From: Nishi Narang [nishinareshnarang@gmail.com]
Sent: Thursday, April 22, 2010 11:08 AM
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Subject: Letter to Pranab Mukerjee

April 20, 2010

Shri Pranab Mukherjee
Hon'ble Finance Minister
Ministry of Finance
North Block, New Delhi

Respected Sir,

Re: Finance Bill, 2010, presented in the Parliament on February 26, 2010
Sub: Proposed inclusion of Section 56(2)(viia) of the Income-tax Act, 1961

Indian Venture Capital and Private Equity Association ('IVCA') is a member-based national organisation which represents most of the active venture capital and private equity firms in India.

You will appreciate that private equity investors have played a significant role in providing long-term funding to critical sectors such as infrastructure, telecom, power, engineering, construction, biotechnology, etc., which in turn has made India one of the fastest growing economies. In turn, private equity investors expect an enabling and stable tax framework to sustain its business of making long term investments.

In this context, we wish to specifically bring to your attention the implications of the proposed amendment to Section 56 of the Income-tax Act, 1961 ('the Act'), contained in the Finance Bill, 2010, by which, companies and firms which receive shares for less than their fair market value are sought to be taxed on the difference.

The proposed provision is so widely drafted that tax could be levied even on receipt of bonus shares, rights shares, shares transferred/ allotted upon exercise of options and a vast range of other transactions not involving any abuse or misuse of the provisions of the Act.

The Memorandum explaining the provisions of the Finance Bill, 2010 states that these provisions are anti-abusive in nature. However, it does not specify the section of the Act, the abuse of which is sought to be plugged. Hence, the intention behind the proposed amendment of Section 56 is not very clear.

Given this backdrop, several transactions undertaken by the private equity/ venture capital industry in India, based on pure commercial considerations would come under the tax net. Some such transactions are listed below:

- Private placements - pricing is based on commercial considerations and which need not necessarily be at fair market value.

- Pre-IPO acquisitions – generally at a discount to the IPO pricing.

- Inter se share transfer agreements between shareholders – based on the terms of share purchase/ share subscription agreement.

- Complex transactions, which comprise a set of transactions that form the consideration for the deal as a whole, and one limb of which may include the transfer of shares for less than fair market value.

- Call and put options – depending on commercial arrangement.

- Agreement to sell shares at a future date at a price based on market value on the date of execution of the agreement, while the fair market value on the date of actual sale is different.

Generally, the private equity model involves working alongside the promoters and the existing management to facilitate the growth of a company or to turn around the company. Therefore the investment structuring in these transactions is based on parameters and performance criteria which are subject to commercial arrangements when seen as a whole. Accordingly, the issuance/transfer of shares to private equity investors may not necessarily be in accordance with the fair market value. Such transactions are driven purely by commercial considerations and investment needs of the investee companies, and provide for means to incentivise the promoters if the investee company performs well, and claw back value from the investee company/promoters if the performance is not as per the set criteria.

It may be appreciated that in respect of such deals, valuations would tend to be subjective and hence what may be construed as fair value would vary from investor to investor.

Having said that, it is important to note that no provision of the Act is sought to be abused or misused in any manner whatsoever, in any of the transactions referred to above. Further, in the case of receipt of shares as distinct from receipt of cash, there is no income escaping tax, since ultimately such income would have to be offered to tax on the sale of shares.

By bringing such transactions within the ambit of the proposed Section 56(2) (vii a), private equity investors and others will be hampered by being denied an enabling tax framework which is the key to their business model.

It may be noted that similar 'gift-tax' provisions were sought to be introduced in Finance (No. 2) Bill, 1998, but were subsequently omitted in the Finance (No. 2) Act, 1998.

In view of the above analysis, we would humbly submit that the proposed section be dropped. If not, the language of the proposed Section 56(2)(viia) may be modified as under:

"where a firm or a company not being a company in which the public are substantially interested, receives, in any previous year, from any person or persons, on or after the 1st day of June, 2010, any property, being shares of a company not being a company in which the public are substantially interested,—

(i) without consideration, the aggregate fair market value of which exceeds fifty thousand
rupees, the whole of the aggregate fair market value of such property;
(ii) for a consideration which is less than the aggregate fair market value of the property by an amount exceeding fifty thousand rupees, the aggregate fair market value of such property as exceeds such consideration:

Provided that this clause shall not apply to any such property received by way of a transaction not regarded as transfer under clause (via) or clause (vic) or clause (vicb) or clause (vid) or clause (vii) of section 47.

Provided further that this clause shall not apply to receipt of shares of a company not being a company in which the public are substantially interested, in the following situations:

- ***bona fide commercial transactions***
- ***exercise or enforcement or working out of a legal, statutory or contractual right***
- ***re-structuring of a company or group of companies***
- ***where cash payment is not the only consideration***

Explanation.—For the purposes of this clause, "fair market value" of a property, being shares of a company not being a company in which the public are substantially interested, shall have the meaning assigned to it in the Explanation to clause (vii);"

Further, the Central Board of Direct Taxes has vide Notification No. 23/ 2010 dated April 7, 2010 prescribed the valuation rules to determine fair market value for the purpose of the proposed amendment to Section 56 of the Act. However, the central issue raised in this letter remains unresolved.

We request you to consider our request regarding this matter favorably. We would be happy to meet and discuss this further in detail on behalf of the venture capital and private equity funds in India.

Yours sincerely,

Mahendra Swarup
President
Indian Venture Capital and Private Equity Association