NANUBHAI DESAI & CO.

# SOVEREIGN WEALTH FUNDS & PENSION FUNDS IN INDIA

# About Nanubhai Desai & Co.

Nanubhai Desai & Co., established in 1950 in Mumbai, has evolved into a well-recognized high quality personalized services firm. Our extensive knowledge and expertise across various service areas, including Audit and Assurance, Direct Taxes, Accounting, International Tax, and Consultancy services, enable us to offer a "One Stop Platform" by setting a benchmark of excellence in each domain.

With years of experience, we cater to a diverse clientele, including multinational companies (MNCs), foreign companies and their Indian subsidiaries, as well as public and private enterprises spanning industries such as hospitality, trading, fund & private wealth management, IT, and more. Our team comprises dedicated professionals with diverse skills and proficiency, capable of serving clients of all sizes across different sectors.

NDCo embodies a harmonious mix of seasoned expertise and youthful vigour, united by a shared vision of delivering exceptional services and unwavering support to our clients. It's a source of great professional pride that we have attained high level of trust and confidence of our clients.

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# TERMINOLOGY GUIDE

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|---|---|
| **AIF** | Alternative Investment Funds |
| **AIF Regulations** | Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012 |
| **CBDT** | Central Board of Direct Taxes |
| **CCI** | Competition Commission of India |
| **FDI** | Foreign Direct Investment |
| **FEMA** | Foreign Exchange Management Act, 1999 |
| **FPI** | Foreign Portfolio Investor |
| **FPI Regulations** | SEBI (Foreign Portfolio Investors) Regulations, 2019 |
| **FVCI** | Foreign Venture Capital Investor |
| **FVCI Regulations** | SEBI (Foreign Venture Capital Investors) Regulations, 2000 |
| **InvIT** | Infrastructure Investment Trust |
| **InvIT Regulations** | SEBI (Infrastructure Investment Trusts) Regulations, 2014 |
| **IPO** | Initial Public Offer |
| **ITA** | Income Tax Act, 1961 |
| **ITAT** | Income Tax Appellate Tribunal |
| **ITR** | Income Tax Rules, 1962 |
| **LLP** | Limited Liability Partnership |
| **NBFC** | Non-Banking Financial Company |
| **NCD** | Non-Convertible Debenture |
| **OCD** | Optionally Convertible Debenture |
| **OCRPS** | Optionally Convertible Redeemable Preference Shares |
| **PF** | Pension Fund |
| **QIB** | Qualified Institutional Buyer |
| **RBI** | Reserve Bank of India |
| **REIT** | Real Estate Investment Trust |
| **SEBI** | Securities and Exchange Board of India |
| **SPV** | Special Purpose Vehicle |
| **SWF** | Sovereign Wealth Fund |

# 1. INTRODUCTION

SWFs are typically established by governments & are designed to manage/invest a country's reserves/surplus funds. The objectives of SWFs can vary & may include saving for future generations, stabilizing the economy, or generating returns to support the government's fiscal policies.

The primary purpose of pension funds is to provide income to individuals during their retirement years. These funds are set up by employers, governments, or other organizations to accumulate and manage assets that will be used to pay pensions/retirement benefits to employees or contributors.

SWFs and PFs play a vital role in supporting global development by serving as crucial financial instruments. SWFs, which are government-owned investment entities, primarily invest overseas to fulfil predetermined macroeconomic goals. PFs, on the other hand, are funds established by governments or social security institutions with the aim of contributing to funding relevant pay-as-you-go pension plans.

India's funding needs, its medium-term growth potential, and its transparent legal framework make it attractive for Sovereign Wealth Funds (SWFs) and Pension Funds (PFs). Compared to other Asian countries, India stands out favourably for these funds. A significant trend is the transition of SWFs and PFs from passive investors in global General Partners' (GPs) funds to direct investments in Indian enterprises. This shift has sparked a notable increase in interest, prompting many funds to establish local offices and investment teams within India.

Besides direct investments, Sovereign Wealth Funds (SWFs) often allocate funds to India through investment in country-focused funds as Limited Partners (LPs). SWFs entrust their funds to investment managers, who follow a carefully vetted investment strategy. With LP allocations, SWFs also gain co-investment rights for direct participation in select opportunities. The table below shows SWF allocations to alternate investments.

| Asset | Allocation |
|---|---|
| **Private Equity** | 7.5% |
| **Real Estate** | 9.2% |
| **Infrastructure** | 4.9% |
| **Hedge/Absolute return funds** | 3.1% |
| **Commodities** | 1.3% |

## What are SWFs and PFs?

In India, the laws related to companies and securities don't specifically define terms like SWF (Sovereign Wealth Fund) or PF (Pension Fund). However, there are guidelines provided by the 2020 CBDT Circular and the Income Tax Act (ITA) for SWFs to apply for tax exemption. These guidelines give an idea of what criteria SWFs need to meet. Similarly, for PFs, the rules for self-certification to get tax exemptions under Section 10(23FE) can be found in Rule 2DB of the Income Tax Rules (ITR), and these rules indicate the criteria for PFs.

Meeting certain criteria can unofficially recognize an investment entity called a Sovereign Wealth Enterprise (SWE). This kind of entity is owned and managed by a SWF. SWEs are set up to give SWFs more flexibility in investing, enjoy tax benefits, or reduce risk by creating another company in between. Since SWEs are usually fully owned and controlled by SWFs, they often meet the criteria and can be considered SWFs for Indian tax purposes. For example, the Indian government has officially recognized Qatar Holding LLC (which is fully owned by the Qatar Investment Authority) as an SWF eligible for tax exemption under specific sections of the Income Tax Act.

It's important to know that not all Sovereign Wealth Funds (SWFs) are the same. The financial goals they aim for help put them into different groups, although the law doesn't specifically say so. Understanding these groups is important to know how a specific fund invests. In general, SWFs use two main strategies: one is investing through fund of funds (FoF), where they put money into funds managed by others, and the other is direct investment, where they invest directly in companies using their own team.

What's interesting in India is that more and more funds are choosing to invest directly in companies.

## Legal Form of SWFs and PFs

Usually, Sovereign Wealth Funds (SWFs) are created in one of the following three structures:

a. SWFs are asset pools without distinct legal entities, with ownership vested in the state/government or central bank. Management is either conducted by a government-owned entity or an external asset manager. Examples include the Botswana Pula Fund and Norway’s Government Pension Fund Global.
b. SWFs are separate legal entities under public law, distinct from the state/government or central bank, with full legal capacity to act. These funds own investment assets and operate under specific constitutive laws. Examples include the Abu Dhabi Investment Authority, the Kuwait Investment Authority, and the Qatar Investment Authority.
c. SWFs are state/government-owned corporations with distinct legal identities, serving as owners of investment assets. They are typically governed by standard company laws, with specific legislation potentially applicable.

## How to buy pension plans in India?

The investments that you make today to plan for retirement are the ones that will sustain you in the future. The ever-increasing cost of living is why you need to get ahead of your retirement plans in time. As you begin planning for your retirement, it is important to be aware of the different types of pension plans in India to make an informed decision.

Here are some of the critical things to remember when finding the right type of pension scheme:

### 1. Evaluate Expenses

All hard-working individuals have to manage their expenses carefully to fulfil several responsibilities in life. It can be challenging to visualize how your life will look after retirement in terms of money. So, find the right type of pension plan by mapping the timeline of significant life expenses. Take the time to determine the possible changes in your responsibilities in a few years. It will help assess the needs of your financial dependents in alignment with your personal goals for post-retirement life.

### 2. Assess Financial Situation

The type of pension plan that can benefit you the most is heavily dependent on your current and future financial situation. If you have any debts or significant expenses in the future, consider if they will be present after retirement as well. Consequently, you can arrive at the amount of investment in a particular type of pension plan to meet these needs.

### 3. Compare Policies

An essential step in identifying the ideal type of pension plan is to compare different policies. Thorough comparison will give you a better perspective on your requirements and how they can be fulfilled efficiently. Going through the different types of pension plan features may uncover a need that you had not considered before.

## Types of Pension Funds in India:

Understanding the various pension plans available is crucial when planning for retirement. It helps assess how each scheme can suit your needs and prepares you for life after retirement. As financial needs may change over time, especially with the loss of income in retirement, selecting the right pension plan can alleviate concerns. Here are some common types of pension plans in India:

- **Deferred Annuity**
  Build retirement funds through lump-sum or regular contributions, with pension payments starting after policy maturity. Tax-exempt portion available upon withdrawal, rest taxable. Locked funds not accessible for emergencies.
- **Immediate Annuity**
  You Immediate pension upon lump-sum payment, annuity amount based on investment. Various options available. Premium exempt from taxation. Nominee receives pension in case of policyholder's demise.
- **Pension Plans with Life Cover**
  Include life insurance & annuity options. Benefits for beneficiaries if policyholder passes away. Offer steady pension and financial security. Small portion of investments allocated to risk cover.
- **Life Annuity & Pension Funds**
  Receive pension until death, partner continues to receive annuity with 'with spouse' option. Ensures partner's financial security. Long-term plans with higher returns upon maturity, regulated by PFRDA. Choose lump sum/smaller investments for steady post-retirement income.
- **National Pension Scheme (NPS)**
  This pension plan, used by the Government of India, offers investment options in equity and debt funds based on risk preference. Withdraw up to 60% of your savings at retirement, with the rest used to buy annuity. NPS accounts typically fall into two categories: All Citizen Model and Corporate Model.
- **Employee Provident Fund**
  Backed by Indian government, regulated by EPFO. Available for salaried individuals and HUF investors. Requires contributions from both employee and employer. Total funds plus interest received upon retirement.

# 2. Tax Regimes of PFs and SWFs in India

## Tax Regime in India

Income taxation in India is governed by the Income Tax Act (ITA), which distinguishes rules for residents and non-residents. Non-residents are taxed solely on income originating in India as per Sections 4 and 5 of the ITA. The definition of 'person' in Section 2(31) of the ITA is crucial for tax determination, excluding foreign states or governments. Sovereign Wealth Funds (SWFs) or Pension Funds (PFs) are classified based on their legal form. Taxpayers can opt for taxation under a tax treaty between India and their country or the ITA, as per Section 90(2), requiring a Tax Residency Certificate (TRC) as proof of residential status for treaty relief.

## Application of Tax Treaty

The terms of tax treaties apply to individuals identified as 'residents' of a contracting state. Many tax treaties encompass the State, its political sub-divisions, and local authorities within the definition of 'resident.' Whether a SWF or a PF qualifies as a resident for tax treaty purposes is contingent upon the specific circumstances of each case. Particularly, when SWFs or PFs are established as subsidiaries of a State or a political sub-division, their classification as a 'person' is determined based on the language used in the relevant tax treaty.

## Exemption under Domestic Tax Laws

To encourage investment from Sovereign Wealth Funds and Pension Funds, the Finance Act of 2020 granted an exemption on income for a designated entity. This income includes dividends, interest, or long-term capital gains derived from specified investments (either in debt or equity) in India. The Finance Act of 2023 expanded the scope of Section 10(23FE) of the Income Tax Act (ITA) to encompass the specified sum mentioned in Section 56(2)(xii) of the ITA. Consequently, any distributions received by SWFs/PFs in the form of the specified sum should be exempt from taxation, provided that they meet the conditions outlined in Section 10(23FE) of the ITA.

## Additional Conditions to be fulfilled by SWFs/ PFs to Claim Exemption

Since the Finance Act 2020, 14 SWFs and 21 PFs have been notified under Section 10(23FE), signalling their active involvement in the Indian investment ecosystem. Below are the additional conditions these SWFs/PFs must meet to claim exemption under Section 10(23FE) of the ITA:

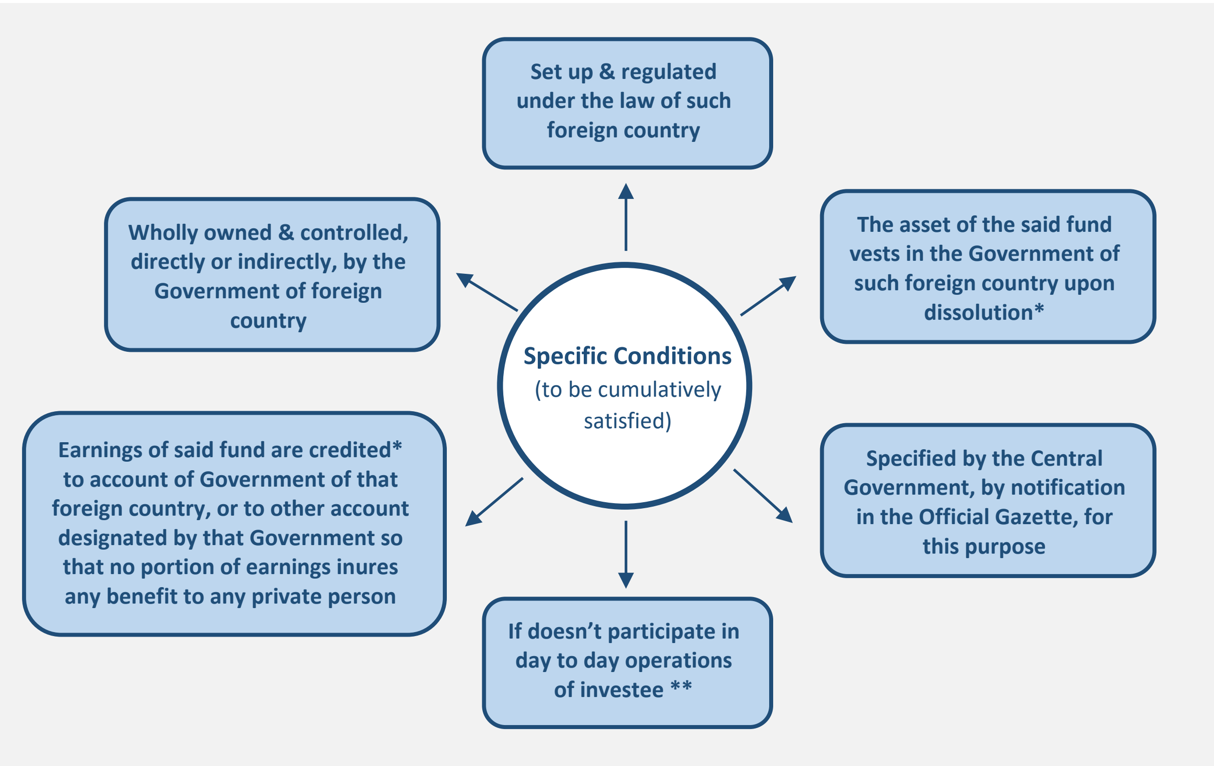
a. Submission of income tax returns is mandatory in accordance with the provisions of the Income Tax Act (ITA) for every year during which the entity held eligible investments qualifying for exemption under Section 10(23FE) of the ITA (referred to as the "Relevant Investment Period").
b. Audit Requirement: Books of account for the Relevant Investment Period must be audited by a designated accountant under Section 288 of the ITA. The audit report should be provided in the prescribed format at least 1 month before the tax return deadline under Section 139 of the ITA.
c. Quarterly Reporting: Quarterly statements must be electronically submitted within one month of each quarter's end, detailing all investments made during the quarter.
d. Segregated Financial Records: The entity must maintain a segregated account that delineates income and expenditure specifically related to all specified investments.

e. Ownership Criteria: The entity must be under the direct or indirect ownership and control of its establishing government, with no other individual or entity exerting control or ownership over the SWF/PF.
f. Regulatory Compliance: The entity must adhere to the laws of its establishing government, ensuring compliance with the applicable legal framework.

In addition to above, PFs are also required to satisfy the below mentioned conditions:

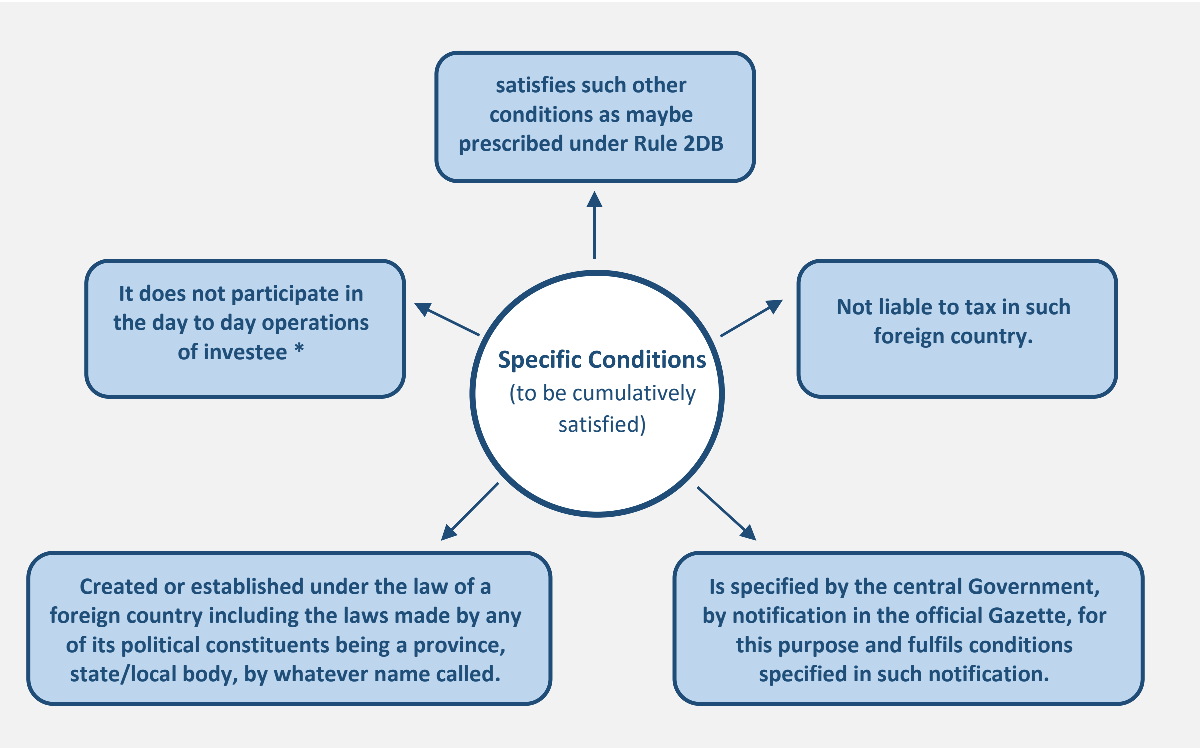
a. The entity oversees or invests assets for various funds or plans providing retirement, social security, employment, disability, death benefits, etc. Compliance is met if these assets constitute less than 10% of the total managed or invested assets. Additionally, the ownership of these assets must belong to the foreign government, and in the event of the fund's dissolution, the assets are transferred to the foreign government.
b. The profits and assets of the Pension Fund (PF) are exclusively utilized to fulfil statutory obligations and defined contributions for the participants or beneficiaries of the funds or plans. No part of the earnings or assets of the pension fund results in any advantage for any private individual. However, this provision does not encompass (a) payments made to creditors or depositors for loans taken or borrowing unrelated to investments in India, and (b) earnings from assets where the profits are allocated to the account of the foreign government and do not confer any benefit to any private individual.

### Specified Conditions: SWF




**This condition shall not apply to any payment made to creators or depositors for loan taken or borrowing for purposes other than for making investment in India.*
*** The monitoring mechanism to protect the investment with the investee including the right to appoint directors or executive director shall not be considered as participation in the day to day operations of the investee.*

**Specified Conditions: PF**




**The monitoring mechanism to protect the investment with the investee including the right to appoint director shall not be considered as participation in the day to day operations of the investee.*

## Investment from Loan or Borrowing

SWFs and PFs are ineligible for the Section 10(23FE) exemption if they have loans or borrowings, directly or indirectly, intended for Indian investments. The CBDT clarified that if loans are acquired explicitly for Indian investments, the exemption doesn't apply. However, if loans aren't specifically for Indian investments, the source shouldn't be presumed from them, maintaining eligibility for exemption under Section 10(23FE) if the investment source isn't from loans or borrowings.

## Secondary Investments

The CBDT clarified that certain secondary investments by SWFs qualify as 'investment' under Section 10(23FE), rendering them exempt. These transfers include:

a. Transfer of shares or units of an 'eligible infrastructure entity' or InvIT to a SWF by any individual after the SWF's notification date under Section 10(23FE).
b. Transfer of AIF units or shares of a domestic company/NBFC invested in an Eligible Infrastructure Entity/InvIT to a SWF post its Section 10(23FE) notification.
c. Transfer of shares of a domestic company/NBFC invested in an Eligible Infrastructure Entity to an AIF, provided the investment is from the specified person's funds post SWF's Section 10(23FE) notification.
d. Transfer of shares of an eligible infrastructure entity by an individual to a domestic company, funded by the SWF post its Section 10(23FE) notification.

## Withdrawal of Exemption under Section 10(23FE)

If SWFs and PFs fail to meet any conditions under Section 10(23FE) of the Income Tax Act in a fiscal year, the exemption granted for all previous years will be revoked. Consequently, previously exempted income becomes taxable in the year it was initially claimed. For example, if an SWF claims exemption for dividend income in fiscal year 2021-2022 and violates conditions in fiscal year 2023-2024, the previously exempted income becomes taxable in fiscal year 2021-2022.

However, there are two exceptions to the aforesaid ‘general rule’:

a. **Lock-in period:**
   To qualify for exemption under Section 10(23FE), investments must be held for three years. Failure to meet this duration may subject the fund's income to taxation, disqualifying it from the exemption. In such cases, capital gains from investments not meeting the three-year rule incur the following tax implications:

| Investments transferred before 3 years | Taxability | Reason |
|---|---|---|
| Investment(s) by the specified person in an Eligible Infrastructure Entity, InvIT, REIT, an AIF, a Specified Company, or an NBFC | In the hands of the specified person | Not be exempt from tax under Section 10(23FE) of the ITA |
| Investment(s) by such an AIF, out of the investment made by the specified person, in an eligible infrastructure entity, InvIT, REIT, an eligible domestic company, or an NBFC | Such capital gains will be taxable in the hands of the specified person | AIF is a pass-through entity and due to the income not being exempt from tax under Section 10(23FE) of the ITA |
| Investment(s) by such domestic company, out of the investment made by the specified person directly or through an AIF, in an eligible infrastructure entity | Income, attributable to such capital gains, shall be taxable in the hands of the specified person | Not be exempt from tax under Section 10(23FE) of the ITA |

   Moreover, any interest/dividend earned on these investments, if transferred in contravention of the 3year holding requirement, which was previously exempt from taxation, will now be liable to be taxed in the hands of the designated entity as income for the relevant fiscal year in which the 3year rule is violated.

b. **Violation of investment thresholds by AIF/domestic company/NBFC**
   If, in any subsequent fiscal year, the AIF/domestic company/NBFC fails to meet the minimum investment threshold in an eligible infrastructure entity, the income exempted for any prior fiscal year (where the threshold was met) remains exempted. However, failure to meet the threshold in the subsequent fiscal year doesn't revoke this exemption. Yet, income in the fiscal year of threshold violation and thereafter won't be exempted. This holds assuming no other specified conditions in Section 10(23FE) or the Income Tax Rules are violated.

## Applicability of Angel Tax

The Finance Act of 2023 has broadened the controversial 'angel tax' to now include non-residents. These provisions address the disparity between the consideration received by an investee company through share issuance and their Fair Market Value, treating it as income from other sources. However, the CBDT proposed exemptions for government-related investors, including central banks, SWFs, international or multilateral organizations or agencies, and government-controlled entities. This exemption is applicable when government ownership, either direct or indirect, is 75% or higher.

# 3. Modes of Investment - Regulatory Framework

While no distinct category or regulatory framework exists under Indian laws for SWFs' or PFs' investments, they can utilize existing investment avenues outlined below:

i. Foreign Direct Investment;

ii. Foreign Portfolio Investment;

iii. Foreign Venture Capital Investment.

## Foreign Direct Investment

Foreign Direct Investment (FDI) in India is regulated by the FEMA in conjunction with the NDI Rules, the Foreign Exchange Management (Mode of Payment and Reporting of Non-Debt Instruments) Regulations, 2019, and the comprehensive FDI Policy established by the Department for Promotion of Industry and Internal Trade, Ministry of Commerce and Industry, Government of India. According to Schedule V of the NDI Rules, entities with a long-term investment horizon, such as SWFs and PFs, are permitted to invest in Indian securities, provided they adhere to the terms and conditions specified by the RBI and the SEBI.

FDI plays a vital role in India's economic growth, serving as a key non-debt financial asset. Overseas enterprises invest in India to benefit from incentives like tax advantages and lower labour costs, leading to technological advancements, job creation, and other benefits. This investment surge is fuelled by supportive government policies, a dynamic business environment, global competitiveness, and economic influence.

Recent government initiatives relaxed FDI regulations in sectors like PSUs, oil refineries, telecom, and defence, boosting India's FDI to a record $46.03 billion in fiscal year 2021-22. Key sectors attracting FDI include IT, telecom, and automobiles. MNCs engaged in strategic collaborations with domestic business groups, leading to an 83% surge in cross-border M&A, totalling $27 billion. India ranks third globally in foreign investment in 2022, with cumulative FDI reaching $596.07 billion over nine years, spanning 101 countries, 31 Union Territories and States, and 57 sectors.

### FDI Regulations in India:

FDI in India is regulated vide prohibited sectors and permitted sectors.

**a. Prohibited Sector:**
Select sectors wherein the Government of India has prohibited FDI in entirety. Illustrative list of prohibited sectors:

- Atomic energy, railways
- Transferrable Development Rights
- Chit Funds
- Nidhi Company

Gambling & Betting

Lottery

Real Estate

Manufacturing tobacco, cigarettes, cigars & other tobacco substitute

**b. Permitted Sector:**

Foreign funds can be directed to approved sectors in India through the Foreign Direct Investment (FDI) pathway, covering areas like infrastructure, manufacturing, civil aviation, satellite establishment and operation, e-commerce, pharmaceuticals, insurance, and more. These investments are subject to sector-specific limits and may follow the automatic route (without central government approval) or the approval route (requiring central government approval), depending on the targeted sector. FDI in permitted sectors can proceed via the Automatic Route or the Government Route.

- Automatic Route: Does not require the prior approval of the Reserve Bank of India or the Central Government. Automatic route allows up to 100% of investment in the Indian entity depending upon the sectoral limits.
- Government Route: Requires prior Government approval and foreign investment received under this route shall be in accordance with the conditions stipulated by the Government in its approval.

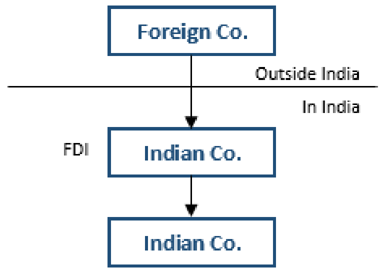
**Illustrative list of FDI in few select sectors:**

| Sector | % of Equity / FDI Capital | Entry Route |
|---|---|---|
| Hospital Sectors | 100% | Automatic |
| Railway Infrastructure | 100% | Automatic |
| Industrial Parks | 100% | Automatic |
| Construction & Development | 100% | Automatic |
| E-commerce | 100% | Automatic |
| Insurance | 49% | Automatic |
| Defence | 100% | Up to 74% - Automatic<br>Beyond 74% - Government |
| Telecom Services | 74% | Up to 49% - Automatic<br>Beyond 49% - Government |
| Banking - Private Sector | 74% | Up to 49% - Automatic<br>Beyond 49% - Government |
| Banking -Public Sector | 20% | Government |
| Print Media - Publishing of newspaper & periodicals dealing with news and current affairs | 26% | Government |
| Satellite - Establishment & Operation | 100% | Government |

## Downstream Investment:

An Indian company, owned or controlled by non-residents, can engage in indirect FDI by investing in another Indian company. This downstream investment must comply with the same regulations as direct FDI, including sector-specific conditions and limits applicable to the downstream entity's sectors. Indirect FDI occurs when investments are made in: (a) another Indian entity receiving foreign investment and not owned or controlled by resident Indian citizens, or owned or controlled by individuals outside India ("); or (b) an investment vehicle whose sponsor, manager, or investment manager is not owned or controlled by resident Indian citizens, or owned or controlled by persons residing outside India. Downstream investments require funding from abroad or through internal accruals, involving profit transfer to a reserve account after tax payments.

- Indirect foreign investment into Indian entity
- Indian company receiving any FDI and that FDI is used for the purpose of investing in the capital instrument in any other Indian company.
- Sectoral conditions as applicable to first level shall be applicable
- Issue/transfer/pricing/valuation of shares shall be in accordance with SEBI/RBI guidelines.




## Instruments for investing in India:

FDI can be in the form of "equity instruments" issued by any Indian company, including equity shares, fully and compulsorily convertible preference shares, fully and compulsorily convertible debentures, convertible notes, partly paid shares, and warrants. These instruments, which may include an optionality clause, are subject to a lock-in period of one year (or longer if specified). Investors cannot exit at a predetermined price. FDI can also occur through share exchange, with valuation conducted by SEBI-registered merchant/investment banker registered in the host country.

- Equity Shares
- Fully, compulsorily and mandatorily Convertible Preference Shares (“CCPS”)
- Fully, compulsorily and mandatorily Convertible Debentures (“CCD”)
- Equity Instruments containing Options
- Swap Options

## Deferred Consideration:

The NDI Rules allow the transfer of shares between a resident buyer and a non-resident seller, or vice versa, with deferred consideration, subject to the following conditions:

a. The deferred consideration should not surpass 25% of the total amount.
b. The deferred consideration must be paid within 18 months from the date of the agreement for the transfer of shares.
c. The deferred consideration may be settled through an escrow arrangement, with a term not exceeding 18 months.
d. In case the entire consideration is paid, the seller may provide an indemnity valid for 18 months for the deferred portion of the transaction.

## Foreign Portfolio Investors

An FPI is an entity that is officially registered under the FPI Regulations. FPIs operating in India are overseen by the FPI Regulations, the NDI Rules (Schedule II), and the Master Circular for FPI issued by SEBI. SWFs (Sovereign Wealth Funds) and PFs (Pension Funds) are categorized as "Category I FPI" according to Regulation 5(a)(i) and (ii) of the FPI Regulations. Consequently, once registered as an FPI, an SWF has the authorization to buy or sell equity instruments of an Indian company listed or intending to be listed on a recognized stock exchange, provided compliance with various conditions, including the ones outlined below:

### FPI Regulations in India:

Each investor is required to register directly as an FPI, wherein the FPIs have been classified into the following two categories:

a. **Category I:**
    - Government and Government related investors.
    - Pension funds and university funds
    - Other regulated entities viz., Insurance, banks, AMC, etc.

b. **Category II:**
    1. Regulated funds not eligible as Category I FPI
    2. Family Office
    3. Corporate Bodies
    4. Trusts and Charitable Organisations

### Investment Limits for FPI:

a. **Individual Limit:** The total holding of one single FPI or an investor group shall be lower than (i) 10% of the total paid-up equity share capital issued by an Indian company, on a fully diluted basis or (ii) 10 % of the paid-up value of each series of debentures, or preference shares, or share warrants issued by an Indian company.

b. **Aggregate Limit:** The total holdings of all FPIs put together, including any other direct and indirect foreign investments in the Indian company shall not exceed 24% of paid-up equity capital on a fully diluted basis or paid-up value of each series of debentures or preference shares or share warrants.

### Instruments for Investment in FPI:

Below is an illustrative list of instruments through which FPIs are permitted to invest:

- Listed or to-be listed shares, debentures & warrants of a Co.;
- Derivatives traded on a recognized stock exchange;
- Non-convertible debentures/ bonds issued by an Indian Co.;
- Listed/unlisted units of schemes floated by a recognized mutual fund;
- Treasury bills and dated government securities;
- Commercial papers issued by an Indian company;
- Indian depository receipts;

- Units of real estate investment trusts, infrastructure investment trusts and unit of applicable Alternate Investment Funds;

As seen from the category of instruments available under this route, investments in debt can also be made by an FPI. Therefore, this route is suitable for yield focussed instruments and other debt and hybrid investments.

**Clubbing of Investment Limits:**

In instances where two or more Foreign Portfolio Investors (FPIs), including foreign governments and their affiliated entities, share common ownership exceeding 50% or common control, they are collectively considered part of an investor group. Furthermore, investments made by foreign government agencies are combined with those made by the foreign government or its related entities when calculating the 10% limit for FPI investments in a single company, provided they constitute an investor group. However, exceptions to this clubbing rule apply, such as in cases where FPIs are regulated public retail funds or public retail funds with appropriately regulated investment managers. Notably, pension funds fall under the category of public retail funds, and as such, they are exempt from compliance with the provisions related to the aggregation of investment limits, as long as they are regulated under the laws of their jurisdiction of origin.

**Consideration:**

FPIs have the option to acquire securities of an Indian company through either a public offering or private placement, subject to the specified individual or aggregate limits, and the fulfilment of the subsequent conditions:

- If FPIs subscribe through a public offer, the share price allocated to them must not fall below the price set for shares issued to resident investors.
- For private placement subscriptions, the share price should not be lower than either: (i) the price determined according to SEBI's pricing guidelines, or (ii) the fair price determined through an internationally accepted valuation methodology for shares, conducted at arm's length. This fair price should be certified by a SEBI registered merchant banker, chartered accountant, or practicing cost accountant.

## Foreign Venture Capital Investment

The FVCI Regulations were promulgated to stimulate foreign investment into venture capital undertakings in India. The FVCI rules make it mandatory for offshore funds to register themselves with SEBI in order to avail the benefits of the FVCI Regulations. SEBI and RBI provide certain advantages to Foreign Venture Capital Investors (FVCI) as opposed to investing through FDI pathway.

a. **Unrestricted Pricing:** Registered FVCIs are not bound by the pricing restrictions that apply to investments through FDI. They enjoy the flexibility of determining prices freely during both the entry and exit phases of their investments. The sale or transfer of securities can occur at a mutually agreed-upon price between the involved parties.
b. **Investment Instruments:** FVCIs have the flexibility to invest in various instruments, including equity instruments, equity-linked instruments (instruments with optional or mandatory conversion into equity shares), or debt instruments such as OCRPS, OCDs, and NCDs.
c. **Lock-in Period:** While the SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2018, impose a lock-in period of 6 months for the entire pre-issue share capital of a company going public, FVCIs enjoy an exemption from this requirement. They can exit their investments post-listing, provided they have held the shares for minimum of 6 months from the date of purchase.
d. **Takeover Code Exemption:** SEBI has granted an exemption to promoters of a listed company from the public offer provisions regarding share transfers between FVCIs and promoters under the Takeover Code.
e. **QIB Status:** FVCIs registered with SEBI are designated as Qualified Institutional Buyers (QIBs) and are eligible to subscribe to securities during an IPO through the book-building route.

### Sectors:

FVCIs are limited to investing exclusively in the specified sectors listed below:

- Biotechnology; Nanotechnology
- IT related to hardware and software development;
- Seed research and development;
- Research and development of new chemical entities in pharmaceutical sector.
- Dairy industry; Poultry industry;
- Production of bio-fuels;
- Hotel-cum-convention centres with seating capacity of more than three thousand;
- Infrastructure sector.

### Investment Thresholds:

A minimum of 66.67% of the investible funds belonging to an FVCI must be allocated to the investment in unlisted equity shares or equity-linked instruments of venture capital undertakings.
Additionally, up to 33.33% of the investible funds of an FVCI can be utilized for:

i. Participating in the initial public offering of a venture capital undertaking or an investee company intending to list its shares;
ii. Investing in the debt or debt instruments of a venture capital undertaking or an investee company in which the FVCI entity has previously invested through equity;
iii. Obtaining preferential allotment of equity shares in a listed company, subject to a lock-in period of 1 year.

# 4. Corporate Structure for Foreign Investors

Foreign investors in India typically opt for legal structures like private limited companies, subject to the Foreign Direct Investment (FDI) policy. Compliance with the Companies Act, 2013, and other corporate governance norms is essential. Consideration of minimum capitalization requirements, understanding the intricacies of India's tax system, and obtaining necessary registrations and approvals, including from the RBI for foreign exchange transactions, are crucial steps in establishing a corporate presence.

A foreign investor/entity can commence business in India either as an incorporated entity or an unincorporated entity.

i. Incorporated Entities: Corporate structures like Private Limited companies, Limited Liability Companies, etc., fall under this category.
ii. Unincorporated Entities: Liaison Offices, Branch Offices, Project Offices are some forms of unincorporated corporate structures under which foreign entity can commence business in India.

| Particulars | Liaison Office | Project/Branch Office | Private Limited Company | Limited Liability Partnership |
|---|---|---|---|---|
| **Legal Status** | Representative status | Extended arm of parent entity | Independent status | Independent status |
| **Approval for commencement** | From AD Bank & RBI | From AD Bank & RBI | Companies Act s.t. FDI guidelines | LLP Act, 2008 s.t. FDI guidelines |
| **Permitted Activities** | • Liaison activities only<br>• No commercial/ business activities | • Restricted Scope<br>• Activities as prescribed by RBI | • Activities specified in MOA of company s.t. FDI guidelines | • Activities specified in LLPagreements.t. FDI guidelines |
| **Income Tax Rate** | Not subject to tax | Tax on Income earned in India@40% | • Tax global income @different rates*<br>• MAT @15% of Book Profits | • Tax global income @30%<br>• MAT @15% of Book Profits |
| **Repatriation of accumulated Profits** | Not Applicable | Can remit post-tax profits | Repatriation after procedural compliances | Repatriation after procedural compliances |
| **Ease of Exit** | Prior Approval of AD Bank and ROC | Prior Approval of AD Bank and ROC | Exit through sale of sales or liquidation | Exit through sale of interest / dissolution |

** 15%/22%/25%/30% depending upon nature of activities, annual turnover and fulfilment of conditions*

# 5. Investment Vehicles

Infrastructure and real estate stand as two crucial pillars in any economy, and India is no exception to this rule. The progress of a nation is often gauged by advancements in its infrastructure and real estate domains. These sectors possess the potential to independently drive economic growth and establish a foundation not just for the well-being of its citizens but also to attract additional investments globally.

Recognizing the pivotal role of infrastructure and real estate in fostering overall development, the government has underscored the imperative to bolster these sectors. It is acknowledged that the growth of other industries hinges on the progress of infrastructure and real estate. The Indian government has explicitly set a target of achieving a GDP of USD 5 trillion by the year 2025. To realize this ambitious goal, an estimated expenditure of USD 1.4 trillion on infrastructure alone is deemed necessary over the specified period.

Substantial financial investments are essential for the advancement of the infrastructure and real estate sectors, a need that necessitates the engagement of external collaborators like SWFs and PFs. Although SWFs and PFs have the authority to invest in India overall, with a specific focus on these sectors, there has been a notable inclination towards REITs and InvITs. REITs and InvITs emerge as optimal channels for these funds due to their distinctive attributes, encompassing the following key characteristics:

a. Listed, liquid and regulated securities;

b. Yield products; and

c. Quasi sovereign credit in most cases.

REITs and InvITs share conceptual parallels with mutual funds in their overarching operational and managerial structures. Similar to mutual funds, both REITs and InvITs aggregate funds from investors and issue units in return. The pooled funds are subsequently invested in various avenues.

InvITs, governed by InvIT Regulations, act as vehicles channelling investor funds for further investment in the infrastructure sector. They hold income-generating assets such as roads, highways, power and gas pipelines, as well as energy projects. Similarly, REITs, regulated by REIT Regulations, utilize investor funds for additional investment in revenue-generating real estate projects like hotels, hospitals, convention centres, and composite real estate projects.

In their nascent stages in India, both InvITs and REITs are already crucial in project development, drawing capital from private entities and recycling funds. Their promising growth prospects, lower volatility, and appealing returns have fuelled their popularity, resulting in significant investment inflows. In the fiscal year 2021-22, InvITs raised around USD 2.56 Billion through avenues like initial offers, preferential issues, and rights issues.

Considering the significant use of public funds in InvITs and REITs, SEBI regulations ensure a well-structured framework. These regulations cover aspects like investment mechanisms, party rights and obligations, mandatory profit distribution, etc., which will be discussed in detail in the following chapters.

## Infrastructure Investment Trusts

Due to its capital-intensive nature and prolonged project timelines, the infrastructure sector provides ideal investment opportunity for long-term investors like SWFs & PFs. Acknowledging this investment potential in the sector, the Government of India enacted the InvIT Regulations through SEBI.

**Structure and Parties:**

An InvIT is a trust registered with SEBI under the InvIT Regulations. It secures funds by issuing units to investors and then allocates these funds to infrastructure sector assets. As of May 10, 2023, there are a total of 20 registered InvITs in India.

**Parties:** The important parties for an InvIT include –

a. Trustee – An individual or entity that safeguards the assets of the InvIT in trust for the benefit of unit holders or investors.
b. Sponsor – A corporation, Limited Liability Partnership (LLP), or any other corporate entity that establishes the InvIT. Following the initial unit offering, a sponsor must retain a minimum of 15% units in the InvIT for a duration of at least three years from the date of unit listing.
c. IM (Investment Manager) – A corporation or LLP designated as such, primarily responsible for making investment decisions related to the InvIT's underlying assets or projects. This includes decisions on additional investments or divestments. The IM also oversees the activities of a Project Manager.
d. PM (Project Manager) – A corporation or LLP designated by the InvIT, responsible for the execution or management of an infrastructure project and ensuring the accomplishment of all associated milestones.
e. Holding Company – A corporation or LLP in which the InvIT holds or plans to hold a minimum of 51% of the equity share capital or interest. This holding company, in turn, invests in other Special Purpose Vehicles (SPVs) that possess the infrastructure assets. The holding company is restricted from engaging in activities other than holding the underlying SPV or managing infrastructure projects and related activities.
f. SPV (Special Purpose Vehicle) – A corporation or LLP directly accountable for the infrastructure project. The InvIT or holding company must have at least a 51% equity share capital or interest in the SPV, except in cases of public-private partnership projects where such holding is prohibited by the government or under a concession agreement. Additionally, at least 90% of the SPV's assets should be directly held in infrastructure projects, and it is prohibited from investing in other SPVs or engaging in activities beyond those related to its underlying infrastructure project.

### Investment Conditions and Distributions by InvIT:

An Infrastructure Investment Trust (InvIT) serves as a means of growth, with unit holders anticipating profits and the return of their investments. Given that an InvIT is a specialized entity created for investing in infrastructure projects, SEBI imposes specific conditions and restrictions on InvIT investments to safeguard the objectives outlined in the InvIT Regulations and prevent their misuse.

a. **Investment Guidelines:**

An Infrastructure Investment Trust (InvIT) is authorized to invest solely in a holding company, Special Purpose Vehicle (SPV), infrastructure projects, or securities within India, aligning with the investment strategy outlined in the offer document or placement memorandum. If the InvIT intends to invest in an infrastructure public-private partnership project, this investment must be channelled through the holding company or the SPV.

In cases where the InvIT invests in infrastructure projects through SPVs, certain provisions apply: (a) a shareholders'/partnership agreement must be established between the InvIT and the shareholders/partners of the SPV, explicitly stating that these entities won't impede the InvIT's compliance with the InvIT Regulations; (b) the Investment Manager (IM) is responsible for ensuring that the InvIT exercises its voting rights in every SPV meeting.

If the InvIT invests in infrastructure projects through the holding company, in addition to meeting the aforementioned conditions, the InvIT must maintain an ultimate holding interest of no less than 26% in the underlying SPV(s).

Furthermore, InvITs are required to:
(a) Refrain from investing in units of other InvITs;
(b) Restrict lending activities to entities other than the holding company or the SPV(s), with the exception of permissible investment in debt securities; and
(c) Retain ownership of an infrastructure asset for a minimum period of 3 years from the date of its acquisition by the InvIT, whether directly or through the holding company and/or SPV.

b. **Disbursements from InvIT:**

i. The method and amount of distributions within an InvIT represent a noteworthy aspect that captures the interest of numerous prospective investors. Specific conditions are imposed on the InvIT, the holding company, and the Special Purpose Vehicle (SPV) concerning the distribution of net distributable cash flows.
   1) The SPV needs to give at least 90% of its available cash to the InvIT/Holding Company, based on their ownership in the SPV. This follows the rules in the Companies Act, 2013, or Limited Liability Partnership Act, 2008.
   2) The InvIT has to share at least 90% of its available cash with the unit holders.
   3) The Holding company must pass on not less than 90% of its earned cash directly to the InvIT. However, all the cash received by the Holding company from the underlying SPVs must go to the InvIT.

Moreover, if the InvIT, holding company, or SPV sells any infrastructure asset, or if the equity shares or interest in the holding company/SPV are sold by the InvIT, the cash flows resulting from such sales will be distributed according to the previously mentioned mechanism. However, if the InvIT plans to reinvest the proceeds from the sale in other infrastructure projects within one year, these proceeds will not be distributed.

Distributions from the net distributable cash flows, as outlined earlier, must be declared and made at least once every six months for publicly offered InvITs and at least once every year for privately placed InvITs during each financial year. Any remaining unclaimed or unpaid amounts from the distributions will be transferred to the 'Investor Protection and Education Fund' established by the Investment Manager's board.

## Real Estate Investment Trust

A REIT is like a group of real estate properties that work a bit like a savings club, giving you money regularly. REITs use their money to buy and build real estate. In India, there are currently five registered REITs as of May 10, 2023. Rules for REITs explain how to join, who can join, and other things about the parts of a REIT.

**Parties:** The important parties for an REIT include –

a. Trustee – The person who takes care of the REIT's stuff to make sure everyone who invested gets what they should.
b. Sponsor – The one who starts the REIT and has to own a good amount of it for three years after it starts.
c. Manager – The Company in India that runs the REIT's money and deals with its day-to-day work.
d. Holding Company – Another company where the REIT owns a lot, and this company invests in other special groups that own the actual properties. This company can only do things related to owning properties.
e. SPV – A special group that owns the actual properties. The REIT or holding company must own a good chunk of it. The SPV can't invest in other groups and can only deal with owning and developing properties.

**Distribution of Monies:**

Here's a quick summary of the rules about how money is shared out, as explained in regulation 18(16) of the REIT Regulations. These rules apply to the REIT, its holding company, or special purpose vehicles.

a. The REIT or its holding company needs to get at least 90% of the money left after expenses from the special purpose vehicles. This share should match how much the REIT or holding company owns in those special purpose vehicles (following the rules of the Companies Act, 2013, and the LLP Act).

b. Here's the least amount of leftover money that a holding company has to give to a real estate investment trust, following the rules of the Companies Act of 2013 or the Limited Liability Partnership Act of 2008, as applicable:

   i. All the money the holding company got from the special group (SPV), which is 100%.
   ii. For the money the holding company made on its own, it has to share 90% of it.

c. A REIT has to give at least 90% of money it makes each year to the people who own units in it.

d. Money pay-outs must happen at least two times in a year.

e. A REIT has to share at least 90% of the money it gets from selling property, stocks, or a share in a company, unless it plans to invest that money again within one year.

If the money isn't given out within 15 days of saying it will be, the person in charge (manager) has to pay extra money (interest) to the unit owners. They have to pay 15% interest each year until the payment is made. However, this extra money can't be taken from the fees or any other money the manager gets from the REIT.

## Alternative Investment Trust

We've noticed that SWFs (Sovereign Wealth Funds) are putting money into AIFs (Alternative Investment Funds) in India. According to the rules for AIFs, SWFs are considered Accredited Investors ("AI"). This means they don't have to get a special certificate to enjoy the benefits of being an Accredited Investor. Because they're Accredited Investors, SWFs qualify for certain exceptions, like:

a. They don't have to follow the rule of investing a minimum of INR 10,000,000.
b. They don't have to meet the minimum amount needed for social impact funds.

Similarly, as Accredited Investors (AIs), SWFs can now invest in large-value funds for accredited investors ("AI Fund(s)"). These funds are AIFs (or schemes within them), where each investor (except for certain individuals related to the AIF and its management) is an Accredited Investor and invests at least INR 70,000,000 (Seventy Million Indian Rupees). Some extra exceptions provided for AI Funds include:

**a. Deadlines for specific regulatory submissions eased for AI Funds**

Unlike regular investment funds that need to send their information documents to SEBI (via a financial expert) at least thirty days before, and they have to include SEBI's suggestions before starting the investment plan, an Accredited Investor Fund can share its documents at any time and doesn't have to include SEBI's suggestions in those documents.

**b. Prolonging the duration beyond two years**

If the rules in the documents that control the Accredited Investor Fund allow it, the fund can continue for more than two years. This is different from a regular investment fund that has to sell off (or keep) its assets after the two-year extension period. Having the option to extend protects Accredited Investor Funds from the chance of having a bad investment year.

**c. Easing the rules on diversification**

Unlike regular investment funds, which can only put 25% (for category I and category II AIFs) or 10% (for category III AIFs) of their available money into one investment, an Accredited Investor Fund can invest up to 50% (for category I and category II AIFs) or 20% (for category III AIFs) in a single investment. This flexibility allows SWFs to make larger bets on investments they believe will be successful.

Also, because SWFs are considered AIs, they don't have to follow the rule of investing a minimum of INR 50,00,000 when choosing portfolio management services.

# What support do we offer?

→ Help clients understand and comply with relevant laws, regulations, and guidelines applicable to their specific situation.

→ Assist in preparing accurate and timely financial statements, reports, and disclosures to meet regulatory requirements and stakeholders' needs.

→ Develop tax-efficient strategies to minimize tax liabilities while ensuring compliance with tax laws and regulations.

→ Identify and assess potential risks to the client's business or investment activities, and recommend risk mitigation strategies.

→ Provide in-depth financial analysis and interpretation to support decision-making processes, such as investment evaluations, performance assessments, and financial forecasting.

→ Offer advice and support throughout various stages of transactions, including due diligence, valuation, negotiation, and deal structuring.

→ Assist clients in developing and implementing strategic plans aligned with their objectives, whether it involves growth, diversification, restructuring, or exit strategies.

→ Establish systems and processes to monitor ongoing compliance with regulatory requirements, tax obligations, and internal policies.

→ Facilitate communication and collaboration between the client and relevant stakeholders, such as regulators, investors, auditors, and legal advisors.

→ Provide training sessions or educational materials to keep clients informed about changes in laws, regulations, and best practices relevant to their business or investments.

## *Disclaimer*

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