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THE INDIAN PRIVATE EQUITY & VENTURE CAPITAL ASSOCIATION

To 12th June, 2014

Shri ArunJaitley

The Honorable Finance Minister

Government of India

North Block, Vijay Chowk

New Delhi – 110 001

India

Respected Sir,

Sub: Pre-budget Memorandum 2014-15

Private Equity ('PE') / Venture Capital ('VC') is an important constituent of the financial services/ asset management space and plays a pivotal role in financial intermediation by providing capital and in promoting entrepreneurship. The contribution of PE / VC investors / funds in the development of a modern economy is well recognized. The investments made by PE/VC investors directly help in growth and job creation and poverty elimination.

The main sources of domestic private equity and venture capital in most countries are pension funds, insurance companies and charitable endowments. These sources are constrained by current regulations in India which we recommend should be liberalized as under:

- Amend circular PFRDA/2014/02/PFM/1 (January 2014) to permit pension funds to invest in AIF's and unlisted shares, unlisted convertible bonds, mezzanine capital & REITS.
- Include Alternative Investment Funds (AIFs) in the permitted list of investments for EPFO.
- AIFs are not a permitted for investment by Charitable Endowments, under Section 11(5) and Rule 17C of the Income Tax Act, 1961. These sections may be amended to permit investment in AIFs.
- Relax limits mentioned in circular IRDA/F&I/CIR/INV/172/08/2013 , and allow room for insurance company discretion.

As a financial investor, it is crucial for PE / VC funds to have certainty on tax consequences.

In light of the above, we write to you to bring to your attention certain key tax & other aspects relevant to PE / VC industry which could provide more certainty to investors on the tax outcome and thereby, a significant fillip to the PE / VC industry which proactively contributes to the growth of the Indian economy:

1. Taxability of offshore transfers:

The Finance Act, 2012 introduced Explanation 5 to section 9(1)(i) of the Income-tax Act, 1961 ('the IT Act'), with retrospective effect from April 1, 1962.

The previous Government introduced these provisions to tax offshore transfers (*a la* Vodafone) with retrospective effect from April 1, 1962. These provisions were not well received by the offshore investor given the extended scope of the provisions and the ambiguity in the interpretation.

To attract foreign investments in India, we humbly request you to consider the following suggestions, many of which have also been considered and accepted by the Expert Committee on Retrospective Amendments Relating to Indirect Transfer ('Expert Committee Report on offshore transfers').

1.1 <u>Carving out an exemption for Fund industry from the rigours of offshore transfer provisions</u>

The offshore transfer provisions were intended to bring into theirambit, overseas transfers of interests in offshore vehicles (that indirectly held controlling interests in Indian entities) which were, as held by the Hon'ble Supreme Court, not liable to tax in India. These provisions are quite wide in scope and could extend to transfer of interests in Fund entities between investors or redemptions by the Funds. It is humbly submitted that

- The Fund industry be kept out of the purview of offshore transfer provisions. For this purpose, Fund could be defined to include FII/FPI, FVCI and any other entity which has multiple investors and which invests in multiple assets.
- It should be clarified that multiple taxation of the same gains is not intended.
- It should also be clarified that any onward repatriation of gains by such Fund to its respective investors by way of redemption of capital should not fall within the ambit of offshore transfer provisions.

Without limiting the above suggestion, we humbly request you to consider the following:

1.2 Prospective applicability

Taxation of offshore transfers should be made applicable only from FY 2012-13 onwards i.e. from the introduction of the provisions. From a tax certainty, this could provide a significant increase in investor confidence.

1.3 Definition of the term "substantially"

As per Explanation 5 to section 9(1)(i) of the IT Act, an asset or a capital asset consisting of any share or interest in a company or entity registered or incorporated outside India shall be deemed to be, and shall always be deemed to have been, situated in India, if the share or interest derives directly or indirectly, its value ***substantially*** from the assets located in India.

The term "substantially" should be objectively defined to ensure clarity. Under the Expert Committee Report on offshore transfers, it was proposed that to tax offshore transfers, if at least fifty percent[1] of the market value of the asset / interest of the foreign company are derived from Indian assets.

Basis the above, we believe the threshold of 50% of the market value of asset / interest of the foreign company deriving should be considered.

1.4 Transfer of shares of overseas listed company or non-controlling stake

- Transactions of listed companies on a stock exchange outside India should be exempted from offshore transfer provisions. Reference[2]can be drawn from the Expert Committee Report, where such transactions are recommended to be exempted.

- Shareholding changes, which do not involve a controlling stake (i.e. not resulting in participation in control and management of the fund or investor along with its associates not have more than26% share in total capital or voting power of the company) at the offshore company level, should be exempted from offshore transfer provisions. Reference[3] can be drawn from the Expert Committee Report, where such transactions are recommended to be exempted.

1.5 Computation mechanism vis-a-vis quantum of gain

[1] Refer para 4.3 (page nos. 35 to 38) of the Expert Committee Report on offshore transfers
[2] Refer para 4.7 (page nos. 45 to 47) of the Expert Committee Report on offshore transfers
[3] Refer para 4.6 (page nos. 41 to 45) of the Expert Committee Report on offshore transfers

The IT Act does not provide a computation mechanism for computing capital gains on offshore transfer relating to India assets. Accordingly, it is suggested that a computation mechanism ensuring only India related gains are taxed which could be specified as under:

- The value of the assets should be computed on a fair market value basis. The fair market value needs to be defined in the context of India assets and non-India assets.

- The term 'assets' should be defined for the purpose of this provision to mean assets recorded in the financial statements.

- The date when the value is to be considered should be specified (for instance, value as at the end of the fiscal year preceding the year of transfer).

- In case the offshore transfer provisions are triggered, the capital gains on such offshore transfers which deems to accrue or arise in India shall be computed in accordance with the formula as under:

  $$A \times \frac{B}{C}$$

  A = Income from the transfer computed as per the provisions of the Act as if the transfer was effected in India;

  B = fair market value of the assets in India, owned, directly or indirectly, by the company;

  C = fair market value of all assets owned by the company

1.6 Cost of acquisition of Indian asset for the purpose of subsequent transfer

- It should be clarified that in case the offshore transfer of an Indian asset has been subject to tax in India as per the amended provisions, the cost of acquisition of that Indian asset (for the purpose of subsequent transfer) shall be the proportionate consideration paid at the time of acquisition of such share. This could be explained below by way of a formula:

  $$\text{Cost of acquisition of India assets} = \text{Amount of consideration paid by the buyer} \times \frac{\text{Fair market value of India assets}}{\text{Fair market value of global assets}}$$

1.7 Intra-group restructuring exemption needed from offshore transfer provisions

- Intra-group restructuring outside India which does not involve transfer of shares / interests to a third party should be exempt from the offshore transfer provisions.

2. Rationalisation of General Anti-Avoidance Rules ('GAAR') and tax benefits to Real Estate Investment Trusts (REITs)

The recommendations on GAAR and tax benefits to REITS have been discussed in detail in **Annexure A** to this letter.

3. Extension of tax pass through status to all the categories of Securities and Exchange Board of India ('SEBI') registered Alternative Investment Funds ('AIF')

3.1 Currently, under the Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012 ('SEBI AIF Regulations'), the tax pass through status provided under section10(23FB) read with section 115U of the IT Act is accorded to only erstwhile VCFs/ VCCs and Category I AIFs –VCFs. Further, the tax pass through is available only in respect of income earned from investments made by VCFs / VCCs / Category I AIF – VCFs in the Venture Capital Undertakings ('VCUs').

Also, section 56(2)(viib) of the IT Act, which taxes the consideration received by a company over and above the face value of shares, provides an exemption to a VCU receiving consideration for issue of shares from a VCF / VCC / Category-I AIF VCF.

3.2 Given the above, the AIFs other than Category-I AIF VCF have to rely on complex trust taxation principles for taxability of gains on sale of their investments.

Recommendations:

3.3 It is humbly suggested that there should be single level of taxation for any pooling vehicle/ collective investments scheme. Multiple levels of taxation / uncertainty on single level of taxation discourage investors from using regulated platform such as AIFs.

3.4 In view of the above, the provisions of section 10(23FB) of the IT Act could be amended asfollows:

any income earned by an erstwhile VCF / VCC registered under the SEBI (Venture Capital Funds) Regulations and all categories of AIF should be exempt

This suggests that the tax pass through benefit in terms of section 10(23FB) read with section 115U of the IT Act should be made available to erstwhile VCFs / VCCs and all categories of AIFs in respect of any income earned by such entities.

3.5 It is suggested that the companies receiving consideration for issue of shares from erstwhile VCF / VCC / all categories of AIFs should be eligible for an exemption from applicability of the provisions of section 56(2)(viib) of the IT Act, once the provisions of section 10(23FB) is amended.

3.6 Further, similar section 196 of the IT Act, a provision should be included to specify that no deduction of tax shall be made from any income credited or paid to AIF as specified under section 10(23FB) of the IT Act.

4. <u>Taxability of long term capital gains arising on transfer of unlisted securities by non-residents</u>

4.1 Pursuant to the amendment in 2012 in section 112(1)(c) of the IT Act as per the Finance Act, 2012, the long term capital gains arising on account of transfer of capital asset being unlisted securities are taxable at the rate of 10% (excluding applicable surcharge and education cess) on the capital gains in the hands of non-residents.

4.2 The above beneficial tax rate applies only to gains on transfer of "securities" as defined under the Securities Contracts (Regulations) Act, 1956 (32 of 1956)("SCRA").

The relevant extract of the expression "securities" as defined in SCRA is as under:

"Section 2(h) - Securities include –
(i) shares, scrips, stocks, bonds, debentures, debenture stock or other marketable securities of a like nature in or of any incorporated company or other body corporate1;

(ii) ...."

A technical reading of the aforesaid definition of securities may lead to an interpretation that the definitionof "securities" would be limited to "marketable securities".

Consequently, there is a view that transfer of shares of any private company shares (not being freely marketable and hence not "securities" under SCRA) may not be able to take the benefit of the concessional tax rate. This may also impact the taxation of offshore transfers where the shares / interest of the overseas entity do not qualify as "securities".

4.3 Restricting the scope of the section only to securities held by non-residents in public companies may not be in line with the intention of the legislature.

Recommendations:

4.4 Keeping with the spirit of the amendment and to avoid needless uncertainty / litigation, the definition of "securities" should be amended to include any shares, scrip, stocks, bonds, debentures, debenture stock, warrants, units or other securities of like nature issued by private company, public company, any other body corporate and includes other securities as specified in section 2(h) of SCRA.

5. Anomalies in taxation of share buy-back

5.1 As per section 115QA of the IT Act, any amount of distributed income paid to a shareholder on buy-back of unlisted shares in accordance with section 77A of the Companies Act, 1956 shall be charged to additional income-tax at the rate of 20% (excluding surcharge and education cess) on such distributed income. Further, such income received will be exempt in the hands of the shareholders.

For the purpose of this provision, the distributed income means the consideration paid by the company on buy-back of shares as reduced by the amount received by the company on issue of shares.

5.2 In this regard, we would like to bring to your attention that the Expert Committee in its Final Report on General Anti-Avoidance Rules ('GAAR') had acknowledged the fact that the payment of dividend to its shareholder or buy back of its shares or issue of bonus shares out of the accumulated reserves is a business choice of a company, which a company is entitled to exercise at any point of time[4].

5.3 Independent of the above, with respect to taxability of share buy-back, there are certain anomalies described below which need to be relooked and clarity needs to be provided.

[4] Refer para 3.11 (page nos. 34 to 36) of the Expert Committee Report on GAAR, Example 2 on page no. 63, Example 2A on page nos. 63-64, Example 12 on page no. 72, Example 12A on page nos. 72-73

There are possibilities of disputes on the expression "amount which was received by the company for issue of shares" in circumstances like (a) debentures which are converted into equity shares;(b) amount for issue of shares may have been received by predecessor entity pre-merger, whereas shares buy-back is undertaken by successor entity; (c) amount for issue of shares may have been received from a shareholder, who would have then sold to another shareholder off-market at a price different than the shares acquired by him.

Recommendations:

5.4 It is suggested that the provisions relating to taxation of buy-back of shares should be withdrawn based on the reasoning rightly pointed by the Expert Committee on GAAR discussed above in para 5.2.

5.5 However, in case the above suggestion is not accepted, clarity should be provided with regard to the anomalies discussed above. In circumstances like:

Anomalies	Suggestions
Debentures which are converted into equity shares	Amount received on issue of debentures shall be deemed to be the amount received by the company for issue of shares
Buy-back of shares from an investor who would have purchased it from another investor	Consideration paid by the investor on secondary purchase to the other investor shall be deemed to be the amount received by the company for issue of shares

6. **<u>AIFs should be permitted to invest through infrastructure asset holding companies and Core Investment Companies(CICs) that do not require registration with RBI</u>**

In view of current definition of 'NBFC' as per RBI which is wider in nature, typical investment holding companies (which are basically SPVs) also get classified as "NBFCs" even when in reality these SPVs are not registered with RBI as NBFCs. Thus, investment by AIFs into such investment holding companies is not permissible under the AIF Regulations. SEBI is requested to remove this anomaly and clarify that investment by AIFs in Investment Holding Companies (which are not registered as NBFCs with RBI) should not be an issue.

7. **<u>Creating Level Playing Field for Domestic AIF managers</u>**

While foreign funds are allowed to invest in almost all sectors subject to sectoral limits, FVCIs are restricted to invest only in infrastructure and nine specified sectors. Further domestic funds (into which FVCIs have made investments) also get restricted from investing in sectors other than the specified sectors.

8. <u>Hurdles to PE exits due to lock-in of shares acquired by way of share swaps</u>

A share swap is one of the ways provide liquidity to PE investors. However, under current ICDR regulations, the swapped shares are locked-in for a period of one year from date of issue. It is necessary that whilst calculating the lock-in period, the original investment period (a period prior to such swap taking place) should be considered.

9. <u>AIF to REITS convertibility</u>

SEBI should consider allowing conversion of AIFs into REITs and Infrastructure Trusts provided they comply with requirements to be fulfilled by REITS/infra trusts.

10. **<u>Overseas Listing conditions and procedures should be liberalised</u>**

In furtherance to a press release published on September 27, 2013 which allowed unlisted Indian companies to list and raise capital abroad without the requirement of prior c or subsequent listing in India, an amendment was introduced by the RBI to the "Issue of Foreign Currency Convertible Bonds and Ordinary shares (Through Depository Receipt Mechanism) Scheme, 1993 via A.P. (DIR Series) Circular No. 69 dated November 8, 2013 ("**Circular 69**"). Circular 69 laid out the conditions on which such listing would be allowed which included restrictions on end use of proceeds arising from raising such capital only for retiring outstanding overseas debt or for bona fide operations abroad including for acquisitions. The end use in this regard can be expanded.

Additionally, the pricing guidelines for the ADRs and GDRs as specified under Circular 69 must be as per internationally accepted pricing methodologies.

Recommendation

Accordingly, the following amendment is suggested to Circular 69:

In paragraph 2(c):

"(c) The pricing of such ADRs/GDRs is to be calculated as per any internationally accepted pricing methodology at the time of issuance of the ADR / GDR, duly certified by a Chartered Accountant or a SEBI registered Merchant Banker"

In paragraph 2(g):

"The capital raised abroad may be utilised for retiring outstanding overseas or domestic debt, or for operations abroad including for overseas or domestic

acquisitions, or for operations in India in the ordinary course of business, including business expansion, consolidation, working capital or operational or business restructuring within India so long as they are consistent with the GOI's FDI Policy."

In paragraph 2(h):

"(h) In case the funds raised are not utilised abroad as stipulated above, the company shall repatriate the funds to India within 182working days and such money shall be parked only with AD Category-1 banks recognised by RBI and shall be used for eligible purposes either domestically or overseas."

11. <u>Service-tax on amounts retained by the Funds</u>

Typically a Fund collects capital from its investors, engages a trustee, investment manager and makes investment in different investee companies. The Fund calls for the money from its investors as and when required and generally invests more than 90% of the capital raised. The balance amounts are utilized to meet the expenses of the Fund. The expenses can be met out of the capital called or from the realizations from the portfolio companies.

However, the service tax authorities have adopted a view that the Funds are providing service to its investors, despite there being no service provider-service recipient relationship between the Funds and its investors. Accordingly, the amounts retained for meeting the expenses of the Fund have been treated as „consideration towards provision of asset management services by the Fund to the investors, liable to service tax under the erstwhile taxable service category of Banking and Other Financial Services (BFS). This has resulted in defeating the very purpose / aspect on which service tax is leviable and is contrary to the intent of the law.

Please note that these expenses incurred by the Funds are routine expenses and would have already suffered service tax that is applicable under the law. The expenses of the Fund primarily consist of expenses like management fees, custodian fees, trusteeship fees, legal and Professional fees, etc.

Even assuming without admitting that they are subject to service tax, the Funds would be entitled to Cenvat credit on the service tax liability paid by it on the above expenses incurred. Therefore, the tax demand would get reduced almost completely, though it has been noticed that such credit has not been granted by the tax authorities.

It may be important to highlight there that the expenses incurred by the Funds are akin to entry / exit load charged by the Mutual Fund industry, where the Central Board of Excise and Customs ("CBEC") had clearly issued a circular explaining that the entry / exit load charge by the Mutual Fund industry is not a service provided by Mutual Funds and should not be subject to service tax liability. However, it appears that the service tax department has ignored this clarification and has taken a view that such monies retained by the Funds are liable to service tax.

The above action of the tax department has created significant uncertainty for the Funds and its investors, and has significantly impacted the investor confidence in the financial services industry.

<u>Recommendation</u>

The Industry requests the assistance in the above matter to provide specific clarity/ direction to mitigate the hardship faced by the industry.

Similar to the Mutual Fund industry, we suggest that a specific clarification be issued by the CBEC for the Funds to provide that the amounts retained by the Funds should not be liable to service tax since there is no concept of a service provider-service recipient relationship between the Fund and its investors.

As an overall point, we wish to mention that the above requests, if considered favorably, would strengthen the tax administrative / collection process and help significantly reduce litigation in this industry.

12. <u>Liberalize distressed and turnaround investing</u>

In the last few years due to lower GDP growth, a number of firms have become distressed.These need to resuscitated and turned by the help of private equity, debt and mezzanine capital. All constraints on such distressed investments should please be removed soonest in order to produce more economic growth and jobs. Relevant RBI circulars should be liberalized and restrictions removed to enable such investments.

We request you to consider the recommendations while framing the Finance Bill, 2014proposals.We will be happy to discuss the recommendations with you.

In case of any clarification, you may contact:

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Thanking you,

Yours faithfully

For **Indian Private Equity and Venture Capital Association**

Name: Arvind Mathur

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Copy (CC)

1. Joint Secretary (Financial Market), North Block, Ministry of Finance
2. Finance Secretary, Ministry of Finance