Critical proposed amendments in the Union Budget 2015-16 - Key recommendations of the private equity / venture capital sector

1. Taxation of Category I and Category II Alternative Investment Funds (collectively referred as Category I and II AIFs or AIFs)

Issue	Rationale for change	Suggested change
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) is 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.	• The proposal to distinguish the tax regime for AIF/ its investors based on income characterisation would lead to litigation and potential double taxation. • Predominantly AIFs invest in unlisted entities with the objective of medium to long term capital appreciation and do not hold these investments as stock-in-trade.	• Amend the definition of 'capital asset' under section 2(14) of the Income-tax Act, 1961 (Act) to include investments held by AIFs for a period of more than 12 months.
Withholding tax at 10% on payment/ credit of income to the AIFs investors	• The proposal will result in withholding tax on credit/ distribution of income which is exempt under section 10 of the Act [for example, 10(34), 10(34A), 10(38), etc.] • Non-resident investors in the AIF could be eligible to beneficial provisions of a double tax avoidance agreement. • Dual tax withholding, where investor in an AIF is also an AIF.	• Tax withholding 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 • Tax withholding in case of non-resident investors in the AIF could be done at rates in force or alternatively, at a lower rate of 5%, (consistent with the rate provided in case of income payable by a business trust (Real Estate Investment Trust) to a non-resident unit holder under section 194LBA(2) of the Act).
If in any year there is a net loss at the AIF level, such loss has to be carried forward by the AIF to be set-off against subsequent year(s) income. Consequently, such losses are not allowed to be passed on to the AIFs investors.	• In absence of pass through for net losses the investors would 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.	• Pass through should be extended to net losses. In order to prevent abuse of tax provisions, 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 allocable to the units transferred shall not be passed on to the investors.

2. **<u>Safe harbour rule for fund management in India</u>**

Issue	Rationale for change	Suggested change
Our research amongst the key members of the IVCA indicates that most of the existing funds private equity / venture capital funds will not be able to satisfy the conditions prescribed in section 9A(3) of the Act, for a fund to qualify as an eligible investment fund. **<u>Refer Annexure 1, for details collated from 5 funds.</u>**	• 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. • Funds registered as FPIs or Foreign Venture Capital Investors (FVCIs) under the applicable regulations framed by the Securities and Exchange Board of India (SEBI), already satisfy some of the conditions of section 9A(3). • In absence of a clear provision to consider direct members/ beneficiaries as well as underlying members/ beneficiaries for the purpose of clause (e), (f) and (g), the funds which invest in India through intermediate holding entity/ies, may not satisfy these condition even when the total of number of direct and underlying members/ beneficiaries is more than 25. • In case of buy-out funds, the activities undertaken in connection with its investment in the investee company will result in the fund carrying on or controlling and managing any business in India or from India.	• The requirement for the fund to have minimum 25 members should be significantly reduced. • Clause (a) to (g) of section 9A(3) should not be applicable to entities registered as FPIs or FVCI under the applicable SEBI regulations. • For the purpose of clause (e), (f) and (g), in order ascertain the number of members in a fund, direct members/ beneficiaries as well as underlying members/ beneficiaries should be counted. • 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
Typically, private equity/ venture capital funds are setup in a partnership/ corporate structure, which entity's control and management is	• The Sponsor of the fund generally owns the fund manager, thereby resulting in the fund manager being treated as an employee of the	• Delete the words 'or a connected person of the fund' from section 9A(4)(a).

Issue	Rationale for change	Suggested change
vested in the fund manager / connected persons. The wide definition of the term 'connected person' in section 102 of the Act would disqualify most fund from claiming the benefits of section 9A of the Act.	connected person of the fund.	

3. **<u>Non-applicability of Minimum Alternate Tax (MAT) on foreign companies</u>**

Issue	Rationale for change	Suggested change
The Bill proposes that specified capital gains will be excluded in computing the MAT liability of FPIs from 1 April 2015 onwards. In other words, MAT is applicable on all other foreign companies and on income other than capital gains for Foreign Portfolio Investors.	• Foreign companies not having presence in India 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). • FPIs could also earn income in the form of interest income eligible for the concessional tax rate of 5% under section 194LD of the Act. In such cases, the applicability of MAT to FIIs will effectively result in nullifying the concessional tax regime. **Refer Annexure 2, for list of sections where income of a foreign company is taxable under the Act at a rate lower than the MAT rate.**	• Clarify 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.

4. **<u>Clarification on indirect transfer provisions</u>**

Issue	Rationale for change	Suggested change
The Bill proposes to provide clarification on several aspects relating to the indirect transfer provisions under section 9 of the Act. From a private equity and venture capital fund perspective, while the proposed amendment fulfil the persistent demand of the industry for clarity and certainty in tax laws, there are few issues which have not been addressed.	• As and when the private equity fund divests an asset in its portfolio (pursuant to a transfer that qualifies as a taxable direct transfer), a series of capital redemptions are made in the entities in the chain holding structure, resulting in taxable indirect transfers in India. **Refer Annexure 3 for illustration.**	• Indirect transfer provisions should not be applicable in following cases (a) where transfer/ redemption is directly or indirectly in consequence of or by reason of transfer of capital assets situated in India or (b) where there is a transfer/ redemption of share or interest which does not alter the ownership of the transferor in the transferee.
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 onerous 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.	• 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

5. **<u>Place of Effective Management</u>**

Issue	Rationale for change	Suggested change
The Bill proposes to provide that a company will be treated as resident in India if its place of effective management, **<u>at any time in that year</u>**, is in India. 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.	• 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. • 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.	• The words 'at any time in that year' should be deleted from the provisions of section 6 of the Act, as it would reduce scope for litigation considerably.

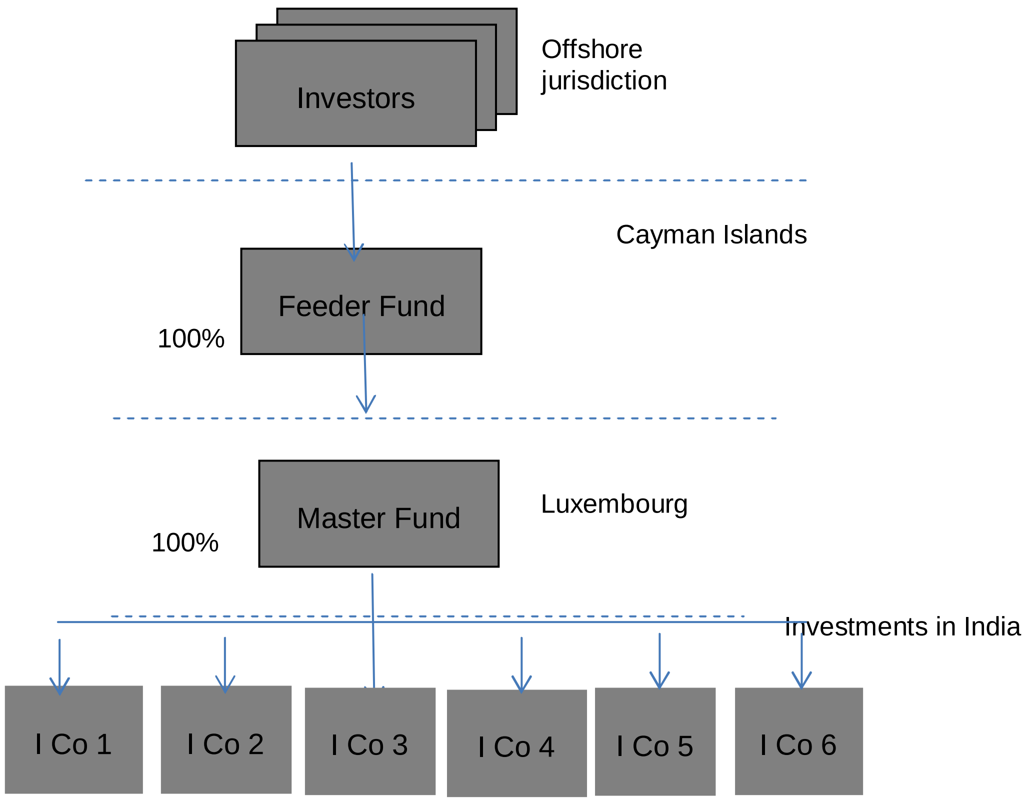
Annexure 1 - Fact pattern of few large funds against some of the key criteria provided in proposed section 9A of the Act

Conditions	Fund 1	Fund 2	Fund 3	Fund 4	Fund 5
Minimum of 25 members	Below 10 investors	9 investors	21 investors	20 investors	27 investors
Top 10 members having more than 50% participation interest	Yes	Yes	-	Yes	-
Single member having more than 10% participation interest	-	Yes	Yes	Yes	Yes
Investment of more than 50% in an investee company	No	No	No	Yes	Yes

Annexure 2 - List of sections where income of a foreign company is taxable under the Act at a rate lower than the MAT rate

Section	Provision	Rate
111A	Short-term capital gains on transfer of equity share/ unit of an equity oriented fund/ unit of a business trust subject to securities transaction tax	15%
112	Long-term capital gains on transfer of unlisted securities without giving effect to indexation and foreign currency benefits	10%
	Long-term capital gains on transfer of listed securities or unit or zero coupon bond without giving impact to indexation benefits	10%
115A	Interest received from an infrastructure debt fund or in respect of monies borrowed in foreign currency under a loan agreement on or after 1 July 2012 but before 1 July 2017 or by way of issue of long-term bond at any time on or after 1 October 2014 but before 1 July 2017	5%
	Income by way of interest payable to Foreign Portfolio investors on rupee denominated bond of an Indian company or a Government security on or after 1 June 2013 but before 1 June 2015 (proposed to be extended to 1 July 2017) provided that the interest rate does not exceed the rate as may be notified by the Government	5%
115A	Royalty/ Fees for technical services from Government or an Indian concern – proposed from 1 April 2016	10%
115AC	Interest/ dividend (other than exempt dividend) in respect of foreign currency convertible bonds/ Global Depository Receipts (GDRs) and long-term capital gains on transfer of the bonds/ GDRs without giving effect to indexation and foreign currency benefits	10%
194LBA	Interest income payable by a business trust to its unit holders, being a foreign company	5%

Annexure 3 – Illustration on capital redemptions triggering indirect transfer provisions



Implications of indirect transfer rules on Redemption of preference shares/ units

Steps

1. Master Fund sells investments in I Co 1; derives capital gains that are chargeable to tax in India.

   Several funds would contractually not have the ability to reinvest and therefore, be obligated to repay their investors the capital and profits every time Indian assets are sold/ transferred. A similar redemption may be triggered at the Master Fund level to repay surplus/ unutilized capital placed by the Feeder Fund.

   In certain cases, it is possible that the Master Fund has received dividends/ interest from investments in I Co1 (there is no sale of investment in I Co 1) which is subject to tax in accordance with the Indian Income-tax Act or the applicable tax treaty. Such dividend or interest is sought to be utilized for repayment of capital and profits to investors (being the Feeder Fund). In this case as well, a similar redemption may be triggered at the Master Fund level.

2. Preference shares/ units in the Master Fund are redeemed to repay capital to Feeder Fund.

   Since the Master Fund has transferred a part (but not all) of its Indian assets, its preference shares/ units would continue to substantially derive value from assets located in India. Hence, its shares/ units would technically be covered within the ambit of Explanation 5 to section 9(1)(i).

3. The above implications would equally apply at the Feeder fund level i.e. the shares/ units held by the investors in the Feeder Fund would qualify as an asset deemed to be situated in India as the same derives, directly or indirectly, its value substantially from assets located in India.

   To summarize, per the current provisions of section 9(1)(i) including the amendments proposed by Finance Bill. 2015, the transfer of the underlying asset will be taxable in the hands of both the Feeder Fund and the non-resident investor on redemption of its units or shares in the Master Fund and Feeder Fund respectively, resulting in a situation of economic double taxation.

   Recommendation

   As per para 5 of Circular No 4 of 2015 (Circular) issued by the Central Board of Direct Taxes (CBDT), the Explanatory Memorandum to the Finance Bill 2015 clearly provides that the amendment of section 9(1)(i) was to reiterate the legislative intent in respect of taxability of gains having economic nexus with India irrespective of the mode of realisation of such gains. The Circular further states that Explanation 5 to section 9(1)(i) would be applicable in relation to deeming any income arsing outside India from any transaction in respect of any share or interest in a foreign company or entity, which has the effect of transferring, directly or indirectly, the underlying assets located in India, as income accruing or arising in India.

   Given the above intent as laid down in the Explanatory Memorandum and the Circular, in order to ensure complete clarity and to dispense with concerns of the fund industry, the following may be clarified.

   a) where there is a redemption/ transfer of share or interest by means of, in consequence of or by reason of transfer of capital assets situated in India; or
   b) where there is a redemption/ transfer of share or interest which does not alter the ownership of the transferor in the transferee;

   the provisions of Explanation 5 read with section 9(1) (i) shall not apply.