

# Private Equity and Private Debt Investments in India

---

Strategic, Legal, Tax and Ethical Issues

May 2019

---

# Private Equity and Private Debt Investments in India

---

Strategic, Legal, Tax and Ethical issues

May 2019

[corpteam@nishithdesai.com](mailto:corpteam@nishithdesai.com)

## About NDA

At Nishith Desai Associates, we have earned the reputation of being Asia's most Innovative Law Firm – and the go-to specialists for companies around the world, looking to conduct businesses in India and for Indian companies considering business expansion abroad. In fact, we have conceptualized and created a state-of-the-art Blue Sky Thinking and Research Campus, Imaginarium *Aligunjan*, an international institution dedicated to designing a premeditated future with an embedded strategic foresight capability.

We are a research and strategy driven international firm with offices in Mumbai, Palo Alto (Silicon Valley), Bangalore, Singapore, New Delhi, Munich, and New York. Our team comprises of specialists who provide strategic advice on legal, regulatory, and tax related matters in an integrated manner basis key insights carefully culled from the allied industries.

As an active participant in shaping India's regulatory environment, we at NDA, have the expertise and more importantly – the VISION – to navigate its complexities. Our ongoing endeavors in conducting and facilitating original research in emerging areas of law has helped us develop unparalleled proficiency to anticipate legal obstacles, mitigate potential risks and identify new opportunities for our clients on a global scale. Simply put, for conglomerates looking to conduct business in the subcontinent, NDA takes the uncertainty out of new frontiers.

As a firm of doyens, we pride ourselves in working with select clients within select verticals on complex matters. Our forte lies in providing innovative and strategic advice in futuristic areas of law such as those relating to Blockchain and virtual currencies, Internet of Things (IOT), Aviation, Artificial Intelligence, Privatization of Outer Space, Drones, Robotics, Virtual Reality, Ed-Tech, Med-Tech & Medical Devices and Nanotechnology with our key clientele comprising of marquee Fortune 500 corporations.

NDA has been the proud recipient of the RSG - FT award for 2019, 2017, 2016, 2015, 2014 as the 'Most Innovative Indian Law Firm' and in 2016 we were awarded the 'Most Innovative Law Firm - Asia Pacific,' by Financial Times (London.)

We are a trust based, non-hierarchical, democratic organization that leverages research and knowledge to deliver extraordinary value to our clients. Datum, our unique employer proposition has been developed into a global case study, aptly titled 'Management by Trust in a Democratic Enterprise,' published by John Wiley & Sons, USA.

## Accolades

A brief chronicle our firm's global acclaim for its achievements and prowess through the years –

- **FT Innovative Lawyers Asia Pacific 2019 Awards:** NDA was ranked second in the Most Innovative Law Firm category (Asia-Pacific)
- **RSG-Financial Times:** India's Most Innovative Law Firm *2019, 2017, 2016, 2015, 2014*
- **Chambers and Partners Asia Pacific:** Band 1 for Employment, Lifesciences, Tax and TMT *2019, 2018, 2017, 2016, 2015*
- **Benchmark Litigation Asia-Pacific:** Top tier for Government & Regulatory and Tax *2019, 2018*
- **IFLR1000:** Tier 1 for Private Equity and Project Development: Telecommunications Networks. *2019, 2018, 2017, 2014*
- **Legal500:** Tier 1 for Dispute, Tax, Investment Funds, Labour & Employment, TMT and Corporate M&A *2019, 2018, 2017, 2016, 2015, 2014, 2013, 2012*
- **AsiaLaw 2019:** Ranked 'Outstanding' for Technology, Labour & Employment, Private Equity, Regulatory and Tax
- **Who's Who Legal 2019:** Vikram Shroff, HR and Employment Law- Global Thought Leader; Nishith Desai, Corporate Tax and Private Funds and Vaibhav Parikh, Data Practices Thought Leaders- India
- **Merger Market 2018:** Fastest growing M&A Law Firm
- **Asia Mena Counsel's In-House Community Firms Survey 2018:** Only Indian Firm for Life Science Practice Sector
- **IFLR:** Indian Firm of the Year *2013, 2012, 2011, 2010*
- **IDEX Legal Awards 2015:** Nishith Desai Associates won the "M&A Deal of the year", "Best Dispute Management lawyer", "Best Use of Innovation and Technology in a law firm" and "Best Dispute Management Firm"

Please see the last page of this paper for the most recent research papers by our experts.

---

## Disclaimer

This report is a copy right of Nishith Desai Associates. No reader should act on the basis of any statement contained herein without seeking professional advice. The authors and the firm expressly disclaim all and any liability to any person who has read this report, or otherwise, in respect of anything, and of consequences of anything done, or omitted to be done by any such person in reliance upon the contents of this report.

## Contact

For any help or assistance please email us on [ndaconnect@nishithdesai.com](mailto:ndaconnect@nishithdesai.com)  
or visit us at [www.nishithdesai.com](http://www.nishithdesai.com)

# Contents

<b>ABBREVIATIONS</b>	<b>01</b>
<b>1. INTRODUCTION</b>	<b>03</b>
I. Success of Bankruptcy Code	03
II. PE Investment in Insurance Companies	03
III. Introduction of Minimum Capitalization Norms for Financial Services	04
IV. Key changes in the foreign exchange regulations	04
V. Amendments to the FDI Policy on e-commerce	05
VI. Regulatory changes in the ECB regime	06
VII. Amendments to the Tax Treaties with Mauritius, Singapore and Cyprus	06
VIII. Tax neutrality on conversion of preference shares to equity shares	06
IX. Further liberalization of the foreign investment	06
X. Introduction of GAAR	07
XI. Introduction of Thin Capitalization Norms	07
XII. Amendments to CA, 2013	07
XIII. Relaxations notified by the Competition Commission of India (“CCI”)	07
XIV. Revised guidelines for the determination of the ‘Place of Effective Management’ (“POEM”)	08
<b>2. PRIVATE EQUITY INVESTMENTS</b>	<b>09</b>
I. FDI regime	09
II. FVCI regime	18
III. FPI regime	19
IV. NRI Investment	24
<b>3. PRIVATE DEBT INVESTMENTS</b>	<b>26</b>
I. The FDI Route	27
II. FVCI regime	28
III. FPI regime	28
IV. CCD vs. NCD	30
<b>4. TAX CONSIDERATIONS AND EVOLVING STRUCTURES</b>	<b>31</b>
I. Overview of Indian Taxation System	31
II. Specific Tax Considerations for PE Investments	36
<b>5. EXITS FOR PRIVATE EQUITY AND PRIVATE DEBT INVESTMENTS</b>	<b>44</b>
I. IPO	44
II. Trade sale	44
III. Buy-back	44
IV. Depository Receipts (“DRs”)	45
V. Externalisation	46
<b>6. DISPUTE RESOLUTION</b>	<b>47</b>
I. Impact of introduction of NCLT	48
II. Class Action	48

<b>ANNEXURE I</b>	<b>50</b>
Debt Funding in India	50
<b>ANNEXURE II</b>	<b>58</b>
Specific Tax Risk Mitigation Safeguards for Private Equity Investments	58
<b>ANNEXURE III</b>	<b>60</b>
Bilateral Investment Treaties	60

# Abbreviations

<b>Abbreviation</b>	<b>Meaning / Full Form</b>
<b>AAR</b>	Authority for Advanced Rulings
<b>ADR</b>	American Depository Receipt
<b>AIF</b>	Alternative Investment Funds
<b>AIF Regulations</b>	SEBI (Alternative Investment Funds) Regulations, 2012
<b>BITs</b>	Bilateral Investment Treaties
<b>CA 1956</b>	Companies Act 1956
<b>CA 2013</b>	Companies Act 2013
<b>CCDs</b>	Compulsorily Convertible Debentures
<b>CCPS</b>	Compulsorily Convertible Preference Shares
<b>CLB</b>	Company Law Board
<b>Contract Act</b>	Indian Contract Act, 1872
<b>DDP</b>	Designated Depository Participant
<b>DDT</b>	Dividend Distribution Tax
<b>DIPP</b>	Department of Industrial Policy and Promotion
<b>DTAA / Tax treaties</b>	Double Taxation Avoidance Agreements
<b>EBITDA</b>	Earnings Before Interest Tax Depreciation Amortization
<b>ECB</b>	External Commercial Borrowing
<b>FDI</b>	Foreign Direct Investment
<b>FDI Policy</b>	Foreign Direct Investment Policy dated May 12, 2015
<b>FEMA</b>	Foreign Exchange Management Act
<b>FIPB</b>	Foreign Investment Promotion Board
<b>FII</b>	Foreign Institutional Investor
<b>FPI</b>	Foreign Portfolio Investor
<b>FPI Regulations</b>	SEBI (Foreign Portfolio Investment) Regulation 2014
<b>Funds</b>	Investment fund
<b>FVCI</b>	Foreign Venture Capital Investor
<b>FVCI Regulations</b>	SEBI (Foreign Venture Capital Investors) Regulations, 2000
<b>FY</b>	Financial Year
<b>GAAR</b>	General Anti-Avoidance Rules
<b>GDR</b>	Global Depository Receipt
<b>ICA</b>	International Commercial Arbitration
<b>ICDR Regulations</b>	SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009
<b>IPO</b>	Initial Public Offering
<b>ITA</b>	Income Tax Act, 1961
<b>IPO</b>	Initial Public Offering
<b>ITA</b>	Income Tax Act, 1961
<b>LTCG</b>	Long Term Capital Gains
<b>LoB</b>	Limitation on Benefits
<b>LP</b>	Limited Partner
<b>MAT</b>	Minimum Alternate Tax
<b>NBFC</b>	Non-Banking Financial Companies
<b>NCD</b>	Non-Convertible Debenture
<b>NRI</b>	Non-Resident Indian
<b>OECD</b>	Organization for Economic Co-operation and Development
<b>OCD</b>	Optionally Convertible Debenture
<b>OCRPS</b>	Optionally Convertible Redeemable Preference Share

<b>ODI</b>	Offshore Derivative Instruments
<b>OHC</b>	Offshore Holding Company
<b>PAN</b>	Permanent Account Number
<b>Press Note 8</b>	Press note 8 of 2015 notified by the DIPP on July 30, 2015
<b>Press Note 12</b>	Press note 12 of 2015 notified by the DIPP on November 24, 2015
<b>P-Notes</b>	Participatory Notes
<b>PD</b>	Private Debt
<b>PE</b>	Private Equity
<b>PIO</b>	Person of Indian Origin
<b>PIPE</b>	Private Investment into Public Equity
<b>PIS</b>	Portfolio Investment Scheme
<b>QFI</b>	Qualified Foreign Investor
<b>R&amp;W Insurance</b>	Representation and Warranties Insurance
<b>RBI</b>	Reserve Bank of India
<b>REITs</b>	Real Estate Investment Trust
<b>RoE</b>	Return on Equity
<b>Rs./INR</b>	Rupees
<b>SEBI</b>	Securities and Exchange Board of India
<b>SGD</b>	Singapore Dollar
<b>STCG</b>	Short Term Capital Gains
<b>STT</b>	Securities Transaction Tax
<b>TISPRO Regulations</b>	Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2017
<b>TRC</b>	Tax Residency Certificate
<b>UN</b>	United Nations
<b>USD</b>	United States Dollar

# 1. Introduction

After recording its highest ever PE investments in the year 2015, staggering to an amount of over \$ 22.4 billion,<sup>1</sup> India Inc. witnessed a slight dip in PE activity in 2016 with PE infusion of \$ 15.2 billion spread across 620 deals. However, the year 2017, surpassed the marvels of 2015 both, in terms of average deal size and overall deal value. The year 2017 recorded PE investments worth \$ 24.3 billion spread across 734 deals, and it jumped 36% in 2018 to \$33.1 billion across 720 transactions.<sup>2</sup>

Following are some of transaction trends / issues that have gained significance in recent years:

## I. Success of Bankruptcy Code

The Insolvency and Bankruptcy Code, 2016 (“**Code**”) has created a framework to expeditiously resolve insolvency and bankruptcy issues and the process of money recovery. Reform of bankruptcy laws was long overdue and was necessary to improve the ease of doing business in India and for meeting global standards. The Code marks a radical change in the field of insolvency with the creation of a specialized cadre of insolvency professionals, an integrated adjudicatory body for conducting / supervising the process of insolvency resolution and liquidation and specialized regulatory bodies. The constitution of the National Company Tribunal (“**NCLT**”) and the National Company Law Appellate Tribunal (“**NCLAT**”) are important steps in the long march towards creating a specialized institution for insolvency proceedings.

After promulgation, amendments have been introduced into the Code to tackle the challenges being faced in the resolution process set out under the Code. All arms of the State machinery have put in dedicated effort in trying to ensure that the Code is effectively implemented and does not suffer from

the same fate as its predecessors. Amongst other things, these amendments to the Code ostensibly put certain safeguards to prevent unscrupulous persons from misusing or vitiating provisions of the Code. Please refer to our analysis on the IBC Ordinance here.<sup>3</sup> However, like all other disruptive mechanisms, the Code even with the amendments, has run into its own set of operational hurdles and interpretational issues. The Supreme Court has already been approached to interpret the provisions of the Code, wherein, the Supreme Court has highlighted the importance of the Code and the urgent requirement to ensure its seamless integration into the existing legal system. The key changes and implications of the introduction of the Code, constitution of NCLT and NCLAT and the Arbitration and Conciliation (Amendment) Act, 2015 have been discussed in greater detail in the subsequent chapters.

## II. PE Investment in Insurance Companies

The Insurance Regulatory and Development Authority of India (“**IRDAI**”) notified the IRDAI (Investment by Private Equity Funds in Indian Insurance Companies) Guidelines, 2017 (“**PE Guidelines**”) on December 5, 2017, which regulates investments by private equity funds into insurance companies. Prior to the PE Guidelines, there were no regulations specifically catering to private equity investors, and they were considered at par with any other investor for the purpose of investment. In 2015, the IRDAI notified the IRDAI (Transfer of Equity Shares of Insurance Companies) Regulations, 2015 (“**2015 Regulations**”), which restricted the quantum of investment by ‘Indian investors’ to 10% individually, and to 25% cumulatively. Private equity investors historically have invested in insurance companies in their capacity as investors, taking minority positions, which would be within

1. [http://www.bain.com/Images/BAIN-REPORT\\_India\\_Private\\_Equity\\_Report\\_2015.pdf](http://www.bain.com/Images/BAIN-REPORT_India_Private_Equity_Report_2015.pdf)

2. <https://www.thehindubusinessline.com/specials/emerging-entrepreneurs/pe-investments-rise-36-to-33-billion-in-2018/article25933485.ece>

3. [www.nishithdesai.com/information/news-storage/news-details/article/bankruptcy-code-ghost-of-retrospectivity-returns-to-haunt-1.html](http://www.nishithdesai.com/information/news-storage/news-details/article/bankruptcy-code-ghost-of-retrospectivity-returns-to-haunt-1.html)

10% (in case of domestic investors, in line with the 2015 Regulations). However, in the recent past, the appetite for private equity funds to take over controlling stake in insurance companies has been on the rise, and this prompted the IRDAI to notify the PE Guidelines and regulate any such investment by private equity funds. The key changes and analysis of the PE Guidelines have been discussed in greater detail in the subsequent chapters.

### III. Introduction of Minimum Capitalization Norms for Financial Services

In a press release dated April 16, 2018, the Ministry of Finance introduced minimum capital requirements for foreign direct investment into ‘unregulated’ financial services activities. The Press Release imposes dual test of: (i) registration for the entity; and (ii) regulation of the activity undertaken by such entity with a financial services regulator, failing which minimum capitalisation norms of USD 20 million (for fund based activities, such as asset management) and USD 2 million (for non-fund based activities, such as investment advisors rendering exempt advisory services) may trigger.

As a result, asset managers of alternate investment funds (“AIF”) who were hitherto considered regulated (by virtue of the AIF being regulated); however, now, in light of the Press Release, such asset managers would be considered unregulated entities, and be subjected to USD 20 million minimum capitalisation and regulatory approval.

### IV. Key changes in the foreign exchange regulations

In November, 2017, the RBI issued the Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2017 (“TISPRO Regulations”) that superseded the seventeen years old Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2000 (“Old TISPRO”). Besides streamlining the foreign direct investment regime in India, the TISPRO Regulations introduced several changes including overhauling of the foreign portfolio investment regime, liberalized investment regime for NRI/ OCI and allowing foreign direct investment in an Indian listed company, that left the stakeholders perplexed. The table below sets out some of the key changes introduced by the TISPRO Regulations and its impact on foreign investments in India.

Key Changes	Changes and analysis
<b>FDI vs. FPI</b>	<p>While the meaning of FDI remains the same as earlier in case of investments into an unlisted Indian company, however any investments of 10 percent or more of the post issue paid-up equity capital on a fully diluted basis of a listed Indian company by a person resident outside India shall now be regarded as FDI.</p> <p>Any investment below 10% made by an entity registered with SEBI as a FPI or otherwise shall be regarded as foreign portfolio investment. TISPRO Regulations clarifies that the total holding of an FPI may increase to 10 percent or more of the total paid up equity capital on a fully diluted basis or 10 percent or more of the paid up value of each series of capital instruments of a listed Indian company, however such investment shall then be re-classified as FDI subject to the guidelines to be specified by SEBI and the RBI in this regard.</p>

<b>Capital Instruments</b>	The term 'Capital' under the Old Regulations has been aligned with changes made to the FDI Policy and replaced with the term 'Capital Instrument' that means equity shares, fully, compulsorily and mandatorily convertible debentures and preference shares and share warrants. It is clarified that the partly paid shares or share warrants can be issued subject to 25 percent upfront payment of the consideration and the balance to be paid within 12 months (in case of partly paid up shares) or 18 months (in case of share warrants) from the date of such issue. It is further clarified that the Capital Instruments may also be issued with an optionality clause subject to a minimum lock-in of 1 year (or as may be prescribed for the specific sector, whichever is higher), however it has to be without any option or right to exit at an assured price.
<b>Acquisition of shares by way of rights or bonus issue</b>	Under the Old TISPRO, the Capital Instruments (other than the share warrants) purchased by the person resident outside India under rights issue or bonus issue shall be subject to same conditions (including restrictions in relation to repatriability) as are applicable to the original shares against which right shares or debentures are issued.  The TISPRO Regulations has eliminated the applicability of retrospective restrictions and has made such transfers subject to the conditions as are applicable at the time of such issue. However, in regard to repatriability restrictions, the position remains the same considering that an individual who is a person resident outside India at the time of exercising the right, which was issued to him when he was a resident in India, shall hold the Capital Instruments (other than the share warrants) so acquired on exercising the option on a non-repatriation basis.
<b>Liberalization of NRI/OCI Investments Regime</b>	The new TISPRO Regulations has relaxed the rules for NRIs/OCIs to be able to transfer the Capital Instruments to a person resident outside India by way of sale or gift, provided that the investment made by the person resident outside India is on a repatriation basis. In relation to the investments by a person resident outside India under non-repatriation basis, while they have been allowed to transfer the Capital Instruments by way of sale without any approval, however transfer of Capital Instruments by way gift would require prior approval of the RBI subject to satisfying several conditions including size of gift should not exceed 5% of the paid up capital of the Indian company, the value of the gift transferred in a year should not exceed rupee equivalent of USD 50,000 etc.

## V. Amendments to the FDI Policy on e-commerce

The Department of Industrial Policy and Promotion, Ministry of Commerce and Industry, Government of India (“DIPP”) has on December 26, 2018 issued a Press Note 2 (2018 Series) (“**Press Note 2 of 2018 Series**”) modifying the policy on foreign direct investment in e-commerce. Vide this clarificatory Press Note 2 of 2018 Series, the DIPP has imposed new restrictions on the e-commerce companies, which might have a considerable impact on the business models currently adopted by major e-commerce entities in India. It is pertinent to note that even prior to the DIPP issuing the Press Note 2 of 2018 Series, foreign direct investment was not permitted in ‘inventory-based model of e-commerce’ and 100% foreign direct investment under automatic route was permitted only in marketplace-based model of e-commerce.

Prior to the issuance of Press Note 2 of 2018 Series there was a restriction on an e-commerce entity to permit more than 25% of the sales value on financial year basis through its marketplace from one vendor or their group companies. Further, an e-commerce entity providing a ‘marketplace’ was not allowed to exercise ownership over the inventory i.e. goods purported to be sold.

The Press Note 2 of 2018 Series however provides that inventory of a vendor will be deemed to be controlled by an e-commerce entity if more than 25 percent of purchases of such vendor are from the marketplace entity or its group companies. Further, it may turn out to be a big jolt to the online e-platforms operating in India since the Press Note 2 of 2018 Series prohibits any entity having equity participation by e-commerce marketplace or its group companies or having control on its inventory by e-commerce marketplace entity to group companies, to sell its products on platform run by such marketplace entity.

## VI. Regulatory changes in the ECB regime

The ECB framework has been governed by the regulations of the RBI framed under the Foreign Exchange Management Act, 1999 (“**FEMA**”), and the ‘Master Direction – External Commercial Borrowings, Trade Credit, Borrowing and Lending in Foreign Currency by Authorised Dealers and Persons other than Authorised Dealers’ (the “**ECB Master Direction**”). The RBI on January 16, 2019 has by way of a circular (“**Circular**”) revised the entire existing regulatory framework for ECBs in India. The key regulatory changes proposed by the Circular have been discussed in greater detail in subsequent chapters.

Further, the Monetary Policy Committee of the RBI on February 7, 2019 issued its ‘Sixth Bi-monthly Monetary Policy Statement, 2018-19’ and also issued the ‘Statement on Developmental and Regulatory Policies’. The ‘Statement on Developmental and Regulatory Policies’ (“**RBI Statement**”) has proposed a number of regulatory changes such as permitting ECBs to be raised for refinancing rupee debt in certain cases, removal of certain concentration norms, harmonizing categories of non-banking financial companies (“**NBFC**”) and amending risk weightage for NBFC. Some of these changes are expected to have substantial bearing on debt raising options by Indian corporates. The key regulatory changes proposed by the RBI Statement have been discussed in greater detail in subsequent chapters.

## VII. Amendments to the Tax Treaties with Mauritius, Singapore and Cyprus

One of the most notable in the last couple of years has been the amendments to the India-Mauritius Treaty (“**Mauritius Treaty**”), India-Singapore Treaty (“**Singapore Treaty**”) and India-Cyprus Treaty (“**Cyprus Treaty**”).

## VIII. Tax neutrality on conversion of preference shares to equity shares

Section 47 of the ITA was amended by The Finance Act, 2017 (“**FA 2017**”) to exempt gains arising upon the conversion of preference shares into equity shares from capital gains tax, which were hitherto typically regarded as a taxable transfers due to certain judgments from courts. The FA 2017 also introduced corresponding amendments to Section 2(42A) and Section 49 of the ITA to provide for determination of holding period and cost of acquisition of the equity shares receivable on conversion of the preference shares. The holding period for the resulting equity shares will now include the holding period of the preference shares and the cost of acquisition of the resulting equity shares will be the cost of acquisition of the preference share in relation to which the equity share was acquired by the investor. The amendments are prospective in nature and came into effect from FY 2017-18.

## IX. Further liberalization of the foreign investment

Since 2015, a large number of sectors, which were hitherto regulated, such as such defense sector, construction-development sector, broadcasting industry, e-commerce, retail, private security agencies etc. have now been liberalized. The Government has been keen on handing over the responsibility of granting approvals to relevant sectoral regulators, instead of the FIPB, for instance insurance, defence and in more recent times the financial services sector. Furthermore, the RBI has allowed FPIs to invest in unlisted debt securities in the form of non-convertible debentures or bonds issued by public or private companies. The key changes in the FDI, FPI and FVCI regimes have been discussed in greater detail in the subsequent chapters.

## X. Introduction of GAAR

After being deferred a few times, the GAAR was introduced in Chapter X – A of the ITA, effective from financial year 2017-18. GAAR brings a shift towards a substance based approach. GAAR targets arrangements whose main purpose is to obtain a tax benefit and arrangements which are not at arm's length, lack commercial substance, are abusive or are not bona fide. It grants tax authorities powers to disregard any structure, reallocate / re-characterize income, deny treaty relief etc. Further, the ITA provides that GAAR is not applicable in respect of any income arising from transfer of investments which are made before April 1, 2017. The implications of GAAR have been discussed in greater detail in the subsequent chapters.

## XI. Introduction of Thin Capitalization Norms

The FA 2017 introduced thin capitalization rules within the ITA ("**Thin Capitalization Norms**") to curb companies from enjoying excessive interest deductions, while effectively being akin to an equity investment. This move would have a significant impact on investments into India through the debt route – both in respect of CCDs and NCDs which are widely used methods for structured finance into India. Thin Capitalization Norms provide that where an Indian company or PE of a foreign company makes interest payments (or similar consideration) to its associated enterprise, such interest shall not be deductible at the hands of the Indian company/ PE to the extent of the "excess interest". Excess interest means an interest amount that exceeds 30% of the EBITDA of the Indian company / PE. In the event the interest payment payable/ paid is less than Excess Interest, the deduction will only be available to the extent of the interest payment payable/ paid.

## XII. Amendments to CA, 2013

Government has introduced a host of changes in the Companies Act by way of introducing amendments especially for the private companies ("**Private Companies Exemption**"), the Companies (Amendment) Act, 2015 ("**CA Amendment Act**") and series of amendments of the ancillary rules. We have analyzed the changes brought about by the Private Company Exemption, CA Amendment Act in greater detail in the subsequent chapters.

## XIII. Relaxations notified by the Competition Commission of India ("CCI")

Under the Competition Act, 2002 ("**Competition Act**"), the Government is required to enhance or reduce the financial thresholds triggering a pre-merger notification before the CCI, every two years on the basis of the wholesale price index or fluctuations in exchange rate of rupee or foreign currencies. Based on these powers conferred on the Government, on March 4, 2011 the Government had *inter alia* provided exemption from pre-merger notification for targets which did not have assets or turnover of the value of more than INR 250 crores and INR 750 crores (USD 115.384 million) in India respectively. In a notification dated March 4, 2016, the Government increased the thresholds under Section 5 of the Competition Act, i.e. the value of assets and turnover by 100% and the target de-minimis exemption threshold ("**CCI Notification, 2016**") has been increased to entities having not more than INR 350 crores in India or turnover of not more than INR 1000 crores. For a more detailed analysis of the changes brought about by the CCI Notification, 2016, please refer to our hotline.<sup>4</sup> Further, on March 27, 2017 the Government issued another notification ("**2017**

4. Available at: <http://www.nishithdesai.com/information/research-and-articles/nda-hotline/nda-hotline-single-view/article/change-in-merger-control-thresholds.html>

**Notification”)** which provides for the following (i) extension of the de-minimis exemption to mergers and amalgamations; (ii) a more commercial way of computing the value of assets and turnover for the purposes of Section 5 of the Competition Act i.e. asset and turnover of only the portion which is being transferred to be considered for the purposes of the de-minimis exemption; and (iii) an extension of the de-minimus exemption for a period of 5 years from the date of publication of the 2017 Notification.

## XIV. Revised guidelines for the determination of the ‘Place of Effective Management’ (“POEM”)

On January 24, 2017, the CBDT issued a circular containing what appear to be the final guiding principles to be taken into account during the determination of the POEM of a foreign company. In Finance Act 2015, Section 6(3) of the ITA was amended to provide that a foreign company would be considered to be a tax resident of India if its’ POEM was found to be situated in India. The guidelines are consistent in their emphasis on substance over form, and maintain that a determination of POEM will depend on facts and circumstances of each case. They retain the distinction between companies that carry on an ‘active business outside India’ and companies that do not.

## 2. Private Equity Investments

FEMA is the principle legislation in India governing all foreign exchange transactions in India. Under FEMA, the RBI has been granted the authority to manage foreign exchange transactions and capital flows in consultation with the Ministry of Finance pursuant to the TISPRO Regulations. As a result, foreign investments into India are primarily monitored by the RBI, the FIPB and the DIPP<sup>5</sup> (an instrumentality of the Ministry of Commerce & Industry).

In addition to these, the Securities and Exchange Board of India (“SEBI”) regulates the dealings in securities that are listed or offered to the public.

The Foreign Exchange Management Act, 1999 (“FEMA”) and the rules framed therein, in particular, the TISPRO Regulations regulate foreign investment into India.

Foreign investment into India can be broadly made through either of the following regimes:

1. Foreign Direct Investment (“FDI”);
2. Foreign Venture Capital Investment regime, for investments made by SEBI registered Foreign Venture Capital Investors (“FVCI”); and
3. Foreign Portfolio Investor regime, for investments made by registered FPI.

### I. FDI regime

FDI in India is mainly governed by the TISPRO Regulations. The DIPP and the RBI used to make policy pronouncements on foreign investment through Press Notes / Press Releases / Circulars. These Press Notes / Press Releases / Circulars were notified by the RBI as amendments to the TISPRO Regulations. Unless otherwise specified, the Press Notes / Press Releases / Circulars were effective from the date of their issue.

In order to bring clarity and certainty in the policy framework, the DIPP for the first time issued a consolidated policy relating to FDI in India on April 1, 2010, which subsumed and superseded all the previous Press Notes / Press Releases / Clarifications / Circulars issued by DIPP. The DIPP now revises the FDI Policy annually and the latest policy is dated August 28, 2017 (“FDI Policy”).

Under the TISPRO Regulations, it has been clarified that any investments of 10 percent or more of the post issue paid-up equity capital on a fully diluted basis of a listed company shall subject to the guidelines to be specified by SEBI and the RBI in this regard.

Furthermore, the government has liberalized the framework for FDI in Limited Liability Partnership (“LLP”). Earlier, FDI in LLPs was permitted only through the Government approval route and LLPs were not allowed to make downstream investments. Now, FDI in LLPs has been permitted under the automatic route in LLPs operating in sectors/ activities where 100% FDI is allowed, through the automatic route and there are no FDI linked performance conditions. Also, an Indian company or LLP, having foreign investment, will be permitted to make downstream investment in another company or LLP in sectors in which 100% FDI is allotted under the automatic route and there are no FDI linked performance conditions. The RBI has further amended the framework of FDI investment in to LLPs by allowing foreign residents or a foreign body corporate to be appointed as designated partner in a LLP, which was hitherto not permitted. It has also been clarified that conversion of a company with FDI in to a LLP would be under the automatic route, for companies operating in sectors in which 100% FDI is allotted under automatic route and there are no FDI linked performance conditions

Further, the government has also allowed entities such companies, trusts and partnership firms incorporated outside India, which are owned and controlled by NRIs to invest in India under the FDI regime.

5. The Indian Union Budget for the financial year 2017-18, announced the Government’s decision to abolish FIPB and measures to monitor foreign investments in regulated sectors. Pursuant to this announcement, FIPB has been abolished.

## A.FDI into Indian companies is regulated as below

### i. Prohibited Sectors

There are some sectors where FDI is prohibited, including:

- i. Atomic energy
- ii. Lottery business
- iii. Real estate business or construction of farm houses
- iv. Trading in Transferrable Development Rights
- v. Gambling and betting including casinos / lottery business
- vi. Manufacturing of cigars, cheroots, cigarillos and cigarettes, of tobacco or of tobacco substitutes

### ii. Sectors under automatic route

Under the automatic route, for investments into an Indian company (carrying on business in the specified sectors that are identified as under 'automatic route') prior approval of India's central bank, RBI or the approval of the Central Government (through FIPB) is not required.

- i. **Sectors under automatic route with 100% FDI:** FDI, up to 100%, is permitted in most sectors in India under the 'automatic route'.
- ii. **Sectors under automatic route with thresholds:** In few sectors, which are under the automatic route, foreign investment cannot exceed specified limits. Sectors with such limits are:
  - a. **Insurance:** FDI cap into the insurance sector has been increased to 49% under the automatic route subject to verification by IRDAI.<sup>6</sup> Further, FDI in this sector is subject to compliance with the provisions of the Insurance Act, 1938 and the condition that an Indian insurance company shall ensure that its ownership and control remains at all times in the hands of resident

Indian entities as determined by the IRDAI as per the rules/ regulation issued by them.

The IRDAI vide the PE Guidelines sought to regulate investments by private equity funds into insurance companies. Prior to the PE Guidelines, there were no regulations specifically catering to private equity investors, and they were considered at par with any other investor for the purpose of investment. In 2015, the IRDAI notified the 2015 Regulations, which restricted the quantum of investment by 'Indian investors' to 10% individually, and to 25% cumulatively. Private equity investors historically have invested in insurance companies in their capacity as investors, taking minority positions, which would be within 10% (in case of domestic investors, in line with the 2015 Regulations). However, in the recent past, the appetite for private equity funds to take over controlling stake in insurance companies has been on the rise, and this prompted the IRDAI to notify the PE Guidelines and regulate any such investment by private equity funds.

The PE Guidelines are applicable for investment by 'Private Equity Funds' into insurance companies. 'Private Equity Funds' ("PE Funds") is defined in an inclusive manner and includes an alternative investment fund formed under the SEBI (Alternative Investment Fund) Regulations, 2012. The investment by PE Funds may be structured either as an investor (if the investment is 10% or lower), or as a promoter (if the investment is in excess of 10%). The PE Guidelines are an extension of the 2015 Regulations, permitting PE Funds to acquire stake of more than 10% if they agree to become a 'promoter' of the insurance company. Prior to the enactment of the PE Guidelines, while there were restrictions on domestic private equity funds to acquire not more than 10% individually and 25% in the aggregate in an Indian insurance company, there were no restrictions on foreign private equity funds.

6.

It appears that it is IRDAI's intention for these requirements to be met by all kinds of PE Funds, both resident and non-resident. The implications of this is significant since the same results in a restriction on foreign funds, which were not hitherto under any such restrictions.

For a detailed analysis of the Revised Guidelines please refer to our hotline.<sup>7</sup>

- b. **Infrastructure Company in the securities market:** FDI up to 49% has been permitted in infrastructure companies in the securities market, viz. commodity derivative exchanges, stock exchanges, depositories and clearing corporations, subject to compliance with applicable SEBI regulations amongst other things. The DIPP by way of Press Note 1 of 2017, has: (a) removed the restriction on individual shareholders to hold more than 5% and (b) permitted FPIs to subscribe to shares of such infrastructure companies, when they were allowed to acquire shares of infrastructure companies only through secondary purchases.

iii. **Sector specific conditionalities:** While FDI in most of sectors have now been brought under the automatic route in the last few years, in order to ensure some checks and balances, either the sectoral regulators have been given the baton to approve FDI or the policy has put in place conditionalities for the FDI to fall under the automatic route. Some of the key sectors in this regard are as follows:

a. **Other Financial Services:**

Following the Government's decision to liberalize the framework for foreign investment in the entities engaged in financial services sector and regulated by financial sector regulators such as the RBI, SEBI, IRDA etc., the RBI on September 9, 2016 notified the amendments to the provisions of TISPRO Regulations, pertaining to foreign investment

in entities engaged in financial services sector. The amendments allow FDI in financial services activities under the automatic route provided the activities are regulated by financial sector regulators such as the RBI, the SEBI, the IRDAI, Pension Fund Regulatory and Development Authority ("PFRDA"), etc. Further, foreign investment in NBFCs not regulated by any financial sector regulators, will require prior government approval.

The amendments have also rationalized the conditionalities prescribed by the FDI policy and that prescribed by the concerned regulator by eliminating the minimum capitalization norms prescribed under the FDI Policy for foreign investment in entities engaged in financial services activities given that the concerned regulators regulating such financial services entity prescribe their own set of capitalization norms.

b. **B2C E-Commerce:**

DIPP through Press Note 3 of 2016 permitted FDI in Business to Consumer ("B2C") segment, subject to the following conditions.

- i. 100% FDI under automatic route is permitted in marketplace model of e-commerce. Marketplace based model of e-commerce has been defined to mean the provision of an information technology platform by an e-commerce entity on a digital and electronic network to act as a facilitator between a buyer and seller.
- ii. FDI is not permitted in inventory based model of e-commerce. Inventory based model of e-commerce means an e-commerce activity where inventory of goods and services is owned by e-commerce entity and is sold to the consumers directly.

For a more detailed analysis on Press Note 3, please refer to our hotline.<sup>8</sup>

7. [http://www.nishithdesai.com/information/research-and-articles/nda-hotline/nda-hotline-single-view/article/pe-investment-in-insurance-companies-relaxation-or-restriction.html?no\\_cache=1&cHash=4e459f6073b12f29a81ce2eff773fdb](http://www.nishithdesai.com/information/research-and-articles/nda-hotline/nda-hotline-single-view/article/pe-investment-in-insurance-companies-relaxation-or-restriction.html?no_cache=1&cHash=4e459f6073b12f29a81ce2eff773fdb)

8. <http://www.nishithdesai.com/information/research-and-articles/nda-hotline/nda-hotline-single-view/article/companies-act-2013-amended-private-company-exemptions-reinstated.html>

**c. FDI Policy changes in E-commerce:**

DIPP through Press Note 2 of 2018 Series modified the policy on FDI in e-commerce with effect from February 1, 2019. Prior to the Press Note 2 of 2018 Series, foreign direct investment was not permitted in 'inventory-based model of e-commerce' and 100% foreign direct investment under automatic route was permitted only in marketplace-based model of e-commerce. Prior to the issuance of Press Note 2 of 2018 Series there was a restriction on an e-commerce entity to permit more than 25% of the sales value on financial year basis through its marketplace from one vendor or their group companies. Further, an e-commerce entity providing a 'marketplace' was not allowed to exercise ownership over the inventory i.e. goods purported to be sold.

Many of the e-commerce entities in India created complex corporate structures to get around these requirements. For instance, when the DIPP restricted large sellers on e-commerce platforms from contributing more than 25% of sales, the online retailers set up complex structures to get around the legal loopholes by mandating other sellers to buy from those large sellers and then in turn sell those products on e-commerce marketplaces. In other instances, large sellers formed multiple stepdown entities, which sold their products separately on online marketplaces. By putting in place complex structures, the major e-commerce market players were leveraging on the fine line distinguishing between an 'inventory-based model' and 'market-place based model' of e-commerce. The Press note 2 of 2018 Series appears to be an effort by the Government of India to plug in these loopholes. The Press Note 2 of 2018 Series now provides that inventory of a vendor will be deemed to be controlled by an e-commerce entity if more than 25 percent of purchases of such vendor are from the marketplace entity or its group companies. Further, the Press Note 2 of 2018

Series prohibits any entity having equity participation by e-commerce marketplace or its group companies or having control on its inventory by e-commerce marketplace entity to group companies, to sell its products on platform run by such marketplace entity.

**d. Single brand product retail trading:**

In January 2018, FDI limits for investment in single brand retail trading under automatic route has been increased up to 100%, from the present 49%, subject to fulfilment of prescribed conditions. One of such conditions is that in respect of proposals involving foreign investments beyond 51%, sourcing of 30% of the value of goods purchased is to be from India, preferably from Micro, Small & Medium Enterprises (MSMEs), village and cottage industries, artisans and craftsmen, in all sectors. However, the proposed change to the FDI Policy would allow a single brand retail trading entity to set off the mandatory sourcing requirement against its incremental sourcing of goods from India for global operations during initial 5 years (starting April 1 of that year) of opening the first store in India. The incremental sourcing for the purpose of set off shall be equal to the annual increase in the value of goods sourced from India for global operations (in INR terms), either directly or through their group companies.

In other words, if the value of incremental sourcing is equivalent to the value of mandatory sourcing, then effectively there is zero local sourcing requirement for the SBRT entity during the initial 5 years. Post completion of the 5 years' period the SBRT entity shall be required to meet the mandatory 30% local sourcing norms directly towards its India operations on an annual basis.

**e. Construction development sector:**

While Press Note 12 of 2015 provided some important relaxations, in the form of removal of minimum area requirements or minimum capitalization norms, FDI in

construction development sector requires compliance with the following conditions:

- i. The investor is permitted to exit from the investment: (1) after 3 years calculated with reference to completion of each tranche of FDI, or (2) on the completion of the project; or (3) on the completion / development of trunk infrastructure.

However, transfer of stake from one non-resident to another non-resident, without repatriation of investment will neither be subject to any lock-in period nor to any Government approval.

- ii. Each phase of a project to be considered a separate project for the purposes of the FDI Policy.

For a more detailed analysis on FDI in construction development sector, please refer to our hotline.<sup>9</sup>

### iii. Sectors under Government approval route

There are some sectors where FDI is allowed only with the approval of the Central Government. Some of them are:

- a. **Print Media:** FDI up to 26% is allowed under the government approval route, in entities engaged in publishing of newspaper and periodicals dealing with news and current affairs and publication of Indian editions of foreign magazines dealing with news and current affairs. Whereas, 100% FDI is allowed under the government approval route, in entities engaged in publishing/ printing of scientific and technical magazines/ specialty journals/ periodicals and publication of facsimile edition of foreign newspapers
- b. **Multi brand retail trading:** Foreign investment up to 51% is permitted under the government approval route which investment shall be in

compliance with the following conditions: (i) minimum capitalization of USD 100 million; (ii) 50% of the total FDI in the first tranche to be invested in the backend infrastructure<sup>10</sup> within 3 years; (iii) retail sales outlets may be set up in cities with a population of more than 1 million as per the 2011 census or any other cities as per the decision of the respective state governments; (iv) 30% mandatory local sourcing requirements from Indian Micro, Small, Medium Enterprises (“MSME”), which have a total investment in plant & machinery not exceeding USD 2 million; (v) retail sales outlets may be set up only in cities with a population of more than 1,000,000 as per 2011 census or any other cities as may be decided by the respective State Governments.

- c. **Terrestrial broadcasting and up-linking of ‘News & Current Affairs’ TV:** Foreign investment up to 49% is permitted under the government approval route, subject to compliance with certain guidelines laid down for the broadcasting sector.

### iv. Sectors with partial automatic route and partial government route

In certain sectors a foreign investor can invest up to a certain percentage of shareholding of an Indian company under the automatic route. Government approval will be required for any investment beyond the specified percentage. These sectors are:

- a. **Private Sector Banks:** Foreign investment up to 74% is permitted in private sector banks including investment by FII/FPI. While foreign investment up to 49% is under the automatic route and government approval is required if it is beyond 49%.
- b. **Railways Infrastructure:** While 100% FDI is allowed in the railways infrastructure sector under the automatic route, proposals involving

9. <http://www.nishithdesai.com/information/research-and-articles/nda-hotline/nda-hotline-single-view/article/fdi-in-real-estate-further-liberalized.html>

10. ‘Back-end infrastructure’ will include capital expenditure on all activities, excluding that on frontend units; for instance, back-end infrastructure will include investment made towards processing, manufacturing, distribution, design improvement, quality control, packaging, logistics, storage, ware-house, agriculture market produce infrastructure etc. Expenditure on land cost and rentals, if any, will not be counted for purposes of backend infrastructure

FDI beyond 49% in sensitive areas require to be brought before the CCS for consideration by the Ministry of Railways (“MoR”) from a security point of view. In November 2014, the MoR issued sectoral guidelines for domestic/ foreign direct investment in railways. The guidelines set out conditions and approvals that are required for private/ foreign participation in the railways sector.

- c. **Telecom Services:** FDI up to 49% is permitted under the automatic route in telecom services, including telecom infrastructure providers subject to observance of licensing and security conditions by licensee as well as investors as notified by the Department of Telecommunications from time to time. FDI beyond 49% requires government approval.
- d. **Defence:** FDI under the automatic route into defence sector has been permitted up to 49%, subject to the recipient having industrial license under Industries (Development and Regulation) Act, 1951 and for manufacturing of small arms and ammunition under Arms Act, 1959. FDI above 49% will be permitted under the government approval route in cases resulting in access to modern technology in the country or for other reasons to be recorded.<sup>11</sup>
- e. **Broadcasting Carriage Services:** 100% FDI under the automatic route is allowed in broadcasting services including teleports, Direct to Home (DTH) services, cable networks, mobile networks etc., provides that any infusion of fresh foreign investment, above 49% in a company which is not seeking license/ permission from sectoral Ministry for change in the ownership pattern or transfer of stake by existing investor to new foreign investor, would require Government approval.

## v. Other key measures towards further liberalization of the FDI regime

- a. **FDI in company which does not have operations:** Prior to the issuance of the Press Note 12, companies which did not carry on any operations were required to obtain Government approval prior to receiving foreign investment. Now, Indian company which does not have any operations and also does not have any downstream investments, will be permitted to have infusion of foreign investment under automatic route for undertaking activities which are under automatic route and without FDI linked performance conditions.
- b. **Entities controlled by NRI:** A company, trust and partnership firm incorporated outside India and owned and controlled by non-resident Indians can invest in India with special dispensation as available to NRIs under the FDI Policy.
- c. **Change in investment limit for proposals to FIPB under the approval route:** The threshold for proposals to be submitted to FIPB under approval route has been increased from less than INR 3500 crore to less than INR 5000 crore. Therefore, all the proposals with total foreign equity inflow in excess of INR 5000 crore would go to the Cabinet Committee of Economic Affairs (“CCEA”) for its consideration and approval and those below INR 5000 crore shall lie before the FIPB.

## B. Downstream Investment

FDI into Indian companies may be direct or indirect and FDI norms apply to both direct and indirect foreign investments into an Indian company. In case of direct investment, the non-resident investor invests directly into an Indian company.

11. [http://dipp.gov.in/English/acts\\_rules/Press\\_Notes/pn5\\_2016.pdf](http://dipp.gov.in/English/acts_rules/Press_Notes/pn5_2016.pdf)

TISPRO Regulations defines 'downstream investments' to mean investments made by any Indian entity (i.e. an Indian company or a LLP) or an Investment Vehicle in the capital instruments of an Indian company or capital of an LLP by any other Indian entity. Further, such downstream investments would be regarded as Indirect Foreign Investment in an Indian entity if they have been made by the following:

- a. another Indian entity which has received foreign investment and (i) is not owned and not controlled by resident Indian citizens or (ii) is owned or controlled by persons resident outside India ("together referred to as **Non-Indian Entity**"); or
- b. an investment vehicle whose sponsor or manager or investment manager (i) is not owned and not controlled by resident Indian citizens or (ii) is owned or controlled by persons resident outside India

Earlier where an investment made by an Indian entity owned and controlled by a person resident outside India was required to adhere to conditions prescribed under the FDI Policy or regulations issued under FEMA, going forward even an Indian entity not owned and not controlled by resident Indian citizens including a 50 - 50 joint venture between an Indian entity and a person resident outside India would also be subject to similar conditions. Downstream Investment into Indian entities are subject to conditions prescribed under the FDI Policy including prior approval of the board of directors, pricing guidelines and requirement of fund for investments to be brought from abroad or arranged through internal accruals (i.e. profits transferred to reserve account after payment of taxes). Similar conditions have also been included in the TISPRO Regulations with following two additional conditions:

- a. Capital instrument of an Indian entity held by another Non-Indian Entity may be transferred to:
  - i. A person resident outside India, subject to reporting requirements in Form FCTRS/Form FDI LLP (II), as the case may be;

- ii. A person resident in India subject to adherence to pricing guidelines;
  - iii. An Indian entity which has received foreign investment and is not owned and not controlled by resident Indian citizens or owned or controlled by person resident outside India.
- b. The first level Indian entity making downstream investment shall be responsible for ensuring compliance with the provisions of the TISPRO Regulations for the downstream investment made by it at second level and so on and so forth. Such first level company shall obtain a certificate to this effect from its statutory auditor on an annual basis. Such compliance of these regulations shall be mentioned in the Director's report in the Annual Report of the Indian company. In case statutory auditor has given a qualified report, the same shall be immediately brought to the notice of the Regional Office of the RBI in whose jurisdiction the Registered Office of the company is located and shall also obtain acknowledgement from the Regional Office of the RBI in this regard.

Based on the above conditions, it appears that the subsidiary of a Non-Indian Entity is being treated as resident company for the purposes of transfer of capital instrument to another person resident outside India and accordingly the same would have to be subject to Form FCTRS reporting. However, for the purposes of transferring capital instruments of the same subsidiary to a person resident in India, it is being treated as company with foreign indirect investment and hence required to adhere to the pricing guidelines. Moreover, in the third scenario where the capital instrument of the same subsidiary is being transferred to an Indian entity which has received foreign investment and is not owned and not controlled by resident Indian citizens or owned or controlled by person resident outside India, it is being treated as a transfer between two resident entity and hence neither the pricing guidelines nor the reporting requirements are applicable.

Downstream investment made by a 100% foreign owned and/or controlled banking company as a result of any loan structuring scheme, in trading books or acquisition of shares as a result of default in loan, will also not be considered as indirect foreign investment.

## C. Instruments for FDI

Under the FDI regime, investment can only be made into equity shares, fully and compulsorily convertible preference shares (“CCPS”) and fully and compulsorily convertible debentures (“CCD”), subject to fulfillment of certain conditions, partly paid shares and warrants. Instruments which are not fully and mandatorily convertible into equity are considered to be external commercial borrowing (“ECB”) and therefore, are governed by ECB regime. Also, any such instrument

having a ‘put option’ in favour of a non-resident shall not be FDI compliant unless in consonance with the conditions laid down by RBI.

The government has also permitted investment under FDI regime by swap of shares under the automatic route, subject to the condition that irrespective of the amount, valuation of the shares involved in the swap arrangement will have to be made by a Merchant Banker registered with the Securities and Exchange Board of India (SEBI) or an Investment Banker outside India registered with the appropriate regulatory authority in the host country. Hitherto, investment involving swap of shares was under Government approval route.

Herein below is a table setting out a brief comparative analysis for equity, CCPS and CCD:

Particulars	Equity	CCPS	CCD
<b>Basic Character</b>	Participation in governance and risk based returns	Fixed dividend – convertible into equity	Assured coupon – convertible into equity
<b>Returns</b>	Dividend may be declared out of profits of the company		Fixed or variable interest coupon - not dependent on profits
<b>Limits to Payment</b>	No cap on dividend	Dividend on CCPS cannot exceed 300 basis points over and above the prevailing State Bank of India prime lending rate at the time of issuance CCPS is issued. No legal restriction on interest on CCD, however in practice it is benchmarked to CCPS limits.	
<b>Tax Implication</b>	Dividend payable from post-tax income and an additional Dividend Distribution Tax of 15% levied on the company making distributions  Tax has been imposed on dividend payout, if the dividend payout to the investor is more than INR 1 million in any financial year, then tax shall be levied at the rate of 10% on the gross amount of dividend paid.		Interest expense deductible – Withholding tax as high as 40% but it can be reduced to 7.5% if investment done from favourable jurisdiction
<b>Statutory Liquidation Preference</b>	CCD ranks higher than CCPS in terms of liquidation preference. Equity gets the last preference. However, liquidation preference may be fixed contractually		
<b>Others</b>	Buy-back or capital reduction permissible. For tax implications refer to Chapter 4	CCPS and CCDs need to be converted to equity before they can be bought back or extinguished by the Indian company.	

## i. Convertible Notes

The RBI issued a notification dated January 10, 2017 (“**Convertible Notes Notification**”) wherein ‘Convertible Note’ were introduced as an eligible instrument for foreign investment in to ‘startups’. Convertible Notes Notification provides for the following key terms for issuance of Convertible Notes:

- i. **Definition of a Convertible Note:** TISPRO Regulations were amended to include the definition of ‘Convertible Note’ to mean an instrument issued by a startup company evidencing receipt of money initially as debt, which is repayable at the option of the holder, or which is convertible into such number of equity shares of such startup company, within a period not exceeding 5 years from the date of issue of the Convertible Note, upon occurrence of specified events as per the other terms and conditions agreed to and indicated in the instrument. A Convertible Note will have to be necessarily converted into equity shares or repaid back within a period of 5 years. This conversion or repayment can be triggered by the events or under terms and conditions as mutually agreed between the startup and the investor.
- ii. **Eligible Issuer:** Convertible Notes can only be issued by entities classified as a ‘start-up’ as per the definition laid down by the DIPP in its notification dated February 17, 2016 (“**DIPP Notification**”). As per the DIPP Notification, an entity (i.e. a private limited company / limited liability partnership or a registered partnership firm) incorporated/ registered in India shall be considered as a ‘startup’:
  1. Up to 5 years from the date of its incorporation/ registration;
  2. If its turnover for any of the financial years has not exceeded INR 25 crores (USD 3,846,153); and
  3. It is working towards innovation, development, deployment or commercialization of new products, processes or services driven by technology or intellectual property.

The DIPP Notification also lays down the process of recognition as a ‘startup’. Accordingly, the recognitions shall be through mobile application/ portal of the DIPP. For the purposes of making applications for being recognized as a startup, entities will be required to submit a simple application along with certain documents. NRIs have also been given the general permission to acquire Convertible Notes, subject to the investment being made on a non-repatriation basis and in accordance with the TISPRO Regulations.

- iii. **Minimum capitalization:** The notification prescribes a minimum investment size of not less than INR 2,500,000 to be invested by each foreign investor, to be invested upfront in a single tranche.
- iv. **Prior government approval:** Any startup company that is engaged in sector wherein any foreign investment requires a prior Government approval may issue Convertible Notes to a non-resident only with approval of the Government. Furthermore, the issue of shares against such Convertible Notes will have to be in accordance with the TISPRO Regulations.
- v. **Transfer of Convertible Notes:** Notification allows a foreign investor to acquire or transfer, Convertible Notes, from or to, a person resident in or outside India. However, such transfer has to take place in accordance with the pricing guidelines prescribed by the RBI. In case of transfers of Convertible Notes issued by a startup company engaged in sector requiring prior Government for a foreign investment, such transfer or sale shall only be made on approval by the Government.

## D.Pricing requirements

FEMA also regulates the entry and exit price of investments made under the FDI regime. The pricing requirements are different for companies having their shares listed and unlisted.

## i. Unlisted Companies

For unlisted companies, the price at which foreign direct investor subscribes / purchases the equity shares from a person resident in India shall not be lower than the price computed by any internationally accepted pricing methodology (“**Fair Value**”) as calculated by a chartered accountant or a merchant banker registered with SEBI. However, this Fair Value does not apply<sup>12</sup> in case the foreign investor is subscribing to the memorandum of the company or purchasing the shares of Indian company from another non-resident. In case of the transfer of equity shares from a non-resident to a resident, such transfer shall not be effected at a price higher than the Fair Value.

## ii. Listed Companies

For listed companies, the price at which the foreign investor subscribes / purchases the shares from a person resident in India shall not be lower than the price at which the preferential allotment of shares can be made under the SEBI guidelines (“**Preferential Allotment Price**”), which is currently higher of the following:

- i. The average of the weekly high and low of the closing prices of the related equity shares quoted on the recognised stock exchange during the six months preceding the relevant date (which shall be the date of purchase or sale of shares); or
- ii. The average of the weekly high and low of the closing prices of the related equity shares quoted on a recognised stock exchange during the two weeks preceding the relevant date.

Similarly, when the non-resident transfers the shares of listed company to a resident, the Preferential Allotment Price becomes the ceiling price.

12. RBI clarified in its A.P. (DIR Series) Circular No. 36 dated September 26, 2012, that shares can be issued to subscribers (both non-residents and NRIs) to the memorandum of association at face value of shares subject to their eligibility to invest under the FDI scheme. The DIPPP inserted this provision in the FDI Policy, providing that where non-residents (including NRIs) are making investments in an Indian company in compliance with the provisions of the Companies Act, 1956, by way of subscription to its Memorandum of Association, such investments may be made at face value subject to their eligibility to invest under the FDI scheme. This addition in the FDI Policy is a great relief to non-resident investors (including NRIs) in allowing them to set up new entities at face value of the shares and in turn reduce the cost and time involved in obtaining a DCF valuation certificate for such newly set up companies.

Please note the consideration for the subscription / purchase has to be brought into India prior to or at the time of allotment / purchase of shares to / by the foreign investor.

## iii. Transfer of shares for deferred consideration

The RBI permits transfer of shares on a deferred consideration basis, subject to: (i) the total consideration being compliant with the applicable pricing guidelines; (ii) the deferred consideration should be paid within a period of 18 months from the date of the agreement for transfer of shares; (iii) the deferred consideration may be paid under an escrow arrangement, whose term shall not exceed 18 months; and (iv) if the total consideration is paid, the seller can furnish an indemnity valid for a period of 18 months, for deferred portion of the condition.

## II. FVCI regime

SEBI introduced the SEBI (Foreign Venture Capital Investors) Regulations, 2000 (“**FVCI Regulations**”) to encourage foreign investment into venture capital undertakings.<sup>13</sup> The FVCI Regulations make it mandatory for an offshore fund to register itself with SEBI if such fund intends to avail of benefits under the FVCI regime.

FVCIs have the following benefits:

- iii. *Free pricing*: The entry and exit pricing applicable to FDI regime do not apply to FVCIs. To that extent, FVCIs can subscribe, purchase or sell securities at any price.
- iv. *Instruments*: Unlike FDI regime where investors can only subscribe to only equity shares, CCDs and CCPS, FVCIs can also invest into Optionally Convertible Redeemable Preference Shares (“**OCRPS**”), Optionally Convertible Debentures

13. Venture capital undertaking means a domestic company:— (i) whose shares are not listed in a recognised stock exchange in India; (ii) which is engaged in the business of providing services, production or manufacture of articles or things, but does not include such activities or sectors which are specified in the negative list by the Board, with approval of Central Government, by notification in the Official Gazette in this behalf.

- (“OCDS”), even Non-Convertible Debenture (“NCDs”) and Non-Convertible Preference Shares (“NCPS”).
- v. *Lock-in*: Under the SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009 (“ICDR Regulations”) the entire pre-issue share capital (other than certain promoter contributions which are locked in for a longer period) of a company conducting an initial public offering (“IPO”) is locked for a period of 1 year from the date of allotment in the public issue. However, an exemption from this requirement has been granted to registered FVCIs, provided, the shares have been held by them for a period of at least 1 year as on the date of filing the draft prospectus with the SEBI. This exemption permits FVCIs to exit from investments immediately post-listing.
- vi. *Exemption under the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011 Takeover Code (“Takeover Code”)*: SEBI has also exempted promoters of a listed company from the public offer provisions in connection with any transfer of shares of a listed company, from FVCIs to the promoters, under the Takeover Code.
- vii. *QIB Status*: FVCIs registered with SEBI have been accorded qualified institutional buyer (“QIB”) status and are eligible to subscribe to securities at an IPO through the book building route.
- viii. *Broader list of eligible sectors*: List of sectors in which FVCI can invest is not specified in any regulations or law. However, RBI while granting the permission/ certificate imposes the conditions that an FVCI can only invest in the following nine sectors:
- a. Biotechnology;
  - b. IT related to hardware and software development;
  - c. Nanotechnology;
  - d. Seed research and development;
  - e. Research and development of new chemical entities in pharmaceuticals sector;
  - f. Dairy industry;
  - g. Poultry industry;
  - h. Production of bio-fuels; and
  - i. Hotel-cum-convention centers with seating capacity of more than three thousand.
- The Consolidated FDI Policy, 2016 issued by DIPP on June 7, 2016 further expanded the scope of FVCIs by: (i) adding another sector, “infrastructure” to the list of permitted sectors above; and, (ii) allowing investments in ‘startups’ irrespective of the sectors they are engaged in.
- However, the FVCI Regulations specify that:<sup>14</sup>
- a. at least 66.67 percent of the investible funds of a FVCI shall be invested in unlisted equity shares or equity-linked instruments of venture capital undertaking; and
  - b. not more than 33.33 percent of the investible funds of a FVCI may be invested by way of, inter alia, debt or debt instrument of a venture capital undertaking in which the FVCI has already made an investment by way of equity.
- SEBI registered FVCIs are also permitted to obtain registration as an FPI subject to fulfillment of certain conditions including compliance with the eligibility criteria for grant of FPI registration under FPI regulations, segregation of funds for investment under FVCI and FPI routes, maintenance of separate accounts with the custodian for execution of trades, separate reporting of transaction under FVCI and FPI routes under the respective regulatory regime etc.

### III. FPI regime

Foreign Portfolio Investor (“FPI”) is the portfolio investment regime. The Foreign Institutional Investor (“FII”) and Qualified Foreign Investor (“QFI”) route have been subsumed into the FPI regime. Existing FIIs, or sub-account, can continue, till the expiry of the block of three years for which fees have been

14. Regulation 11 of the FVCI Regulations. These investment conditions may be achieved by the FVCI at the end of its life cycle.

paid as per the SEBI (Foreign Institutional Investors) Regulations, 1995, to buy, sell or otherwise deal in securities subject to the provisions of these regulations. However, FII or sub-account shall be required to pay conversion fee of USD 1000<sup>15</sup> on or before the expiry of its registration for conversion in order to buy, sell or otherwise deal in securities under the FPI Regulations. In case of QFIs, they may continue to buy, sell or otherwise deal in securities subject to the provisions of these regulations, for a period of 1 year from the date of commencement of FPI Regulations, or until they obtain a certificate of registration as FPI, whichever is earlier. Under the new regime, SEBI has delegated the power to designated depository participants (“DDP”) who will grant the certificate of registration to FPIs on behalf of SEBI.

Portfolio investment up to aggregate foreign investment level of 49% or sectoral/ statutory cap, whichever is lower, will not be subject to either Government approval or compliance with the sectoral conditions, as the case may be, provided such investment does not result in change in ownership leading to control of Indian entities [within the meaning of Regulation 14 (1) of Foreign Exchange Management (Transfer or issue of security by a person resident outside India) Regulations, 2000] by non-resident entities. FPIs are permitted to hold securities only in the dematerialized form. Among various measures introduced with a view to improve ease of doing business in India, the Finance Minister in the budget speech for this year announced that a common application form for registration, opening of demat accounts and issue of Permanent Account Number (“PAN”) will be introduced for FPIs.

## A. Categories

Each investor shall register directly as an FPI, wherein the FPIs have been classified into the following three categories on the basis of risk-based approach towards know your customer.

### i. Category I FPI

Category I includes Government and government-related investors such as central banks, Governmental agencies, sovereign wealth funds or international and multilateral organizations or agencies.

### ii. Category II FPI

Category II includes the following:

- i. Appropriately regulated broad based funds;
- ii. Appropriately regulated persons;
- iii. Broad-based funds that are not appropriately regulated but their managers are regulated;
- iv. University funds and pension funds; and
- v. University related endowments already registered with SEBI as FIIs or sub-accounts.

The FPI Regulations provide for the broad-based criteria. To satisfy the broad-based criteria two conditions should be satisfied. Firstly, fund should have 20 investors even if there is an institutional investor. Secondly, both direct and underlying investors i.e. investors of entities that are set up for the sole purpose of pooling funds and making investments shall be counted for computing the number of investors in a fund.

### iii. Category III FPI

Category III includes all FPIs who are not eligible under Category I and II, such as endowments, charitable societies, charitable trusts, foundations, corporate bodies, trusts, individuals and family offices.

## B. Investment limits

- f. *Individual Limit:* The total holding of one single FPI or an investor group<sup>16</sup> shall be lower than: (i) 10 percent of the total paid-up equity share capital issued by an Indian company, on a fully diluted

15. Specified in Part A of the Second Schedule of the FPI Regulations

16. As per Regulation 23(3) of the FPI Regulations, “In case the same set of ultimate beneficial owner(s) invest through multiple entities, such entities shall be treated as part of same investor group and the investment limits of all such entities shall be clubbed at the investment limit as applicable to a single foreign portfolio investor.”

basis; or (ii) 10 percent of the paid-up value of each series of debentures, or preference shares, or share warrants issued by an Indian company

g. *Aggregate Limit*: The total holdings of all FPIs put together shall not exceed 24% of the Indian company's paid-up equity share capital on a fully diluted basis, or the paid-up value of each series of debentures, or preference shares, or share warrants issued by the Indian company.

In case the investment made by an FPI is in excess of the prescribe Individual Limit, such investment shall be re-classified as an FDI investment, subject to further compliances by SEBI and RBI Regulations framed in this regard.

Under the FPI Regulations, ultimate beneficial owners investing through the multiple FPI entities shall be treated as part of the same investor group subject to the investment limit applicable to a single FPI, with no investor holding more than forty-nine per cent of the shares or units of the fund.

Press note 8 of 2015 issued by the DIPP on July 30, 2015 ("**Press Note 8**") introduced the concept of composite caps, clarifying that foreign investment (direct or indirect) will include all types of foreign investments, irrespective of the investment being made as FDI/ FPI/ NRI/ FVCI and the sectoral caps would include foreign investments via all these routes. Press Note 8, further clarified that FPI may invest in an Indian company under PIS which limits the aggregate limit for FPI investment in an Indian company to 24% of its share capital, which may be increased to the applicable sectoral cap by the Indian company by way of a special resolution passed by the shareholders of such Indian company.

## C. Instruments

FPI entities are permitted to invest by way of the following instruments:

- a. Listed or to-be listed shares, debentures and warrants of a company
- b. Listed/unlisted units of schemes floated by a recognized mutual fund

- c. Units of schemes floated by a collective investment scheme
- d. Derivatives traded on a recognized stock exchange
- e. Treasury bills and dated government securities;
- f. Commercial papers issued by an Indian company
- g. Rupee denominated credit enhanced bonds
- h. Security Receipts ("**SRs**") issued by ARCs (to this extent, FPIs are allowed to invest up to 100% of each tranche in SRs issued by ARCs, subject to RBI guidelines and within the applicable regulatory cap)
- i. Perpetual debt instruments and debt capital instruments
- j. Listed and unlisted NCDs/ bonds issued by an Indian company in the infrastructure sector
- k. Non-convertible debentures or bonds issued by NBFC-IFCs
- l. Rupee denominated bonds or units issued by Infrastructure Debt Funds
- m. Indian depository receipts
- n. Unlisted NCDs/ bonds issued by an Indian company
- o. Securitized debt instruments (such as mortgage-backed securities and asset-backed securities)

## D. Consideration

FPIs are allowed to purchase instruments of an Indian company through public offer or private placement, subject to the individual/ aggregate limits, and the following conditions:

- a. In case of subscription by way of public offer, the price of the shares issued to FPIs shall not be less than the price at which shares are issued to resident investors.
- b. In case of subscription by way of private placement, the price shall not be less than: (i) the price arrived at in terms of the pricing guidelines (as applicable to FDI investment) issued by

SEBI; or (ii) the fair price worked out as per any internationally accepted pricing methodology for valuation of shares, on an arm's length basis. Such fair price arrived at shall be certified by a SEBI registered merchant banker or chartered accountant or a practicing cost accountant.

- c. Minimum maturity period of the NCDs shall be 1 year. The minimum residual maturity has been reduced from 3 years to 1 year vide a recent circular dated April 27, 2018. This change is prospective in nature, and does not impact NCDs issued before the date of the circular.
- d. If foreign investment by an FPI is made up to an aggregate limit of 49% of the paid-up equity share capital of the Indian company, or the applicable statutory/sectoral cap, whichever is lower, no government approval or compliance with sectoral conditions is required. However, it must be ensured that such an investment does not result in transfer of ownership and control of the resident Indian company to non-resident investors.
- e. The FPI Regulations further prescribe that the transaction of business in securities by an FPI shall be carried out only through SEBI registered stock brokers. However, an exemption is provided to Category I and Category III FPIs while transacting in corporate bonds.

## E. ODIs / P Note

An offshore derivative instrument (“ODIs”) means any instrument, by whatever name called, which is issued overseas by a foreign portfolio investor against securities held by it that are listed or proposed to be listed on any recognized stock exchange in India, as its underlying units Participatory Notes (“P-Notes”) are a form of ODIs.<sup>17</sup>

P-notes are, by definition a form of ODI including but not limited to swaps,<sup>18</sup> contracts for difference,<sup>19</sup> options,<sup>20</sup> forwards,<sup>21</sup> participatory notes,<sup>22</sup> equity linked notes,<sup>23</sup> warrants,<sup>24</sup> or any other such instruments by whatever name they are called.

Below is a diagram that illustrates the structure of an ODI.

<sup>17</sup>. Section 2(1)(j) of the FPI Regulations

<sup>18</sup>. A swap consists of the exchange of two securities, interest rates, or currencies for the mutual benefit of the exchangers. In the most common swap arrangement one party agrees to pay fixed interest payments on designated dates to a counterparty who, in turn, agrees to make return interest payments that float with some reference rate.

<sup>19</sup>. An arrangement made in a futures contract whereby differences in settlement are made through cash payments, rather than the delivery of physical goods or securities. At the end of the contract, the parties exchange the difference between the opening and closing prices of a specified financial instrument.

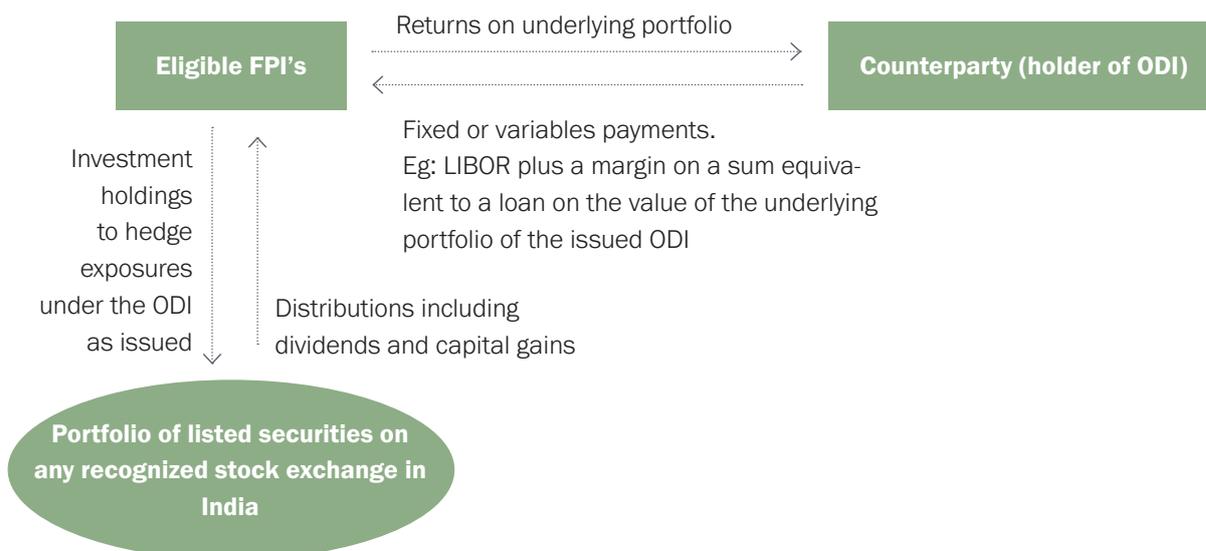
<sup>20</sup>. An option is a financial derivative that represents a contract sold by one party to another party. It offers the buyer the right, but not the obligation, to call or put a security or other financial asset at an agreed-upon price during a certain period of time or on a specific date.

<sup>21</sup>. A forward contract is a binding agreement under which a commodity or financial instrument is bought or sold at the market price on the date of making the contract, but is delivered on a decided future date. It is a completed contract – as opposed to an options contract where the owner has the choice of completing or not completing.

<sup>22</sup>. Participatory notes (P-notes) are a type of offshore derivative instruments more commonly issued in the Indian market context which are in the form of swaps and derive their value from the underlying Indian securities.

<sup>23</sup>. An Equity-linked Note is a debt instrument whose return is determined by the performance of a single equity security, a basket of equity securities, or an equity index providing investors fixed income like principal protection together with equity market upside exposure.

<sup>24</sup>. A Warrant is a derivative security that gives a holder the right to purchase securities from an issuer at a specific price within a certain time frame.



**Fig 1: Investment through ODIs.**

The position of the holder of an ODI is usually that of an unsecured counterparty to the FPI. Under the ODI (the contractual arrangement with the issuing FPI), the holder of a P-note is entitled only to the returns on the underlying security with no other rights in relation to the securities in respect of which the ODI has been issued. ODIs have certain features that prevent the holder of such instruments from being perceived as the beneficial owner of the securities. These features include the following aspects: (i) whether it is mandatory for the FPI to actually hedge its underlying position (i.e. actually “hold” the position in Indian securities), (ii) whether the ODI holder could direct the voting on the shares held by the FPI as its hedge, (iii) whether the ODI holder could be in a position to instruct the FPI to sell the underlying securities and (iv) whether the ODI holder could, at the time of seeking redemption of that instrument, seek the FPI to settle that instrument by actual delivery of the underlying securities. From an Indian market perspective, such options are absent considering that the ownership of the underlying securities and other attributes of ownership vest with the FPI. Internationally, however, there has been a precedence of such structures, leading to a perception of the ODI holder as a beneficial owner – albeit only from a reporting perspective under securities laws.<sup>25</sup>

25. CSX Corporation v. Children's Investment Fund Management (UK) LLP. The case examined the total return swap structure from a securities law perspective, which requires a disclosure of a beneficial owner from a reporting perspective.

The FPI Regulations provide that Category I FPIs and Category II FPIs (which are directly regulated by an appropriate foreign regulatory authority) are permitted to issue, subscribe and otherwise deal in ODIs.<sup>26</sup> However, those Category II FPIs which are not directly regulated (which are classified as Category-II FPI by virtue of their investment manager being appropriately regulated) and all Category III FPIs are not permitted to issue, subscribe or deal in ODIs.

On November 24, 2014, SEBI issued a circular (“Circular”) aligning the conditions for subscription of ODIs to those applicable to FPIs. The Circular makes the ODI subscription more restrictive. As per the Circular, read with the FPI Regulations, to be eligible to subscribe to ODI positions, the subscriber should be regulated by an IOSCO member regulator or in case of banks subscribing to ODIs, such bank should be regulated by a BIS member regulator.

Further, the Circular states that an FPI can issue ODIs only to those subscribers who meet certain eligibility criteria mentioned under regulation 4 of the FPI Regulations (which deals with eligibility criteria for an applicant to obtain registration as an FPI) in addition to meeting the eligibility criteria mentioned under

26. Reference may be made to Explanation 1 to Regulation 5 of the FPI Regulations where it is provided that an applicant (seeking FPI registration) shall be considered to be “appropriately regulated” if it is regulated by the securities market regulator or the banking regulator of the concerned jurisdiction in the same capacity in which it proposes to make investments in India.

regulation 22 of the FPI Regulations. Accordingly, ODIs can now only be issued to those persons who (a) are regulated by an ‘appropriate foreign regulatory authority’; (b) are not resident of a jurisdiction that has been identified by Financial Action Task force (“FATF”) as having strategic Anti-Money Laundering deficiencies; (c) do not have ‘opaque’ structures (i.e. protected cell companies (“PCCs”)/ segregated portfolio companies (“SPCs”) or equivalent structural alternatives); and (d) comply with ‘know your client’ norms. The Circular further requires that multiple FPI and ODI subscriptions belonging to the same investor group would be clubbed together for calculating the below 10% investment limit.

The Circular grandfathered the existing ODI positions until the expiry of their ODI contracts. However, the Circular specifies that there will not be a rollover of existing ODI positions and for any new ODI positions, new contracts will have to be entered into, in consonance with the rules specified in the Circular.<sup>27</sup> The removal of the ‘grandfathering’ provisions would immensely affect the operations for several operators as the unregulated grandfathered entities happen to be the majority investors through the ODI route. As such, hedge funds will not be permitted to renew or extend the existing ODI positions after August 01, 2016, and certain restructuring exercises will have to be undertaken for the beneficial owners to continue holding ODI positions.<sup>28</sup>

FPIs shall have to fully disclose to SEBI any information concerning the terms of and parties to ODIs entered into by it relating to any securities listed or proposed to be listed in any stock exchange in India (Fig 1).

Please refer to our research paper ‘*Offshore Derivate Instruments: An Investigation into Tax Related Aspects*’<sup>29</sup> for further details on ODIs and their tax treatment.

27. [http://www.nishithdesai.com/information/research-and-articles/nda-hotline/nda-hotline-single-view/article/sebi-rewrites-rules-on-offshore-derivative-instruments-odi.html?no\\_cache=1&CHash=60c81c4a0fcc1c1ffbbe8d2aae5e2e5b](http://www.nishithdesai.com/information/research-and-articles/nda-hotline/nda-hotline-single-view/article/sebi-rewrites-rules-on-offshore-derivative-instruments-odi.html?no_cache=1&CHash=60c81c4a0fcc1c1ffbbe8d2aae5e2e5b)

28. <http://www.nishithdesai.com/information/news-storage/news-details/article/sebi-closes-doors-on-previously-eligible-subscribers-to-offshore-derivative-instruments.html>

29. **Offshore Derivate Instruments: An Investigation into Tax Related Aspects** [http://www.nishithdesai.com/fileadmin/user\\_upload/pdfs/Research%20Papers/Offshore\\_Derivative\\_Instruments.pdf](http://www.nishithdesai.com/fileadmin/user_upload/pdfs/Research%20Papers/Offshore_Derivative_Instruments.pdf)

## IV. NRI Investment

### A. Direct Investment in Unlisted Securities

#### i. Investment on repatriation basis

NRIs are permitted under Schedule 3 of the TISPRO Regulations to open and maintain Non-Residential External Rupee (NRE) accounts. Further, Schedule 3 specifies that the limit of investment of up to 5 per cent of the paid up value of shares/ CCPS/ CCDs/ warrants by an individual NRI is applicable to investments on a repatriation basis only. Such NRI investment on a repatriation basis under Schedule 3 will be subject to the FDI policy and Schedule 1 of FEMA 20 with respect to sectoral caps wherever applicable.

#### ii. Investment on Non-repatriation Basis

Under Schedule 4 of TISPRO Regulations, NRIs, on a non-repatriation basis, are permitted to acquire shares, CCPS, CCDs, warrants or units of a listed or an unlisted Indian company without any limit and permission to acquire. The above permission is not available to NRIs for certain prohibited companies.<sup>30</sup> It is to be noted that such investments would be deemed to be domestic investments at par with investments made by residents.

### B. Investment in Listed Securities

NRIs can also acquire the securities or units issued by a real estate developer entity under the PIS. On February 15, 2016, the TISPRO Regulations were amended to permit NRIs to acquire the securities or units issued by an Indian company, or the units of an investment vehicle, on repatriation basis, when such securities / units are listed on a recognized stock exchange, subject to certain conditions being

30. Prohibited companies means - company which is a chit fund or a nidhi company or is engaged in agricultural/plantation activities or real estate business or construction of farm houses or dealing in transfer of development rights

satisfied. Here, investment vehicles are defined under the TISPRO Regulations<sup>31</sup> to include REITS as well, thereby allowing NRIs to invest in REITS through the issuance of securities / units.

Under Schedule 3 of the TISPRO Regulations, NRIs are permitted to invest in shares, convertible preference shares, convertible debentures and warrants of an Indian company, on a stock exchange, subject to various conditions prescribed therein. The regulations prescribe the following limits on the investment by NRIs:

- a. The total investment in shares by an NRI cannot exceed 5% of the total paid up capital of the company and the investment in convertible preference shares / convertible debentures / warrants of any series cannot exceed 5% of the paid up value of that respective series issued by the company concerned; and
- b. The aggregate of the NRI investments in the company cannot exceed 10% of the paid up capital of the company, and the aggregate NRI investment in the paid-up value of each series of convertible preference shares / convertible debentures / warrants cannot exceed 10% of the paid-up value of that respective series. However, this limit could be increased up to 24% with a special resolution of the company.

---

31. The definition of 'Investment vehicle' under Regulation 2(iig) of the TISPRO Regulations includes REITS.

### 3. Private Debt Investments

Private debt investments are becoming increasingly popular in India. Private debt is usually in the form of structured debt instruments customized to suit the needs of the borrower and the investor. These instruments may either take the form of listed/unlisted NCDs (subscribed to under the FPI route) or redeemable debentures or shares (subscribed to under the FVCI route, subject to the sector limitation for the FVCIs).

Private debt can be structured in the manner that is commercially best suited – with a coupon that is payable annually, or a coupon that is paid only upon cash flows in the company, or any other trigger event. The amount of coupon payable can also be a function of underlying equity price, EBITDA or any other commercially agreed variable. Since the coupon paid is a deductible for the investee company, and in many ways the instrument works more as a form structured equity than structured debt, private debt is quickly gaining ground in the Indian context.

To summarize, private debt offers the following benefits:

- i. **Tailored Financing:** Unlike Indian banks, which may be unable to tinker with their financial terms and are generally averse to advance loans to few sectors such as software, bio-technology, real estate etc. Private debt would not only offer highly tailored solutions (such as longer coupon moratoriums, profit linked coupons etc.) but would also cater to niche industry segments where banks may be apprehensive to lend, or may have significantly higher exposure limits.
- ii. **Tax Optimization:** Private debt offers tax optimization to the investee company since any coupon paid on the debt is a deductible for the Indian company. Not only does this result in a saving of approximately 30% corporate income tax for the investee company, it also saves the 15% dividend distribution tax (“DDT”) as set out in the table later. Unlike DDT, which may not be creditable against the domestic taxes in the home jurisdiction of the investor, foreign tax credit is usually available against the withholding tax paid on the coupon in India.
- iii. **Structured transaction:** Return of capital is a huge challenge in case of equity or instruments mandatorily convertible into equity. However, with private debt investors can structure their investment as quasi-debt or quasi-equity or both. Investors can structure their investments in private debt in such a way that they have an option to protect their downside and to link their upside to the profits, share price, EBITDA of the investee company.
- iv. **Security Creation:** Private debt allows the investee company to create security interest on the assets of the company or the shares of the founders. Security is created in favour of a local security trustee that would act on the instructions of the debenture holders. Security creation would not be permissible if the instrument for FDI investments or investments where the instrument is either equity or mandatorily convertible into equity.

Some of the benefits of private debt vis-à-vis through PE in the Indian context are set out in the table below:

Sl. No.	Particulars	Private debt	Private equity
1.	Assured returns	Investors are eligible for assured returns on their investment through interest and redemption premium, both of which can be legally assured.	Returns on PE investments cannot be assured. Put Options are not looked at favorably and will be subject to the conditionalities prescribed by the RBI. However, in the <i>Cruze City</i> and <i>Docomo</i> , court has upheld put options providing downside protection to the investors.
2.	Capital repatriation	Capital can be fully repatriated.	Repatriation of capital limited to buy-back or reduction of capital and subject to the conditionalities as set out later in this paper.
3.	Tax benefits	Interest payments are a deductible expense of the borrower.	Dividend payment and buyback are taxed at the hands of the investee company at 15% or 20% respectively in addition to corporate tax of 30%.  However, as per the Finance Act, 2016, if the dividend payout to the investee company is more than INR 1 million in any financial year than tax shall be levied at the rate of 10% on the gross amount of dividend paid. Foreign tax credit against such tax paid in India may be available.
4.	Sources of payment	Interest may be paid out of any source of the borrower.	Dividends can be paid out of profits only. Reduction of capital may be done without profits, but is a court driven process and subject to lender approvals.
5.	Security	Debt may be secured by creation of security over the assets of the borrower.	No security creation is possible to secure the investment amount or returns thereon.
6.	Equity upside	Returns may be structured as interest or redemption premium and linked to cash flow, share price etc. hence achieving equity like structure with tax optimization.	Returns may be structured by way of dividends or capital reduction, both of which may be tax inefficient structures.

In India, foreign investment in private debt can be currently made through either FPI regime or FVCI regime.

## I. The FDI Route

Under the FDI regime, investment can only be made into (i) equity; (ii) CCPS; and (iii) CCDs issued by an Indian company. Instruments which are not fully, compulsorily and mandatorily convertible (for instance, an optionally convertible preference share or a non-convertible debenture) shall be considered to be foreign capital in the form of an ECB. ECBs are separately governed under the ECB regime.

Debt investments under the FDI route should be by way of subscription to CCDs. Such debt investment is subject to all norms applicable to FDI. It may be

noted here that the FDI regime essentially permits investments having an 'equity flavour'; in debt investments through CCDs there is a definite commitment to convert the CCDs into common equity shares of the investee Indian company.

### A. No Assured Returns

While interest accrued and payable on CCDs is permitted, given the legal character of the instrument, an instrument issued to a non-resident investor under the FDI route cannot otherwise guarantee to such foreign investor an assured return on the investment. An instrument issued under the FDI route subject to an optionality clause (such as a 'put option') in favour of the non-resident investor shall not be considered to be FDI compliant unless it complies with the conditions prescribed by the RBI. The valuation

norms prescribed by the RBI for such optionality clauses prohibit any guaranteed returns to the non-resident investor. However, in the recent Delhi High Court rulings in *Cruz City*, and *Docomo*, has clarified that optionality clauses offering downside protection to the foreign investor should not be construed as one guaranteeing assured returns.

## II. FVCI regime

Under Schedule VI of the TISPRO Regulations and the FVCI Regulations, FVCIs can invest, *inter alia*, in NCDs and OCDs of an Indian venture capital undertaking or a venture capital fund.

As discussed in the Chapter 2, investments by FVCIs are subject to certain restrictions. In addition, the FVCI Regulations specify that:<sup>32</sup>

- a. at least 66.67 percent of the investible funds of a FVCI shall be invested in unlisted equity shares or equity-linked instruments of venture capital undertaking; and
- b. not more than 33.33 percent of the investible funds of a FVCI may be invested by way of, *inter alia*, debt or debt instrument of a venture capital undertaking in which the FVCI has already made an investment by way of equity.

## III. FPI regime

Under Schedule V of the TISPRO Regulations, read with the provisions of the FPI Regulations, FPIs are currently, permitted to invest in, *inter alia*, listed or to be listed NCDs issued by an Indian company. FPIs are permitted to hold securities only in the dematerialized form. FPIs were permitted to invest in ‘*unlisted debt securities*’ in 2016 which eventually led to the removal of administrative compliances and costs in the form of listing of these securities on a recognized stock exchange. This also shielded potential issuers of such debt securities from the implications of the Securities and Exchange Board of India (Listing Obligations and Disclosure

Requirements) Regulations, 2015, which imposes greater restrictions than the erstwhile Securities and Exchange Board of India (Issue and Listing of Debt Securities) Regulations, 2008 and the erstwhile listing agreement with the stock exchange.

Currently, there is an overall limit of USD 51 Billion on investment by FPIs in corporate debt. Further, FPIs can also invest up to USD 30 Billion in government securities.

Listing of NCDs on the wholesale debt market of the Bombay Stock Exchange is a fairly simple and straight forward process which involves the following intermediaries:

- a. Debenture trustee, for protecting the interests of the debenture holders and enforcing the security, if any;
- b. Rating agency for rating the non-convertible debentures (There is no minimum rating required for listing of debentures); and
- c. Registrar and transfer agent (“**R&T Agent**”), and the depositories for dematerialization of the non-convertible debentures.

The entire process of listing can be completed in about three weeks. The typical cost of intermediaries and listing for an issue size of INR 10 Million is approximately INR 1 Million to INR 1 Million and 200,000.

Using the NCD structure bears certain distinct advantages over other structures:

- d. In February 2015, the RBI and SEBI amended relevant regulations to provide for conditions that FPIs will be allowed to invest only in those NCDs which have a minimum residual maturity of three years and FPIs are prohibited from investing in NCDs with optionality clauses exercisable prior to 3 years. However, FPIs will not be subject to the lock-in period and shall be free to sell the NCDs even those with a maturity of less than 3 years to domestic investors. This was considered as a major impediment to foreign investment, since this restricted raising short term financing

32. Regulation 11 of the FVCI Regulations. These investment conditions may be achieved by the FVCI at the end of its life cycle.

through NCDs. Accordingly, by way of Circular No. 24 dated April 27, 2018, RBI reduced the minimum maturity period from 3 years to 1 year. However, a major dampener was restriction imposed on a single FPI to not subscribe to more than 50% of NCD issuance. For a detailed analysis of the aforementioned Circular, please refer to our hotline;<sup>33</sup>

- e. Assured returns to the investor by way of interest / redemption premium, irrespective of profits of the issuer company;
- f. No specified limit on interest/ redemption premium;
- g. Interest expense is deductible from the taxable income of the issuer company. In some cases, redemption premium may also be allowed to be deducted from the taxable income of the company;
- h. Security of investment by way of creation of charge on the assets of the borrower; and
- i. Cost-effective implementation.

In a move to streamline and strengthen the debt recovery process, Indian parliament passed the Enforcement of Security Interest and Recovery of Debt Laws and Miscellaneous Provisions (Amendment) Act, 2016 (“**Amendment Act**”). The Amendment Act intends to amend the *inter alia* Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (“**SARFAESI Act**”), the Recovery of Debts due to Banks and Financial Institutions Act, 1993 (“**DRT Act**”) etc. One of the key change brought in by the Amendment Act is the inclusion of listed debt securities within the purview of SARFAESI Act and the DRT Act. It grants, a SEBI registered debenture trustee (appointed for custody of the security interest created to secure such debt securities) the right to enforce the security interest, in case of non-payment of any amount payable on such debt securities, after the borrower company has been served with a 90 days’ notice for payment of dues.

A comparison between the key features of FPIs and FVCIs is provided below:

Sl. No.	Particulars	FPI	FVCI
1.	Registration	Registration with DDP is mandatory.	Registration with SEBI is mandatory under the FVCI Regulations.
2.	Investment instruments permitted	Listed or to-be-listed and unlisted NCDs of Indian companies.	NCD, OCD or OCRPS of Indian venture capital undertaking and/ or venture capital funds.
3.	Maximum interest payable	No limits specified on interest payable.	No limits specified on interest payable.
4.	Sectoral restrictions	No sectoral restrictions – FPIs may invest in debt securities of Indian companies engaged in any sector.	Sectoral restrictions are present – FVCIs may invest in the infrastructure sector or in Indian venture capital undertakings as discussed in Chapter 2.

For a detailed analysis of the FPI route, please see Chapter 2 above.

33. [http://www.nishithdesai.com/information/research-and-articles/nda-hotline/nda-hotline-single-view/article/death-knell-for-foreign-investors-in-indian-corporate-debt-markets.html?no\\_cache=1&cHash=c8b56873212de12dfd8e0fb299c73af5](http://www.nishithdesai.com/information/research-and-articles/nda-hotline/nda-hotline-single-view/article/death-knell-for-foreign-investors-in-indian-corporate-debt-markets.html?no_cache=1&cHash=c8b56873212de12dfd8e0fb299c73af5)

## IV. CCD vs. NCD

Following table gives a brief comparative analysis of investment through FDI (CCDs) and FPI (NCDs) route:

Particulars	CCD – FDI	NCD – FPI
<b>Equity Ownership</b>	Initially debt, but equity on conversion	Mere lending rights; however, veto rights can ensure certain degree of control.
<b>ECB Qualification</b>	Assured returns on FDI compliant instruments may be construed as ECB.	Purchase of NCDs by the FPI from the Indian company on the floor of the stock exchange is expressly permitted and shall not qualify as ECB.
<b>Coupon Payment</b>	Interest pay out may be limited to SBI PLR + 300 basis points. Interest can be required to accrue and paid only out of free cash flows.	Arm's length interest pay out should be permissible resulting in better tax efficiency. Higher interest on NCDs may be disallowed. Interest can be required to accrue only out of free cash flows. Redemption premium may also be treated as business expense.
<b>Pricing</b>	Fair Value applicable	Fair Value not applicable
<b>Security Interest</b>	Creation of security interest is not permissible either on immovable or movable property	Listed NCDs can be secured (by way of pledge, mortgage of property, hypothecation of receivables etc.) in favor of the debenture trustee who acts for and in the interest of the NCD holders
<b>Sectoral conditionalities</b>	Only permissible for FDI compliant activities	Sectoral restrictions not applicable.
<b>Equity Upside</b>	Investor entitled to equity upside upon conversion.	NCDs are favorable for the borrower to reduce book profits or tax burden. Additionally, redemption premium can be structured to provide equity upside which can be favourable for lender since such premium may be regarded as capital gains which may not be taxed if the investment comes from Singapore.
<b>Administrative expenses</b>	No intermediaries required	NCD listing for listed NCDs may cost around INR 10-15 lakh including intermediaries cost.

## 4. Tax Considerations and Evolving Structures

### I. Overview of Indian Taxation System

Income tax law in India is governed by the Income Tax Act, 1961 (“**ITA**”). Under the ITA residents are taxed on their worldwide income in India, whereas non-residents are taxed only on income sourced in India. Companies are held to be resident in India for tax purposes if a) they are incorporated in India, or (b) their POEM is in India’. Therefore, it is possible for a company incorporated outside India to be considered to be an Indian resident in a year if its POEM is considered to be in India during that year.

India has entered into more than 88 Double Taxation Avoidance Agreements (“**DTAAs**” or “**tax treaties**”). A taxpayer may be taxed either under domestic law provisions or the DTAA, whichever is more beneficial. In order to avail benefits under the DTAA, a non-resident is required to furnish a tax residency certificate (“**TRC**”) from the government of which it is a resident in addition to satisfying the conditions prescribed under the DTAA for applicability of the DTAA. Further, the non-resident should also file tax returns in India and furnish certain prescribed particulars in Form 10F to the extent they are not contained in the TRC. For the purpose of filing tax returns in India, the non-resident should obtain a tax ID in India (called the permanent account number “**PAN**”). PAN is also required to be obtained to claim the benefit of lower withholding tax rates, whether under domestic law or under the DTAA. If the non-resident fails to obtain a PAN, payments made to the non-resident may be subject to withholding tax at the rates prescribed under the ITA or 20%, whichever is higher. However, the CBDT issued a circular dated June 24, 2016 clarifying that in case of payment of interest, royalty, FTS and payments on transfer of any capital asset, a non-resident deductee availing lower withholding tax rates shall not be required to obtain a PAN, provided the following details and documents are provided: 1) name, e-mail id, contact number; 2) address in the

country of residence; 3) Tax Residency Certificate (TRC), if the law of country of residence provides for such certificate; and 4) Tax Identification Number (TIN) in the country of residence, or any other equivalent government registration.

### A. Place of Effective Management

Since the inception of the ITA in 1961 and up until the FY 2014-15, a foreign company was considered a resident in India only if the control and management of its affairs was wholly situated in India. This test of residence was both objective and predictable for the taxpayers.

The Finance Act, 2015 amended Section 6(3) of the ITA to provide that a foreign company would be considered to be a tax resident of India if its POEM was found to be situated in India (the “**POEM Test**”).<sup>34</sup> As per the amended criteria, to ensure that the company is not construed to be tax resident of India in a particular financial year, the company’s POEM in that financial year should not be located in India.

On December 23, 2015 the Indian tax authorities released draft guidance for determining POEM of a company (“**Draft Guidance**”). The Draft Guidance emphasized that the test of POEM is one of substance over form and will depend on facts and circumstances of each case. Further, the Draft Guidance contemplated different tests for companies with active and passive businesses outside India. The POEM for an active company was presumed to be outside India if the majority of its board meetings are held outside India. To determine the POEM of passive companies, the persons who actually make key management and commercial decisions for the business as a whole was to be identified, followed by identifying the place where decisions are actually taken. Earlier this year, on January 24, 2017, the CBDT issued a circular containing

34. Explanation to Section 6(3) defines POEM to mean a place where key management and commercial decisions that are necessary for the conduct of business of an entity as a whole are, in substance made.

what appear to be the final guiding principles (“**Revised Guidelines**”) to be taken into account during the determination of the POEM of a foreign company. The Revised Guidelines were issued with only a couple of months left in the FY for companies to set their affairs in order and, although there has been an attempt to address some of the concerns raised by stakeholders, the uncertainty and subjectivity inherent in the POEM Test remain.

For a detailed analysis of the Revised Guidelines please refer to our hotline.<sup>35</sup>

To bring some respite, CBDT on February 24, 2017 issued a circular clarifying that provisions of Section 6(3) and the Revised Guidelines relating to determination of POEM won’t apply to companies having turnover or gross receipts less than INR 500 million (approx. USD 7.4 million) during a financial year.

## B. Corporate tax

Resident companies are generally taxed at 30%.<sup>36</sup> However, in 2015 the Finance Minister had committed to reduce corporate tax rate to 25% by 2019. As the first step towards achieving this objective, Finance Act, 2016 reduced the corporate tax rate to 29% for small companies having a turnover of less than INR 1 crore. Finance Act 2016 also provided the option to companies set up on or after March 1, 2016, and engaged solely in the business of manufacture or production, to be taxed at the reduced rate of 25% provided they did not claim any profit or incentive linked benefits under the ITA. Subsequently, in order to make medium and small enterprises more viable and to encourage firms to shift to company structure, the Finance Act 2017 reduced the corporate tax rate to 25% (as opposed to the current rate of 30%) for domestic companies whose total turnover or gross receipt did not exceed INR 500 million (approx. USD 7.4 million) in FY 2015-16. Further, through Finance Act, 2018, the said rate of 25% was extended to companies whose

turnover did not exceed INR 2.5 billion (approx. USD 40 million) in the FY 2016-2017.

Non-resident companies are taxed at the rate of 40% on income derived from India, including in situations where profits of the non-resident entity are attributable to a permanent establishment in India.

## C. Tax on dividends and share buy-back

Dividends distributed by Indian companies are subject to a distribution tax (DDT) at the rate of 15% on a grossed up basis (effectively at the maximum rate of 20.36% including surcharge and cess), payable by the company. The shareholders are not subject to any further tax on the dividends distributed to them under the ITA. Having said that, Finance Act, 2016 amended the ITA to provide that dividends declared by a domestic company and received by a resident individual, limited liability partnership or partnership firm, in excess of INR 1 million, shall be chargeable to a tax at the rate of 10% (on a gross basis) in the hands of the recipient. FA 2017 expanded this tax to cover all resident shareholders except a domestic company, a registered charitable trust, and certain institutions involved in charitable activities.

An Indian company would also be taxed at the rate of 20% on gains arising to shareholders from distributions made in the course of buy-back or redemption of shares. The Finance Act, 2016 widened the definition of ‘buyback’ to include a buyback of shares in accordance with company laws currently in force. It seems that the intention of the legislature is to cover buybacks under the CA 2013 or any legislation that may be applicable. However, a wide definition of ‘buyback’ could have an inadvertent effect on transactions such as share capital reductions, which may also be covered under deemed dividends and lead to unintended double taxation.

The concept of ‘*distributed income*’ on which the buyback tax was applicable has also undergone a change. Earlier, it was computed by subtracting the issue price from the consideration. The Finance Act, 2016, clarified that for computing ‘distributed income’, the amounts received by the company as

35. <http://www.nishithdesai.com/information/research-and-articles/nda-hotline/nda-hotline-single-view/newsid/3763/html/1.html>

36. Unless otherwise specified, all tax rates in this paper is exclusive of applicable surcharge and cess.

consideration shall be determined in a manner to be prescribed. This amendment was aimed at tackling cases where the consideration/ issue price was paid in tranches or non-monetary in nature. The CBDT released the final rules for computation of 'distributed income' for the purposes of buyback tax through notification no. 94 of 2016.<sup>37</sup>

## D.Capital gains

Tax on capital gains depends upon the holding period of a capital asset. Short term capital gains ("STCG") may arise if the asset has been held for 2 years or less before being transferred. In the case of listed securities, STCG is derived based on the holding period being 1 year or less and gains arising from the transfer of assets having a longer holding period than the above are characterized as long term capital gains ("LTCG"). LTCCG earned by a non-resident on sale of unlisted securities may be taxed at the rate of 10% or 20% depending on certain considerations. LTCCGs earned by a non-resident on sale of listed shares on the stock exchange are subject to a beneficial tax rate of 10% where such gains exceed INR 100,000 provided that securities transaction tax (STT) is paid both at the time of acquisition and sale of shares.<sup>38</sup>

STCG earned by a non-resident on sale of listed securities are taxable at the rate of 15%, or at ordinary corporate tax rate with respect to other securities. Foreign institutional investors or foreign portfolio investors are also subject to tax at 15% on STCG. All income earned by FIIs or FPIs are also treated as capital gains income. In the case of earn-outs or deferred consideration, Courts have held that capital gains tax is required to be withheld from the total sale consideration (including earn out) on the date of transfer of the securities / assets. India also has a rule to tax non-residents on the transfer of foreign securities the value of which may be substantially (directly or indirectly) derived from assets situated in India. Therefore, the shares of a foreign incorporated company can be considered to be "situated in India" and capable of yielding

capital gains taxable in India, if the shares of a foreign company derive their value "substantially from assets located in India". Please refer below for a detailed explanation on taxation of indirect transfers. However, income derived from the transfer of P-notes and ODIs derive their value from the underlying Indian securities and is not considered to be income derived from the indirect transfer of shares in India because it does not constitute an 'interest' in the Indian securities.

Under Section 56(2)(x) of the ITA, tax is levied on private companies and firms that buy/ receive shares of a private company for less than their fair market value. Therefore, where the consideration paid by a private company or firm is less than the fair market value of the shares, the purchaser would be taxed on the difference under these provisions.

The FA, 2017 introduced section 50CA in the ITA as per which, in respect of transfers of unlisted shares of a company, at less than the fair market value, the fair market value would be deemed to be the full value consideration for computing capital gains. This essentially results in increasing the capital gains tax burden for the transferor by bringing into the tax net a concept of notional gains which is actually not received by the transferor. While this was seemingly introduced as anti-abuse provision, and is similar to an existing provision under Section 50C of the ITA which is applicable in respect of immovable property, the challenge lies in the fact that even commercial transactions between unrelated parties can be subject to this notional tax. The other major concern with this provision is that when read with Section 56, it leads to a situation of double taxation since (a) the transferor company is taxed on a notional capital gains on the difference between the notional fair market value of the shares and the actual consideration received; and (b) the transferee company is taxed under Section 56 in respect of the difference between the notional fair market value of the shares and the consideration actually paid. This provision can lead to a lot of hardship, especially in situations such as distress sale or where the business prospects have eroded. In such circumstances, double taxation can lead to a significant concern for the parties to the transaction.

37. <https://www.incometaxindia.gov.in/news/notificaiton942016.pdf>

38. Section 112A of the Income Tax Act, 1961

Coupled with the fact that the scope of Section 56 was further expanded to cover a wide category of persons (explained below), this provision could lead to an undesirable economic double taxation on the notional amount which is the difference between the fair market value and the actual consideration.

## E. Interest

In order to incentivise access to foreign capital, the ITA provides for a beneficial concessional withholding tax rate of 5% for interest on all types of long term borrowings from non-residents. Section 194LC of the ITA, provides concessions to ECBs, foreign currency corporate bonds such as foreign currency convertible bonds, and foreign currency exchangeable bonds, long term foreign currency denominated bonds, etc. which were availed prior to July 1, 2017. However, considering the representations made by industry participants, the FA, 2017 amended section 194LC of the ITA to extend the benefits in the provision to July 1, 2020. This was put into effect from FY 2017-18.

In view of the beneficial TDS regime made available in respect of ECBs in section 194LC, various stakeholders had made representations to amend Section 194LC in order to extend the benefits of Section 194LC to rupee denominated bonds (masala bonds) issued to non-residents. The government had acceded to the request and issued a press release on October 29, 2015, which indicated that the beneficial TDS rate of 5% would be extended to such issuances. In order to give effect to the allowance made through the press release, the FA, 2017 amended section 194LC of the ITA to extend the benefit to interest payable to non-residents in respect of rupee denominated bonds (masala bonds). This amendment was retrospectively made effective from April 1, 2016. The benefit shall be available to all masala bonds issued by Indian companies to foreign investors before July 1, 2020.

## F. Minimum Alternate Tax (“MAT”)

Section 115JB imposes an obligation on companies to pay a MAT of 18.5% (Eighteen point per cent) of its book profit (calculated in accordance with the provisions of the Companies Act, 2013), if the tax otherwise payable on total income is lesser after taking into account other allowable deductions under the ITA. Thus, MAT was intended to be a measure akin to a presumptive tax and an anti-avoidance measure. It has no correlation to actual profits and impacts genuine businesses in India. While the ask is to eliminate MAT altogether, the Government has retained these provisions albeit with tweaks. The Government has repeatedly expressed the intention to phase out the various exemptions available under the ITA, however, as it may be several years before it can benefit from the phasing out of such exemptions, the Government has decided to not do away with MAT.

Further, currently it is the difference between the MAT paid and the tax computed under the normal ITA provisions that can be carried forward as credit for future years and be set off against tax payable under normal ITA provisions. However, as per the provisions introduced through the FA, 2017, MAT credit will not be allowed to be carried forward to the extent that the amount of Foreign Tax Credit (“FTC”) that can be claimed against MAT exceeds the amount of FTC that is claimable against tax computed under the normal ITA provisions. Further, in light of the implementation of the new Indian Accounting Standards, detailed provisions have been proposed to compute MAT in accordance with the revised accounting standards. There are provisions for the first time adoption of MAT as well as for the accounting and MAT treatment in the future years.

## G. Thin Capitalization Norms

The FA, 2017 introduced the thin capitalization rules within the ITA to curb companies from enjoying excessive interest deductions, while effectively being akin to an equity investment. This move is likely to severely impact investments into India through the debt route – both in respect of Compulsorily Convertible Debentures (“CCDs”) and NCDs, which are widely used methods for funding into India.

The FA, 2017 introduced section 94B (“**Thin Capitalization Rules**”) of the ITA to provide that where an Indian company or permanent establishment of a foreign company makes interest payments (or similar consideration) to its associated enterprise, such interest shall not be deductible at the hands of the Indian company/ PE to the extent of the “Excess Interest”. Excess Interest has been defined to mean an interest amount that exceeds 30% of the Earnings before Interest, Taxes, Depreciation and Amortization (“**EBITDA**”) of the Indian company / the permanent establishment. In the event that the interest payment payable/ paid is less than Excess Interest, the deduction will only be available to the extent of the interest payment payable/ paid. Interest payments which are less than INR 10 million (approx. USD 150,000) are exempt from the above requirement (on a per assessment year basis).

The provisions are an outcome of the BEPS Action Plan 4 adopted by the OECD which proposed a 10 to 30% of EBITDA range for limit on interest payments in intra group transactions. In line with the BEPS Action Plan, the Thin Capitalization Rules provide for a de minimis threshold, provision for carry forward of the Excess Interest for a period of 8 years and exemptions to banking and insurance companies.

### Other key points of the amendment include:

- **Associated enterprise:** The Thin Capitalization Rules are applicable not only in case of interest payments to ‘associated enterprises’, as defined under the ITA but they also cover third party lenders who provide a loan on the basis of an associated enterprise either providing an explicit or implicit guarantee to such third party lender or depositing or a corresponding amount with the

lender. This is to cover situations where indirect deposits / guarantees are made by associated enterprises with financial institutions on the basis of which a loan is provided by the financial institution to the assessee.

- **Meaning of Debt:** The definition of ‘debt’ is wide and covers any loan, financial instruments, financial lease, financial derivative or any other arrangement giving rise to interest, discount or other financial charges. This could potentially cover debt instruments like masala bonds, NCDs, CCDs, ECBs etc.
- **De-minimis threshold:** Interest payments which are less than INR 10 million (approx. USD 150,000) are exempt from the above requirement (on a per assessment year basis).
- **Exception:** An exception has been carved out for Indian companies / PE of foreign companies engaged in the banking or insurance business.
- **Carry forward of interest deductibles:** As a clarification, Section 94B also provides for a carry forward of interest expenditure which is not wholly deductible against income under the head ‘profit or gains arising from business’ to the next assessment year (for eg. In case of a loss making Indian company). The carry forward of interest deductible is available for eight assessment years but cannot exceed the Excess Interest.

While the proposals are in line with the BEPS Action Plan 4, there are significant issues that may arise out of their introduction.

## H. Rationalization of tax withholding requirement for AIFs

Following a demand to rationalize the tax withholding requirements made by the industry and in line with the Alternative Investment Policy Advisory Committee’s (“**AIPAC**”) report, the Finance Act, 2016 rationalized the deduction requirements by making the following changes with respect to the amount that is required to be withheld by an investment fund:

- Distributions to non-residents (not being a company) or a foreign company:** Tax will be required to be deducted as per the “rates in force”. The term “rates in force” has been defined under Section 2(37A) of the ITA and the FA, 2017 introduced amendments to the provision to include deductions under 194LBB. This made the withholding rate subject to the rates that are applicable under the ITA or those in accordance with the applicable DTAA, whichever is more favorable. The change also ensured that there is nil or lower withholding of tax required when distributions are being made to investors who are residents of countries such as Singapore or Mauritius, which have a beneficial DTAA with India. It was a welcome change that worked in favor of unified fund structures and encouraged participation by NRIs/foreign nationals into AIFs.
- Distributions to residents:** Tax will be required to be deducted at the rate of 10%. This is a continuation of the existing provisions as far as distributions to residents are considered. Consequently, the provision still does not differentiate between taxable streams of income and streams of income not subject to tax. For example, an investment fund would still be required to deduct tax at 10% when distributing income earned from dividends received. This creates an anomaly as such dividend income is not subject to tax in the hands of the investor. Further, the provision does not account for distributions to exempt domestic investors. However, Section 197 of the ITA has been amended to allow AIFs to obtain nil/ reduced tax withholding certificates with respect to exempt investors and exempt streams of income.

While the pass-through regime is a welcome development, it is not without its set of difficulties. For example, the withholding provision in its current form would apply to exempt income such as dividends and long-term capital gains on listed equity shares.

## II. Specific Tax Considerations for PE Investments

### A. Availability of Treaty Relief

Benefits under a DTAA are available to residents of one or both of the contracting states that are liable to tax in the relevant jurisdiction. However, some fiscally transparent entities such as limited liabilities companies, partnerships, limited partnerships, etc. may find it difficult to claim treaty benefits. For instance, Swiss partnerships have been denied treaty benefits under the India-Switzerland DTAA. However, treaty benefits have been allowed to fiscally transparent entities such as partnerships, LLCs and trusts under the US and UK DTAA, insofar as the entire income of the entity is liable to be taxed in the contracting state; or if all the beneficiaries are present in the contracting state being the jurisdiction of the entity. On the other hand, Swiss partnerships have been denied treaty benefits under the India-Switzerland.

Benefits under the DTAA may also be denied on the ground of substance requirements. For instance, the India-Singapore DTAA and now, the India – Mauritius DTAA denies benefits under the DTAA to resident companies which do not meet the prescribed threshold of total annual expenditure on operations. The limitation on benefits (“LoB”) clause under the India-Luxembourg DTAA permits the benefits under the DTAA to be overridden by domestic anti-avoidance rules. Further, India amended the DTAA with Mauritius, Singapore and Cyprus, which had a significant impact on fund structuring. In 2015, India signed a Protocol amending agreement with Japan for providing internationally accepted standards for effective exchange of information on tax matters, exemption of income interest from taxation. India’s revised tax treaty with Korea, had significant effect in India in respect of income derived in fiscal years beginning on or after 1st April, 2017.

## B. Permanent Establishment and Business Connection

Profits of a non-resident entity are typically not subject to tax in India. However, where a permanent establishment is said to have been constituted in India, the profits of the non-resident entity are taxable in India only to the extent that the profits of such enterprise are attributable to the activities carried out through its permanent establishment in India and are not remunerated on an arm's length basis. A permanent establishment may be constituted where a fixed base such as a place of management, branch, office, factory, etc. is available to a non-resident entity; or where a dependent agent habitually exercises the authority to conclude contracts on behalf of the non-resident entity. Under some DTAs, employees or personnel of the non-resident entity furnishing services for the non-resident entity in India may also constitute a permanent establishment. The Delhi High Court ruling in *e-Funds IT Solutions/ e-Funds Corp vs. DIT*<sup>39</sup> laid down the following principles for determining the existence of a fixed base or a dependent agent permanent establishment:

- i. The mere existence of an Indian subsidiary or mere access to an Indian location (including a place of management, branch, office, factory, etc.) does not automatically trigger a permanent establishment risk. A fixed base permanent establishment risk is triggered only when the offshore entity has the right to use a location in India (such as an Indian subsidiary's facilities); and carries out activities at that location on a regular basis.
- ii. Unless the agent is authorized to and has habitually exercised the authority to conclude contracts, a dependent agent permanent establishment risk may not be triggered. Merely assigning or sub-contracting services to the Indian subsidiary does not create a permanent establishment in India.
- iii. An otherwise independent agent may, however, become a permanent establishment if the agent's activities are both wholly or mostly

wholly on behalf of foreign enterprise and that the transactions between the two are not made under arm's length conditions.

Where treaty benefits are not available, the concept of 'business connection', which is the Indian domestic tax law equivalent of the concept of permanent establishment, but which is much wider and has been defined inclusively under the ITA, would apply to non-resident companies deriving profits from India.

The Finance Act, 2015 brought about certain amendments to encourage fund management activities in India – by providing that having an eligible manager in India should not create a tax presence (business connection) for the fund in India or result in the fund being considered a resident in India under the domestic 'place of effective management' rule.

However, while this change may be well intentioned, it employs a number of rigid criteria that would be impossible for PE funds and difficult for FPIs to satisfy:

1. **No ability to "control and manage"**: To qualify, the fund shall not carry on or control and manage, directly and indirectly, any business in India. It is unclear whether shareholders rights such as affirmative rights can be considered "control and management". Further, particularly in a PE/VC fund context, it is expected that the fund brings in management expertise that enables the company to grow.
2. **Broad basing requirement**: The fund is required to have a minimum of 25 members who are directly/ indirectly unconnected persons. This seems similar to the broad-basing criteria applied to Category 2 FPIs and isn't quite appropriate for PE/VC funds which may often have fewer investors. Further, there is no clarity on whether the test will be applied on a look through basis (which could impact master-feeder structures).
3. **Restriction on investor commitment**: It is required that any member of the fund, along with connected persons should not have a participation interest exceeding 10%. It has also been stated that the aggregate participation of

39. TS-63-HC-2014 (DEL); MANU/DE/0373/2014

10 or less people should be less than 50%. This would restrict the ability of the fund sponsor/ anchor investor to have a greater participation. It would also have an impact on master feeder structures or structures where separate sub-funds are set up for ring fencing purposes.

4. **Fund manager cannot be an employee:** The exemption does not extend to fund managers who are employees or connected persons of the fund. Further, it is not customary in industry to engage managers on a consultancy/ independent basis, for reasons of risk and confidentiality, particularly in a PE/VC fund context. Therefore, this requirement is likely to be very rarely met.

## C. Indirect transfer of shares in India

As stated above, for a non-resident to be subject to tax in India, the ITA requires that the income should be received, accrued, arise or deemed to be received, accrued or arisen to him in India. The indirect transfer tax provisions essentially provide that where there is a transfer of shares or interest of a foreign company or entity, whose value is derived substantially from assets located in India, in such case, income arising from such transfer can be brought within the Indian tax net.

The indirect transfer tax provisions, a controversial set of provisions brought about in light of the Vodafone<sup>3</sup> case, expanded the existing source rules for capital gains. The indirect transfer tax provisions were introduced with retrospective effect by the Finance Act, 2012 by way of Explanation 5 to Section 9(1)(i) of the ITA, “clarifying” that an offshore capital asset would be considered to have a situs in India if it substantially derived its value (directly or indirectly) from assets situated in India.

In order to provide clarity as to what would constitute *substantial* value, the then Prime Minister appointed the Shome Committee. On the basis of the recommendations provided by the Shome Committee, the Finance Act, 2015 amended the ITA to provide the thresholds and test to determine as to when shares or interests of a non-resident company

would be deemed to derive their value substantially from assets (tangible or intangible) located in India. These provisions which are summarized below:

- **Threshold test on substantiality and valuation:** The Finance Act, 2015 provided that the share or interest of a foreign company or entity shall be deemed to derive its value substantially from the assets (whether tangible or intangible) located in India, if on the specified date, the value of Indian assets (i) exceeds the amount of INR 10 Crores (INR 100 million); and (ii) represents at least fifty per cent of the value of all the assets owned by the company or entity. The value of the assets shall be the fair market value of such asset, without reduction of liabilities, if any, in respect of the asset. The manner of determination of the fair market value of the assets was left to be provided for in the rules. However, even today, there are no rules in place to determine fair market value for application of the indirect transfer tax provisions.
- **Date for determining valuation:** Typically, the end of the accounting period preceding the date of transfer shall be the specified date of valuation. However, in a situation when the book value of the assets on the date of transfer exceeds by at least 15% of the book value of the assets as on the last balance sheet date preceding the date of transfer, then the specified date shall be the date of transfer. This results in ambiguity especially in cases where intangibles are being transferred.
- **Taxation of gains:** The gains arising on transfer of a share or interest deriving, directly or indirectly, its value substantially from assets located in India will be taxed on a proportional basis based on the assets located in India vis-à-vis global assets. The Finance Act, 2015 did not provide for determination of proportionality and left it to be provided in the rules which were finally introduced through a notification issued by CBDT dated June 28, 2016.<sup>40</sup> The rules sought to ensure that only the value of the Indian assets is taxed in India. It is important to address the cost adjustment, if at a later point in time, the Indian assets are transferred. For example,

40. NOTIFICATION NO. SO 2226(E) [NO.55/2016 (F. NO.142/26/2015-TPL)], DATED 28-6-2016

if an offshore company derives substantial value from Indian company shares held by it, and tax is paid on transfer of the offshore company on account of the value derived from India, will there be a step up in cost basis if the shares of the Indian company are subsequently transferred? These concerns continue to haunt investor community.

**Exemptions:** The Finance Act, 2015 also provides for situations when this provision shall not be applicable. These are:

- a. Where the transferor of a shares or interest in a foreign entity, along with its related parties does not hold (i) the right of control or management; and (ii) the voting power or share capital or interest exceeding 5% of the total voting power or total share capital in the foreign company or entity directly holding the Indian assets (Holding Co).
- b. In case the transfer is of shares or interest in a foreign entity which does not hold the Indian assets directly, then the exemption shall be available to the transferor if it along with related parties does not hold (i) the right of management or control in relation to such company or the entity; and (ii) any rights in such company which would entitle it to either exercise control or management of the Holding Co or entitle it to voting power exceeding 5% in the Holding Co.

Therefore, no clear exemption was provided to portfolio investors as even the holding of more than 5% interest could trigger these provisions. This is a far cry from the 26% holding limit which was recommended by the Committee. Further, no exemption was provided for listed companies, as was envisaged by the Committee

- c. In case of business reorganization in the form of demergers and amalgamation, exemptions have been provided. The conditions for availing these exemptions are similar to the exemptions that are provided under the ITA to domestic transactions of a similar nature.

These provisions had unintended consequences, especially for the India-focused offshore funds industry. A circular was released by the CBDT on December 21, 2016 (“**Indirect Transfer Circular**”) containing responses to questions raised by various stakeholders (including FPIs, PE, VC investors etc.) in the context of the applicability of the indirect transfer provisions under the ITA. While the Indirect Transfer Circular was intended to provide clarity on the circumstances in which the indirect transfer provisions are to be applied, it failed to address the concerns of various stakeholders, chiefly FPIs, with regard to issues like potential double and triple taxation, onerous compliance requirements, and lack of tax neutral foreign corporate restructurings. Consequently, it ended up creating more confusion and failed to address key industry concerns with regard to potential double and triple taxation, onerous compliance requirements, and lack of tax neutral foreign corporate restructurings. Due to wide industry wide representation, the Indirect Transfer Circular was kept in abeyance.

The FA 2017 brought changes to clarify that the indirect transfer tax provisions shall not be applicable to an asset or capital asset that is held directly/ indirectly by way of investment in a Category I or Category II FPI. This resolves concerns for a class of offshore funds which are registered as a category I or category II FPIs as redemptions by investors at the level of the fund shall not be subject to the indirect transfer taxation. Further, in multi-tiered structures, if the entity investing into India is a Category I or Category II FPI, any upstreaming of proceeds by way of redemption / buyback will not be brought within the Indian tax net. The provisions also exclude, from applicability of the indirect transfer tax provisions, situations where any redemptions or re-organizations or sales result in capital gains by investors in Category I or Category II FPIs.

The clarificatory explanations are applicable retrospectively from FY starting April 1, 2012, and therefore should help bring about certainty on past transactions that have been entered into by Category I and Category II FPI entities.

The amendment left out a large chunk of the affected sector i.e. Category III FPIs, PE and VC investors investing in Indian securities. During the 2017-18 budget speech, the Finance Minister had indicated that further clarifications will be issued with respect to redemptions or buybacks of shares or interests in any foreign company (having underlying Indian investments) as a result of or arising out of the redemption or sale of Indian securities which are chargeable to Indian taxes, and the same would be exempt from the applicability of the indirect transfer tax provisions. The said clarifications were finally issued through CBDT circular No. 28 of 2017 dated November 21, 2017.<sup>41</sup>

## D. General Anti-Avoidance Rule (“GAAR”)

Chapter X-A of the ITA provides for GAAR, which came into effect from April 1, 2017. GAAR confers broad powers on the revenue authorities to deny tax benefits (including tax benefits applicable under the tax treaties), if the tax benefits arise from arrangements that are “impermissible avoidance arrangements”.

The introduction of GAAR in the ITA brought a shift towards a substance based approach. GAAR targets arrangements whose main purpose is to obtain a tax benefit and arrangements which are not at arm’s length, lack commercial substance, are abusive or are not bona fide. It grants tax authorities powers to disregard any structure, reallocate / re-characterize income, deny treaty relief etc. Further, the ITA provides that GAAR is not applicable in respect of any income arising from transfer of investments which are made before April 1, 2017.

Section 90(2A) of the ITA contains a specific treaty override in respect of GAAR and states that the GAAR shall apply to an assessee with respect to tax treaties, even if such provisions are not beneficial to the assessee.

On January 27, 2017, the CBDT issued Circular No. 7 of 2017 containing clarifications on the implementation of GAAR. Herein, the CBDT clarified that: (i) GAAR will not interplay with the right of a taxpayer to select or choose the method of implementing a transaction; and (ii) GAAR shall not be invoked merely on the ground that an entity is located in a tax efficient jurisdiction. Specifically in response to a query raised with regard to issuance of P-notes referencing Indian securities, the CBDT has clarified that if the jurisdiction of an FPI is finalized based on non-tax commercial considerations and the main purpose of the arrangement is not to obtain a tax benefit, then GAAR will not apply. The CBDT has further clarified that, in situations where the anti-abuse is sufficiently addressed by the LOB provision in the DTAA, GAAR shall not apply. However, what the standard for the LOB to be sufficiently addressed is not provided and may result in additional complexities.

## E. Transfer pricing regulations

Under the Indian transfer pricing regulations, any income arising from an “international transaction” is required to be computed having regard to the arm’s length price. There has been litigation in relation to the mark-up charged by the Indian advisory company in relation to services provided to the offshore fund / manager. In recent years, income tax authorities have also initiated transfer pricing proceedings to tax foreign direct investment in India. In some cases, the subscription of shares of a subsidiary company by a parent company was made subject to transfer pricing regulations, and taxed in the hands of the Indian company to the extent of the difference in subscription price and fair market value.

An important change brought about by FA, 2017 with respect to transfer pricing under the ITA is the introduction of secondary adjustment. This amendment is applicable from FY 2017-18.

41. See [http://www.nishithdesai.com/information/research-and-articles/nda-hotline/nda-hotline-single-view/article/indias-tax-regulator-issues-circular-to-address-multiple-taxation-levels-in-indirect-transfers.html?no\\_cache=1&cHash=ba3f6072e78858feb80cbco26bb95c52](http://www.nishithdesai.com/information/research-and-articles/nda-hotline/nda-hotline-single-view/article/indias-tax-regulator-issues-circular-to-address-multiple-taxation-levels-in-indirect-transfers.html?no_cache=1&cHash=ba3f6072e78858feb80cbco26bb95c52)

The amendment introduces Section 92CE which requires a resident taxpayer who has entered into an international transaction to make a secondary adjustment in the event that a primary adjustment as per transfer pricing provisions:

1. has been made suo moto by the taxpayer in his income tax return,
2. has been made by the Assessing Officer and accepted by the taxpayer,
3. has been determined by and advanced pricing agreement,
4. is made as per safe harbor rules under the ITA,
5. is a result of mutual agreement procedure under a tax treaty

The provisions further prescribe that where, as a result of primary adjustment, there is an increase in the taxpayer's total income or a reduction in allowable loss, a secondary adjustment shall have to be made.

## F. Withholding Obligations

Tax would have to be withheld at the applicable rate on all payments made to a non-resident, which are taxable in India. The obligation to withhold tax applies to both residents and non-residents. Withholding tax obligations also arise with respect to specific payments made to residents. Failure to withhold tax could result in tax, interest and penal consequences. Therefore, often in a cross-border transaction, the purchasers structure their exits cautiously and rely on different kinds of safeguards such as contractual representations, tax indemnities, tax escrow, nil withholding certificates, advance rulings, tax insurance and legal opinions. Such safeguards have been described in further detail under **Annexure II**.

## G. Structuring through intermediate jurisdictions

Investments into India are often structured through holding companies in various jurisdictions for number of strategic and tax reasons. For instance, US investors directly investing into India may face difficulties in claiming credit of Indian capital gains tax on securities against US taxes, due to the conflict in source rules between the US and India. In such a case, the risk of double taxation may be avoided by investing through an intermediary holding company.

While choosing a holding company jurisdiction it is necessary to consider a range of factors including political and economic stability, investment protection, corporate and legal system, availability of high quality administrative and legal support, banking facilities, tax treaty network, reputation and costs.

India has entered into several BITs and other investment agreements with various jurisdictions, most notably, Mauritius. It is important to take advantage of structuring investment into India, may be the best way to protect a foreign investor's interest. Indian BITs are very widely worded and are severally seen as investor friendly treaties. Indian BITs have a broad definition of the terms 'investment' and 'investor'. This makes it possible to seek treaty protection easily through corporate structuring. BITs can also be used by the investors to justify the choice of jurisdiction when questioned for GAAR. However, the Government formulated a model text for Indian BIT ("**Model BIT**"). In order to ensure that the foreign investors do not use the protection under BIT when questioned for GAAR, the Model BIT requires all investors to comply with the tax laws of India.

Please refer to **Annexure III** for detailed note on BITs.

Over the years, a major bulk of investments into India has come from countries such as Mauritius, Singapore and Netherlands, which are developed and established financial centers that have favorable tax treaties with India. The following table summarizes some of the key advantages of investing from Mauritius, Singapore, Netherlands and Cyprus:

Head Of Taxation	Mauritius	Singapore	Netherlands	Cyprus
<b>Capital gains tax on sale of Indian securities</b>	<p>Mauritius has the right to tax capital gains arising from alienation of shares acquired on or prior to April 1, 2017 in a company resident in India. It is pertinent to note that there is no local tax in Mauritius on capital gains, Mauritius residents.</p> <p>From April 1, 2017, India shall have the right to tax capital gains arising from alienation of shares acquired on or after April 01, 2017 in a company resident in India.</p> <p>Lower tax rate is applicable for the period between April 1, 2017 and March 31, 2019 i.e. tax on alienation of shares during this period shall not exceed 50% of the domestic tax rate in India. Such reduced tax rate shall only be available to such Mauritius resident who is (a) not a shell/ conduit company and (b) satisfies the main purpose and 'bonafide' business test.</p> <p>Further, a Mauritius resident shall be deemed to be a shell/ conduit company if its total expenditure on operations in Mauritius is less than INR 2,700,000 (approximately 40,000 US Dollars) in the 12 months immediately preceding the alienation of shares.</p>	<p>Singapore has the right to tax capital gains arising from alienation of shares acquired on or prior to April 1, 2017 in a company resident in India. It is pertinent to note that there is no local tax in Singapore on capital gains, Singapore residents.</p> <p>From April 1, 2017, India shall have the right to tax capital gains arising from alienation of shares acquired on or after April 01, 2017 in a company resident in India.</p> <p>Lower tax rate is applicable for the period between April 1, 2017 and March 31, 2019 i.e. tax on alienation of shares during this period shall not exceed 50% of the domestic tax rate in India.</p> <p>Such reduced tax rate shall only be available to such Singapore resident who satisfy the following 'substance' criteria and expenditure test: (a) if the Company has not arranged its affairs for the primary purpose of gaining exemption of tax on capital gains; (b) if the Company is deemed not to be a shell company or a conduit, that is, if its total annual expenditure on operations is equal to or more than S\$ 200,000 in Singapore in the immediately preceding period of 2 years or if it is listed on a recognized stock exchange of the contracting state.</p>	<p>Dutch residents not taxed if sale made to non-resident.</p> <p>Exemption for sale made to resident only if Dutch shareholder holds lesser than 10% shareholding in Indian company. Local Dutch participation exemption available in certain circumstances.</p>	<p>As per the revised DTAA between India and Cyprus, India shall have the right to tax capital gains arising from the transfer of investments made on or after April 01, 2017.</p> <p>The treaty provides for source based taxation of capital gains arising from alienation of shares, instead of residence based taxation provided under the existing DTAA. However, a grandfathering clause has been provided for investments made prior to April 1, 2017, in respect of which capital gains would continue to be taxed in the country of which taxpayer is a resident.</p>
<b>Tax on dividends</b>	<p>Indian company subject to DDT at the rate of 15%.</p>	<p>Indian company subject to DDT at the rate of 15%.</p>	<p>Indian company subject to DDT at the rate of 15%.</p>	<p>Indian company subject to DDT at the rate of 15%</p>

<b>Withholding tax on outbound interest</b>	7.5%	15%	10%	10%
<b>Withholding tax on outbound royalties and fees for technical services</b>	10%	10%	10%	
<b>Other comments</b>		There are specific limitations under Singapore corporate law (e.g. with respect to buyback of securities).	To consider anti-abuse rules introduced in connection with certain passive holding structures.	

## 5. Exits For Private Equity and Private Debt Investments

### I. IPO

Globally one of the most popular forms of exit for the PE investors is through the IPO. Although, the Indian IPO market was sluggish in 2015, with only 21 mainboard listings on the stock exchange, 2016 witnessed 66 IPOs, with the companies raising approximately USD 3.8 billion. An IPO is a tax-optimized exit since there is no capital gain tax on the shares sold on the floor of the stock exchange if the shares are held for more than 12 months.

It is pertinent to note that under ICDR Regulations, the entire pre-issue capital held by persons other than promoters shall be locked-in for a period of one year. However, an exemption is provided to the equity shares held by a venture capital fund or a FVCI for a period of at least one year prior to the date of filing the draft prospectus with the SEBI.<sup>42</sup>

### II. Trade sale

The investor could also exit either by way of a sale of shares of Indian company or by the selling the offshore holding company (“OHC”), holding the shares of Indian company to another party. If the transfer of shares of the Indian company is between a non-resident and resident then the pricing requirements of the TISPRO Regulations will apply as mentioned earlier. Pricing guideline shall not apply in case of the sale of the OHC.

### III. Buy-back

In this exit option, shares held by the foreign investor, are bought back by the investee company. Buy-back of securities is subject to certain conditionalities as stipulated under Section 68 of the CA 2013, such as:

- Buy-back normally requires a special resolution<sup>43</sup> passed by the shareholders of the company unless the buy-back is for less than 10% of the total paid-up equity capital and free reserves of the company;
- Buy-back cannot exceed 25% of the total paid up capital and free reserves of the company in one financial year; and
- Post buy-back, the debt equity ratio of the company should not be more than 2:1.

A company can only utilize the following funds for undertaking the buy-back (a) free reserves (b) securities premium account, or (c) proceeds of any shares or other specified securities.

From a tax perspective, traditionally, the income from buyback of shares has been considered as capital gains in the hands of the recipient and accordingly if the investor is from a favourable treaty jurisdiction, he could avail the treaty benefits. However, in a calculated move by the government to undo this current practice of companies resorting to buying back of shares instead of making dividend payments the Budget 2013-2014 levied an additional distribution tax of 20% on domestic companies, when such companies make distributions pursuant to a share repurchase or buy back.

The said tax at the rate of 20% is imposed on a domestic company on consideration paid by it which is above the amount received by the company at the time of issuing of shares. Accordingly, gains that may have arisen as a result of secondary sales that may have occurred prior to the buy-back will also be subject to tax now. Under the Finance Act, 2016 the concept of ‘*distributed income*’ on which

42. Regulation 37, SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009

43. Under Companies Act 2013, a Special Resolution is one where the votes cast in favor of the resolution (by members who, being entitled to do so, vote in person or by proxy, or by postal ballot) is not less than three times the number of the votes cast against the resolution by members so entitled and voting. (The position was the same under the Companies Act, 1956)

the buyback tax was applicable has undergone a change. Earlier, it was computed by subtracting the issue price from the consideration. Finance Act, 2016 clarified that for computing 'distributed income', the amounts received by the company as consideration shall be determined in a manner to be prescribed. This amendment was introduced to tackle cases where the consideration/ issue price was paid in tranches or non-monetary in nature.

The buy-back tax has a significant adverse impact on offshore funds and foreign investors who have made investments from countries such as Mauritius, Singapore and Netherlands etc., where buy-back of shares would not have been taxable in India due to availability of tax treaty benefits. Further, being in the nature of additional income tax payable by the Indian company, foreign investors may not even be entitled to a foreign tax credit of such tax.

## IV. Depository Receipts (“DRs”)

In 2014, Ministry of Finance notified the Depository Receipts Scheme, 2014 (“**New Scheme**”). The New Scheme rationalises the old framework and proposes significant deregulation and rationalisation of the manner in which Indian companies could tap global capital markets. It provides the Indian firms, domestic investors and foreign investors freedom to access financial markets within the prevalent foreign investment regime in India. Therefore, aims at bringing the DR route at par with any other foreign investment.

Broadly, the New Scheme was introduced with the intention to provide the Indian firms, domestic investors and foreign investors freedom to access financial markets within the prevalent foreign investment regime in India. As per the New Scheme:

- a. Any Indian company, listed or unlisted, private or public or any other issuer or person holding permissible securities is eligible to issue or transfer permissible securities to a foreign depository for the purpose of issuance of DRs. Except for persons barred from accessing international capital markets, no restrictions as

such have been set out under the New Scheme as regards Indian issuer of securities.

- b. DRs can be issued on the back of any permissible securities (“**Permissible Securities**”). Permissible Securities has been defined to include securities as defined in the Securities Contracts (Regulation) Act, 1956 whether issued by a company, mutual fund, government or any other issuer and similar instruments issued by private companies.
- c. A regulated entity having the legal capacity to issue DRs (i.e. a person which is not prohibited from acquiring Permissible Securities), that is regulated in a permissible jurisdiction and that has the legal capacity to issue depository receipts in the permissible jurisdiction, may issue DRs.
- d. A domestic custodian has been defined to include a custodian of securities, an Indian depository, a depository participant, or a bank and having permission from SEBI to provide services as custodian.
- e. Both sponsored and unsponsored DRs can be issued on the back of Permissible Securities. Unsponsored DRs can be issued on the back of listed Permissible *only* if two conditions are fulfilled viz., (i) DRs give the holder the right to issue voting instructions and (ii) the DRs are listed on an international exchange.
- f. A company, whether listed or unlisted, can issue shares for issue of DRs only in permissible jurisdictions (“**Permissible Jurisdictions**”). As per the New Scheme, a Permissible Jurisdiction would be a foreign jurisdiction that satisfies twin requirements i.e. the foreign jurisdiction is a member of the FATF and the securities regulator of that jurisdiction is a member of IOSCO.
- g. The New Scheme does not prescribe any specific pricing norms for issuance of DRs. The only restriction imposed under the New Scheme is that Permissible Securities shall not be issued to a foreign depository at a price less than the price applicable to a corresponding mode of issue of such securities to domestic

investors under applicable laws. Pricing of ADR / GDR issues shall be done in accordance with the pricing guidelines issued under FEMA. For the purpose of issue of depository receipts for listed companies, the minimum pricing norms as applicable under the SEBI Guidelines shall be complied with.

- h. There are no end-use restrictions on the deployment of proceeds from issuance of DRs.
- i. Voting rights should be exercised by the foreign depository in respect of underlying securities; the depository may take instructions from DR holders. If the DR holders have the right to instruct the depository to vote on their behalf, they would have the same obligations as if it is the holder of the underlying equity shares under the Takeover Code. Also, shares of a company underlying the DRs shall form part of 'public shareholding' (i) if the holder of the securities has the right to issue voting instructions and (ii) such DRs are listed on an international stock exchange.

## V. Externalisation

One of the means of exit for shareholders of a company and also a way of accessing global

public capital is by setting up of an OHC. In this structure, the promoter flips his interest in the Indian company to an OHC set up in a tax optimized jurisdiction which can be used to raise global capital offshore or to give an exit to offshore investors. In externalization, while exiting one should take into account potential tax liability due to indirect transfer. Please refer to Chapter 4 for a detailed analysis on taxation of indirect transfers.

While deciding the country for setting up of an OHC, the investor should broadly consider the following points:

- i. whether the country is a sophisticated and reputed jurisdiction with an established banking framework and a well-developed corporate law system;
- ii. whether the country has an independent, efficient and mature judicial system;
- iii. if the country has a treaty with India for the avoidance of double taxation or not and what are terms of the treaty; and
- iv. if the country have treaties for avoidance of double taxation with other major jurisdictions; and
- v. what is the corporate tax rate in that country.

## 6. Dispute Resolution

To address the long standing requirement for a stable and efficient dispute resolution system ensuring quick enforcement of contracts, the Government has introduced host of measures for speedy resolution of the commercial disputes. Some of the key measures in this regard are set out below:

- The Commercial Courts, Commercial Division and Commercial Appellate Division of High Courts Act, 2015 (“**Commercial Courts Act**”)

The Commercial Courts Act provides for the establishment of commercial courts in India, which will have jurisdiction to try commercial disputes of a value not less than INR 10 million (USD 150,000). Further, the Commercial Courts Act has streamlined the processes and expedited proceedings, with an estimated time line of approximately 16 weeks to complete a dispute. Global practices such as holding of case management hearing and “*cost to follow event*” have been introduced. Further, institution of appeals needs to be done within 60 days from the date of decision and appeals need to be disposed within 6 months.

- The Arbitration and Conciliation (Amendment) Act, 2015 (“**Arbitration Amendment Act**”)

The Arbitration Amendment Act brought in certain key changes such as putting in place 12 month deadline for completion of arbitration, deeming interim orders passed by arbitral tribunals as orders of court, ability to involve third parties in arbitrations seated in India, which have in fact taken India beyond the global standards.

- The Bankruptcy and Insolvency Code, 2016 (the “**Code**”)

The Bankruptcy Code seeks to create a framework to expeditiously resolve insolvency and bankruptcy issues and the process of money recovery. Reform of bankruptcy laws was long overdue and was necessary to improve the ease of doing business in India and for meeting global standards. The Code marks a radical change in the field of insolvency with the creation of a specialized cadre of insolvency professionals, an

integrated adjudicatory body for conducting / supervising the process of insolvency resolution and liquidation and specialized regulatory bodies. The constitution of the National Company Tribunal and the National Company Law Appellate Tribunal are important steps in the long march towards creating a specialized institution for insolvency proceedings.

These amendments have taken into consideration the present requirements and provided for an expeditious and efficient resolution of commercial disputes. The intent is to look at these regimes of court processes and arbitration proceedings to complement each other. However, in scenarios where a foreign party face a dispute with an Indian party in a cross border agreement, it would be advisable for the parties to refer their disputes to arbitration rather than litigate under the general civil laws of dispute resolution, which could be an expensive and time consuming alternative to arbitration.

Further, though a series of judicial decisions in the first decade of the new millennium showed a lack of pro-arbitration approach by the Indian judiciary while interpreting arbitration laws, the trend is changing and Indian courts are increasingly adopting a pro-arbitration approach and reducing unnecessary judicial interference in arbitral proceedings. Arbitration in India can be of two types, ad hoc and institutional, the advantages of institutional arbitration over ad hoc arbitration are as follows:

1. Availability of pre-established rules and procedures which assure that arbitration will get off the ground and proceed to conclusion expeditiously;
2. Administrative assistance from institutions providing a secretariat or court of arbitration;
3. Lists of qualified arbitrators, often categorized by fields of expertise;
4. Physical facilities and support services for arbitrations and
5. An established format with a proven record.

The major institutional arbitration centers in India are the Mumbai Center for International Arbitration, Delhi International Arbitration Centre and Nani Palkhivala Arbitration Centre. Further, the Singapore International Arbitration Centre (SIAC) entered into a Memorandum of Agreement with the Gujarat International Finance Tec-City Company Limited (GIFTCL) to collaborate to promote and resolve international commercial disputes in India's International Financial Services Centre in Gujarat International Finance Tec-City (IFSC-GIFT).

Furthermore, the government constituted the much awaited National Company Law Tribunal ("NCLT") which is expected to consolidate multiple forums which currently exist for resolving company law matters and bring about speed and efficiency in resolution of company matters. NCLT was originally contemplated in the Companies (Second Amendment) Act, 2002, however, it took considerable amount of time to constitute the tribunal.

## I. Impact of introduction of NCLT

1. Currently matters involving same companies or parties would be spread across various forums such as High Courts for winding up and merger/amalgamation schemes, CLB for oppression and mismanagement and before the Board of Industrial Financial Reconstruction ("BIFR") pursuant to reference under Sick Industrial Companies Act, 1985. On multiple occasions litigants would adopt approach of moving before various forums causing multiplicity of proceedings and delays. The NCLT aims at consolidating the various forums and providing a one stop shop for adjudication of company matters.
2. The NCLT and NCLAT are expected to dispose-off appeals, applications and petitions filed before it within a period of 3 months from the date of the filing.<sup>44</sup>

3. Currently the High Courts were burdened with company matters including winding up proceedings. Transfer of such proceedings to NCLT is expected to reduce the burden. Additionally, as appeal from an order of NCLT will lie before the NCLAT, High Courts will have a further reduced burden, considering that earlier, appeal from the order of Company Law Board was filed before High Court. However, an area of concern is that NCLAT may be faced with a very high volume of appeals which earlier stood divided amongst various High Courts. Thus there would be a need for multiple members of the NCLAT. However considering the requirements for being appointed as a member of the NCLAT are fairly high, there may be a dearth of such members causing delay in disposition of appeals.
4. With the notification of the provisions of the Bankruptcy Code, NCLT would form a forum offering a completely new and improved process for liquidation of companies in India.

## II. Class Action

A much awaited reform brought into effect along with the introduction of the NCLT, is the statutory remedy of class action proceedings. Class action proceedings are one where a group or class of people similarly affected can initiate a proceeding collectively. This allows to reduce time and costs and also inspires confidence amongst the parties as they act collectively. Currently, class action proceedings were initiated in form of representative's suits, minority action for oppression & mismanagement, proceedings before the consumer forums or through public interest litigation. However, none of these provided a holistic remedy.

A dearth of such remedy was felt particularly in the wake of the *Satyam Scam*, where the public shareholders in India had no remedy as opposed to the bondholders in the United States. With the notification of Section 245 of the Companies Act, 2013, members and depositors in a company have the additional remedy in form of class action proceedings which could be initiated before the NCLT. The

44. Section 422 of the Companies Act, 2013

recent surge in shareholder activism in India, makes the introduction of class actions remedy highly interesting. It is a critical tool in the hand of minority shareholders who may question the decisions made by the management and the intent thereof.

Arbitration Act and the constitution of NCLT marks another seminal shift in the Indian judicial landscape and clearly demonstrates that the judicial system is turning for the better. Further,

the notification of the provisions of Bankruptcy Code is imminent and it is expected that upon such notification NCLT would take over the corporate insolvency matter from courts, and the Government's commitment to making India into an arbitration friendly country could serve as an International Arbitration hub for the world. This is being exemplified by amending the existing law and bringing it at par with international standards.

# Annexure I

## Debt Funding in India

The ECB Route is a highly regulated investment route. Typically, in the nature of commercial loans to eligible resident Indian entities, ECBs can be raised through secured NCDs and OCDs issued by the eligible resident Indian entities.

However, it may be noted that NCDs issued to FPIs shall not be construed to be investments routed through the ECB Route. Provisions regarding ECB are further included in the following regulations framed under FEMA:

- Foreign Exchange Management (Borrowing or Lending in Foreign Exchange) Regulations, 2000; and
- Foreign Exchange Management (Guarantees) Regulations, 2000, notified vide Notification No. FEMA 8/2000-RB dated May 03, 2000.

The ECB framework has been governed by the regulations of the RBI framed under the Foreign Exchange Management Act, 1999 (“**FEMA**”), and the ‘Master Direction – External Commercial Borrowings, Trade Credit, Borrowing and Lending in Foreign Currency by Authorised Dealers and Persons other than Authorised Dealers’ (the “**ECB Master Direction**”). The RBI on January 16, 2019 has by way of a circular (“**Circular**”) revised the entire existing regulatory framework for ECBs in India. The RBI has substantially relaxed the regime for ECBs. The changes (detailed in the link below) have removed almost all restrictions on eligible lenders and eligible borrowers and have substantially expanded the scope of end-use restrictions.

## I. External Commercial Borrowings: Regulatory Framework Substantially Relaxed

- Regulatory framework for ECBs substantially liberalized.
- Basket of eligible lenders expanded and end-use restrictions limited.
- Eligible borrowers substantially expanded, and includes LLPs

Funding Indian corporates through debt has been traditionally been a preferred mode of funding due to inherent advantages such as security creation, minimum guaranteed returns and tax optimization for both the lender as well as the borrower. The modes for offshore debt funding have been limited to external commercial borrowings (“**ECB**”), non-convertible debentures (“**NCD**”), compulsorily convertible debentures and certain hybrid debt instruments. Each of these options have been subjected to regulatory restrictions in terms of eligible lenders, eligible borrowers, end-use restrictions, etc. Tightening of the NCD route (see hotline here), and the introduction of Rupee-denominated bonds under the ECB route (see hotlines here and here) have seen the ECB route gain more prominence as a preferred route, despite the challenges in the route for parties.

The Reserve Bank of India (“RBI”) has now revised the framework substantially relaxing the regime for ECBs. The changes have removed almost all restrictions on eligible lenders and eligible borrowers and have substantially expanded the scope of end-use restrictions.

## A. Background

The ECB framework has been governed by the regulations of the RBI framed under the Foreign Exchange Management Act, 1999 (“FEMA”), and the ‘Master Direction – External Commercial Borrowings, Trade Credit, Borrowing and Lending in Foreign Currency by Authorised Dealers and Persons other than Authorised Dealers’ (the “ECB Master Direction”). The RBI on January 16, 2019 has by way of a circular (“Circular”) revised the entire existing regulatory framework for ECBs in India.

## B. Changes

### ■ *Forms of ECB*

#### Existing regulatory framework

- Track I and Track II: Foreign currency ECB
- Track III: Rupee denominated ECB
- Rupee denominated bonds (“RDB”) as a separate category

#### Revised framework introduced under the Circular

- Option 1: Track I and Track II ECBs clubbed as ‘Foreign currency denominated ECB’ (“FCY ECB”)
- Option 2: Track III and Rupee denominated bonds clubbed as INR denominated ECB (“INR ECB”)

### ■ *Eligible borrowers*

#### Existing regulatory framework

- Track I, Track II and Track III: Specified entities – engaged in particular activities
- RDB: Any corporate / body corporate / Real Estate Investment Trusts / Infrastructure Investment Trusts.

#### Revised framework introduced under the Circular

- FCY ECB: All entities eligible to receive foreign direct investment (“FDI”)
- INR ECB: Same as FCY ECB, i.e. all entities eligible to receive FDI.

### ■ *Eligible lenders*

#### Existing regulatory framework

- Track I, Track II and Track III: Specified entities – engaged in particular activities
- RDB: Any corporate / body corporate / Real Estate Investment Trusts / Infrastructure Investment Trusts.

#### Revised framework introduced under the Circular

- FCY ECB: All entities eligible to receive foreign direct investment (“FDI”)
- INR ECB: Same as FCY ECB, i.e. all entities eligible to receive FDI.

**Takeaway:** One of the most important considerations for determining if ECB was a viable option for raising offshore debt was whether the proposed borrower is eligible to raise ECB. This was often considered to be a substantial bottleneck, considering that the ECB framework also provided for end-use restrictions in terms of the funds raised through the ECB (see below).

The RBI has now done away with the specific eligibility requirements, and prescribed that any entity eligible to raise FDI shall be permitted to raise ECB. This is a positive move in considering that the list of entities eligible to raise FDI are sufficiently regulated in any case under the regulations applicable to FDI. The specific permission for real estate investment trusts and infrastructure investment trusts have been removed since FDI is permitted in such entities, and they would qualify for availing ECB in any case. Basis the same logic, an interesting aspect to be noted here is that FDI is also permitted in certain limited liability partnerships (“LLP”), and hence ECB may also be availed of by LLPs. It is unclear if the RBI intended to open the ECB route for LLPs as well, but if this is the case, it would provide a much needed encouragement to LLPs as well, and may result in growth in the number of LLPs used for structuring investments.

▪ **Eligible lenders**

**Existing regulatory framework**

- Track I, Track II and Track III: Specified entities – engaged in particular activities
- RDB: Any resident of a country (i) which is a member of the Financial Action Task Force (FATF) (or a member of a FATF style regional body); or (ii) whose securities market regulator is (a) a signatory to International Organization of Securities Commissions Multilateral Memorandum of Understanding or (b) a signatory to bilateral memorandum of understanding with SEBI for information sharing arrangements. ‘Related parties’ of the borrowing entity are not entitled to invest in the RDBs being issued.

**Takeaway:** The Circular revises the persons who are eligible to be lenders under the ECB framework. While earlier specified persons were only entitled to be eligible lender (under the 3 tracks), the RDB route was preferred since there was no specific requirement on a person to be an eligible lender. However, by now having the same eligibility for lenders under the FCY ECB and INR ECB, lenders who were not eligible under track I and track II are also now eligible. This would provide a major push for such lenders, who wanted to lend in foreign currency, but were unable to due to ineligibility as lenders. This also broadens the options available for potential lenders under the ECB framework.

Another major benefit of the changes introduced under the Circular is the removal of the restriction on related parties (defined under the applicable accounting standard) to invest in RDBs. Captive lending, i.e. lending by parent companies to its Indian subsidiaries has often been a preferred mode of investment into subsidiaries by offshore parents. However, this restriction on subscription of RDBs by related parties resulted in this option being unavailable to parent companies till now. The removal of the restriction would also provide offshore parents the option to invest through RDBs.

**Revised framework introduced under the Circular**

- FCY ECB and INR ECB:
- All residents of a FATF or IOSCO compliant country.
  - Individuals are eligible to be lenders under the ECB framework if they are foreign equity holders (i.e. hold 26% directly or 51% indirectly in the borrower).

### ■ *Minimum average maturity period*

#### Existing regulatory framework

- Track I: Minimum average maturity period (“**MAMP**”) of 3 years for ECB of up to USD 50 million, and 5 years for ECB of above USD 50 million (save certain exceptions);
- Track II: MAMP of 10 years;
- Track III: MAMP of 3 years for ECB of up to USD 50 million, and 5 years for ECB of above USD 50 million (save certain exceptions);
- RDB: MAMP of 3 years for ECB of up to USD 50 million, and 5 years for ECB of above USD 50 million (save certain exceptions). Call / put options (if any) also to comply with the MAMP.

#### Revised framework introduced under the Circular

FCY ECB and INR ECB: MAMP of 3 years (irrespective of amount). However, for ECB raised from foreign equity holders for general corporate / working capital purposes, the MAMP is 5 years.

**Takeaway:** The Circular has removed the distinction between the MAMP applicable under the various tracks and RDB. The new ECB framework has a single MAMP applicable to both FCY ECB as well as INR ECB. This is a welcome step since the distinguishing factor between the various tracks was becoming redundant. For instance, the long MAMP under Track II was proving to be a deterrent for parties to avail ECB under Track II.

### ■ *End-use restrictions*

#### Existing regulatory framework

- Track I and Track III: The end use restrictions are (a) real estate / purchase of land; (b) investment in capital market; (c) equity investments; (d) working capital purposes or general corporate purposes; (e) repayment of Rupee loans; and (f) on-lending for the above activities;
- Track II: The end use restrictions are (a) real estate / purchase of land; (b) investment in capital market; (c) equity investments; and (d) on-lending for the above activities;
- RDB: The end use restrictions are (a) real estate / purchase of land; (b) investment in capital market; (c) equity investments; (d) activities prohibited as per FDI guidelines; and (d) on-lending for the above activities.

#### Revised framework introduced under the Circular

FCY ECB and INR ECB: The end use restrictions in case of both FCY ECB and INR ECB are (a) real estate activities; (b) investment in capital market; (c) equity investments; (d) repayment of Rupee loans (except if from foreign equity holder); (e) working capital purposes and general corporate purposes (except if from foreign equity holder); and (f) on-lending for the above activities.

**Takeaway:** While the Circular has sought to simplify and harmonize the end-use restrictions across the various tracks and RDB by prescribing a single negative / restrictive end-use prescription. However, an unwanted implication of the harmonizing the end-use restriction is that the restrictions that were not applicable to Track II and RDBs earlier (most notably being general corporate purpose and working capital purposes) are now applicable to them. This could have major implications for ECBs through RDBs, since general corporate purposes / working capital purposes was one of the pre-dominant purposes for which ECB was raised.

The Circular has removed the distinction between the MAMP applicable under the various tracks and RDB. The new ECB framework has a single MAMP applicable to both FCY EBC as well as INR ECB. This is a welcome step since the distinguishing factor between the various tracks was becoming redundant. For instance, the long MAMP under Track II was proving to be a deterrent for parties to avail ECB under Track II.

## C. Conclusion

The revision of the regulatory framework for ECB by the RBI is a positive step in simplifying the extant regime for ECB, and has resulted in substantial easing of the regime for debt funding by foreign corporates. The tax sops that have been introduced for ECBs, coupled with relaxation on LLPs raising ECBs, bucket of eligible lenders and the purpose for which ECBs can be raised, should encourage further ECB flows into the country.

The Monetary Policy Committee of the RBI on February 7, 2019 issued its 'Sixth Bi-monthly Monetary Policy Statement, 2018-19' and also issued the 'Statement on Developmental and Regulatory Policies' The 'Statement on Developmental and Regulatory Policies' ("**RBI Statement**") has proposed a number of regulatory changes such as permitting ECBs to be raised for refinancing rupee debt in certain cases, removal of certain concentration norms, harmonizing categories of non-banking financial companies ("**NBFC**") and amending risk weightage for NBFC. Some of the changes are expected to have substantial bearing on debt raising options by Indian corporates.

## II. Debt Funding: India Inc. Gets More To Cheer

While debt funding has been the preferred mode of investment, historically India has offered very few routes for offshore debt investment into Indian entities. Over the last 18 – 24 months, the government and the exchange control regulator, the Reserve Bank of India ("**RBI**") have been relaxing regulatory norms around debt funding, especially overseas debt funding. Recently, the regulatory regime for the external commercial borrowings ("**ECB**") was overhauled in a substantially liberalized manner.<sup>45</sup>

### A. Background

The Monetary Policy Committee of the RBI on February 7, 2019 issued its 'Sixth Bi-monthly Monetary Policy Statement, 2018-19' and also issued the 'Statement on Developmental and Regulatory Policies'<sup>46</sup> The 'Statement on Developmental and Regulatory Policies' ("**RBI Statement**") has proposed a number of regulatory changes such as permitting ECBs to be raised for refinancing rupee debt in certain cases, removal of certain concentration norms, harmonizing categories of non-banking financial companies ("**NBFC**") and amending risk weightage for NBFC. Some of these changes are expected to have substantial bearing on debt raising options by Indian corporates. In this hotline, we have dealt with some of the important changes proposed in the RBI Statement, and the potential impact of the same.

45. For a detailed analysis on this, please refer to our hotline available here. [Link: [http://www.nishithdesai.com/information/research-and-articles/nda-hotline/nda-hotline-single-view/article/external-commercial-borrowings-regulatory-framework-substantially-relaxed.html?no\\_cache=1&cHash=225dfoar15bad7dc66b993edb783fe9f8](http://www.nishithdesai.com/information/research-and-articles/nda-hotline/nda-hotline-single-view/article/external-commercial-borrowings-regulatory-framework-substantially-relaxed.html?no_cache=1&cHash=225dfoar15bad7dc66b993edb783fe9f8)]

46. Available here and here respectively [links [https://www.rbi.org.in/Scripts/BS\\_PressReleaseDisplay.aspx?prid=46235](https://www.rbi.org.in/Scripts/BS_PressReleaseDisplay.aspx?prid=46235) and [https://www.rbi.org.in/Scripts/BS\\_PressReleaseDisplay.aspx?prid=46237](https://www.rbi.org.in/Scripts/BS_PressReleaseDisplay.aspx?prid=46237)]

## B. Regulatory Changes Proposed

### ■ Raising of ECBs for companies under the CIRP process

The RBI under the RBI Statement decided to permit ECB to be raised for refinancing of Rupee loans of corporates which are under the corporate insolvency resolution process (“CIRP”) of the Insolvency and Bankruptcy Code, 2016 (“IBC”). This was not allowed under the current regulations, and ECB could only be used to retire foreign debt. The RBI has also issued a Circular on February 7, 2019<sup>47</sup> amending the existing ECB framework to permit this.

With the introduction of the IBC, a large number of companies have gone / are undergoing the CIRP. Under the CIRP process, potential bidders prepare and submit resolution plans which are evaluated by lenders of the company under the CIRP process (known as ‘corporate debtor’). One of the main features of the resolution plans for large companies has been the manner in which the existing outstanding debt has been dealt with by bidders. These include repayment of existing debt, restructuring existing debt and even refinancing existing debt. In most of the important cases thus far, the amounts owed by the corporate debtor have been substantially large, running into billions of dollars. In these cases, refinancing of existing debt has not been feasible for bidders. Restructuring of loans (where lenders have agreed to re-set interest rate, repayment schedules and moratorium) have been preferred by bidders, but this has faced hurdles by lenders (mainly being banks and financial institutions) wanting to completely exit their exposure from these stressed companies.

The only other option open for dealing with existing debt is refinancing of loans. Considering the quantum of loans involved, funding from resident sources (mainly banks) have been a challenge. This coupled with restriction on Indian banks to lend for acquisition financing restricted borrowing in India by potential acquirers. Borrowing offshore

was considered more palatable to bidders, especially to non-resident bidders, since they could raise such leverage on the back of their global financial wherewithal and at more competitive rates. These funds could be raised in two modes – raising acquisition financing offshore and then using the funds to acquire the target in India and repay the existing loan through fresh investment into the target; or by re-financing existing loans. The former was not preferred by bidders, since the inability of the target to benefit from interest expense in India made it tax inefficient. In addition, the funds raised were directly on the books of the acquirers / bidders, instead of the target. The other option of refinancing existing debt is generally preferred by all bidders.

Most of the debt raised from offshore banks and financial institutions are by way of ECBs. However, the ECB norms prohibit ECB to be raised for certain end-uses, which include refinancing of Rupee loans. This restricted the ability of potential bidders to raise ECBs for refinancing debt. To further encourage bids under the IBC, the RBI Statement has now proposed to permit ECBs to be raised for refinancing of Rupee loans of companies under the CIRP process. The RBI has, on February 7, 2019 issued a Circular<sup>48</sup> permitting companies under CIRP to raise funds under the ECB route for the purpose of refinancing existing Rupee loans. These are however, subject to certain conditions, being (i) the company under the CIRP, which shall be the borrower shall be an eligible borrower generally; and (ii) the raising of the ECB shall be under the automatic route.

The relaxation in the end-use restriction for ECB should provide a major fillip to potential bidders under the CIRP process, considering that they are now entitled to raise fresh ECB in the target for refinancing both Rupee and foreign currency loans.

### ■ Relaxation of risk-weightage of lending by banks to NBFCs

Under the existing regulatory framework applicable, banks lending to NBFCs are required to have a risk-weightage of 100% for all lending to NBFCs.

47. A.P. (DIR Series) Circular No. 18 dated February 7, 2019 available online at <https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=11472&Mode=0>

48. A.P. (DIR Series) Circular No. 18 dated February 7, 2019 available online at <https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=11472&Mode=0>

The RBI Statement has proposed to remove the requirement for banks to maintain a risk weightage of 100% uniformly and instead apply a risk-weighted approach based on ratings assigned by rating agencies.

Banks lending to NBFCs are required to assign a 100% risk weightage to such loans, thereby requiring banks to provision for such loans. This meant that a substantial portion of the bank's capital was blocked. This was considered to be a harsh requirement, considering some of these NBFCs were strong financially and did not merit a 100% risk weightage. To ensure that the risk-weightage was aligned to the actual risks involved, the RBI Statement now proposes that the risk weightage of loans to NBFCs by banks be linked to the actual risks involved, based on the ratings assigned to such NBFCs by accredited rating agencies. This is in line with the risk-weightage involved in lending by banks to corporates. This is a positive move and would free up additional capital on the balance sheet of banks, encouraging more lending by banks. The change however, excludes core investment companies ("CIC") from its purview, thereby meaning that banks would still need to assign a 100% risk weightage for loans offered to CICs.

The official circulars to effect such changes are awaited.

- **Relaxation in concentration norms for FPI investments**

Foreign Portfolio Investor ("FPI") investments into non-convertible debentures ("NCD") issued by Indian corporates have been subjected to certain credit concentration norms since 2018 whereby no FPI was permitted to invest in excess of 20% of its total debt portfolio into a single corporate group. The RBI Statement has now proposed to remove this 20% restriction.

One of the most widely used routes for debt investments into India till early 2018 was investment through NCD under the FPI regime. In April – May 2018, the SEBI and the RBI introduced credit concentration / diversification norms to provide for the maximum portion of a debt issuance that a single FPI can invest, and also concentration norms for an FPI, i.e. the maximum portion of an FPI's portfolio

that it can invest in a single corporate entity, along with its group entities.

RBI's circular No. 24 dated April 27, 2018 ("**FPI Circular**") prescribed that an FPI cannot invest more than 20% of its debt portfolio in a single corporate entity (along with its group companies). FPIs were required to comply with this requirement effective March 31, 2019.

However, FPIs were facing substantial challenges to meet this diversification requirement. The introduction of the 50% limitation on FPIs to invest in a single debt issuance has already resulted in substantial reducing of debt inflows into Indian corporates. Further, the requirement to diversify meant that FPIs were compelled to invest in multiple deals in a short span of time to ensure that the 20% restrictions are not breached. This requirement was putting further strain on FPIs to invest into India. The removal of this restriction is going to provide a major push to NCD investments by FPIs into India.

While the removal of the 20% concentration norm is an extremely positive move, the 50% limit is proving to be a much greater impediment to FPIs for their investments into India. The removal of this restriction would provide FPI- NCD investments the shot in the arm they seek.

The formal notification of the RBI and SEBI removing the credit concentration norms are still awaited.

- **Harmonization of NBFCs**

The RBI Statement also proposes to harmonize various NBFCs to shift from an NBFC based regulatory regime to an activity based regulatory regime.

There are various categories of NBFCs under the RBI guidelines<sup>49</sup> and the rationale for the categorization has been questioned time and time again. The RBI Statement proposes to now harmonize the NBFCs based on activities. Accordingly, the RBI Statement has proposed to harmonize NBFCs in credit

49. Asset finance companies, investment company, loan company, infrastructure finance company, core investment company, infrastructure debt fund, NBFC – micro finance institution, NBFC – factors, mortgage guarantee companies and NBFC – Non-operating financial holding companies

intermediation, vis-à-vis asset finance companies, loan companies and investment companies into a single category. The final notification in this regard is still awaited and it is to be seen how the RBI decides to implement these NBFCs, considering these categories has different requirements and regulatory framework. It is likely that the RBI would prefer a phased approach whereby it requires the NBFCs being merged into a single class to start complying with the applicable regulations over a period of time. Further, it is also to be seen how RBI looks at investment companies which do not raise funds from external sources, namely, core investment companies.

### III. Conclusion

The changes proposed by the RBI Statement would provide debt inflows into India a major push. Further, the changes to the risk weightage is also expected to encourage further lending by banks into NBFCs. While certain concerns have been addressed, the RBI Statement falls short in certain areas, such as removal of the 50% requirement, relaxing end-use restrictions for Rupee refinancing for companies not under the CIRP.

## Annexure II

### Specific Tax Risk Mitigation Safeguards for Private Equity Investments

In order to mitigate tax risks associated with provisions such as those taxing an indirect transfer of securities in India, buy-back of shares, etc., parties to M&A transactions may consider or more of the following safeguards.

- **Nil withholding certificate:** Parties could approach the income tax authorities for a nil withholding certificate. There is no statutory time period prescribed with respect to disposal of applications thereof, which could remain pending for long without any clarity on the time period for disposal. In the last few years, there have not been many instances of such applications that have been responded to by the tax authorities. However, recently, in January 2014, an internal departmental instruction was issued requiring such applications to be decided upon within one month. The extent to which the instruction is adhered to remains yet to be seen.
- **Advance Ruling:** Advance rulings obtained from the Authority for Advance Rulings (“AAR”) are binding on the taxpayer and the Government. An advance ruling may be obtained even in GAAR cases. The AAR is statutorily mandated to issue a ruling within six months of the filing of the application, however due to backlog of matters; it is taking about 8-10 months to obtain the same. However, it must be noted that an advance ruling may be potentially challenged in the High Court and finally at the Supreme Court.
- **Contractual representations:** Parties may include clear representations with respect to various facts which may be relevant to any potential claim raised by the tax authorities in the share purchase agreement or such other agreement as may be entered into between the parties.
- **Escrow:** Parties may withhold the disputed amount of tax and potential interest and penalties and credit such amount to an escrow instead of depositing the same with the tax authorities. However, while considering this approach, parties should be mindful of the opportunity costs that may arise because of the funds getting blocked in the escrow account.
- **Tax insurance:** A number of insurers offer coverage against tax liabilities arising from private equity investments. The premium charged by such investors may vary depending on the insurer’s comfort regarding the degree of risk of potential tax liability. The tax insurance obtained can also address solvency issues. It is a superior alternative to the use of an escrow account.
- **Legal opinion:** Parties may be required to obtain a clear and comprehensive opinion from their counsel confirming the tax liability of the parties to the transaction. Relying on a legal opinion may be useful to the extent that it helps in establishing the bona fides of the parties to the transaction and may even be a useful protection against penalties associated with the potential tax claim if they do arise.
- **Tax indemnity:** Tax indemnity is a standard safeguard used in most M&A transactions. The purchasers typically seek a comprehensive indemnity from the sellers for any tax claim or notice that may be raised against the purchaser whether in relation to recovery of withholding tax or as a representative assessee. The following key issues may be considered by parties while structuring tax indemnities:

- *Scope:* The indemnity clause typically covers potential capital gains tax on the transaction, interest and penalty costs as well as costs of legal advice and representation for addressing any future tax claim.
- *Period:* Indemnity clauses may be applicable for very long periods. Although a limitation period of seven years has been prescribed for reopening earlier tax cases, the ITA does not expressly impose any limitation period on proceedings relating to withholding tax liability. An indemnity may also be linked to an advance ruling.
- *Ability to indemnify:* The continued ability and existence of the party providing the indemnity cover is a consideration to be mindful of while structuring any indemnity. As a matter of precaution, provision may be made to ensure that the indemnifying party or its representatives maintain sufficient financial solvency to defray all obligations under the indemnity. In this regard, the shareholder/s of the indemnifying party may be required to infuse necessary capital into the indemnifying party to maintain solvency. Sometimes back-to-back obligations with the parent entities of the indemnifying parties may also be entered into in order to secure the interest of the indemnified party.
- *Conduct of proceedings:* The indemnity clauses often contain detailed provisions on the manner in which the tax proceedings associated with any claim arising under the indemnity clause may be conducted.
- *Dispute Resolution Clause:* Given that several issues may arise with respect to the interpretation of an indemnity clause, it is important that the dispute resolution clause governing such indemnity clause has been structured appropriately and covers all important aspects including the choice of law, courts of jurisdiction and/or seat of arbitration. The dispute resolution mechanism should take into consideration urgent reliefs and enforcement mechanisms, keeping in mind the objective of the parties negotiating the master agreement and the indemnity.

## Annexure III

### Bilateral Investment Treaties

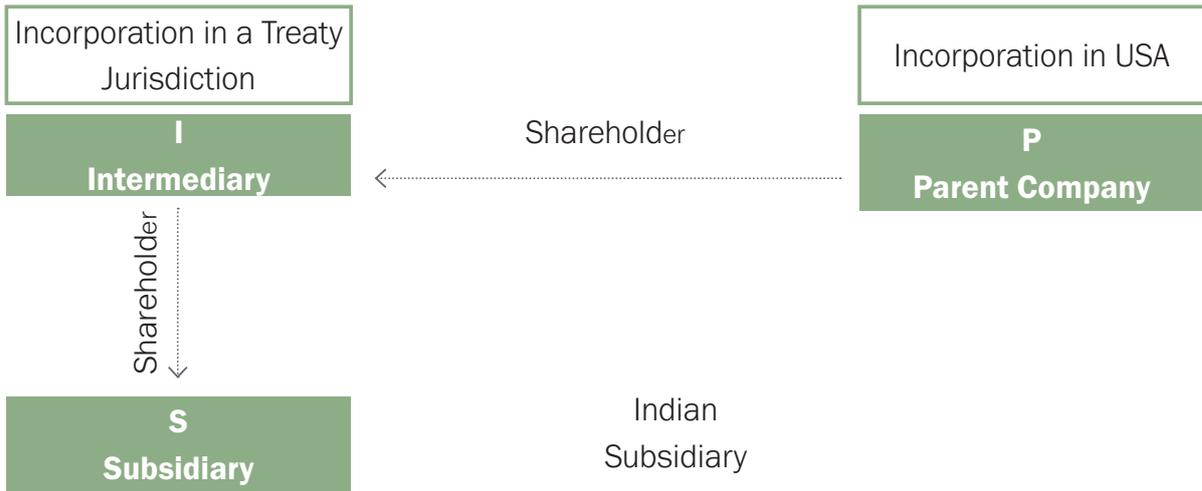
India has entered into several BITs and other investment agreements. Relying on the BITs in structuring investment into India, may be the best way to protect a foreign investor's interest. Indian BITs are very widely worded and are severally seen as investor friendly treaties. Indian BITs have a broad definition of the terms 'investment' and 'investor'. This makes it possible to seek treaty protection easily through corporate structuring. BITs can also be used by the investors to justify the choice of jurisdiction when questioned for GAAR.

The model clauses for Indian BITs include individuals and companies under the definition of an "investor". Further, companies are defined to include corporations, firms and associations. More importantly, Indian BITs adopt the incorporation test to determine the nationality of a corporation. This is a very beneficial provision as a holding company, which even though is merely a shell company, would not be excluded from treaty benefits.

Further, the word "investment" is defined to include every kind of asset established or acquired including changes in the form of such investment, in accordance with the national laws of the contracting party in whose territory the investment. It specifically includes the following within the ambit of investment:-

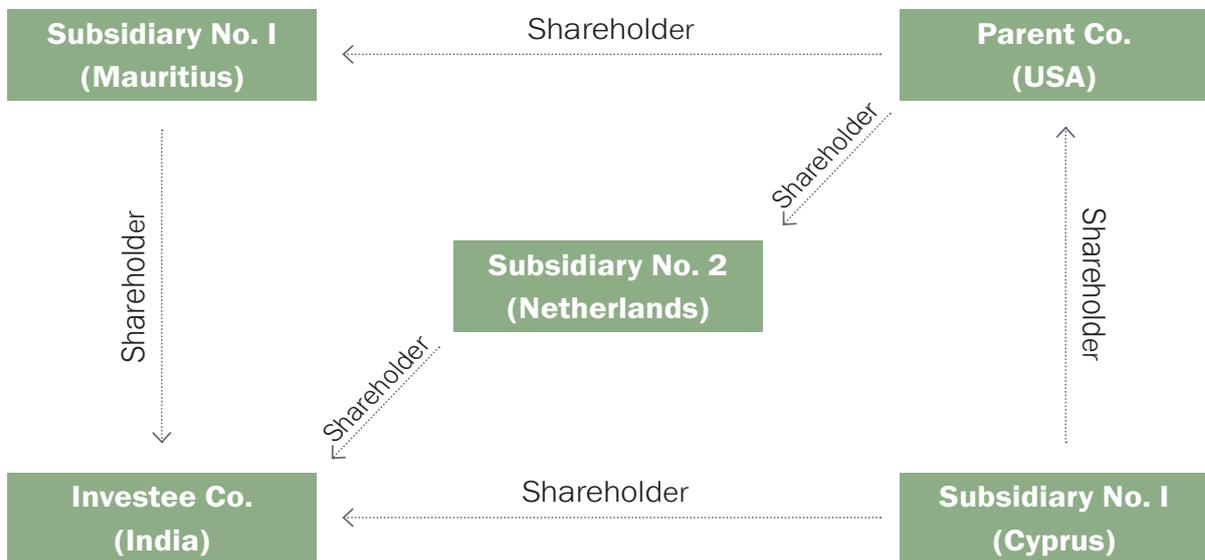
- i. movable and immovable property as well as other rights such as mortgages, liens or pledges;
- ii. shares in and stock and debentures of a company and any other similar forms of participation in a company;
- iii. rights to money or to any performance under contract having a financial value;
- iv. intellectual property rights, in accordance with the relevant laws of the respective contracting party; and
- v. business concessions conferred by law or under contract, including concessions to search for and extract oil and other minerals.

The benefit of this is that even if the foreign parent or subsidiary is merely a shareholder in a locally incorporated Indian company, they would be able to espouse claims under the treaty by the virtue of their investment in the nature of shares in India. This again aids corporate structuring and enables an investor to achieve maximum treaty benefits. Thus, if the parent company incorporated within a non-treaty jurisdiction (P), carries out operation in India through an Indian subsidiary (S) which is held through an intermediary incorporated within a treaty jurisdiction (I), the parent company can seek protection of their investment in the subsidiary through the treaty benefits accrued to the intermediary (See fig 1).



**Fig 1: Operations through an India subsidiary which is held through an intermediary in a treaty jurisdiction.**

Further, it is an established principle under international law that minority shareholder rights too are protected under BITs. This gives a right to the non-controlling shareholders to espouse claims for losses to their investments. This also enables an investor to diversify its investments through different treaty jurisdictions which will enable the investor to bring multiple claims under different proceedings to ensure full protection of one’s investment (See fig. 2). The exact right guaranteed to a particular structure will vary on case to case basis and can be achieved to the satisfaction of the investors by pre-analyzing treaty benefits at the time of making the investments.



**Fig 2: Investment in Indian Investee Company through multiple Subsidiaries in different treaty jurisdiction.**

An important point further in favour of the foreign investor investing in India is that India has lucrative BITs with almost all tax efficient jurisdictions including Mauritius, Netherlands, Switzerland, Cyprus, Singapore etc. This enables an investor to achieve maximum benefit from one’s investment.

The following research papers and much more are available on our Knowledge Site: [www.nishithdesai.com](http://www.nishithdesai.com)

	<b>Fund Formation: Attracting Global Investors</b>		<b>Social Impact Investing in India</b>		<b>The Curious Case of the Indian Gaming Laws</b>
	February 2019		July 2018		February 2018
	<b>Corporate Social Responsibility &amp; Social Business Models in India</b>		<b>Incorporation of Company LLP in India</b>		<b>Outbound Acquisitions by India-Inc</b>
	March 2018		February 2019		September 2014
	<b>Internet of Things</b>		<b>Doing Business in India</b>		<b>Private Equity and Private Debt Investments in India</b>
	January 2017		September 2018		May 2019

## NDA Insights

TITLE	TYPE	DATE
Blackstone's Boldest Bet in India	M&A Lab	January 2017
Foreign Investment Into Indian Special Situation Assets	M&A Lab	November 2016
Recent Learnings from Deal Making in India	M&A Lab	June 2016
ING Vysya - Kotak Bank : Rising M&As in Banking Sector	M&A Lab	January 2016
Cairn – Vedanta : 'Fair' or Socializing Vedanta's Debt?	M&A Lab	January 2016
Reliance – Pipavav : Anil Ambani scoops Pipavav Defence	M&A Lab	January 2016
Sun Pharma – Ranbaxy: A Panacea for Ranbaxy's ills?	M&A Lab	January 2015
Reliance – Network18: Reliance tunes into Network18!	M&A Lab	January 2015
Thomas Cook – Sterling Holiday: Let's Holiday Together!	M&A Lab	January 2015
Jet Etihad Jet Gets a Co-Pilot	M&A Lab	May 2014
Apollo's Bumpy Ride in Pursuit of Cooper	M&A Lab	May 2014
Diageo-USL- 'King of Good Times; Hands over Crown Jewel to Diageo	M&A Lab	May 2014
Copyright Amendment Bill 2012 receives Indian Parliament's assent	IP Lab	September 2013
Public M&A's in India: Takeover Code Dissected	M&A Lab	August 2013
File Foreign Application Prosecution History With Indian Patent Office	IP Lab	April 2013
Warburg - Future Capital - Deal Dissected	M&A Lab	January 2013
Real Financing - Onshore and Offshore Debt Funding Realty in India	Realty Check	May 2012

## Research @ NDA

**Research is the DNA of NDA.** In early 1980s, our firm emerged from an extensive, and then pioneering, research by Nishith M. Desai on the taxation of cross-border transactions. The research book written by him provided the foundation for our international tax practice. Since then, we have relied upon research to be the cornerstone of our practice development. Today, research is fully ingrained in the firm's culture.

Our dedication to research has been instrumental in creating thought leadership in various areas of law and public policy. Through research, we develop intellectual capital and leverage it actively for both our clients and the development of our associates. We use research to discover new thinking, approaches, skills and reflections on jurisprudence, and ultimately deliver superior value to our clients. Over time, we have embedded a culture and built processes of learning through research that give us a robust edge in providing best quality advices and services to our clients, to our fraternity and to the community at large.

Every member of the firm is required to participate in research activities. The seeds of research are typically sown in hour-long continuing education sessions conducted every day as the first thing in the morning. Free interactions in these sessions help associates identify new legal, regulatory, technological and business trends that require intellectual investigation from the legal and tax perspectives. Then, one or few associates take up an emerging trend or issue under the guidance of seniors and put it through our "Anticipate-Prepare-Deliver" research model.

As the first step, they would conduct a capsule research, which involves a quick analysis of readily available secondary data. Often such basic research provides valuable insights and creates broader understanding of the issue for the involved associates, who in turn would disseminate it to other associates through tacit and explicit knowledge exchange processes. For us, knowledge sharing is as important an attribute as knowledge acquisition.

When the issue requires further investigation, we develop an extensive research paper. Often we collect our own primary data when we feel the issue demands going deep to the root or when we find gaps in secondary data. In some cases, we have even taken up multi-year research projects to investigate every aspect of the topic and build unparalleled mastery. Our TMT practice, IP practice, Pharma & Healthcare/Med-Tech and Medical Device, practice and energy sector practice have emerged from such projects. Research in essence graduates to Knowledge, and finally to *Intellectual Property*.

Over the years, we have produced some outstanding research papers, articles, webinars and talks. Almost on daily basis, we analyze and offer our perspective on latest legal developments through our regular "Hotlines", which go out to our clients and fraternity. These Hotlines provide immediate awareness and quick reference, and have been eagerly received. We also provide expanded commentary on issues through detailed articles for publication in newspapers and periodicals for dissemination to wider audience. Our Lab Reports dissect and analyze a published, distinctive legal transaction using multiple lenses and offer various perspectives, including some even overlooked by the executors of the transaction. We regularly write extensive research articles and disseminate them through our website. Our research has also contributed to public policy discourse, helped state and central governments in drafting statutes, and provided regulators with much needed comparative research for rule making. Our discourses on Taxation of eCommerce, Arbitration, and Direct Tax Code have been widely acknowledged. Although we invest heavily in terms of time and expenses in our research activities, we are happy to provide unlimited access to our research to our clients and the community for greater good.

As we continue to grow through our research-based approach, we now have established an exclusive four-acre, state-of-the-art research center, just a 45-minute ferry ride from Mumbai but in the middle of verdant hills of reclusive Alibaug-Raigadh district. **Imaginarium AliGunjan** is a platform for creative thinking; an apolitical eco-system that connects multi-disciplinary threads of ideas, innovation and imagination. Designed to inspire 'blue sky' thinking, research, exploration and synthesis, reflections and communication, it aims to bring in wholeness – that leads to answers to the biggest challenges of our time and beyond. It seeks to be a bridge that connects the futuristic advancements of diverse disciplines. It offers a space, both virtually and literally, for integration and synthesis of knowhow and innovation from various streams and serves as a dais to internationally renowned professionals to share their expertise and experience with our associates and select clients.

We would love to hear your suggestions on our research reports. Please feel free to contact us at [research@nishithdesai.com](mailto:research@nishithdesai.com)

# Nishith Desai Associates

LEGAL AND TAX COUNSELING WORLDWIDE

## MUMBAI

93 B, Mittal Court, Nariman Point  
Mumbai 400 021, India

tel +91 22 6669 5000  
fax +91 22 6669 5001

## SILICON VALLEY

220 California Avenue, Suite 201  
Palo Alto, CA 94306-1636, USA

tel +1 650 325 7100  
fax +1 650 325 7300

## BANGALORE

Prestige Loka, G01, 7/1 Brunton Rd  
Bangalore 560 025, India

tel +91 80 6693 5000  
fax +91 80 6693 5001

## SINGAPORE

Level 30, Six Battery Road  
Singapore 049 909

tel +65 6550 9856

## MUMBAI BKC

3, North Avenue, Maker Maxity  
Bandra-Kurla Complex  
Mumbai 400 051, India

tel +91 22 6159 5000  
fax +91 22 6159 5001

## NEW DELHI

C-5, Defence Colony  
New Delhi 110 024, India

tel +91 11 4906 5000  
fax +91 11 4906 5001

## MUNICH

Maximilianstraße 13  
80539 Munich, Germany

tel +49 89 203 006 268  
fax +49 89 203 006 450

## NEW YORK

375 Park Ave Suite 2607  
New York, NY 10152

tel +1 212 763 0080