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Mr Ajay Tyagi **21th November, 2014**
Additional Secretary
Ministry of Finance
North Block, New Delhi, India

Subject: Appeal to Accord Pass-through status to SEBI-registered Alternative Investment Funds (AIFs) and Measures to Facilitate Private Equity / Venture Capital

Dear Sir,

Venture Capital Funds (VC) and Private Equity Funds (PE), part of Alternative Investment Funds or AIFs, have contributed over USD 80 billion in the last 10 years to a large number of Indian companies at different stages of evolution, with about USD 7 – 10 billion invested in 300 – 400 transactions every year. In fiscal year 2014 itself, the industry invested USD8.2 billion in over 400 transactions. In the last 5 years, PE / VC has provided over twice the capital raised from public markets.

PE / VC funds are the only significant source of risk capital for start-ups, SMEs and growing businesses before they can access the public markets. They have not only provided long-term capital, but have contributed in improving corporate governance, creating jobs and generating increased tax revenues for the exchequer, through direct and indirect tax contribution by their portfolio companies.

The progress of the industry is marked by active participation of domestic fund managers and increasing fund management talent in the country. Domestic institutions such as banks, development financial institutions and insurance companies are increasingly investing in venture capital and private equity funds. Thus, rupee domestic capital has emerged as a significant source of PE / VC in India.

According to the latest study of IIT Madras, nearly 26 percent of investor commitments from funds are from domestic sources. The emergence of domestic sources of PE / VC is a positive trend and needs further encouragement. Larger flow of much needed rupee domestic capital can be tapped, with the help of a sound and appropriate regulatory framework.

According to a study by global consulting firm PricewaterhouseCoopers, there is potential to increase the yearly PE / VC deployment can go up from about USD 10 billiona year to USD

40 billion a year by the year 2025. This potential is highly realizable, and the PE / VC industry can thus become an even greater contributor to the growth of the Indian economy. However, the industry requires the government's support with a few regulatory changes that would help significantly in attracting capital and realizing the said potential.

The summary of the suggested changes are:

1. Tax pass-through for all AIF Categories
2. Encourage and facilitate institutional capital pools to invest in AIFs
3. Clarify non-applicability of Permanent Establishment for Indian offices of foreign funds

A more detailed discussion is provided below.

1. Tax pass-through for all AIF Categories:

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

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

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

Therefore, a reinstatement of the pass-through status to all AIFs is recommended.

2. Encourage and facilitate institutional pools to invest in AIFs:

In most countries, the main sources of PE / VC money are domestic capital pools such as pension funds, insurance companies and charitable endowments. In India these sources are constrained by current regulations. We recommend the restrictions be liberalized as under:

- **Pension Funds:** Amendment of circular PFRDA/2014/02/PFM/1 (January 2014) to permit pension fund managers to invest in AIFs is recommended.
- **Provident Funds:** Inclusion of AIFs in the permitted list of investments for EPFO is recommended.
- **Charitable Endowments:** AIFs are not permitted for investment by Charitable Endowments, under Section 11(5) and Rule 17C of the Income Tax Act, 1961. An amendment of these sections to permit investment in AIFs is recommended.

3. <u>Clarify non-applicability of Permanent Establishment for Indian offices of Offshore Funds:</u>

A recent clarification issued to Foreign Portfolio Investors (FPIs) clarified that fund managers of FPIs who are present in India would not be treated as permanent establishmentsin India, addressing the concern that the FPIs may be taxable in India to the extent attributable to permanent establishments. An extension of the clarifications to AIFs would encourage foreign funds to set up offices in India and help the growth of the industry in the country. This will create local talent pools, which will help in attracting further PE / VC capital into the economy.

Further discussion on these issues are included as Annexures:

- Annexure 1: **Domestic Capital Pools**
- Annexure 2: **Tax pass-through for all AIF Categories**
- Annexure 3: **Opinion by Nishith Desai Associates on the pass-through issue for Alternative investment Funds**
- Annexure 4: **Clarification on non-applicability of Permanent Establishment for Indian offices of Offshore Funds**

We look forward to an expeditious and favourable action to facilitate all sources of private equity, venture capital and domestic AIFs.

Thanking you

Respectfully,

Arvind Mathur
President
Indian Private Equity & Venture Capital Association (IVCA)
+91 97111 10011/+91 98189 34615/+91 95400 84999

Annexure 1 –Domestic Capital Pools

Broad estimates of domestic capital pools in India is indicated below:

Pool	Capital Market Exposure	Investible Wealth (USD Bn)
Individual Wealth (HNI / UHNI)	10% of total wealth	175
Insurance (IRDA)	Cap of 10% of corpus	30
Pension Funds (EPFO & PPF)	Cap of 10% of corpus	45
Charitable Endowments (CBDT)	10% of endowment	10
Total Domestic Pool		**260**

Domestic capital pools have been largely inaccessible to PE / VC Funds (AIFs):

- Only USD 1 Bn (0.4% of investible pool of USD 260 Bn) domestic capital was raised by PE, VC, infrastructure and real estate funds
- 50% allocated to Real Estate Funds
- 40% allocated to PE / VC
- 10% allocated to Infra Funds

Annexure 2 –Tax pass-through for all AIF Categories

Issue

1. Section 10(23FB) of the Act, inserted in the Act by the Finance Act 2000, encapsulates the current provisions for taxation of VCFs registered with SEBI[1]. Section 10(23FB) of the Act, until its amendment by the Finance Act 2007, provided an exemption on *any* income earned by SEBI registered VCFs. At this stage, VCFs were exempt from tax on any income earned irrespective of whether the income is derived from investment in a venture capital undertaking (VCU)[2] (albeit section 115U of the Act provides for the discharge of taxes by the investors on the income earned by the VCF). This provision was amended by the Finance Act 2007 to introduce limitations to the aforesaid exemption to only income from investment in specified sectors[3]. Subsequently, based on industry representations on the hardships faced by VCFs, section 10(23FB) of the Act was again amended by the Finance Act 2012 to remove the sector restrictions and once again exempt income earned by VCFs. The distinction however was that in the 2012 amendment, the exemption was restricted to only income from investments in VCUs (as defined in the VCF Regulations) leaving the residual income (from treasury investments and investments in entities that do not qualify as a VCU) to be taxed at the VCF level.
2. As discussed above, in May 2012, the VCF Regulations were repealed and the AIF Regulations were notified by SEBI. With a new regulatory framework, there was a need for the Act to provide a basis for taxation of AIFs. Consequently, the Finance Act 2013 amended section 10(23FB) of the Act to extend the tax treatment for VCFs to only the VCF sub-category of Category I AIFs. Therefore, this amendment left outside the purview of section 10(23FB) a majority of the AIFs who presently do not have a specific code in the Act for their taxation.
3. Pertinently, section 115U of the Act which is a corresponding provision in the tax law that deals with taxation of income earned by investors in VCFs (and now AIFs) provides a direct charge of tax on the investors for such income (to the extent it is exempt at the VCF/AIF level) in the same manner as it would have been taxed had the investor made the investment directly. *In essence therefore the provisions of sections 10(23FB) and 115U of the Act provide a single level levy of tax on specified income from investments in venture capital funds.* This is similar to the manner in which determinate trusts formed and registered in India are taxed. The sections merely clarify the party that will be liable under the Act to pay the tax.
4. The present tax provisions creates the following disparities:
    - Sections 10(23FB) and 115U of the Act apply only to VCF sub-category of Category I AIFs. The AIF Regulations recognise Category I AIFs as AIFs that *"are generally*

1 Before the introduction of section 10(23FB), taxation of VCFs was governed by section 10(23F) and subsequently by section 10(23FA) of the Act

2The SEBI (VCF) Regulations, 1996 have historically permitted registered VCFs to invest in any sector (subject to a negative list). The investment conditions permit VCFs to invest (upto a specified extent) in companies other than those that qualify as a VCU under the VCF Regulations

3The Act specified a list of nine sectors for this purpose by defining the term VCU in a more restrictive manner *perceived to have positive spillover effects on economy and for which the Board or Government of India or other regulators in India might consider providing incentives or concessions"*. However, the tax provisions have only been extended to VCF sub-category of Category I AIFs thereby creating a disparity inter se in the tax treatment of different types of Category 1 AIF funds (other subcategories include SME funds, social venture funds, infrastructure funds).

- *Category II (which comprise of private equity and debt funds also have a positive spillover effect on the economy) and Category III funds are not entitled to tax pass through status.*

Finally, VCFs/AIFs are permitted by the SEBI regulations to make investments in entities that do not qualify as VCUs to a specified extent. The present tax pass-through treatment, where available, only extends to income from investment in VCU. This creates dual points of tax compliance ie income from VCU investments is taxed at the investor level and income from non-VCU investments at the trust level, which adds to the complexity for investors, fund managers and the tax administration.

Issues with trust taxation

5. The majority of domestic VCFs/AIFs are constituted in the form of trusts. Where a codified tax provision for taxation of VCFs/AIFs (including for a portion of their income) is not available, one would need to fall back on the provisions of the Act as relevant to taxation of trusts generally. The provisions for taxation of trusts contained in section 160 to 166 of the Act had been designed prior to the evolution of the funds industry - mutual funds, private equity, AIFs etc.

Determinate vs indeterminate

The provisions of section 161(1) of the Act impose the tax liability in respect of a trust's income on its trustee in a representative capacity, the trustee in turn is required to determine the tax liability *"in a like manner and to the same extent"* had the tax been recoverable from the beneficiaries directly. This section applies where the individual shares of the beneficiaries are determinate and known. Explanation 1 to section 164 is a special provision that sets out the circumstances in which the individual shares of a beneficiary are indeterminate and unknown. The Explanation casts some doubt on whether the individual shares of the beneficiaries of a VCFs/ AIFs, who may join the fund at various stages, are "determinate and known" for the purposes of taxation[4]. Briefly, a trust is regarded as a determinate trust, if the name of the beneficiaries and their individual shares are expressly stated in the instrument of trust and are identifiable on the date of instrument. If the individual share of the persons for whose benefit such income is receivable is not ascertainable on the date

[4] Conceptually, a VCF/AIF will always be determinate given that at any given point of time, the income/assets of the trust belong to a determinate set of investors for a certain share

of the instrument, the trust is regarded as an indeterminate trust. In such a case, the income of the trust is taxable in the hands of the trustee at maximum marginal rate (MMR).

Circular No. 281 dated September 22, 1980, which explained the amendments to the Act by the Finance (No 2) Act, 1980, specifically stated that "it is not necessary that the beneficiary in the relevant previous year should be actually named in the … instrument of trust, all that is necessary is that the beneficiary should be identifiable with reference to the … instrument of trust on the date of such … deed". Further, the Circular clarifies that trusts under which discretion is given to the trustee to decide allocation of income every year or where a right is given to the beneficiary to exercise the option to receive the income or not each year will be regarded as discretionary trusts.

Given the manner in which AIF's raise investor commitments, it is practically not feasible to know the names of the beneficiaries at the time of formation of trust as the raising of money typically happens subsequent to the formation of trust/ registration with SEBI. Thus, in a majority of the cases, the investor names and shares are not known on the date of the trust deed. However, since the trust deed and associated legally binding documentation expressly set out the manner in which beneficiaries are to be ascertained and also the shares to which each of the beneficiaries would be entitled a position is adopted that the trust is a determinate trust. In this regard, reliance is placed on the decision of the Authority for Advance Rulings, in the case of AIG [1997] 224 ITR 473.

Capital gains vs business profits

Section 161(1A) of the Act provides that where the income of a trust consists of or includes profits and gains of business, tax shall be charged on the whole of the income of the trust at the maximum marginal rate.

CBDT Circular No. 13 dated 28 July 2014 (CBDT Circular)

6. In response to the clarifications sought on tax treatment of AIFs (not covered under section 10(23FB) of the Act), the CBDT Circular provides the following clarification -

- Where the trust deed does not name the investors or does not specify their beneficial interest, the trust will be regarded as an indeterminate (or discretionary trust) - resultantly, under the provisions of section 164 of the Act, the entire income of the fund shall be taxed at MMR in the hands of the AIF's trustee. Provisions for direct taxation of investors contained in section 166 of the Act shall not be invoked as income has already been taxed in the hands of the trustee.

- Where the trust deed names the investors and their beneficial interest and the trust's income consists of or includes business profits, the whole of the AIF's income would be subject to tax at MMR in the hands of the trustee as per section 161(1A) of the Act.

- The circular also states that it shall not be operative in the area falling in a High Court jurisdiction that takes or has taken a contrary decision on the issue.

The circular instead of clarifying and simplifying the taxation of AIFs (not covered under section 10(23FB) of the Act), has created significant tax uncertainty.

We have summarised below the key tax issues faced by AIFs -

- As on 31 May 2014, 106 funds have been registered under the AIF Regulations. Out of these, about 90 AIFs are Category I (other than VCF)/ Category II/ Category III, with majority being Category II AIFs i.e. funds which invest in companies/ sectors which have a high growth potential. Under the Act, AIFs registered as Category I (Other than VCF), II & III do not have a specific tax 'Pass through', since section 10(23FB) of the Act, is applicable only to Category I - VCFs.

- Characterization of income from investments in securities has always been a vexed issue with no objective criteria and only guiding principles to distinguish a capital asset and stock in trade. The CBDT Circular provides that if the income of a determinate trust consists of or includes business profits, it will be subject to taxation at MMR. While this is already provided under the Act, now there is greater probability of tax authorities characterising the gains from investments by AIFs as 'business profits' so as to tax the entire income at MMR. In view of the subjective nature of this determination, given that Category I and II AIF's typically have a medium to long term view on their investments a clarification that their income would be deemed to be capital gains would help in achieving certainty on this aspect as well.

Section 10 (23FB) of the Act does not provide tax pass through treatment to non-VCU income of VCFs and AIF Category I - VCF. Taxation of non-VCU income at trust level, creates dual points of tax compliance ie income from VCU investments is taxed at the investor level and income from non-VCU investments is taxed at the trust level. This adds to the complexity for investors, fund managers and the tax administration.

Suggestion

- Amend section 10(23FB) of the Act to provide a tax pass through status to all Categories of AIFs (at least all Category I and II AIFs) and all income earned by them.

- Correspondingly amend section 115U of the Actto impose the tax liability on the AIFs income on its investors, based on the details provided by the AIF.
- Exempt from tax withholding provisions any interest payments to AIFs (this will mitigate the AIFs need to file a tax return solely for the purposes of claiming a tax refund).

Rationale

- Several committees[5] have greatly emphasized the importance of providing fiscal neutrality to VCFs, as income is taxed in the hands of the final recipient and the intermediary body is considered a pass-through entity. A pass-through tax status granted to SEBI-registered AIFs would put India at par with other countries, where the tax pass-through is automatically available to collective investment vehicles.
- A tax pass-through system ensures that tax collected on the fund's income is no more than the tax that would have been payable had the investor invested funds directly in the investee company/asset. This is fundamentally the basis on which Indian determinate trusts are taxed under the provisions of the Act. Accordingly, where the tax pass-through is extended to AIFs, there should not be any loss to the revenue, on an as is basis. Further, there is also no deferral of tax since the investors will be liable to pay tax as and when income is accrued to the AIFs.
- On the contrary, clarity of tax pass through should bring additional flows into the AIFs, which as they accrue capital appreciation should result in additional tax receipts to the Government. Further, growth of the AIFs in India would directly contribute to growth in fees for managers of AIFs, which again will directly correspond to growth in corporate and individual income-tax and service tax collections[6].

[5]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

[6]Illustratively, for every Rs 1,000 crores growth in assets under management (AUM), the approximate service tax collected will be Rs 2.5 crores (assuming an average fee of 2% of AUM) and corporate and individual income-tax will be Rs 4.5 crores (assuming that 75% of gross income would be subject to income-tax allowing for 25% of expense deduction other than salaries). Itis estimated that tax certainty can contribute to at least a 50% growth in inflows in PE funds which would have a significant multiplier effect on the Indian economy.

Annexure 3- Opinion by Nishith Desai Associates on the pass-through issue for Alternative Investment Funds

Sub: Pass-through status for Private Equity / Venture Capital Funds

The difficulties relating to pass-through status for alternate investment funds in India has a critical impact on domestic and cross-border fund raising and investments. Pass-through status for funds is an internationally accepted norm and is never an issue in most countries globally.

Over 10 billion dollars have been invested by Private Equity Funds into India over a period of last 10 years although there has been significant slowdown in the past few years. There is an opportunity to attract huge investment from the Private Equities in the coming years if we set our tax environment in place.

Most collective investment vehicles in India are organized as trusts due to the absence of other sophisticated vehicles in India. Internationally funds are organized as trusts, limited partnerships, limited liability companies (LLCs), specialized corporate fund vehicles such as the open ended Société d'Investissement À Capital Variable (SICAV) or closed ended Société d'investissement à Capital Fixe (SICAF), etc. In all cases, only the investors (ie the beneficiaries or limited partners) are taxed. The fund itself is never taxed as it is simply a pooling vehicle for investors. True pass-through treatment is always guaranteed and an integral aspect of fund economics. Therefore, imposing tax at the fund or trust level is a non-starter for investors.

Unfortunately in India, the regime for taxation of trusts has become very complicated. We have over time deviated significantly from not only international standards but also from the well-defined principles of trust taxation as originally contemplated in the Income Tax Act of 1961 (IT Act). Therefore, even in cases where attempts have been made by lower authorities to deny pass-through status, Courts have consistently rejected such approaches. It is unfortunate that funds and investors have to always be anxious of litigation in relation to a matter as simple as pass-through status of the fund / trust.

The basic principle of trust taxation is that only the beneficiaries / investors should be directly taxed as long as the trustees can, at any point in time, identify the beneficiaries (ie the investors) and their respective share. Otherwise, the trust (i.e. trustee) could be taxed at the highest tax rate.

This has always been the law as upheld by the Supreme Court (*HEH Nizam's trust case*), the Authority for Advance Ruling (*AIG case*) and very recently by the Income Tax Appellate Tribunal (*India Advantage Fund case*). However, this basic principle is not applied in practice and funds are often drawn into avoidable litigation.

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In India, we have created different tax regimes for venture capital funds (as opposed to private equity funds), infrastructure funds, social impact funds, securitization trusts, mutual funds, real estate investment funds, etc. This is further complicated by provisions relating to business trusts, capital gains tax regime and the ambiguities created by the recent Circular No. 13/ 2014. The structure, articulation and drafting of the laws itself has been a cause of uncertainty resulting in enormous litigation.

Suggested action:

We suggest that India introduces a consolidated and simple regime for taxation for all kinds of trusts and funds based on the internationally accepted norm of true pass-through status.

Considering the urgency in providing a boost to fund raising and attracting foreign and domestic investment, we recommend the following immediate steps:

1. Withdraw Circular No. 13/2014 and immediately issue a new circular providing true pass through to AIFs.
2. Introduce amendments to relevant sections of the IT Act especially Section 10 (23FB) and 115 U.

It is important to provide true pass-through status for funds backed by a clear, principle-based regime for trust taxation in line with international standards. This will bring immense certainty for domestic and foreign investors and will give a boost to fund raising and investments. Today, the time is ripe to tap these investment pools and India really needs these funds to fuel its economic growth.

C-7, PASHCHIMI MARG, VASANT VIHAR, NEW DELHI-110057, +91 (11) 41730003, 46160389, info@indiavca.org
CIN: U74900DL2010NPL198236, www.indiavca.org

Annexure 4 – Clarification on non-applicability of Permanent Establishment for Indian offices of Offshore Funds

Issue

Fund managers have been sceptical about setting up operations in India/ appointing an Indian Manager to manage foreign funds on account of the risk that the offshore fund's profits / gains and other income may be exposed to tax in India at the maximum rates.

Briefly, the presence of Offshore Fund Manager in India or appointment of an Indian Fund Manager could create a business connection or a Permanent Establishment (PE) of the Offshore Fund in India, in certain circumstances. In such a case, the income of the Offshore Fund to the extent attributable to the operations in India, could be taxed in India. Further, if the Offshore Fund is a non-corporate entity, it could also result in the Offshore Fund being regarded as a tax resident of India. In such a case, the global income of the Offshore Fund could be exposed to tax in India. All this discourages the Offshore Funds from shifting the fund operations to India / appointing qualified and experienced Indian Fund managers.

With a view to putting an end to this uncertainty and to encourage the fund managers to shift to India, an amendment[7] was made by the Finance (No. 2) Act 2014, to provide that income earned by Foreign Portfolio Investors (FPIs) from investment in securities would be characterised as capital gains.

However, a similar clarification was not provided for Offshore Funds which invest under the Foreign Direct Investment route or the Foreign Venture Capital Investment route i.e. private equity funds, real estate funds, infrastructure funds amongst others, which face the same challenges that the FPIs face.

Suggestion

Provide clarification that the management of all or part of the activities of the Offshore Fund in India would not result in the Offshore Fund or its investment manager being regarded as resident in India. Further, clarify that activities carried out in India would not result in the investment manager in India being considered a PE of the Offshore Fund.

In this regard, we request that the following amendment could be considered in the relevant provisions of the Income Tax Act, 1961 (the Act):

"Inclusion of clause (e) in Explanation (1) of section 9(1)(i)

[7] Section 2(14) of the Act

(e) in the case of an Offshore Fund, no income shall be deemed to accrue or arise in India to the Offshore Fund by reason of the management of all or part of its activities being carried out from India and / or its Investment Manager or an Advisor based in India.

For the removal of doubts, it is clarified that the management of all or part of the activities of the Offshore Fund from India would not result in the Offshore Fund or its Manager being regarded as being Resident in India as that term is defined in Section 2(42). It is also further clarified that these activities carried out in India would not result in the Investment Manager or the Advisor in India being considered a Permanent Establishment of the Offshore Fund or its Manager as that term is defined in Section 92F(iii)(a).

For the purpose of this clause, an 'Offshore Fund' means a collective investment scheme or an investment entity that carries on similar activities, domiciled in a country outside India.

A 'Manager' or 'Investment Manager' means any person who has the authority directly or indirectly to exercise discretion on behalf of the Offshore Fund."

Rationale

- Given the adverse tax consequences, a large number of Offshore Funds choose to locate their investment manager outside India. By providing clarity on issues relating to business connection/ PE and residential status of the Offshore Funds, India could benefit immensely since it would provide a sense of comfort to the investors for choosing India as the base for investment managers.

- Additionally, in the long run, clarity on the tax issues would encourage Offshore Funds to directly pool money from its investors into funds located in India. This has the potential of immediately switching substantial foreign investment commitment presently raised by funds domiciled in offshore jurisdictions as commitments to Indian AIF of the sponsor's affiliates thereby potentially giving a boost to the sector.