

# STRATEGIES FOR FOREIGN INVESTMENT IN INDIAN START-UPS

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Foreign investment in Indian start-ups offers significant opportunities for investors who understand their options. This is especially true for investment in technology start-ups developing artificial intelligence and consumer facing apps. Various investment avenues available to nonresidents are outlined in the paragraphs below.

## INVESTMENT ENVIRONMENT

Indian start-ups have begun attracting nonresident high net worth individuals and family offices in significant numbers. These groups represent a large portion of the \$38.3 billion garnered by Indian start-ups in over 1,000 deals during 2018.

In particular, wealthy business families have been promising supporters of Indian start-ups. These families often come with significant expertise in the industries where they invest and are more flexible in their exit strategies than venture capitalists, funds, and other investors. This has often resulted in nonresident individuals and families owning prominent and profitable Indian start-ups that were considered risky in their early stages.

## PURCHASING SHARES AND DEBT

Nonresidents can invest directly in start-ups by subscribing to shares (equity or compulsorily convertible preference shares) or debt issued by the start-up. During the tenure of these investments, nonresident investors would continue to receive income in the form of dividends or interest to the extent of free cash.

Dividends paid by Indian companies are subjected to Dividend Distribution Tax (“D.D.T.”) at the company level under Section 115-O of the Indian Income Tax Act, 1961 (“I.T.A.”) and are tax-free in the hands of shareholders. Since individual investors do not directly incur the tax, it may be difficult for an individual to claim foreign tax credit relief in the home country for D.D.T. imposed on dividends without further analysis of the D.D.T. under home country tax concepts. Interest would be taxed under Indian tax law at the individual rate applicable to nonresidents, subject to relevant tax treaty relief.

Upon the sale of these shares or controlling rights, nonresidents would be liable to pay capital gains tax under domestic law, subject to any relevant tax treaty benefits. Under domestic law, the capital gains tax rate is dependent on the holding period. Where the holding period is more than 36 months (assuming the shares of the Indian start-up are unlisted), gains are taxed as long-term capital gains at the rate of 10% (plus applicable surcharge and cess) without the benefit of foreign currency conversion or cost indexing under Section 112(1)(c) of the I.T.A. Capital receipts would be received by nonresident H.N.W.I.’s (net of tax). Further, nonresidents

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would be required to obtain a permanent account number (“P.A.N.”) from the Indian tax authorities and file an Indian income tax return with respect to the transaction.

## CAPITAL CONTRIBUTIONS IN LIMITED LIABILITY PARTNERSHIPS

Nonresidents can also invest in Indian limited liability partnerships (“L.L.P.’s”) by way of capital contributions.

Income earned by an Indian L.L.P. would be taxed in hands of L.L.P. at a rate of 30% (plus applicable surcharge and cess). Any distributions to nonresident partners would be tax-free.

In the case of a change in shareholding, there may be no exit tax in the hands of the outgoing partner.

## INVESTING THROUGH FUNDS

Nonresidents can incorporate alternate investment funds (“A.I.F.’s”) registered with the Securities Exchange Board of India (“S.E.B.I.”) (in the form of a company, trust, L.L.P., or body corporate) for the purpose of investing in eligible start-ups.

A.I.F.’s can take several forms:

- Category I, Subcategory I A.I.F.’s enjoy passthru status. That is, any income earned by these funds is tax-exempt in the hands of the fund under Section 10(23FB) of the I.T.A. and taxable in the hands of the nonresident investor under Section 115U of the I.T.A. Neither D.D.T. nor withholding tax would be applicable on the distribution of income to the nonresident investor.
- Other A.I.F.’s registered as Category I & II (also known as “Investment Funds”) enjoy passthru status for income other than business income. That is, business income would be taxable in hands of the A.I.F. under Section 115UB of the I.T.A. and the distribution would be tax-free in the hands of the nonresident investor. All other income (other than business income) would be exempt for the A.I.F. under Section 10(23FBA) of the I.T.A. and, hence, taxable in the hands of the nonresident investor. No D.D.T. would be applicable on the distribution of income to the nonresident investor.
- Income from Category III A.I.F.’s does not enjoy passthru status. Income would be taxed at the rates applicable to the entity. For instance, if an A.I.F. is incorporated in the form of a business trust, its taxation would be governed by the income tax provisions applicable to business trusts. D.D.T. or withholding tax, as per the I.T.A., would be applicable on the distribution of income to nonresident investors.

In all these forms, the investor can exit at any time by transferring its interest in the A.I.F. and paying tax on the capital gains on the sale, subject to relevant tax treaty relief. Nonresident investors are entitled to claim tax benefits under a relevant tax treaty during the investment tenure and on exit, if the treatment is more favorable than the I.T.A. provisions.

## INVESTING THROUGH BUSINESS TRUSTS

Nonresident individuals can set up business trusts that, in turn, invest in eligible start-up companies.

On the tax front, any interest and dividend income is exempt under Section 10(23FC) of the I.T.A. in the hands of the trust but is taxable in the hands of the investor as per applicable tax rates. Capital gains, business income, or other income is taxed in the hands of the trust in accordance with Section 115UA of the I.T.A. and, hence, is tax-free on distribution to the nonresident investor.

Upon a transfer of units in the business trust, the nonresident would be liable for tax on the capital gains, subject to the relevant tax treaty relief.

## CONCLUSION

Investment in Indian start-ups is a high-risk, high-reward activity. The space offers a potential win-win for foreign investors looking to multiply investments with high rates of return and for the country as a whole, with Indian start-ups providing jobs, digitalization, and innovations that contribute to a vibrant economy and produce a positive social impact.

As an investor, there is always a question of whether to become involved in day-to-day management of the business or to let the concept owner take the lead. In either case, the ease of entry and exit, clear Indian tax laws, and availability of tax treaty benefits make investing in Indian start-ups a promising and lucrative opportunity for nonresidents.

