IVCA
IVC ASSOCIATION
THE INDIAN PRIVATE EQUITY & VENTURE CAPITAL ASSOCIATION

15th October, 2014

Dr K. P. Krishnan
Additional Secretary
Ministry of Finance
North Block, New Delhi, India

Subject: Appeal to accord Pass-through status to SEBI-registered Alternative Investment Funds (AIFs) and facilitate private equity / venture capital

Dear Sir,

SEBI-registered Venture Capital Funds (VCFs)/AIFs & Foreign Venture Capital Investors (FVCIs)have contributed Rs 83,000 Cr as Private Equity (PE) investments to a large number of Indian companies at different stages of evolution, averaging about 9000 cr per year.

Unlike many other sources of capital, such as Foreign Portfolio Investment or IPO markets, private equity (administered through Venture Capital Fund (VCF)/AIF and FVCI) is a steady source of long term (generally 5-7 years) capital, mainly to provide scarce equity capital to emerging and growing businesses in India.

In 2012,the erstwhile VCF regulations were substituted with AIF regulations, but due to coordination gaps between SEBI/RBI/CBDT at the time of the promulgation of the AIF regulations, the "pass-through" status of the erstwhile VCFs was not grand-fathered for all types of AIFs when erstwhile VCFs were categorised into AIF category I, II & III.

A "pass-through" [u/s 10 (23 FB) read with 115 U, the IT Act, 1961] status for different types of AIFs does not result in any tax leakage, or revenue loss, to the exchequer and therefore, it is not a Tax concession. Further, AIFs can be asked to provide details of their income and list of beneficiaries in Form 64. Under section 115 U all beneficiaries of AIFs income, are liable to pay tax on income received, based on their tax status.

In the absence of pass-through status for AIF's, pooling of Funds in India is not feasible as Indian Investors as well as FVCIs shy away from investing through a taxable AIF vehicle which compromises their tax status. For instance, with no pass-through status, domestic institutions with special tax status such as Life Insurance Corporation and General Insurance Corporation, and foreign investors from countries with which India has double taxation treaty, all get taxed at the vehicle level.

In the absence of pass-through status for all AIFs, various AIFs had adopted a determinate trust structure to ensure taxpass-through. However, a recent CBDT circular No 13 dated 28th July 2014,in the context of charitable trusts, has issued clarifications on determinate trusts, whereby, all existing AIFs structured as determinate trusts may lose their pass-through status, unless a pass-through status is explicitly provided to AIFs. In the absence of a pass-through status, future AIFs will not be feasible.

The recent clarification from CBDT seeks to have the names and beneficial interest of all the contributors of a determinate trust upfront, at the time of forming the Trust/AIF. It is nearly impossible to achieve this as seeking commitments for a registered AIF from prospective investors is a time drawn process, often spread over 12-18 months, post which the final list of contributors and their beneficial interests are known.

In view of the above reality, and in order to facilitate the growth of AIFs/VCFs, it is sincerely requested to accord tax pass-through status to all SEBI registered AIFs to encourage the formation of domestic pools of capital.

We have also requested SEBI to consider an amendment of the AIF Regulations in order to harmonize the categorization of private equity and venture capital funds in line with the earlier VCF Regulations, as indicated below:

Recommended Amendment in Chapter II, 4(b) of SEBI AIF Regulations, 2012

“Category II Alternative Investment Fund” which does not fall in Category I and III and which does not undertake leverage or borrowing other than to meet day-to-day operational requirements and as permitted in these regulations;

Explanation. For the purpose of this clause, Category II Alternative Investment Funds consists of private equity funds, real estate funds and debt funds. Private equity funds are generally perceived to have positive spill over effects on the economy and for which the Board or Government of India or other regulators in India might consider providing incentives or concessions shall be included. Such funds which are formed as trusts or companies shall be construed as “venture capital company” or “venture capital fund” as specified under sub-section (23FB) of Section 10 of the Income Tax Act, 1961.

A pass-through status [u/s 10 (23FB) read with 115 U] for AIFs and widening the scope of the recent clarification issued to Foreign Portfolio Investments (relating to Business Income vs Capital gains andthe non-applicability of permanent establishment to managers of FPI vehicles) to AIFs/VCFs will increase the size of the capital of AIF/VCFs manifold.

We look forward to an expeditious and favourable action to facilitate AIFs/VCFs which have not only provided capital, but have contributed in improving corporate governance, creating jobs and generating increased tax revenues for the exchequer, through direct and indirect tax contribution by their portfolio companies.

Thanking you

Yours Sincerely,

Arvind Mathur
President
Indian Private Equity & Venture Capital Association (IVCA)
+91 98189 34615/+91 97111 10011/+91 99100 78276

Annexure 1 - Relevance of PE-VC investments in the Indian economic scenario and background on AIF Regulations

1. The PE-VC industry has rapidly evolved during the last 10 years. From an annual investment volume of less than USD 0.25 billion in 2001, the Indian PE-VC industry has grown significantly to annual investment volume of USD 8-10 billion across 300-350 investment deals, thereby reaching out to a vast majority of the Indian industry. The AIF Regulations have also provided a good framework for domestic capital to flow into the industry.

2. PE investments have been a part of India's emerging story for years, during which time we have seen a multitude of events shaping the investment climate in India. PE has been a significant source of long-term risk capital for the Indian industry, especially in the last decade. It is reported that PE funds (foreign and domestic) have invested a total of US$ 71.13 billion[1] from 2006 to July 2013. The PE-VC industry has accounted for an estimated USD 93 billion of sticky, long term foreign capital flows into the country's economy during the last 13 years. The impact of the PE sector on economic development in India is amplified by the scarcity of capital available with the entrepreneurial class and the challenges in accessing the IPO route for raising capital.

3. As exemplified by the investment data, while PE funds have invested in start-up/ early stage investments, a significant portion of PE investments have been made in the expansion/ growth stage of Indian companies. This trend would be reflected both in investment by foreign funds and by domestic VCFs/ AIFs.

4. Further, the investments in the small and mid-size companies have also remarkably increased in last few years. A significant proportion of PE-VC capital has been invested in unlisted, SME companies which have very few avenues of raising equity capital from the markets. With the increase in the number of entrepreneurs looking to raise funds, angel and seed stage funding are also expected to increase in the coming years.

5. The domestic PE/VC sector in India is a relatively new means of raising capital for Indian entrepreneurs. SEBI issued the VCF Regulations in 1996. However, investment through this route only gained momentum in 2006. As per SEBI data, domestic VCFs have cumulatively investedINR 35,987 crores and foreign investors under the FVCI route have cumulatively invested INR 45,262 crores, as on 31 March 2014[2]. A majority of these investments, consistent with the above statistics, would be expansion/ growth capital investments made by PE funds that have been raised under the VCF Regulations.

[1] Ernst & Young research
[2] Source: SEBI

A sector-wise break-up of investments (in INR, crores) by VCFs and FVCIs from inception till 31 March 2014 is provided in table below-

Sectors of Economy	VCF/ FVCI
Information Technology	5,380
Telecommunication	7,642
Pharmaceuticals	1,039
Biotechnology	327
Media / Entertainment	1,271
Services Sector	3,867
Industrial Products	2,274
Real Estate	12,053
Others	36,201
Total	**70,054**

6. On the regulatory front, SEBI introduced a comprehensive legal framework in the form of AIF Regulations in May 2012 repealing the VCF Regulations and grandfathering funds that have already been raised under the VCF Regulations. AIF Regulations were introduced acknowledging the sector's demand to allow fund managers the flexibility to design fund products to cater to wider investor demand/ risk profiles, to provide targeted concessions to certain funds, as well as to bring within the ambit of regulation all types of domestic pooling vehicles. Due to possible coordination gaps between SEBI and CBDT and the transition from VCF Regulations to AIF Regulations not being effectively harmonized, at the time of promulgating AIF Regulations, the 'Pass through' status of erstwhile VCFs was not appropriately carried over to the AIF Regulations. The 'Pass through' status was limited only to one sub-type of the six identified fund-types under AIF regulations. The sub-type that has been given 'Pass through' status under AIF regulations is "Venture Capital Funds" under Category I *(the definition of "Venture Capital Funds" under AIF Regulations is limited only to early-stage funds, as against the generic wider definition of the same term under erstwhile VCF Regulations not restricted to early stage funds only),*and not to others i.e. AIFs registered as Category I (other than VCF), II and III were not granted a 'Pass through' status under the Act.

7. Under the AIF Regulations, domestic funds are required to register as AIFs under three broad categories depending on their investment strategy –

- Category I - Funds that invest in startup or early-stage ventures or social ventures or SMEs or infrastructure or other sectors or areas that the government or regulators consider as socially or economically desirable. This includes VCFs, SME funds, social venture funds and infrastructure funds.

- Category II - Funds that do not fall in Category I and III AIF and that do not undertake leverage or borrowing other than to meet the permitted day-to-day operational requirement. This includes private equity and debt funds.

- Category III - Funds that employ diverse or complex trading strategies and may employ leverage, including through investment in listed or unlisted derivatives. This includes hedge funds.

8. With the AIF Regulations now making a clear distinction between VCFs and PE funds, fund managers raising capital primarily for growth capital investments are registering as Category II AIFs. Based on the data available from SEBI, under the AIF Regulations, 106 funds have been registered till 31 May 2014. Out of these AIFs, about 85% are non-Category I - VCFs (i.e. registered under other categories/ sub-categories). In the terms of value of the share of these AIFs, nearly 98% of the total capital commitments raised by these AIFs do not represent VCFs i.e. out of a total commitment of INR 13,465 crores, only INR 264 crores is from AIF category I - VCFs. Effectively, less than 2% of the PE-VC capital pool has been given the 'Pass through' status, as against the total 100% getting the status under the erstwhile VCF Regulations. A category wise break-up of commitments/ funds raised and investments made (in INR, crores), as on 31 March 2014 is provided in table below –

Category	Commitments raised	% of Total Commitments raised
Category I		
Infrastructure Fund	5,619.25	41.73%
Social Venture Fund	428.29	3.18%
Venture Capital Fund	264.09	1.96%
SME Fund	0	0.00%
Category I Total	**6,311.63**	**46.87%**
Category II Total	**6,059.08**	**45.00%**
Category III Total	**1,094.63**	**8.13%**
All Categories Grand Total	**13,465.34**	**100.00%**

Note : The above report is compiled on the basis of quarterly/monthly information submitted to SEBI by registered AIFs.

Annexure 2–Categories of AIFs under AIF Regulations, 2012

Chapter II, 4(a)   **"Category I Alternative Investment Fund"** which invests in start-up or early stage ventures

or social ventures or SMEs or infrastructure or other sectors or areas which the government or regulators consider as socially or economically desirable and shall include venture capital funds, SME Funds, social venture funds, infrastructure funds and such other Alternative Investment Funds as may be specified;

Explanation.– For the purpose of this clause, Alternative Investment Funds which are generally perceived to have positive spillover effects on economy and for which the Board or Government of India or other regulators in India might consider providing incentives or concessions shall be included and such funds which are formed as trusts or companies shall be construed as —venture capital company or —venture capital fund as specified under sub-section (23FB) of Section 10 of the Income Tax Act, 1961.

Chapter II, 4(b)

"Category II Alternative Investment Fund" which does not fall in Category I and III and which does not undertake leverage or borrowing other than to meet day-to-day operational requirements and as permitted in these regulations;

Explanation.– For the purpose of this clause, Alternative Investment Funds such as private equity funds or debt funds for which no specific incentives or concessions are given by the government or any other Regulator shall be included.

Chapter II, 4(c)

"Category III Alternative Investment Fund" which employs diverse or complex trading strategies and may employ leverage including through investment in listed or unlisted derivatives.

Explanation.– For the purpose of this clause, Alternative Investment Funds such as hedge funds or funds which trade with a view to make short term returns or such other funds which are open ended and for which no specific incentives or concessions are given by the government or any other Regulator shall be included.