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India continues to attract a substantial portion of the global private equity capital. This article discusses the various structures for the domestic and offshore funds being invested into India. It details the regulatory framework within which it has to operate in, focusing on the conditions and restrictions applying to all investors. It also highlights the features of the tax regime which is still evolving in this sector.

The collection of articles in this journal is designed to be a pragmatic and functional resource for a wide audience including limited partners of investment funds; supply-side practitioners; and demand-side stakeholders. academia and press

Nishith Desai Associates is a Indian based international law firm specialising in globalisation of Indian corporates, international financial and tax laws, corporate and securities laws, IT and media and telecom law.

dickenson
intellinetics

Dickenson intellinetics pvt. ltd.
'9 JVPD', 10th N.S. Road, Juhu, Mumbai - 400 049, India.
Email: info@vcindia.com
www.vcindia.com

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Indian Private Equity: 'Venturing' into India

A Legal and Structural Overview

Siddharth Shah
Bijal Ajinkya
Nishith Desai Associates

India continues to attract substantial portion of the global private equity capital. Backed by a strong IT services sector and the more recent IT enabled services (more commonly understood as business process outsourcing), India continues to be on the radar screen of most global private equity players. In 2004, during the period January-December, India attracted private equity investment of USD 3.75 billion.[1] This figure, however, only includes inflows on account of equity component of foreign investment, and excludes other investments, such as reinvested profits that form the international norms adopted by countries like China. In the year 2004, Foreign Direct Investment from Mauritius accounted for 31.23% of total inflows into the country followed by U.S.A. with 20.15%, Netherlands with 15.41%, Germany with 4.92%, U.K. with 4.46% & Japan with 3.61% of the total inflows.[2]

China which continues to be India's closest competitor in the Asian region, attracted private equity investments of USD 61 billion. (Source: AVCJ Journal: December 2004). The annual private equity disbursements in India have grown significantly over the past several years and as per the IVCA (Indian Venture Capital Association), the private equity investment is likely to touch USD 10 billion by 2007-08. A snapshot of the Indian private equity scenario is given below :

Year	Rupees (in Millions)	US Dollars (in Millions)
1996 - 97	700	20
1997 - 98	3,200	80
1998 - 99	10,520	250
1999 - 2000	21,600	500
2000 - 01	54,700	1,200
2001 - 02	52,000	1,100
2007 - 08 F	600,000	10,000

Source: Nasscom website

While these numbers may not look significant when compared to funds committed in other countries like the US and Israel, the players in the industry reckon that India is on its way to be one of the significant player in the world.

Structures

Domestic funds

For domestic venture funds (in which the funds are raised within India), the structure that is most commonly used is that of a domestic vehicle for the pooling of funds from the investors and a separate investment adviser for carrying on asset management activities. In terms of choice of entities for setting up the pooling vehicles, the choice is generally between a trust and a company. Unlike most developed countries, India does not recognize a limited partnership, which is a common choice of entity in countries like the US. On account of operational flexibility, trust structure has been the most favoured option for the domestic VCFs.

Offshore funds

Commonly there are two alternatives available to offshore investors participating in Indian venture capital investments. The offshore investors can either use an 'offshore structure' or a 'unified structure'.

[1] Govt. of India, DIPP website at http://dipp.nic.in/anrepo_e/A-R-04-05 English.pdf visited on June 6, 2005
[2] Ibid

Offshore structure

Under this structure, an investment vehicle which could be a LLC or an LP organized in a jurisdiction outside India, makes investments directly into Indian portfolio companies. There would generally be an offshore manager for managing the assets of the fund and an investment advisor in India for identifying deals and to carry out preliminary due-diligence on prospective investment opportunities. The structure is depicted in Figure 1 below:

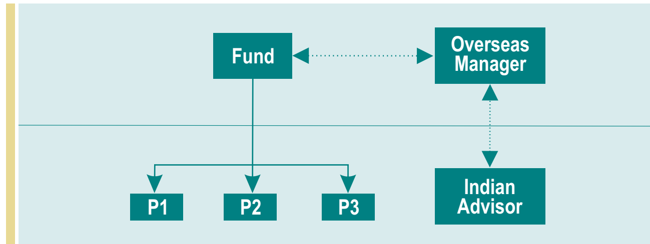

Figure 1: Offshore structure

Unified Structure

This structure is generally used where domestic (i.e. Indian) investors are expected to participate in the fund. Under this structure, a trust or a company is organized in India. The domestic investors would directly contribute to the trust whereas overseas investors pool their investments in an offshore vehicle and this offshore vehicle invests in the domestic trust. The portfolio investments are made by the trust. The trust would generally have a domestic manager or an adviser. The structure is depicted in Figure 2.

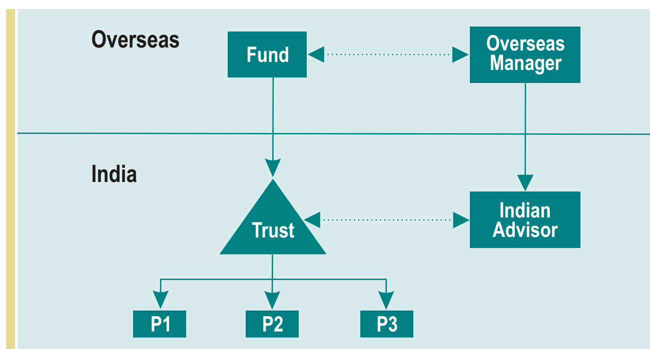

Figure 2: Unified structure

The Regulatory Framework

Domestic and offshore VC funds investing in India are regulated by the SEBI. Until recently, SEBI only regulated the domestic VC funds vide the SEBI VCF Regulations. India did not have any mechanism to regulate or monitor foreign VC/private equity investors although regulations existed for domestic VC funds. While this put the domestic VC investors at a disadvantage especially after foreign investment in most sectors were through the automatic route, the Indian government felt the need to monitor (if not regulate) foreign investment in the VC sector. In order to address this, in September 2000, in addition to bringing in some major reforms to the existing SEBI VCF Regulations, which apply to VC funds based in India, the SEBI also introduced a new set of regulations applicable to offshore funds, called the SEBI (FVCI) Regulations, 2000.

The SEBI (Venture Capital Funds) Regulations, 1996

Under the VCF Regulations, a venture capital fund can be organized either in the form of a trust or as a company. Though the guidelines do not appear to make registration with SEBI mandatory, SEBI has made its intention clear to regulate all domestic VCFs.

The VCFs are permitted to invest only in venture capital undertakings (VCUs) which are not engaged in activities which have been classified under the negative list which broadly includes undertakings engaged in non-banking financial services (excluding those non-banking financial services companies which are registered with the RBI and have been categorized as equipment leasing or hire purchase companies), gold financing (excluding those companies which are engaged in gold financing for jewellery) etc. Furthermore, the VCU has to be a domestic company whose shares are not listed on a recognized stock exchange, which effectively means that domestic VCFs are not permitted to invest in companies whose securities are listed on a stock exchange or in foreign securities.

Investment conditions and restrictions

VCFs are subjected to following investment conditions /restrictions.

- A VCF cannot invest more than 25% of its aggregate Capital Commitments in any one VCU (defined above).
- Minimum investment to be accepted from any investor should be Indian Rupees 500,000 except in the case of employees, principal officers or directors of the VCF, employees of the manager of the VCF where lower amounts may be accepted.
- Aggregate minimum capital commitments from its investors should be Indian Rupees 50 million.
- A VCF cannot invest in associate companies. 'Associate company' means a company in which a director or trustee or sponsor or settlor of the VCF or the investment manager holds either individually or collectively, equity shares in excess of 15% of its paid-up equity share capital of VCU.

The SEBI (Foreign Venture Capital Investor) Regulations, 2000 ("FVCI Regulations")

Foreign private equity players can invest in India either directly under the foreign direct investment (FDI) regime or may invest under the Foreign Venture Capital Investor (FVCI) regime. To invest under the FVCI regime, the foreign investor is required to register with the SEBI under the FVCI Regulations. While it is not mandatory to register with SEBI as a FVCI, in order to encourage foreign investors to register with SEBI, several benefits have been granted to SEBI registered foreign venture capital investors ("FVCI"). These benefits have been discussed later in this article.

Eligibility criteria

The eligibility criteria for a FVCI registration are broad. In order to determine the eligibility of an applicant, SEBI would consider, inter alia, the applicant's track record, professional competence, financial soundness, experience, whether the applicant is regulated by an appropriate foreign regulatory authority or is an income tax payer or submits a certificate from its banker of its or its promoter's track record where the applicant is neither a regulated entity nor an

income tax payer. The applicant can be a pension fund, mutual fund, investment trust, investment company, investment partnership, asset management company, endowment fund, university fund, charitable institution or any other investment vehicle incorporated and established outside India.

Investment conditions and restrictions

All investments to be made by a FVCI would be subject to the following conditions :

- FVCI is permitted to invest its entire corpus in a domestic SEBI VCF.
- At least two-thirds of the FVCI's investible funds shall be invested in unlisted equity shares or equity linked instruments of a venture capital undertaking. Further, FVCIs can invest upto 33.33% by way of:
  - Subscription to IPO of a Venture Capital Undertaking ("VCU") whose shares are proposed to be listed;
  - Debt or debt instrument of a venture capital undertaking in which the FVCI has already made an investment by way of equity;
  - Preferential allotment of equity shares of a listed company, subject to a lock-in period of one year;
  - The equity shares or equity linked instruments of a financially weak company (i.e. a company which has at the end of the previous financial year accumulated losses, which has resulted in erosion of more than 50% but less than 100% of its networth as at the beginning of the previous financial year) or a sick industrial company whose shares are listed; and
  - Special Purpose Vehicles which are created by an FVCI for the purpose of facilitating or promoting investment in accordance with the FVCI Amendments.

    As stated above, a VCU means a domestic company whose shares are not listed in a recognized stock exchange in India and which are not engaged in activities which have been classified under the negative list which broadly includes undertakings engaged in, non-banking financial services (excluding those non-banking financial services companies which are registered with the RBI and have been categorized as equipment leasing or hire purchase companies), gold financing (excluding those companies which are engaged in gold financing for jewellery), etc., and whose shares are not listed on a recognized stock exchange.

The FVCI will have to appoint a domestic custodian and will have to enter into an arrangement with a designated bank for the purpose of opening a special non-resident Indian rupee or foreign currency account. SEBI acts as a nodal agency for all necessary approvals including the permission of the RBI for opening of the bank account. In addition to the above investment conditions and restrictions, there are certain reporting and disclosure requirements that need to be satisfied by a registered FVCI on a continuing basis.

Benefits Of FVCI Registration

It is not mandatory for an offshore fund to register with SEBI as a foreign venture capital investor ("FVCI"). However, SEBI and the Reserve Bank of India have extended certain benefits to SEBI registered FVCIs which make it beneficial to register with SEBI as a FVCI. FVCIs registered with SEBI would be entitled to the following benefits :

- As per Press Note 1 of 2005 issued by the Ministry of Commerce and Industry, Government of India has exempted FVCIs from taking prior Governmental approval even if the FVCI seeks to invest in the same field as the one in which it already has an investment.
- As per a notification issued by the RBI in December 2000, FVCIs shall benefit from free entry and exit pricing and thus investments or exits by FVCI involving transfer of shares between residents and non-residents will not be subjected to the restrictive pricing guidelines of the RBI otherwise applicable to foreign investors under the foreign direct investment route.
- As per a RBI notification issued in December 2000, FVCIs shall benefit from free entry and exit pricing. Under the FEMA and the regulations issued thereunder, the entry and exit pricing of non-resident investors under the FDI route is regulated. For purchase of shares of an unlisted company, the minimum price to be paid by the non-resident investor is linked to the net asset value ("NAV") of the shares. Similarly, for exits involving transfer from a non-resident to a resident, the exit price is capped at the price of the shares on the stock exchange (if the shares are listed) or to the NAV if the shares are unlisted. A special exemption has been carved out for FVCIs whereby they will be exempted from both the entry and exit pricing regulations.

  This could be a very significant benefit from the FVCI's point of view especially when they are looking at an exit from unlisted companies through strategic sale or through buy-back arrangement with the promoters.

- SEBI has also exempted transfer of shares from FVCIs to the promoters from the public offer provisions under the Takeover Code, if the portfolio company gets listed post investment. This ensures that if the promoters have to buy back the shares from the FVCIs, they will not be burdened with the public offer requirement which otherwise could require them to make an offer to the other shareholders of the company to buy from them up to 20% of the paid-up capital of the company.
- FVCIs registered with SEBI have been accorded Qualified Institutional Buyer ("QIB") status and would accordingly be eligible for subscribe to securities at the Initial Public Offering ("IPO") of a VCU through the book-building route.
- Under the SEBI (Disclosure and Investor Protection) Guidelines, 2000, the entire pre-issue share capital of a company going in for an IPO is locked for a period of one-year from the date of allotment in the public issue. However, an exemption has been granted to domestic venture capital funds registered with SEBI and FVCIs. This would essentially allow the FVCI to exit from their investments post-listing.
- Generally the definition of a 'promoter' under the SEBI (Disclosure and Investor Protection) Guidelines, 2000 is very broad and includes any person who has a role to play in the decision of a company considering an IPO. A private equity investor generally reserves certain veto rights in the company and in most cases is actively involved in the IPO decision by the company. If the private equity is not registered as a FVCI, there is a possibility that the private equity investor be treated as a part of the promoter group thereby subjecting it to certain onerous requirements otherwise applicable to promoters. The SEBI has clarified that a SEBI registered venture capital fund or a FVCI would generally not be treated as promoters for the purpose of the above guidelines.

Taxation

Domestic VCFs and investors

Domestic VCFs are entitled to tax benefits under Section 10(23FB) of the Income Tax Act, 1961 (ITA). As per this section, any income earned by a SEBI registered VCF (which could be a trust or a company) set up to raise funds for investment in a venture capital undertaking is exempt from tax. This section has to be read with Section 115U of the ITA which gives SEBI registered VCFs a pass-through status whereby the investors in the VCF are directly taxed on any income distributed by the VCFs as though the investors have made direct investment in the portfolio companies. The taxation of such income in the hands of the investors will depend on the nature of income, which will remain the same as in the hands of the VCFs. Under the ITA, the capital gains tax applicable in the hands of the domestic investors varies between 10% to 30% (exclusive of any surcharge) depending on the status of the investor i.e. individual or corporate; the nature of capital gains (i.e. long-term (above 12 months) or short term); and type of investment (i.e. listed or unlisted). In case of non-resident investors the tax rate could be as high as 40% (exclusive of surcharge). The tax rates for fiscal year 2005-2006 applicable to residents as well as non-residents in respect of the various types of income earned in India have been summarized in the table below:

Category	Status	Capital Gains				Dividend/Withholding
		Long Term#		Short Term		
		Listed	Unlisted	Listed	Unlisted	
Individual	Resident	0*/10%**	20%	10%	30%	Dividends declared by an Indian company are tax exempt in the hands of the shareholders and the company distributing dividends will be required to pay an additional dividend distribution tax at the rate of 12.5%
	Non - Resident	0*/10%**	20%	10%	30%	
Corporate	Resident	0*/10%**	20%	10%	30%	
	Non - Resident	0*/10%**	20%	10%	40%	

#Long-term means where securities have been held for more than 12 months.
* Provided the transaction takes place on the stock exchange and the Securities Transaction Tax ("STT") has been paid.
**For transactions outside the stock exchange.

The above rates are exclusive of the currently applicable surcharge of 2.5% on the tax and an education cess of 2% on the tax as well as the surcharge. In case of a domestic company the surcharge applicable is 10%.

All transactions entered on a recognised stock exchange in India are subject to a STT levied on the transaction value. In case of purchase/sale of equity shares and units of an equity oriented mutual fund which is settled by way of actual delivery or transfer of the equity share/ unit, STT will be levied at the rate of 0.01% on both the buyer and seller of the equity share/ unit. For sale of equity shares and units of an equity oriented mutual fund settled otherwise than by way actual delivery or transfer of the equity share/ unit, STT will be levied at the rate of 0.02% on the seller of the equity share/ unit. Seller of derivatives would be subjected to an STT of 0.0133% while in case of sale of a unit of an equity oriented fund to the mutual fund would attract STT at the rate of 0.2%. The STT can be setoff against business income tax calculated as per the provisions of Indian tax law.

Offshore Investors

There is no specific tax exemption available for the income earned by a FVCI. However, based on the jurisdiction from which the FVCI invests into India, it can avail of any benefit available under double taxation avoidance treaty (DTAT) that India may have with such jurisdiction. On account of its favourable tax treaty with India, Mauritius has become a favourite jurisdiction for investing into India. Under the India-Mauritius DTAT, any capital gains earned by a resident of Mauritius are exempt from tax in India. Further, the withholding tax on dividend also gets reduced to 5% (or 15%) as against normal applicable withholding tax of 20%.

While, the India-Mauritius DTAT has been in the eye of the storm time and again, it still continues to be one of the most favoured jurisdiction for investing into India. Recently, the Supreme Court of India has heard a case involving a public interest litigation undertaken by a NGO which besides questioning the powers of the government to enter into such a treaty has also questioned the validity of the India-Mauritius DTAT. While the ruling on this issue has been reserved and is expected to be published in next few weeks, we are hopeful that the Supreme Court will uphold the governments position on the treaty as well as the treaty itself.

It is extremely important for the private equity players using Mauritius for investments into India to ensure that their operations are structured appropriately so as to minimize the risk of denial of treaty benefits by the Indian tax authorities. There have been instances in the past where the use of Mauritius as a conduit for investing into India has been looked upon unfavourably by the Indian tax authorities. In the case of NatWest, the Authority for Advance Rulings (AAR) had denied a ruling on the grounds that use of Mauritius was merely for tax avoidance and the AAR need not rule on an application, which is prima facie for avoidance of tax.

However, post NatWest, there has been a ruling in case of AIG followed by DLJ and several others, wherein the AAR granted the benefits of India-Mauritius Tax Treaty and observed that if there was a commercial justification for setting up an SPV and then if the same was established in Mauritius, that per se should not result in denial of the benefits under the India-Mauritius Tax Treaty. In one of the recent rulings, the AAR held that the income of private equity player is in the nature of business income and not capital gains. However, it was argued that even if the income is in the nature of business income and if the investor does not have a "permanent

establishment" (PE) in India, such income is not taxable in India. In light of the above ruling and even otherwise, it is extremely important to ensure that the operations of the FVCI should be carried out in a manner so as to avoid constitution of any PE in India. The consequences of having a PE in India would result in the income attributable to such PE being subject to tax in India. There is a fair amount of subjectivity involved in the determination of a PE and hence very careful thought has to be given while finalizing structure, especially to the management of the FVCI.

Conclusion

The venture capital regime in India is still evolving and the government is quite upbeat on the future prospects of the venture capital industry in India. India continues to offer great investment opportunities in the knowledge sectors and these sectors are likely to attract lot more venture capital funds, both domestic and offshore. The regulators have also made their intentions clear that they are willing to go an extra mile to facilitate such inflow of venture capital investments into the country. Further, the current slowdown resulting in attractive valuations makes this an opportune time for private equity investors to look at India as an investment destination.■

About The Authors

Siddharth Shah

Siddharth Shah heads the funds practice group at Nishith Desai Associates, a prominent Indian law firm with a strong focus on the funds industry. He has vast experience of working on a variety of funds including domestic and offshore private equity funds, offshore investment funds and mutual funds. Within the Funds practice group, he deals with issues related to structuring, regulatory framework, exchange control, incentive based management structures, etc. Besides the Funds practice group, he is also a member of the firm's M&A and Banking and Structured Finance groups of the firm and as a member of these groups he focuses on advising clients on corporate and securities law issues and on structuring of inbound and outbound investments.

He has authored various articles and research papers and has spoken at various conferences. Some of the articles and research papers authored by him include "Venture Capital at Crossroads", Presented at the CII Venture Summit at Bangalore; "Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Ordinance, 2002 - Boon or Bane?", "ADR Offerings by Indian Companies", "Acquiring Companies in the US", "Issues in domestic takeover of companies" for The Economic Times, India; "Legal and Tax issues in Cross-border M&A", "Foreign Investment into India - in comparison to China", OFC Asia Pacific Journal, December 1996, Campden Publications, London Practice.

Bijal Ajinkya

Bijal Ajinkya heads the international tax litigation group at Nishith Desai Associates. She is also a member of the funds practice group and the international tax group and at Nishith Desai Associates. She has vast experience of working on a variety of funds including domestic and offshore private equity funds, offshore investment funds and mutual funds. Within the Funds practice group, she deals with issues related to structuring, regulatory framework, exchange control, incentive based management structures, etc. Her practice includes international taxation, globalization, structuring of inbound/outbound investments, structuring of offshore funds, taxation of EPC contracts, taxation of e-commerce and software contracts, and international tax litigation. She is a member of the International Bar Association and the Bar Council of Maharashtra & Goa. Bijal is a special lecturer at the Xavier's Institute of Management on International Law.

Bijal's research papers include: "Venture Capitalism in India" for the International Bureau of Fiscal Documentation; "Investments in India via Mauritius" for Offshore Investments; "Permanent Establishments and Business Connection" for the International Fiscal Association; "Mutual Agreement Procedure and Non-Discrimination" for the International Fiscal Association; "Globalization" for the Economic Times; "Taxation of Employee Stock Option Schemes"; "Transfer Pricing in E-Commerce" for the Federation of Indian Chambers of Commerce and Industry (FICCI); and "Constitutionality of Advance Rulings" for FICCI. She has also been involved in the drafting of the publication "Taxation of Electronic Commerce in India."

Nishith Desai Associates

Nishith Desai Associates is a research based international law firm with offices in Mumbai and Silicon Valley. The multidisciplinary firm specializes in globalisation of Indian corporates, international financial & tax laws, corporate & securities laws, information technology and media & telecom law. The firm has structured and acted for a large number of private equity funds for India. The firm has also acted as counsel to several ADR offerings out of India including Infosys, Wipro, Rediff. The firm also has a strong focus on M&As and has worked on several cross-border M&A deals involving stock swaps, ADR-Share swaps, asset purchase, etc. The firm also has a dedicated team focusing on intellectual property, technology laws and media and entertainment. On the infrastructure side, besides working on project finance deals, the firm has been actively participating on the public policy formulation and was instrumental in drafting the Andhra Pradesh Infrastructure Development Enabling Act ("APIDEA").

The firm is intensely research oriented and has undertaken studies in different areas of law and tax, some of which can be found on its website www.nishithdesai.com.

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