INDIAN PRIVATE EQUITY
& VENTURE CAPITAL ASSOCIATION

To,

18th June, 2014

Shri Manoj Joshi
Joint Secretary
Ministry of Finance, North Block
New Delhi

Dear Sir,

Sub: Pre-budget Memorandum 2014-15 for Development of Long-term & Stable Private Equity & Venture Capital in India: Summary & PART A & PART B

Private Equity ('PE') / Venture Capital ('VC') have provided more than $ 75 billion of long term equity capital for enterprises in India and are an important source of stable long-term capital for the Indian economy. According to a recently released report of PWC, India can mobilize nearly $ 40 billion PE & VC to India as compared to an average of $ 10 billion in the last few years, if India has the right policies.

The Private Equity and Venture Capital Industry needs to grow substantially to meet the requirements of Indian Entrepreneurs and the economy. There are more than 100 domestic private equity and venture capital funds are registered with SEBI. Domestic funds have mobilized nearly Rs. 7,000 crores to date. More needs to done to meet the full needs of a growing Indian economy. Developing domestic pools of capital is critical to help grow not only domestic fund managers but also it gives confidence to international fund managers.

In addition, we believe that over 100 international funds have exposure to Indian businesses. Both domestic and international funds would like to increase their investments in India which will lead to much needed job creation and economic growth which has fallen under the previous government.

All categories of PE and VC are critical for economic development. Initially angel capital- which is family and community capital- forms the foundation of an enterprise. This is followed by early stage funding by venture capital funds. Ultimately as the enterprise becomes larger, funding for further growth and pre-IPO, or acquisitions internationally, is provided by Private Equity funds. This interlinked chain of long term financing leads to the benefit of growing job creation and innovation in India which is much needed in a competitive global environment.

In order to facilitate PE and VC investment, IVCA is pleased to provide recommendations in two parts with **Part A** covering tax-related amendments and **Part B** covering changes of a policy nature.

The following list of recommendations for the Indian Government's budget of 2014 (details are given in the attachments).

Budget Recommendations: Summary

1. Tax pass-through should apply to Alternative Investment Funds & REITS
2. Permit pension funds & charitable trusts to invest in AIF's and unlisted shares, unlisted convertible bonds , mezzanine capital & REITS
3. Withdraw the provisions relating to taxation of buy-back of shares based on the reasoning rightly pointed by the Expert Committee on GAAR
4. Clear and specific provisions, in the income Tax act, to enable Tax credits for Tax paid by the Fund to the beneficiaries of a trust. A suitable mechanism, so that required credit will appear in the Form 26AS of the beneficiaries and revenue authorities may not dispute the tax credit and avoid unnecessary litigation.
5. Define "substantially" . Tax offshore transfers, if at least 50%[1] of the market value of the asset / interest are derived from Indian assets. Trades of listed companies on a foreign stock exchange, or shareholding changes, not involving a controlling stake at the offshore company level, should be exempted from offshore transfer provisions. Provide a mechanism for computing capital gains on offshore transfers relating to India assets. Ensure that only India- related gains are taxed. Intra-group restructuring abroad to be exempt from the offshore transfer provisions.
6. DVCF/AIF Category -I should be permitted to invest through infrastructure asset holding companies and Core Investment Companies(CICs) that do not require registration with RBI
7. Creating Level Playing Field for Domestic AIF managers: 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. Remove hurdles to PE& VC exits due to lock-in of shares acquired by way of share swaps or through merger of investee company with the demerged entity of listed company.
9. Permit AIF to REITS convertibility
10. Overseas Listing conditions and procedures need to be liberalized
11. Liberalize and enable distressed and turnaround investing
12. Carve out an exemption for the Fund industry from offshore transfer provisions
13. Tax offshore transfers only from FY 2012-13 onwards
14. Definition of Unlisted Securities to be amended: 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 unlisted securities are taxable at the rate of 10% on the capital gains in the hands of non-residents. 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..
15. GAAR: Grandfather existing arrangements up to 3/31/15 .Where anti-avoidance rules are in a tax treaty in the form of Limitation of Benefits article etc. (like India-Singapore Tax Treaty), the GAAR provisions should not override the treaty. Where Specific Anti-Avoidance Rules (SAAR) are applicable to a particular aspect/element, then GAAR shall not be invoked to look into that aspect/element. Include examples of criteria where GAAR provisions would not be triggered

Attachments:

Details have been divided into two parts.

i. **Part A** (attached) includes recommendations which require amendments to the Income Tax Act, 1961. These are of a revenue-neutral nature but with growth will enhance revenues.

ii. **Part B** (attached) presents practical recommendations of a policy nature which could be considered for announcement in the FM's budget speech in order to develop the Indian private equity and venture capital industry and to boost confidence .

iii. A note with details on GAAR and REITs recommendations is also attached.

We request you to please consider the recommendations while framing the Finance Bill, 2014 proposals and in the related policy announcements. We will be happy to discuss the recommendations with you.

In case of any clarification, we will be happy to respond.

Thanking you,

Respectfully,

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

Arvind Mathur

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Part A: Indian Private Equity & Venture Capital Association (IVCA)

Pre-Budget Recommendations

1. **Provide Pass- through status to all the categories of Alternative Investment Funds ('AIF'): Amend Sctions. 10(23FB) & s. 196 of the IT Act**

- *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 process 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.
- 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).

2. **Angel Capital should be encouraged- s. 56(2)(viib) should ideally be repealed or at least amended.**

- Angel capital is at the foundation of entrepreneurship. Act s. 56(2)(viib) of the IT Act militates against growth of new entrepreneurs. This section and related regulations should be repealed.
- At the very least, 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 the provisions of section 56(2)(viib) of the IT Act, once the provisions of section 10(23FB) is amended.
- Crowd-Equity funding: - s. 56(2)(viib) should not apply whether raised through the proposed SEBI crowd-equity fund platform or angel investments directly made by friends and families of promoters.

3. **Permit Investment by Charitable Endowments in AIFs**

- AIFs are not 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.

4. **Amend definition of "securities'- s. section 112(1)(c) of the IT**

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. **Section 115QA of the IT Act : Tax on buyback of unlisted shares should be repealed**

- At the very least, the following amendments may be made:
- Debentures which are converted into equity shares:
- Recommendation: 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: Recommendation:
- 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. **Offshore Transfers**

- Tax offshore transfers only from FY 2012-13 onwards.
- PE & VC Funds should be outside the purview of Offshore Transfer Provisions (Explanation 5 to section 9(1)(i) of the Income-tax Act 1961. A Fund could be defined to include FII/FPI, FVCI including private equity and venture capital funds, which have multiple investors and which invest in multiple assets.
- It should be clarified that (i) multiple taxation of the same gains is not intended and (ii) 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.
- Define "substantially" . Tax offshore transfers, if at least 50% of the market value of the asset / interest are derived from Indian assets. Trades of listed companies on a foreign stock exchange, or shareholding changes, not involving a controlling stake at the offshore company level, should be exempted from offshore transfer provisions.
- Provide a computation mechanism for computing capital gains on offshore transfer relating to India assets. Ensure that only India- related gains are taxed.
- Intra-group restructuring abroad to be exempt from the offshore transfer provisions.

7. **Double taxation of income earned by the Venture Capital/ Private Equity Funds ("VCFs/ PEs" or "the Funds")**

- To provide a clarification that where income (from both investments in VCU and other than VCU) has been included and offered to tax by either the VCFs/ PEs or the beneficiaries and reasonable proof of the same is provided by the other person, no further proceedings for

assessing such person should be initiated (as the underlying objective of the provisions of the Act for an effective collection mechanism for taxes is already fulfilled by the other person).

- To provide clarification that income should be computed qua the beneficiaries, and the taxes paid by the Fund or beneficiary should be given credit for in the hands of the other person. For this purpose, a mechanism like Form 26AS to be introduced, by which the Fund can prepare a return providing details of the income, the beneficiaries, their PAN, the taxes remitted on their behalf, details of the remittances, etc - this should provide automatic credit to the PAN of the beneficiaries thereby providing relief from double taxation.

8. Service-tax on amounts retained by the Funds

- 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.

9. Tax Credits to the Beneficiaries- Transfer Mechanism

- Clear and specific provisions, in the income Tax act, to enable Tax credits for Tax raid by the Fund to the beneficiaries of a trust. A suitable mechanism, so that required credit will appear in the Form 26AS of the beneficiaries and revenue authorities may not dispute the tax credit and avoid unnecessary litigation.

- We recommend that an appropriate administrative procedure should be introduced for passing the credit for advance tax/ self assessment tax paid by a representative assessee to the beneficiaries. This could be along similar lines as Rule 37BA of the Income-tax Rules, 1962 which provides tax credit to a beneficiary for tax deduction at source based on declarations filed by the trustee. Based on the procedure, the beneficiaries can claim credit for taxes paid by the trustee on their behalf, in their return of income while also reporting the income earned by the beneficiaries from the VCF trust.

- We also recommend that since the SEBI registered VCF are already exempt from payment of tax, a separate circular should be issued providing exemption to such entities from the provision of withholding tax provisions.

We request you to consider these recommendations while framing the Finance Bill, 2014proposals and in your policy announcements. We will be happy to discuss the recommendations with you.

In case of any clarification, you may contact the undersigned.

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Part B: Recommendations for Policy Changes To Promote Private Equity & Venture Capital for growth & job creation

The following recommendations can be implemented by suitable amendments to relevant regulations/appropriate clarification from the Revenue authorities or the relevant Government body:

1. Developing Domestic Capital Pools for Private Equity & Venture Capital

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

(1.1) 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.

(1.2) Include Alternative Investment Funds (AIFs) in the permitted list of investments for EPFO.

(1.3) Relax limits mentioned in circular IRDA/F&I/CIR/INV/172/08/2013 , and allow room for insurance company discretion.

2. DVCF/AIF Category -I should be permitted to invest through infrastructure asset holding companies and Core Investment Companies(CICs) that do not require registration with RBI

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 DVCFs/AIF Category I into such investment holding companies is not permissible under the DVCF/AIF Regulations. SEBI is requested to remove this anomaly and clarify that investment by SEBI registered DVCFs /AIF Category I in Investment Holding Companies is not an issue.

3. Creating Level Playing Field for Domestic AIF managers

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.

4. Remove hurdles to PE& VC exits due to lock-in of shares acquired by way of share swaps or through merger of investee company with the demerged entity of listed company.

A share swap is one of the ways provide liquidity to private equity funds. However, under current ICDR regulations, the swapped shares are locked-in for a period of one year from the 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.

As per SEBI notification CIR/CFD/DIL/5/2013 whole of the premerger capital of investee company merging into the demerged entity of listed company is locked in for a period of 3 years from date of listing. It's recommended to provide exemption to SEBI registered DVCF/AIF/FVCI funds shareholding from such lock-in to enable exit for such funds. This is specifically relevant as a merger of any investee company into a listed entity (instead of demerged entity of the same listed entity) does not entail such lock in.

5. Permit AIF to REITS convertibility

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

6. Overseas Listing conditions and procedures need to be liberalised

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."

Recommendation

The PE & VC 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.

7. Liberalize and enable distressed and turnaround investing

In the last few years due to lower GDP growth, a number of firms have become distressed. These need to resuscitated and turned around by the help of private equity, debt and mezzanine capital funds. 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 lending and investment.

Annexure A

IVCA representation – GAAR & REITs

This document highlights the tax related recommendations to the Ministry of Finance on General Anti-Avoidance Rules ('GAAR') and Real Estate Investment Trusts ('REITs').

A. RATIONALIZATION OF GAAR UNDER THE INCOME TAX ACT, 1961 ('THE ACT')

1. Background &Issue

1.1. The GAAR provisions introduced in the Act vide Chapter X-A providethat an arrangement entered into by an assessee may be declared to be an 'impermissible avoidance arrangement' and the consequence in relation to tax arising therefrom may be determined, subject to the provisions therein, which could include denial of treaty benefits, re-determination of residential status, disregarding of entities / structures etc. These provisions are very widely worded and subjective. On an overall basis, the said provisions would result in a high degree of uncertainty, which is clearly detrimental to the growth of PE/VC investments in India.

1.2. Treaty override

From a VC / PE standpoint, it is critical to have certainty on whether or not offshore VC / PE funds investing into India would be entitled to treaty benefits, as may be applicable. If GAAR is invoked, treaty benefits could be denied. This could effectively make the treaty provisions redundant (in case where GAAR is invoked), which could have the impact of India breaching the contractual treaty terms and hence international law as well as could impact the foreign flow of funds in India.

1.3. Precise scope & objective guidelines

The language of the conditions triggering GAAR including '*misuse or abuse of provisions of tax laws*', '*lacks commercial substance*', '*not for bona fide purposes*' and '*substantial commercial purpose*' etc are very widely worded and subjective. This could be amenable to various differing interpretations even among the income tax authorities. This would result in significant uncertainty on whether or not offshore India investment structures set up by offshore VC / PE funds would be respected and treaty benefits

granted. These provisions could also impact transaction closure/costs owing to uncertainty on witholding tax/representative assessee related liabilities etc.

1.4. Grandfathering for existing structures / arrangements

It is important to grandfather existing structures / arrangements / investments as part of the GAAR provisions and agree from the Revenue authorities' perspective that sham, tax avoidant schemes / structures must not enjoy protection / legitimacy by virtue of grandfathering.

As per Press release dated January 14, 2013 issued by Government of India, it has been stated that investments made before August 30, 2010 i.e. the date of introduction of the Direct Taxes Code, Bill, 2010, will be grandfathered. Further, it has been stated that GAAR is proposed to be effective from April 01, 2016. However, we may also like to re-iterate that GAAR may impact many bona fide structures that have been legitimately put in place based on judicial precedents including those pronounced by the Supreme Court of India and certain circulars issued by the Central Board of Direct Taxes.

Our jurisprudence has always distinguished between tax planning and tax avoidance / evasion; the sanctity of legitimate tax planning has been upheld by the Supreme Court of India on multiple occasions. Owing to the rigour of the proposed GAAR regime, many structures, which may erstwhile have been considered legitimate may get impacted. Such structures have been in existence for several years and many commercial / legal arrangements would have been implemented on the basis thereof at significant cost. It would be prejudicial and unfair to the taxpayer to mid-way subject him to provisions, which did not exist in law when the transactions were entered into.

The Report of the Standing Committee of Finance on the DTC presented before the Speaker on March 9, 2012 ("Standing Committee Report") also states the following:

*"**It would also be fair to apply GAAR provisions prospectively so that it is not made applicable to existing arrangements/transactions.** Alternatively, suitable grandfathering provisions may be made to protect the interest of the tax- payers who have entered into structures / arrangements under the existing law."<<emphasis supplied>>*

In light of the above, in our view, it would be fair to apply GAAR provisions prospectively i.e. from financial year beginning from April 01, 2015 and all the existing arrangements/transactions upto March 31, 2015 be grandfathered.

2. RECOMMENDATIONS

2.1. Treaty override

Clarity on treaty override in appropriate cases must be made explicit so that India's credibility as a reliable treaty partner is not affected. Based on the Shome Committee recommendation, it may be clarified that in cases where anti-avoidance rules are provided in a tax treaty in the form of Limitation of Benefits article etc. (like India-Singapore Tax Treaty), the GAAR provisions should not override the treaty. Further, where Specific Anti-Avoidance Rules (SAAR) are applicable to a particular aspect/element, then GAAR shall not be invoked to look into that aspect/element.

2.2. Objective criteria/ conditions

It is submitted that certain objective criteria / conditions be laid down, which if fulfilled would not result in the triggering of GAAR provisions and its consequential implications on any offshore entity including denial of treaty benefits.

Further, it is recommended that the language clarifying the objective criteria / conditions also include examples of where GAAR provisions would not be triggered. Some such examples could be as follows:

i. Pooling

Where the main object of the offshore entity is to undertake investments, it has at least 10 unrelated shareholders from multiple jurisdictions, none of whom holds more than 49% of the capital of such offshore entity.

Pooling in India presents several regulatory challenges including in terms of obtaining several regulatory approvals, ease of repatriation / transfer, shareholder rights etc. It is quite expedient for parties especially based in multiple jurisdictions to pool at a convenient location outside India, both from a regulatory and commercial perspective. Therefore, the requirement to pool must be construed as a strong substance indicator. The above position is supported by certain rulings pronounced by the Authority for Advance Rulings.

ii. Expenditure

An average expenditure of USD 50,000 per year for a period of 24 months immediately preceding the date on which the income in respect of which treaty benefits is claimed has been earned by the offshore entity.

As you may appreciate, incurring of such expenditure will be on operational matters and is a good indicator of substance.

iii. ***Residuary test***

All the under-mentioned conditions to be cumulatively satisfied:

a) At least two directors who are residents of the jurisdiction wherein the overseas entity is incorporated / set up;

b) The control and management is exercised by the board of directors of the overseas entity;

c) Board meetings are conducted only in the jurisdiction of the overseas entity at least once a quarter and are chaired by the resident directors;

d) Registered office is in the overseas entity jurisdiction;

e) Principal bank account is maintained at all times in the overseas entity jurisdiction; unless economic circumstances deem it fit otherwise (e. g. recent developments in Europe)

f) Books of accounts, accounting records and secretarial records are maintained at all times at its registered office in the overseas entity jurisdiction;

g) Statutory auditor is a resident of the overseas entity jurisdiction;

h) Company secretary is a resident of the overseas entity jurisdiction; and

i) Holds a tax residency certificate issued by the tax authorities of the overseas entity jurisdiction.

A cumulative satisfaction of the above criteria would mean that the entity is not a 'post-box entity' and hence, should be entitled to treaty benefits, as applicable.

Note for all the above examples:

i. If any of the above tests is met by the direct / indirect parent entity (ie. holding more than 50 per cent beneficial interest in the capital of the overseas entity or more than 50 per cent voting power of the overseas entity) of the overseas entity and such parent is established in the same jurisdiction as that of the overseas entity, then it shall be deemed that such test is also complied at the overseas entity level.

ii. Where the main purpose of the overseas entity is to make investments and its investment management or related function is undertaken by any other entity set up in the same jurisdiction as that of the overseas entity and such management entity meets any of the aforementioned tests, then it shall be deemed that such test is also complied at the overseas entity level including any subsidiaries of such overseas entity set up in the same jurisdiction.

2.3. Grandfathering provisions

It is humbly submitted that in the interest of fairness and consistency, the proposed GAAR provisions should not be made applicable to existing structures / arrangements / investments, which are legitimate as on March 31, 2015 and ought to be grandfathered. For instance, any offshore investment vehicle, which is incorporated under a valid local law prior to March 31, 2015, holds a valid tax residency certificate and but for the applicability of the GAAR provisions would have been entitled to treaty benefits, ought to be grandfathered.

B. TAX BENEFITS FOR REITs

1. Background

1.1. SEBI had released the Draft SEBI (REIT) Regulations, 2013 ('Draft REIT Regulations'), which were earlier posted for public comments. The REIT regime has been warmly welcomed by the industry and investor community.

1.2. Under the Draft REIT Regulations, REITs can primarily invest in completed, revenue generating real estate assets and distribute major part of the earning among its investors.

1.3. The REIT regime, once implemented, shall provide an alternative option to investors in the real estate sector in the form of an asset backed investment with regular revenue stream. More importantly, REITs shall provide much needed transparency and liquidity the real estate segment in India. From a private equity/ venture capital standpoint, REITs will create exit opportunities for developers and financial investors and free up cash for further development in this sector.

1.4. While the Draft REIT Regulations are a positive step in maturing the real estate market in India, certain key changes are required in the tax regime for REITs to make it an attractive investment option.

2. RECOMMENDATIONS ON KEY CHANGES IN THE TAX REGIME FOR REITs

2.1. Pass through status to REITs

2.1.1. Under the extant tax regime, income earned by REITs shall be subject to tax at multiple levels (including taxes at SPV level), making it a tax inefficient structure. Further, a high tax outflow would substantially reduce return to investors and make REITs inattractive. Hence, keeping in line with international practice, REITs should be subject to single level of taxation.

2.1.2. In order to ensure pass-through status and a single level of taxation for REITs from an income-tax perspective, the following are the suggested recommendations:

Income-tax

- Income earned by SPVs should be exempt from corporate tax/ Minimum Alternate Tax ('MAT')
- Income earned by REITs should be exempt from tax and REITs should be given a pass through status to ensure single level taxation
- Distributions to unitholders could be subjected to tax at a concessional tax rate of 10-15% in the hands of unitholders

Distribution tax

- Distribution by SPVs to REIT should be exempted from distribution tax.
- Distribution by REIT to unit holders should be exempted from distribution tax.

Withholding tax

- Investee companies and REITsshould be exempted from withholding requirements.

2.2. Taxes on transfer of real estate assets/ shares of SPV

2.2.1. Currently, the real estate assets (such a land, building etc.) may be housed in a SPV by the real estate developer. Accordingly, transfer of such real estate assets/ shares in the SPV would entail huge capital gains tax and stamp duty cost. It would also not be feasible for the developer to transfer the real estate assets at nominal value since the provisions of section 50C/ section 43CA of the Act would impute the stamp duty value to be the deemed sales consideration.

2.2.2. Elimination of capital gains tax and stamp duty cost at the initial stage of transfer of assets/ shares in SPV from the real estate developer to the REIT would assist in making REIT an attractive investment proposition.

2.2.3. In light of the above, the following are the suggested recommendations:

- Capital Gains on initial transfer of real estate assets/ share of SPV by the Sponsor to the REIT should be deferred until the sale of REIT units by the Sponsor since there is no monetization for the Sponsor and also considering that there is a lock-in of 3 years for the Sponsor.
- Stamp duty exemption should be provided: (i) on initial transfer of assets/ shares in SPV into REIT; and (ii) on purchase of real estate assets by REITs.

2.3. **Taxes on transfer of units of REITs**

2.3.1. As per the Draft REIT Regulations, units of REITs are proposed to be listed on the stock exchange. Accordingly, in order to make REITs attractive, concessional tax regime should be provided for units of REITs [similar to listed shares/ mutual fund units]

2.3.2. In light of the above, the following are the suggested recommendations:

- Purchase/ Sale of units of REITs on the stock exchange should be subject to Securities Transaction Tax ('STT')
- Capital gains on purchase and sale of listed REIT units should be subject to concessional tax regime (0% - 15%), subject to payment of STT in line with existing tax structure for listed securities.

IVCA: Budget Recommendations

17 June, 2014

Private Equity / Venture Capital (PE/VC) in India

IVCA

- Over 200 active fund managers operating in India
  - Of which, about 100 are domestic fund managers
- USD 75 Bn investment in Indian companies by PE/VC over the last 10 years
  - USD 7 - 10 Bn of yearly PE/VC investments, which is about 4x the capital raised from IPO
- PE/VC invests across stages – early, growth and matures stages including listed companies

Yearly investment can go from 0.8% to 2 – 3% of GDP with right policies

Potential to invest USD 40 Bn a year by 2015*

IVCA

- Domestic capital pools are opening up, with over USD 1 Bn currently being raised, growing from USD 0.7 Bn in the last year
- Domestic pools are critical for stable long term capital investment in economy
- Domestic pools (pension funds, provident funds, insurance companies) can get high returns from PE / VC, while growing productive assets, compared to other asset classes
- Nature of recommended changes:
  - Revenue-neutral tax modifications
  - Opening up domestic capital pools

*Source: PWC Report

Simplification in applicable tax laws

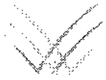
IVCA

- Tax pass-through benefits to all categories of AIFs (PE / VC funds)
- Angel Capital (Community Capital) should be encouraged - s. 56(2)(viib) should ideally be repealed or at least amended.
- Broaden definition of "securities'- s. section 112(1)(c) of the IT
- Section 115QA of the IT Act : Tax on buyback of unlisted shares should be repealed
- Simplify Offshore Transfers
- Tax credit to beneficiary on tax paid by Trusts
- Double taxation of income earned by the PE/VC

Opening up domestic capital pools

IVCA

- Relax regulatory restrictions on institutional pools (insurance funds, pension funds, provident funds and charitable endowments) for investments in PE / VC funds
- DVCF / AIF Category -I should be permitted to invest through infrastructure asset holding companies and Core Investment Companies(CICs) that do not require registration with RBI
- Creating Level Playing Field for Domestic AIF managers
- Remove hurdles to PE / VC exits due to lock-in of shares acquired by way of share swaps or through merger of investee company with the demerged entity of listed company
- Permit AIF to REITS convertibility
- Overseas Listing conditions and procedures need to be liberalised
- Liberalize and enable distressed and turnaround investing



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Asset Management

INDIAN RESTRUCTURING ISSUES LIST

Issue/Action	Position under "Creditor Friendly" European Jurisdiction	Position under Indian Restructuring Law/Practice	Comments/Questions
Transfer of Loan to Fund	Onshore and off-shore funds can typically acquire funded debt receivables without regulatory consents	Off-shore funds cannot buy debt receivables of an Indian company without regulatory consent other than through an ARC.	Ability for offshore funds to buy debt receivables that are in default other than through ARC to be considered. This could simplify process as ARC adds a layer of complexity that is not required in European restructurings.
Legal Treatment of Offshore Funds	Offshore funds tend to have same legal rights in restructuring both contractually and statutorily as on-shore funds	Only banks, financial institutions (as defined in SARFAESI) and ARCs can benefit from SARFAESI rights.	This is an extension of the point above. To extent offshore funds can buy into debt or provide rescue financing, it would be beneficial to enable them to have same rights as Indian banks/ARCs.
No restriction on Sponsor/Promoter tips	Existing shareholders can receive payments/equity for consensual deal without litigation risk from banks who have sold at less	Banks can pursue promoters/equity holders if they receive payments in a consensual restructuring where	The Indian restructuring position makes it difficult to incentivise promoters to enter

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	than par.	banks have not recovered par.	into consensual restructurings.
Share Pledge Enforcement (a) Pledge enforcement	Share pledge enforcements are contractual and can be effected without delays – security trustee can appropriate shares away from the equity and sell to lenders via private (ie non auction) sale provided appropriately valuable (including non-cash) consideration is obtained.	(a) Share pledge enforcement can take up to the contractually agreed number of days to take effect. In the instant case, the pledge agreement requires a notice of 7 days.	Simplified share pledge enforcement mechanics would be beneficial.
(b) Takeover code obligations		(b) Acquisition of a controlling stake in a listed company may trigger the requirement of making an open offer to public shareholders which can take around 60 days. Invocation of pledge by banks and public financial institutions are exempted from an open offer. PS: Clarity required as to whether an ARC would also be exempted.	
(c) Change of management		(c) The process for removing the existing directors can 55-60 days	

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Lender Appointed Administrators	**In UK, non-consensual restructurings are executed through administrators who are officers of the court. They will be able to sell assets and run business and owe duty of care to creditors as a whole but act on the instruction of secured lenders. They can be selected before a sale so that a sale can occur immediately upon an insolvency appointment (via prepackaged sale) thus reducing disruption to the underlying business. Administrators have the power to apply to court to sell the assets free and clear of security. US court has a similar power.**	SARFAESI contains the ability for Banks and ARCs to change the board of directors to implement a sale process but the law does not contain the concept of an administrator. In civil suits, the Court has the right to appoint receivers for a property and confer upon the receiver the power to manage, protect, preserve and or sell the property. Similar principle is followed in Debt Recovery Tribunals i.e. special tribunals set up for recovery of debts due to banks and financial institutions including ARCs. Under SARFAESI, a manager can be appointed in respect of the property	**The ability to effect a quick administration sale is the cornerstone of the rescue culture in the UK and the US. There are sufficient safeguards to prevent sales taking place for anything other than full fair value.** Banks and ARCs are reluctant to implement the management takeover rights as there are fears of shareholder action against interim management with respect to any decisions/steps taken. A European style administrator with statutory rights and protections or a more robust code insulating interim management from shareholder action (or clarifying the duties of the interim management) would be preferable. A stay on litigation when a company goes into administration or if SARFAESI rights invoked would assist in implementation of

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			Indian restructurings.
Taking Management Control	Ability through an administrator to take control as above immediately and to be appointed by secured lenders. Administrators often taken from accounting firms to take management of asset sales.	60 day period for taking management control. No equivalent to a UK administrator under Indian restructuring regime.	The availability of administrator route for managing asset and the speed and ease of appointing an administrator is key to UK restructurings. There is also a wide choice of who can act as an administrator.
Fraudulent Conveyance	Transactions can be set aside and potential recourse to directors/participants	TBD	Ability to examine transactions in the 12 months leading to onset of restructuring and for courts to invoke criminal sanctions for fraudulent conveyances to be available.
Court process	Administrator is an officer of the court and provides a specific specialist restructuring element to court process. Courts are sophisticated and experienced in dealing with restructuring issues.	Litigation relating to enforcement/restructuring is heard by general courts and can be plagued by delays.	The ability to use obstructive litigation as a tool for hold up value by equity holders who are out of the money is an issue for restructurings in India. A separate court for business restructurings and a more expedient court based process would be beneficial.
Directors liability	Directors in UK are flexible on when company needs to file for formal insolvency. The tests are cash flow or balance sheet insolvency with balance sheet rarely relevant. No real criminal liability thus facilitating company rescue.	TBD	This flexibility promotes the rescue of companies in difficulty without directors needing to file for insolvency too early.

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Fiduciary Obligations	Directors ordinarily owe fiduciary duties to the company but the pendulum swings to the creditors where no value in equity or more specifically when the company is in the 'zone of insolvency'.	It is unclear whether directors duties are owed to creditors even if restructuring where not equity value. Directors owe a fiduciary duty towards shareholders. The fiduciary duty may not be linked to equity value.	This avoids a situation where directors act in the interests of shareholders who no longer have an economic interest.
Disclaiming onerous contracts/terminating contracts	In UK, liquidators can disclaim/terminate contracts subject to conditions. In a US Chapter 11 the company can reject onerous contracts.	SARFAESI flexibility to terminate contracts is unclear.	This is a powerful mechanism to be able to assist a company emerge having eliminated unprofitable contracts. Counterparties are still able to claim in the insolvency.
Rescue financing	No UK lender or director liability for permitting lenders to fund a company in distress (unlike other EU jurisdictions). Similarly in the US.	[TBA] India does not have a codified lender liability law and directors' liability is governed by fiduciary responsibility based on the principles of duty and care.	Promotes rescue.
Credit cram down	A scheme of arrangement can be used to drag non-consenting creditors into a restructuring where the majority of creditors of that class (in value and number) consent to the terms of the restructuring including debt releases and changes in terms of the debt.	TBC	It would be beneficial for Indian law to allow 51% by value of creditors to be able to effect a restructuring without non-consenting creditors being able to block the restructuring.

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	This is a useful tool to avoid creditor hold ups.		