Changing Landscape for Private Equity
Indian Tax and Regulatory Insights
Private Equity (PE) / Venture Capital (VC) has been an important source of risk capital which has contributed to the economic development of various sectors in India. 2017 was a record year for PE / VC investments in India, with investments reaching an all-time high of US$26.5 billion and an increase in investments by 63% compared to 2016. An overall positive investment sentiment for India amongst the global investor community, upsurge in investment in key sectors such as financial services, real estate, e-commerce, etc. and increase in “big” deals has contributed to the rise of PE / VC investment into India.

On the tax and regulatory front, the government and regulators have made several transformative policy changes that are helping to reshape the manner in which investments into India are structured. Some of these include:

- Resolution of the Mauritius tax conundrum: The amendment to the India-Mauritius Double Tax Avoidance Agreement (DTAA) to provide a calibrated phase-out of the capital gain tax exemption, while grandfathering tax benefits to investments made until March 2017, provides certainty on an issue that has persisted for over two decades. The India-Singapore DTAA was also re-negotiated on similar lines.
- Introduction of a 10% tax rate on long-term capital gains arising from transfer of equity shares of listed companies which reversed a tax policy that exempted such gains since 2004.
- Introduction of the General Anti Avoidance Rules (GAAR) and the concept of Place of Effective Management (POEM) for determining the tax residence of foreign companies in India.
- Allowing foreign investment in the Securities and Exchange Board of India (SEBI) regulated Alternative Investment Fund (AIF) under the automatic route with a liberal policy that allows AIFs, whose sponsor/ fund manager are owned and controlled by resident Indian citizens, to make investments in India without attracting exchange control limitations.
- Gradual amendment in the domestic tax law to implement the actions agreed under the Base Erosion and Profit Shifting (BEPS) project to curb tax evasion. India, as part of the BEPS project, has agreed to amend its tax treaties by signing the multilateral instrument (MLI) along with 78 other jurisdictions.

On the distressed asset front, the high levels of debt sitting on the balance sheets of major companies combined with the heat that the banks are bringing on the promoters has already unleashed a wave of deleveraging. The financial stress, passage of the new law to deal with insolvency and bankruptcy and the reform of the existing laws for securitization and asset reconstruction is already attracting a new wave of PE / VC funds that are willing to write big cheques at reasonable valuations and turn around such companies.

The PE / VC industry in India is clearly in transition. The rules for investment into India have been changed to provide foreign investors a sense of certainty and clarity and at the same time ensure that India collects its fair share of tax on the income earned from investments in India. Going forward, this approach may provide a significant impetus to PE / VC activity and capital flow to India, which is sorely-needed for growth of the Indian economy at large.

In this report, we have made an effort to bring together the key tax and regulatory frameworks applicable to PE / VC investments in India, so as to enable you to better understand the investment landscape in India.

1. EY analysis of VCC Edge Data
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PE / VC investment in India:
An overview
Private equity as an asset class in India has progressed considerably over the past two decades. Starting in the late 1990s, private equity has provided an alternative source of financing to local businesses who, back then, had only two sources of capital—limited credit options from banks and the then not so developed public equity markets. Today, private equity is well accepted by Indian entrepreneurs as a source of strategic capital that can play a pivotal role in the growth of their businesses by bringing in required new capabilities and discipline not available with other forms of capital. Over the past 20 years, the industry has been a relatively stable source of capital despite many challenges.

If we look at the history of the Indian PE / VC industry, we find that notwithstanding intervals of weak macro indicators, political instability, unstable currency and lack of awareness of the India opportunity by the global Limited Partners (LPs) community, and a variety of other negative factors, the Indian PE / VC ecosystem has grown from approximately US$200 million in 1998 to almost US$39.5 billion in 2017 (PE / VC investments plus exits), a CAGR of almost 32%. From 2007 till the first quarter of 2018, India has received close to US$149 billion in PE / VC investments, which is almost 45% of the total foreign direct investment received over the same period.

In 2017, both PE / VC, investments and exits, recorded all-time highs. India received US$26.5 billion in PE / VC investments in 2017, 35% higher than the previous high of 2015 and 63% higher than 2016. PE / VC exits in 2017 almost doubled in value to US$13 billion compared to the previous high recorded in 2016. The record level of growth has been driven primarily by large sized deals, both in case of investments and exits. Fund raising by PE / VCs focussed on investing in Indian businesses increased by nearly 33% to US$5.8 billion in 2017 compared to US$4.3 billion in 2016, further adding to the already high level of dry powder available with PE / VC funds.
Some of the key trends witnessed in 2016 which became established in 2017 include:

**Deals are becoming larger and more complex**


**LPs are increasingly co-investing with General Partners (GPs) and/or investing directly**

Direct investments by LPs in the Indian market over the past 10 years add up to approximately US$20 billion, of which almost US$6 billion was invested in 2017 alone.

**Investments rise across most sectors**

Sectors like financial services, real estate, e-commerce, retail and consumer products and healthcare recorded the highest ever investments by PE / VC investors in India.

**Buoyant capital markets support record level of exits via open market and IPOs**

The rise in capital markets in 2017 provided a favorable environment for open market exits (US$6.2 billion, a 3.7x increase over 2016) as well as PE / VC backed IPOs (20 PE / VC backed IPOs, highest in five years).

**Secondary exits are gaining traction**

Strong interest by global pension and sovereign funds as well as big bracket PE / VC funds has helped exits via secondary sale record an all-time high of US$3.4 billion, a seven-fold increase in value compared to 2016.

In 2018 as well, the Indian PE / VC industry is off to a very strong start, with US$7.9 billion of PE / VC investments in 1Q eclipsing the previous 1Q high (2016) seen over the past four years by over 83%. 1Q2018 is now the second best quarter in the last four years for PE / VC investment activity, as it saw 13 deals with investment amounts greater than US$100 million, against six such deals in 1Q2017. This is an amalgamation of all asset classes, including PE, real estate and infrastructure, which accounted for US$4.8 billion, US$1.5 billion and US$1.6 billion worth of investments respectively in 1Q2018. Although pure play PE investments declined from US$5.6 billion in 4Q2017 to US$4.8 billion in 1Q2018, they are almost 26% more than the US$3.9 billion invested in 1Q2017. The deficit in PE investment from 4Q2017 was more than adequately picked up by the infrastructure and real estate asset classes.

A significant portion of the PE / VC investment discussed above has been made by global fund managers operating regional or India-focused offshore funds and Indian fund managers operating offshore funds. In past few years, the share of domestic capital in PE / VC investments is gradually growing. This is largely due to the various bold and transformative policy changes made by the Indian government for encouraging domestic pooling of capital.
With many positives now backing the Indian PE / VC story, strong 1Q numbers and the deal momentum in play, we believe that PE / VC investment activity in 2018 may eclipse the record highs seen in 2017. The changes unleashed by the Insolvency and Bankruptcy Code (IBC) have opened India to a new PE asset class of stressed assets/ distressed debt, adding more wind to the already full sails of the Indian PE / VC story. The infrastructure asset class too is expected to see a lot of investment dollars, especially in the roads sector as the government looks to privatize arterial routes to fund their ambitious roads’ capex plans. Real estate is also projected to see good investment activity, especially commercial real estate as more “REITable” platforms get built.

On the exits front, there are strong undercurrents of strategic M&A deals in play. If and when they materialize, early stage backers of the Indian e-commerce sector might see strong exits, taking the Indian early stage investing eco-system to new highs. Overall, PE / VC exits should put up a strong performance in 2018 also, unless the Indian equity indices correct materially. The strong PE / VC exits seen in the past three years (over US$26 billion) have played a material role in “re-rating” the India PE / VC sector in the eyes of global LPs. These exits have underlined the ability of the Indian market to return foreign capital to LPs with returns, which in turn will attract more LPs and lead to an increase in India’s share of their emerging markets capital allocation.

With technology led disruptions and internet connectivity bringing us closer to realizing the power of India’s demographic dividend, we believe that the next five years will be the golden age of the Indian PE / VC industry. Further, given the big push by the Government for creating a conducive and stable environment for the direct pooling of capital in India, share of domestic capital in PE / VC investments in India is expected to increase manifold.

In our view, political and policy stability permitting, by 2021 annual Indian PE / VC investment levels could potentially be in the range of 1.5x-2x the highs of 2017.
Regulatory and tax landscape for foreign investment in India
2.1 Regulatory landscape for foreign investment in India

An objective of the Government of India is to attract foreign investment in India in order to supplement domestic capital, promote domestic manufacture and job creation. In the last few years, the regulatory landscape for foreign investment in India has been significantly rationalized by removing restrictions in most sectors, expanding investment routes and leveraging information technology for efficient governance.

The policy framework for foreign investments into India is laid down by the Department of Industrial Policy and Promotion, the Ministry of Commerce and Industry, Government of India. The administration and implementation of the foreign investment rules is undertaken by the Reserve Bank of India (RBI, India’s central bank which also controls the monetary policy) through the exchange control regulations. In addition to this, foreign investment in listed securities is also regulated by the SEBI, the securities market regulator in India.

Based on the investment objectives, a foreign investor can invest directly in India under one or a combination of the following routes:

**Foreign Direct Investment (FDI)**

Foreign investment under the FDI route can be made either under the automatic route or under the approval route depending on the sector/activities in which the Indian entity is engaged. Foreign investment in most sectors is permitted under the automatic route without any ownership restrictions or conditions. Foreign investment caps, minimum capitalization norms and lock-in requirements are specified for certain sectors/activities and purchase/transfer of securities is subject to pricing guidelines. Foreign investment in certain sectors such as real estate business, lottery business, chit funds, atomic energy, etc. is completely prohibited.

**Foreign Portfolio Investor (FPI)**

Foreign investment under the FPI route can be made pursuant to the foreign investor obtaining registration as an FPI with the SEBI. An FPI can invest in listed shares, listed or unlisted debt securities subject to conditions and exchange traded derivatives. While there is no prescribed monetary limit for equity investment by an FPI, debt investment by an FPI is subject to an overall monetary limit prescribed by the RBI/SEBI. An FPI is required to designate a bank in India to route all its investment transactions in India.

**Foreign Venture Capital Investor (FVCI)**

Foreign investment under the FVCI route can be made pursuant to the foreign investor obtaining registration as an FVCI with the SEBI. An FVCI is allowed to invest in specified sectors which include infrastructure, biotechnology, IT related to hardware and software development, dairy industry, etc. The investment by an FVCI in any security of a company in the specified sector is not subject to pricing guidelines and purchase/transfer of such security is permitted at a price that is mutually acceptable to the buyer and the seller/issuer.

**Types of instruments**

An Indian company can raise funds by way of shares or debt. Shares of a company are categorized as equity or preference shares. Debt securities that are issued by companies are called debentures or bonds. Debentures are a instrument of debt executed by a company acknowledging its obligation to pay interest on the debt at a fixed rate at regular intervals. Debentures do not carry any voting rights and are generally secured against property. Additionally, debentures can be redeemed or converted into equity or a combination of both. Debt funding from non-resident lenders (excluding compulsorily convertible instruments and listed Non-Convertible Debentures (NCDs)) is generally referred to as External Commercial Borrowing (ECB) and is closely regulated specifically with respect to end use, party from whom lending is sought, interest payment, amount of funding, maturity period, etc. Either of the above mentioned instruments or their combination could be used for investing in an Indian company.

**Entities in which foreign investment is permitted**

Foreign investment is permitted in a company and limited liability partnership (LLP) subject to compliance with sectoral caps and conditions. In case of partnership and proprietary concerns, the foreign investment is restricted only to Non Resident Indians (NRI) and persons of Indian origin. Lastly, foreign investment in a trust is not permitted, unless the trust is registered as a Venture Capital Fund (VCF), AIF, REIT or Infrastructure Investment Trust (InviTs) with the SEBI.

4. Real estate business shall not include development of townships, construction of residential/commercial premises, roads or bridges and real estate investment trusts registered and regulated by SEBI.
5. Under the SEBI (Foreign Portfolio Investors) Regulations, 2014. (‘SEBI (FPI) Regulations’)
6. Under the SEBI (Foreign Venture Capital Investors) Regulations, 2000. (SEBI (FVCI) Regulations
7. Governed by the Companies Act, 2013
9. Partnership or a proprietary concern is not a legal entity independent of its partner or the owner
10. A trust is not regarded as a legal entity
2.2 Tax landscape for foreign investment in India

The Income-tax Act, 1961 (ITA or domestic tax law) is the charging statute for income-tax in India. It provides for levy, administration, collection and recovery of the income-tax. Every year on 1 February the Finance Minister of India presents the annual budget along with the tax proposals to modify the ITA and provide the tax rate applicable for the ensuing financial year.

The Indian tax year runs from 1st April in any year until 31st March of following year. The Central Board of Direct Taxes (CBDT) is the apex body charged with the responsibility of levy and collection of direct taxes through the ITA and rules there under.

As per the ITA, the basis of charge of income tax depends upon the residential status of the taxpayer during a tax year and the nature of the income earned. If the taxpayer is regarded as tax resident in India in a tax year, then the global income is taxable in India under the ITA. However, if the taxpayer is regarded as a non-resident in India in a tax year, then only the Indian source income is taxable in India under the ITA or DTAA (if any) entered between India and the country of residence of the non-resident, whichever is more beneficial. India has a comprehensive tax treaty network with over 90 countries, providing relief from double taxation.

General Anti-Avoidance Rules

GAAR has been introduced with the objective of dealing with aggressive tax planning through the use of sophisticated structures and codifying the doctrine of “substance over form”. While the GAAR provisions are applicable from 1 April 2017, income from transfer of investments made before 1 April 2017 have been grandfathered.

The rules provide that an arrangement whose main purpose is to obtain a tax benefit and which also satisfies at least one of the four specified tests (i.e., arrangement is not at arm’s length, misuse or abuse of tax laws, lacks or is deemed to lack commercial substance or not carried out for bona fide purpose) can be declared as an “impermissible avoidance arrangement”. Once an arrangement is held to be an impermissible avoidance arrangement, the Indian tax authorities have been given powers to disregard entities in a structure, reallocate income and expenditure between parties to the arrangement, alter the tax residence of such entities and the legal situs of assets involved, treat debt as equity and vice versa, deny DTAA benefits, etc.

Keeping in mind the wide powers given to the Indian tax authorities and the far reaching impact GAAR provisions can have on transactions, the following clarifications, amongst others, are relevant:

- GAAR is not applicable where aggregate tax benefit to all parties of the arrangement does not exceed INR 30 million (c.US$ 0.46 million).
- Instruments compulsorily convertible from one form to another at terms finalized at the time of issue of such instruments before 1 April 2017, are eligible for grandfathering (i.e., GAAR shall not apply to such investments).
- Shares coming into existence by way of split/consolidation or by way of bonus in respect of shares acquired before 1 April 2017 are eligible for grandfathering.
- GAAR is not applicable in case of an FPI assessed under the domestic tax laws.

In the past anti-avoidance principles were based on judicial precedents. However, with the GAAR provisions now codified and effective, it is imperative that robust documentation is maintained to demonstrate the non-tax motive behind investing from a treaty jurisdiction or for steps in a transaction structure.

Taxation of capital gains

Any profits or gains arising from transfer of a “capital asset” are treated as capital gains. However, gains arising from the transfer of securities may be treated either as “capital gains” or as “business income” for tax purposes, depending upon whether such securities were held as a “capital asset” or “trading asset” (i.e., stock-in-trade). Historically, the issue of characterization of gains (whether taxable as business income or capital gains) has been a subject matter of litigation with the Indian tax authorities.

In order to mitigate litigation, the CBDT has issued several circulars clarifying instances where gains on transfer of securities should be regarded as capital gains. Based on these circulars, in most instances, a PE / VC investor should be eligible to treat the exit gains as capital gains. In certain scenarios, the Indian tax authorities have the powers to examine the transaction to conclude on the aforesaid characterization.

The table below provides an overview of the tax rates applicable on capital gains earned by a non-resident from investment in Indian securities (shares and debentures). The tax rates mentioned are base rates, to be increased by the applicable surcharge and cess. Subject to its applicability, the taxation of gains in India could be mitigated under an applicable DTAA.
Changing Landscape for Private Equity

1. **Note**

Any transaction on a recognized stock exchange and a sale of shares in an IPO is subject to a Securities Transaction Tax (STT). Further, the tax rate mentioned in the table is subject to payment of STT, both at the time of sale and purchase of shares, in all cases except in certain specified exceptions.

Up to 31 March 2018, any long term capital gains arising from transfer of equity shares on a recognized stock exchange were exempt from tax in India. With effect from 1 April 2018, this exemption has been withdrawn. Further, in respect of long term capital gains arising on or after 1 April 2018, from sale of equity shares acquired before 1 February 2018, capital gains computation has been modified such that the cost of acquisition of such shares is considered to be the higher of:

- (a) Actual cost of acquisition or
- (b) Lower of sale price and fair market value (computed in prescribed manner) as on 31 January 2018. Accordingly, capital gains accruing to an investor up to 31 January 2018 have been protected.

2. **Note**

Where an unlisted share is sold for a value less than its fair market value (determined in a prescribed manner), irrespective of whether the transaction is between related or unrelated parties, the fair market value shall be deemed to be the sale consideration and the capital gains will be determined accordingly.

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### Capital gains taxation under select DTAAs entered by India

Over the past few decades, Mauritius and Singapore have emerged amongst the largest contributors of foreign investment into India due to a combination of several factors, including favorable tax treatment in India for capital gains on sale of shares of Indian companies by Mauritius and Singapore tax residents under the India-Mauritius DTAA and India-Singapore DTAAs (both the DTAAs provided an exemption, subject to conditions).

In 2016, the Government of India re-negotiated the DTAAs with Mauritius and Singapore to provide India the right to tax capital gains arising from transfer of shares acquired on or after 1 April 2017, the benefit of grandfathering was provided to investments made until 31 March 2017.

Presently, except for few DTAAs (example, the Netherlands and France, subject to conditions), India has the taxing rights on capital gains derived from sale of shares. Having said that, in most Indian tax treaties, with limited exceptions (example, the United States of America, the United Kingdom), capital gains derived from hybrid, debt and other instruments (not being shares in an Indian resident company) continue to be exempt from tax in India. The table below provides a snapshot of the basis of taxation of capital gains under select DTAAs:

<table>
<thead>
<tr>
<th>Particulars</th>
<th>Holding period</th>
<th>Tax rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stock exchange / IPO sale</td>
<td></td>
<td></td>
</tr>
<tr>
<td>a. Sale of shares on a stock exchange in India</td>
<td>a. &gt; 12 months</td>
<td>10%&lt;sup&gt;12&lt;/sup&gt; (Note 1)</td>
</tr>
<tr>
<td>b. Sale of unlisted shares in an IPO</td>
<td>a. ≤ 12 months</td>
<td>15%</td>
</tr>
<tr>
<td></td>
<td>b. &gt; 24 months</td>
<td></td>
</tr>
<tr>
<td></td>
<td>b. ≤ 24 months</td>
<td></td>
</tr>
<tr>
<td>Secondary transfer in a private trade</td>
<td></td>
<td></td>
</tr>
<tr>
<td>a. Sale of listed shares</td>
<td>a. &gt; 12 months</td>
<td>10%&lt;sup&gt;12&lt;/sup&gt;</td>
</tr>
<tr>
<td>b. Sale of unlisted equity shares (Note 2)</td>
<td>a. ≤ 12 months</td>
<td>40% / 30%&lt;sup&gt;13&lt;/sup&gt;</td>
</tr>
<tr>
<td></td>
<td>b. &gt; 24 months</td>
<td></td>
</tr>
<tr>
<td></td>
<td>b. ≤ 24 months</td>
<td></td>
</tr>
<tr>
<td>Sale of listed debentures</td>
<td>&gt; 12 months</td>
<td>10%&lt;sup&gt;12 &amp; 14&lt;/sup&gt;</td>
</tr>
<tr>
<td></td>
<td>≤ 12 months</td>
<td>40% / 30%&lt;sup&gt;13&lt;/sup&gt;</td>
</tr>
<tr>
<td>Sale of unlisted securities (other than equity shares)</td>
<td>&gt; 36 months</td>
<td>10%&lt;sup&gt;12&lt;/sup&gt;</td>
</tr>
<tr>
<td></td>
<td>≤ 36 months</td>
<td>40% / 30%&lt;sup&gt;13&lt;/sup&gt;</td>
</tr>
</tbody>
</table>

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11. Circular 6 of 2016 dated February 29, 2016 and Circular dated May 2, 2016 in respect of listed shares/securities and unlisted shares, respectively and clarification dated 24 January 2017 in respect of transfer of shares by category I and II AIFs

12. Gains to be calculated in INR. Gain/loss due to foreign currency translation and inflation is ignored.

13. For FPI and non-corporates.

14. Foreign exchange adjustment may be available, however, there are conflicting judicial precedents.

<table>
<thead>
<tr>
<th>Jurisdiction</th>
<th>Sale of shares</th>
<th>Capital gains on Other than shares</th>
</tr>
</thead>
<tbody>
<tr>
<td>United States of America</td>
<td>Taxable under the ITA</td>
<td>Taxable under the ITA</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>Taxable under the ITA</td>
<td>Taxable under the ITA</td>
</tr>
</tbody>
</table>
| Mauritius            | • Shares acquired on or before 31 March 2017: Not taxable  
                        • Shares acquired on or after 1 April 2017 and sold on or before 31 March 2019: Taxable at 50% of tax rates prescribed under the ITA, subject to the Limitation of Benefit (LOB)18 clause  
                        • Shares acquired on or after 1 April 2017 and sold after 31 March 2019: Taxable under the ITA |
| Mauritius            | Not taxable                                        |                                   |
| Singapore            | • Shares acquired on or before 31 March 2017: Not taxable, subject to the LOB19 clause  
                        • Shares acquired on or after 1 April 2017 and sold on or before 31 March 2019: Taxable at 50% of tax rates prescribed under the ITA, subject to the LOB20 clause  
                        • Shares acquired on or after 1 April 2017 and sold after 31 March 2019: Taxable under the ITA |
| Singapore            | • For securities acquired on or before 31 March 2017: Not taxable, subject to the LOB13 clause  
                        • For securities acquired on or after 1 April 2017: Not taxable |
| Netherlands          | Not taxable in certain situations21                | Not taxable                       |
| Luxembourg           | Taxable under the ITA                              | Not taxable                       |
| France               | Not taxable in certain situations22                | Not taxable                       |

**Interest income and dividend income**

The table below provides an overview of the tax rates applicable on interest income and dividend income earned by a non-resident from investment in Indian securities (shares and debentures) without considering benefit under an applicable DTAA.

<table>
<thead>
<tr>
<th>Particulars</th>
<th>Tax rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest on foreign currency borrowings by Indian companies</td>
<td>20%</td>
</tr>
<tr>
<td>Interest on foreign currency long-term bonds/ loan agreements and rupee denominated bond (masala bond)</td>
<td>5% 23</td>
</tr>
<tr>
<td>Interest on rupee denominated bond paid to an FPI</td>
<td>5% 24 or 20%</td>
</tr>
<tr>
<td>Interest in any other case</td>
<td>40%</td>
</tr>
<tr>
<td>Dividends on equity shares</td>
<td>Exempt- Indian company subject to DDT at c.21%</td>
</tr>
</tbody>
</table>
Taxation of interest income under select DTAAAs entered by India

<table>
<thead>
<tr>
<th>Jurisdiction</th>
<th>Tax rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>United States of America, United Kingdom, Singapore</td>
<td>15%</td>
</tr>
<tr>
<td>Netherlands, Luxembourg, France</td>
<td>10%</td>
</tr>
<tr>
<td>Mauritius</td>
<td>7.5%</td>
</tr>
</tbody>
</table>

Other repatriation options

Buy-back
Buy-back of shares is a scheme wherein an Indian company repurchases its own shares from its shareholders. Offer for buy-back is typically made to all shareholders (holding shares of the same class) and is at the discretion of the shareholder to accept or reject. For listed companies, in certain situations, a specified class of shareholders may not be eligible to tender their shares in the offer for buy-back.

Capital reduction
Capital reduction is a process of cancellation of subscribed capital of an Indian company or reduction of the face value of shares. The process is regulated by the National Company Law Tribunal (NCLT, a quasi-judicial body set up under the Companies Act, 2013 for adjudicating matters in relation to companies including but not limited to schemes of arrangements/corporate reorganizations, winding up etc.). From a tax perspective, capital reduction typically involves distribution of accumulated profits and capital.

16. Vide protocol dated 10 May 2016
17. Vide protocol dated 30 December 2016
18. A Mauritian resident availing the 50% concessional capital gains tax rate under the India-Mauritius DTAA must satisfy the following conditions:
   • Its affairs are not arranged with the primary purpose to take advantage of the benefits of LOB clause under the DTAA
   • It should not be a shell/conduit company, i.e., expenditure on operations in Mauritius is equal to or more than Mauritian Rs1,500,000 in the immediately preceding 12 months from the date on which capital gains arise from transfer of shares
   • It is listed on a recognised stock exchange in Mauritius
19. A Singapore resident availing the capital gain exemption under the India-Singapore DTAA must satisfy the following conditions:
   • Its affairs are not arranged with the primary purpose to take advantage of the benefits of LOB clause under the DTAA
   • It should not be a shell/conduit company, i.e., expenditure on operations in Singapore is equal to or more than SGD$200,000 for each of the 12 month period in the immediately preceding 24 months from the date on which capital gains arise from transfer of shares
   • It is listed on a recognised stock exchange in Singapore
20. A Singapore resident availing the 50% tax rate concession under the India Singapore DTAA must satisfy the following conditions:
   • Its affairs are not arranged with the primary purpose to take advantage of the benefits of LOB clause under the DTAA
   • It should not be a shell/conduit company, i.e., expenditure on operations in Singapore is equal to or more than SGD$200,000 in the immediately preceding 12 months from the date on which capital gains arise from transfer of shares
   • It is listed on a recognised stock exchange in Singapore
21. Where shares are sold to a non-resident or to a resident and the shares form part of less than 10% interest in the capital stock of the company or shares are sold pursuant to a corporate organization, re-organisation, amalgamation, division or similar transaction.
22. Where shares do not represent participation of at least 10% in the Indian company.
23. Concessional rate is available on bonds/loan agreements executed before 1 July 2020 (subject to conditions)
24. Concessional rate is available on interest payable up to 1 July 2020 on rupee denominated bonds (subject to conditions)
### Key aspects relating to each of the above repatriation options:

<table>
<thead>
<tr>
<th>Criteria</th>
<th>Buy-back</th>
<th>Capital reduction</th>
</tr>
</thead>
</table>
| **Taxation in the hands of the shareholders** | • Buy-back by listed company: Subject to capital gains tax, shareholders can claim tax exemption, if available, under applicable DTAA  
• Buy-back by unlisted company: Exempt from tax | Subject to capital gain tax on distribution in excess of accumulated profits; shareholders can claim tax exemption, if available, under applicable DTAA |
| **Taxation in the hands of the company** | • Buy-back by listed company: No tax implications  
• Buy-back by unlisted company: Taxable, at c.23% on consideration paid by the company as reduced by the amount received by company for issue of such shares | Taxable at c.21% to the extent of accumulated profits distributed |
| NCLT process                     | Typically, no                                  | Yes                                                    |
| Approval of creditors            | No                                            | Yes                                                    |
| Selective distribution           | Depends on response to buy-back offer         | Yes                                                    |
| Applicability of RBI pricing guidelines | Yes                                          | Yes                                                    |

**Withholding tax obligation on acquisitions from a non-resident**

Any person responsible for making a payment to a non-resident, which is chargeable to tax in India, is required to withhold tax at the applicable rates at the time of credit of such income to the account of the payee or at the time of payment (whichever is earlier). Non-compliance with the provisions on withholding tax could result into interest and penal consequences on the buyer. The withholding tax provisions are not applicable on capital gains payable to an FPI from transfer of securities.

In order to determine the amount of tax to be withheld on a sale transaction, the buyer is required to ascertain seller’s cost of acquisition, period of holding, eligibility to any DTAA benefits, etc. Given that this information may not be publicly available, the buyer typically relies on a certificate / opinion provided by a Chartered Accountant regarding the capital gains tax liability of the seller. Alternatively, an application can be filed with the Indian tax authorities for determining the rate at which tax should be withheld from the payment being made to the non-resident, however, this may have an impact on the transaction closing since the result and timeline of obtaining a response from the Indian tax authorities is uncertain.

The Indian tax authorities have time limit of up to eight years (after the year of deal closing) to recover tax. Accordingly, in transactions where the buyer does not withhold any tax on the capital gains earned by the seller on the basis of benefit under a DTAA, the general market practice is for the buyer to seek an indemnity from the seller to make good any amount payable by the buyer as a consequence of not withholding tax, in case the DTAA benefit is denied at a later stage.

**Tax on acquisitions at lower than fair market value**

There could be tax implication on the buyer where it receives any share or security for a consideration which is less than the aggregate fair market value (to be determined in a prescribed manner) of such share or security by an amount exceeding INR 50,000 (c. US$800). In such a case, the difference between the fair market value and the actual consideration is taxable in the hands of the buyer at 30% (for non-corporates) / 40% (for corporates), unless exempt under a DTAA.

In the context of determination of the fair market value of unquoted equity shares of a company, the rules also provide adoption of an independent fair valuation of jewelry, artistic work, immovable property and shares and securities held by such company plus the book value of all other assets and liabilities of such company. This results in a multi-layered calculation where the target company has invested in the aforesaid assets (including shares and securities of other companies).

With regard to unquoted preference shares, the rules provide that fair market value shall mean the price such shares would fetch in the open market based on valuation report from a merchant banker or an accountant.
Indirect transfer

In 2012, the ITA was amended to introduce indirect transfer provisions for taxation of gains arising from transfer of any share or interest in a company or entity, registered or incorporated outside India, which derives, directly or indirectly, its value “substantially” from assets located in India. A share or interest is deemed to derive its value “substantially” from assets (whether tangible or intangible) located in India, if on the specified date, the value of Indian assets:

- Exceeds the amount of INR 100 million (c. US$1.5 million); and
- Represents at least 50% of the value of all assets owned by the company or entity

Specified date refers to the date on which the accounting period of the company or entity ends preceding the date of transfer or the date of transfer, if the book value of assets of the company or entity from the aforesaid date to the date of transfer is exceeded by at least 15%.

In order to ascertain whether indirect transfer is triggered or not, detailed rules have been prescribed for determination of the fair market value of assets and the income attributable to assets in India.

Where the indirect transfer provisions are triggered, the proportionate capital gains relating to the assets located in India are taxable in India, unless relief is available under a DTAA. Having said this, indirect transfer provisions are not applicable in the following scenarios:

- Transfer (direct or indirect) of share or interest in a company or entity which is registered as a Category I or Category II FPI.
- Corporate reorganizations such as amalgamations/demergers, where the amalgamating/demerging company is exempt from capital gains tax in home jurisdiction and a minimum 25% shareholders of amalgamating/demerging company continue to be the shareholders in amalgamated/resulting company.
- Transferor of the share or interest in a company or entity, either individually or with an Associated Enterprises (AEs), does not hold, at any time in 12 months preceding the date of transfer, the right of management/control or the voting power/share capital/interest exceeding 5% of the total voting power/total share capital/total interest of the company or entity holding the Indian assets (directly or indirectly).
- Declaration of dividend outside India by a foreign company since such declaration and payment of dividend does not have an effect of transfer of any underlying asset located in India.
- Redemption/buy-back of shares or interest held indirectly in a VCF or a Category I and II AIF (Specified Funds) provided the income accrues or arises from or in consequence of transfer of shares or securities held in India by the specified funds and the same being chargeable to tax in India.

From a compliance perspective, the transferor of the share or interest in the foreign company or entity and the Indian company are required to furnish information and documentation in prescribed manner.
Place of Effective Management

Tax residence in India forms the basis of determination of India’s taxing right under the ITA. A company is said to be a resident of India if it is incorporated in India or during the financial year, its POEM is in India. The term “place of effective management” has been defined to mean a place where key management and commercial decisions necessary for the conduct of business of an entity, as a whole are, in substance made.

Guidelines have been issued to enable a foreign company to determine whether it could be regarded as a tax resident in India and consequently, offer its global income to tax in India. Under these guidelines determination of POEM is primarily based on whether or not a company has “Active Business outside India (ABOI)”. The ABOI test needs to be evaluated on the following basis:

- Passive income of the company is not more than 50% of its total income
- Less than 50% of its total assets are situated in India, less than 50% of the total number of employees are situated in India or are resident in India; and
- The payroll expenses incurred on such employees is less than 50% of its total payroll expenditure

For such companies, the POEM is deemed to be situated outside India, if majority of the Board meetings are held outside India, unless facts suggest that Board of Directors is not the de-facto decision making authority.

For companies other than those engaged in ABOI, the guidelines prescribe a twin test:

- Identification of persons who take key management and commercial decisions
- Determining the place where these decisions are, in fact, made

The guidelines also provide for certain guiding principles for determination of POEM such as determination of the location of board meetings, place of committee meetings where board delegates its authority to one or more committees, location of the Head Office, who constitutes senior management, etc.

From a PE / VC perspective, the fund or its investment vehicle is not likely to satisfy the ABOI test and hence it becomes critical to demonstrate that the person(s) who take key management and commercial decisions and the place where they take these decisions is not in India. Further, where decisions are taken by an Investment Committee comprising of individuals from different countries, including India, it would be relevant to demonstrate that the individuals participating in such committee from India do not have any veto power.

Where a foreign company is regarded to have a POEM in India, its global income is taxable in India at the rates applicable to a foreign company in India and could also trigger certain other compliance obligations that are only applicable to Indian tax residents.

Safe harbor for onshore management of offshore funds

Historically, the presence of a fund manager in India could create a business connection or a permanent establishment for an offshore fund in India. Further, the presence of a fund manager under certain circumstances may lead to the offshore fund being held to be a resident in India. The constitution of business connection/ permanent establishment/ tax residence in India could result in adverse Indian tax consequences for the offshore fund. This discouraged offshore funds from shifting the fund management activity to India or appointing experienced fund managers in India.

In order to encourage fund management from India, the ITA to provides a safe harbor to offshore funds from the aforesaid tax consequences. The safe harbor is available subject to the fund and the fund manager satisfying various conditions to qualify as an “eligible investment fund” and an “eligible fund manager”. Specifically, one of the condition mandates that the fund shall not carry on or control and manage (i.e., directly or indirectly holding 26% or more voting rights) any business in India.

From a PE / VC perspective, the threshold of 26% voting rights in an investee company to determine whether the fund controls or manages a business carried out in India, becomes a hurdle for several private equity funds and consequently, continues to pose a challenge for several fund managers to consider relocating their fund management activity entirely to India and apply for the safe harbor.

25. Circular No. 6 of 2017 dated 24 January 2017
Changing Landscape for Private Equity

Base Erosion and Profit Shifting

Base erosion and profit shifting refers to tax avoidance strategies adopted by multinationals that exploit gaps and mismatches in tax rules to artificially shift profits to low or no-tax locations where there is little or no economic activity, resulting in little or no tax being paid. The BEPS project aims to help governments protect their tax bases by increasing transparency and improved data in order to evaluate and stop the growing disconnect between where money and investments are made and where profits are actually reported for tax purposes by multinationals.

In 2015, the Organization for Economic Co-operation and Development (OECD) released reports on 15 key areas identified in the BEPS Action Plan that intend to scrutinize and correct tax evasion mechanisms such that countries can levy and collect their “fair share” of tax. On 7 June 2017, India and 67 other jurisdictions signed the MLI, a multilateral instrument that allows a coordinated approach to implement changes recommended under the BEPS Action Plans. Recognizing the complexity of designing a general instrument and to the specific provisions included in bilateral tax treaties, the MLI provides flexibility to the jurisdictions to implement parts of the MLI based on their needs, but mandates compliance with certain “minimum standards”.

A minimum standard mandated by the MLI is the principal purpose test (PPT) which has been introduced as a default test which provides that no benefit under a treaty shall be granted where obtaining that benefit was one of the principal purposes of any arrangement. India has opted to apply the simplified limitation of the benefit rule which limits the availability of treaty benefits to certain specified individuals, along with the mandatory minimum standard of the PPT to counter treaty shopping.

Additionally, India has opted for a wider definition of permanent establishment to include the activities of an agent that plays a principal role in concluding contracts even though such contracts are formalized outside India. Where an entity has a permanent establishment in India, the income attributable to such a permanent establishment is chargeable to tax in India. Some of the changes recommended under the BEPS Action Plan on permanent establishment and thin capitalization have already been implemented by India in the ITA.

Goods and Services Tax (GST)

The GST is a destination-based tax on consumption of goods and services and was introduced with effect from 1 July 2017. This is a substantial shift from the erstwhile indirect tax regime. India, being a federal country where both the center and states have been assigned the powers to levy and collect taxes through appropriate legislations, a dual GST model has been implemented with the center and states simultaneously levying GST on a common base thereby breaking the tax into three components: Central GST, State/Union Territory GST and Integrated GST. It is pertinent to note that GST is not levied when the services provided qualify under the “Export of Services” subject to satisfying certain specified conditions.
2.3 Investment structures

Historically, foreign funds have structured themselves by establishing in and investing from jurisdictions which have a DTAA with India (such as Mauritius, Singapore, etc.) and provides an exemption in India on capital gains derived from their investments and concessional rates on interest income. In most of these jurisdictions, special regimes are available to exempt investment gains of fund/ investment companies from taxation in the domestic tax laws. Therefore, effectively, the fund was able to pass on investment gains to its investors without any (or significant) incidence of tax in India and the country where the fund/ investment company is formed.

The presence of an investment advisory entity in India to provide non-binding investment advisory services helps in mitigating the risk of tax residency or permanent establishment of the fund/ investment company in India. Alternatively, the PE / VC funds can adopt a “fly in and fly out” approach for their investment professionals. However, this approach is not sustainable for a long term because physical presence of investment professionals in India (employed by a foreign enterprise) for negotiating investment transactions can give rise to a permanent establishment / tax residency risk for the investing fund and the management/advisory entity in India.

A diagrammatic representation of a simplified offshore structure (only for illustrative purposes) used for foreign investment in India is as under -

While the offshore structure has worked well in past, the following tax and regulatory changes have led to the use of onshore structures (especially by Indian GPs) to raise capital from offshore and onshore investors.

- Introduction of GAAR provisions from 1 April 2017 making it critical to demonstrate that obtaining tax benefit is not the main purpose for setting-up of the fund in a tax favorable jurisdiction.
- The re-negotiation of India’s DTAA with Mauritius and Singapore to give India the right to tax capital gains arising from transfer of shares acquired from 1 April 2017.
- Taxation of long term capital gains from sale of quoted and unquoted shares at 10%.
- Change in the test of residency for non-resident companies to POEM.
- Allowing foreign investment in AIFs under the automatic route, i.e., without any government approval. Further, if the manager and sponsor of the AIF is majority Indian resident citizen owned and controlled, the investment by the AIF irrespective of the level of foreign investment in it is regarded as domestic investment and the foreign investment policy conditions/ limitations are not applicable to investment by such AIFs.

In this structure, the foreign investment in the portfolio companies in India is made under the FDI or FPI or FVCI or a combination of routes.
Given the aforesaid developments and push from the Government of India to encourage the direct pooling of foreign investment in India, there is significant interest from foreign funds to evaluate the setting up of an AIF in India. A diagrammatic representation (only for illustrative purposes) of a typical onshore structure (involving an AIF) is as under:

The key considerations that are relevant to foreign investment in India through, both, offshore and onshore structure have been discussed in detail.
3 Offshore structures/ routes
3.1 FDI regime

Foreign investments under the FDI route can be made either under the automatic route or under the approval route depending on the sector/activities in which the Indian entity is engaged. Foreign investment in most sectors is permitted under the automatic route without any ownership restrictions or conditions. Foreign investments requiring government approval is considered and approved by the respective sector ministries/departments. FDI norms for certain select sectors and sectors in which FDI is prohibited is provided in Appendix 1.

An Indian company can raise funds by way of shares or debt. Shares of a company are categorized as equity or preference shares. Investment in Indian debt is not permitted under the FDI route but permitted under alternative routes discussed later.

Eligible instruments

- Equity shares
- Fully compulsorily and mandatorily convertible preference shares (CCPS)
- Fully compulsorily and mandatorily convertible debentures (CCD)
- Partly-paid shares: 25% of total amount to be brought up front and balance within 12 months of such issue
- Share warrants: 25% of total amount to be brought up front and balance within 18 months of such issue
- Options: Aforesaid instruments can contain an optionality clause subject to a minimum lock (higher of one year or as specified for sector) and without any option or right to exit at an assured price

Pricing guidelines

- The price of the aforesaid capital instruments issued by an Indian company to a non-resident should not be less than:
  i. In case of listed company: Price worked out as per SEBI guidelines
  ii. In case of unlisted company: Price worked out as per internationally accepted pricing methodology duly certified by chartered accountant or a SEBI registered merchant banker or a practicing cost accountant
- In case of CCPS/ CCD, the price/conversion formula of the instrument should be determined at the time of issue of the instrument and the price at the time of conversion should not be lower than fair market value worked out, at the time of issuance of such instrument.
- In case of share warrants, pricing and the price/conversion formula should be determined upfront.

Foreign investment in a LLP

Foreign investment is permitted in capital of a LLP operating in sectors where foreign investments up to 100% are allowed under the FDI automatic route and there are no FDI linked performance conditions.

The investment can be made either by way of capital contribution or acquisition of profit share, subject to the same being at a price higher than the fair price worked out as per any valuation norm and a valuation certificate issued by a chartered accountant or a practicing cost accountant obtained. Further, transfer of capital contribution/profit share from a non-resident to a person resident in India should not be made at a price higher than fair value determined as above.
Foreign Investment in a Startup Company

Foreign investment in capital instruments of a private company which is recognized as a startup company by the government, is subject to the sectoral caps, pricing guidelines, etc., as discussed above. In addition, investment is also permitted in convertible notes initially treated as debt and which is either repayable or convertible into equity shares within a period of 5 years from issue.

Downstream Investment

Downstream investment (i.e., indirect foreign investment by one Indian company/LLP into another Indian company/LLP by way of subscription or acquisition) by an Indian company/LLP owned or controlled by non-resident entities are required to comply with sectoral caps, pricing norms, etc., as specified under the FDI route. Also, the Indian company/LLP is prohibited from borrowing funds from domestic market to make downstream investments. However, downstream investments can be made using funds borrowed from foreign markets or from internal accruals (net of taxes) of such Indian entity.

An Indian company is regarded to be owned or controlled by non-resident, when the non-resident beneficially holds more than 50% of the capital instruments of such company or has a right to appoint a majority of the directors or to control the management or policy decisions including by virtue of the shareholding or management rights or shareholder agreement or voting agreement.

A LLP is regarded to be owned or controlled by a non-resident, when the non-resident contributes more than 50% in the capital and has majority profit share in the LLP or has a right to appoint majority of the designated partners that have control over all policies of a LLP.

A methodology has been prescribed to determine the level of foreign investment in a multi-layered investment structure.

Cross Border Mergers

Foreign investment by way of inbound and outbound mergers (i.e., merger, amalgamation or arrangement between an Indian company and a foreign company) is now permitted under the FDI route subject to RBI approval and prescribed conditions.

In case of an inbound merger (resultant company being an Indian company), following conditions have been prescribed:

- Issue of capital instruments to the non-resident is subject to the sectoral caps, pricing guidelines, etc., as discussed above.
- Guarantee or borrowings of the foreign company from overseas sources which become the borrowing of the resultant Indian company shall conform to the ECB guidelines/ trade credit norms or other foreign borrowing norms as prescribed, within a period of two years. Also, no repatriation for repayment of such liabilities is permitted within such period of two years. Further, conditions with respect to end use shall not apply on the resultant company.

If the Indian company is not permitted to acquire any asset or security outside India, it is required to dispose of the asset or security within a period of two years from the date of sanction of scheme by the NCLT.

In case of an outbound merger (resultant company being a foreign company), following conditions have been prescribed:

- Indian resident can acquire securities of the resultant foreign company subject to compliance with the outbound regulations.
- Guarantee or borrowings of the Indian company which become liability of the resultant foreign company should be repaid as per the scheme sanctioned by the NCLT.

A valuation of the Indian company and the foreign company is required to be done in accordance with internationally accepted principles.

Foreign Investment in an Investment Vehicle

Foreign investment in units of an investment vehicle is permitted under the automatic route. An investment vehicle has been defined to mean an entity which is registered with the SEBI, either as an AIF or REIT or InvIT. Any investment by such investment vehicle is considered as indirect foreign investment and has to comply with downstream investment conditions where the sponsor and/or manager of such investment vehicle in foreign “owned or controlled”.

Option

Start
3.2 FPI regime

Any investment under the FPI route can be made only after the foreign investor has registered itself as an FPI under the SEBI (FPI) Regulations. The application for registration as a FPI has to be made with a Designated Depository Participant and typically, the registration process takes 4-6 weeks. An NRI and any entity with an opaque structure cannot register as a FPI.

Categories of FPIs

- **Category I FPI**: Government and government related investors such as central banks, governmental agencies, sovereign wealth funds and international or multilateral organizations or agencies.
- **Category II FPI**: Regulated entities viz. broad based funds, other appropriately regulated persons, broad based funds where only the investment manager is a regulated entity, university funds and pension funds, etc.
- **Category III FPI**: All others not eligible under Category I and II foreign portfolio investors such as endowments, charitable societies, charitable trusts, foundations, corporate bodies, trusts, individuals and family offices.

The investment basket for each of the aforesaid categories of FPIs is largely the same, however, depending on which category the entity falls into for registration purposes, the KYC requirements would differ.

Eligible instruments

FPIs are permitted to invest in listed/ to be listed securities, some of which are listed below:

- Shares, debentures and warrants of companies, listed or to be listed on a recognized stock exchange in India through primary and secondary markets
- Derivatives traded on a recognized stock exchange
- Treasury bills and dated government securities
- Commercial papers issued by an Indian company
- Security receipts issued by asset reconstruction companies
- Such other instruments specified by the Board from time to time
- Perpetual debt instruments and debt capital instruments, as specified by the RBI from time to time
- Rupee denominated bonds or units issued by infrastructure debt funds
- Indian depository receipts
- Unlisted NCDs / bonds issued by an Indian company
- Securitized debt instruments

Key investment conditions/ restrictions

- Investment in debt securities and government securities is subject to the overall limits specified from time to time. Where the utilization of combined corporate debt limit exceeds 95%, an FPI is required to obtain the debt limits under an auction mechanism.
- RBI has recently issued a circular on investment in government securities and corporate bonds:
  - FPIs are permitted to invest in Central Government securities (G-secs) and State Development Loans (SDLs) with residual maturity below one year, provided investment by such FPI under either category does not exceed 20% of the total investment of that FPI in that category
  - FPIs are permitted to invest in corporate bonds with minimum residual maturity of more than one year
  - Aforesaid investment by FPIs is subject to concentration and diversification norms. Specifically, investment by any FPI, including investments by related FPIs, in a corporate bond should not exceed 50% of issue of such bond and the FPI should not have an exposure of more than 20% of its corporate bond portfolio to a single corporate
  - FPIs shall not invest in partly paid instruments

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26. Opaque structure is defined to mean any structure such as protected cell company, segregated cell company or equivalent, where the details of the ultimate beneficial owners are not accessible or where the beneficial owners are ring fenced from each other or where the beneficial owners are ring fenced with regard to enforcement. FPI satisfying the following criteria shall not be treated as having opaque structure: (i) The applicant is regulated in its home jurisdiction (ii) each fund or sub fund in the applicant satisfies broad based criteria, and (iii) The applicant gives an undertaking to provide information regarding its beneficial owners as and when asked for.

27. Broad based fund means a fund, established or incorporated outside India, which has at least 20 investors with no investor holding more than 49% of the shares or units of the fund or in a case where an institutional investor invests in the fund, such institutional investor must itself be a broad based fund. If an FPI has a bank, sovereign wealth fund, insurance/ reinsurance company or a pension fund as its institutional investor, then such an applicant shall be deemed to be broad based subject to the condition that such institutional investor(s) shall, jointly or separately, hold more than 50% percent of the shares or units of the fund in the applicant fund at all times.

28. Vide circular no SEBI/IMD/FPI/CSR/2018/70 dated 12 April 2018, limits for FPIs in Central Government securities has been enhanced to INR 207,300 crores on 12 April 2018 and INR 223,300 on 1 October 2018 and corporate bond limit has been enhanced to INR 266,700 crores on 12 April 2018 and INR 289,100 crores on 1 October 2018.
Transactions in securities to be undertaken only through registered stock brokers (except for transactions in government securities, open offers, buy-backs and other prescribed transactions)

The purchase of equity shares of each company by a single FPI shall be below 10% of the total paid-up equity capital on a fully diluted basis or less than 10% of the paid-up value of each series of debentures or preference shares or share warrants issued by an Indian company. The total holdings of all FPIs put together cannot exceed 24% of the paid-up equity capital on a fully diluted basis or paid up value of each series of debentures or preference shares or share warrants. However, this limit can be increased by the Indian company up to the sectoral cap/statutory ceiling, as applicable, with the approval of its Board of Directors and its shareholders.

Foreign investment in listed entities is considered as FDI and reported as such only if the investment is 10% or more, of the post issue paid-up equity capital of the company on a fully diluted basis. Any investment of less than 10%, of the post issue paid-up share capital of the company on a fully diluted basis is considered as FPI investment.

3.3 FVCI

Any investment under the FVCI route can be made pursuant to the foreign investor registering as a FVCI under the SEBI (FVCI) Regulations. The registration process requires, inter-alia, furnishing of applicant’s track record, investment strategy, targeted investors, investor commitment of at least US$1 million, etc.

Investment conditions

- At least 66.67% of the investible funds to be invested in unlisted equity shares or equity linked instruments of a venture capital undertaking
- Up to 33.33% of the investible funds may be invested by way of subscription to IPO or investment in debt instrument of a VCU

Eligible sectors

Where an FVCI invests in any sector other than those listed below, the investment should be in compliance with the regime (FDI, FPI, etc.) under which the investment is done:

- Infrastructure: This has been defined to include transport and logistics, energy, water and sanitation, communication and social and commercial infrastructure.
- Biotechnology
- IT related to hardware and software development
- Nanotechnology
- Seed research and development
- Research and development of new chemical entities in pharmaceutical sector
- Dairy industry
- Poultry industry
- Production of bio-fuels
- Hotel-cum-convention centers with seating capacity of more than 3,000

Eligible instruments

In addition to the instruments permitted under the FDI route, an FVCI is also permitted to invest in optionally convertible preference shares, optionally convertible debentures and NCDs.

Pricing norms

The entry and exit pricing norms applicable to investments under the FDI route are not applicable to investments made in eligible sectors under the FVCI route. This is one of biggest advantages of investing under the FVCI route since it allows flexibility for purchase/transfer of any security of a company at a price that is mutually acceptable to the buyer and the seller/issuer.

30. Circular no IMD/FPIC/CIR/P/2017/81 dated 20 July 2017
31. A.P. (DIR Series) Circular no. 24 dated 27 April 2018
32. A detailed definition of infrastructure is as provided under the ECB guidelines/policies notified under the extant FEMA Regulations as amended from time to time
Special benefits

- The one year lock-in of pre-issue share capital of a company undergoing an IPO, is not applicable to shares held by FVCIs provided such shares have been held by the FVCi for a period of at least one year as on the date of filing the draft prospectus with the SEBI.
- The transfer of shares of a listed company from FVCIs to promoters is exempted from public offer provisions under the Takeover Code.
- FVCIs are granted the status of a qualified institutional buyer and hence are eligible to subscribe to securities in an IPO through the book building route.
Changing Landscape for Private Equity

4 Onshore structures/ routes
4.1 AIF regime

AIF as a fund raising alternative has gained momentum in India over the last few years, since the introduction of the SEBI (AIF) Regulations. AIFs not only provide a mechanism to unlock the domestic pool of capital but as a structure also has several regulatory advantages over the offshore routes to raise and invest funds without impacting the tax attributes that apply to foreign investments in India.

An AIF is registered and regulated under the SEBI (AIF) Regulations and is a privately pooled investment vehicle that collects funds from investors, whether Indian or foreign, in accordance with a defined investment policy. An AIF can be established as a company, a trust or a LLP, or any other body corporate.

All AIFs are required to mandatorily seek registration in one of the categories mentioned in the table below. In case of Category I AIF, they also need to register under one of the sub-categories as prescribed. An AIF can launch schemes without seeking prior SEBI approval.

Eligibility criteria and conditions

<table>
<thead>
<tr>
<th>Parameters</th>
<th>Category I AIF</th>
<th>Category II AIF</th>
<th>Category III AIF</th>
</tr>
</thead>
<tbody>
<tr>
<td>Type of funds</td>
<td>Funds that invest in start-up or early-stage ventures or social ventures or SMEs or infrastructure</td>
<td>Funds that cannot be categorized as Category I AIFs or Category III AIFs</td>
<td>Funds that employ diverse or complex trading strategies and may employ leverage including through investment in listed or unlisted derivatives</td>
</tr>
<tr>
<td>Tenure²⁵</td>
<td>Minimum three years close ended fund</td>
<td>No minimum tenure prescribed. May be close ended or open ended</td>
<td></td>
</tr>
<tr>
<td>Sponsor commitment</td>
<td>2.5% of the corpus of the fund / scheme or INR 50 million (c. US$0.8 million), whichever is lower</td>
<td>5% of the corpus or INR 100 million (c. US$1.5 million), whichever is lower</td>
<td></td>
</tr>
<tr>
<td>Minimum corpus</td>
<td>AIF / scheme to have minimum corpus of INR 200 million (c.US$3 million)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Minimum investment</td>
<td>Minimum investment per investor- INR 10 million (c. US$1.5 million). For employees or directors, etc. of AIF / Manager- INR 2.5 million (c. US$0.4 million)</td>
<td>Maximum 10% of the investible funds in one company</td>
<td>May engage in leverage or borrow subject to investor consent and maximum limit specified by SEBI (not to exceed twice the Net Asset Value of the fund)</td>
</tr>
<tr>
<td>Investment restrictions</td>
<td>Maximum 25% of investible funds in one company</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Leverage/ Hedging</td>
<td>Shall not borrow funds or engage in leverage except for meeting temporary fund requirements</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Permissible investments</td>
<td>Permitted to invest in investee companies or in VCU or in SPV or in LLP or in units of AIFs. However, each of the sub-category under Category I AIF are required to invest in the sector/ stage relevant to that sub-category</td>
<td>Permitted to invest primarily in unlisted investee companies. No specific target/ sector approach as that required for Category I AIFs</td>
<td>Permitted to invest in securities of listed or unlisted investee companies or derivatives or complex or structured products</td>
</tr>
</tbody>
</table>

²³. SEBI (Alternative Investment Funds) Regulations, 2012
²⁴. Exceptions include family trust, ESOP trust, employee welfare trusts or any other trusts for employees’ benefits, holding companies, securitisation trust or any other pool of funds directly regulated by any other regulatory authority in India.
²⁵. Extension permitted up to 2 years subject to approval of 2/3rds of unit holders (value)
Foreign investment in AIFs

A person resident outside India, including an FPI or an NRI is permitted to acquire, purchase, hold, sell or transfer units of an AIF under the automatic route.

Downstream investment by AIFs is regarded as foreign investment (subject to sectoral caps and conditions/restrictions) if the sponsor or the manager: (i) is not owned and not controlled by resident Indian citizens or (ii) is owned or controlled by person resident outside India. Where the AIF is considered as Indian owned and controlled, the AIF could invest in any securities without any restriction, thereby providing significant advantage compared to investment through other routes which need to comply with the respective regulatory conditions.

Category III AIFs having foreign investments are permitted to make investments only in securities/instruments in which an FPI is allowed to invest under the SEBI (FPI) Regulations.

An NRI or an Overseas Citizen of India, including a company, trust and a partnership firm incorporated outside India and owned and controlled by NRIs or an Overseas Citizen of India is permitted to invest in AIFs on a non-repatriation basis. Such investment will be deemed to be a domestic investment at par with the investment made by residents.

Foreign investments by AIF

An AIF is permitted to invest up to 25% of its investible funds in equity and equity linked instruments of unlisted foreign company (have an Indian connection), subject to an overall ceiling of US$500 million for all AIFs. An approval from SEBI is required for AIFs to make such investments which may be granted subject to conditions.

4.2 Non-banking financial companies (NBFC) regime

Cross border lending/debt to Indian corporates is restricted and is subject to several conditions. With an increasing interest amongst foreign investors in making investments that generate high yield and provide regular/assured returns to the investors, there is a heightened interest in being able to lend/invest in debt instruments freely. In this context, NBFC provide an attractive platform to lend/make investments in Indian debt and take local leverage to magnify investment returns.

NBFC provide an alternative platform for offshore investors to set-up a company in India for lending or investing in Indian portfolio companies. NBFCs are governed by the regulatory framework notified/prescribed by RBI. A company which proposes to carry on business of a NBFC (except certain categories which are regulated by other regulators) is required to have minimum net owned funds of INR 20 million (c. US$0.3 million) and also obtain a certificate of registration from RBI.

Any company whose financial assets constitute more than 50% of the total assets and income from financial assets constitute more than 50% of the gross income is required to be registered as a NBFC with RBI.

Depending on the asset size and nature of business undertaken a NBFC can be broadly categorized as under:

- Deposit taking NBFCs: New licenses for this category are generally not given
- Non Deposit taking NBFCs (a) Non-Systemically Important NBFC with asset size of less than INR 5 billion (c. US$80 million) and (b) Systemically Important NBFC with asset size of INR 5 billion (c. US$80 million) or more
- Core investment companies, a company which acquires shares and securities of group companies.

Tax regime

<table>
<thead>
<tr>
<th>Category I</th>
<th>Category II</th>
<th>Category III</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Tax “pass-through” available for income other than business income</td>
<td>• No tax “pass through” status accorded to category III AIF</td>
<td>• Income-tax applicable as per the legal status of the AIF (i.e., whether set-up as a company, LLP or trust)</td>
</tr>
<tr>
<td>• Business income taxable at AIF level</td>
<td>• Tax to be discharged/withheld as per the normal provisions of the ITA depending on the legal status of the AIF</td>
<td>• Tax to be discharged/withheld as per the normal provisions of the ITA depending on the legal status of the AIF</td>
</tr>
<tr>
<td>• No pass-through status for net losses incurred at AIF level</td>
<td>• • Withholding at 10% for distributions made to resident investors</td>
<td>• • Withholding at rates in force for distributions made to non-resident investors</td>
</tr>
</tbody>
</table>
Special benefits


Earlier, NBFCs did not have the recourse to the SARFAESI Act and hence, were at a disadvantage compared to banks and other financial institutions. In order to bring parity in regulation of NBFCs with other financial institutions in matters relating to recovery, the SARFAESI Act has been amended to include NBFCs registered with the RBI and as notified by the GOI within the definition of financial institution.

Pursuant to the same, the Government of India has notified NBFCs registered with RBI and having an asset size of INR 5 billion (c. US$80 million) and above as per their last audited balance sheet as financial institutions. Further, such notified financial institutions can enforce their security interest for securing repayment of secured debt with principal amount of INR 10 million (c. US$0.15 million) or more.

4.3 Asset Reconstruction Company (ARC) regime

ARC as an alternative could be looked into by funds wanting to acquire and resolve/turnaround the defaulting companies or loans. ARCs are governed by the regulatory framework notified/prescribed by the RBI. A company which proposes to carry on business of an ARC is required to have a minimum net owned funds of INR 1 billion (c. US$15 million) and also obtain a certificate of registration from RBI. Typically, ARC registration process takes 6-8 months. An ARC cannot undertake activities other than the asset reconstruction activities.

Acquisition of loans under ARC route

An ARC can acquire the loan portfolio either on its balance sheet or under a securitization trust (ST) by floating schemes for raising funds through issuance of security receipts (SRs) to qualified buyers.\[36\]

Where the loan portfolio is acquired by floating schemes, an ARC is required to subscribe to at least 15% of the SRs under each scheme and continue holding the same on an ongoing basis till the SRs are redeemed under the schemes.

36 Qualified buyers include financial institution, insurance company, bank, state financial corporation, state industrial development corporation, trustee or asset reconstruction company or any asset management company of a mutual fund or a pension fund or a foreign portfolio investor or an Alternative Investment Fund or specified Non-Banking Financial Companies or any other body corporate as may be specified by SEBI. QBs to also include any category of non-institutional investors as may be specified by RBI.

Foreign investment in an ARC and the ST floated by the ARC

FDI in ARC is permitted up to 100% under the automatic route. An investor could also invest in listed/unlisted NCDs of ARCs under the FPI route.

Further, FPIs could invest up to 100% in SRs of the ST (given that ARCs have to invest at least 15% in each tranche of the SRs, FPI could invest up to 85% of each tranche of the SR). The investment in SRs is subject to overall corporate bond limits and conditions.

Tax regime

- ARCs are taxable in India under the normal provisions of the ITA.
- Tax pass-through is available for income earned by ST, i.e., the income earned by ST, if any, is taxable directly in the hands of the SR holders and exempt in the hands of ST itself.
- Any income paid by any person to a ST is not subject to withholding tax provisions.
- ST is required to withhold tax on distributions to SR holders as follows:
  - 25% in case of payment made to resident individuals or Hindu Undivided Family
  - 30% in case of other resident investors
  - Rates in force in case of payments to non-resident investors
- Investors could apply for NIL/lower withholding certificate.
Setting-up an Indian advisory entity
A foreign fund proposing to have a focused investment team based in India can do so by setting up an entity in which such individuals could be employed for providing investment advisory services to the overseas fund or its manager. Typically, the advisory entity acts as a non-binding advisor for investment/divestment of the Indian portfolio and is compensated on a cost plus margin basis for the services rendered.

**SEBI (Investment Advisers) Regulations, 2013 [SEBI (IA) Regulations]**

Under the SEBI (IA) Regulations, an investment adviser is required to obtain a registration. However, an adviser who provides investment advice exclusively to clients based outside India is exempt from obtaining a registration. In case of an Indian advisory entity which renders services exclusively to the overseas fund or its manager, there is no need to obtain a registration under the IA Regulations.

**Foreign investment in an Indian advisory entity**

Prior to September 2016, foreign investment (up to 100%) in an investment advisory entity was permitted under the automatic route (i.e., without prior government approval) subject to minimum capitalization requirement of US$0.5 million (to be brought upfront) by the foreign investor, irrespective of the level of foreign investment in such advisory entity. Subsequently, the foreign investment guidelines were amended to allow foreign investment under the automatic approval route in entities in India that are regulated by a financial sector regulator (such as the RBI, SEBI etc.) subject to such entities meeting the minimum capitalization requirements as specified by the concerned regulator. For entities which are unregulated by any financial service regulator and the entity is unregistered/exempted from obtaining registration, 100% foreign investment is permitted under the approval route subject to following minimum capitalization (irrespective of the level of foreign ownership):

- **Non-fund based activity**
  - US$2 million

- **Fund based activity**
  - US$20 million

Based on above, if the advisory entity (non-fund based) is not registered with/regulated by a financial sector regulator, any level of foreign investment in such entity will need to satisfy the minimum capitalization requirement of US$2 million.

**Legal form of the Indian advisory entity**

Foreign investment in a LLP is permitted in sectors where foreign investments up to 100% is allowed under automatic route and there are no FDI linked performance conditions. In case of an investment advisory entity, the foreign investment is subject to certain conditions (as discussed above) and hence, foreign investment in an investment advisory entity set-up as a LLP may not be permitted. One of the key advantage of setting up the advisory entity as an LLP, apart from the significant operational ease and flexibility is the non-applicability of dividend distribution tax that a company is subject to (c. 21%). A detailed comparison between LLP and company form is provided in Appendix 2.
## Appendix 1

### FDI norms in select sectors and sectors where foreign investment is prohibited

<table>
<thead>
<tr>
<th>Sectors</th>
<th>Sectoral cap</th>
<th>Entry route</th>
<th>Additional conditions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Asset reconstruction company</td>
<td>100%</td>
<td>Automatic</td>
<td>Yes</td>
</tr>
<tr>
<td>Broadcasting</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Broadcasting carriage services</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Non-news and current affairs’ TV channels</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Terrestrial broadcasting FM, news and current affairs’ TV channels</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Banking: Public sector</td>
<td>20%</td>
<td>Approval</td>
<td>Yes</td>
</tr>
<tr>
<td>Banking: Private sector</td>
<td>74%</td>
<td>Above 49% and up to 74% under government route</td>
<td>Yes</td>
</tr>
<tr>
<td>Cash and carry wholesale</td>
<td>100%</td>
<td>Automatic</td>
<td>Yes</td>
</tr>
<tr>
<td>Construction and development of townships, built up infrastructure</td>
<td>100%</td>
<td>Automatic</td>
<td>Yes</td>
</tr>
<tr>
<td>Defense</td>
<td>100%</td>
<td>Automatic up to 49%. Above 49% under government route wherever it is likely to result in access to modern technology or for other reasons to be recorded</td>
<td>Yes</td>
</tr>
<tr>
<td>E-commerce activities</td>
<td>100%</td>
<td>Automatic</td>
<td>Yes</td>
</tr>
<tr>
<td>Industrial parks</td>
<td>100%</td>
<td>Automatic</td>
<td>Yes</td>
</tr>
<tr>
<td>Insurance</td>
<td>49%</td>
<td>Automatic</td>
<td>Yes</td>
</tr>
<tr>
<td>Multi-brand retail</td>
<td>51%</td>
<td>Approval</td>
<td>Yes</td>
</tr>
<tr>
<td>Non-banking financial services company (registered with the RBI)</td>
<td>100%</td>
<td>Automatic</td>
<td></td>
</tr>
</tbody>
</table>
Changing Landscape for Private Equity

<table>
<thead>
<tr>
<th>Sectors</th>
<th>Sectoral cap</th>
<th>Entry route</th>
<th>Additional conditions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pharmaceuticals</td>
<td>100%</td>
<td>Automatic (Green-field) / Approval up to 74% (Brownfield)</td>
<td>Yes</td>
</tr>
<tr>
<td>Print media</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Newspaper dealing with current affairs</td>
<td>26%</td>
<td>Approval</td>
<td>Yes</td>
</tr>
<tr>
<td>• Facsimile edition of foreign newspapers and scientific and technical magazines</td>
<td>100%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Single brand retail</td>
<td>100%</td>
<td>Automatic</td>
<td>Yes</td>
</tr>
<tr>
<td>Telecom services</td>
<td>100%</td>
<td>Automatic up to 49%</td>
<td>Yes</td>
</tr>
</tbody>
</table>

List of sectors in which foreign investment is prohibited

1. Lottery business including government/private lottery, online lotteries
2. Gambling and betting including casinos
3. Chit funds
4. Nidhi company
5. Trading in transferable development rights
6. Real estate business\(^\text{37}\) or construction of farm houses
7. Manufacturing of cigars, cheroots, cigarillos and cigarettes, of tobacco or of tobacco substitutes
8. Activities not open to private sector investment, e.g., (i) Atomic energy and (ii) Railways operation
9. Foreign technology collaboration in any form including licensing for franchise, trademark, brand name, management contract is also prohibited for lottery business and gambling and betting activities

\(^{37}\) Real estate business shall not include development of townships, construction of residential/commercial premises, roads or bridges and real estate investment trusts registered and regulated by SEBI
### Appendix 2

**LLP vs. Private Limited Company (Company)**

<table>
<thead>
<tr>
<th>Parameters</th>
<th>LLP</th>
<th>Company</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Statute</strong></td>
<td>The LLP Act, 2008</td>
<td>The Companies Act, 2013</td>
</tr>
<tr>
<td><strong>Registration</strong></td>
<td>Registration with Registrar of Companies (RoC) required</td>
<td></td>
</tr>
<tr>
<td><strong>Members</strong></td>
<td>Minimum partners: 2</td>
<td>Minimum members: 2</td>
</tr>
<tr>
<td></td>
<td>Maximum number of partners: No limit specified (partners are not required to be residents, however, at least one designated partner (DP) is required to be an Indian resident)</td>
<td>Maximum number of members: 200 (members can be resident or non-resident)</td>
</tr>
<tr>
<td><strong>Liability of LLP/private company</strong></td>
<td>For non-compliance or contravention of the provisions of laws, the LLP and the DPs shall be liable</td>
<td>For non-compliance or contravention of the provisions of laws, the Company and the officer in default shall be liable</td>
</tr>
<tr>
<td><strong>Liability of partners/members</strong></td>
<td>Limited, to the extent of their contribution towards LLP. However, joint and several for tax purposes</td>
<td>Limited to the extent of unpaid amount on the shares held by the shareholders</td>
</tr>
<tr>
<td><strong>Voting power</strong></td>
<td>Based on LLP agreement</td>
<td>Based on number of shares with voting rights held</td>
</tr>
<tr>
<td><strong>Transferability</strong></td>
<td>Partners can transfer their interest/profit share in LLP, as mutually agreed subject to Indian exchange regulations</td>
<td>Transfer of shares subject to provisions of the Articles of Association and consent of Board of Directors.</td>
</tr>
<tr>
<td><strong>Corporate law compliances</strong></td>
<td>Relatively lesser- governed by LLP Agreement and no mandatory meetings required</td>
<td>Periodic Board meeting and annual general meeting required to be held</td>
</tr>
<tr>
<td><strong>Dissolution</strong></td>
<td>By agreement or by order of the NCLT</td>
<td>Voluntary or by order of NCLT once the affairs of the company have been wound up</td>
</tr>
</tbody>
</table>
### Parameters

<table>
<thead>
<tr>
<th>Parameters</th>
<th>LLP</th>
<th>Company</th>
</tr>
</thead>
<tbody>
<tr>
<td>Regulatory restrictions on repatriation of profits/ returns</td>
<td>No exchange control restrictions on repatriation of profits from the LLP to its partners</td>
<td>Repatriation/ payment of dividend buyback, capital reduction, etc., subject to Companies Act and FDI guidelines for transfer of shares from non-resident to resident</td>
</tr>
<tr>
<td>Pricing</td>
<td>Transfer of interest in the LLP from a resident to a non-resident or vice versa is subject to FEMA pricing guidelines</td>
<td>Transfer of shares from a resident to a non-resident or vice-versa is subject to FEMA pricing guidelines</td>
</tr>
<tr>
<td>Rate of tax</td>
<td>The effective tax rate may range between c.31% to c.35% (based on taxable income). Alternate Minimum Tax (AMT) applicable at 18.5% of the adjusted total income (in specified cases)</td>
<td>The effective tax rate may range between c.26% to c.35% (based on turnover and taxable income). Minimum Alternate Tax (MAT) applicable at 18.5% of the book profits</td>
</tr>
<tr>
<td>Applicability of Dividend Distribution Tax (DDT), Buy-back tax (BBT)</td>
<td>There is no DDT or BBT payable on distribution of profits by an LLP to its partner. Share of profit from an LLP is exempt from tax in the hands of the partner</td>
<td>Effective rate of DDT is c.21% and for BBT it is c.23%. Where DDT/BBT is paid by the company, no additional tax is payable by a non-resident shareholder</td>
</tr>
<tr>
<td>Remuneration to partners/ Managerial remuneration</td>
<td>Allowable as deduction in the hands of LLP subject to limits</td>
<td>Allowable as deduction in the hands of company (not subject to limits)</td>
</tr>
</tbody>
</table>
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