INDIAN PRIVATE EQUITY
& VENTURE CAPITAL ASSOCIATION

To,

18th June, 2014

Hon'ble Smt. Nirmala Sitharaman,
Minister of State (IC) for Commerce and Industry
Room Number 45
Udyog Bhawan
New Delhi
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Dear Honorable Smt. Nirmala Sitharaman,

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.

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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.

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 the Transfer TDS credits by the Fund to the beneficiaries. Further suitable mechanism, so that required credit will appear in the Form 26AS of the beneficiaries and revenue authorities may not dispute the tax credit.

- 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 (see email dated 12th June, 2014).