Treelife

# AIFs in India:
## A Comprehensive Overview

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# Meet the Team Behind our Report

**Jitesh Agarwal**
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Jitesh Agarwal, the Founder of Treelife, is a qualified Chartered Accountant with over 12 years of deep domain expertise in the startup and alternative investment fund (AIF) space. Prior to founding Treelife, Jitesh gained valuable experience working in the BFSI-focused assurance and forensic verticals at Deloitte India for over 6 years. As the driving force behind Treelife's practices, Jitesh has helped over 1,000 clients across India and globally navigate the complex regulatory and financial landscape. His specialized expertise extends to the AIF domain, where he assists clients with the entire lifecycle of setting up and managing Category I, II, and III funds. Jitesh and his team provide end-to-end support, from fund structuring and documentation to obtaining regulatory approvals and ensuring ongoing compliance. Leveraging his strong financial background, Jitesh also provides strategic advisory on fund management, portfolio construction, and exit planning for alternative investment strategies. His comprehensive understanding of the AIF ecosystem and ability to navigate the evolving regulatory environment have made Jitesh a trusted partner for clients seeking to establish and grow their alternative investment funds in India.

**Garima Mitra**
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Garima Mitra, Co-Founder of Treelife, is a seasoned legal expert specializing in transaction support, commercial contracts, and regulatory compliance. As the head of Treelife's legal and secretarial compliance teams, Garima plays a pivotal role in guiding startups and investors through complex legal frameworks. She has been instrumental in negotiating and structuring key transaction agreements for over 250 deals, helping clients close transactions worth over $500M across a variety of industries. Garima's legal expertise covers the full transaction lifecycle—from conducting due diligence to the final execution of agreements. She works closely with clients on mergers and acquisitions (M&A), joint ventures, private equity investments, and fund structuring. Garima's legal acumen also extends to advising Alternative Investment Funds (AIFs), supporting investors with regulatory approvals, fund documentation, and compliance throughout the lifecycle of Category I, II, and III funds. Her involvement in major transactions, including those for startups like CleverTap, WhiteHat Jr., Traaya, Rentomojo and more, has made her a trusted advisor in the startup ecosystem.

**Priya Kapasi Shah**
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Priya, a qualified Chartered Accountant with experience at PwC and KPMG, currently leads the Financial Advisory team at Treelife. She specializes in investment structuring, cross-border transactions, and tax and regulatory advisory. Furthermore, she leads AIF setups and offers advisory and setup services for GIFT IFSC. Priya has conceptualized and implemented more than 50 domestic and offshore fund structures for investments in India, providing expert advice on key fund structuring aspects such as carried interest, management fees, and distribution waterfalls. She has also obtained regulatory licences such as AIF, FPI and FVCI. Priya has also been involved in a variety of investment and divestment deal structures, offering strategic insights and advising on capital structures. In addition, she has provided tax opinions on a wide range of matters, including withholding tax on secondary transactions and the taxability of income from securities like equity shares, NCDs, CCDs and Convertible Notes.

# Index

# Introduction

Alternative Investment Funds, often abbreviated as AIFs, have become a buzzword among sophisticated investors, especially High Net Worth Individuals (HNIs).

As of November 2024, India has nearly 1,400 registered AIFs.[1] This domain has witnessed remarkable growth, underscored by an almost 77% surge in commitments which escalated from Rs. 22.73 trillion in the fiscal year 2021-22 to a staggering Rs. 40.19 trillion in 2023-24.[2] This growth translated to a substantial Rs. 17.46 trillion jump within two years!

The total assets under management (AUM) of AIFs have grown at a CAGR (Compound Annual Growth Rate) of 28% between June FY19 and June FY24s[3].

In light of the burgeoning AIF industry, its regulatory authority, the Securities and Exchange Board of India (SEBI), hasn't remained a silent observer. SEBI has proactively been fortifying protocols to guarantee investor safety, heighten transparency, and ensure fair practices within the AIF guidelines.

So, the question arises, what exactly are AIFs? And how do they function within the Indian regulatory landscape?

# Understanding AIFs

An Alternative Investment Fund (AIF) is a privately pooled investment vehicle that gathers funds from investors, Indian or foreign, for investment as per a defined investment policy to benefit its investors.

AIFs are becoming a favoured choice for discerning investors, including High Net Worth Individuals (HNIs). With their promise of high returns across diverse asset classes, AIFs are attractive for those aiming to diversify and enhance their portfolios.

# Some Key Terms used in AIFs

1. **Carry**
   Carry or carried interest is akin to performance fees which is paid to the investment manager as a share of the AIF's profits which the investment manager is entitled to if they exceed a specific threshold return. Carry is typically in the range of 15-20% of the profits earned by the AIF in excess of the specified threshold.

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[1] According to SEBI Bulletin - October 2024, there are a total of 1382 AIFs registered by September 2024.
[2] According to the 'Data relating to activities of Alternative Investment Funds (AIFs)' by SEBI
[3] https://aifpms.com/blog/growth-of-aif-pms-investments-in-india/

2. **Hurdle / Preferred rate of return**

   Minimum percentage of returns that an investor earns before the Investment Manager can catch-up and charge carry to investor

3. **Catch-up**

   Catch-up allows the investment manager to earn the hurdle rate of return on its investment in the AIF but only after the investors have received their investment along with the hurdle rate of return on such investment

4. **Distribution waterfall**

   Provides for an order of specified priority in which the distributions are made by AIF which includes the capital contributions, fees, hurdle, catch up (if any), carry, etc.

5. **Closing**

   Closing is the date fixed by the Investment Manager as a cut-off date to obtain capital commitment from investors.

# Regulatory Framework

In India, AIFs operate under the purview of the Securities and Exchange Board of India (SEBI).

Since their establishment in the late 1980s, Venture Capital Funds (VCFs) have been a significant focus for the government to bolster the growth of specific sectors and early-stage companies. However, the desired outcomes in supporting emerging sectors and startups were not realized, largely due to regulatory uncertainties. Recognizing this challenge, in 2012, the Securities and Exchange Board of India unveiled the SEBI (Alternative Investment Funds) Regulations. This was done to categorize AIFs as a unique asset class, similar to Private Equities (PEs) and VCFs.

Any entity wishing to function as an AIF must seek registration with SEBI. While there are various legal structures under which an AIF can be established - such as a trust, a company, an LLP, or a body corporate - trusts are the most commonly chosen form in India.

A typical AIF structure looks like the following:

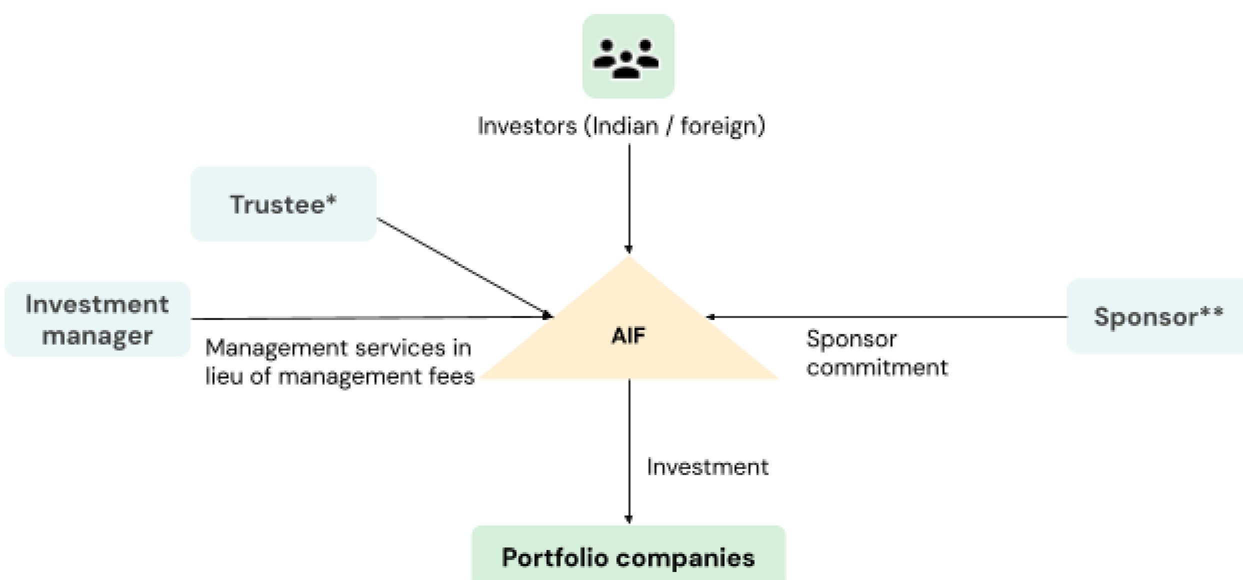


Figure 1: Typical AIF structure

The entities are:

- Settlor - Person who settles the trust with a nominal initial settlement
- Trustee - Person in charge of the overall administration and management of the Trust. In practice, this responsibility is then outsourced to the investment manager.
- Contributor - Investor to the Trust (AIF) and makes a capital commitment to the AIF
- Sponsor - Face of the AIF i.e. Person who sets up the AIF

- Investment Manager - Brain of the AIF i.e. Person who is appointed to manage the investments

It's noteworthy that the roles of the Sponsor and Investment Manager can be unified, with one entity performing both functions.

Under the SEBI AIF Regulations, AIFs are classified into 3 distinct categories. Each category serves a unique purpose and is characterized by specific investment conditions and varying degrees of regulatory oversight. Below is an overview of the categories, highlighting their primary purpose and key conditions:

| Parameters | Category I AIF | Category II AIF | Category III AIF |
|---|---|---|---|
| Definitions | Funds with strategies to invest in start-up or early stage ventures or social ventures or SMEs or infrastructure or other sectors or areas which the government or regulators consider as socially or economically desirable.<br><br>Includes:<br>● Venture Capital Funds (angel funds are a sub-category of VCFs)<br>● SME funds<br>● Social Impact Funds<br>● Infrastructure Funds<br>● Special Situation Funds | Funds that cannot be categorized as Category I AIFs or Category III AIFs. These funds do not undertake leverage or borrowing other than to meet day-to-day operational requirements and as permitted in the AIF Regulations.<br><br>Examples - Private Equity or Debt Funds | Funds which employ diverse or complex trading strategies and may employ leverage including through investment in listed or unlisted derivatives.<br><br>Examples - Hedge funds or funds which trade with a view to make short-term returns |
| Minimum ticket size | INR 1 crore | INR 1 crore | INR 1 crore |
| Minimum fund size | INR 20 crore | INR 20 crore | INR 20 crore |
| Open or close ended fund | Close-ended | Close-ended | Can be open or close-ended |
| Tenure | Minimum tenure of 3 years | Minimum tenure of 3 years | NA |
| Continuing interest of Sponsor / Manager | Lower of:<br>● 2.5 % of corpus<br>● INR 5 crores | Lower of:<br>● 2.5 % of corpus<br>● INR 5 crores | Lower of:<br>● 5 % of corpus<br>● INR 10 crore |

| Parameters | Category I AIF | Category II AIF | Category III AIF |
|---|---|---|---|
| (a.k.a skin in the game) | | | |
| Investment outside India | Permissible subject to SEBI approval | | |
| Concentration norms | Cant invest more than 25% in 1 investee company | Cant invest more than 25% in 1 investee company | Cant invest more than 10% in 1 investee company |
| Borrowing | Cant borrow funds except for :<br>(a) temporary funds not more than 30 days<br>(b) less than 4 occasions in a year<br>(c) less than 10% of investable funds | Cant borrow funds except for :<br>(a) temporary funds not more than 30 days<br>(b) less than 4 occasions in a year<br>(c) less than 10% of investable funds | Can engage in leverage & borrowing as per prescribed rules |
| Overall restrictions / compliances | Low | Medium | High |
| SEBI registration fees | INR 500,000 | INR 1,000,000 | INR 1,500,000 |
| Per scheme filing fees | INR 100,000 | INR 100,000 | INR 100,000 |

Table 1: Categories of AIFs

Apart from the categories mentioned above, any of the three categories of AIFs can be classified as a large-value fund (LVFs), provided that each investor is an "accredited investor" as per the AIF Regulations and invests a minimum of INR 70 crores in the AIF. LVFs have certain investment and compliance related exemptions.

Angel Funds also hold a distinct categorization under the AIF Regulations. These funds are a sub-category of Category I AIFs - VCFs, primarily designed to acknowledge and support the unique role of angel investors in the startup ecosystem. The key characteristics of Angel funds are summarised below:

| Parameters | Category I AIF |
|---|---|
| Minimum ticket size | INR 25 lakhs |
| Minimum fund size | INR 5 crore |
| Investments | Should be not less than INR 25 lakhs and not more than INR 10 crores, with |

| Parameters | Category I AIF |
| --- | --- |
| | a minimum lock-in period of 3 years. |
| Open or close ended fund | Close-ended |
| Continuing interest of Sponsor / Manager<br>(a.k.a skin in the game) | Lower of:<br>● 2.5 % of corpus<br>● INR 50 lakhs |
| Investors | Angel investors who meet the specified criteria |
| SEBI registration fees | INR 200,000 |
| Per scheme filing fees | NIL |

Table 2: Angel Funds

## Key Investment Team

The key investment team of the Investment Manager of all AIFs have to comply with certain qualification conditions which are specified below:

| | |
| --- | --- |
| **Experience** | Minimum 1 key person to obtain certification from the NISM by passing the NISM Series-XIX-C: Alternative Investment Fund Managers Certification Examination |
| **Educational Qualification** | Minimum 1 key person with professional qualification in any of the below from a university or an institution recognized by Central Government or any State Government or a foreign university –<br>● Finance<br>● Accountancy<br>● Business management<br>● Commerce<br>● Economics<br>● Capital markets or<br>● Banking<br>● CFA charter from the CFA institute |

The experience and education qualification criteria may be satisfied by the same person.

# Taxability of AIFs

### Category I and II AIFs:

Category I and II AIFs are granted pass-through status from an income-tax perspective, whereby any income earned by these AIFs (other than profits or gains from business) is not taxed at the AIF level, but directly taxed as income at the hands of the investors as if these investors had directly received this income from the investments.

Unabsorbed losses (other than business losses) of the AIF may be allocated to the investors for them to set off against their respective individual incomes, subject to such investors having held the units in the AIF for at least 12 months.

Further, the distributions from Category I and II AIFs are subject to a withholding tax of 10% in the case of resident investors, and at the rates in force in the case of non-resident investors (after giving due consideration to any benefit available to them under the applicable tax treaty).

Business income of Category I and II AIFs is chargeable to tax at the maximum marginal rate (MMR) i.e. 30% plus applicable surcharge and education cess at the AIF level as per the legal status of the AIF and once this tax is paid, no further tax on the same is payable by the investors.

### Category III AIFs

Category III AIFs have not been granted statutory pass-through status. Typically, they are set up as "determinate and irrevocable trusts." This means the trusts have identifiable beneficiaries, and their respective beneficial interests can be determined at any given time. In such trusts, the trustee can discharge the tax obligation for the income of the trust on behalf of its beneficiaries (i.e., the investors) in a representative capacity. This is similar to the tax liability an investor would face if they had received the income directly. However, there's an exception: trusts with any business income must pay tax at the MMR. As per income-tax law, tax authorities can recover tax either from the trustee or directly from the beneficiaries. Given this flexibility, a trustee might opt to pay the entire tax amount at the AIF level. Moreover, the law permits the trustee (acting as a representative assessee) to recover from investors any taxes it has paid on their behalf.

We have not covered tax implications for investment managers and sponsor entities above.

# Key Documents

### Private Placement Memorandum (PPM):

The PPM provides comprehensive details about the AIF. Contents include information about the manager, key investment team, targeted investors, proposed fees and expenses, scheme tenure, redemption conditions or limits, investment strategy, risk factors and management, conflict of interest procedures, disciplinary history, service terms and conditions by the manager, affiliations with intermediaries, winding up procedures, and any other relevant details helping investors make informed decisions about investing in an AIF scheme.

SEBI has introduced mandatory templates for PPMs (for and) which provides for two parts:
Part A – section for minimum disclosures
Part B – supplementary section to allow full flexibility to the AIF in order to provide any additional information, which it may deem fit.

There are two templates - one for Category I and II AIFs and the other for Category III AIFs.

Angel Funds, LVFs and AIFs in which each investor commits to a minimum capital contribution of INR 70 crores are exempted from following the aforementioned template.

### Indenture of Trust / Trust Deed:

This document is an agreement between the settlor and the trustee. It involves the settlor transferring an initial settlement (can be nominal) to the trustee to create the fund's assets. The Indenture details the roles and responsibilities of the trustee.

### Investment Management Agreement:

This agreement is entered between the trustee and the investment manager. Here, the trustee designates the investment manager and transfers most of its management powers regarding the fund to them. However, certain powers retained by the trustee are outlined in the Indenture of Trust.

### Contribution Agreement:

This agreement is between the contributor (investor), the trustee, and the investment manager. It mentions the terms of an investor's participation in the fund, covering areas like beneficial interest computation, distribution mechanism, expense list to be borne by the fund, and the investment committee's powers. SEBI mandates that the Contribution Agreement's terms should align with the PPM and shouldn't exceed its provisions.

## How to get registered with SEBI?

To register an AIF with SEBI, the fund needs to make an application to SEBI on its online portal.

The trust deed i.e. incorporation document of the fund where it is set up as a trust, needs to be registered with the local authorities. Further, the PAN needs to be obtained before making the application to SEBI.

The application to SEBI has the following key documents to be submitted:

- Application form in Form A
- Private Placement Memorandum (PPM)
- Trust Deed
- Declarations and KYC documents of the entities involved i.e. investment manager, sponsor, trustee (if the AIF is structured as a trust), and the AIF itself

Further, before submitting the application to SEBI, the AIF must engage a merchant banker who performs due diligence on the PPM and subsequently provides a certification that needs to be filed with SEBI. However, there's an exemption for LVFs and Angel Funds for this requirement.

Once the application is submitted, SEBI will evaluate the application. Generally, the entire setup and registration process, including SEBI's assessment, spans around four to six months.

Broadly, the process flow looks as follows:

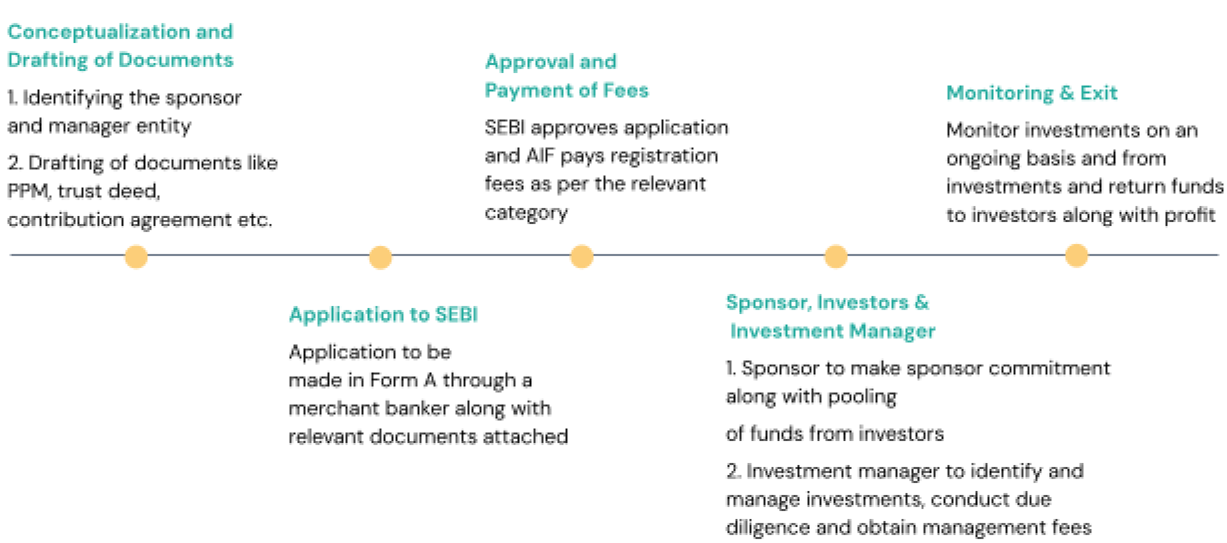


Figure 2: AIF process flow

## Final Thoughts

With their ability to diversify investment portfolios and provide potential high returns, AIFs undeniably present an attractive avenue for investment in today's dynamic market scenario.The regulatory framework, set by SEBI, ensures transparency, credibility, and alignment with global best practices, further instilling confidence among stakeholders.

However, AIFs can be tricky to understand because of the different types, how they are taxed, and the many documents involved. It's like trying to put together a puzzle with lots of pieces.

For both potential AIF managers and investors, understanding this intricate ecosystem is crucial. It is recommended to talk to experts who know the details. They can guide you through the process, help you understand the rules, and make sure you're making the best decisions. As the world of AIFs keeps changing, staying informed and getting the right advice will be key to success.

# FAQs

**1. What is an Alternative Investment Fund (AIF)?**

Answer: An AIF is a privately pooled investment vehicle that collects funds from investors, either Indian or foreign, to invest as per a defined investment policy, with the aim of benefiting its investors. It offers diversified asset classes and promises potentially high returns, making it an attractive choice for High Net Worth Individuals (HNIs) and other discerning investors.

**2. How are AIFs regulated in India?**

Answer: AIFs in India operate under the regulatory framework of the Securities and Exchange Board of India (SEBI). SEBI introduced the SEBI (Alternative Investment Funds) Regulations in 2012 to categorize AIFs as a distinct asset class. All entities desiring to function as an AIF must register with SEBI.

**3. What are the different categories of AIFs?**

Answer: SEBI classifies AIFs into three categories:

- Category I AIF: Focus on sectors or areas which are socially or economically desirable. Includes Venture Capital Funds, SME funds, and more.
- Category II AIF: Funds that do not fall under Category I or III and don't undertake excessive leverage.
- Category III AIF: Funds employing diverse or complex trading strategies, often using leverage. Examples include hedge funds.

**4. How is the taxability of AIFs determined?**

Answer:

- Category I and II AIFs: Granted pass-through status, meaning income (other than business profits) is taxed directly in the hands of investors.
- Category III AIFs: Not granted a statutory pass-through. Typically, tax liability for trusts can be met by the trustee or the beneficiaries directly.

**5. What are Angel Funds and how do they fit into the AIF landscape?**

Answer: Angel Funds are a sub-category of Category I AIFs – specifically Venture Capital Funds. They are designed to support the crucial role of angel investors in the startup ecosystem. Angel funds have distinct features like a minimum ticket size of INR 25 lakhs and a minimum fund size of INR 5 crores.

**6. How does one register an AIF with SEBI?**

Answer: To register with SEBI, the fund must make an online application. Prior to this, the trust deed must be registered locally, and a PAN should be obtained. Key documents like the PPM, Trust Deed, and relevant KYC documents must be submitted. The entire setup and registration process usually takes around four to six months.

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Our goal at Treelife, is to provide you with peace of mind and ease in business for startups, investors, global businesses and accelerators/incubators.

**We are Problem Solvers. And take Accountability.**


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