Nishith Desai Associates
LEGAL AND TAX COUNSELING WORLDWIDE

MUMBAI SILICON VALLEY BANGALORE SINGAPORE MUMBAI BKC NEW DELHI MUNICH NEW YORK

Private Equity and Debt in Real Estate

January 2017

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Abbreviations

Abbreviation	Meaning / Full Form
AAR	Authority for Advanced Rulings
AIF	Alternate Investment Funds
CCDs	Compulsorily Convertible Debentures
CCPS	Compulsorily Convertible Preference Shares
DCF	Discounted Cash Flows
DDT	Dividend Distribution Tax
DIPP	Department of Industrial Policy and Promotion
DTAA	Double Taxation Avoidance Agreements
ECB	External Commercial Borrowing
FATF	Financial Action Task Force
FDI	Foreign Direct Investment
FDI Policy	The Consolidated Foreign Direct Investment Policy as published by the DIPP from time to time
FEMA	Foreign Exchange Management Act
FIPB	Foreign Investment Promotion Board
FII	Foreign Institutional Investor
FPI	Foreign Portfolio Investor
FVCI	Foreign Venture Capital Investor
GAAR	General Anti-Avoidance Rules
GP	General Partner
HNI	High Net worth Individuals
InvIT	Infrastructure Investment Trust
InvIT Regulations	Securities And Exchange Board of India (Infrastructure Investment Trusts) Regulations,
IPO	Initial Public Offering
ITA	Income Tax Act, 1961
LP	Limited Partner
LRS	Liberalized Remittance Scheme
NBFC	Non-Banking Financial Services
NCD	Non-Convertible Debenture
NRI	Non-Residential Indian
OCD	Optionally Convertible Debenture
OCRPS	Optionally Convertible Redeemable Preference Shares
PE	Permanent Establishment
PIO	Person of Indian Origin
PIS	Portfolio Investment Scheme
PN2	Press Note 2 of 2005
Press Note 10	Press note 10 of 2014 issued by the Ministry of Commerce and Industry dated December 03, 2014
Press Release	Press release issued by the Ministry of Commerce and Industry dated October 29, 2014
RBI	The Reserve Bank of India
TISPRO Regulations	Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2000
SGX	Singapore Exchange
SBT	Singapore Business Trust
QIB	Qualified Institutional Buyer

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Introduction: Real estate sector looking up!

Last year, the finance minister in his budget speech had announced that the investment conditions for FDI in real estate will be further liberalized. There have been concerns regarding the ability of the various policy measures boosting real estate activities, and the negative impact of the recent demonetization of high denomination currency notes by the Government of India. While clouds of uncertainty shroud the real estate sector, our discussions with offshore real estate funds present a rather optimistic picture, even as they remain in wait and watch mode for the next quarter or two.

We believe the optimism is based on broadly the following three drivers:

First, the routes for foreign investment in real estate companies have been substantially liberalised. On the one hand, almost all sectoral restrictions for foreign direct investments have been relaxed. On the other hand, substantial relaxations for raising foreign debt have also been provided for. Indian real estate companies that hesitated listing their securities can now raise foreign debt by issuing unlisted debentures to foreign portfolio investors. Offshore funds get tax optimised redeemable instruments with security interests without any coupon restrictions.

Second, Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (**"SARFAESI"**) benefits which was hitherto available only to banks and financial institutions have now been extended to even offshore funds through the local debenture trustees. This is a huge give away by the government, which affords significant leverage in terms of enforcement of security interests, which has otherwise been criticised as a toothless protection.

Third, the Real Estate Regulation Act, which is scheduled to be effective in most states from March 2017. With 70% of the revenues escrowed for development costs and the requirement to complete the construction in a time bound manner, there is assurance on usage of proceeds and timely delivery. Though standard investor protections like step in rights and enforcement of security interests could now be called into question (since any change in the 'promoter' or developer will require prior approval of 2/3 allottees and the regulator), offshore funds tend to respect the discipline that RERA seeks to bring in.

These regulatory changes are likely to imbibe ethical behaviour and streamline the market to large and serious players - an environment most conducive to offshore funds. It's wait and watch for the next few months, but India is slowly climbing up the ladder of priority in the list of global private equity funds.

This paper analyses the changes to the legal and tax framework in India which is expected to increase the inflows of foreign capital in the Indian real estate sector.

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1. Regulatory Framework for Foreign Investment

Foreign investments into India are primarily monitored by primarily three regulators, the Reserve Bank of India (**"RBI"**), the Foreign Investment Promotion Board (**"FIPB"**) and the Department of Industrial Policy and Promotion (**"DIPP"**). In addition to these regulators, if the securities are listed or offered to the public, dealings in such securities shall also be regulated by the Indian securities market regulator, Securities and Exchange Board of India (**"SEBI"**).

Foreign investment into India is regulated under Foreign Exchange Management Act, 1999 (**"FEMA"**) and the regulations thereunder, primarily Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2000 (**"TISPRO Regulations"**). Keeping in view the current requirements, the DIPP (an instrumentality of the Ministry of Commerce & Industry), and the RBI make policy pronouncements on foreign investment through Press Notes / Press Releases / Circulars which are notified by the RBI as amendments to the TISPRO Regulations. These notifications take effect from the date of issue of Press Notes / Press Releases/ Circulars, unless specified otherwise therein.

Foreign investment can be classified into the following investment regimes –

i. Foreign Direct Investment (**"FDI"**);

ii. Foreign Venture Capital Investment regime, for investments made by SEBI registered Foreign Venture Capital Investors (**"FVCI"**);

iii. Foreign Portfolio Investor regime, for investments made by SEBI registered Foreign Portfolio investor (**"FPI"**);

iv. Non Resident Indian regime, for investments made by non-resident Indians and persons of Indian origin (**"NRI"**).

Separately, Indian entities are not permitted to avail of External Commercial Borrowings (**"ECB"**), which are essentially borrowings in foreign currency, if the end use of the proceeds of the ECB will be utilized towards investment in real estate. However, recently, the ECB norms were relaxed to allow ECB in low cost affordable housing. This paper does not discuss ECB.

We now discuss each of the investment routes together with their attendant regulatory challenges. Tax issues are dealt with later on under a separate taxation head in this paper.

I. Foreign Direct Investment

In order to bring clarity and certainty in the policy framework, the DIPP for the first time issued a consolidated policy relating to FDI in India on April 1, 2010, which is now revised annually and represents the current 'policy framework' on FDI. The latest consolidated policy published as on the date of this paper is dated June 7, 2016 (**"FDI Policy"**). Under the FDI Policy, Indian companies with FDI are prohibited from engaging in 'Real Estate Business'. However, it may be noted that the term 'Real Estate Business' has been defined in the FDI Policy to mean 'dealing in land and immovable property with a view to earning profit therefrom and does not include the development of townships, construction of residential/ commercial premises, roads or bridges, educational institutions, recreational facilities, city and regional level infrastructure, townships. Further, earning of rent/ income on lease of property, not amounting to transfer, will not amount to a real estate business'.

Over the period of years, Government has liberalized foreign investment in real estate sector. First notable step in this direction was taken in 2005 when DIPP issued the press note 2 of 2005 (**"PN2"**). PN2 permitted FDI in townships, housing, builtup infrastructure and construction-development projects (which would include, but not be restricted to, housing, commercial premises, hotels, resorts,

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hospitals, educational institutions, recreational facilities, city and regional level infrastructure) subject to fulfillment of certain entity level and project level requirements. PN2 required that real estate companies seek foreign investments only for construction and development of projects, and not for completed projects.

Press Note 12 of 2015 had substantially relaxed requirements relating to the minimum area for project development, minimum capitalization norms, further exemptions for investments in low cost, affordable housing, and investments in completed projects. Please refer to **Annexure I** for our analysis of these exemptions.

A. Instruments for FDI

As per the FDI Policy, FDI can be routed into Indian investee companies by using equity shares, fully, and mandatorily/Compulsorily Convertible Debentures (**"CCDs"**) and fully and Compulsorily Convertible Preference Shares (**"CCPS"**). Debentures which are not CCDs or optionally convertible instruments are considered to be ECB and therefore, are governed by clause (d) of sub-section 3 of section 6 of FEMA read with Foreign Exchange Management (Borrowing or Lending in Foreign Exchange) Regulations, 2000 as amended from time to time. RBI recently amended the TISPRO Regulation to permit issuance of partly paid shares and warrants to non-residents (under the FDI and the FPI route) subject to compliance with the other provisions of the FDI and FPI schemes.

Since, these CCPS and CCDs are fully and mandatorily convertible into equity, they are regarded at par with equity shares and hence the same are permissible as FDI. Further, for the purpose of minimum capitalization, in case of direct share issuance to non-residents, the entire share premium received by the Indian company is included. However, in case of secondary purchase, only the issue price of the instrument is taken into account while calculating minimum capitalization.

Herein below is a table giving a brief comparative analysis for equity, CCPS and CCDs:

Particulars	Equity	CCPS	CCD
Basic Character	Participation in governance and risk based returns	Assured Dividend – Convertible into Equity	Assured Coupon – Convertible into Equity
Liability to Pay	Dividend can be declared only out of profits	Fixed dividend if profits accrue	Fixed Interest payment - not dependent on accrual of profits
Limits to Payment	No cap on dividend	Dividend on CCPS cannot exceed 300 basis points over and above the prevailing SBI prime lending rate in the financial year in which CCPS is issued. No legal restriction on interest on CCD, however in practice it is benchmarked to CCPS limits.	
Tax Efficiency	No tax deduction, dividend payable from post-tax income - Dividend taxable @ 15%[1] in the hands of the company		Interest expense deductible - Withholding tax as high as 40% but it can be reduced to 5% if investment done from favourable jurisdiction
Liquidation Preference	CCD ranks higher than CCPS in terms of liquidation preference. Equity gets the last preference.		
Others	Buy-back or capital reduction permissible	CCPS and CCDs need to be converted to equity before they can be bought back or extinguished by the Indian company.	

1. All tax rates mentioned herein are exclusive of surcharge and

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B. Pricing Requirements

TISPRO Regulations regulate the price at which a foreign direct investor invests into an Indian company. The RBI amended the TISPRO Regulations and rationalized the pricing guidelines from the hitherto Discounted Cash Flows (**"DCF"**) / Return on Equity (**"RoE"**) to 'internationally accepted pricing methodologies'. Accordingly, shares in an unlisted Indian company may be freely issued or transferred to a foreign direct investor, subject to the following conditions being satisfied:

i. The price at which foreign direct investor subscribes to / purchases the Indian company's shares is not lower than the floor price computed on the basis of the internationally accepted pricing method. However, if the foreign investor is subscribing to the memorandum of the company, the internationally accepted pricing methodologies does not apply[2]; and

ii. The consideration for the subscription / purchase is brought into India prior to or at the time of the allotment / purchase of shares to / by the foreign direct investor.

If any of the above conditions is not complied with, then the prior approval of the FIPB and / or the RBI would be required. If the foreign investor is an FVCI registered with the SEBI, then the pricing restrictions would not apply. In addition, if the securities are listed, the appropriate SEBI pricing norms become applicable.

education cess.

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

II. FVCI Route

SEBI introduced the SEBI (Foreign Venture Capital Investors) Regulations, 2000 (**"FVCI Regulations"**) to encourage foreign investment into venture capital undertakings.[3] The FVCI Regulations make it mandatory for an offshore fund to register itself with SEBI if such fund intends to avail of benefits under the FVCI regime.

FVCIs have the Following Benefits

A. Free Pricing

The entry and exit pricing applicable to FDI regime do not apply to FVCIs. To that extent, FVCIs can subscribe, purchase or sell securities at any price.

B. Instruments

Unlike FDI regime where investors can only subscribe to only equity shares, CCDs and CCPS, FVCIs can also invest into Optionally Convertible Redeemable Preference Shares (**"OCRPS"**), Optionally Convertible Debentures (**"OCDs"**), even Non-Convertible Debenture (**"NCDs"**) and Non-Convertible Preference Shares (**"NCPS"**).

C. Lock-in

Under the SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009 (**"ICDR Regulations"**) the entire pre-issue share capital (other than certain promoter contributions which are locked in for a longer period) of a company conducting an initial public offering (**"IPO"**) is locked for a period of 1 year from the date of allotment in the public issue. However, an exemption from this requirement has been granted to registered FVCIs, provided, the shares have been held by them for a period of at least 1 year as on the date of filing the draft prospectus with the SEBI. This

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

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exemption permits FVCIs to exit from investments immediately post-listing.

Exemption under the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011 Takeover Code ("Takeover Code")

SEBI has also exempted promoters of a listed company from the public offer provisions in connection with any transfer of shares of a listed company, from FVCIs to the promoters, under the Takeover Code.

D. QIB Status

FVCIs registered with SEBI have been accorded qualified institutional buyer (**"QIB"**) status and are eligible to subscribe to securities at an IPO through the book building route.

E. FII sector restrictions are not applicable to FVCIs

However, the RBI while granting the permission/ certificate mandates that an FVCI can only invest in the following sectors, viz. infrastructure sector, biotechnology, IT related to hardware and software development, nanotechnology, seed research and development, research and development of new chemical entities in pharmaceuticals sector, dairy industry, poultry industry, production of bio-fuels and hotel-cum-convention centers with seating capacity of more than three thousand. It may be noted that infrastructure includes industrial parks, informational technology parks and special economic zones (**"SEZs"**).

III. FPI Route

This is a regime governed by the SEBI (Foreign Portfolio Investment) Regulation 2014 (**"FPI Regulations"**).

A. Categories

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

i. Category I FPI

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

ii. Category II FPI

Category II includes the following:

a. Appropriately regulated broad based funds;

b. Appropriately regulated persons;

c. Broad-based funds that are not appropriately regulated but their managers are regulated;

d. University funds and pension funds; and University related endowments already registered with SEBI as FIIs or sub-accounts

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

iii. Category III FPI

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

B. Investment Limits

The FPI Regulations states that a single FPI or an investor group shall purchase below ten percent of the total issued capital of a company. The position under the FII Regulations was that such shareholding was not to exceed ten percent of the share capital.

Under the FPI Regulations ultimate beneficial owners investing through the multiple FPI entities shall be treated as part of the same investor group subject to the investment limit applicable to a single FPI.

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C. ODIs/P Note

An offshore derivative instrument (**"ODIs"**) means any instrument, by whatever name called, which is issued overseas by a foreign portfolio investor against securities held by it that are listed or proposed to be listed on any recognized stock exchange in India, as its underlying units.

Participatory Notes (**"P-Notes"**) are a form of ODIs.[4] P-notes are, by definition a form of ODI including but not limited to swaps [5], contracts for difference[6], options [7], forwards [8], participatory notes [9], equity linked notes [10], warrants[11], or any other such instruments by whatever name they are called.

Below is a diagram which illustrates the structure of an ODI:

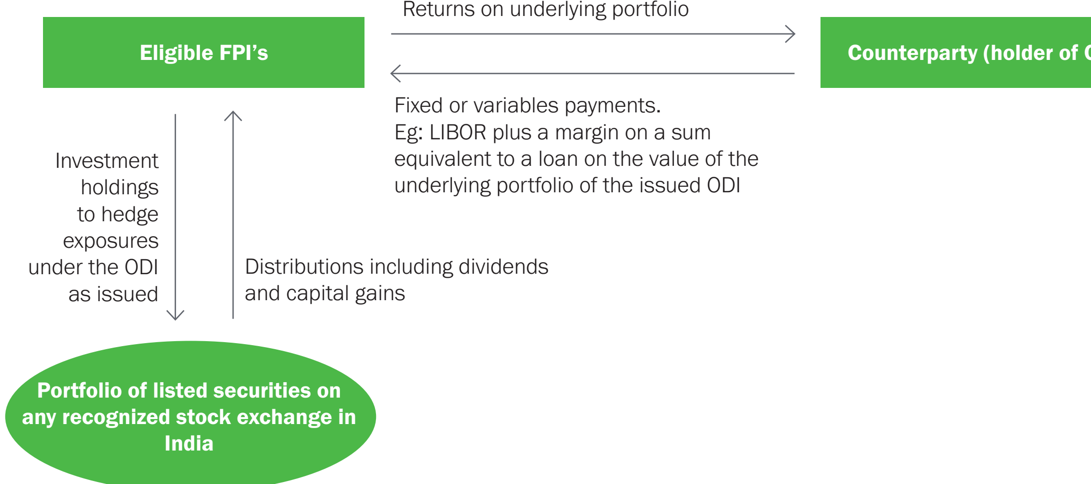

Fig 1: Investment through ODIs.

4. Section 2(1)(j) of the FPI Regulations
5. A swap consists of the exchange of two securities, interest rates, or currencies for the mutual benefit of the exchangers. In the most common swap arrangement one party agrees to pay fixed interest payments on designated dates to a counterparty who, in turn, agrees to make return interest payments that float with some reference rate.
6. An arrangement made in a futures contract whereby differences in settlement are made through cash payments, rather than the delivery of physical goods or securities. At the end of the contract, the parties exchange the difference between the opening and closing prices of a specified financial instrument.
7. An option is a financial derivative that represents a contract sold by one party to another party. It offers the buyer the right, but not the obligation, to call or put a security or other financial asset at an agreed-upon price during a certain period of time or on a specific date.
8. A forward contract is a binding agreement under which a commodity or financial instrument is bought or sold at the market price on the date of making the contract, but is delivered on a decided future date. It is a completed contract – as opposed to an options contract where the owner has the choice of completing or not completing.
9. Participatory notes (P-notes) are a type of offshore derivative instruments more commonly issued in the Indian market context which are in the form of swaps and derive their value from the underlying Indian securities.
10. An Equity-linked Note is a debt instrument whose return is determined by the performance of a single equity security, a basket of equity securities, or an equity index providing investors fixed income like principal protection together with equity market upside exposure.
11. A Warrant is a derivative security that gives a holder the right to purchase securities from an issuer at a specific price within a certain time frame.

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

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

On November 24, 2014, SEBI issued a circular 1(**"Circular"**) aligning the conditions for subscription of offshore derivative instruments (**"ODIs"**) to those applicable to FPIs. The Circular makes the ODI subscription more restrictive. As per the Circular, read with the FPI Regulations, to be eligible to subscribe to ODI positions, the subscriber should be regulated by an IOSCO member regulator or in case of banks subscribing to ODIs, such bank should be regulated by a BIS member regulator.

Further, the Circular states that an FPI can issue ODIs only to those subscribers who meet certain eligibility criteria mentioned under regulation 4 of the FPI Regulations (which deals with eligibility criteria for an applicant to obtain registration as an FPI) in addition to meeting the eligibility criteria mentioned under regulation 22 of the FPI Regulations. Accordingly, ODIs can now only be issued to those persons who (a) are regulated by an 'appropriate foreign regulatory authority'; (b) are not resident of a jurisdiction that has been identified by Financial Action Task force (**"FATF"**) as having strategic Anti- Money Laundering deficiencies; (c) do not have 'opaque' structures (i.e. protected cell companies (**"PCCs"**) / segregated portfolio companies (**"SPCs"**) or equivalent structural alternatives); and (d) comply with 'know your client' norms.

The Circular further requires that multiple FPI and ODI subscriptions belonging to the same investor group would be clubbed together for calculating the below 10% investment limit.

The existing ODI positions will not be affected by the Circular until the expiry of their ODI contracts. However, the Circular specifies that there will not be a rollover of existing ODI positions and for any new ODI positions, new contracts will have to be entered into, in consonance with the rules specified in the Circular.[12]

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

Please refer to our research paper 'Offshore Derivate Instruments: An Investigation into Tax Related Aspects' [13], for further details on ODIs and their tax treatment.

12. http://www.nishithdesai.com/information/research-and-articles/nda-hotline/nda-hotline-single-view/article/sebi-rewrites-rules-on-offshore- derivative-instruments-odi.html?no_cache=1&cHash=60c81c4a0fcc1c1ffbbe8d2aae5e2e5b

13. **Offshore Derivate Instruments: An Investigation into Tax Related Aspects** http://www.nishithdesai.com/fileadmin/user_upload/pdfs/Research%20 Papers/Offshore_Derivative_Instruments.pdf

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D. Listed Equity

The RBI has by way of Notification No. FEMA. 297/2014-RB dated March 13, 2014 amended the TISPRO Regulations to provide for investment by FPIs. Under the amended TISPRO Regulations, the RBI has permitted 'Registered Foreign Portfolio Investors' (**"RFPI"**) to invest on the same footing as FIIs.

A new Schedule 2A has been inserted after Schedule 2 of the TISPRO Regulations to provide for the purchase / sale of shares / convertible debentures of an Indian company by an RFPI under the Foreign Portfolio Investment Scheme (**"FPI Scheme"**). The newly introduced Schedule 2A largely mirrors Schedule 2 of TISPRO which provides for investments in shares / convertible debentures by FIIs under the portfolio investment scheme (**"PIS"**). Accordingly, an FPI can buy and sell listed securities on the floor of a stock exchange without being subjected to FDI restrictions.

Since, the number of real estate companies that are listed on the stock exchange are not high, direct equity investment under erstwhile FII route was not very popular. FPI investors are also permitted to invest in the real estate sector by way of subscription// purchase of Non-Convertible Debenture (**"NCD"**), as discussed below.

E. Listed / Unlisted NCDs

Under Schedule V of the amended TISPRO Regulations, read with the provisions of the FPI Regulations, FPIs are permitted to invest in, inter alia, listed or unlisted NCDs issued by an Indian company. FPIs are permitted to hold securities only in the dematerialized form.

Listing of non-convertible debentures on the wholesale debt market of the Bombay Stock Exchange is a fairly simple and straightforward process which involves the following intermediaries:

i. Debenture trustee, for protecting the interests of the debenture holders and enforcing the security, if any;

ii. Rating agency for rating the non-convertible debentures (there is no minimum rating required for listing of debentures); and

iii. Registrar and transfer agent (**"R&T Agent"**), and the depositories for dematerialization of the NCDs.

The entire process of listing, including the appointment of the intermediaries can be completed in about three weeks. The typical cost of intermediaries and listing for an issue size of INR One Billion is approximately INR One Million.

An FPI may subscribe to unlisted NCDs issued by a real estate company as well, provided that the end use of the NCDs is not to be used *inter alia* for land acquisition or capital market purchases. However, use of proceeds for construction development is permitted. For an exit, these debentures may be sold on the floor of the stock exchange [14], but most commonly these NCDs are redeemed by the issuing company. So long as the NCDs are being offered on private placement basis, the process of offering and listing is fairly simple without any onerous eligibility conditions or compliances.

The NCDs are usually redeemed at a premium that is usually based on the sale proceeds received by the company, with at least 1x of the purchase price being assured to the NCD holder. Whilst creation of security interest[15] is not permissible with CCDs under the FDI route, listed NCDs can be secured (by way of pledge, mortgage of property, hypothecation of receivables etc.) in favor of the debenture trustee that acts for and in the interest of the NCD holders.

Also, since NCDs are subscribed by an FPI entity under the FPI route and not under the FDI route, the restrictions applicable to FDI investors in terms of pricing are not applicable to NCD holders. NCDs, in fact, are also in some situations favored by developers who do not want to share their equity interest in the project. Further, not only are there no interest caps for the NCDs (as in the case of CCDs

14. There have been examples where offshore private equity funds have exited from such instruments on the bourses.

15. Security interest is created in favour of the debenture trustee that acts for and on behalf of the NCD Holders. Security interest cannot be created directly in favour of non-resident NCD holders.

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or CCPS), the redemption premium on the NCDs can also be structured to provide equity upside to the NCD holders, in addition to the returns assured on the coupon on the NCD.

Separately, purchase of NCDs by the FPI from the Indian company on the floor of the stock exchange is excluded from the purview of ECB and hence, the criteria viz. eligible borrowers, eligible lenders, end-use requirements etc. applicable to ECBs, is not applicable in the case of NCDs.

The table below gives a brief comparative analysis for debt investment through FDI (CCDs) and FPI (NCDs) route:

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

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2. Taxation Structure

I. Overview of the Indian Taxation System

Income tax law in India is governed by the Income Tax Act, 1961 (**"ITA")**. Under the ITA, individuals and entities, whether incorporated or unincorporated, if resident for tax purposes in India, shall be taxed on their worldwide income in India. Companies are held to be resident in India for tax purposes a) if they are incorporated in India; or b) if they are controlled and managed entirely in India. Therefore, it is possible for companies incorporated outside India to be considered to be resident in India if they are wholly controlled in India. Non-residents are taxed only on income arising from sources in India.

India has entered into more than 80 Double Taxation Avoidance Agreements (**"DTAAs"** or "**tax treaties"**).

A taxpayer may be taxed either under domestic law provisions or the DTAA to the extent that it is more beneficial. In order to avail benefits under the DTAA, a non-resident is required furnish a tax residency certificate (**"TRC"**) from the government of which it is a resident in addition to satisfying the conditions prescribed under the DTAA for applicability of the DTAA. Further, the non-resident should also file tax returns in India and furnish certain prescribed particulars to the extent they are not contained in the TRC. For the purpose of filing tax returns in India, the non-resident should obtain a tax ID in India (called the permanent account number **"PAN"**). PAN is also required to be obtained to claim the benefit of lower withholding tax rates, whether under domestic law or under the DTAA. If the nonresident fails to obtain a PAN, payments made to the non-resident may be subject to withholding tax at the rates prescribed under the ITA or 20%, whichever is higher.

II. Corporate Tax

Resident companies are taxed at 30%. Companies are held to be resident in India for tax purposes if:

a. Their 'place of effective management is in India'; or

b. They are controlled and managed entirely in India.

Therefore, it is possible for companies incorporated outside India to be considered to be resident in India if they are wholly controlled in India. Non-residents are taxed only on income arising from sources in India.

A. Place of Effective Management

Since the inception of the ITA in 1961 and up until the FY 2014-15, a foreign company was considered a resident in India only if the control and management of its affairs was wholly situated in India. However, the Finance Act 2015 replaced the old test for corporate residence with a new test which provides that, from FY 2015-16, a foreign company will be deemed to be an Indian resident if its POEM is situated in India at any time in the relevant financial year. POEM is defined as a place where key management and commercial decisions that are necessary for the conduct of the business of an entity as a whole are, in substance made. Therefore, for example, in the situation described above, where an offshore company has 100% Indian resident shareholders, majority of Indian directors and one director offshore, the company could now be considered Indian resident under the POEM test. In that case, the worldwide profits of the offshore company would be taxable in India. Even if the shareholding is less than 100%, with some portion held by non-Indian investors, Indian promoters may still want ownership and management control, which could create exposure. This could impact a range of structures, including outbound investment structures by Indian business families and personal

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wealth/carried interest structures such as personal holding companies. The POEM test for residency is set to be implemented from April 1, 2016.

B. Capital Gains Tax

Tax on capital gains depends upon the holding period of a capital asset. Short term capital gains (**"STCG"**) may arise if the asset has been held for less than two years [16] (or in the case of listed securities, less than one year) before being transferred; and gains arising from the transfer of assets having a longer holding period than the above are characterized as long term capital gains (**"LTCG"**). However, gains from listed shares which are held for a period of more than one year are categorized as LTGC, and where traded on the floor of the stock exchange, there is no capital gains tax payable.[17] LTCG on sale of listed securities on a stock exchange are exempt and only subject to a securities transaction tax (**"STT"**). STCG earned by a non-resident on sale of listed securities (subject to STT) are taxable at the rate of 15%, or at ordinary corporate tax rate with respect to other securities.

On the other hand, in the case of unlisted securities, an investment and sale would qualify for LTCG benefits only where the security being transferred has been held for a period of more than 3 years. Further, the Finance Act, 2016 has amended the ITA to reduce the holding period for an investment in unlisted securities to qualify as long term capital asset from three years to two years and reduced the LTCG tax rate levied on the sale of shares of unlisted private companies to 10% from 20% for foreign investors. The reduction in rates for foreign investors and holding period for qualifying as LTCG will provide significant relief and re-emphasize the commitment of the Government to making India an attractive investment destination for foreign investors. Currently, LTCG earned by a non-resident on sale of unlisted securities may be taxed at the rate of 10% or 20% depending on certain considerations. Foreign institutional investors or foreign portfolio investors are also subject to tax at 15% on STCG and are exempt from LTCG (on the sale of listed securities). All income earned by Foreign Institutional Investors or Foreign Portfolio Investors are also treated as capital gains income.

16. Three years in the case of debentures
17. This is subject to payment of the securities transaction tax.

C. Tax on Buyback of Shares and Dividends

Dividends distributed by Indian companies are subject to a distribution tax (DDT) at the rate of 15%, payable by the company. However, the domestic law requires the tax payable to be computed on a grossed up basis; therefore, the shareholders are not subject to any further tax on the dividends distributed to them under the ITA. An Indian company would also be taxed at the rate of 20% on gains arising to shareholders from distributions made in the course of buy-back or redemption of shares.

D. Safe Harbor Rules

'Safe harbour rules' have been notified with the aim of providing more certainty to taxpayers and to address growing risks of transfer pricing litigation in India. Under this regime, tax authorities will accept the transfer price set by the taxpayer if the taxpayer and transaction meet eligibility criteria specified in the rules. Key features of these rules are:

i. The rules will be applicable for 5 years beginning assessment year 2013-14. A taxpayer can opt for the safe harbor regime for a period of his choice but not exceeding 5 assessment years. Once opted for, the mutual agreement procedure would not be available.

ii. Safe harbor margins have been prescribed for provision of: (i) IT and ITeS services; (ii) Knowledge Process Outsourcing services; (iii) contract R&D services related to generic pharmaceutical drugs and to software development; (iv) specified corporate guarantees; (v) intra-group loan to a non-resident wholly owned subsidiary; (vi) manufacture and export of core and non-core auto components.

iii. For provision of IT and ITeS services, KPO and contract R&D services, the rules would apply

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where the entity is not performing economically significant functions.

iv. Taxpayers and their transactions must meet the eligibility criteria. Each level of the authority deciding on eligibility (i.e. the Assessing Officer, the Transfer Pricing Officer and the Commissioner) must discharge their obligations within two months. If the authorities do not take action within the time allowed, the option chosen by the taxpayer would be valid.

v. Once an option exercised by the taxpayer has been held valid, it will remain so unless the taxpayer voluntarily opts out.

The option exercised by the assessee can be held invalid in an assessment year following the initial assessment year only if there is change in the facts and circumstances relating to the eligibility of the taxpayer or of the transaction.

E. Wealth Tax

Buildings, residential and commercial premises held by the investee company will be regarded as assets as defined under Section 2(ea) of the Wealth Tax Act, 1957 and thus be eligible to wealth tax in the hands of the investee company at the rate of 1 percent on its net wealth in excess of the base exemption of INR 30,00,000. However, commercial and business assets are exempt from wealth tax.

F. Stamp Duty

The real estate activities of the venture capital undertaking would be subject to stamp duties and other local/municipal taxes, property taxes, which would differ from State to State, city to city and between municipals jurisdictions. Stamp duties may range between 3 to 14 percent. It may also be noted that state governments in India also provide exemptions and specific incentives by way of waiver of applicable stamp duties in order to promote investments in infrastructure development, including industrial parks, informational technology and software parks and SEZs.

II. Specific Tax Considerations for Investments in India

A. Availability of Treaty Relief

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

B. Permanent Establishment and Business Connection

Profits of a non-resident entity are typically not subject to tax in India. However, where a permanent establishment is said to have been constituted in India, the profits of the non-resident entity are taxable in India only to the extent that the profits of such enterprise are attributable to the activities carried out through its permanent establishment in India and are not remunerated on an arm's length basis. A permanent establishment may be constituted where a fixed base such as a place of management, branch, office, factory, etc. is available to a non-resident entity; or where a dependent agent habitually exercises the authority to conclude contracts on behalf of the non-resident entity. Under some DTAAs, employees or personnel of the non-resident entity furnishing services for the non-resident entity in India may also constitute a permanent establishment.

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The recent Delhi High Court ruling in e-Funds IT Solutions/ e-Funds Corp vs. DIT [18] laid down the following principles for determining the existence of a fixed base or a dependent agent permanent establishment:

i. The mere existence of an Indian subsidiary or mere access to an Indian location (including a place of management, branch, office, factory, etc.) does not automatically trigger a permanent establishment risk. A fixed base permanent establishment risk is triggered only when the offshore entity has the right to use a location in India (such as an Indian subsidiary's facilities); and carries out activities at that location on a regular basis.

ii. Unless the agent is authorized to and has habitually exercised the authority to conclude contracts, a dependent agent permanent establishment risk may not be triggered. Merely assigning or sub-contracting services to the Indian subsidiary does not create a permanent establishment in India.

iii. An otherwise independent agent may, however, become a permanent establishment if the agent's activities are both wholly or mostly wholly on behalf of foreign enterprise and that the transactions between the two are not made under arm's length conditions.

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

C. General Anti-Avoidance Rules

India has introduced general anti-avoidance rules (**"GAAR"**) which provide broad powers to tax authorities to deny a tax benefit in the context of 'impermissible avoidance agreements', i.e., structures (set up subsequent to August 30, 2010) which are not considered to be bona fide or lack commercial substance. GAAR is proposed to come into effect from April 1, 2017. Introduction of regime of substance over form as against form over substance as currently in force. Any arrangement entered into with the main purpose of obtaining a tax benefit and is either (i) not at arm's length, (ii) non-bona fide, (iii) results in abuse or misuse of the tax provisions, or (iv) lacks commercial substance could be viewed as an impermissible "impermissible avoidance arrangement". Incomes arising from structures set up before April 1, 2017 are proposed to be grandfathered. This becomes all the more significant with the ownership of Indian companies having recently been flipped overseas to create a structure where an overseas holding company holds the Indian subsidiary, which is in turn the operating company. Such flips would need to be engineered to protect against the impending GAAR. We successfully engineered several such flips of late stage companies on the request of private equity clients.

D. Transfer Pricing Regulations

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

E. Withholding Obligations

Tax would have to be withheld at the applicable rate on all payments made to a non-resident, which are taxable in India. The obligation to withhold tax applies to both residents and non-residents. Withholding tax obligations also arise with respect to specific payments made to residents. Failure to withhold tax could result in tax, interest and penal consequences. Therefore, often in a cross-border the purchasers structure their exits cautiously and rely on different kinds of safeguards such as contractual representations, tax indemnities,

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

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tax escrow, nil withholding certificates, advance rulings, tax insurance and legal opinions. Such safeguards have been described in further detail under **Annexure II**.

F. Structuring through Intermediate Jurisdictions

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

While choosing a holding company jurisdiction it is necessary to consider a range of factors including political and economic stability, investment protection, corporate and legal system, availability of high quality administrative and legal support, banking facilities, tax treaty network, reputation and costs. The choice of jurisdiction is also relevant from the perspective of the GAAR. Over the years, a major bulk of investments into India has come from countries such as Mauritius, Singapore and Netherlands, which are developed and established financial centers that have favorable tax treaties with India.

India has however re-negotiate the tax treaties with Mauritius and Singapore in order to avoid loss of tax base. India and Mauritius have signed a protocol (**"Protocol"**) amending the double tax avoidance arrangement between the two countries. The Protocol is the outcome of an extensive and long drawn-out negotiation process that has been going for more than a year and a half. The Protocol amends the prevailing residence based tax regime under the double tax avoidance arrangement and gives India a source-based right to tax capital gains arising out of the alienation of securities of Indian resident companies by a Mauritian tax resident.

However, the Protocol provides for grandfathering of investments and the revised position shall only be applicable to investments made on or after April 1, 2017. In other words, all existing investments up to March 31, 2017 have been grandfathered and exits/ transfers beyond this date will not be subject capital gains tax in India. For a detailed analysis of the India-Mauritius double tax avoidance arrangement and the Protocol, please refer to **Annexure III**.

The re-negotiation of the India-Singapore tax treaty was also conducted on similar lines with India obtaining for itself the source-based right to tax transfer of shares of Indian companies by resident of Singapore. For a detailed analysis of the India-Singapore tax treaty and the amendments, please refer to **Annexure IV**.

The following table illustrates the comparative tax rates and benefits under the different tax treaties with Mauritius, Singapore, USA and Cayman Islands:

Particulars	Mauritius	Singapore	US	Cayman
Capital Gain on Shares (long term)	10%	10%	10%	10%
Capital gain on debentures	0%	0%	10%	10%
Interest on Debentures	7.5%	15%	15%	40%
Dividend on Shares	Subject to dividend distribution tax @ 15% in India.			

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3. Exit Options/ Issues

One of the largest issues faced by private equity investors investing in real estate under the FDI route is exit. Following are some of the commonly used exit options in India, along with attendant issues / challenges:

I. Put Options

Put options in favour of a non-resident requiring an Indian resident to purchase the shares held by the non-resident under the FDI regime were hitherto considered non-compliant with the FDI Policy by the RBI. RBI has legitimized option arrangements[19] through an amendment in the TISPRO Regulations. The TISPRO Regulations now permit equity shares, CCPS and CCDs containing an optionality clause to be issued as eligible instruments to foreign investors. However, the amendment specifies that such an instrument cannot contain an option / right to exit at an assured price.

The amendment, for the first time, provides for a written policy on put options, and in doing that sets out the following conditions for exercise of options by a non-resident:

i. Shares/debentures with an optionality clause can be issued to foreign investors, provided that they do not contain an option/right to exit at an assured price;

ii. Such instruments shall be subject to a minimum lock-in period of one year;

iii. The exit price should be as follows:

a. In case of listed company, at the market price determined on the floor of the recognized stock exchanges

b. In case of unlisted equity shares, at a price not exceeding that arrived on the basis of internationally accepted pricing methodologies

c. In case of preference shares or debentures, at a price determined by a Chartered Accountant or a SEBI registered merchant banker per any internationally accepted methodology.

II. Buy-Back

In this exit option, shares held by the foreign investor, are bought back by the investee company. Buy-back of securities is subject to certain conditionalities as stipulated under Section 68 of CA 2013. A company can only utilize the following funds for undertaking the buy-back (a) free reserves (b) securities premium account, or (c) proceeds of any shares or other specified securities. However, buy-back of any kind of shares or other specified securities is not allowed to be made out of the proceeds of an earlier issue of the same kind of shares or same kind of other securities.

Further, a buy back normally requires a special resolution[20] passed by the shareholders of the company unless the buyback is for 10% or less of the total paid-up equity capital and free reserves of the company. Additionally, a buy back cannot exceed 25% of the total paid up capital and free reserves of the company in one financial year, and post buy-back, the debt equity ratio of the company should not be more than 2:1. Under CA 1956, it was possible to conduct two buy-backs in a calendar year, i.e., one in the financial year ending March 31 and a subsequent offer in the financial year commencing on April 1. However, in order to counter this practice, the CA 2013 now requires a cooling off period of one year between two successive offers for buy-back of securities by a company.

From a tax perspective, traditionally, the income from buyback of shares has been considered as capital gains in the hands of the recipient and accordingly the investor, if from a favourable treaty jurisdiction, could avail the treaty benefits. However, in a calculated move

19. http://www.rbi.org.in/scripts/NotificationUser.aspx?Id=8682&-Mode=0

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

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by the Government to undo this current practice of companies resorting to buying back of shares instead of making dividend payments, it levied a tax of 20% on domestic unlisted companies, when such companies make distributions pursuant to a share repurchase or buy back. The said tax is imposed on a domestic company on consideration paid by it which is above the amount received by the company is above the amount received at the time of issuing of shares. Accordingly, gains that may have arisen as a result of secondary sales that may have occurred prior to the buy-back will also be subject to tax now.

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

Additionally, in the context of the domestic investor, even the benefit of indexation would effectively be denied to such investor and issues relating to proportional disallowance of expenditure under Section 14A of the ITA (Expenditure incurred in relation to income not includible in total income) may also arise. This may therefore result in the buyback of shares being even less tax efficient than the distribution of dividends.

As an alternative to buy-back, the investor could approach the courts for reduction of capital under the provisions of section 66 of CA 2013; however, the applications for such reduction of capital need to be adequately justified to the court. From a tax perspective, the distributions by the company to its shareholders, for reduction of capital, would be regarded as a dividend to the extent to which the company possesses accumulated profits and will be taxable in the hands of the company at the rate of 15% [21] computed on a grossed up basis, distribution over and above the accumulated profits (after reducing the cost of shares) would be taxable as capital gains.[22]

21. Exclusive of surcharge and cess

22. CIT v G. Narasimhan, (1999)1SCC510

III. Redemption

In recent times, NCDs have dominated the market. NCDs can be structured as pure debt or instruments delivering equity upside. The returns on the NCDs can be structured either as redemption premium or as coupon, the tax consequences of the same is set out earlier in this paper. The redemption premium in certain structured equity deals can be pegged to the cash flows or any commercially agreed variable, enabling such debentures to assume the character of payable when able kind of bonds. A large amount of foreign investment into real estate has been structured through this route. However, not much data is available on how many such bonds have been redeemed and at what IRRs. The instances of default are few and it does seem that in most cases such debentures are indeed providing returns and exits to the investors as contemplated.

IV. Initial Public Offering

Another form of exit right which an investor may have is in the form of an Initial Public Offering (**"IPO"**). However, looking at the number of real estate companies which have listed in the previous decade in India, this may not be one of viable exit options. The reason why real estate companies do not wish to go public in India is manifold.

For instance, real estate companies are usually self-liquidating by nature. Thus, unless the flagship or the holding company goes public, there may not be enough public demand for and interest in such project level SPVs. There is also some reluctance in going for an IPO due to the stringent eligibility criteria (for instance 3 year profitability track record etc.) and the level of regulatory supervision that the companies (usually closely held) will be subjected to post listing.

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V. Third Party Sale

In this option, the investor sells its stake to a third party. If the sale is to another non-resident, the lock-in of 3 years would start afresh and be applicable to such new investor. Also, since FDI in completed 'assets' is not permitted, the sale to a non-resident can only be of an under-construction project.

In a third party sale in real estate sector, it may also be important to negotiate certain contractual rights such as 'drag along rights'. For instance, if the sale is pursuant to an event of default, and the investor intends to sell the shares to a developer, it is likely that the new developer may insist on full control over the project, than to enter a project with an already existing developer. In such cases, if the investor has the drag along rights, he may be able to force the developer to sell its stake along with the investor's stake.

VI. GP Interest Sale

A private equity fund is generally in the form of a limited partnership and comprises two parties, – the General Partner (**"GP"**) and the Limited Partner (**"LP"**). The GP of a fund is generally organized as a limited partnership controlled by the fund manager and makes all investment decisions of the fund. In a GP interest sale, the fund manager sells its interest in the limited partnership (**"GP Interest"**) to another fund manager[23] or strategic buyer. While technically sale of GP Interest does not provide exits to the LPs as they continue in the fund with a new fund manager, it provides an effective exit to fund managers who wish to monetize their interests in the fund management business.

VII. Offshore Listing

The Ministry of Finance (**"MoF"**) by a notification[24] has permitted Indian unlisted companies to list their ADRs, GDRs or FCCBs abroad on a pilot basis for two years without a listing requirement in India. In pursuance to this, the Central Government amended the Foreign Currency Convertible Bonds and Ordinary Shares (Through Depositary Receipt Mechanism) Scheme, 1993 (**"FCCB Scheme"**). RBI also directed the authorized dealers towards the amendment to the FCCB Scheme.

Regulation 3(1)(B) of the FCCB Scheme, prior to the amendment restricted unlisted Indian companies from issuing GDRs/FCCBs abroad as they were required to simultaneously list in Indian stock exchanges.

The notification amended the regulation 3(1)(B) to permit Indian unlisted companies to issue GDRs/ FCCBs to raise capital abroad without having to fulfill the requirement of a simultaneous domestic listing.

But it is subject to following conditions:

- The companies will be permitted to list on exchanges in IOSCO/FATF compliant jurisdictions or those jurisdictions with which SEBI has signed bilateral agreements (which are yet to be notified).
- The raising of capital abroad shall be in accordance with the extant foreign FDI Policy, including the sectoral caps, entry route, minimum capitalization norms and pricing norms;
- The number of underlying equity shares offered for issuance of ADRs/GDRs to be kept with the local custodian shall be determined upfront and ratio of ADRs/GDRs to equity shares shall be decided upfront based on applicable FDI pricing norms of equity shares of unlisted company;
- The funds raised may be used for paying off overseas debt or for operations abroad, including for the funding of acquisitions;
- In case the money raised in the offshore listing is not utilized overseas as described, it shall be remitted back to India within 15 days for domestic use and parked in AD category banks.
- The Central Government has recently prescribed that SEBI shall not mandate any disclosures, unless the company lists in India.

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23. Reaping the Returns: Decoding Private Equity Real Estate Exits in India, available at http://www.joneslanglasalle.co.in/ResearchLevel1/Reaping_ the_Returns_Decoding_Private_Equity_Real_Estate_Exits_in_India.pdf
24. The Press Release is available on:http://finmin.nic.in/press_room/2013/lisitIndianComp_abroad27092013.pdf

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VIII. Flips

Another mode of exit could be by way of rolling the real estate assets into an offshore REIT by flipping the ownership of the real estate company to an offshore company that could then be listed. Examples of such offshore listings were seen around 2008, when the Hiranandani Group set up its offshore arm 'Hirco PLC' building on the legacy of the Hiranandani Group's mixed use township model. Hirco was listed on the London Stock Exchange's AIM sub-market. At the time of its admission to trading, Hirco was the largest ever real estate investment company IPO on AIM and the largest AIM IPO in 2006. Another example is Indiabulls Real Estate that flipped some of its stabilized and developing assets into the fold of a Singapore Business Trust (**"SBT"**) that got listed on the Singapore Exchange (**"SGX"**). However, both Hirco and Indiabulls have not been particularly inspiring stories and to some extent disappointed investor sentiment. Based on analysis of the listings, it is clear that there may not be a market for developing assets on offshore bourses, but stabilized assets may receive good interest if packaged well and have the brand of a reputed Indian developer. Hence, stabilized assets such as educational institutions, hospitals, hotels, SEZs, industrial parks et al may find a market offshore.

IX. Domestic REITs

Recently, SEBI introduced the REIT Regulations. REITs would serve as an asset-backed investment mechanism where an Indian trust is set up for the holding of real estate assets as investments, either directly or through an Indian company set up as a Special Purpose Vehicle (**"SPV"**). Even though the REITs Regulations have been released, so far the regime has not taken off on account of non-tax and tax issues. Please refer to our compendium on issues affecting the commercial viability of REITs in India here: http://www.nishithdesai.com/fileadmin/user_upload/pdfs/Event/Real_Estate-Compendium-Index-Page-2.pdf.

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4. Developments in the Real Estate Sector

I. Real Estate (Regulation and Development) Act, 2016

In 2016, the real estate sector witnessed a paradigm change in its regime with the enactment of the much-debated Real Estate (Regulation and Development) Act, 2016 (**"Act"**). The Act was notified on April 26, 2016, and 69 out of the 92 sections of the Act came into force on May 1, 2016. The notified provisions include those that provide for the establishment of a Real Estate Regulation Authority (**"RERA"**), Real Estate Appellate Tribunal, Central Advisory Council, and certain provisions relating to adjudication. The Act applies to the construction of buildings used for both residential as well as commercial purposes, or for the purposes of any business, occupation, profession, or trade, or any other related purposes, so long as they satisfy a minimum threshold of area of land and number of apartments proposed.

The main objective of the Act is to regulate and promote the real estate sector, while ensuring efficiency and transparency in the system, especially in relation to the sale of plots, apartments, buildings, or the real estate project itself. Overall, the Act seeks to protect the interest of consumers in the real estate sector. To this effect, the Act has put in place an oversight mechanism to ensure greater accountability in the sector. This includes several compliances such as registration of the project, restrictions on the amount of advance that can be taken from allottees (the person to whom a plot / apartment / building in the project has been allotted, sold, or otherwise transferred by the promoter), restrictions on any alteration/modification of the project plan, etc.; these are required to be adhered to by 'promoters' of real estate projects. Non-compliance of the provisions of the Act attracts stringent penalties, including fines which may extend to 10% of the project cost, or imprisonment extending upto 3 years, in addition to compensation which may be payable to the allottees.

As such, the Act does not regulate any investments made into a real estate project. However, the onerous nature of the promoters' obligations under the Act may impact the investment made into a real estate project, and may even affect the relationship between the investor and the promoter, which was hitherto decided through contractual terms only. Some of the key impacts of the Act on investors who invest in construction and development projects have been highlighted below.

A. Definition of 'Promoter'

The definition of 'promoter' under the Act includes, inter alia, a person who causes to be constructed an independent building / building consisting of apartments for their sale, and 'such other person who constructs any building or apartment for sale to the general public'. The explanation to the definition provides that in situations where the person who constructs / develops the buildings, and the person who sells the apartments, are different persons, both of them shall be deemed to be promoters, and shall be jointly liable for the responsibilities under the Act.

In the context of a platform arrangement, where an investor and a developer set up a special purpose vehicle (**"SPV"**) for the purposes of construction of the real estate project, it becomes clear that the SPV will be a 'promoter' under the Act. Due to the explanation provided to the definition, the developer, who, under most Development Management Agreements (**"DMA"**), is responsible for the sale of the apartments, will also fall within the ambit of promoter, and must comply with the obligations under the Act. Where the investor is also given the right to sell the apartments, such investor may also fall within the definition of 'promoter'.

Previously, the DMA was negotiated on a purely contractual basis, with no laws affecting the rights and obligations of the two parties. The inclusion of the developer as a 'promoter' under the Act will have several ramifications on the relationship between the investor and developer, and will

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affect the negotiations between the two parties for the DMA. Most of the promoter obligations that were negotiated between the two parties are now statutorily mandatory for the promoter to follow. However, this does not imply that these obligations may be excluded from the negotiations for the DMA. This is because the Act only provides for promoter obligations and breach thereof; there is no mention of protection to investors in case of defaults / non-compliances by promoters. The only way an investor may protect its interests in this situation is by securing its rights in the DMA.

For instance, presently, if the developer defaults in his obligation to develop the land, the investor has the right to cause the developer to exit from the project, and sell his shareholding to any person of the investor's choice, to continue the development of the project. However, once all the provisions of the Act come into effect, the developer, now the promoter, will be prohibited from selling his shareholding unless he obtains the approval of two-thirds of the allottees, as well as the approval of the RERA. In other words, the exercise of the investor's step-in rights will be dependent on the allottees and the RERA. Therefore, the investor must factor in the promoter functions and responsibilities while negotiating the DMA with the developer.

B. Pre-approval Investments

Under the Act, every real estate project needs to be registered with the RERA before any development work can begin on the land. The promoter's application for registration must be accompanied by, inter alia, the brief details of the promoter's enterprise, of the projects launched by him in the preceding 5 years (including the current status of the projects, delays therein, etc.), authenticated copies of approvals and commencement certificate obtained by the promoter from competent authorities, sanctioned layout plans, a declaration that that 70% of the amount realized from the allottees for the real estate project will be deposited in a separate account and will be used only to cover the cost of land and construction. It is unclear how determinative the above information will be, in the RERA's decision to grant approval to the promoter. There is no indication from the Act regarding whether delays in prior projects, for instance, would disincline the RERA from granting approval. The RERA is fully empowered to reject applications, after giving an opportunity of hearing, and recording reasons in writing, if the application does not conform to the provisions of the Act.

Investing in a real estate projects prior to obtaining registration under RERA, a practice currently existing in the sector, would be a highly risky proposition once the Act comes into effect, given the extent to which the project hinges on approval from RERA. Should the project be rejected after an investment is made, the investor will lose his expected returns, and may even face difficulties in recovering the amount invested.

C. Timelines

One of the most common practices that plague the real estate sector in India are delays in construction and completion of real estate projects. The Act has sought to address this issue by imposing **severe consequences for delays or failures to complete construction and/or delivery of the apartments to allottees**. While this is a positive move even from an investor's perspective in that it incentivizes the promoter to stick to timelines, the down side is that the consequences of default may affect the investor's ability to gain returns from his investment.

Under the Act, upon the promoter's failure to complete the project in the time specified by him in the agreement for sale with **the allottees, the allottees will be entitled to withdraw from the project without prejudice to other available remedies. The promoter will then become liable to return the amount that had been received from such withdrawing allottees, with interest (to be prescribed in the rules)**. Additionally, the **promoter will be liable to pay compensation to such allottees.** Those allottees who do not withdraw from the project will become en**titled to interest for every month of delay, until delivery of possession** of the apartment. The Act further provides that in case the promoter defaults in doing anything required under the Act, then the RERA may revoke

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the registration granted to him; it can be reasonably understood to mean that in case the promoter delays / fails to complete the project, the RERA may revoke registration, and, according to the Act, cause another promoter to be appointed to complete the project.

The Act does not provide any remedies to an investor in case of such a default by a promoter. Presently, the investor's remedies are worked into the DMA, through the insertion of put / call obligations, step-in rights, etc. However, the implementation of the Act will render the exercise of these clauses difficult, due to certain restrictions on promoters' ability to transfer his interests in the project. Importantly, the investor will have no say in the appointment of a new promoter, should the RERA choose that course of remedy.

Consequently, the investor will have to negotiate remedies for himself within the DMA itself, to protect himself against delays in the project construction. One of the ways in which the investor can secure his interests is to negotiate with the promoter that his right to claim compensation is subordinate to that of the allottees.

Additionally, given the heavy monetary liabilities that the promoter will face upon default, the investor needs to take due caution that the promoter does not satisfy his liabilities from the amounts that have been supplied by the investor as investment, or are due to the investor as returns from the investment. Clauses to this effect need to be inserted into the DMA, so as to ensure that the promoter satisfies these liabilities from sources other than the amounts tendered by / due to the investor.

D. Ring-fencing of project receivables

Under the Act, the **promoter must deposit 70% of the amount realized from the allottees for the real estate project, into a separate account maintained in a scheduled bank**. This deposited amount may only be used to cover **the cost of construction and the land cost**, and may not be used for any other purpose. The only qualification stipulated by the Act in the maintenance of this account is that whenever the promoter withdraws amounts from the account, he must do so in proportion to the percentage of completion of the project.

Ordinarily, it is from this amount received from allottees that the investor will receive the returns for investment into the project. Therefore, it is imperative that the investor has some sort of control over the account where the amount is deposited, so that he can secure his interests over the returns. The Act does not envisage any such control of the investor. To overcome this, it would be ideal for the investor to negotiate with the promoter that the account maintained be an escrow account in favour of the investor.

Consider a situation wherein the promoter faces a cash shortfall in the construction of the project. To overcome this, an investor may be willing to have more than 70% deposited in the escrow.

It is pertinent to note that the Act does not provide the mechanism by which the account will be maintained and money from the same be utilized. Therefore, it is unclear as to what will happen to the account once the construction of the real estate project has been completed. The Act does not contemplate a mechanism by which the remaining amount in the account, post the construction, would be transferred to the investor in satisfaction of his returns.

E. Revocation of registration

One of the serious consequences that a promoter may face for non-compliance with the Act is the revocation of the registration of the real estate project. The RERA may revoke the registration after giving not less than **30 days' notice in writing**, stating the grounds for proposed revocation, and considering any cause shown by the promoter within the notice period. The RERA is even empowered to impose any other measure instead of revocation on the promoter, and the promoter shall be bound by such measure.

Upon revocation, the RERA shall, after consulting the appropriate central or state government, **facilitate the remaining development works to be carried out by a competent authority / association**

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of allottees / in any other manner, as determined by the RERA. Further, the RERA shall direct the bank holding the project bank account to **freeze the account**; subsequently, the RERA may order de-freezing the account to facilitate the remaining development works.

The above provisions in the Act have been undertaken purely for the benefit of the allottees; there is no consideration granted for the investor's remedies in the above. Upon revocation, the investor loses the project to a third party developer as appointed by the RERA, and also faces a frozen bank account. The Act is unclear as to the procedure regarding freezing of the bank account, and the consequence of the same to the investor, whose money is currently in the account. It remains to be seen whether the rules will throw more light in this regard. There is also no clarity on how the bank account would be used once the new promoter is appointed.

Presently, upon default of the promoter, the investor contractually secures his interests by inserting a right to appoint a third-party developer. Under the Act, however, this right is taken away by the RERA, while the investor stands helplessly by. Additionally, the Act provides that the promoter cannot transfer his rights in the project to any third party without obtaining the consent of two-thirds of the allottees. One of the ways in which the investor may be able to take control of the situation would be to obtain a power of attorney from the allottees regarding consent to appoint a third party developer, which we will explore in the last section.

One of the events of default that trigger revocation, which has clearly been articulated under the Act, is the practice of making false statements/ representations regarding the standards of the project or the approvals that the promoter is supposed to obtain, the publication of any advertisement / prospectus of services that are not intended to be offered, and the indulgence in any fraudulent practices. The extent of damage caused by engaging in these practices is revocation and subsequent replacement of the promoter. This, once again, leaves the investor in the lurch as to how to secure his investment in the project.

It is imperative, in these situations, that the investor clearly negotiate his rights into the DMA with the promoter / developer. For this purpose, the investor must obtain adequate representations and warranties from the promoter regarding continued compliance under the Act, particularly with respect to false advertisements, with provisions for indemnity in case of default and subsequent revocation. The need for strong protection under the DMA is emphasized in light of the provision for freezing bank accounts upon revocation, under the Act, in which case the investor's only remedy is through the defaulting promoter.

F. Restrictions on taking advance

Under the Act the **promoter cannot accept more than 10% of the cost of the apartment as advance payment from any person**, without entering into a written agreement for sale with such person, and registering the same.

In this situation, the investor may be required to contribute more capital to promoter so as to enable the commencement of construction. Simultaneously, the promoter will be entering into agreements for sale at an earlier stage, so as to obtain more funds from the allottees. In this situation, the investor must be careful to ensure that his rights and interests are secured above that of the allottees.

G. Step-in rights

As mentioned earlier, one of the **consequences of revocation of registration under the Act is the appointment, by the RERA / the association of allottees, of a new developer, in order to complete the remaining development work in the project**. The Act is not clear as to the procedure for such appointment, and the impact on the other stakeholders of the project, namely the investors.

Ordinarily, in a platform transaction, upon default of the promoter, the investor would, under the contract, obtain the right to exercise an option (being a call / put) in his favour, on the securities of the real estate project held by the defaulting promoter. **The Act has created an obstruction to this practice, by prescribing that**

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the promoter shall not transfer / assign his majority rights in the real estate project to any third party without obtaining prior written consent from two-thirds allottees, and without the prior written approval from the RERA. Consequently, the investors in existing platform projects will not be able to freely exercise his option any longer, as the above two consents will be required. Future investors will likely be unable to negotiate such clauses in their framework agreements, as they will not be enforceable without the above two consents.

One of the ways by which the investor may be able to secure his rights is by procuring a power of attorney from the allottees at the time of allotment, in favour of the investor, for the right to appoint a third party developer in case of default of the present promoter. This will ensure that the investor has a say in the appointment of the new promoter, and will act as a substitute to the step-in rights he has under existing DMAs. In this manner, the investor will be able to appoint a new promoter while satisfying the requirement for consent from two-thirds allottees under the Act. It remains to be seen whether this is a practically viable option.

Additionally, there is ambiguity on how the investor will be factored in with the new promoter. In the event that the new promoter appointed by the RERA / allottees is not willing to accept investments from the current investor, then the latter will need to find other ways to recover his investments. It remains to be seen whether the rules will be more detailed in this regard. Meanwhile, the investors need to secure their rights through the DMA, by providing for adequate indemnity clauses for the promoter's default.

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Annexure I

FDI in Real Estate: Further Liberalized

n a recent press note issued on November 10, 2015 (**"PN 2015"**), the Central Government, in furtherance of its objective to attract greater foreign direct investment (**"FDI"**), has announced significant relaxations to the consolidated foreign direct policy of India (**"FDI Policy"**). Consequently, substantial changes have also been announced to the FDI provisions governing the construction-development sector.

Last year, the government through Press Note 10 of 2014 and clarifications on Press Note 10 of 2014 issued by DIPP (**"PN 2014"**)[1] introduced extensive amendments to the FDI provisions relating to the construction-development sector. However, certain critical ambiguities still prevailed and the amendments introduced by PN 2014 were counter-productive to the objective which the government intended to achieve. PN 2015 has now ironed out most of the unresolved creases, and is likely to serve as a huge fillip to foreign investors intending to acquire equity interest in the real estate space.

In this hotline, we analyze the changes brought about by PN 2015, specifically with respect to the construction-development sector.

- The reduction of the minimum area requirements from 50,000 sq. meters to 20,000 sq. meters by PN 2014 was a welcome step towards encouraging further foreign investment into the construction-development sector, since availability of 50,000 sq. meters in Tier I cities was a challenge. Hence, removal of the minimum land area requirement under PN 2015 is an enormous step towards deregulation of foreign investment into the real estate sector in India.
- This change also sets to rest the debate on floor area versus built up area.

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I. Changes and Analysis

Removal of minimum land stipulation

Proposed changes as per PN 2015	Existing FDI Policy
No minimum area requirement	Minimum floor area to be developed under each project would be 20,000 sq. meters for construction-development projects.

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Removal of minimum capitalization requirement

Proposed changes as per PN 2015	Existing FDI Policy
No minimum capitalization requirement any more.	Minimum capitalization of USD 5 million to be brought in within 6 (six) months of the commencement of the project.

- Whilst the removal of minimum capitalization requirements will be extremely beneficial to small projects, the challenge to an FDI investor in the current regime was not the requirement of bringing in the minimum capitalization, but the timing when it had to be brought in. The intent of the government on this issue has been clear from the beginning that minimum capitalization must be achieved at the earliest possible stage of a project. Hence, the government mandated (per the Existing FDI Policy) that the minimum capitalization condition had to be fulfilled within 6 months from the commencement of a project. Further, the government even clarified that 'date of commencement' should be identified as the date of approval of building plan/ layout plan. However, pegging the time to 'commencement of project' was felt counter-productive since foreign investors were precluded from investment post the IOD/ sanction plan stage.

- While the minimum capitalization norms have been removed, it remains to be seen if the government prescribes any timeline at which stage the foreign investment must come in, and whether the pegging of investment to 'commencement of project' will be removed in entirety.

- Additionally, it is also to be seen if it is prescribed in what stage can a project qualify as being in the 'construction-development' phase, since PN 2014 did mention that subsequent tranches of foreign investment can be brought in only up to 10 years from the commencement of the Project.

Lock-in restrictions

Proposed changes as per PN 2015	Existing FDI Policy
The investor is permitted to exit from the investment: (i) after 3 years from the date of each tranche of foreign investment, or (ii) on the completion of the project; or (iii) on the completion / development of trunk infrastructure. Transfer of stake by a non-resident investor to another non-resident investor, without any repatriation of investment would not be subject to any lock-in or prior FIPB approval.	The investor is permitted to exit from the investment upon: (i) development of trunk infrastructure, or (ii) the completion of the project. Repatriation of FDI or transfer of stake by a non-resident investor to another non-resident investor would require prior FIPB approval.

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- The Existing FDI Policy mandates that the earliest exit available for a foreign investor will be after the 'trunk infrastructure' of a project is developed. However, development of 'trunk infrastructure' was more suited in context of serviced housing plots, but not in context of 'heart-of-the-city' projects where all parameters of trunk infrastructure were already satisfied (for instance, in redevelopment projects). In such situations, there was thus a question as to whether exit could be achieved only after the completion of the project, since trunk infrastructure was already present at the time of investment. PN 2015 now allows for a more rationalized approach for exit by bringing in the 3 year lock-in period and hence foreign investors who had run out of money to develop the trunk infrastructure can now exit post the expiry of the 3 year period. This is a major relaxation especially in context of large projects which have not been successful, but the foreign investors wish to exit.

- The intent behind the 3 year lock-in is to ensure committed capital which should be used for development purposes. However, the 3 year lock in period should not be read in insolation, and the 'real estate business' restriction under capital account regulations should be adhered to.2 Hence, before achieving an exit, foreign investors must put in all possible efforts to ensure that developers have put their best foot forward to utilize the foreign capital for development purposes.

- PN 2015 also makes a path breaking change by allowing non-resident to non-resident transfers without the requirement of obtaining any approval. PN 2 of 2005 and PN 2014, have always restricted non-resident to non-resident transfers without the approval of FIPB during the lock-in (whether in context of (i) the 3 year lock-in; or (ii) development of trunk infrastructure; or (iii) completion of the project). Consequently, questions were raised as to whether the intent is to lock-in the investor or the investment. The challenge was that for the new foreign investor, the lock-in restarted from the date such new investor acquired the shares. PN 2015 now seems to clarify that only the investment is locked–in and not the investor, and hence a non-resident may transfer its shares at any time to another non-resident investor under the automatic route.

Multiple phases - Each a separate project

Proposed changes as per PN 2015	Existing FDI Policy
Each phase of a project to be considered a separate project for the purposes of the FDI Policy	No such clarification

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- The Existing FDI Policy does not clarify whether a 'project' would include all phases or single phase of a project. Further, as mentioned above, since the Existing FDI Policy mandated that the earliest possible exit was after construction of 'trunk infrastructure', investors were unsure whether investment in a particular phase of a multi-phased project was locked-in till 'trunk infrastructure' was developed for all phases of the project. PN 2015 now clarifies that all FDI conditions will be seen on a 'phase' specific basis and hence, so long as the exit criteria for one particular phase is satisfied, foreign investors should be able to exit from their investment in that phase. It remains to be seen how the term 'phase' evolves to be interpreted, whether on a sanction plan basis or otherwise.

- That position now seems to be clarified since PN 2015 clearly sets out that income earned by way of rent / income on lease not amounting to 'transfer' does not tantamount to *'real estate business'*. However, investment in completed assets has only been cautiously opened up by restricting 'transfers' in any manner. The term 'transfer' is defined very widely[3] (and includes relinquishment of asset or extinguishment of any right), and its significance will have to be analyzed further on a case-by-case basis. Further, certain provisions of the definition of 'transfer' (such as compulsory acquisition of law) seems misplaced from an FDI perspective, which is perhaps because the definition of the term 'transfer' is a direct import from Section 2 (47) of the Income Tax, 1961. Nonetheless, in light of the clarification afforded by PN 2015, foreign investment in yield generating stabilized assets such as malls, business centers, etc. will be permitted.

Completed Assets

Proposed changes as per PN 2015	Existing FDI Policy
100% FDI was permitted under automatic route into completed projects for operation and management of townships, malls/ shopping complexes and business centers. Transfer of control from residents to non-residents as a consequence of foreign investment is also permitted. Earning of rent or income from the lease of the project would not tantamount to 'real estate business'.	100% FDI was permitted under automatic route into completed projects for operation and management of townships, malls/ shopping complexes and business centers.

- PN 2014, for the first time, had clarified that foreign investment into completed projects for operation and management of townships, malls/ shopping complexes and business centers was permitted. However, there was still a debate if foreign investment was permitted only in companies involved in the operation – management of such assets or even in companies which owned such completed assets. This has been detailed in our previous hotline here.[25]

II. Other Changes

A. 100% FDI permitted in limited liability partnerships ("LLP")

FDI in LLPs was hitherto permitted under the approval route, in sectors where 100% FDI was permitted under the automatic route, and where there were no FDI linked performance conditions.

PN 2015 has now permitted 100% FDI in LLPs under the automatic route for sectors in which 100% FDI is permitted under the automatic route without any conditions. LLPs engaged in the construction-

25. http://www.nishithdesai.com/information/research-and-articles/nda-hotline/nda-hotline-single-view/article/fdi-in-real-estate-liberalized.html?no_cache=1&cHash=aab4287c1bb5517a914df41d068bd6fc

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development sector would still not be permitted to receive FDI under the automatic route, since there are a number of FDI linked performance conditions for the construction-development sector.

In a sector where setting up of special purposes vehicles for housing separate projects coupled with the perpetual requirement to upstream funds, LLPs are becoming the preferred vehicle for developers domestically. Given the tax optimization that the LLP as a vehicle provides, the government seems to have missed the opportunity to permit FDI in LLPs for construction-development sector to attract further FDI.

B.Non-resident investment

Under the FDI regulations, non-resident Indians (**"NRI"**) were provided certain exemptions from minimum capitalization, minimum area and lock – in restrictions in cases of direct investments by NRIs in their individual capacity. Subsequently, Press Note 7 of 2015 further liberalized the investments by NRIs on non-repatriation basis under Schedule 4 of FEMA (Transfer or Issue of Security by Persons Resident Outside India) Regulations, 2000 to be treated at par with domestic investment. Being treated at par with domestic investors meant that the investment was not subject to any of the conditions to be complied with under the FDI Policy.

However, in order to attract further investment by NRIs, PN 2015 has now clarified that the relaxation extended to NRIs (i.e. treatment at par with domestic investors) will also apply to companies, trusts and partnership firms, incorporated outside India and owned and controlled by NRIs. Such intermediated investment regime for NRIs will be hugely beneficial since now NRIs will be able to pool their capital in optimal jurisdictions for investment into India. Further, based on PN 7 (and now this PN 2015) a technical argument may also be made that NRI investment will now be permitted in AIFs / LLPs, though such investment decisions should ideally be made post discussions with the regulators.

On a separate note, the Government must also permit NRI owned entities to be qualified for procuring an FPI Category III registration so that NRIs can also make investments in listed bonds of real estate companies.

III. Conclusion

These proposed changes will certainly open-up the construction-development sector further, and will augment foreign investment into the Indian real estate sector. PN 2015 is still not law and we will have to wait for the final amendments; however, considering the resurgence of equity interest in real estate, PN 2015 could not have been better timed. While a number of issues have been sorted, few things to further accentuate interest would be a clear entitlement of NRIs to invest in AIFs and LLPs (on repatriable basis), opening up foreign investment in real estate LLPs, allowing foreign participation in real estate focused AIFs and streamlining REIT taxation.

– Shreyas Bhushan, Abhinav Harlalka & Ruchir Sinha

You can direct your queries or comments to the authors

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Annexure II

Specific Tax Risk Mitigation Safeguards For Private Equity Investments

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

These safeguards assume increasing importance, especially with the GAAR coming into force from April 1, 2017 which could potentially override treaty relief with respect to tax structures put in place post August 30, 2010, which may be considered to be 'impermissible avoidance arrangements' or lacking in commercial substance.

I. Nil withholding certificate

Parties could approach the income tax authorities for a nil withholding certificate. There is no statutory time period prescribed with respect to disposal of applications thereof, which could remain pending for long without any clarity on the time period for disposal. In the last few years, there have not been many instances of such applications that have been responded to by the tax authorities. However, recently, in January 2014, an internal departmental instruction was issued requiring such applications to be decided upon within one month. The extent to which the instruction is adhered to remains yet to be seen.

II. Advance Ruling

Advance rulings obtained from the Authority for Advance Rulings (**"AAR"**) are binding on the taxpayer and the Government. An advance ruling may be obtained even in GAAR cases. The AAR is statutorily mandated to issue a ruling within six months of the filing of the application, however due to backlog of matters, it is taking about 8-10 months to obtain the same. However, it must be noted that an advance ruling may be potentially challenged in the High Court and finally at the Supreme Court. There have been proposals in the 2014-15 Budget to strengthen the number of benches of the AAR to relieve this burden.

III. Contractual representations

Parties may include clear representations with respect to various facts which may be relevant to any potential claim raised by the tax authorities in the share purchase agreement or such other agreement as may be entered into between the parties.

IV. Escrow

Parties may withhold the disputed amount of tax and potential interest and penalties and credit such amount to an escrow instead of depositing the same with the tax authorities. However, while considering this approach, parties should be mindful of the opportunity costs that may arise because of the funds getting blocked in the escrow account.

V. Tax insurance

A number of insurers offer coverage against tax liabilities arising from private equity investments. The premium charged by such investors may vary depending on the insurer's comfort regarding the degree of risk of potential tax liability. The tax insurance obtained can also address solvency issues. It is a superior alternative to the use of an escrow account.

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VI. Legal opinion

Parties may be required to obtain a clear and comprehensive opinion from their counsel confirming the tax liability of the parties to the transaction. Relying on a legal opinion may be useful to the extent that it helps in establishing the bona fides of the parties to the transaction and may even be a useful protection against penalties associated with the potential tax claim if they do arise.

VII. Tax indemnity

Tax indemnity is a standard safeguard used in most M&A transactions. The purchasers typically seek a comprehensive indemnity from the sellers for any tax claim or notice that may be raised against the purchaser whether in relation to recovery of withholding tax or as a representative assessee.

The following key issues may be considered by parties while structuring tax indemnities:

- Scope: The indemnity clause typically covers potential capital gains tax on the transaction, interest and penalty costs as well as costs of legal advice and representation for addressing any future tax claim.

- Period: Indemnity clauses may be applicable for very long periods. Although a limitation period of seven years has been prescribed for reopening earlier tax cases, the ITA does not expressly impose any limitation period on proceedings relating to withholding tax liability. An indemnity may also be linked to an advance ruling.

- Ability to indemnify: The continued ability and existence of the party providing the indemnity cover is a consideration to be mindful of while structuring any indemnity. As a matter of precaution, provision may be made to ensure that the indemnifying party or its representatives maintain sufficient financial solvency to defray all obligations under the indemnity. In this regard, the shareholder/s of the indemnifying party may be required to infuse necessary capital into the indemnifying party to maintain solvency. Sometimes backto-back obligations with the parent entities of the indemnifying parties may also be entered into in order to secure the interest of the indemnified party.

- Conduct of proceedings: The indemnity clauses often contain detailed provisions on the manner in which the tax proceedings associated with any claim arising under the indemnity clause may be conducted.

- Dispute Resolution Clause: Given that several issues may arise with respect to the interpretation of an indemnity clause, it is important that the dispute resolution clause governing such indemnity clause has been structured appropriately and covers all important aspects including the choice of law, courts of jurisdiction and/or seat of arbitration. The dispute resolution mechanism should take into consideration urgent reliefs and enforcement mechanisms, keeping in mind the objective of the parties negotiating the master agreement and the indemnity.

TP Janani & Ruchir Sinha

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Annexure III

India-Mauritius Treaty: The Protocol-Through The Looking Glass

Key Takeaways

- Shift to source based taxation restricted to capital gains accruing to Mauritius residents from sale of shares in Indian companies.
- India shall have the right to tax capital gains arising from alienation of shares by a Mauritius investor acquired on or after April 01, 2017 in a company resident in India with effect of financial year 2017-18. However, share investments before April 01, 2017 shall be grandfathered and shall not be subject to the amended regime.
- Capital gains arising out of convertible debentures should be entitled to benefits of taxation in Mauritius for Mauritius based residents. However, the aforementioned benefit shall not be available for compulsorily convertible preference shares.
- The changes brought about by the protocol make debt structures based out Mauritius lucrative. Interest income earned by Mauritius residents from Indian debt holdings to be taxed at a lower rate of 7.5%.
- As per the current state of affairs, the beneficial regime available in respect of capital gains on sale of shares under the India-Singapore tax treaty should fall away on March 31, 2017. However, media reports suggest that the Indian government has reached out to the Singapore government for renegotiation talks.
- A specific fee for technical services article, and service permanent establishment concept has been introduced.

I. Overview

The double tax avoidance arrangement between India and Mauritius (**"India-Mauritius DTAA"**) was amended through the protocol (**"Protocol"**) earlier this month. Our earlier hotline on the issue can be found here.

Before the text of the Protocol was released, speculation was rife in respect of the treatment that would be accorded to derivative instruments, convertibles and the like. Similarly, there was uncertainty surrounding whether the revised understanding on interest income would be extended to all recipients of such income or whether the revisions were related to banks alone.

Now that the text of the Protocol has been released, these concerns stand clarified for the most part, and investors can hope for tax certainty going forward.

Below are the key amendments and impact of the Protocol on foreign investments through Mauritius:

II. Amendments to the India-Mauritius DTAA

The amendments have been geared towards resolving the issues of round tripping faced by the Indian revenue authorities while dealing with Mauritius based entities. While the limelight

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has been reserved for the reversal in capital gains taxation provisions , the Protocol also brings about significant changes to the status quo through:-

1. The introduction of service permanent establishment
2. Changes in allocation rights for "other income" to source country;
3. Introduction of a provision covering taxation of Fee for Technical Services (**"FTS"**)
4. Introduction of stringent collection and recovery measures.

The table below provides a comparative analysis of the provisions of the DTAA before and after the Protocol:-

S. No.	Particulars	Treatment before the Protocol	Treatment after the Protocol
1.	**Capital gains arising on alienation of equity shares/ preference shares**	Taxed in the State where the alienator resides	Tax levied by the source rate as per the rates applicable under the domestic law
2.	**Capital gains arising on alienation of convertible debentures**	Taxed in the State where the alienator resides	Taxed in the State where the alienator resides
3.	**Capital gains arising on alienation of derivative instruments**	Taxed in the State where the alienator resides	Taxed in the State where the alienator resides
4.	**Taxation of income categorized as "income from other sources" under the Income Tax Act, 1961, India**	Taxable in the State of the resident i.e. Mauritius	Taxable in the source country i.e. India as well.
5.	**Mauritian residents earning fee for technical services from Indian sources**	Likely to be business income not taxable in India in the absence of a PE.	Taxed at the rate of 10%.
6.	**Presence of employees constituting permanent establishment for an enterprise**	No specific provision	Deemed to be a permanent establishment if the employees/other personnel spend more than 90 days in aggregate over a 2 month period in the other contracting state
7.	**Cross collection of revenue claims**	No provision for collection of revenue claims arising in the other contracting State	Revenue claims of the other contracting states may upon request, be collected by the other contracting states through mechanisms available under local law.

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III. Impact On Transactions

A. The verdict on taxing capital gains

i. Equity Shares & Preference Shares

Capital gains derived by a Mauritius resident from alienation of shares of a company resident in India shall be taxable in India from April 01, 2017. Earlier, such gains were taxable only in the country of residence, resulting in no Indian capital gains taxes on sale of securities by Mauritius based investors.

Grandfathering: As per the Protocol, shares of an Indian company that have been acquired before April 01, 2017 shall not be affected by the Protocol irrespective of the date of sale /alienation of these shares. Such investments shall continue to enjoy the treatment available to them under the erstwhile Article 13(4) of the DTAA. Importantly, grandfathering has only been offered to "shares" and not to a broader set of investments. Consequently, convertible debentures which post-conversion into equity shares, are sold after April 1, 2017 would not be grandfathered.

Transition Period: The Protocol also provides for a relaxation in respect of capital gains arising to Mauritius residents from alienation of shares between April 01, 2017 and March 31, 2019. The tax rate on any such gains shall not exceed 50% of the domestic tax rate in India. This benefit shall only be available to such Mauritius resident who is (a) not a shell/conduit company and (b) satisfies the main purpose and bonafide business test.

Limitation of Benefits: For the purpose of the above relaxations, a Mauritius resident shall be deemed to be a shell/conduit company if its total expenditure on operations in Mauritius is less than INR 2,700,000 (approximately 40,000 US Dollars) in the 12 months immediately preceding the alienation of shares.

While the position in respect of taxation of capital gains marks a change that would lead to higher taxation on an absolute basis, the parallel rationalizations under Indian domestic law may ease the tax impact of such transactions and promote debt investments through Mauritius.

For eg, the Finance Act, 2016 reduced the rate of tax on short term capital gains arising out sale of unlisted shares of an Indian private company to 10%, when indexation benefits are not availed. This will reduce the tax impact on the Mauritius based investors. Additionally, a lower holding period of two years has been prescribed to be classified as a long term capital asset in case of unlisted shares.

Going forward, Indian taxes may just be factored as an incremental cost and may accordingly form a part of the valuation methodology for investments while determining the rate of return etc.

As far as foreign portfolio investors (**"FPIs"**) are concerned, the real challenge is the tax costs for short term investments, since sale of listed shares held for more than a year over the stock exchange are, in any event tax exempt under Indian domestic law. Alternatively, foreign investors may look at exploring other jurisdictions such as Netherlands, which provide exemption from Indian capital gains tax, albeit with certain conditions – a) If Dutch shareholder holds lesser than 10% in Indian company or b) in case of sale of shares to non-Indian resident purchasers.

B. Other securities / capital assets

i. Convertible Debentures

Convertible debentures not being in the nature of 'shares' should continue to enjoy the benefits available to such instruments under the residual provision i.e. Article 13(4) of the India-Mauritius DTAA. Capital gains arising on alienation of such instruments shall only be taxable in the contracting state where the alienator is resident i.e. Mauritius.

The use of such instruments could witness a surge as equity/ preference shares may longer represent a viable option to Mauritius based investors – especially for private equity players.

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Gains from other capital assets such as interest in Limited Liability Partnerships (LLPs) may also continue to be taxed only in Mauritius. Given the recent liberalization of foreign direct investment in LLPs, this is another tax efficient investment avenue that may be explored going forward.

ii. Derivatives

The Protocol should not adversely impact derivatives, which should also continue to enjoy exemptions from Indian capital gains taxes.

The gap that is created between the tax treatment for equity shares vis-à-vis derivative instruments may lead to a shift in strategies that are dominated by exposure to derivative instruments as opposed to investments in equity shares.

a. Debt investments

As discussed above, sale of convertible and non-convertible debentures should continue to enjoy tax benefits under the India-Mauritius DTAA. That, coupled with the lower withholding tax rate of 7.5% for interest income earned by Mauritius investors from India, comes as big boost to debt investments from Mauritius.

Prior to the Protocol, interest income arising to Mauritius investors from Indian securities / loans were taxable as per Indian domestic law. The rates of interest could go as high as 40% for rupee denominated loans to non-FPIs.

The Protocol amends the DTAA to provide for a uniform rate of 7.5% on all interest income earned by a Mauritian resident from an Indian company. The withholding tax rate offered under the Mauritius DTAA is significantly lower than India's treaties with Singapore (15%) and Netherlands (10%). This should make Mauritius a preferred choice for debt investments into India, going forward.

b. Other income

Earlier, the 'other income' provisions i.e. Article 22 of the India-Mauritius DTAA stated that other streams of income not provided in the above articles shall be taxable in the resident's state, and not in the source country.

However, the Protocol amends this language to provide that 'other income' arising to a resident of one state shall be taxed in the source country i.e. other contracting state.

A direct consequence of this amendment would be that shares sold at a price lower than fair value, shall be taxed at the hands of the purchaser to the extent of such difference between the sale price and fair value. This is by virtue of Indian domestic provisions on taxing "other income" (Section 56).

This puts the India-Mauritius DTAA at par with the treaty with Singapore (in this respect) and other treaty jurisdictions as such incomes were already subject to tax under the DTAA between India and Singapore.

IV. Impact on ODI Issuers

The Protocol will have an adverse effect the offshore derivative instrument (**"ODI"**) issuers that are based out of Mauritius. While most of the issuers have arrangements to pass off the tax cost to their subscribers, the arrangement may become less lucrative due to the tax incidence. However, this problem may be temporarily be a non-issue for ODI issuers who have existing losses that have been carried forward as any gains that arise can be set off against such losses.

Even in a scenario where the tax cost is being passed off the subscriber, complications shall arise due to a timing mismatch as the issuer shall be subject to tax on a FIFO basis (as opposed to a one-to-one co-relation).

V. Effect on the India-Singapore DTAA

Article 6 of the protocol to the India-Singapore DTAA states that the benefits in respect of capital gains arising to Singapore residents from sale of shares of an Indian Company shall only remain in force so long as the analogous provisions under the India-Mauritius DTAA continue to provide the benefit.

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Consequently, benefits available in respect of capital gains under the India-Singapore DTAA shall fall away after April 01, 2017. Further, it is not clear whether the grandfathering of investments made before April 01, 2017 will be available to investments made by Singapore residents.

However, media reports suggest that the Indian government is actively interacting with Singapore to renegotiate the treaty. It is a likely scenario as Singapore has an interest in the renegotiation since at present due to the lack of grandfathering, there is no tax certainty for Singapore based investors on the way forward.

VI. Conclusion

While the changes brought about through the Protocol may be significant, it would be unfair to consider its implementation to be the demise of Mauritius and Singapore as preferred routes of inbound activity. The modification on capital gains taxation is limited to gains arising on sale of shares. This ensures continuity of benefit to other instruments and also provides much needed certainty in respect of the position of the treaty.

This is important as there was a marked hesitation among the investors to use such structures during the prolonged negotiation period.

This certainty coupled with easing of tax rates in India and the added benefits available in respect of interest income due to the Protocol should ensure that Mauritius remains a jurisdiction of choice for investments into India.

The Protocol also seeks to promote debt investments from Mauritius, as it now emerges has the preferred jurisdiction for debt considering the lower withholding tax rates for interest income as well as the capital gains tax exemption.

On a final note, there no longer remains a straitjacket formula for foreign investors to minimize Indian tax costs by investing through Mauritius entities. Depending on investment strategies, nature of investment – whether portfolio or direct, nature of instruments (debt of equity), different structuring options may be explored or Indian taxes would need to be factored in by investors as a cost of doing business in India.

– Linesh Lalwani & Shipra Padhi

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Annexure IV

India and Singapore Sign Protocol Revising Tax Treaty

- India and Singapore sign a protocol amending the agreement for avoidance of double taxation with Singapore.
- India shall have the right to tax capital gains arising from alienation of shares acquired on or after April 01, 2017 by a Singapore resident.
- Investments in shares made before April 01, 2017 have been grandfathered and will continue to enjoy the benefits of the erstwhile provisions of the India-Singapore tax treaty. Capital gains arising from the alienation of such investments will not be subject to capital gains tax in India, subject to a revised Limitation of Benefits clause provided for under the protocol.
- Capital gains arising out of the alienation of instruments other than shares (convertible debentures, bonds etc.) held by Singapore residents should continue to be entitled to benefits of taxation only in Singapore.
- The protocol provides for domestic anti-avoidance measures to override treaty provisions.

I. Overview of the Protocol

In a press note dated December 30, 2016 (**"Press Note"**), the Indian government announced the signing of the third protocol (**"Protocol"**) to amend the double tax avoidance arrangement between India and Singapore (**"Singapore Treaty"**). The amendments introduced by the Protocol are largely along the lines of those introduced by the protocol amending the double tax avoidance arrangement between India and Mauritius (**"Mauritius Protocol"**), which India and Mauritius recently entered into. While the Indian government is yet to release the text of the Protocol, the same has been made available on the website of the Inland Revenue Authority of Singapore.[1]

The Protocol amends the prevailing residence based tax regime under the Singapore Treaty and gives India a source based right to tax capital gains which arise from the alienation of shares of an Indian resident company owned by a Singapore tax resident. It provides for (i) the grandfathering of investments made on or before March 31, 2017, (ii) a revised limitation of benefits (**"Revised LOB"**) clause, the conditions of which need to be fulfilled in order to obtain the benefit of the capital gains provisions, (iii) a transitory period from April 01, 2017 to March 31, 2019 during which a reduced rate of tax should be applicable on capital gains arising on the alienation of shares acquired on or after April 1, 2017, and (iv) explicit language allowing treaty provisions to be overridden by domestic anti-avoidance measures such as the General Anti-Avoidance Rule (**"GAAR"**), which is slated to come into effect from April 1, 2017.

II. Background

India and Singapore signed the Singapore Treaty on January 24, 1994. Since then the Singapore Treaty has been amended twice by protocols dated June 29, 2005 (**"2005 Protocol"**) and June 24, 2011 (**"2011 Protocol"**).

Under the Singapore Treaty as it stands today (i.e., after its amendment by the 2005 Protocol), capital gains arising from the alienation of shares of an Indian company by a tax resident of Singapore are taxable only in Singapore. This position is in line with that under the India-Mauritius Tax Treaty

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(**"Mauritius Treaty"**) as it stood before amendments introduced by the Mauritius Protocol.

However additionally, the 2005 Protocol provides that the capital gains tax benefit should be available subject to a 'limitations of benefit' (LOB) clause, which provides that a Singapore tax resident would not be entitled to the capital gains tax benefit if (i) its affairs are arranged with the primary purpose of taking advantage of the benefits provided under the Singapore Treaty, or (ii) it is a shell / conduit company. A shell/conduit company is defined to mean any legal entity falling within the definition of resident with negligible or nil business operations or with no real and continuous business activities carried out in Singapore. The LOB clause provided that in order for a Singapore entity not to be deemed a shell / conduit company (thereby making such entity eligible to claim the capital gains tax benefit), such entity would have to either (a) be listed on a recognized stock exchange in Singapore or (b) incur total annual expenditure of SGD 200,000 on operations in Singapore in the 24 months immediately preceding the date on which the gains arise.

Further, Article 6 of the 2005 Protocol provides that the benefits with respect to capital gains which were made available under the 2005 Protocol would be co-terminus with the benefits made available under the Mauritius Treaty. Consequently the beneficial regime available under the Singapore Treaty is slated to fall away on March 31, 2017, when the Mauritius Protocol is to come into effect. Clouds of uncertainty have hung over the Singapore Treaty, especially regarding whether it would be revised to confer similar benefits to investments made by Singapore based entities as will be available under the revised Mauritius Treaty. This uncertainty has now been addressed by the signing of the Protocol.

III. Amendments Introduced by the Protocol

A. Taxation of capital gains on shares

By virtue of the 2005 Protocol, capital gains derived by a Singapore resident from the alienation of shares of a company resident in India (**"Indian Company"**) were taxable in Singapore alone, subject to fulfilment of the LOB clause. However, the Protocol marks a shift from residence-based taxation to source-based taxation. Consequently, capital gains arising on or after April 01, 2017 from alienation of shares of a company resident in India shall be subject to tax in India. The aforementioned change is subject to the following qualifications:-

i. Grandfathering of investments made before April 01, 2017

The Protocol states that capital gains arising out of sale of shares of an Indian Company that have been acquired before April 01, 2017 shall not be affected by the Protocol. Such investments shall continue to enjoy the treatment available to them under the erstwhile provisions of the Singapore Treaty. However, investors will need to fulfil the requirements of the Revised LOB clause instead of the LOB clause under the 2005 Protocol.

ii. Transition period

The Protocol provides for a relaxation in respect of capital gains arising to Singapore residents from alienation of shares acquired after April 1, 2017 but alienated before March 31, 2019 (**"Transition Period"**). The tax rate on any such gains shall not exceed 50% of the domestic tax rate in India (**"Reduced Tax Rate"**). However, this benefit will also be subject the Revised LOB provided under the Protocol.

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iii. Limitation of benefits

The Protocol provides that grandfathered investments i.e. shares acquired on or before 1 April 2017 which are not subject to the provisions of the Protocol will still be subject a Revised LOB in order to avail of the capital gains tax benefit under the Singapore Treaty, which provides that:

- The benefit will not be available if the affairs of the Singapore resident entity were arranged with the primary purpose to take advantage of such benefit;
- The benefit will not be available to a shell or conduit company, being a legal entity with negligible or nil business operations or with no real and continuous business activities.

An entity is deemed to be a shell or conduit company in case its annual expenditure in Singapore is less than SGD 200,000 in Singapore, during each block of 12 months in the immediately preceding period of 24 months from the date on which the capital gain arise (**"Expenditure Test"**). A company is deemed not to be a shell/conduit company if it is listed on recognized stock exchange of the country or it meets the Expenditure Test. This is in line with the existing LOB that is in place under the 2005 Protocol.

With respect to availing the benefit of the Reduced Tax Rate during the Transition Period, the Revised LOB will still apply with one exception: the Expenditure Test will need to be fulfilled only in the immediately preceding period of 12 months from the date on which the capital gain arises. This is a departure from the earlier LOB clause under the 2005 Protocol, which required expenditure of SGD 200,000 on operations in Singapore in the 24 months immediately preceding the alienation of shares.

B. Interest Withholding Rate Remains at 15%

The Protocol has not introduced any changes to the rate of withholding tax on interest payments prescribed under the Singapore Treaty. This may place Singapore at a disadvantage to Mauritius as an ideal jurisdiction to structure debt investments into India, though it should be noted that unlike in the case of Mauritius, the domestic tax rate in Singapore is 17%, meaning that a lower withholding tax rate would not necessarily result in any significant benefit for Singapore in relation to Mauritius. Of course, for funds which enjoy exemptions under the Singapore fund regime or in cases where there is leverage in the Singapore company, the 15% withholding tax rate can end up being a cost or, alternatively such funds or companies may have relied on the lower withholding tax rates for certain types of interest prescribed under the Indian domestic tax regime; in such scenarios, there may have been the expectation that if the Protocol introduced capital gains tax benefits on the lines of those introduced by the Mauritius Protocol, the lower withholding tax rate for interest payments available under Mauritius Protocol would have also been adopted for the Singapore Treaty.

More importantly, gains arising from the alienation of instruments other than shares (such as convertible debentures, bonds etc.) should remain taxable only in Singapore. Investors based in Singapore for other reasons may prefer to invest via debentures, as investments via equity/preference shares may no longer be viable. This would however be subject to application of domestic general anti avoidance rules.

Further, gains arising from the transfer of other capital assets such as interests in Limited Liability Partnerships (LLPs) may also continue to be taxed only in Singapore. Given the recent liberalization of foreign direct investment in LLPs, this is another tax efficient investment avenue that may be explored going forward.

C. Enabling language for GAAR

The Protocol has inserted Article 28A to the Singapore Treaty which reads:

"This Agreement shall not prevent a Contracting State from applying its domestic law and measures concerning the prevention of tax avoidance or tax evasion."

The language of the newly inserted Article 28A makes it clear that the Indian government's sees the GAAR as being applicable even to situations where

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a specific anti-avoidance provision (such as an LOB clause) may already exist in a tax treaty. Interestingly, similar language was not introduced by the Mauritius Protocol.

Making the GAAR applicable to companies that meet the requirements of a LOB clause is likely to adversely impact investor sentiment. Under the GAAR, tax authorities may exercise wide powers (including denial of treaty benefits) if the main purpose of an arrangement is to obtain a tax benefit and if the arrangement satisfies one or more of the following: (a) non-arm's length dealings; (b) misuse or abuse of the provisions of the domestic income tax provisions; (c) lack of commercial substance; and (d) arrangement similar to that employed for non-bona fide purposes. It will be interesting to see the interplay between the Revised LOB provision and the GAAR as well as any measures that the Revenue may take to override the provisions under the treaty.

IV. Impact and Analysis

A. Impact on private equity funds and holding companies

As mentioned earlier, while investments by a Singapore resident in shares of an Indian Company made before April 01, 2017 should continue to be eligible to avail of the benefits of the erstwhile provisions of the 2005 Protocol, such benefits shall be subject to fulfilling the requirements of the Revised LOB clause. Further, shares purchased on or after April 1, 2017, and alienated during the Transition Period should be subject to tax in India at the rate of 50% of the tax rate prevailing in India. However, availing such benefits will again be subject to the Revised LOB clause. Purchase of shares after April 01, 2017 which are then alienated after the expiry of the Transition Period should be subject to regular tax as per the domestic tax rate in India. Investments made through hybrid instruments such as compulsory convertible debentures should continue to be exempt from tax in India and Singapore should have the right to tax gains from such instruments.

The impact of the Protocol will have to be carefully considered by Indian companies looking to set up Singapore based holding structures. Quick implementation may still allow companies to avail of the benefit of the grandfathering provisions. However, with the GAAR set to come into force, and a concerted effort by the Indian authorities to introduce source based taxation in those treaties which do not already provide for it, offshore investors may also need to carefully reconsider their choice of intermediate jurisdiction and the overall value of investing through intermediate jurisdictions.

B. Impact on shares held by Foreign Portfolio Investors ("FPIs")

Under the Indian income tax law, shares of listed Indian companies held by FPIs are deemed to be capital assets irrespective of the holding period or the frequency of trading equity carried out by the concerned FPI. As such, income from sale of shares results in capital gains and at present, FPIs enjoy the benefits of the capital gains provisions under the Singapore Treaty.

While the Protocol should provide some relief to FPIs based out of Singapore as regards the tax regime to be applicable to their investments after March 31, 2017, they will find themselves in a similar position to FPIs based out of Mauritius. The signing of the Protocol will no doubt result in an increase in tax costs, especially where short terms capital gains are earned. However, what appears clear from the spate of amendments to India's tax treaties in the recent years, is that the Indian government is making a concerted effort to bring the era of tax free investments in India to a close, and is consciously moving towards a source based taxation regime which factor should be considered by investors looking to invest in India.

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C. Impact on derivatives, P-Notes etc.

The Protocol will have a significant impact on P-Notes issued against underlying shares of Indian companies. While to a large extent the changes to the treaty were expected, there was a hope that residence based taxation for portfolio investments would be extended. However, the amendments do not create a distinction and this will have an impact on P-Note investments, especially in issues relating to tax pass through to the P-Note holders on the taxes payable by the FPI. The Protocol should not adversely impact derivatives, which should also continue to enjoy exemptions from Indian capital gains taxes. The gap that is created between the tax treatment for equity shares vis-à-vis derivative instruments may lead to a shift in strategies that are dominated by exposure to derivative instruments as opposed to investments in equity shares.

V. Conclusion

The signing of the Protocol is welcome as it sets to rest uncertainty regarding the future taxation regime that would be applicable to investments by Singapore based entities. While the Protocol does result in increased taxation for foreign investors, this was expected, given recent trends, especially the amendment of the Mauritius and Cyprus tax treaties. While the Protocol puts Singapore at an advantage over Cyprus, in that the Protocol provides for grandfathering of existing investments and provides for a transition phase of reduced taxation, the Protocol may result in Singapore falling behind Mauritius as a preferred jurisdiction for debt investments into India. Along with the Netherlands, where a number of debt investment platforms have recently been set up, Mauritius will give Singapore some competition for being the preferred intermediate jurisdiction for investment into India. However, it is not unlikely that the Indian government will push for the tax treaty with the Netherlands to be revised. In such a scenario, existing investment structures will need to be relooked at, and preferred intermediate jurisdictions reassessed.

One troubling factor is the treaty article that provides for the GAAR override of treaty provision. GAAR confers sweeping powers on tax authorities, including the denial of treaty benefits, and investors are sure to be apprehensive about what situations the tax authorities may see as fit for applying the GAAR. The apprehension of being subject to GAAR may serve to counteract the certainty that the LOB provisions are intended to provide.

– Joachim Saldanha, Ashish Sodhani & Rajesh Simhan

You can direct your queries or comments to the authors

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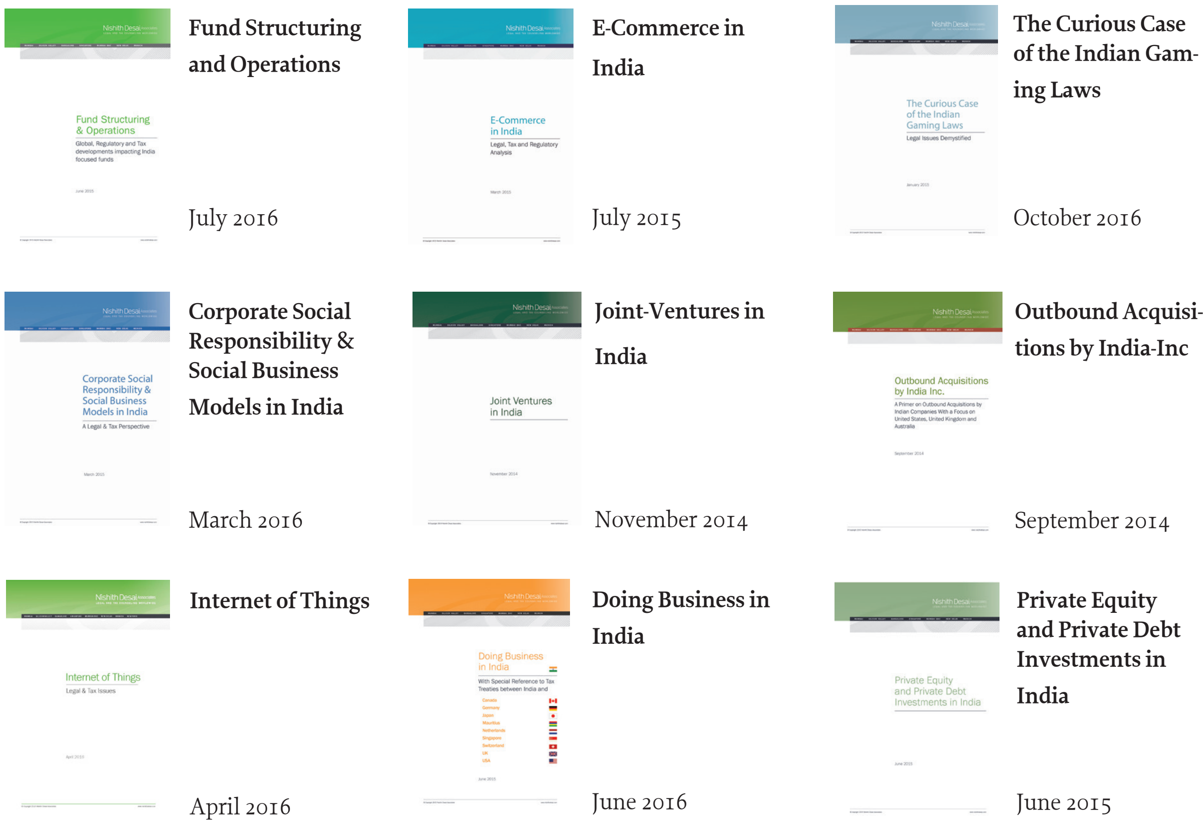

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