Recommendations: Providing a Fillip to Private Equity and Venture Capital in India

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For further clarification or discussion please contact Mr. Arvind Mathur, President Indian Private Equity & Venture Capital Association, New Delhi/ Gurgaon (+91 9818934615, arvind@indiavca.com . In preparing this list of reforms IVCA has performed its own research, consulted several of its members in face- to- face discussions as well as analysed written submissions to it by various Private Equity and VC professionals. IVCA expresses its gratitude to all professionals who have made submissions and participated in discussions on potential reforms.

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Reforms Needed for Growth of Private Equity & Venture Capital Funds	
Domestic Funds (i.e. India-domiciled Funds)	1. Private equity and venture capital funds help create employment and increase the tax base of their portfolio companies. At the same time, India's domestic private equity industry is highly undeveloped. It is standard practice in many countries to accord **pass-through status** to venture capital and private equity funds. Hence, it is recommended that Private Equity Funds should be included in Category 1 of SEBI's AIF Guidelines and subject to pass-through status for all such funds and that such pass- through status should also be recognized under the Income tax Act regardless of the form of such funds. 2. In line with the international practice where the tax pass-through status is automatically available to AIFs in the form of choice of various entities such as limited liability partnerships and limited liability companies, in India the pass-through status should also be granted to SEBI-registered AIFs, including all Venture Capital & Private Equity funds. A pass-through system would ensure that tax collected on the fund's income is no more than the tax that would have been payable had the investor injected funds directly in the investee company/asset. 3. Several committees[1] have greatly emphasized the importance of providing ***fiscal neutrality*** *to* AIFs, as income is taxed in the hands of the final recipient and the intermediary body is considered a pass-through entity. The pass-through status granted to SEBI-registered AIFs would put India at par with other countries, where the tax pass-through is automatically available in the form of choice of various entities available such as limited partnerships and limited liability companies. 4. Category I AIFs have been granted pass-through status for income received from investments in VCUs ('specified income').Specified income received by such AIFs is taxed directly in the hands of beneficiaries. However, Category I AIFs (for non-specified income), Category II and Category III AIFs (for specified as well non-specified income) are not accorded a pass-through status. Tax implications for such funds are currently based on the legal status of such funds i.e. whether such funds are set up as companies, LLPs or trusts. **Include all PE / VC Funds, including growth-equity funds under AIF Category I** Issue: In AIF Regulations (2012), growth equity funds have not been explicitly recognized, and by default got included in the AIF Category II, which is by definition for funds that do not fall in Category I and III, although early-stage venture capital is included under Category I. This is in contrast to the earlier Venture Capital Funds Regulations (1996), in which no distinctions were made between early-stage and growth-stage funds. Suggestion: Redefine venture capital fund to include growth equity funds as below:

[1] The K.B. Chandrasekhar Committee Report dated 8 January 2000,The Advisory Committee on Venture Capital set up under the Chairmanship of Dr. Ashok Lahiri in its report issued in the year 2003.

Existing definition: "venture capital fund" means an Alternative Investment Fund which invests primarily in unlisted securities of start-ups, emerging or early-stage venture capital undertakings mainly involved in new products, new services, technology or intellectual property right based activities or a new business model.

Suggested definition: "venture capital fund" means an Alternative Investment Fund which invests primarily in unlisted securities of start-ups, emerging or early-stage or growth stage venture capital undertakings mainly involved in new products, new services, technology or intellectual property right based activities or a new business model.

Tax pass-through benefits

Issue: In budget 2013, tax pass-through was given only to venture capital (VC) funds under AIF Category I (VC funds under Category I are early stage funds or social venture funds).

Suggestion: Tax pass-through benefit should be extended to all Categories of AIF Funds.

Reconcile material differences between AIF Regulations (2012) and Venture Capital Funds Regulations (1996) to create level-playing field

Issue: RBI has not updated its regulations in line with the new AIF Regulations.

Suggestion: RBI should recognize AIF (Categories I and II) alongside and at par with DVFs. Two instances of significance are:

a. RBI, under FEMA Regulations, allows FVCI investments in the DVFs, and it should be extended to include AIFs.

b. RBI should also recognize the fact that the 9 sector restriction on DVF was removed and the same should apply to AIFs.

5. Tax authorities should respect the tax pass-through structure of trusts.

6. There should be no prohibition on domestic funds for investing in NBFC's, since there is no such prohibition on foreign private equity funds. There should be a level playing field in this regard.

7. Domestic Funds should have the same tax treatment on capital gains as applicable to Mauritius or Singapore – based funds. Currently, for domestic private equity funds the long-term capital gains tax rate is 10 % of gains, but can be much lower for foreign funds due to treaty benefits.

	8. Domestic LP's should be encouraged. PFRDA should permit pension funds to invest up to 10% of their corpus in private equity and venture capital funds. CBDT should permit charitable trusts to invest in private equity and venture capital funds. 9. Asset Restrictions under AIF Guidelines-Domestic funds should be able to invest up to 25% overseas as against 10 % now under AIF Cat 1. Other asset side restrictions on all CAT 1 and CAT 2 AIF's should be removed, so that they can be decided mutually by GP's and LP's and reflected in their Information Memorandum and monitored by an ' Advisory Board' of the respective fund as recommended under ILPA[2] Guidelines. 10. Foreign investment in SEBI registered Alternative Investment Funds (AIFs) should be allowed under the automatic approval route: Foreign investment in SEBI registered AIFs (and in feeder fund vehicles constituted in India to invest in AIFs) should be allowed under the automatic approval route irrespective of the legal constitution of AIF i.e. whether the AIF is constituted as a trust, limited liability partnership (LLP), company or other body corporate. Therefore, investment in and transfer/ redemption of investment in AIFs should not require Government of India/Reserve Bank of India approvals. The following are some of the other recommendations and safeguards which could be put in place to prevent regulatory arbitrage from the aforesaid foreign investment in AIFs: a. The investment activities of AIFs having foreign investment should be subject to the sectoral foreign investment policy issued and updated by the Department of Industrial Policy and Promotion. b. The downstream foreign investment restriction that presently applies to an LLP having foreign investment should be made inapplicable to a SEBI registered AIF constituted as an LLP. c. SEBI-registered foreign venture capital investors should be permitted to invest in Category I AIFs without complying with the sectoral restrictions that are presently being imposed in approval letters at the time of the grant of registration. d. AIFs having foreign investment that propose to make portfolio investments in Indian listed securities (secondary market acquisition) should be mandatorily required to comply with the norms prescribed by SEBI under the SEBI (Foreign Institutional Investors) Regulations and the corresponding Reserve Bank of India regulations. e. Foreign investment in AIF management entities should be specifically included in the list of activities in which foreign investment is permitted in the non-banking financial services sector. The activities of an AIF manager should be specifically included in the defined list of non-fund-based activities that attract the minimum capitalization requirement of USD 0.5 million irrespective of the level of foreign ownership in the AIF management entity.

[2] Institution Limited Partners Association

India-based General Partners (GPs)	1. Enable India-based advisers to act as “GP’” s rather than as “advisors” by not regarding their activities as constituting permanent establishments (PE).This suggested measure will increase the number of GPs operating with offices in India, rather than in overseas locations.
Funds – Singapore & Mauritius Domiciled	1. Discard look-through approach for funds registered in Mauritius & Singapore so long as LP’s include standard category of LP’s i.e. pension funds, sovereign wealth funds, insurance companies, corporate investors, endowments, high-net worth individual vehicles, co-investment vehicles and GP’s providing capital as ‘ skin-in-the-game’. A KYC disclosure by each LP should be enough. 2. Tax Residency Certificate (TRC) in Mauritius: in practice, the tax authorities in India are going beyond the TRC and are looking into the management, control and substance of intermediate holding companies seeking treaty benefits. This practice should be avoided. The TRC should be sufficient.
	3. Exit Pricing: RBI should permit pricing in accordance with international accepted valuation practices and not ‘ROE’ under put options. 4. Suggestions regarding RBI’s Circular 86 [3] : a) Applicability to existing agreements : i. Circular 86 states that all existing contracts will have to comply with the conditions provided therein to qualify as FDI compliant. However, Circular 86 is not clear as to whether it will be necessary for contracts to actually be amended in order to be in compliance with these conditions. Suggestion: i. We recommend that it should be clarified that existing contracts with optionality clauses are valid and are enforceable if they comply with the conditions mentioned in Circular 86. Accordingly, there will be no requirement to amend existing agreements, so long as the price at which the options are actually exercised is in conformity with the pricing guidelines laid out in Circular 86.

[3] A.P. (DIR Series) Circular No. 86 dated January 9, 2014 - Pricing Guidelines for Foreign Direct Investment (‘FDI’) instruments with optionality clauses (‘Circular 86’)

ii. In other words, we suggest that an agreement be regarded as compliant if the amount payable on the exercise of the option /right is within the price parameters laid out in the extant pricing guidelines, irrespective of the methodology adopted for commercially determining the exit price.

b) Grandfathering:

i. Circular 86 states that an existing agreement will have to comply with the conditions given in the circular, in order to be FDI compliant.

ii. The related Notification was announced in December 2013 and Circular 86 was announced in January 2014. Prior to this, the following guidance was available:

iii. As per the Master Circular on foreign investments in India issued on July 1, 2004, Indian companies had a general permission to issue partly convertible debentures /partly convertible preference shares, subject to certain conditions, and were treated as instruments under the FDI route.

iv. In June 2007, the RBI issued A.P. (DIR Series) Circular No 73, dated June 8, 2007 ('Circular 73'), which provided that - with effect from May 1, 2007 - only preference shares which are fully and mandatorily convertible into equity (within a specified time) would be considered to be a part of share capital.

v. Furthermore, the RBI also issued A.P. (DIR Series) Circular No 74, dated June 8, 2007 ('Circular 74'), which restricted the issue of instruments other than those that are fully and mandatorily convertible into equity (within a specified time). In Circular 74, it was also stated that the RBI wants to restrict the issue (under the FDI route) of hybrid instruments, such as optionally convertible /partially convertible debentures which are intrinsically debt-like instruments.

vi. Circular 73 and Circular 74 provided that instruments other than those that were fully and mandatorily convertible into equity shares (within a specified time) should be considered as debt. Through these circulars, the RBI stated that it was not permissible to treat hybrid instruments as equity.

vii. According to the Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2000, 'Capital' means equity shares, preference shares and convertible debentures.

	viii. The definition of capital was changed with effect from May 1, 2007 but prior to this the definition read as 'Capital' means equity shares, preference shares, convertible preference shares and convertible debentures. This meant that instruments which were akin to debt could be issued prior to May 1, 2007 under the FDI route. ix. From a reading of the paragraph 2.2.1 above to 2.2.3 above, it appears that hybrid instruments or instruments with optional or partial conversion (which are akin to debt) were permitted to be issued up to June 2007 (as result of an extension granted by a Press Release issued by the Government of India, thereafter they could be issued until July 26, 2007) under the FDI route. Suggestion: i. We recommend that existing agreements (i.e. agreements entered into prior to January 9, 2014), which contain optionality clauses, be grandfathered. Without prejudice, at least all agreements entered into prior to July 26, 2007, which contain optionality clauses, should at least be grandfathered. c) Compulsorily convertible preference shares (‘CCPS’) /compulsorily convertible debentures (‘CCDs’) and equity shares: i. Circular 86 provides for a different methodology for computing the return when equity shares are exited (at the time of exercising the option /right) as compared to the methodology for computing the return when CCDs /CCPS are exited (at the time of exercising the option /right). ii. In Circular 86, the method for computing the return on equity shares of an unlisted company is linked to a price arrived at on the basis of the return on equity (‘ROE’) (at the time of exercising the option /right). iii. However, as per Circular 86, instruments (i.e. CCPS or CCDs) may be transferred at a price calculated by applying the internationally accepted pricing methodology at the time of exit (at the time of exercising the option /right). Suggestion: i. Equity shares, CCPS and CCDs (together “equity instruments”) have been treated at par for foreign investment purposes under the Foreign Exchange Management (Transfer or Issue of Security by a Person Resident outside India) Regulations, 2000, read with the Circular 1 of 2013 (the FDI Policy). We recommend that the pricing of equity shares (with optionality clauses) of unlisted companies should also be at par with the pricing of CCPS /CCDs (with optionality clauses), i.e. in accordance with internationally accepted pricing norms, at the time of exercising the option /right.

	ii. The current ROE mechanism that is provided in Circular 86 for computing the exit price calculates the return on equity: it does not calculate the value of the equity share. We would suggest that the pricing of equity shares with optionality clauses should be in accordance with internationally accepted pricing norms. d) Sale of shares to an investee company /promoter: i. Circular 86 states that "The optionality clause will oblige the buy-back of securities from the investor at the price prevailing/value determined at the time of exercise of the optionality, so as to enable the investor to exit without any assured return." ii. As is clear from the previous paragraph, Circular 86 refers to the buyback of equity shares /CCPS /CCDs with optionality clauses by an investee when the investor exercises the option/right. However, the Circular 86 does not explicitly refer to a transfer of equity shares /CCPS /CCDs with optionality other than a buy-back by the investee. Suggestion : i. We recommend that it be clarified that a transfer of equity shares /CCPS /CCDs with optionality clauses by an investor, whether to the investee company or any other transferee, should conform to the pricing and other conditions specified in Circular 86. ii. We believe that agreements with optionality clauses that relate to transfers to transferees should be considered valid under the Circular 86 and not only those with buy-back by an investee company.
Overseas Listing of Unlisted Indian Companies	1. It is suggested that the fourth bullet point on Overseas Listings Regulations as per Government of India(GOI), Press Information Bureau (PIB), notification dated September 27, 2013, be amended as follows: "The capital raised abroad may be utilised for retiring outstanding overseas debt or for operations abroad including for acquisitions ***or for operations in the ordinary course of business within India so long as they are consistent with the GOI's FDI Policy.*** The rationale for this is that India is a capital-deficit country and the inflow of equity capital is desirable as it will lead to expansion of businesses leading to greater employment. Enhanced foreign –exchange inflows due to overseas listings will also support the country's foreign exchange reserve.

	2. It is suggested that the fifth bullet point on Overseas Listings Regulations as per GOI, PIB, notification dated September 27, 2013, should be amended as follows: In case the funds raised are not utilised abroad as stipulated above, such companies shall remit the money back to India within **90** days (not 15 days) and such money shall be parked only in AD category banks recognized by RBI ***until their utilization domestically by the issuer in the ordinary course of its business. Corresponding changes should be made in RBI's Circular 68.*** 3. It is suggested that Para 2 (c) of RBI.2013-14/363/ A.P. (DIR Series) Circular No. 69, notification dated September 27, 2013, be amended as follows: The pricing of such ADRs/ GDRs, including equity shares, to be issued shall be based on any internationally accepted pricing methodologies.
Companies Act, 2013	1. It is suggested that Companies Act: Nominee Directors of PE / VC funds holding a minority shareholding in companies should not be deemed as having control and should be exempt from liabilities of Directors under the Companies Act, 2013. The rationale for this is that such Nominee Directors are Non-Executive Directors which do not engage in day to day management of the enterprise, and by virtue of the minority shareholding of their nominator they are not in a position to exercise control or direct day to day management. Accordingly the Companies Act should explicitly provide that Nominee Directors are not promoters or key managerial personnel and hence not liable under the Companies Act 2013.
Negotiable Instruments Act,1881	1. Negotiable Instruments Act, 1881: Nominee Directors of PE / VC funds holding a minority shareholding in companies should not be liable for bounced cheques. It is suggested that an amendment be made in the Negotiable Instruments Act, 1881, section 138 & 141. The rationale for this amendment is that the Nominee Directors are not Executive Directors and do not control the day to day functioning of companies where they are directors.
Indirect Transfer of overseas ownership of Indian Subsidiaries	1. Taxation in India of Indirect Transfers Overseas of Indian Subsidiaries: a) Amendments should be introduced prospectively – if the government opts for retrospective application, buyers should not be considered to have defaulted for not withholding taxes, and instead provisions should apply to the sellers who earned the profits on the sale. b) The term "substantially derives value from India" should be defined as a threshold of 50 percent of the total value derived from the assets of the entity. c) Small shareholders should be exempt from tax if the transferor and the associates have owned less than 26 percent of the intermediate holding company which has the underlying assets in India for the preceding 12 months.

	d) An exception should be made for foreign companies listed on a recognised foreign stock exchange. e) Transfers of shares in a foreign company as part of an intra-group restructuring should be exempt, subject to the condition that such transfers are not taxable in the foreign jurisdiction. f) The rules should be relaxed for private equity investors which hold a less than 26 percent interest in a private equity fund, that invest in a listed private equity fund, or that invest in a private equity fund that has less than 50 percent of its assets in India. 2. There are still many open issues with regards to the taxation of the indirect transfer of shares such as: a) what the "cost of acquisition" is for the indirect transfer of shares, b) how total consideration into Indian and non-Indian underlying assets is allocated, and c) what percentage threshold triggers the "substantially derives value from India" test. 3. Winding-up of Companies. There should be a limited period of ----years by which winding up must be completed.
GAAR	Grandfathering: 1. Should not be applicable to investments made by funds in operation before 30 August, 2010 or investments made before that date 2. Simple and specific definition of ' substance' should be introduced .Specific anti-avoidance Rules (SAAR) should be more widely introduced to provide certainty to taxpayers.
Domestic Limited Partners (LPs)	1. Restrictions on AIFs investments by institutional capital pools Issue: Regulations restrict investments by institutional pools (insurance funds, pension funds and charitable endowments) in AIFs.

	Suggestion: a) Insurance Funds (IRDA): Earlier, IRDA restricted investments to only Infra and SME fund investments were allowed. Recently, IRDA (circular Aug 2013) has allowed investments in AIF Category II. However, exposure is limited to 3% and 5% of fund for life insurance and general insurance companies respectively. Relaxation of limits may be considered. b) Pension Funds (PFRDA) / Provident Funds (EPFO): In budget 2013, Pension and Provident funds have been allowed to invest in ETFs, debt mutual funds and asset backed securities, but AIFs were excluded. Inclusion of AIFs is suggested. c) Charitable Endowments (CBDT): Currently, allowed to invest in only a select list of asset classes including mutual funds and select debt and equity instruments, but not AIFs. Inclusion of AIFs is suggested. 2. Domestic LP's should be encouraged. PFRDA should permit pension funds to invest in private equity and venture capital funds. CBDT should permit charitable trusts to invest in private equity and venture capital funds. 3. AIF Guidelines- Be able to invest up to 25% overseas as against 10 percent now under AIF Cat 1
Promoter Lock-in in IPO	Issue: Promoters are required to lock-in at least 20% stake for at least 3 years after IPO. Suggestion: Review promoter lock-in on IPO for AIF-backed companies.
Tax on Share Buy-back	Issue: In budget 2013, unlisted companies are levied a withholding tax of 20% on buyback of shares on the difference between original issue price and amount received from buyback of shares. Suggestion: Review taxation on share buy-back by unlisted companies, in the context of AIF investments.