

Investment Funds: Monthly Digest

April 06, 2021

GIFT CITY – NEW INCENTIVES TO SET UP AIF'S IN INDIA'S FIRST INTERNATIONAL FINANCIAL-TEC CITY

GIFT CITY SNAPSHOT

Over the past few months there has been a flurry of developments involving the Gujarat Internal Finance Tech-City ("GIFT City"). New guidelines are being issued and MOUs executed with financial institutions on a weekly basis, all with the aim of incentivizing overseas financial institutions and overseas branches /subsidiaries of Indian financial institutions to bring to Indian shores those financial services transactions that are currently carried on outside India. The underlying key to this incentivization is the International Financial Services Centre ("IFSC") which is set up in the special economic zone ("SEZ") within GIFT City. While the IFSC is technically located on Indian soil, it is considered an offshore jurisdiction for foreign exchange purposes, allowing investors to invest in businesses located within the IFSC without having to comply with India's foreign exchange regime. Special tax incentives have also been provided to units located within the IFSC to further incentivize offshore investment and bring the IFSC at GIFT City on par with IFSCs globally.

Financial services providers located in the IFSC were originally regulated by various domestic financial regulators, namely RBI, SEBI, PFRDA and IRDAI; however, as of April 27, 2020 the International Financial Services Centres Authority ("IFSCA") has been established as a unified authority for the development and regulation of financial products, financial services and financial institutions in the IFSC.

The establishment of IFSCA to act as a single-window for regulating activities in an IFSC has already proven an effective tool for rapidly implementing stakeholder asks, and should help build investor confidence through consistency, transparency and clarity in policy measures as GIFT City continues to develop. The ability and desire of the IFSCA to form regulations which are intended to quickly bring the IFSC at GIFT City in line with IFSC's around the world is an important consideration for both foreign and Indian GPs to take into account when deciding the best jurisdiction for their fund platform.

As further set out below, the IFSC at GIFT City already has in place a robust regulatory and tax framework which affords GPs and their investors an ease of doing business and tax incentives akin to jurisdictions like Singapore and Mauritius, while allowing Indian GPs to manage their funds from within India without the economic burden of Indian taxation.

LEGAL FRAMEWORK FOR AIFS IN GIFT CITY

SEBI (International Financial Services Centre) Guidelines, 2015 ("2015 Guidelines") provide a broad framework for setting up Alternative Investment Funds ("AIFs") in an IFSC ("IFSC AIF"). Based on deliberations with the Alternative Investment Policy Advisory Committee and in consultation with stakeholders, SEBI also issued a Circular dated November 26, 2018 ("2018 Circular") to further clarify AIF operations within the IFSC. After its establishment as a unified authority governing the IFSC at GIFT City, the IFSCA further addressed stakeholder concerns by issuing Circular dated December 9, 2020 ("2020 Circular") which provides IFSC AIF's added benefits with respect to leveraging activities, co-investment opportunities and a relaxation of diversification norms.

Accordingly, the 2015 Guidelines read with the 2018 Circular and the 2020 Circular (together, "IFSC AIF Regulations") generally provide the legal framework under which IFSC AIFs operate in GIFT City. Some of the key governing features are as follows:

Eligible investors

An IFSC AIF is permitted to accept funds, in foreign currency, from the following types of investors:

1. person resident outside India;
2. non-resident Indian;
3. institutional investor resident in India who is eligible under FEMA to invest funds offshore, to the extent of outward investment permitted;
4. person resident in India to the extent allowed under the Liberalized Remittance Scheme ("LRS Route")¹

Permissible investments by the IFSC AIF

An IFSC AIF is permitted to make investments into the following:

1. Securities which are listed in IFSC;
2. Securities issued by a company incorporated in IFSC;
3. Securities issued by companies incorporated in India or foreign jurisdiction;

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4. units of other AIFs;

5. other permissible investments as per SEBI (AIF) Regulations, 2012 (ie. LLP, REIT, InvIT, Derivatives, SPV)

With respect to investments in Indian securities, it has been clarified that an IFSC AIF can invest in India under the foreign venture capital investment ("FVCI") route, foreign portfolio investor ("FPI") route, or foreign direct investment ("FDI") route. Earlier, IFSC AIFs were allowed to invest under the FPI route only. This move by SEBI allows offshore investors flexibility to invest through IFSC AIFs and avail the benefits of the IFSC regime. At the same time, IFSC AIF's can also invest overseas without adhering to restrictions otherwise provided for domestic AIFs under the AIF Regulations such as the requirement to obtain SEBI approval prior to overseas investment and the inability to invest more than 25% of their investible funds overseas.

Most recently, the IFSCA has responded to demands from stakeholders that the IFSC AIF regime be more in line with international standards, by issuing the 2020 Circular. The key benefits provided under the 2020 Circular are set out in the following table:

IFSC AIF	Domestic AIF	IFSC Benefit
IFSC AIF is permitted to co-invest in a portfolio company through a segregated portfolio by issuing a separate class of units to certain investors, subject to such investments not being on terms more favourable than those offered to the common portfolio of the IFSC AIF, and adequate disclosures being made in the placement memorandum.	Domestic AIFs are generally not permitted to allow any set of investors to increase their allocation to a particular deal on a standalone basis.	This will simplify deal structuring and provide flexibility to IFSC AIFs and investors to allocate more capital to lucrative opportunities.
IFSC AIF is permitted to invest in domestic AIFs registered with SEBI, alongside other permissible investments.	While the AIF Regulations permit Category-I AIF to invest in units of other Category-I AIFs and Category-II AIF to invest in units of other Category-I AIF / Category-II AIF, the AIF Regulations provide that the AIF should only invest in such units and shall not invest in units of other Funds of Funds. Accordingly, it is not clear whether a domestic AIF can investment in both a fund and portfolio investment simultaneously.	This will simplify deal structuring and provide flexibility to IFSC AIFs to execute invest strategies which involve investment in both units of domestic / overseas funds as well as portfolio companies.
IFSC AIF is permitted to make investments without having to comply with the diversification requirements provided under the SEBI (Alternative Investment Funds) Regulations, 2012 ("AIF Regulations").	AIF Regulations prohibit CAT I/II AIFs from investing more than 25%, and 10% for CAT III, of their investible funds in one company.	As it is common for offshore funds to be set up for investment in a few targeted companies or sectors this relaxation helps IFSC AIFs to be competitive with other offshore fund vehicles.
Borrow funds or engage in leveraging activities, subject to (i) disclosures in the placement memorandum, (ii) consent of the investors, and (iii) maintaining a comprehensive risk management framework.	Domestic CAT I/II AIFs are prohibited from borrowing funds directly or indirectly or engaging in any leverage except for meeting temporary funding requirements for not more than thirty days, on not more than four occasions in a year and not more than ten percent of the investable funds. Domestic CAT III AIF funds are permitted to engage in leverage, but only with investor and subject to a maximum limit not exceeding 2 times of the Net Asset Value of the AIF.	As offshore funds do not generally need to comply with restrictions on borrowings, relaxation of such restrictions for IFSC AIFs is another move to help ensure that IFSC AIFs are competitive with other offshore fund vehicles.

The 2020 Circular is indeed a very welcome move for the fund industry, and it illustrates the IFSCA's commitment to onshoring the fund management industry to India. These relaxations offered to IFSC AIFs should help simplify deal structures which often involved multiple layers and offshore entities in order to accommodate for domestic AIF's co-investment and diversification restrictions, and complex investment strategies that target both funds and portfolio companies. These changes, along with IFSC AIF's ability to leverage funds, and the tax incentives (as set out below) provided to IFSC AIF's brings the IFSC AIF regime one step closer to being on par with international offshore jurisdictions like Singapore, Mauritius, Netherlands, Luxembourg etc.

Sponsor / Manager Entity

Keeping in mind the goal of IFSC to become a financial services hub, it is expected that IFSC AIF managers are also physically located within the IFSC at GIFT City. While an existing sponsor / manager entity of a domestic AIF is permitted to set up a branch or subsidiary in the form of a company or LLP, foreign exchange control provisions, including Foreign Exchange Management (Transfer or issue of any foreign security) Regulations, 2004 ("TIFS Regulations") and requisite RBI approval for investing in overseas company engaged in financial services should be applicable. These requirements may of course, increase compliance burdens for Indian GPs wanting to manage IFSC AIF from their existing offices outside the IFSC. Having said that, it should be noted that the same foreign exchange control issues would also apply to domestic investors investing in an offshore fund set up in a jurisdiction

on Simplification of registration for FPIs

September 26, 2024

Scope of judicial interference and inquiry in an application for appointment of arbitrator under the (Indian) Arbitration and Conciliation Act, 1996

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like Singapore or Mauritius. However, given that the GIFT City IFSC is regulated by Indian regulatory authorities, at the minimum the need for obtaining prior RBI approval for establishment of a manager / sponsor entity in the IFSC and for purposes of complying with the sponsor commitment requirements should be relaxed. This would further incentivize fund managers to choose IFSC AIFs over offshore fund structures, all other commercials being the same.

TAX FRAMEWORK FOR AIFS IN GIFT CITY

General

While any unit in an IFSC including an IFSC AIF and its manager / sponsor entity set up in IFSC is treated as a person resident outside India from a foreign exchange control perspective, for income-tax purposes, such entities are considered to be persons resident in India. That being said, the Income-tax Act, 1961 ("ITA") provides several incentives to units, including IFSC AIFs and their Investment Managers, located in IFSC, inter-alia including 100 percent tax holiday with respect to business income for any consecutive 10 years out of the unit's first 15 years in the IFSC under Section 80LA of the ITA. Specifically with respect to income earned by investment managers, the fund industry is currently exposed to the risk of re-characterisation of carry as business income (instead of capital gains). However, this risk is mitigated for manager entities set up within the IFSC as the tax holiday provided under section 80LA should be applicable for performance fees received by the IFSC AIF. This combined with GST exemption makes the GIFT City management structure an attractive model.

The ITA also provides other tax incentives to units located in an IFSC, including reduced minimum alternate tax, concessional withholding tax on interest income, exemption from capital gains tax on transfer of specified securities etc. The Central Board of Direct taxes ("CBDT") has also clarified that income received by non-resident investors from off-shore investments routed through a Category-I or Category-II AIF, being a deemed direct investment outside India by the non-resident investor, would not be taxable in India. Therefore, income received by non-resident investor from overseas investment made by Category-I or Category-II IFSC AIFs should not be subject to tax in India. Moreover, the CBDT has exempted non-residents having income from investments in an IFSC AIF which is chargeable under the ITA, from filing of income-tax return in India. However, such exemption is available only if tax has been appropriately deducted and deposited to the government by the IFSC AIF as per provisions of the ITA. Along similar lines, the CBDT has also provided an exemption for non-residents with respect to obtaining a Permanent Account Number ("PAN"), provided certain conditions are satisfied.

Relocating offshore funds to the IFSC

Recently, the Finance Act, 2021 has amended various provisions of the ITA to facilitate tax neutrality with respect to the relocation of offshore funds to the IFSC. Such provisions are applicable where the shares and assets of the 'original fund' are 'relocated' to a 'resultant fund' in India. In this context, 'original fund' has specifically been defined under the ITA to mean *a fund established or incorporated or registered outside India, which collects funds from its members for investing it for their benefit and fulfills the following conditions, namely:—*

1. *the fund is not a person resident in India;*
2. *the fund is a resident of a country or a specified territory with which an agreement referred to in sub-section (1) of section 90 or subsection (1) of section 90A has been entered into; or is established or incorporated or registered in a country or a specified territory as may be notified by the Central Government in this behalf;*
3. *the fund and its activities are subject to applicable investor protection regulations in the country or specified territory where it is established or incorporated or is a resident; and*
4. *fulfils such other conditions as may be prescribed;*

Further, 'relocation' has been defined to mean *the transfer of assets of the original fund, or of its wholly owned special purpose vehicle, to a resultant fund on or before the 31st day of March, 2023, where consideration for such transfer is discharged in the form of share or unit or interest in the resulting fund to,*

1. *shareholder or unit holder or interest holder of the original fund in the same proportion in which the share or unit or interest was held by such shareholder or unit holder or interest holder in such original fund, in lieu of their shares or units or interests in original fund; or*
2. *The original fund, in the same proportion as referred in sub-clause (i), in respect of which share or unit or interest is not issued by resultant fund to its shareholder or unit holder or interest holder;'*

The ITA also specifies that the 'resultant fund' must be a fund established or incorporated in India in the form of a trust, company, or LLP, registered with SEBI has a CAT – I, CAT – II, or CAT – III AIF and is located in an IFSC.

Pursuant to the Finance Act, 2021, the ITA has also been amended to provide the following provisions for ensuring tax neutrality:

1. Exemption from capital gains tax from transfer of capital asset in a *relocation* by the *original fund* to the IFSC AIF. This provision essentially seeks to exempt capital gains arising on transfer of shares of an Indian companies and other Indian securities held by an offshore fund to an IFSC AIF. However, the consideration for such transfer has to be discharged in form of allotment of shares / unit in the AIF located in IFSC to the shareholder / unit holder of the offshore fund in the same proportion which such shareholder / unit holder had in the offshore fund.
2. Exemption from capital gains tax from transfer by a shareholder / unit holder, in a relocation, of capital asset being share / unit held by him in the original fund in consideration for share / unit in the resultant fund. This provision seeks to exempt the transfer at the shareholder level from capital gains tax on account of indirect transfer provisions
3. Exemption from capital gains tax arising or received by a non-resident investor, on account of transfer of shares of an Indian company by the IFSC AIF which were acquired by the IFSC AIF pursuant to relocation and where the capital gains on such transfer would originally not been subject to tax had the relocation not taken place. This provision seeks to place the non-resident investor at par while exiting from an offshore fund where the exit was not subject to tax in India (example on account of grandfathering under provisions of a favourable tax treaty) vis-a-vis exiting from an IFSC AIF.

4. Section 79 has also been amended to allow the company the benefit of set off and carry forward of loss to the extent the change in shareholding has taken place on account of relocation.

CONCLUSION

While there still exist some challenges in setting up an IFSC AIF, the list is growing shorter at a tremendous pace as the IFSCA focusses on creating a globally competitive environment to incentivize both Indian and foreign GPs to set up AIFs and their investment manager entities within the IFSC. For a more detailed discussion on AIF's set up in GIFT City, please refer to our collateral titled "[Opportunities in GIFT City – Setting up Funds in India's New Offshore Financial Centre](#)".

– [Radhika Parikh & Parul Jain](#)

You can direct your queries or comments to the authors

¹ IFSCA issued Circular dated February 19, 2021 clarifying that the USD 1 million net value threshold applicable for individual Indian residents to open a freely convertible foreign currency account with a bank set up in the IFSC under the LRS route, shall not be applicable for Indian resident investors remitting funds under LRS to the IFSC for investment in foreign securities.

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