6th April, 2015

Mr. Ashok Lahiri,
Chairman, The High Level Committee (HLC)
Former Chief Economic Advisor (CEA),
Room No. 215 – Janpath Hotel,
New Delhi - 110001

Shri Sidhartha Pradhan,
Member, The High Level Committee (HLC)
Retired Member, Settlement Commission (Income Tax & Wealth Tax)

Shri Gautam Ray,
Member, The High Level Committee (HLC)
Retired DG (Audit) Customs and Central Excise

Subject: Recommendations: Proposed amendments in the Union Budget 2015-16 – AIF/private equity / venture capital sector

Dear Sirs,

The Indian Private Equity & Venture Capital Association and its members (IVCA) wish to congratulate the Government on the various proposals announced in the Union Budget 2015-16 for beginning India's journey towards sustained growth and macro-economic stabilization, through job creation, promotion of domestic manufacturing, investment and 'Make in India'.

This letter is divided into the following parts:

Part I : Introduction

Part II : Domestic Private Equity & VC Funds - Alternative Investment Funds

Part III : International / Offshore Private Equity & Venture Capital Funds

Part I: Introduction

From a private equity and venture capital funds perspective, the proposals to defer GAAR by two years and clarifications on indirect transfer provisions have been welcomed by the investor community. The proposed tax 'pass through', subject to some modifications, to Alternative Investment Funds will provide clarity to funds and investors on tax treatment of their investments in such funds.

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Further, the proposed safe harbour rule for fund management in India is a step in the right direction to remove the tax impediments which have deterred offshore funds from shifting fund management activity to India. In summary, the proposals, if suitably enhanced will provide a compelling vision that will encourage (i) the flow of domestic savings into private equity and venture capital assets and (ii) strengthen the onshore fund management industry.

Private equity has been a significant source of long-term risk capital for the Indian industry and it is reported that private equity funds (domestic and foreign) have invested an estimated USD 93 billion in Indian companies at different stages of evolution, during the last 13 years. The investment has resulted in the creation of several lakh jobs in the organised sector.

To the extent possible, we have also recommended the drafting language which could be considered for amending the Finance Bill 2015 (Bill) as it relates to the issues identified herein.

The following key recommendations, if implemented in their entirety, would go a long way in developing India's private equity and venture capital sector.

Part II: Domestic PE & VC Funds - Alternative Investment Funds (AIFs)

(A) Taxation of Category I and Category II Alternative Investment Funds (collectively referred as Category I and II AIFs or AIFs) - refer Annexure 1 for detailed rationale

- Provide tax pass-through for any income of Category I and II AIFs and amend the definition of 'capital asset' under the Income-tax Act, 1961 (Act) to include investments held by AIFs for a period of more than 12 months. Certainty that there cannot be any dispute with tax authorities on business income will go a long way in creating a positive environment.
- Clarify that 10% tax withholding should not apply to payment of income which is exempt under the Act. In case of payment of income to a non-resident, tax withholding should be at a lower rate of 5% or at the rates in force.
- Similar to the pass through for net income, net losses incurred by AIFs under any head of income, should also be allowed to be passed on to investors.

Part III: International / Offshore Private Equity & Venture Capital Funds

(A) Safe harbour rule for fund management in India - refer Annexure 2 for detailed discussion

- Entities registered as Foreign Portfolio Investors (FPIs or FIIs) or Foreign Venture Capital Investors (FVCIs) under the applicable regulations framed by the Securities and Exchange Board of India (SEBI) should automatically qualify as an 'eligible investment fund'.
- The minimum number of members of a fund could be lowered. For ascertaining the number of members in a fund, direct members/ beneficiaries as well as underlying members/ beneficiaries should be counted.

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- Some of the clauses of section 9A(3) should not apply where the investing entity is a foreign Government or a Government related investor including sovereign wealth funds, pension funds, etc.
- The threshold of participation interest of a single investor in the fund should be increased from 10% to 49%.
- Clarify that activities undertaken by a fund in connection with its investment in the investee company will not result in the fund carrying on, or controlling and managing, any business in India or from India.
- Clarify that non-compliance with the reporting requirements under section 9A(5) will not result in an eligible investment fund losing the benefits under section 9A of the Act.

(B) **Non applicability of Minimum Alternate Tax (MAT) provisions to foreign companies - refer Annexure 3 for detailed discussion**

- Clarify that MAT provisions shall not apply to foreign companies investing into India (including FIIs) which do not have a place of business in India.

(C) **Clarification on indirect transfer provisions - refer Annexure 4 for detailed discussion**

- Clarify that indirect transfer provisions shall not apply to (a) transfer of units (which do not result in participation in control and management of the fund) by the non-resident investors in the fund and (b) transfer caused by redemption of capital assets that may be deemed to be situated in India, if the said transfer/ redemption is directly, or indirectly, in consequence of, or by reason of, transfer of capital assets situated in India.

(D) **Place of Effective Management - refer Annexure 5 for detailed discussion**

- Delete the words 'at any time in that year' from clause (ii) sub-section (3) of section 6 of the Act, since it significantly widens the definition of resident, resulting in unintended consequences.

We firmly believe that if the above recommendations are implemented, it will help in stepping-up the ability of the private equity / venture capital sector to mobilise a larger volume of much-needed, stable long-term capital for investments in small and medium enterprises, infrastructure, social projects and start-ups. This will eventually result in additional flow of long-term funds for domestic manufacturing, jobs and higher revenues for the Government.

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We will be very grateful if the Government can implement the suggestions made in this letter and in the attachments.

Thanking you,

Respectfully,

Arvind Mathur, President
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Attachments

Annexure 1: Domestic Private Equity & Venture Capital Funds Alternative Investment Funds (AIFs)

Annexure 2: Offshore Private Equity & Venture Funds: Safe harbour rule for fund management in India

Annexure 3: Offshore Private Equity & Venture Capital Funds-Non applicability of MAT provisions to foreign companies

Annexure 4: Offshore Private Equity & Venture Capital Funds: Clarifications on indirect transfer Provisions

Annexure 5: Offshore Private Equity & Venture Capital Funds: Place of Effective Management

Appendix 1: Offshore Private Equity & Venture Capital Funds: Regulation 4 of SEBI (Foreign Portfolio Investors) Regulations, 2014

Appendix 2: Offshore Private Equity & Venture Capital Funds: Regulation 4 of SEBI (Foreign Venture Capital Investors) Regulations, 2000

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Annexure 1

Domestic Private Equity & Venture Capital Funds
Alternative Investment Funds (AIFs)

1. Taxation of Category I and II AIFs

1.1. Background

1.1.1. As a progressive move to rationalise the taxability of AIFs and their investors, the Finance Bill, 2015 (Bill) proposes to provide a special tax regime for Category I and II AIFs (defined as 'investment funds') by insertion of a new chapter, Chapter XII-B in the Act. The amendments to the Act proposed to be introduced by the Bill are summarised below:

- Income of a unit holder out of investments made in an investment fund shall be chargeable to tax in the same manner as if it were income of the unit holder from investments made directly.
- Income in the hands of the unit holder shall be deemed to be of the same nature and in the same proportion as it has been received or accrued to the investment fund.
- Income taxable under the head "Profits and gains of business or profession" shall be taxable in the hands of the investment fund at the applicable tax rates where such fund is a company or firm and at the maximum marginal rate in other cases.
- Income, other than business income taxable at the investment fund level, shall be exempt from tax in the hands of the investment fund.
- Business income of the investment fund shall be exempt from tax in the hands of the unit holder.
- Undistributed income of the investment fund shall be deemed to have been credited to the unit holder on the last day of the financial year (i.e. 31 March).
- Net loss, computed in accordance with the provisions of the Act, incurred by the investment fund in any financial year shall be carried forward to be set-off by the investment fund in accordance with the Act and shall not be distributed to the investors in the manner described above.
- The provisions of dividend distribution tax (section 115-O) and tax on distributed income (section 115R) shall not apply to the income paid by an investment fund to its unit holders.
- Taxes shall be withheld at the rate of 10% (proposed section 194LBB) on income payable by an investment fund to a unit holder (other than business income).
- The investment fund shall be mandatorily required to file a return of income [proposed section 139(4F)] and to provide to the Indian Revenue authorities and the unit holders; a statement giving details of various components of income and such other particulars as may be prescribed.

Further, the Memorandum to the Bill provides that the income received by the investment fund would not be subject to tax withholding requirements.

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The Indian private equity and venture capital sector welcomes the proposed special tax regime, which should provide the much needed clarity and certainty to AIFs and their investors. The special tax regime, along with the recommendations outlined below, should provide a significant fillip to AIFs to mobilise higher resources, domestic and foreign, and make higher investments in small and medium enterprises, infrastructure and social projects and provide the much required private equity to new ventures and start-ups.

1.2. ***Characterisation of gains earned by AIF as 'capital gains'***

1.2.1. The characterisation of income/gains derived by an AIF is the premise on which the tax liability of the AIF/ its investors is to be determined under the proposed special tax regime. Once the income/ gains derived by an AIF (or a portion thereof) are treated as business profits, the tax of such income/ gains is charged in the hands of the AIF and the investor in the AIF is exempt from tax on such income/ gains.

1.2.2. The characterisation of gains from an investment activity as 'capital gains' or 'business profits' is a vexed issue. There are several judicial precedents on this aspect, which have established certain subjective principles. The CBDT vide Instruction No. 1827 dated 31 August 1989 and Circular No. 4/2007 dated 15 June 2007 provide some guidance for determining whether shares are held as 'stock-in-trade' or as 'capital asset'.

1.2.3. AIFs are privately pooled investment vehicles which collect funds from investors, whether Indian or foreign, for investing in accordance with a defined investment policy for the benefit of their investors. Further, Category I and II AIFs predominantly invest in unlisted investee entities with a medium to long-term investment horizon (typical holding periods would range from 2-5 years). The investments by AIFs are made out of the funds collected from their investors; their ability to borrow is severely restricted under the Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012 (AIF Regulations).

1.2.4. Historically, Category I and II AIFs have characterised their gains from investment activity as 'capital gains' relying on the principles emanating from the CBDT instruction/ circular and judicial precedents. In the course of scrutiny audits, however, the Indian Revenue authorities re-characterise the gains/income of the AIFs as 'business profits' thus leading to litigation.

1.2.5. In view of the controversy on this subject, the proposal to distinguish the tax regime for the AIF/ its investors based on income characterisation would lead to litigation, potential double taxation and diminish the impact of the proposed special tax regime for the private equity / venture capital sector.

To illustrate the point, take an example of an AIF that takes a view that gains from investments in unlisted equity shares of Indian companies are 'capital gains'. The AIF would claim an exemption for such 'capital gains' in its tax return and pass on the capital gains to its investors after withholding tax at the rate of 10% at the time of credit/ payment of

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income. The investors, in turn, subject to their individual tax attributes, would offer such capital gains to tax in their income-tax return. Should the Indian Revenue authorities re-characterise the gains as ‘business profits’ in concluding the scrutiny audit of the AIF, tax would be collected from the AIF at 30% on such profits without any corresponding relief/ refunds to the AIFs investors who would be distributed across several jurisdictions in India.

Recommendations

1.2.6. Based on the above, it is humbly submitted, that in order to mitigate controversy and provide clarity and certainly to AIFs and their investors, the special tax regime should not make a distinction between ‘business profits’ and other income and consequently provide a tax pass-through treatment for any income of Category I and II AIFs.

Additionally, it should be provided that investments held by a Category I / II AIF for a period of more than 12 months shall be deemed to be a ‘capital asset’ as defined in section 2(14) of the Act.

Further, since the issue on characterisation of gains from an investment activity as ‘capital gains’ or ‘business profits’ is also relevant for offshore private equity funds, it should be provided that investments made by an eligible investment fund (as defined in the proposed section 9A(3)) shall be deemed to be a ‘capital asset’ under the Act.

This will require following amendments-

In **clause 7** of the Bill, (c) after clause (23FB), the following clauses shall be inserted, namely:— ‘(23FBA) any income of an investment fund ~~other than the income chargeable under the head “Profits and gains of business or profession”~~; ~~(23FBB) any income referred to in section 115UB, accruing or arising to, or received by, a unit holder of an investment fund, being that proportion of income which is of the same nature as income chargeable under the head “Profits and gains of business or profession”.~~ Explanation.—For the purposes of clause~~s~~ (23FBA) ~~and (23FBB)~~, the expression “investmentfund” shall have the meaning assigned to it in clause (a) of the Explanation 1 to section 115UB;’; In **clause 32** of the Bill, CHAPTER XII-FB SPECIAL PROVISIONS RELATING TO TAX ON INCOME OF INVESTMENT FUNDS AND INCOME RECEIVED FROM SUCH FUNDS ~~(4) The total income of the investment fund shall be charged to tax—~~

~~(i) at the rate or rates as specified in the Finance Act of the relevant year, where such fund is a company or a firm; or~~
~~(ii) at maximum marginal rate in any other case.~~

In **clause 46** of the Bill,

'194LBB. Where any income~~, other than that proportion of income which is of the same nature as income referred to in clause (23FBB) of section 10,~~ is payable to a unit holder in respect of units of an investment fund specified in clause (a) of the Explanation 1 to section 115UB, the person responsible for making the payment shall, at the time of credit of such income to the account of payee or at the time of payment thereof in cash or by issue of a cheque or draft or by any other mode, whichever is earlier, deduct income-tax thereon at the rate of ten per cent.

Proposed amendment to section 2(14) of the Act:

Capital asset means –
(a) property of any kind held by an assessee, whether or not connected with his business or profession;
(b) any securities held by a Foreign Institutional Investor which has invested in such securities in accordance with the regulations made under the Securities and Exchange Board of India Act, 1992
(c) any investment held for a period of more than 12 months by an Investment Fund in accordance with the regulations made under the Securities and Exchange Board of India Act, 1992.
(d) any investment made by an eligible investment fund.

Explanation 2: For the purpose of this clause –
(a) the expression "Foreign Institutional Investor" shall have the meaning assigned to it in clause (a) of the Explanation to section 115AD
(b) the expression "Investment Fund" shall have the meaning assigned to it in clause (a) of the Explanation 1 to section 115UB
(c) the expression "securities" shall have the meaning assigned to it in clause (h) of section 2 of the Securities Contracts (Regulation) Act, 1956
(d) the expression "eligible investment fund" shall have the meaning assigned to it in sub-section 3 of section 9A

1.3. *Withholding tax at 10% by the AIF*

1.3.1. Withholding tax serves as a useful mechanism for the Indian Revenue authorities to combat tax evasion and to track whether the income has been offered to tax by the recipient tax payer.

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1.3.2. AIFs welcome the introduction of a withholding tax on payment/ credit of income to the AIFs investors. The tax withholding provision proposed in the Bill (section 194LBB) is however drafted in a manner that may lead to the following implications, perhaps unintended:

- Applicability of withholding tax on credit/ distribution of income exempt under section 10 of the Act, for example, dividend income [exempt under section 10(34)], specified long-term capital gains [exempt under section 10(38)], and gains on buyback of shares by domestic companies [exempt under section 10(34A)].
- Applicability of withholding tax on credit/ distribution of income paid/ payable to non-resident investors eligible for beneficial provisions of a double tax avoidance agreement.
- Applicability of withholding tax on credit/ distribution of income to entities which are exempt from tax under the Act, for example, any Regimental Fund or Non-Public Fund established by the armed forces of the Union for the welfare of the past and present members of such forces or their dependants, etc.
- It is pertinent to note that the AIF Regulations permit (a) Category I AIF to invest into units of Category I AIFs of same sub-category and (b) Category II AIF to invest in units of Category I AIF and Category II AIFs. In such a scenario, the applicability of withholding tax on income payable by an AIF to another AIF will result in dual tax withholding before the income is credited to the investor in the AIF.

1.3.3. Tax withholding in the above scenarios would lead to deferment of realisation of income/ gains for the investors as they will need to claim the tax withheld in their respective income-tax returns as refunds. As such, collection of withholding tax in such cases would not increase the revenues of the Government and result in the Government incurring interest costs for the period the tax is not refunded to the tax payers. Accordingly, it would be appropriate to exclude the above from the withholding tax net.

1.3.4. The provisions of section 197 of the Act provides an opportunity to the assessee to apply for certificate allowing deduction of income-tax at lower rates or no deduction of income-tax. However, such certificate can be applied only in case of withholding requirements prescribed under certain sections of Chapter XVII of the Act. The list of such sections mentioned as part of section 197(1) does not include the proposed section 194LBB. The absence of section 194LBB as part of section 197(1) will lead to unintentional hardships to investors who could otherwise have obtained nil or lower withholding tax certificate under section 197 of the Act.

Recommendations

1.3.5. Based on the above, it is humbly submitted that the tax withholding provisions should not apply to payment of income by the AIFs to its investors if the income is exempt from tax under section 10 of the Act (either based on the nature of income paid/ payable or the tax attributes of the investor). Further, the tax withholding in the case of a non-resident (including a foreign company) should be at a lower rate of 5%, consistent with the

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withholding tax rate on income payable by a business trust(Infrastructure Investment Trust or Real Estate Investment Trust) to a non-resident unit holder under section 194LBA(2) of the Act.

Additionally, include section 194LBB as part of section 197(1) for providing an opportunity to apply for Nil/ lower withholding tax certificate, where total income justifies lower or no deduction of income-tax.

This will require following amendments -

In **clause 46** of the Bill,

'194LBB. **(1)** Where any income~~, other than that proportion of income which is of the same nature as income referred to in clause (23FBB) of section 10,~~ is payable to a unit holder**, being a resident,** in respect of units of an investment fund specified in clause (a) of the Explanation 1 to section 115UB, the person responsible for making the payment shall, at the time of credit of such income to the account of payee or at the time of payment thereof in cash or by issue of a cheque or draft or by any other mode, whichever is earlier, deduct income-tax thereon at the rate of ten per cent.

Provided that no such deduction shall be made in respect of any income referred to in section 10.

(2) Where any income is payable to a unit holder, being a non-resident (not being a company) or a foreign company, in respect of units of an investment fund specified in clause (a) of the Explanation 1 to section 115UB, the person responsible for making the payment shall, at the time of credit of such income to the account of payee or at the time of payment thereof in cash or by issue of a cheque or draft or by any other mode, whichever is earlier, deduct income-tax thereon at the rate of five percent or at the rates in force.

Provided that no such deduction shall be made in respect of any income referred to in section 10.]

In **clause 32** of the Bill insert following Explanation after sub-section (1) of section 115UB

Explanation: It is hereby declared that, all the provisions of this Act shall apply to an investment fund that, wholly or partially, makes investments in units of another investment fund, as they would apply to an investment fund that makes investments in investee companies directly under the Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012.

Proposed amendment to section 197(1) of the Act:

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> 197. (1) Subject to rules made under sub-section (2A), [where, in the case of any income of any person [or sum payable to any person], income-tax is required to be deducted at the time of credit or, as the case may be, at the time of payment at the rates in force under the provisions of sections 192, 193, 194,194A, 194C, 194D, 194G, 194H, 194-I, 194J,194K, 194LA, **194LBB** and 195, the Assessing Officer is satisfied that the total income of the recipient justifies the deduction of income-tax at any lower rates or no deduction of income-tax, as the case may be, the Assessing Officer shall, on an application made by the assessee in this behalf, give to him such certificate as may be appropriate

1.4. ***Losses incurred by AIFs***

1.4.1. One of the provisions in the tax regime proposed for AIFs is that if in any year there is a net loss at the AIF level, under any head of income, computed as per the provisions of the Act, such loss shall be carried forward by the AIF to be set-off against subsequent year(s) income in accordance with the provisions of set-off and carry forward of losses under the Act (Chapter VI). Consequently, such losses are not allowed to be passed on to the AIFs investors.

1.4.2. Under the AIF Regulations, Category I and II AIFs are close ended funds and the tenure of a specific fund / scheme is determined at the time of its launch. Typically, an AIF's tenure would not exceed 10 years from its launch. Based on the proposed provisions, where the AIF incurs net losses on its investments towards the end of its lifecycle or has unabsorbed losses which cannot be utilised by the AIF, such losses would lapse. The investors would in this scenario be taxed on an amount that would be greater than the "real" taxable income derived by them from their investment in the AIF causing the AIF alternative becoming unattractive to an investor vis-a-vis direct investments.

Recommendation

1.4.3. As such a pass through tax regime should not distinguish between gains and losses. Therefore, similar to the pass through for net income, net losses incurred by AIFs under any head of income, should also be allowed to be passed on to the investors. Further, it could be provided that in case of transfer (excluding transactions which are not regarded as transfer under section 47 of the Act) of units by the investors in the AIF, the net loss proportionate to the units transferred shall not be passed on to the investors.

> In **clause 32** of the Bill:
>
> 115UB. (1) Notwithstanding anything contained in any other provisions of this Act and subject to the provisions of this Chapter, any income accruing or arising to, or received by, a person, being a unit holder of an investment fund, out of investments made in the investment fund, shall be chargeable to income-tax in the same manner as if it were the

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income accruing or arising to, or received by, such person had the investments made by the investment fund been made directly by him.

(2) Where in any previous year, a person, being a unit holder of an investment fund, transfers the units to another person (excluding transfers referred to in section 47) and the net result of computation of total income of the investment fund [without giving effect to the provisions of clause (23FBA) of section 10] is a loss under any head of income and such loss cannot be or is not wholly set-off against income under any other head of income of the said previous year, then with respect to the transferor or transferee of such units, the loss shall be ignored for the purposes of sub-section (1).

(3) The income paid or credited by the investment fund shall be deemed to be of the same nature and in the same proportion in the hands of the person referred to in sub-section (1), as it had been received by, or had accrued or arisen to, the investment fund during the previous year subject to the provisions of sub-section (2).

~~(4) The total income of the investment fund shall be charged to tax—~~
~~(i) at the rate or rates as specified in the Finance Act of the relevant year, where such fund is a company or a firm; or~~
~~(ii) at maximum marginal rate in any other case.~~

(5) The provisions of Chapter XII-D or Chapter XII-E shall not apply to the income paid by an investment fund under this Chapter.

(6) The income accruing or arising to, or received by, the investment fund, during a previous year, if not paid or credited to the person referred to in sub-section (1), shall subject to the provisions of sub-section (2), be deemed to have been credited to the account of the said person on the last day of the previous year in the same proportion in which such person would have been entitled to receive the income had it been paid in the previous year.

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Annexure 2

Offshore Private Equity & Venture Funds
Safe harbour rule for fund management in India

1.5. Background

1.5.1. The presence of a fund manager in India could create a business connection or a permanent establishment for offshore funds in India. Further, presence of a fund manager under certain circumstances may lead to the offshore fund being held to be resident in India. The constitution of business connection/ permanent establishment/ tax residence in India could result in adverse Indian tax consequences for the offshore fund. This discourages offshore funds from shifting the fund management activity to India or appointing experienced Indian fund managers.

1.5.2. In order to encourage fund management from India, the Bill proposes to introduce a new section 9A in the Act, to provide a safe harbour rule to offshore funds which satisfy the prescribed conditions. We welcome the proposed safe harbour rule since it would provide clarity and certainty in taxation for choosing India as the base for investment managers, thereby leading to more employment and taxes.

1.5.3. Briefly, as per the proposed section 9A, fund management activity carried out through an eligible fund manager on behalf of an eligible investment fund, will not constitute a business connection and tax residency of the eligible investment fund in India.

1.5.4. Sub-section (3) of section 9A, prescribes conditions which a fund needs to satisfy in order to qualify as an eligible investment fund. Some of the key conditions are as follows-

(a) Fund to have a minimum of 25 members who are not connected persons (directly or indirectly).
(b) Any member along with connected person(s) to not have participation interest exceeding 10% in the fund.
(c) Ten or less members along with their connected person(s) to not have participation interest exceeding 50% in the fund.
(d) Fund to have a monthly average corpus of more than Rs 100 crores.
(e) Fund to not carry on or control and manage any business in India or from India.

1.5.5. Sub-section (4) of section 9A, prescribes conditions which a fund manager needs to satisfy in order to qualify as an eligible fund manager. Some of the key conditions are as follows-

(a) Fund manager is not an employee of the fund or its connected person.
(b) Fund manager is registered as a fund manager or an investment advisor in accordance with the specified regulations.
(c) Fund manager along with the connected person is not entitled to more than 20% of the profits accruing or arising to the fund from transactions carried out by the fund through the fund manager.

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1.5.6. Our research amongst the key members of the IVCA indicates that most of the existing funds private equity / venture capital funds and their fund managers will not be able to satisfy the aforesaid conditions so as to avail the benefit of the proposed safe harbour rule. In this context and with a goal to encourage fund management from India, we have highlighted below the challenges envisaged by the private equity / venture capital sector in complying with the provisions of section 9A of the Act and the recommendations to rationalise some the conditions.

1.6. ***Clarity on permanent establishment***

1.6.1. In the Budget speech, the Hon. Finance Minister said that–

"The present taxation structure has an inbuilt incentive for fund managers to operate from offshore locations. To encourage such offshore fund managers to relocate to India, I propose to modify the Permanent Establishment (PE) norms to the effect that ***mere presence of a fund manager in India would not constitute PE of the offshore funds*** *resulting in adverse tax consequences."*

1.6.2. The language in sub-section (1) of section 9A provides as under-

"Notwithstanding anything contained in sub-section (1) of section 9 and subject to the provisions of this section, in the case of an eligible investment fund, the fund management activity carried out through an eligible fund manager acting on behalf of such fund shall not constitute business connection in India of the said fund."

Recommendation

1.6.3. From the above, it is clear that while the language in the proposed section adequately addresses the 'business connection' tax exposure, the same does not clarify that the presence of the fund manager will not cause the offshore fund to constitute a permanent establishment in India, where the offshore fund is eligible for and claims taxation in India in accordance with the provisions of a tax treaty. This exposure therefore also needs to be addressed through an appropriate provision in section 9A.

In **clause 6** of the Bill:

9A. (1) Notwithstanding anything contained in sub-section (1) of section 9 and subject to the provisions of this section, in the case of an eligible investment fund, the fund management activity carried out through an eligible fund manager acting on behalf of such fund shall not constitute business connection **or permanent establishment** in India of the said fund.

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For the purposes of this clause, the expression "permanent establishment" shall have the meaning assigned to it in clause (iiia) of section 92For, where applicable, in an agreement referred to in section 90 or section 90A.

1.7. **Conditions to qualify as an 'eligible investment fund'**

1.7.1. Sub-section (3) of section 9A, prescribes conditions which a fund needs to satisfy in order to qualify as an eligible investment fund. At the outset, based on our research, it is our understanding that the conditions specified to qualify as an 'eligible investment fund' are based on similar rules that exist in United Kingdom and Australia. In those countries, the rules have been prescribed in the context of funds that actively trade in marketable instruments which are inherently different from private equity/ venture capital funds in terms of their setup/ activities.

1.7.2. Before we discuss the challenges envisaged by the private equity / venture capital funds in complying with the prescribed conditions, we have provided below an overview of the private equity fund structures and the aspects which are unique to such funds.

- Private equity/ venture capital funds investing in India predominantly mobilise capital from Government/ sovereign wealth funds, banks, institutional investors, international/ multilateral organisations, pension funds, insurance funds, school/ university endowment funds, high net worth individuals, family offices, etc., spread across the globe. Given the diverse profile, geographic location and commercial considerations of the investors, typically, the fund is set up in a neutral jurisdiction for investing in India. Due to various legal, regulatory and commercial considerations, the funds may invest in India through intermediate entity(ies). For example, in case of an Asia focused fund, the main fund could be set up in Country A which in turn may set up multiple intermediate entities in Country B for investing in India and separate intermediate entities in Countries B and C for investing in other countries in the Asian continent.

- Sovereign wealth funds, school/ university endowment funds, Government / private pension funds and international/ multilateral organisations are some of the largest investors investing in India focussed private equity/ venture capital funds. These investors are generally deemed to be institutional investors / broad based in nature although they may not have defined members. Many India focussed private equity / venture capital funds will have a concentration of investors comprising the above investor classes.

- Depending on the nature of investment in India i.e. private or public / debt or equity, the fund/ intermediate entity could either make investment in India as a Foreign Direct Investor (FDI) or a FII or a Foreign Venture Capital Investor (FVCI). Where the investment is made under the FII or FVCI route, the fund/ intermediate entity is registered with the SEBI under the applicable regulations.

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- SEBI regulations permit FIIs to acquire only upto 10% stake in an Indian listed company. However, there is no such limitation under the FDI/ FVCI route, where the investor(s) are permitted to acquire a controlling stake in an Indian company, subject to the sectoral limits prescribed by the Government of India.

1.7.3. ***Private equity funds registered with SEBI***

Funds registered as FIIs

Where a private equity fund invests in India under the FII route, the investing entity is required to register as a FII in accordance with the provision of the Securities and Exchange Board of India (Foreign Portfolio Investors) Regulations, 2014 (FPI Regulations). As per the FPI Regulations, registration as an FPI is granted to the investing entity only after taking into consideration, inter-alia, whether the investing entity is domiciled in an appropriate jurisdiction, is well regulated, is broad based in nature, etc. The relevant extract of the eligibility criteria under the FPI Regulations based on which the FPI registration is granted, is provided in **Appendix 1**.

Funds registered as FVCIs

Where a private equity fund invests in India under the FVCI route, the investing entity is required to register as a FVCI in accordance with the Securities and Exchange Board of India (Foreign Venture Capital Investors) Regulations, 2000 (FVCI Regulations). As per the FVCI Regulations, registration as a FVCI is granted to the investing entity only after taking into consideration, inter-alia, the track record of the fund, whether the fund has been granted an approval by the Reserve Bank of India for making investment under the FVCI route, whether the fund is regulated by an appropriate foreign regulatory authority, etc. The relevant extract of the eligibility criteria under the FVCI Regulations based on which the FVCI registration is granted by SEBI, is provided in **Appendix 2**.

Recommendation

In view of the robust FPI Regulations and FVCI Regulations already in force, we humbly submit that the investing entity which is registered as a FPI/ FVCI under the respective SEBI regulations, should automatically qualify as an 'eligible investment fund' under sub-section 3 of section 9A of the Act.

In **clause 6** of the Bill:

After sub-section 3, the following proviso should be inserted, namely:-

Provided that nothing contained in clauses (a) to (g) of sub-section (3) of this section, shall be applicable to an entity which is registered as a Foreign Portfolio Investor under the

Securities and Exchange Board of India (Foreign Portfolio Investors) Regulations, 2014 or as a Foreign Venture Capital Investor under the Securities and Exchange Board of India (Foreign Venture Capital Investors) Regulations, 2000.

1.7.4. ***Private equity funds not registered with SEBI***

As discussed above, not all private equity / venture capital funds invest in India as a FPI / FVCI, depending on the nature of investment in India, the investing entity could invest in India under the FDI route. Given their nature, we have highlighted below the key challenges which private equity funds may face in complying with some of the conditions in sub-section (3) of section 9A and have recommended changes in some of the clauses of the said sub-section, while keeping in perspective the potential intent of the legislature in seeking a diversification of the investor base of a fund. The recommendations are broadly consistent with the SEBI rules for determination of a broad based fund.

Clause (e) - "the fund has a minimum of twenty-five members who are, directly or indirectly, not connected persons"

- Private equity and venture capital funds usually have a sponsor or anchor investor, who invests 25-49% of the Fund. Also most funds are set up with subscriptions from less than 10 investors; our research amongst the key members of the IVCA indicates that most of the existing funds private equity / venture capital funds have much less than 25 institutional investors. Unless the minimum number of members is reduced, it will be difficult for most of the funds to satisfy this condition.

- In absence of a clear provision to consider direct members as well as underlying members for ascertaining the number of members in a fund, the funds which invest in India through intermediate holding entity/ies, may not satisfy the aforesaid condition even when the total of number of direct members and underlying members is more than 25. Further, in certain situations (for example in case of a pension fund), the fund may not have any members but only have beneficiaries.

- Government and government related investors such as central banks, Government agencies, sovereign wealth funds may not satisfy this condition as they do not have named members.

- School/ university endowment funds, pension funds, etc., may not have named members with determinate shares.

Recommendation

The requirement for the fund to have minimum 25 members could be reduced. Further, it should be clarified that for the purpose of ascertaining the number of members in a fund,

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direct members/ beneficiaries as well as underlying members/ beneficiaries shall be considered.

Further, it should be provided that the condition should not be applicable where the entity investing in India is a foreign Government or Government related investors including central banks, Government agencies, sovereign wealth funds and international or multilateral organizations or agencies, school/ university funds, pension funds**, mutual funds, investment trusts, insurance/ reinsurance companies, banks** and school/ university related endowments.

In **clause 6** of the Bill:

After clause (e) of sub-section 3, the following proviso and explanation should be inserted, namely:-
Provided that this clause shall not apply to foreign Government and Government related investors including central banks, Government agencies, sovereign wealth funds and international or multilateral organizations or agencies and to school/ university funds, pension funds, mutual funds, investment trusts, insurance/ reinsurance companies, banks, and school/ university related endowments.

Explanation - For the purpose of this clause, for ascertaining the number of members in a fund, direct members/ beneficiaries as well as underlying members/ beneficiaries shall be considered.

Clause (f) - "any member of the fund along with connected persons shall not have any participation interest, directly or indirectly, in the fund exceeding ten per cent"

- A typical private equity fund has an anchor investor based on whose backing several other investors commit capital to the fund. The capital committed by the sponsor investor along with its connected persons could be in the range of 5% to 20% depending on several commercial considerations. In such cases, the fund will not be able to satisfy the condition prescribed in clause (f).

- It is a general practice for institutional investors to commit large sums of money to a few good fund managers. In such cases, the investors may end up holding more than 10% participation interest in the fund. In such cases too, the fund will not be able to satisfy the condition prescribed in clause (f).

Recommendation

A higher threshold of participation interest could be prescribed in alignment with the FPI Regulations. For example, under the FPI Regulations, a broad based fund has been defined to include a fund which has at least 20 investors with no investor holding more than 49% of the shares or units of the fund. Under the FPI Regulations, the broad based test is considered

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satisfied even if an institutional investor, which is in turn broad based, holds more than 49% of the shares or units of the fund. A similar rule should be applicable under section 9A.

Further, it should be provided that for the purpose of ascertaining participation interest, direct members/ beneficiaries in the fund as well as underlying members/ beneficiaries shall be considered.

> In **clause 6** of the Bill:
>
> (f) any member of the fund along with connected persons shall not have any participation interest, directly or indirectly, in the fund exceeding ~~ten~~**forty-nine** per cent
>
> **Provided that if the fund has an institutional investor who holds more than forty nine percent participation interest, then this condition shall be deemed to be satisfied if such institutional investor itself satisfies the condition in clause (e) of sub-section (3) of section 9A.**
>
> **Explanation - For the purpose of this clause, for ascertaining the participation interest, direct members/ beneficiaries in the fund as well as underlying members/ beneficiaries shall be considered.**

Clause (g) - "the aggregate participation interest, directly or indirectly, of ten or less members along with their connected persons in the fund, shall be less than fifty per cent"

- This clause amplifies the conditions stipulated in clauses (e) and (f) thereby severely restricting the benefits of the safe harbour rule. From a diversification of investors' standpoint, the recommendation in connection with clause (f) is aligned with the FPI Regulations. As such, we humbly submit that this condition should be dropped in the determination of an eligible investment fund.

Recommendation

> In **clause 6** of the Bill:
>
> ~~(g) the aggregate participation interest, directly or indirectly, of ten or less members along with their connected persons in the fund, shall be less than fifty per cent.;~~

Clause (j) - "the monthly average of the corpus of the fund shall not be less than one hundred crore rupees:

- Venture capital funds, which invest small amounts of capital, may face challenges in meeting the stipulated Rs 100 crore corpus.

- The term ‘corpus’ has been defined in clause (b) of sub-section 8 of section 9A to mean the total amount of funds ‘raised’ for the purpose of investment. In this connection, it is important to note that in case of private equity funds, the entire corpus is not immediately raised at the fund launch stage. The investors only commit capital to the fund which is provided to the fund in stages over a number of years as and when the fund manager identifies investment opportunities. For example, a fund could have obtained a capital commitment of Rs 300 crores from its investors; however, in Year 1, only 15% of the committed capital is called i.e. Rs 45 crores. This would mean that the fund will not be able to satisfy this condition till the time at least 34% (approx.) of the corpus is called and also none of the existing investments have been sold (since a sale will reduce the corpus).

- There could also be situations where the fund satisfies the condition of having a monthly average corpus of more than Rs 100 crores during the initial years of the fund life, however, in the last few years, the condition may not get satisfied since the fund is in the winding down mode.

- In case of a newly set up fund, particularly, if set up is closer to March 31, it may be difficult for such fund to have a corpus of more than Rs 100 crores by March 31.

Recommendation

The threshold of having a monthly average corpus of more than Rs 100 crores should be reduced to Rs 50 crores. Further, in case of a newly set up fund, a 12 month period should be provided for satisfying this condition. Further, the definition of the term ‘corpus’ in clause (b) of sub-section (8) of section 9A should be amended to include funds ‘committed’.

In **clause 6** of the Bill:

(j) the monthly average of the corpus of the fund shall not be less than ~~one hundred~~**fifty**crore rupees:
Provided that if the fund has been established or incorporated in the previous year, the corpus of fund shall not be less than one hundred crore rupees at the end of such previous year **or 12 months from the date of establishment or incorporation of the fund;**
Provided further that in case of a close ended fund, the corpus of the fund shall not be less than fifty crore rupees 12 months from the date of establishment or incorporation of the fund;

In clause (b) of sub-section (8) of section 9A –

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“corpus” means the total amount of funds raised **or committed**by investors for the purpose of investment by the eligible investment fund as on a particular date”

Clause (k) - “the fund shall not carry on or control and manage, directly or indirectly, any business in India or from India”

- Private equity funds, typically, buy-out funds acquire controlling stake in the investee companies. While such funds hold a majority stake in the company, they are not involved in the day to day management of the investee company (except in their capacity as shareholders).
- Private equity / venture capital investors may also have minority interest protection rights, which could be viewed as resulting in control over the business of the investee company in India.
- In the absence of a specific clarification to provide that activities undertaken by a fund in connection with its investment in the investee company will not result in the fund carrying on or controlling and managing any business in India or from India, such funds may not satisfy the aforesaid condition and hence not qualify as an eligible investment fund.

Recommendation

In **clause 6** of the Bill: ~~(k) the fund shall not carry on or control and manage, directly or indirectly, any business in India or from India;~~

1.8. **Conditions to qualify as an ‘eligible fund manager’**

1.8.1. Sub-section (4) of section 9A, prescribes conditions which a fund manager needs to satisfy in order to qualify as an eligible fund manager. We have highlighted below the challenges envisaged by fund managers in complying with some of the conditions to qualify as an eligible fund manager and our recommendations.

1.8.2. *Clause (a) - “the person is not an employee of the eligible investment fund or a connected person of the fund”*

- Typically, private equity/ venture capital funds are setup in a partnership/ corporate structure, which entity’s control and management is vested in the fund manager / connected persons. The wide definition of the term ‘connected person’ in section 102 of

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the Act would disqualify most fund managers from claiming the benefits of section 9A for funds launched by the fund managers / connected persons.

We therefore humbly submit that this condition should not apply. The diversification of investor rules provided in section 9A of the Act ensures that the fund manager / its connected persons cannot misuse the provisions of section 9A.

Recommendation

In **clause 6** of the Bill: (a) the person is not an employee of the eligible investment fund ~~or a connected person of the fund~~;

1.8.3. Clause *(d) - "the person along with his connected persons shall not be entitled, directly or indirectly, to more than twenty per cent of the profits accruing or arising to the eligible investment fund from the transactions carried out by the fund through the fund manager"*

- The requirement of the fund manager (along with connected persons) not being entitled to more than 20% of the profits from the funds transactions carried out through the fund manager, results is capping of the remuneration of the fund manager/ connected persons which is determined pursuant to commercial negotiations between the investors and the fund manager. In certain cases, the fund manager/ connected persons may commercially negotiate a share of greater than 20% of the profits from the funds transactions.

- Clause (m) of the proposed section 9A(3) already provides that the remuneration paid to the fund manager should be arm's length in nature. It should be clarified that the ongoing fees paid to the fund manager by the fund for fund management activities should not be tested against the above threshold.

- Additionally, there is ambiguity around the period to be considered for ascertaining profits ie whether the fund manager's entitlement should be viewed based on the fund's lifecycle or on an annual basis.

We therefore humbly submit that this clause should be deleted.

Recommendation

In **clause 6** of the Bill:

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> ~~(d) the person along with his connected persons shall not be entitled, directly or indirectly, to more than twenty per cent. of the profits accruing or arising to the eligible investment fund from the transactions carried out by the fund through the fund manager;~~

1.9. **Changes proposed in sub-section (5) of the section 9A - Reporting requirements**

1.9.1. Sub-section (5) of section 9A of the Act, provides that every eligible investment fund is required to furnish a statement containing information relating to the fulfillment of the prescribed conditions and other relevant information, within 90 days from the end of the financial year. Further, section 271FAB of the Act provides that failure to furnish the aforesaid statement within the time prescribed under section 9A of the Act could result in a penalty of Rs 500,000.

1.9.2. It is not clear whether non-compliance with this section (i.e. if the statement is not furnished within 90 days) will result in denial of the safe harbor under section 9A of the Act, even when the fund qualifies as an eligible investment fund and the fund manager qualifies as an eligible fund manager.

Recommendation

> **It should be clarified that non-compliance with the provisions of sub-section (5) of section 9A will not result in an eligible investment fund losing the benefits under section 9A of the Act.**

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Annexure 3

Offshore Private Equity & Venture Capital Funds
Non applicability of MAT provisions to foreign companies

1.10. ***Background***

1.10.1. The Bill proposes to amend section 115JB of the Act to provide that capital gains arising to FII from transactions in securities [other than short-term capital gains on transactions on which securities transaction tax (STT) is not chargeable] and expenditure relatable to such income will be excluded in computing the MAT liability of FIIs. This amendment is proposed to be made effective from 1 April 2015.

1.11. ***Issues in applicability of MAT to foreign companies***

1.11.1. The issue of applicability of MAT provisions to foreign companies has been a subject matter of litigation for the past several years. The primary argument for non-applicability of MAT provisions to foreign companies not having a presence (in the form of a permanent establishment) in India is that they are not required to prepare a profit and loss account under the provisions of the Companies Act (a pre-requisite for calculation of book profit on which MAT is computed). This view is also supported by various internal indicators in section 115JB and the legislative intent of enactment of the MAT provisions which, inter alia, include:

- MAT provisions were first introduced in the year 1996 with a view to tax zero tax companies and companies paying marginal tax. The rationale outlined by the legislature on several occasions at the time of enactment of/ amendments to the MAT provisions indicates that MAT is a levy of tax on domestic companies.

- The computation of book profits under section 115JB of the Act requires various adjustments (many of which related to deductions that are available only to domestic companies) to be made to the net profit as shown in the profit and loss account. Where foreign companies do not maintain books of accounts under the provisions of the Companies Act, it is not possible to compute the book profit for the purpose of section 115JB of the Act.

- Section 115JB was amended to provide that the companies which are not required under section 211 of the Companies Act to prepare their profit and loss account in accordance with the Schedule VI of the Companies Act, 1956, profit and loss account prepared in accordance with the provisions of their regulatory Acts shall be taken as a basis for computing the book profit under section 115JB (e.g. insurance, electricity or banking companies).

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Based on above, it could be said that the intention of the legislature has always been to apply the provisions of section 115JB of the Act only to domestic companies and not to foreign companies else the legislature would have clarified the manner in which book profits of the foreign company is required to be calculated.

1.11.2. By providing that specified capital gains will be excluded in computing the MAT liability of FIIs from 1 April 2015 onwards, there is fear that for past years the tax authorities will levy MAT on any income earned by FIIs. This will result in a retrospective application of MAT provisions on any income earned by FIIs.

1.11.3. Further, the amendment proceeds on the basis that FIIs only earn income in the nature of capital gains. For instance, FIIs could also earn income in the form of interest income eligible for the concessional tax rate of 5% under section 194LD of the Act (since 2012). In such cases, the applicability of MAT to FIIs will effectively result in nullifying the concessional tax regime.

1.11.4. Further, given that the amendments proposed to the Act only address concerns of FIIs (to a limited extent as discussed above), the uncertainty over the applicability of MAT to foreign private equity / venture capital investors and other foreign investors generally remains unaddressed and is therefore a huge area of concern.

Recommendation

1.11.5. In view of the above, we request that it should be clarified in the Act that MAT provisions do not apply to foreign companies investing into India (including FIIs) which do not have a place of business in India. Where a foreign company has a presence in India, the MAT provisions should apply to the extent the income arises through or from a business connection or permanent establishment in India. This will require the following amendment in section 115JB of the Act.

Insert following after sub-section (1) in section 115JB of the Act: **Explanation: For the removal of doubts, it is hereby declared that for purposes of this clause, an assessee being a company shall not include a foreign company, including a Foreign Institutional Investor referred to in section 115AD.** **Provided that where such foreign company has in relation to any assessment year earned any income accruing or arising through or from any business connection in India or a permanent establishment as referred to in clause (iiia) of section 92F, the total income and book profit for the purposes of this clause, shall be computed for such assessee solely in relation to such income.**

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Annexure 4

Offshore Private Equity & Venture Capital Funds
Clarifications on indirect transfer provisions

1.12. Background

1.12.1. The Bill proposes to provide clarification on several aspects relating to the indirect transfer provisions under section 9 of the Act. Some of the clarifications are as under -

- Share or interest of the foreign entity deemed to derive substantial value from Indian assets if the value of Indian assets represents at least 50% of value of all assets owned by the company and exceeds INR 10 crore.
- Taxation of gains on proportionate basis in the manner to be prescribed.
- Exemption in case of transfer of shares by small shareholders (not having management or control and holding less than 5% of voting power/ share capital) and transfer under foreign amalgamations and demergers on meeting certain conditions.

1.12.2. From a private equity and venture capital fund perspective, the proposed amendment fulfils the persistent demand of the industry for clarity and certainty in tax laws. In particular, we welcome the proposal of restricting levy of tax on gains in proportion to assets located in India.

1.13. Issues not addressed in the Bill

1.13.1. In any format of fund raising, the external (third party) investors only hold an economic interest in the private equity fund. The control and management rights are always retained by the sponsor of the private equity fund although the external investors as a collective group may be in a position to assume such rights in documented exceptional situations (which mainly relate to breach by the fund sponsor of its fiduciary obligations). Under the current provisions of the Act, the transfer of interest greater than 5% in the private equity fund by an investor will qualify as taxable indirect transfer in India (the Bill proposed exemption for small shareholders), even when there is no change in control and management of the fund.

1.13.2. Private equity funds commonly make investments in portfolio assets through chain holding structures with special purpose vehicles holding individual assets in the private equity funds' portfolio. As and when the private equity fund divests an asset in its portfolio (pursuant to a transfer that qualifies as a taxable direct transfer that is exempted or otherwise under a tax treaty), a series of capital redemptions are made in the entities in the chain holding structure ultimately leading to the repayment of capital with profits to the external investors of the private equity fund. Such redemptions would be required every time the private equity fund divests an asset in its portfolio until the end of the tenure of the private equity

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fund. Under the current provisions of the Act, at various levels, the redemption of capital to entities in the chain holding structure would qualify as taxable indirect transfers in India.

1.13.3. In case of foreign listed companies which have substantial assets in India, frequent trading of shares would take place on the exchange everyday leading to numerous instances of indirect transfer. It would be impossible to track all such indirect transfers and offer them to tax in India. Given that the objective behind introduction of indirect transfer provisions was to tax indirect transfer through paper companies, a listed company should not be considered as a shell or conduit company and be subject to indirect transfer rules.

1.13.4. While the Bill proposes to provide an exemption from applicability of indirect transfer rules for the amalgamating/ demerged foreign company (subject to satisfaction of conditions) no similar exemption has been provided for the shareholders in these companies. Providing an exemption from indirect transfer rules for the shareholders is essential for granting tax neutrality to intra-group transactions in its entirety.

1.13.5. The Bill proposes to cast an obligation on the Indian company to report all cases of taxable indirect transfer in a prescribed manner. This requirement assumes that whenever there is a transfer of voting power or share capital or interest exceeding 5% in an offshore entity (deriving substantial value from assets located in India), the Indian company has the knowledge of such transactions. This is extremely onerous and impractical to monitor, especially, in a case where the offshore entity (deriving substantial value from assets located in India) holds a minority stake in the Indian company or the shareholder of the offshore entity do not inform the Indian company about the transfer of shares of the offshore entity.

Recommendations

1.13.6. It is recommended that where investments by the non-resident investor in a private equity fund is in the form of units which do not result in participation in control and management of the fund i.e. mere economic interest, the indirect transfer of the investment by the non-resident investor should be excluded from the scope of the Explanation 5 to section 9(1)(i) of the Act. This is in line with the recommendation made by the Expert Committee on Indirect Transfer.

1.13.7. Any transfer caused by redemption of capital assets that may be deemed to be situated in India under Explanation 5 to section 9(1) should not be taxed in India if the said transfer/ redemption is directly or indirectly in consequence of or by reason of transfer of capital assets situated in India.

1.13.8. All transfer of shares of listed foreign companies should be exempted from the purview of indirect transfer rules.

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1.13.9. In case of intra-group restructuring, shareholders of the amalgamating/ demerged foreign company should also be exempted from applicability of the indirect transfer rules.

1.13.10. The Indian company should be required to report cases of taxable indirect transfer only if the offshore entity, directly or indirectly, holds more than 51% of share capital of the Indian company.

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Annexure 5

Offshore Private Equity & Venture Capital Funds
Place of Effective Management

*1.14. **Background***

1.14.1. Currently, a foreign company is considered as a resident in India during a previous year, if the control and management of its affairs is situated wholly in India. The Bill proposes to provide that a company will be treated as resident in India if its place of effective management, at any time in that year, is in India. The term 'place of effective management' is defined to mean, a place where key management and commercial decisions that are necessary for the conduct of the business of an entity as a whole are, in substance made.

1.14.2. This is a paradigm shift compared to the extant provision which provides for the management and control of a company to be in India for whole of the year. If the proposed provisions are construed literally, even single board meeting in India of a foreign company may have the consequence of that foreign company being a tax resident of India.

*1.15. **At any time in that year***

1.15.1. The place of effective management concept is introduced along the lines of what is internationally understood. However, the reference to 'at any time' is inconsistent with international practices since it is only in case of some stray countries that the expression is used.

1.15.2. The words 'at any time in that year' significantly widens the definition of resident, resulting in unintended consequences. For example, in a scenario where a non-resident Director or a key management personnel of a company incorporated outside India, makes a key management and commercial decision, when he is in India, then such company would be treated as a resident of India.

1.16. **Recommendation**

1.16.1. In view of the above, we request that the words 'at any time in that year' are deleted from the provisions of section 6 of the Act, as it would reduce scope for litigation considerably.

In **clause 4** of the Bill:

In section 6 of the Income-tax Act, -
(3) A company is said to be resident in India in any previous year, if, -
(i) it is an Indian company; or
(ii) its place of effective management, **~~at any time in that year~~**, is in India.

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Appendix 1

Offshore Private Equity & Venture Capital Funds
Regulation 4 of SEBI (Foreign Portfolio Investors) Regulations, 2014

Eligibility criteria of foreign portfolio investor

4. The designated depository participant shall not consider an application for grant of certificate of registration as a foreign portfolio investor unless the applicant satisfies the following conditions namely, -

(a) the applicant is a person not resident in India;

(b) the applicant is resident of a country whose securities market regulator is a signatory to International Organization of Securities Commission's Multilateral Memorandum of Understanding (Appendix A Signatories) or a signatory to bilateral Memorandum of Understanding with the Board;

(c) the applicant being a bank, is a resident of a country whose central bank is a member of Bank for International Settlements;

(d) the applicant is not resident in a country identified in the public statement of Financial Action Task Force as:

(i) a jurisdiction having a strategic Anti-Money Laundering or Combating the Financing of Terrorism deficiencies to which counter measures apply; or
(ii) a jurisdiction that has not made sufficient progress in addressing the deficiencies or has not committed to an action plan developed with the Financial Action Task Force to address the deficiencies;

(e) the applicant is not a non-resident Indian;

(f) the applicant is legally permitted to invest in securities outside the country of its incorporation or establishment or place of business;

(g) the applicant is authorized by its Memorandum of Association and Articles of Association or equivalent document(s) or the agreement to invest on its own behalf or on behalf of its clients;

(h) the applicant has sufficient experience, good track record, is professionally competent, financially sound and has a generally good reputation of fairness and integrity;

(i) the grant of certificate to the applicant is in the interest of the development of the securities market;

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(j) the applicant is a fit and proper person based on the criteria specified in Schedule II of the Securities and Exchange Board of India (Intermediaries) Regulations, 2008; and

(k) any other criteria specified by the Board from time to time.

Explanation.- For the purposes of this regulation:

(i) The term "person" shall have the same meaning as assigned to it under section 2 (31) of the Income-tax Act, 1961;

(ii) The term "non-resident" shall have the same meaning as assigned to it under the Income-tax Act, 1961;

(iii) The term "resident in India" shall have the same meaning as assigned to it under the Income-tax Act, 1961;

(iv) "Bilateral Memorandum of Understanding with the Board" shall mean a bilateral Memorandum of Understanding between the Board and the overseas regulator that, inter alia, provides for information sharing arrangements under clause (ib) of sub section (2) of Section 11 of the Act.

Categories of foreign portfolio investor

5. An applicant shall seek registration as a foreign portfolio investor in one of the categories mentioned hereunder or any other category as may be specified by the Board from time to time:

(a) "Category I foreign portfolio investor" which shall include Government and Government related investors such as central banks, Governmental agencies, sovereign wealth funds and international or multilateral organizations or agencies;

(b) "Category II foreign portfolio investor" which shall include:

(i) appropriately regulated broad based funds such as mutual funds, investment trusts, insurance/reinsurance companies;
(ii) appropriately regulated persons such as banks, asset management companies, investment managers/ advisors, portfolio managers;
(iii) broad based funds that are not appropriately regulated but whose investment manager is appropriately regulated: Provided that the investment manager of such broad based fund is itself registered as Category II foreign portfolio investor: Provided further that the investment manager undertakes that it shall be responsible and liable for all acts of commission and omission of all its underlying broad based funds and other deeds and things done by such broad based funds under these regulations.
(iv) university funds and pension funds; and

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(v) university related endowments already registered with the Board as foreign institutional investors or sub-accounts.

Explanation 1.- For the purposes of this clause, an applicant seeking registration as a foreign portfolio investor shall be considered to be "appropriately regulated" if it is regulated or supervised by the securities market regulator or the banking regulator of the concerned foreign jurisdiction, in the same capacity in which it proposes to make investments in India.

Explanation 2.- A) For the purposes of this clause, "broad based fund" shall mean a fund, established or incorporated outside India, which has at least twenty investors, with no investor holding more than forty-nine per cent of the shares or units of the fund:

Provided that if the broad based fund has an institutional investor who holds more than forty nine per cent of the shares or units in the fund, then such institutional investor must itself be a broad based fund.

B) For the purpose of clause A of this Explanation, for ascertaining the number of investors in a fund, direct investors as well as underlying investors shall be considered.

C) For the purpose of clause B of this Explanation, only investors of entities which have been set up for the sole purpose of pooling funds and making investments, shall be considered for the purpose of determining underlying investors.

(c) "Category III foreign portfolio investor" which shall include all others not eligible under Category I and II foreign portfolio investors such as endowments, charitable societies, charitable trusts, foundations, corporate bodies, trusts, individuals and family offices.

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Appendix 2

Offshore Private Equity & Venture Capital Funds
Regulation 4 of SEBI (Foreign Venture Capital Investors) Regulations, 2000

Eligibility Criteria

4. (1) For the purpose of the grant of a certificate to an applicant as a Foreign Venture Capital Investor, the Board shall consider the following conditions for eligibility, namely:-

(a) the applicants track record, professional competence, financial soundness, experience, general reputation of fairness and integrity.

(b) Whether the applicant has been granted necessary approval by the Reserve Bank of India for making investments in India;

(c) whether the applicant is an investment company, investment trust, investment partnership, pension fund, mutual fund, endowment fund, university fund, charitable institution or any other entity incorporated outside India; or

(d) whether the applicant is an asset management company, investment manager or investment management company or any other investment vehicle incorporated outside India;

(e) whether the applicant is authorised to invest in venture capital fund or carry on activity as a foreign venture capital investors;

(f) whether the applicant is regulated by an appropriate foreign regulatory authority or is an income tax payer; or submits a certificate from its banker of its or its promoter’s track record where the applicant is neither a regulated entity nor an income tax payer.

(g) the applicant has not been refused a certificate by the Board.

(h) whether the applicant is a fit and proper person.

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