



# Private Equity

## Union Budget 2016

Post-Budget sectoral point of view



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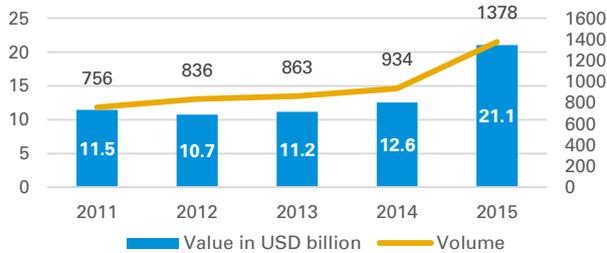


# Context



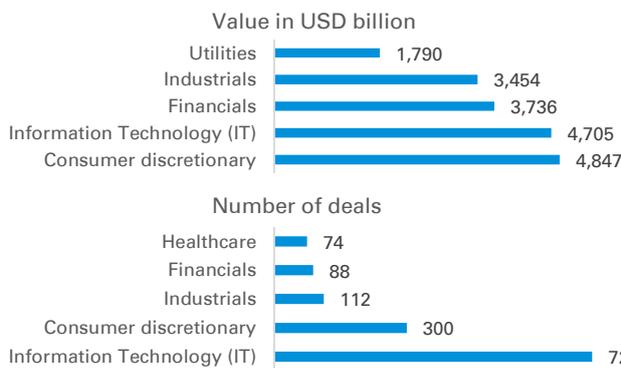
## Where we are

### PE/VC Investments in India



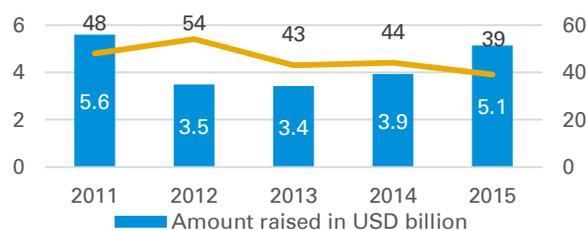
Source: Annual Deal Report, 2016, VCCEdge

### Top sectors attracting PE investments



Source: Annual Deal Report, 2016, VCCEdge

### PE/VC funds raised in India



Source: Annual Deal Report, 2016, VCCEdge

### PE/VC exits in India



Source: '2016, Annual Deal Report', VCCEdge

The year 2015 has been a record-breaking year for the Private Equity (PE) sector. The inflow of private equity and Venture Capital (VC) investment stood at USD21 billion last year, much more than USD18 billion registered in 2007, before the global economic crisis erupted. After relatively sideways movement between 2011 and 2014, which witnessed investment levels of about USD11 to 12 billion, 2015 was indeed a phenomenal year for the industry.

The consumer discretionary sector, dominated by e-commerce companies, led deal-making; it was closely contested by IT and ITeS companies. A pro-business government with a number of investor-friendly measures focussing on ease of doing business, favourable Foreign Direct Investment (FDI) norms and a host of key tax reforms, coupled with the advent of a start-up revolution, have led PE/VC players to invest heavily in the country. Planned initiatives like 'Start-up India Stand-up India' are expected to strengthen investor morale.

The positive sentiment of the industry was further reflected in fund-raising trends, as firms raised capital commitments of over USD5.1 billion in 2015, an impressive 30 per cent jump from USD3.9 billion raised in 2014.

Exits, which have been a perennial challenge for investors in India, also rose to USD5.5 billion in 2015, as compared to USD4.8 billion in 2014. However, the number of exits reduced from 270 to 252 during this period.

There still remain a few key expectations and reform requirements of the PE/VC industry. These are likely to get un-boxed post the Union Budget 2016 announcements and implemented throughout the year in 2016. If the present investor-friendly approach and industrial reforms continue, 2016 could surpass the investment levels of 2015.

## Key issues/challenges



**Currency depreciation:** The flagging Indian National Rupee (INR) against the U.S. Dollar (USD) is a worry for foreign PE/VC investors in the country as it adversely impacts their dollar returns during exit.

**Exits:** Exits remain a key challenge for PE funds in India as decelerating capital markets and lack of clear Mergers and Acquisitions (M&A) guidelines across a number of key sectors continue to hamper a healthy exit environment. In fact such has been the lack of exit opportunities, that some funds have turned 'Zombies'. These are near closed-down PE funds stuck with investments for far longer than the targeted range of three to five years. As a result, these funds are not able to raise fresh funds from Limited Partners (LPs).

**Tax and regulatory bottlenecks:** Although a number of tax-related concerns and issues were addressed by the government in 2015, many bottlenecks still remain. For instance, litigation risks have increased because tax treatment on exits have arose primarily due to General Anti-Avoidance Rules (GAAR) w.e.f. 2017. Also, ground level issues over treaty eligibility are yet to be addressed. Unlike the provisions for Foreign Portfolio Investors (FPIs), there is still no clarity on the characterisation of income earned by Alternative Investment Funds (AIFs) and this may potentially lead to litigation. Secondly, in the case of domestic funds, while tax pass-through was granted for category I and II AIFs, a withholding tax regime was introduced whereby, all non-business income, which is payable to investors would be subjected to withholding tax of 10 per cent. Further, the current provisions suggest that withholding tax would also be applicable on distribution of exempt income. This could be a hindrance for foreign investors looking to invest in AIFs. Lastly, while a Safe Harbour Rule for eligible foreign investors was introduced last year to remove tax impediments, which have deterred offshore funds from shifting fund management activity to India, the prescribed qualifying criteria is not practical.

## Government's stance



- The government has put a lot of focus on ease of doing business in India, with the primary intention of minimum government, maximum governance. To ensure this, the Budget proposed to form a task force for rationalisation of human resources across ministries
- The Budget also announced granting residency status to foreign investors, which is beyond the current norm of a five-year business visa. This initiative is expected to improve the connect with foreign investors and encourage them to set up manufacturing units in India, thereby enabling the government's 'Make in India' initiative

- The Budget speech highlighted strong Gross Domestic Product (GDP) growth of 7.6 per cent and reduction in Consumer Price Index (CPI) inflation to 5.4 per cent, despite global headwinds
- Key focus areas of the government in the current Budget were rural development, agriculture, social and infrastructure
- The Finance Minister (FM) stressed on a number of pending reforms, including the implementation of the Goods and Service Tax (GST), passage of Insolvency and Bankruptcy Law, among others
- In a major boost to the business environment, the government committed to creating a stable taxation regime and gave assurance against implementing retrospective tax changes
- The Budget laid stress on a stable banking system for enabling a strong economy; stringent insolvency laws proposed in the Budget should empower the banking sector
- Overall, the Budget looks at strengthening the economy by providing prudent fiscal management, which should lead to lower interest rates and reduced borrowing costs for corporates.

## Expectations (policy/fiscal/tax)



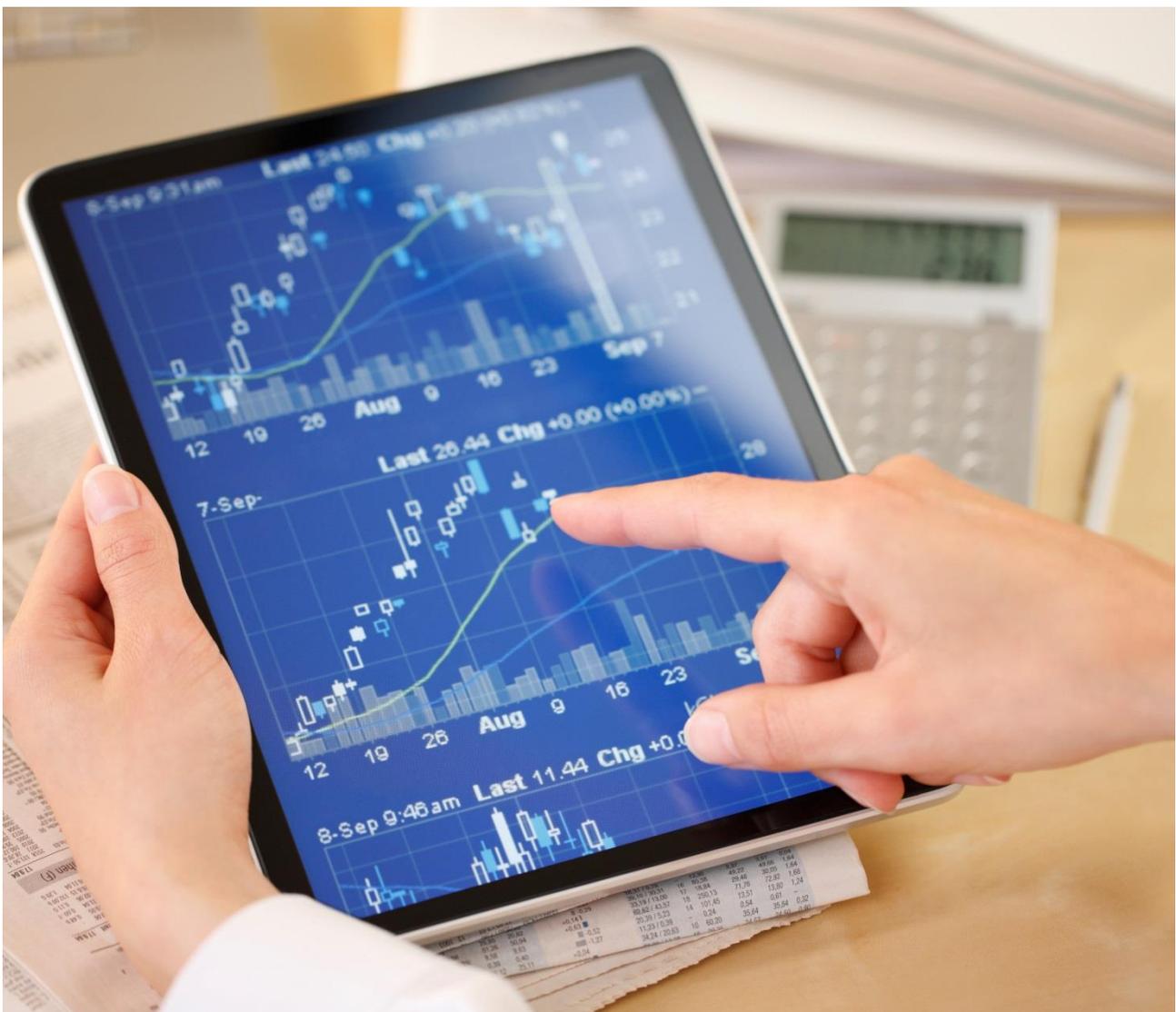
The PE firms were expecting a number of key reforms and were prepared with their wish-list. During 2015, the government implemented various measures to attract PE/VC investments in India. Some of the key measures included liberalisation of Foreign Direct Investment (FDI) policy, tax pass-through for certain AIFs, rationalisation of the Minimum Alternate Tax (MAT) provisions, introduction of Safe Harbour Rules, and the announcement of 'Start-up India' Action Plan.

With high hopes, the PE industry articulated its wish list for boosting investments and removal of further hurdles in its expectations from the Union Budget 2016-17. Key expectations were:

- **Clarity on income categorisation:** Characterisation of income from securities as investment income (capital gains or income from other sources) or business income has created uncertainty for investors in AIF over a long period of time. The Union Budget 2014 had made an amendment that the securities held by Foreign Portfolio Investors (FPIs) would be treated as 'capital assets'. It was expected that similar benefit should be extended to AIFs, erstwhile venture capital funds (VCFs), foreign venture capital investors (FVCLs) and other PE investors as the investments made by these entities are long-term and of similar nature as FPIs.

- **Removal of 'withholding tax' and modification of tax 'pass-through' guidelines:** Currently, category I and II AIFs are treated as tax pass-through with respect to all income other than business income. However, all non-business income payable to investors are subject to withholding tax of 10 per cent. It was expected that the 10 per cent withholding tax should not apply to payment of income, which is exempt or to payments of income to exempt investors or to an investor who is an AIF. In case of withholding on payment of income to a non-resident investor in the AIF, the applicable tax treaty benefit should be provided. A tax pass-through regime should not differentiate between gains and losses. Therefore, similar to the tax pass-through regime for net income of the investors, net losses incurred by the AIFs under any head of income, should also be allowed to be passed on to the investors.
- **Exemption from Sections 56(2)(viiia)/(viiib):** Section 56(2)(viiia) of the Income Tax Act, 1961 (the Act) provides that if a person receives shares of a company, not being a company in which public is substantially interested (widely held company) at less than fair market value (FMV), the difference should be taxed in the hands of the recipient. Section 56(2)(viiib) provides that where a company other than a widely held company issues shares to a resident (other than a VCF or a Category I AIF – VCF) at a consideration higher than the FMV, then the difference will be taxed in the hands of the issuer company. All categories of AIFs and their investee companies should be exempted from the rigor of these provisions.
- **Tax pass-through status for category III AIFs:** Currently, the tax pass-through status is granted only to category I and II AIFs. The government should extend it to category III AIFs as well.
- **Easing of Safe Harbour qualifying norms:** The Safe Harbour Rule for fund management in India was introduced in the Union Budget 2015 to remove tax impediments, which have deterred offshore funds from shifting fund management activity to India. However, to qualify for Safe Harbour, funds need to meet stringent criteria such as minimum of twenty five investors, 10 per cent stake limit per investor and minimum fund size of INR100 crore. Many of these conditions are cumbersome and not practical. It was expected that the government would liberalise these conditions by providing, *inter alia*, the following.
  - Regulated entities like FPIs and FVCIs should automatically qualify as an eligible investment fund
  - For ascertaining the number of members, direct as well as underlying members should be considered
  - The threshold of participation interest of a single investor in the fund should be increased to 49 per cent
- Clarify that activities undertaken by a fund in connection with its investment in the investee company will not result in the fund carrying on or controlling and managing any business in India or from India.
- **Rationalisation of indirect transfer provisions:** The current indirect transfer tax provisions cover any redemption, transfer, buy-back if shares/units of offshore entities, which may be focused on India or derive substantial value from Indian investments. This may lead to double taxation as the exit by offshore entity from its Indian investment would be taxable in India and subsequently when the returns are distributed to the investors of the offshore entities, they may also come under the purview of indirect transfer tax provisions. Accordingly, it was expected that once tax laws are applied on direct transfers, the subsequent distribution should not be covered by indirect transfer tax provisions. It was also expected that transfer of units of AIFs (which do not result in participation in control and management of the fund) by non-resident investors should be excluded from the ambit of indirect transfer provisions.
- **Place of Effective Management (POEM):** The criteria for determining POEM of a company laid down by the draft guiding principles issued by the government in December 2015, is very subjective. The PE industry was expecting that Union Budget 2016 would provide objective criteria to determine POEM to aid in eliminating uncertainties and avoid potential litigation.
- **Taxation of convertible preference shares:** Unlike convertible debentures, there is no specific tax exemption for conversion of preference shares into equity shares. It was expected that in order to avoid litigation, Union Budget 2016 would exempt conversion of preference shares into equity shares. The government was also expected to clarify that for determining holding period of such converted equity shares, the period of holding preference shares (pre-conversion) would also be included
- **Beneficial tax rate on Long-Term Capital Gains (LTCG):** Union Budget 2016 would amend the definition of the term 'securities' in Section 112(1) of the Income-Tax Act to include shares of private limited companies so that non-resident investors can avail the benefit of concessional rate of 10 per cent on LTCG earned from transfer of shares of private limited companies
- **Clear guidelines on GAAR:** Even though GAAR is more than a year away and would only apply to transactions post 1 April 2017, the government needs to provide more information on the blueprint to alleviate fears and concerns in the minds of investors

- **Removal of retrospective tax laws:** After the Income Tax Act was amended in 2012, it gave power to tax authorities to claim taxes stretching back a period of seven years. This created huge uncertainty in the PE/VC industry as seven years is well beyond the investment life-cycle, with profits being returned to LPs at the end of it
- **Removal of barriers to enable LPs such as pension and provident funds to invest in PE funds:** Like most developed countries, pension and provident funds could become a huge source of capital for PE/VC firms in India.
- **Faster implementation of bankruptcy norms:** PE and VC firms in India usually back risky, early stage companies. The Budget should have eased the norms to ensure timely closure of failed businesses



# Key policies/fiscal and tax proposals



## Key announcements<sup>1</sup>

### No more retrospective tax changes

- The FM clearly announced that the government is focussing its efforts on creating a stable taxation regime, and would not levy any retrospective tax changes in the future.

### POEM deferred by one year

- POEM proposed to be made effective from FY2016-17 (as against FY2015-16)
- Government to notify the rules of residence and provide for the transition mechanism for assessing a foreign company, which is said to be a resident in India (due to its POEM being in India) for the first time and where the said company has never been a resident in India before.

### GAAR is here

- No deferment of GAAR, to be effective from 1 April 2017.

### Withholding tax norms for AIFs

- Taxes to be withheld at 10 per cent for income credited/paid to resident investors and at 'rates in force' for non-resident investors. Tax treaty benefits available in case of non-resident investors
- Remedy of nil/lower withholding certificate from the tax authorities available to investors.

### Limited relaxation of Safe Harbour Rules for fund managers

- Extended to offshore funds even if they are not residents in a particular jurisdiction but are incorporated/registered in a notified jurisdiction
- Condition for offshore funds to not carry business from India omitted.

### Period of holding for unlisted securities reduced

- The FM announced that the holding period for unlisted securities to qualify as long term capital assets reduced from three to two years. However, the amendment to this effect is not provided in the Finance Bill or the Memorandum.

### Lower capital gains tax rate for non-residents

- The LTCG tax rate of 10 per cent extended to shares of companies not being companies in which the public is substantially interested (widely held companies).

### MAT not applicable to foreign companies

- Retrospective clarification from 1 April 2001 on non-applicability of MAT to (i) foreign companies from a country with which India has entered into a tax treaty and not having a permanent establishment in India,

and (ii) foreign companies from non-treaty countries with no requirement of registration under any law relating to companies.

### Rationalisation of tax regime for REITs/InvITs (Business trusts)

- Business trusts to be exempt from tax on interest and dividend income received from a Special Purpose Vehicle (SPV)
- Dividend income received by investors in business Trust to be exempt in their hands
- Business trusts to withhold taxes from interest income at the time of payment or credit, whichever is earlier
- No DDT on dividends declared by SPV to business trusts, if it holds 100 per cent of the SPV or maximum stake permitted under relevant law. DDT exemption available only on dividends declared out of current profits after the business trust acquired the holding in the SPV
- Amendments to be effective from 1 June 2016.

### Buy-back distribution tax

- Buy-back distribution tax applicable on buy-back of unlisted shares in accordance with the Companies Act and not only under Section 77A of the Companies Act, 1956
- To compute the distributed income, the amount received by the company in respect of shares bought back shall be determined in the prescribed manner. Rules in this regard to be announced
- Amendments to be effective from 1 June 2016.

### Tax on dividends

- Resident individuals, Hindu Undivided Family (HUFs) and firms, who receive dividends in excess of INR10 lakh per annum, will have to pay 10 per cent additional tax on such dividend income over and above the corporate tax on profits and DDT paid by the companies

### Thrust on 'Start-Up India, Stand Up India'

- Eligible start-ups entitled to 100 per cent deduction of profits from 'eligible business' for three consecutive years out of five years from its incorporation. However, MAT would be applicable in such cases
  - 'Eligible start-up' defined to mean a company engaged in eligible business incorporated between 1 April 2016 to 31 March 2019 with total turnover not exceeding INR25 crore from FY2016-17 to FY2020-21 and certified by Inter-Ministerial Board of Certification

1. Union Budget 2016-17, <http://indiabudget.nic.in/glance.asp>, 29 February 2016

- 'Eligible business' defined to mean 'business involving innovation, development, deployment or commercialisation of new products, processes or services driven by technology or IP'.
- LTCG exemption on investment in units of fund of funds to be specified by the central government for start-ups, subject to maximum deduction of INR50 lakh on all and lock-in period of three years
- Long term capital gains on transfer of residential property by an individual/HUF would be exempt if out of the net consideration, such taxpayer makes a majority investment (more than 50 per cent of voting power/share capital) in an eligible start-up. Exemption to be available only if the start-up utilises the invested funds for acquisition of new assets and holds such assets at least for five years
- The government is also looking to modify the Companies Act to provide benefits for start-ups; in fact the Budget speech stressed on a one-day registration for new companies
- The above policies are likely to attract PE/VC investments in start-ups.

#### Country-by-country (CBC) reporting

- In line with the Base Erosion and Profit Sharing (BEPS) Action Plan 13, transfer pricing documentation rules to undergo a change as CBC reporting to be introduced
- CBC to be applicable for consolidated revenues of previous year exceeding agreed threshold of EUR750 million equivalent in local currency (currently equivalent of INR5,396 crore to be considered in case of CBC reporting for an Indian parent company having international group entities)
- CBC reporting to be effective from FY2016-17.

#### Easing of FDI norms/other regulatory proposals

- Eligible FDI instruments to be expanded to include hybrid instruments subject to certain conditions
- Foreign investment in insurance and pension sectors under the automatic route will be allowed up to 49 per cent
- FDI to be allowed beyond 18 specified NBFC activities in the automatic route in other activities regulated by financial sector regulators
- FDI cap for investments in Asset Reconstruction Companies (ARCs) have been increased to 100 per cent under the automatic route. FPIs will be allowed up to 100 per cent of each tranche in securities receipts issued by ARCs subject to sectoral caps

- The total investment cap of foreign entities in Indian stock exchanges have been made equal to that of domestic counterparts by increasing the same to 15 per cent from 5 per cent
- Increase in investment caps from 24 per cent to 49 per cent for investments by FPIs in listed central public sector enterprises
- Hundred per cent FDI allowed in marketing of food products in India
- Foreign investors are proposed to be given 'Residency Status', subject to fulfillment of some conditions; at present, five year business visas are granted.

#### Bankruptcy norms for financial firms

- A detailed 'Code on Resolution of Financial Firms' would be implemented in FY2016-17 to enable a smooth resolution for dealing with bankruptcy cases in banks, insurance firms and other financial sector companies
- This is likely to provide confidence in PE/VC firms looking to invest in financial services companies as it will provide them a platform for distancing themselves in case things go wrong.

#### International Financial Services Centre (IFSC)

- With a view to boost the growth of IFSC and to turn it into world class financial service hub, various incentives are being proposed in order to render competitive tax regime
- A unit located in IFSC shall be subject to MAT at a concessional rate of 9 per cent
- No capital gains tax on income arising from transaction undertaken in foreign currency on a recognised stock exchange, located in IFSC
- No tax on distribution of dividend either in the hands of the unit located in IFSC or persons receiving such dividend income
- Securities/commodities listed on a recognised stock exchange in an IFSC to be exempt from Securities Transaction Tax (STT) and Commodities Transaction Tax (CTT) (w.e.f. 1 June 2016)

The Union Budget 2016 saw a lot of focus on the agriculture sector with announcement of a dedicated long-term irrigation fund and benefits for pulse production. The Budget also stressed on infrastructure as a priority, highlighting the importance of transport and logistics for a growing economy. The education sector



saw an allocation of INR1000 crore for creation of a 'Higher Education Financing Agency'. The government also proposed an INR25,000 crore recapitalisation plan for public sector banks. The following were the key highlights of the Budget speech:

- Emphasis on governance and ease of doing business
- A strong focus on agriculture with allocation for agriculture and farmers' welfare of INR35,984 crore and a dedicated irrigation fund with an initial corpus of about INR20,000 crore
- Significant allocations INR87,765 crore were made for the rural sector; further, INR2.87 lakh crore is to be given as grant in aid to gram panchayats and municipalities
- Allocations for social, education and healthcare sectors of INR1,51,581 crore
- To boost to the healthcare sector and BPL families, a new health protection scheme with cover up to INR1 lakh per family, will be provided
- Sixty two new 'Navodaya Vidyalayas' to be opened. A sum of INR1000 crore to be used for setting up a 'Higher Education Financing Agency'
- A budgeted outlay of INR2,21,246 crore was proposed for infrastructure; out of this, the road sector would get INR97,000 crore during 2016-17, with a target of 10,000 kms of national highways. Further strong steps to be taken to facilitate Public-Private Partnerships (PPPs)
- The Budget proposed modifications in the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act 2002 to allow an investor of an asset restructuring company (ARC) to hold up to 100 per cent stake; it is also proposed to allow non-institutional investors to invest in Securitisation Receipts
- The government provided an allocation of INR25,000 crore for recapitalisation of public sector banks
- The government has proposed the listing of government-owned general insurance companies
- With the introduction of 0.5 per cent Krishi Kalyan Cess on value of all taxable services, the effective service tax rate to marginally increase to 15 percent w.e.f. 1 June 2016

## Our point of view

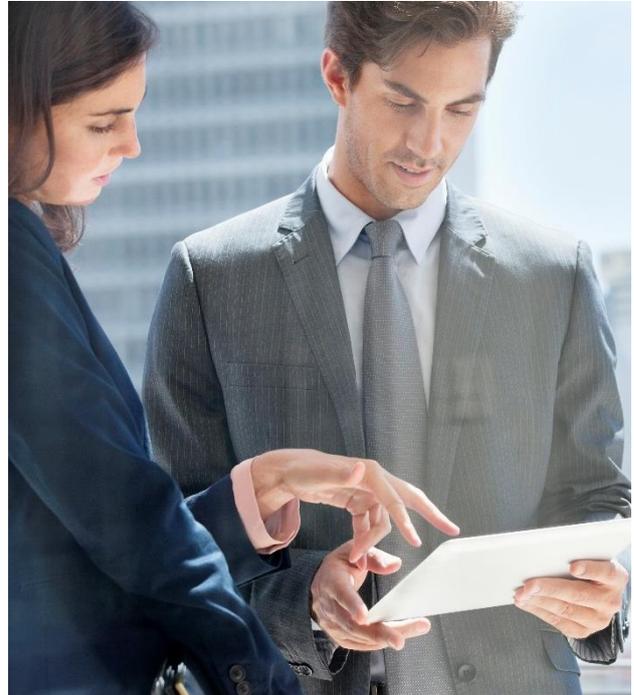
The Union Budget 2016 largely focused on the agriculture and rural sectors, with a clear mandate of benefitting the poor. Compared to last year's Budget, which had a focus on the PE sector, the current Budget was relatively quieter. The key announcements made by the government with respect to investors are expected to have the following impact:

- The clarity regarding non-application of retrospective taxes may come as a welcome announcement for investors
- The stress on bankruptcy code is likely to improve investor confidence and is likely to provide ease of separation in case of financial distress
- The benefits laid out for start-ups would be closely looked into by PE/VC firms, who have invested heavily in new companies last year; it is likely to attract more investments in start-ups in India
- Tax over DDT in case of dividends over INR10 lakh per annum. This move is intended to levy more taxes on the super rich
- Easing of FDI norms may attract higher capital investments in respective sectors
- Foreign investors are likely to invest heavily in AIFs after removal of the 'withholding tax'.

### Analysis of some of the key tax proposals

- The FM in his speech stated that this government is committed to provide a stable and predictable taxation regime and they will not resort to retrospective amendments in future. Further, a specific explanation is inserted in the Income-tax Act to clarify that MAT provisions are not applicable and were never intended to apply to foreign companies from treaty countries having no permanent establishment in India and from non-treaty countries which are not required to register here. These two announcements should send out strong signals to foreign investors and boost investor sentiment in India.
- On the AIF front, as was widely expected the withholding tax on income paid/credited to foreign investors would be at 'rates in force' to enable them to claim available treaty benefits. However, the withholding tax rate on income paid/credited to resident investors would continue to be flat 10 per cent. While no specific relief from withholding tax is available on distribution of exempt income or distribution to investors who are exempt from tax, the investors in the AIF now have an option to approach the tax authorities to obtain a nil/lower withholding certificate.

- The tweaks to certain conditions in the Safe Harbour Rules for fund managers of offshore funds are welcome. However, changes to the key conditions like investor diversification, 10 per cent stake limit per investor, investment diversification, minimum fund size, etc. are required to make the Safe Harbour Rules feasible for the fund industry to enable relocation of fund managers to India. Having said this, Safe Harbour Rules seem to be relevant only in case of funds earning business income and should not impact those earning capital gains.
- As regards POEM provisions, the 'draft guiding principles to determine POEM' had caused a lot of concerns for the existing offshore fund structures and various representations have been made by the PE/VC industry to address these issues. While the applicability of POEM provisions has been deferred to FY2016-17, one will wait for the final guiding principles and analyse the impact thereof on offshore funds.
- Exemption of DDT on dividends declared by SPVs of REITs/InvITs is a step in the right direction and it is likely to provide impetus to promoters/investors in real estate and infrastructure companies to migrate to a relatively tax efficient REIT/InvIT structure.
- Though the FM announced that the holding period for unlisted securities to qualify as long term is reduced to two years, the same has not been provided for in the fine print. It is expected that this amendment will be incorporated in the Finance Bill before it is passed by the Parliament.
- Tax incentives for start-ups are likely to spur investments in eligible start-ups.
- To summarise, the tax proposals in Budget 2016 have strived to address a few issues relevant to the PE sector but there are some more unresolved concerns that are yet to be addressed.



# Unfinished agenda

## What remains



Tax norms have been one of the biggest challenges faced by the PE sector. Although some of path-breaking tax reforms were announced last year, the sector had a number of expectations from the current Budget. The following areas remained unanswered:

- Clarity on Place of Effective Management (POEM)
- More details required on GAAR
- Clear guidelines for income categorisation as investment income or business income
- Exemption of AIFs from sections 56(2)(vii)/(viii) of the Income Tax Act
- Tax pass-through status for category III AIFs
- Easing of Safe Harbour qualifying norms
- Rationalisation of indirect transfer provisions
- Tax benefits for convertible preference shares.

## What is expected going forward



The NDA government made a policy shift to announce a pro-farmer and a pro-poor Budget. However, development and attracting foreign investments remain as key agendas for the government. In these circumstances, the government is likely to come up with investor-friendly norms and guidelines in the near future. Additionally, the government's increased focus on start-ups is likely to improve investor confidence as they look at high-growth investment opportunities in India.





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