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

Hon'ble Minister,

Re: Venture Capital Industry
Sub: Issues faced by Venture Capital industry – scope of income-tax exemption under section 10(23FB) of the Income-tax Act, 1961 ('the Act')

Indian Venture Capital and Private Equity Association ('IVCA') is the oldest member based national organization that represents most of the active venture capital and private equity firms in India. Our members represent funds under management ranging from USD 5 million to USD 3 billion.

IVCA members provide capital for seed ventures, early stage companies, later stage expansion, and growth finance. Majority of investment by these firms result in fresh infusion of capital into the undertakings thus facilitating growth of economic activity and employment. Further, investment by these firms is typically made with a medium to long-term outlook. Hence, these firms expect certainty on taxation and regulatory front which in turn ensures stability and attractiveness of India as an investment market. In the last five and a half years US\$ 44.8 billion (INR 2,24,000 Crores) has been invested by VC/PE firms in India in over 13,000 Indian enterprises.

We, at the IVCA, on behalf of all our members, herewith enclose a representation regarding a key income-tax issue faced by all Venture Capital Funds in the country and seek certain amendments to the Act.

This amendment will significantly alleviate tax issues faced by VCFs, will encourage flow of capital into multiple sectors in India and assist in promoting India as an International Financial Services Centre.

We acknowledge with thanks the assistance and help provided by Price Waterhouse & Coopers in the preparation of this representation.

Thanking you,
Yours sincerely,

Mahendra Swarup
President – IVCA

1. Background

- 1.1 The venture capital industry in India is still at a relatively nascent stage when compared globally. With a view to encourage innovation, enterprise and conversion of scientific technology and knowledge based ideas into commercial production, it is very important to promote venture capital activity in India. India's recent success story in the area of information technology has shown that there is a tremendous potential for growth.
- 1.2 The vast pool of skilled and cost competitive manpower, technology and research institutes, and entrepreneurship need to be catalysed through proper policy support and financing of risk capital for achieving this objective. Venture capital funding is critical in this context.
- 1.3 Venture Capital funding is different from traditional sources of financing. Venture capitalists finance innovation and ideas which have potential for high growth, but with it, inherent uncertainties. This makes it a high-risk, high return investment. In addition to finance, venture capitalists also provide hands-on management support and other skills that help to convert the entrepreneurial vision into marketable products. Venture Capital Funds (VCFs) not only provide funds but also promote entrepreneurship, create new jobs and stimulate economic growth. Further, it helps in creating good corporate governance standards and leads to good quality IPOs providing over-all benefit and protection to the investors.

Additionally, judging from the global experience, this will result in substantial and sustainable employment generation. The spin off effects of such activities would create other support services and further employment.

- 1.4 The regulatory, tax and legal environment plays an enabling role in the growth and operation of Venture Capital industry. Internationally, venture funds have evolved in an atmosphere of structural flexibility, fiscal neutrality and operational adaptability. Worldwide, it is ordinary practice that VCFs are considered as pass through vehicles, with tax being paid on returns earned by the investors i.e. there is no double taxation of income. Similarly, in India, section 10(23FB) and 115U of the Income-tax Act, 1961 provided pass through status to VCFs.
- 1.5 However, the pass through status was restricted and diluted by the Finance Act 2007, which amended section 10(23FB) to restrict the pass through exemption to investments made by VCFs in certain, specified sectors only¹.

The aforementioned amendment is causing tremendous hardship to VCFs in terms of uncertainty qua tax consequences on investments made by VCFs. Further, the tax issues multiply in the context of VCFs that invest in both, specified sectors and other sectors. These issues have been discussed herein below.

¹ (i) Nanotechnology (ii) Information technology relating to hardware and software development (iii) seed research and development (iv) bio-technology (v) research and development of new chemical entities in pharmaceutical sector (vi) production of bio-fuels (vii) building and operating hotel cum convention centre with seating capacity of more than 3,000 (viii) developing or operating and maintaining or developing, operating and maintaining infrastructure facilities (as specifically defined) (ix) dairy or poultry industry

2. Need for restoration of pass through status

For following reasons, we humbly submit that the pass through status provided to VCFs by section 10(23FB) and 115U of the income-tax Act, which has been restricted to specified sectors should be restored back to all the sectors, as prior to amendment by the Finance Act 2007.

2.1 Congruence of definition of VCUs

- 2.1.1 VCFs are registered with Securities and Exchange Board of India (SEBI) and need to invest in accordance with SEBI VCF Regulations. SEBI is the Regulatory Authority for registering and monitoring of VCFs. Various committees such as Ashok Lahiri Committee and Chandrashekhar Committee have recommend recognizing SEBI as the nodal authority for governance of VCFs.
- 2.1.2 Just as the CBDT and Revenue authorities, SEBI also falls within the Ministry of Finance of the Government of India.
- 2.1.3 Till the Act was amended, the definition of Venture Capital Undertaking (i.e. the companies in which VCFs can invest) was linked to the definition of VCU under SEBI VCF Regulations. However, the definition of VCU was amended and is different and much narrower in scope as compared to the definition of the same term under SEBI VCF Regulations.
- 2.1.4 SEBI VCF Regulations do not provide for any sectoral restrictions for investment except for investments in businesses considered in a short, negative list.
- 2.1.5 It is humbly submitted that SEBI should be regarding as the nodal authority for regulation of VCFs and investments made by VCFs in accordance with SEBI VCF Regulations should be eligible for pass through status. In other words, the definition of VCU under the Act should be aligned with the definition of the term under SEBI VCF Regulations. This will ensure consistency of views amongst the Regulators and will promote an atmosphere of stability, consistency and certainty.

2.2 Need of seed capital in various sectors

- 2.2.1 Capital and finance are life-blood of any economy. On account of the restrictions imposed by Finance Act, 2007 on sectors eligible for pass through status qua investment by VCFs, investments in other sectors could possibly face double taxation. This adversely impacts the flow of investments and capital in other sectors. It is humbly submitted that India faces scarcity of capital and this has been admitted by the Government at different forums. Thus, any change in taxation regime that adversely impacts flow of capital has a detrimental effect on the economy and our growth rate.
- 2.2.2 VCFs invest in various other sectors such as healthcare, logistics, food processing, infrastructure (other than those specifically covered under section 10(23FB), etc. Admittedly,

these sectors are critical for the economy and they have huge capital requirements. Many of these sectors are high risk sectors, which ordinary investors may refrain from investing into and are more appropriate for venture capitalists.

2.2.3 Considering the requirement for capital in the economy, it is humbly submitted that the benefit of the section 10(23FB) should be extended to all sectors as permitted by SEBI.

2.3 Pass through status - Merely shifts the incidence of taxation

2.3.1 VCFs are merely a dedicated pool of capital and therefore, they need to operate in fiscal neutrality. Globally, they are treated as pass through vehicles and the incidence of taxation is on the investors in VCFs. There is a well established successful precedent in the case of Mutual Funds which, once registered with SEBI, are automatically entitled to tax exemption at pool level. Like mutual funds, VCFs should also be treated as a pool of capital, entitled to pass through status.

2.3.2 Section 10(23FB) does not provide a blanket exemption to returns earned by investments made by VCFs. It merely shifts the incidence of taxation from the VCF to the investors. As long as there is merely shift of taxation of incidence of taxation (and not exemption), it is humbly submitted that the Revenue does not stand to loose.

2.3.3 Thus, restoring the scope of section 10(23FB) to all sectors as permitted by SEBI may not lead to any significant loss of revenue to the Government. It will send out a strong, positive signal to the investor community.

2.4 Pass though status – Reinstated under Direct Tax Code

2.4.1 In the Direct Tax Code (proposed to be enacted from April 1, 2011), VCFs have been accorded a complete pass-through status with respect to all their investments.

2.4.2 It is humbly submitted that the principles of the Direct Tax Code on treatment of pooling vehicles as pass through entities, which have been welcomed by the industry, merit to be considered even under the current taxation regime. Thus, till the time the Direct Tax Code is implemented, we humbly request for reinstatement of the pass through status to VCF.

2.5 Trust taxation provisions - complex and not envisaged for pooling vehicles/contributory trusts

2.5.1 Most of the VCFs are set-up in the form of trusts. With the pass through status not being available for investments in sectors other than specified sectors, these trusts will now be governed by the provisions of trust taxation. It is humbly submitted that the provisions of trust taxation are archaic. They are meant for private trusts and are difficult to apply in the context of contributory trusts/pooling vehicles. The outcome of trust taxation principles to a VCF adds to complexities and results in more uncertainties for investors.

2.5.2 For example, there are following difficulties in applying trust taxation principles to contributory trusts -

- o Classification issues such as whether the trust would be regarded as a revocable trust or irrevocable trust and whether the trust would be regarded as a specific trust or discretionary trust?
- o Timing of taxation of income: whether on accrual basis or on distribution? Investors in VCFs investing in both, specified sectors and other sectors would be subject to tax on accrual basis and on distribution. There will be significant complexities at the time of taxation investors.
- o TDS credit issues.

2.5.3 As discussed above, investors in VCFs are averse to uncertainties qua taxation. Taxation issues can easily be resolved if the pass through status is restored for VCFs.

3. Prayer

- 3.1 The concurrent prevalence of multiple sets of definitions (such as that of VCU) under different enactments creates inconsistencies and results in a negative perception about the regulatory and taxation India. It detracts from the overall objective of development of Venture Capital industry in India.
- 3.2 VCFs are merely a pool of capital of certain investors and merit to be accorded pass through status. Denial of pass through status results in uncertainties qua taxation of investors of VCFs as VCFs then face complex trust taxation issues and related litigation.
- 3.3 To facilitate flow of capital into all sectors of the economy and thus, place India onto a high growth trajectory of 9% plus as envisaged by our Honorable Prime Minister, it is imperative to encourage Venture Capital Industry. A significant step in that direction would be to restore the pass through status to VCFs for investments made in all sectors as permitted by SEBI VCF Regulations.
- 3.4 Further, it is humbly submitted that the amendment to section 10(23FB) of the Act be provided with a retrospective effect, since the assessment proceedings in relation to the years in respect of which the benefit of pass through status has been withdrawn are yet to commence and the retrospective amendment will mitigate the potential litigation arising to the venture capital industry.