Executive summary

To encourage offshore fund management from India, the Indian Income Tax Law (ITL) provides a safe harbor regime for onshore management of offshore funds to neutralize the impact of business connection, permanent establishment (PE) and tax residence risks for the offshore funds in India. Certain conditions must be complied with by an entity to qualify as an Eligible Investment Fund (EIF) or Eligible Fund Manager (EFM).

To further rationalize and incentivize this regime, the Central Board of Direct Taxes (the CBDT) has provided in a recently issued notification, that an investment fund set up by a Category-I or Category-II Foreign Portfolio Investor (FPI) registered with the Securities and Exchange Board of India (the SEBI) need not satisfy the investor diversification conditions stated in the ITL to qualify as an EIF. Additionally, the CBDT has specified the list of countries in which the investment fund should be established, incorporated or registered to be eligible for benefits under the safe harbor regime.
Detailed discussion

Background
The presence of a fund manager in India could cause business connection, PE and tax residence risks for offshore funds in India. To encourage offshore fund management from India, the ITL provides a safe harbor regime that lessens exposure to business connection, PE and tax residence risks for the offshore funds in India.

However, to qualify as an EIF and an EFM under the safe harbor rule, the fund and the fund manager are required to comply with 13 and 4 conditions in the aggregate for the EIF and the EFM, respectively.

The conditions were onerous and required guidance for their application but over the last two years, the Indian Government has attempted to modify some of the conditions and also issued additional guidance to help promote the regime. In addition, the regime provides the EIF a preapproval option from the Government to secure certainty of the tax outcome for the fund.

To further rationalize and incentivize this regime, the CBDT recently issued a notice (the Notification) providing that an investment fund set up by a Category-I or Category-II FPI registered with the SEBI need not satisfy certain conditions specified in the ITL to qualify as an EIF.

Amendment provided in the Notification
The Notification removes the following three conditions:

1. The fund must have a minimum of 25 members who are, directly or indirectly, not connected persons.1
2. Any member of the fund and connected persons should not have any participation interest, directly or indirectly, in the fund exceeding 10%.
3. The aggregate participation interest, directly or indirectly, of 10 or less members along with their connected persons in the fund, should be less than 50%.

The elimination of the above three conditions is applicable to an investment fund set up by a Category-I or Category-II FPI registered with the SEBI. As a result, a Category-I or Category-II FPI registered with SEBI is only required to comply with the investor diversification conditions set forth in the SEBI (FPI) Regulations, 2014.

As a result, the Notification removes one of the significant hurdles for offshore funds (particularly newly launched funds) to maintain (and track) a diversified investor base based on two separate sets of regulations - one for the purpose of SEBI (FPI) Regulations, 2014 and the other for the purposes of the ITL.

This will also help to eliminate the burdensome requirement of testing whether the investors in the fund are “connected persons”, as mandated under the ITL.

Further, to be eligible to qualify as an EIF, the investment fund must be:

> A resident of a country or specified territory with which India has entered into an income tax treaty or tax information exchange agreement.

Or

> Established, incorporated or registered in a notified country or specified territory.

The CBDT has compiled a list of 121 countries where the investment fund would need to meet the second requirement above to be eligible for the safe harbor regime. The list includes jurisdictions such as Cayman Islands, Cyprus, Ireland, Luxembourg, Mauritius, the Netherlands, and Singapore but excludes Hong Kong.

Implications
The issuance of the Notification reflects another effort by the Indian Government to attract offshore funds to the safe harbor regime. Eliminating the requirements relating to investor diversification for Category-I and Category-II FPIs that are well regulated by SEBI, is a logical step and will encourage FPIs to participate in this regime. For private equity funds, however, the 26% or less ownership requirement in a portfolio company continues to act as a barrier.

Endnote
1. The term “connected person” is defined in a wide manner to include any person who is connected directly or indirectly to another person and includes certain specified connections.
For additional information with respect to this Alert, please contact the following:

**Ernst & Young LLP (India), Mumbai**
- Sudhir Kapadia  +91 22 6192 0900  sudhir.kapadia@in.ey.com

**Ernst & Young LLP (India), Hyderabad**
- Jayesh Sanghvi  +91 40 6736 207  jayesh.sanghvi@in.ey.com

**Ernst & Young LLP – Indian Tax Desk, New York**
- Riad Joseph  +1 212 773 4496  riad.joseph1@ey.com
- Sameep Uchil  +1 212 773 4862  sameep.uchil@ey.com

**Ernst & Young LLP – Indian Tax Desk, Chicago**
- Roshan Samuel  +1 312 879 2531  roshan.samuel1@ey.com

**Ernst & Young LLP – Indian Tax Desk, San Jose**
- Archit Shah  +1 408 947 4930  archit.shah@ey.com

**Ernst & Young LLP – Indian Tax Desk, Dallas**
- Monika Wadhwa  +1 214 665 5527  monika.wadhwa1@ey.com

**Ernst & Young LLP, Asia Pacific Business Group, New York**
- Chris Finnerty  +1 212 773 7479  chris.finnerty@ey.com
- Kaz Parsch  +1 212 773 7201  kazuyo.parsch@ey.com
- Bee Khun Yap  +1 212 773 1816  bee-khun.yap@ey.com

**Ernst & Young LLP, Asia Pacific Business Group, Houston**
- Trang Scott  +1 713 751 5775  trang.scott@ey.com
About EY
EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit ey.com.

© 2017 EYGM Limited.
All Rights Reserved.

EYG no. 05118-171Gbl
1508-1600216 NY
ED None

This material has been prepared for general informational purposes only and is not intended to be relied upon as accounting, tax, or other professional advice. Please refer to your advisors for specific advice.

ey.com