fund, ie it does not need a separate manager entity, which would result in reduced compliance burden and costs.

Additionally, even for non-resident HNFs, an FIF in GIFT City brings several incentives like tax breaks, flexibility of investing in and outside India and across asset classes including bullion, real estate, art etc, borrowing and leveraging and so on. Further, unlike other investment funds, an FIF is a self-pooling and self-managed fund, ie it does not need a separate manager entity, which would result in reduced compliance burden and costs.

Let us now have a closer look at the intricacies of the laws governing an FIF in GIFT City. The following primary legislation governs an FIF:

- the International Financial Services Centre Authority (Fund Management) Regulations 2022 (FME Regulations);
- the exchange control laws – Foreign Exchange Management Act 1999 (FEMA) and rules and regulations thereunder (FEMA Regulations); and
- the Income-tax Act 1961 (IT Act).

FME Regulations

The enabling legislation of an FIF are the FME Regulations. They lay down the flexibilities and limitations within which an FIF can function. They define an FIF to mean a "a self-managed fund pooling money only from a single family". The term 'single family' has been defined to mean: (i) all individuals who are the lineal descendants of a common ancestor; and (ii) spouses and children of such individuals.

Interestingly, the meaning of the term 'single family' was defined in a literal fashion to only include 'individuals' or rather 'natural persons' within the meaning. However, on 1 March 2023, the IFSCA issued a circular (2023 Circular) to clarify the intent of the FIF regime and accordingly broaden the scope of the term 'single family'.

The 2023 Circular provided that an FIF, by its very nature, represents the interests of a single family and hence even the following shall be included within the meaning of a 'single family':

- sole proprietorship concern;
- partnership firms or limited liability partnerships (LLPs); and
- trusts and body corporates (ie, companies)

in which members of the single family exercise control and directly or indirectly hold at least 90% of the economic interest.

The implications of this clarification were far-reaching for two important reasons:

- HNFs often have investments and assets across several jurisdictions and hence are held under some form of holding structure (such as a company or an LLP). This clarification allows such HNFs to form an FIF without having to liquidate such structures, which might be cumbersome and time-consuming and would likely entail tax costs; and
- As far as Indian resident individuals are concerned, the GIFT City IFSC is an offshore jurisdiction and hence investments into an FIF would be subject to the exchange control restrictions applicable under FEMA (as will be discussed later in this article). One such restriction on individuals is that they cannot remit more than US$250,000 in a financial year (as of today) outside India. However, an Indian entity (like a company) is permitted to invest up to 50% of its net worth outside India, including in GIFT City. Accordingly, it is on account of this clarification that the HNFs in India would be able to seamlessly invest funds in an FIF.

The table on the next page shows some of the salient features of an FIF as laid down under the FME Regulations.

Flexibility for performance fee structuring

The FME Regulations further acknowledge the market practice of professional wealth managers making investment decisions for HNFs and being remunerated in the form of a percentage of the returns generated by them. The requirement of the single family having at least 90% economic interest would have caused hindrances for the performance fees of the persons managing these FIFs. Therefore, the 2023 Circular provides a carve-out as to which employees, directors or other persons providing services to the FIF can be awarded an economic interest in the FIF, subject to a cap of 20%.

FEMA and FEMA Regulations

Introduction to FEMA

As noted above, the flow of money into and from India is not freely permissible. All transactions

Shabnam Shaikh Khaitan & Co 108.162.227.123 1_59_392 2024-04-04 13:22:08 Print

Particulars	Criteria
Legal form	Company, a contributory trust (determinate) or an LLP.
Investors	Single family (as explained above).
Registration	FIF, being self-managed, shall register itself with IFSCA as an authorised FME under the FME Regulations.
Permissible investments	• securities issued by unlisted entities; • securities listed or to be listed or traded on stock exchanges in IFSC, India or any other foreign jurisdictions; • money market instruments; • debt securities; • securitised debt instruments, which are either asset-backed or mortgage-backed securities; • other investment schemes set up in the IFSC, India and foreign jurisdiction; • derivatives including commodity derivatives; • units of mutual funds and alternative investment funds in India and foreign jurisdictions; • investment in limited liability partnerships; and • physical assets such as real estate, bullion, art, etc.
Net worth requirements	No net worth requirements
Management entity	No separate management entity is required as it is to be self-managed (unlike other fund structures that are mandated to register a separate fund management entity).
Minimum corpus	An FIF is required to maintain a minimum corpus of US$10 million within a period of three years from date of registration.
Borrowing	An FIF may borrow or engage in leveraging activities as per its defined risk management policy.
Human resources/ experience	One principal officer (PO) (PO must have five years of relevant experience and professional qualification/PG degree/PG diploma from a recognised university, or certification from IFSCA, SEBI or international regulator).

between a person resident in India (PRI) and a person resident outside India (PROI) are governed by FEMA. Under FEMA, transactions are categorised into one of two types: (i) capital account transaction; or (ii) current account transaction.

A capital account transaction is a transaction which: (a) alters the assets or liabilities of PRIs outside India; or (b) alters assets or liabilities of PROIs in India. For instance, if a PROI acquires shares in an Indian company, such PROI's assets in India increase. Hence, such a transaction qualifies as a capital account transaction.

Any transaction that is not a capital account transaction is termed as a current account transaction. Thus, where a PROI sells its goods in India and earns revenue out of such a sale, the assets or liabilities of such a PROI in India do not alter; hence, it is not a capital account transaction. As a consequence, it is a current account transaction.

The basic principle under FEMA is that a current account transaction is generally permissible, unless expressly restricted under law. However, a capital account transaction is generally impermissible unless expressly allowed under law. Therefore, investments into and from an FIF shall not be permissible unless expressly allowed under FEMA. The special considerations extended to an FIF in a GIFT IFSC under FEMA are discussed below.

Shabnam Shaikh Khaitan & Co 108.162.227.123 1_59_392 2024-04-04 13:22:08 Print

<table>
<tr><th colspan="2">What does this mean for foreign HNFs?</th></tr>
<tr><td colspan="2">Investment into the FIF: As the FIF is deemed to be a PROI, all transactions between the foreign HNF and the FIF would be between two PROIs and hence not be subjected to any exchange control regulations.

Investments by FIF outside India: This would again entail a transaction between two PROIs and hence not be subjected to the rigours of Indian exchange control laws.

Investments by FIF in India: Such investments would be between a PROI and PRI; accordingly, these shall be subject to the pricing guidelines, sectoral caps and other conditionalities laid down under the relevant FEMA Regulations.

This therefore enables the foreign HNFs to have access to the Indian ecosystem (in terms of cost-efficient technology, manpower, offices) but at the same time, are treated the same as an offshore jurisdiction and thereby not subjected to the rigours of foreign exchange control restrictions (for overseas investments).</td></tr>
<tr><th colspan="2">What does this mean for Indian HNFs?</th></tr>
<tr><th>Investments through regular modes</th><th>Investment through an FIF</th></tr>
<tr><td colspan="2">It is pertinent to highlight that as the foreign exchange control restrictions do not apply on PRI investments into Indian companies, one might not need to consider an FIF structure.</td></tr>
<tr><td>Overseas investments by resident individuals
• FEMA Regulations permit a resident individual to make investments only under the liberalised remittance scheme (LRS) which limits outward remittances of up to US$250,000 per financial year.
• Individuals are not permitted to make investments in holding companies or those that are engaged in financial services activity (which would include investment holding companies). Further, several restrictions are placed on acquisition of immovable properties outside India.

Overseas investments by Indian entities
FEMA Regulations permit Indian entities to make overseas investments of up to 50% or 400% of its net worth (depending on the route of investment). However, several restrictions are placed on investments in entities engaged in the financial services activity and acquisition of immovable properties outside India.</td><td>When overseas investments are made through an FIF, it is only the first limb of the transaction, ie investment of funds into an FIF, that shall be subjected to the rigours of FEMA. Once the funds are in an FIF, they are not subjected to any quantum or category-specific restrictions under FEMA.

Investment into the FIF: As the FIF is deemed to be a PROI, the transaction between the Indian HNF/HNF group entity and FIF would be a capital account transaction between a PRI and PROI.

Investment into FIF by resident individuals:
Investment into an FIF is permitted despite the same being engaged in financial services activity, subject to the annual LRS limits. This allows the PRIs to have an offshore holding vehicle for their investments (which was otherwise not permitted); further, as the FIF is not restricted from making any kinds of overseas investments, it can freely acquire immovable properties and invest in all kinds of asset classes. However, it is interesting to note that due to the limitations on remittance to an FIF by individuals (LRS limits), one would be unable to meet the minimum corpus requirement of an FIF of US$10 million (as laid down under FME Regulations) in his or her own capacity. Therefore, individuals will need to structure their investments via an intermediary into the FIF.

Investment into FIF by Indian entities:[1]
Indian entities are permitted to invest up to 50% of their net worth into an FIF. Akin to resident individuals, the FIF route permits the Indian entities to have an offshore holding vehicle that can make investments across asset classes that might otherwise be restricted or subjected to conditionalities, including in immovable properties and foreign entities engaged in financial services activity.

Investments by FIF outside India: As discussed above, this would entail a transaction between two PROIs and hence would not be subjected to the rigours of Indian exchange control laws.</td></tr>
</table>

Shabnam Shaikh Khaitan & Co 108.162.227.123 1_59_392 2024-04-04 13:22:08 Print

Residency of an FIF in GIFT IFSC
In 2015, the RBI laid down that any unit in a GIFT IFSC shall be deemed to be a PROI for the purposes of FEMA, ie FEMA treats the GIFT IFSC the same as a foreign jurisdiction and, accordingly, an FIF in the GIFT IFSC would be considered as a PROI.

Further, the FEMA Regulations that regulate/govern overseas investments by Indian residents exempts units in the GIFT IFSC, including an FIF, from the applicability of these regulations altogether. The resulting implication being that any investment that is contemplated to be made by an FIF into any asset class outside India would not be prohibited or regulated by FEMA.

IT Act and IT Rules
The discussion on the scheme of taxation applicable to FIFs revolves around two broad topics: (i) scope of taxation; and (ii) special exemptions.

Scope of taxation
The IT Act levies tax on both income and capital gains. Whether a particular income/gain is taxable in India or not would be determined by the residential status of the FIF.

It is worth noting that the PROI status granted to an FIF is only for the purposes of FEMA; the residential status of the FIF for the purposes of the IT Act would need to be determined independently in accordance with the provisions of the IT Act. Unlike FEMA, the GIFT IFSC is treated as a part of India itself under the IT Act and is not treated as an offshore jurisdiction.

Based on residency, the IT Act classifies taxpayers into two categories:[2] (i) resident; or (ii) non-resident. In the case of a resident, global income earned by the resident is chargeable to tax under the IT Act. On the other hand, for a non-resident, only such income under the IT Act that is either received in India or has its source in India (India-sourced income) is chargeable to tax.

Residential status – how determined?
The IT Act lays down different conditions for determining the residency of a taxpayer. In case of an FIF, the FME Regulations require the FIF to be either: (i) a company; (ii) a limited liability partnership (LLP); or (iii) a trust (contributory trust only). The following table shows the residency tests for each of them:

Legal Form	Test of residency
Company	• All companies incorporated in India are Indian residents. • Foreign companies having their place of effective management in India is an Indian resident. • Given that the FIF has to be located in GIFT IFSC (India), an FIF set up as a company would always qualify as an Indian tax resident under the IT Act.
LLP	• An LLP shall be an Indian resident only if its control or management is wholly or partly in India. • Partners of an LLP generally control and manage its operations. Therefore, their residential status and the place from where decisions of the FIF are taken shall have to be evaluated on a case-by-case basis to determine if control or management, whether whole or in part, is in India or not. Interesting to note is that the law governing LLPs in India requires for at least one designated partner to be resident in India. Therefore, it is likely that an LLP in an FIF would end up being an Indian tax resident.
Trust	• As per the FME Regulations, an FIF can only be set up as a determinate trust (and not a discretionary one). • Determinate trusts in India are pass-through, ie taxes on the income of such trusts are to be assessed as if earned directly by the beneficiaries. Therefore, it is the residential status of each beneficiary that shall determine the scope of income chargeable to tax under the IT Act.

Shabnam Shaikh Khaitan & Co 108.162.227.123 1_59_392 2024-04-04 13:22:08 Print

> *The debate on whether the profits made from sale of investments would be business profits or capital gains has been a long-standing controversy in India and is often litigated in tax tribunals and courts.*

What is the impact of residency?
Where the FIF (or in case of a determinate trust, the beneficiary) is a tax resident of India, its global income would be subjected to tax in India (subject to any special exemption discussed below). However, where the FIF (or in the case of a determinate trust, the beneficiary) is a non-resident, only its India-sourced income would be subject to tax in India.

Special exemptions
With a view to incentivise investments in a GIFT IFSC, the government has provided a 10-year tax holiday on business profits earned by any unit in the GIFT IFSC, including an FIF. The taxpayer can opt to utilise this 10-year period over a 15-year extent.

It is interesting to note that the IT Act does not provide a blanket exemption to all incomes of a unit in the IFSC. The tax exemption is available only on the business profits of the unit and not on capital gains. The debate on whether the profits made from sale of investments would be business profits or capital gains has been a long-standing controversy in India and is often litigated in tax tribunals and the courts. Several criteria such as the regular activities of the taxpayer, frequency of transactions, and intention are assessed in arriving at a conclusion.

Given that the objective and core activity of an FIF is making profits from investment activities, it will be interesting to see whether the tax authorities are amenable to treating profits of FIFs as business profits and thus extend the tax holiday.

Conclusion
The GIFT City IFSC is one of the ambitious projects of the present government of India where millions of dollars have been spent developing the infrastructure and to ensure regulatory stability. In fact, the government has also adjusted its social policies to make the GIFT IFSC more attractive. In a major recent development, the ban on alcohol consumption, which is otherwise in place for the entire state of Gujarat, was lifted from GIFT City with a view to making the infrastructure of the place such that it caters to all from a social standpoint and thus incentivise people to settle in the city, thereby improving the availability of skilled manpower in the region. Further, in December 2023, the government unveiled a draft plan on the expansion of GIFT City from a current area of 886 acres to over 3,300 acres. Thus, the intent is to expand and fortify this project to its maximum potential.

It is notable that when the FIF regime was introduced a number of well-known Indian HNFs applied for registration of their FIF in the GIFT City. Recently, one of India's leading business tycoons received approval to set up an FIF and this is just the start. With the introduction of corporate taxes in Dubai and a capital gains tax in Singapore on disposal of foreign assets, it will be interesting to see if the GIFT City IFSC is able to adequately incentivise and capitalise on the opportunity to attract an array of foreign investors and establish India as a top-choice jurisdiction for financial and investment services.

Shabnam Shaikh is a partner in the private client, direct tax and employee incentive and benefits practices at Khaitan & Co. Shabnam extensively advises private clients on matters relating to structuring and holding of personal or business assets. She also focuses on Indian and international tax issues and Indian regulatory implications in relation to migration to and from India.

Pranav Doshi is an associate in the private client and tax practice at Khaitan & Co. He is a qualified lawyer and chartered accountant in India. Pranav advises private clients from a legal and tax perspective on matters of succession, asset protection and wealth planning, structuring and reorganisation of family businesses, and multi-jurisdictional planning of their personal and business assets.

1 Such Indian entities that qualify within the meaning of a 'single family' as provided under the FME Regulations and the 2023 Circular.

2 The IT Act also provides for a temporary third category which is a 'resident but not ordinarily resident' status; however, such status is available only to an individual. As the FIF cannot be an individual, this has not been discussed here.

Shabnam Shaikh Khaitan & Co 108.162.227.123 1_59_392 2024-04-04 13:22:08 Print