Paper 8

Structuring Venture Capital Funds for Indo-Asian Region [1]
- With a Focus on India

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Synopsis :

A. Need for Venture Capital in the Region
B. Venture Capitalists
C. Structuring a Venture Capital Fund
D. Venture Capital Regime in India
E. Taxation of Vanture Capital Funds in India
F. Tax Treaties
G. Mauritius
    Mauritius Tax Regime
H. Taxation under India-Mauritius Treaty
I. Taxation in other Regions
J. Exit Mechanisms
K. Risks Associated with the Region

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[1] The Indo-Asian region includes India, Pakistan, Sri Lanka, China, Malaysia, Thailand, Nepal, Bhutan, Bangladesh, Singapore etc.

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Capital markets play a very significant role in development of any economy. Most of the countries in the Indo-Asian region are developing and are in the continuous process of political and economic reforms. The entire south Asian region[2] has great economic potential which is yet to be fully exploited. Besides its vast population, this region is also rich in natural resources. This provides two-fold advantages to the companies - large domestic market for their products and cheap labour costs.

A. Need for Venture Capital in the Region

Till recently, most countries in this region had a closed economy. Foreign investment was looked upon with a suspicion and was mostly restricted. At the beginning of this decade, some countries like India, Pakistan and Bangladesh started liberalizing their economies. For the first time, foreign investment was welcome into certain specified high-priority industries. With a competitive advantage in terms of low labour costs and highly qualified pool of human resources, the domestic companies had export opportunities open to them. The liberalization of imports gave them an access to advanced technology from the developed countries.

Emerging companies which were run by the family groups were historically dependent upon long-term debt from banks or financial institutions for their expansion capital requirements. The capital markets were mostly underdeveloped. The high interest rates and illiquidity in the capital markets paved the way for emergence of foreign venture capital as a lucrative alternative for funding the requirements of local entrepreneurs.

B. Venture Capitalists

So who would be willing to put monies in these developing economies where the risk by definition is very high? Furthermore, it is a known principle that higher the risk, higher could be the returns. Only sophisticated investors who understand the risks involved and who have the capacity to bear the risk would be willing to take up the challenge and make handsome gains from investments. There are some developmental institutions like World Bank, Asian Development Bank, IFC, Commonwealth Development Corporation etc. who would also be the willing investors, however, with a different objective. Their main objective is to boost the growth in the developing economies by providing the private capital to the entrepreneurs, to increase job opportunities and to provide them an access to advanced technologies. Some of these investors prefer to invest in regional funds, thereby diversifying their exposure and taking advantage of smaller markets where they may not be willing to make direct commitments. Pension plans (mostly U.S.) are also seen as keen providers of private equity. However, because of the high risk involved, their fund managers have to comply with the ERISA regulations[3] to provide security that the manager will exercise proper care and supervision in the companies where monies of the pension plans are invested.

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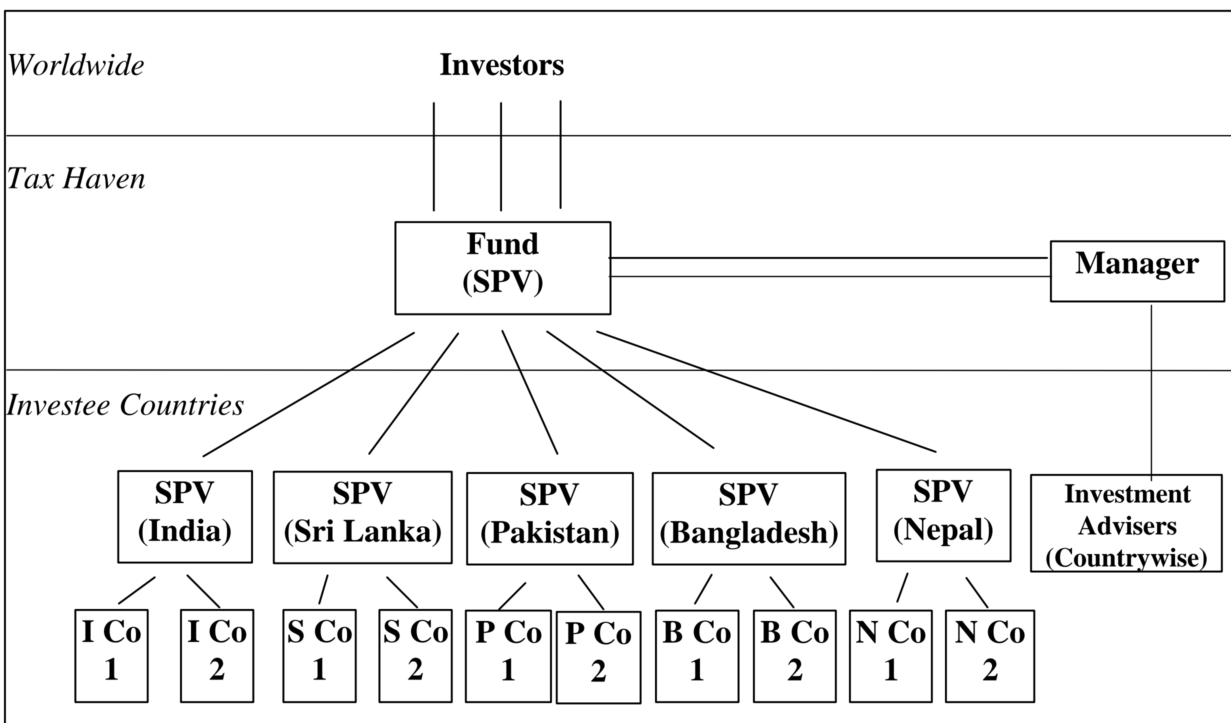
[2] The south Asian region includes India, Pakistan, Sri Lanka, Nepal, Bangladesh, the Maldives and Bhutan

[3]The Employee Retirement Income Security Act, 1974 (**ERISA**) which applies to the investments by the US employee benefit plans in a fund.

C. Structuring a Venture Capital Fund

The investors from the developed countries find the returns on investments in the companies in this region very attractive. Venture capital, by its nature, is risk capital. As the risk and returns are directly proportional to each other, only those investors who are familiar with the risk factors associated with the developing countries and have the capacity to bear the risks can enter this market. Most of the fund managers get their premium on venture capital investments by way of 'carried interest'. For investments in the Indo-Asian region, it is common to split the excess returns on investments between the investors and the fund manager in the ratio of 80:20 after meeting the hurdle (preferred) rate of return of 8-9% p.a. They generally prefer to set up the funds in a tax favourable and exchange control neutral jurisdiction to avoid inherent costs and delays in the investment and divestment process. If such a jurisdiction also has a good tax treaty network with the countries in which investee companies are situated, it gives an added advantage to the fund investors and the fund manager. A typical structure is illustrated below :



This structure envisages that the Fund, which will be a Collective Investment Vehicle for the investors, will be set up in a tax haven or a tax favoured jurisdiction. The Fund in tunr will set up a Special Purpose Vehicle (**SPV**) in each of the investee countries. This would shorten the investment process as it will eliminate the need for approval of the governments of the investee countries each time the Fund identifies an investment opportunity. This would also facilitate quick divestment and free pricing of the investments. Many countries including India have guidelines or regulations to govern the venture capital investment in the domestic companies. These regulations lay down broad parameters within which a foreign venture capital fund can invest, without any specific approvals. In order to encourage venture capital investments, the governments of developing countries also offer tax concessions to the investors.

D. Venture Capital Regime in India

Venture capital funds can be set up either in the form of a trust or a company in India. They need to be registered with the Securities and Exchange Board of India (**SEBI**)[4]. There are three different sets of guidelines which regulate venture capital funds in India. We discuss below the salient features of each of these guidelines.

Ministry of Finance Guidelines for Overseas and Domestic Venture Capital Funds -

On September 20, 1995, the Indian Ministry of Finance issued guidelines for overseas and domestic venture capital funds (VCFs). The highlights of the guidelines are listed below:

- There will be a minimum lock-in period of three (3) years (unless the investee company gets listed earlier) on all investments by VCFs and venture capital companies(VCCs).
- VCFs will be allowed to invest only in unlisted companies and their investment shall be limited to 40% of the paid-up capital of the company. Further, VCFs and VCCs cannot invest more than 5%[5] of their paid-up corpus in a single company.

- The overseas VCFs will be allowed to invest up to 100% in approved domestic VCFs or VCCs set up under the new policy, after obtaining approval from the Foreign Investment Promotion Board[6]. Once cleared by the FIPB, any subsequent investments by the domestic VCFs or VCCs in Indian companies will not require FIPB approval.

- Offshore VCCs may also set up domestic Investment Management Companies[7] to manage the fund. However, the setting up of an IMC with foreign investment will also require FIPB approval and will be subject to the existing norms for foreign investment in non-bank financial services companies. The capitalization requirements for foreign investment in non-bank financial services companies, are as follows:

up to 50% equity	Nil
50% - 75% equity	US$ 5 million
more 75%	US$ 50 million

The RBI has recently come out with a notification for foreign equity in NBFCs. The foreign companies can set-up fully owned subsidiary NBFCs in India with the approval from the FIPB. This company can act as a holding company and can set-up subsequent joint ventures in India. However, in such Jvs, a minimum domestic equity of 25 per cent is required. For the domestic equity, the initial 10% has to come upfront and the balance 15% can come in during the subsequent 24 months.

[4] SEBI is the capital market regulating body in India
[5] increased to 20% by the Finance Act, 1997
[6] Hereinafter referred to as FIPB
[7] Hereinafter referred to as IMC

- Offshore investors may also invest directly in the equity of unlisted Indian companies without going through the route of a domestic VCF or VCC. However, such investments will need separate approvals for each investment as required under the general policy of foreign investment proposals.

SEBI (Venture Capital Funds) Regulations, 1996 -

The SEBI announced its guidelines to be followed by VCFs to operate in India on December 4, 1996. These guidelines are titled *SEBI (Venture Capital Funds) Regulations, 1996.* These regulations lay down the eligibility criteria for registration of VCFs and operational guidelines for the VCFs. The excerpts of these regulations are as follows:

- Any company or a trust willing to register as a VCF/VCC should have as its main objective, to carry on the activity of a venture capital fund. In case of companies this should be mentioned clearly in the Memorandum of Association.

- In case of a VCF, the instrument of trust has to be in the form of a deed and has to be duly registered under the provisions of the Indian Registration Act, 1908.

- Any director or principal officer or employee should not be involved in any litigation connected with the securities market and nor should at any time have been convicted of any offense involving moral turpitude or any economic offense.

- VCFs must invest at least 80 per cent of the funds raised in
  - the equity shares or equity related securities of an unlisted company
  - the equity shares or equity related securities of a financially weak company or a sick industrial company which may be a listed or an unlisted company
  - providing financial assistance in any other manner to companies in which the VCF has invested in either of the two mentioned above

- The VCFs will not be allowed to invest in equity shares of any company or institution providing financial services.

- The VCF will not be entitled to gets its own securities or units listed on any recognised stock exchanges till the expiry of three years from the date of issuance of securities or units.

- VCFs are restricted from issuing any document or advertisement inviting offers from the public for the subscription or purchase of any of its securities or units. However, the VCFs are free to raise monies for its activities through private placement of its securities or units.

The SEBI guidelines have not distinguished between a domestic VCF and an off-shore VCF. The most critical issue for any VCF whether domestic or foreign is that of an exit route. The guidelines issued by the SEBI are silent on the exit route to be adopted by the VCFs for offloading their investments and thus give the VCFs a flexibility to decide on their exit route. Further, the SEBI has not made it mandatory for the VCFs to have a two-tier structure. Thus, it will not be compulsory for the VCFs to set up a separate Asset

Management Company ("AMC"). A VCF can manage its funds on its own and this would help the fund to cut down on costs relating to the asset management fees to be paid to AMC.

CBDT Notification -

The Central Board of Direct Taxes (**CBDT**) issued a notification[8] on July 18, 1995, giving the Director of Income-tax (Exemptions) the power to exempt domestic VCFs and VCCs from income-tax on dividends and long term capital gains, subject to the fulfillment of certain conditions as follows -

- In order to be eligible for the tax exemption, domestic VCFs or VCCs must be approved by and registered with the SEBI and must invest not less than 80% of their total funds in the equity of unlisted companies.

- Domestic VCFs or VCCs must be registered under the Registration Act, 1908.

- VCFs should not be allowed to invest in non-banking finance companies.

- At least 20% of the total funds of VCFs or VCCs should be invested in the equity shares of Venture Capital Undertakings[9] (**VCUs**), before the end of the assessment year in which the application (for tax exemption) is made. Furthermore, at least 50% of the total funds of VCFs or VCCs must be invested in the equity shares of the VCUs before the end of the previous year immediately following the previous year in which the application is made and at least 80% of the total funds of VCFs or VCCs must be invested in the equity of VCUs before the end of the previous year immediately succeeding the previous year in which 50% investment (referred to above) is made.

- In order to claim the tax exemption, a VCF or VCC cannot invest more than 5% of its paid up share capital in any one VCU. This limit has been raised to 20% by the Finance Act, 1997.

- A VCF or VCC cannot invest in more than 40% of the equity capital of a single VCU.

- Every VCF or VCC must maintain books of accounts audited by a qualified chartered accountant.

- Income earned by offshore investors from domestic VCFs or VCCs will be subject to tax as per the normal rates applicable to foreign investors or tax treaties.

- The equity shares held in the VCU are subject to a lock-in period of three (3) years from the date of their acquisition, unless the VCU gets listed earlier. If the said shares are transferred at any time within a period of three (3) years, the aggregate amount of

[8] [*vide* Notification # 9816 [F.No.142/21/95.TPL] dated July 18, 1995]

[9] VCU means such domestic company whose shares are not listed on a recognized stock exchange in India and which is engaged in the manufacture or production of such articles or things (including computer software) other than those notified by the Central Government as restricted in this behalf.

income by way of dividends on such equity shares which has not been included in the total income of the preceding year(s) in which such transfer has taken place shall be deemed to be the income of the VCF or the VCC.

E. Taxation of Venture Capital Funds in India

Section 10(23F) of the ITA exempts any income by way of dividends or long-term capital gains of a domestic VCF or a VCC from investments made by way of equity shares in a VCU, subject to the conditions laid down by the CBDT. With the Finance Act, 1997, the dividend income has any way been exempted from tax and thus the benefits of the section 10(23F) will accrue only in case of long-term capital gains. Any other income of a VCC will be taxed at the rate of 35% and in case of a VCF set up in the form of a trust, could be taxed at the rate of 30%.

According to the provisions of section 115 of the ITA, the offshore fund (whether structured as a trust, partnership or company) will be taxed at the rate of 20% on the long-term capital gains it earns on the transfer of securities held by it directly in the Indian investee companies. All other income, including short-term capital gains earned on the transfer of securities will be taxed at the rate of 48%. Non-residents like the offshore fund can compute their long-term capital gains on shares in the original currency in which investment was made to avoid any loss on account of exchange rate fluctuations.

F. Tax Treaties

This tax incidence could get further reduced if the country in which fund is situated has a tax treaty with India. Currently, India has tax treaties with over 55 countries. The Government of India is in the process of negotiating/finalizing such treaties with a number of other countries. Recently, India has signed new treaties with Bulgaria, Cyprus, Malta, Oman, China, Vietnam and South Africa. India has also revised its tax treaties with Belgium, France, United Kingdom, Italy and Singapore. The treaty with Italy is pending ratification by the Italian Parliament and therefore, has not come into force. The list of countries with which India has a tax treaty is enclosed herewith as *Annexure*.

Out of these tax treaties, a mention may be made of the Indian tax treaties with countries like the Netherlands, Mauritius, Cyprus, U.A.E. and France, which offer substantial tax concessions on the capital gains. Mauritius, Cyprus and U.A.E. tax treaties offer total exemption from any capital gains tax in respect of investments in shares and securities in India. The Netherlands and France tax treaties offer conditional tax concessions. The Netherlands tax treaty provides for total tax exemption from capital gains where the investment is less than 10% of the Indian company's stock. In case of investment of 10% or more, capital gains are tax exempt unless the shares are sold to Indian residents. The new India-France tax treaty exempts capital gains arising on transfer of shares held in an Indian company, where the investment is less than 10% of the total share capital of the Indian company.

G. Mauritius

Mauritius has emerged as the third largest investor in India. Till May, 1997, the actual direct investment inflow into India from Mauritius is to the tune of US$ 1,500 million[10]. This is in addition to the portfolio investments made by the offshore funds located in Mauritius. Most of the credit goes to the favorable tax treaty which it has with India and its increasing credibility as a reputed and efficient offshore financial center. Mauritius is one country which has been able to negotiate very favorable tax treaties with most of the major countries of the World. It has an excellent treaty network even with most of the countries in the Indo-Asian region. Although the investors from the developed countries are more familiar with certain other jurisdictions like Bermuda and Cayman Islands, these countries do not have tax treaties like Mauritius does. Therefore, for investment in the Indo-Asian region, Mauritius has become a popular jurisdiction.

Mauritius Tax Regime :

Mauritius has a very well developed regime for offshore funds. The administrators provide the required secretarial and accounting support to the offshore funds. The banks make available the custodial services and the facilities for calculation of Net Asset Value (**NAV**) of the funds. The Mauritius Offshore Business Activities Authority (**MOBAA**) monitors the activities of the funds and other offshore companies and is responsible for enforcing strict reporting requirements. The offshore funds and companies have an option to choose a tax rate between 0 to 35%. The chosen rate will be applied to their income and they will be liable to pay tax at that rate after setting off the taxes paid in countries of source. There is no capital gains tax payable in Mauritius. The Mauritius Income tax Commissioner issues a 'Tax residency' certificate to the funds and other offshore companies which certifies that they are proper tax residents in Mauritius. On this basis, they can claim tax treaty benefits in the investee countries.

H. Taxation under India-Mauritius Treaty :

Most of the tax treaties which Mauritius has with the countries in this region offer complete exemption from capital gains in respect of shares held in the investee companies. This is the key attraction to locating the Fund in Mauritius. The Treaty reduces the tax rate on dividends to a level of 5% or 15% depending upon the shareholding. (However, this is no longer an incentive as the local tax regime in India exempts the shareholders from any withholding tax on dividends. Instead, the companies distributing the dividends are subject to a 10% distribution tax on dividends declared by them). The Treaty does not offer any concession from withholding tax on interest. Interest is taxed at the rate applicable under the local laws which is currently 20% for debt incurred in foreign currency. Any other interest income could be subject to tax at the rate of 48%. This rate could be reduced to a level of 35% (being the rate applicable to the domestic companies) under the article on 'Non-discrimination' under the Treaty. Interestingly, as per the treaty provisions, income from other sources which is not covered within any other articles, is tax exempt in the country of source. This has recently been confirmed by the Advance Ruling Authority in India in respect of income from units in a mutual fund in India, which are held by a Mauritius based fund.

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[10] Source : The Economic Times, September 1, 1997

I. Taxation in Other Regions

Mauritius has a favorable tax treaty network with many countries in the Indo-Asian region. Its tax treaty with Pakistan will entitle a Mauritius fund to reduce the withholding tax on interest and dividend to 10% and capital gains will be tax exempt, as in the case of India. Its tax treaty with Sri Lanka would entitle the Fund to reduce the withholding tax on dividends to 5% or 15% depending upon the level of holding in the investee company. Interest income could get reduced to 10% and capital gains tax would be tax exempt. Mauritius is in the process of negotiating a tax treaty with Bangladesh. However, till such time the treaty is in place, the Fund's dividend income will be subject to a withholding tax of 15%. As per the local laws in Bangladesh, interest income could be tax exempt. (Non-exempt interest income is subject to tax at the rate of 45%). Capital gains on sale of listed stock is tax exempt in Bangladesh. Capital gains on sale of unlisted stocks could be taxed at a rate upto 25%. The China-Mauritius tax treaty reduces the tax on dividends to 5%, interest to 10% and exempts capital gains tax in China. The Mauritius tax treaty with Malaysia provides for a dividend withholding tax of 5% if the Mauritius fund holds at least 10% of the shares in a Malaysian company. Otherwise, the rate is reduced to 15%. Interest is taxed at the rate of 15%. Capital gains are tax exempt in Malaysia.

Mauritius does not have a tax treaty with Nepal, Bhutan and Maldives. Accordingly, the local tax regime in each of these countries will prevail. Nepal generally taxes an offshore fund at the rate of 39.2%(35% + 12% Surcharge) on its dividend and interest income. Capital gains are tax exempt in Nepal. In Bhutan, dividends, interest and capital gains could be taxable at the rate of 30%. In Maldives, there is no taxation of income or capital gains.

J. Exit Mechanisms

The exit options for the investments are generally decided at the time of making investment in the investee companies. In most cases, the fund is given an exit by listing the company on a recognized stock exchange in that country. In some other cases, the fund is granted a put option where, at the option of the fund, upon underperformance by the investee company or even otherwise, the local promoters buy the shares of the company at a pre-determined price. This gives the fund an assured rate of return.

In the Indian context, any disinvestment of shares by a foreign investor is governed by the Reserve Bank of India (**RBI**) guidelines. The highlights of these guidelines are as follows -

The RBI will grant an approval on 'automatic' basis to the non-resident seller where the divestment is in favor of a resident and up to a total value of Rs. 2 million per annum, per company. For divestment in excess of Rs. 2 million, a prior clearance of the RBI has to be obtained in respect of thinly traded shares or shares of unlisted companies. The price can be arrived at by using any of the following three options :

1. The shares may be sold at the price based on the Earning Per Share (**EPS**)[11] linked to price earnings (**P/E**) multiple[12] or the price based on the Net Asset Value (**NAV**)[13] linked to its Book Value (**BV**) multiple[14] (i.e. Price : BV ratio), whichever is higher.

[11] EPS = Net profit / Total no. of shares ; Net profit = (Sales turnover-Expenses) - Tax
[12] P/E multiple = Share market price / EPS ; Market price = EPS * PE Note: RBI - EPS * (PE-40%)

For computing the price based on the EPS, the EPS based on the latest audited balance sheet of the company will be used in conjunction with the average P/E multiple of the Bombay Stock Exchange (**BSE**) National Index for the calendar month immediately preceding the month in which the application was made. The P/E multiple will however be discounted by 40%.

For computing the price based on the NAV, the NAV of the shares as per the latest audited balance sheet of the company will be used in conjunction with the average BV multiple of the BSE National index during the calendar month immediately preceding the month in which the application is made. The BV multiple will also be discounted by 40%; or

2. Sale of shares on a screen-based stock exchange at the prevailing market price in small lots so that the entire holding is sold in not less than five trading days; or

3. Sale of shares at a price based on independent valuations. An application in this regard must be accompanied by two separate valuation reports, one by the statutory auditors and the other by the Chartered Accountant or SEBI registered Category-I merchant banker, giving a reasoned report in support of the price. The RBI will clear such proposals at the lower of the two valuations and its decision will be final.

As per these guidelines, a share will be considered thinly traded if on the main exchanges in India, the annualized trading turnover in that share during the six calendar months prior to the month in which the application is submitted, is less than 2% (of the total number of shares) of the listed stock. In case of shares with a history of listing and trading less than six months, the trading turnover may be annualized with reference to the actual number of days for which the stock has been listed.

The RBI approves disinvestment of listed stocks at the market price (plus or minus 5%). In case of sale of shares in favour of promoters, the disinvestment will be approved at the market price (plus or minus 25%).

K. Risks Associated with the Region

Some of the inherent risks associated with the venture capital investment in the Indo-Asian region are as follows :

Currency Fluctuations - Since this region consists of growing economies, there is a risk of depreciation in the value of investments due to downward pressure on the local currencies with reference to the US Dollar.

Investment Restrictions - The maximum investment permissible by the fund in each country may vary. This may affect the degree of diversification of the fund’s portfolio of investments.

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[13] NAV = (Fixed Assets=Current Assets-Liabilities) / (No. of shares), NAV = BV
[14] BV multiple = Market price / NAV

Legal and Regulatory Risks - Most of the countries are in the process of liberalization. Therefore, their laws and regulations related to foreign investments and securities markets, keep on changing. This may affect the performance of the funds.

Liquidity Risks - Many of the countries may not have sophisticated, well developed capital markets. In the absence of listing of the stocks or even where the stock is listed, there may not be the buyers of the stocks at the prevalent market price. Therefore, the fund may be forced to hold the investments for a longer period or to liquidate its holding at a lower price.

Political Uncertainty - Some of these countries do face the persistent threat of political instability. The change in the Government could mean change in the investment policy and it could, at times, reverse the direction in which the growth is projected.

Economic Risks - The economies of the countries in these region are dependent upon international trade. Therefore, they may be adversely affected by trade barriers, exchange controls, balance of payment position and their political relation with their trade partner countries. Further, they may not be able to achieve the reduction in the inflation rate and higher Gross Domestic Product rate, as targeted.

Imperfect Market Conditions - Due to underdeveloped capital markets, some of the countries have settlement problems. This could delay the registration of securities. There have been instances of forged certificates and difficulties in establishing legal ownership of stocks. Further, even where the market regulator exists, its role and the powers vested in it are not well defined. Most of the countries do not recognize stocks in dematerialized form. All these factors make investments in these countries more vulnerable that investment in developed countries.

Accounting Standards - Accounting and auditing standards as applicable in these countries are not as stringent as they are in developed countries. The disclosure requirements are also not adequately designed to provide more information to the shareholders. In the absence of full information, the fund managers may have a difficulty in analyzing the performance of investments and taking investment/divestment decisions.

Repatriation Risks - Some of the countries in this region have restrictions on repatriation of investments and returns thereon. In some cases, the Governments intervene on the pricing of stocks before permitting the repatriation of proceeds. This could reduce the net return to the fund and its investors.
Natural Risks - Many countries in this region are still dependent upon agriculture for their economic growth. In the absence of advanced technology, the growth of this sector is dependent upon monsoon.

Cultural and Ethical Disparities - The fund managers may not be familiar with the business culture and ethical standards prevalent in the local business groups.

Annexure

India has tax treaties with the following countries:

Australia	Mauritius
AustriaBangladesh	Nepal
Belgium	Netherlands
Brazil	New Zealand
Bulgaria	Norway
Canada	Oman
Cyprus	Philippines
China	Poland

Czechoslovakia	Romania
Denmark	Singapore
Finland	Sri Lanka
France	South Africa
Germany	Spain
Greece	Sweden
Hungary	Switzerland
Indonesia	Syria
Israel	Tanzania
Italy	Thailand
Japan	UAE
Kenya	United Arab Republic
Korea	United Kingdom of Great Britain
Libyan Arab Jamahiriya	USA
Malaysia	Vietnam
Malta	Zambia

India has limited tax treaties with the following countries:

Afghanistan
Bulgaria
Ethiopia
Iran
Kuwait
Lebanon
Oman
Peoples Democratic Republic of Yemen
Pakistan
Saudi Arabia
Yemen Arab Republic

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