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THE INDIAN PRIVATE EQUITY & VENTURE CAPITAL ASSOCIATION

To,

11th April, 2016

Ms. Pragya Saksena
Joint Secretary, CBDT
Ministry of Finance, North Block, New Delhi

Dear Ms. Saksena,

Re: - IVCA: Post-budget Discussion for the Private Equity and Venture Capital Sector

The Indian Private Equity & Venture Capital Association and its members (IVCA) wish to congratulate your Ministry on the various proposals announced in the Union Budget 2016-17 for beginning India's journey towards sustained growth and macro-economic stabilization, through job creation, promotion of domestic manufacturing, investment and 'Make in India'.

From a domestic private equity and venture capital funds perspective, the following proposed amendments/ clarifications in the budget (and post budget) are steps in right direction:

- Tax withholding at 10% by SEBI registered Category I & II Alternative Investment Funds (AIFs) to be applicable only to Indian residents; for non-residents, the tax withholding will be at the applicable domestic law or tax treaty (DTAA) rates
- Remedy of nil/lower withholding certificate from tax authorities in respect of income of AIFs credited/paid to investors
- Reduced tax rate of 10% on long term capital gains from transfer of shares of private limited company in the hands of non-residents
- Proposed reduction of holding period for unlisted shares from three years to two years.
- Clarification for non-foreign portfolio investors vis-à-vis characterisation of gains from investments in listed securities
- Inclusion of period of holding of debentures (pre-conversion) in computing the period of holding of shares of a company, received on conversion of debentures.

Private equity and venture capital funds have invested over $100 billion in Indian companies, ranging from start-up, early, growth and late stage, in the last 14 years. These investments were made in more than 3,100 companies across 12 major sectors. Private equity and venture capital is 'strategic' capital because it

- provides valuable long term, illiquid risk capital for start-ups to stand-up, to grow, to list on exchanges and to turn-around in difficult times;

- private equity and venture capital have a significant impact in job creation, technology & innovation, exports, corporate governance and tax collection.

While the tax proposals in Union Budget 2016-17 have strived to address many issues relevant to the PE sector, there are few issues that critically need to be addressed. We have provided the recommendations in respect of certain tax issues pertaining to the private equity industry which are as follows:

1. Taxation on convertible preference shares

   The IVCA welcomes the clarification by CBDT to include the period of holding of debentures (pre-conversion) in the period of holding of shares (post conversion) by way of Notification No. 18/2016 dated 17 March 2016. CBDT should also consider providing a similar rule/ clarification on the period of holding in the context of investment in convertible preference shares. In this regard, we had shared the suggested wording for a circular vide our letter dated 15 January 2016. For reference purpose, the suggested wording for a circular has been attached as **Annexure 1**.

2. Characterisation of income from SEBI registered AIFs

   The IVCA welcomes the clarification by CBDT vide Circular No.6/2016 which provides an option to the assessee to characterize the income on transfer of listed shares and securities held for a period of more than 12 months as capital gains. In this regard, the CBDT may also consider clarifying that where the investments of the AIF are held for a period of more than 12 months, then at the AIF's option, any income arising on transfer of investments by the AIF could be characterized as capital gains. A suggested wording for a circular is attached as **Annexure 2**.

3. Tax withholding in respect of exempt investors on income of Investment Funds

   In this context, a Circular No. 4/2002, dated 16-7-2002 states few class of bodies/ institution (in section 10) to whom no tax withholding would apply on payment or credit of income to their account. Accordingly, based on the aforesaid circular, we had shared a listing of bodies/ institution which could be considered for no tax withholding as **Annexure 3.**

Subject to your satisfaction, the above recommendations, if implemented, would make India globally the best practice and be followed by the world for "NEXT PRACTICES". We appreciate your attention in this regard and would request you to consider the above suggestions.

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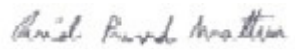
Respectfully,

Thank you very much.

Kind regards,



Arvind Mathur
President, IVCA
09818934615
cc: Aakriti Bamniyal, AVP, IVCA, 097 1111 001; Yogesh Arora,IVCA 095 400 84999

Annexure 1

Relevant Extract of the Circular

F. No. 12/1/64 – IT (AI)
GOVERNMENT OF INDIA
MINISTRY OF FINANCE
(DEPARTMENT OF REVENUE AND COMPANY LAW)
NEW DELHI, the 12th MAY, 1964.

. . .

From Shri G. R. Desai,
Deputy Secretary to Govt. of India

To All Commissioners of Income Tax

Sir,

Sub:- Conversion of one kind of shares of the Company into another kind – Capital gains and bonus tax – Finance Act, 1964

Attention is invited to Section12 of the Finance Act, 1964, which introduces new sub-section (2) in section 45 of the Income-tax Act, 1961, so as to provide for the charging of tax on capital gains on allotment of shares by a company by way of bonus. Section 14 of the Finance Act, 1964 introduces a new sub-clause (v) in sub-section (2) of section 55 of the Income-tax Act, 1961, laying down the method for determining the cost of acquisition of a new share which becomes the property of the assessee on conversion of one type of share into another type of share. A question has been raised whether the transaction of conversion of one type of share into another attracts the capital gains tax under section 45(1) or the bonus tax of 12.5% or the capital gains tax on the issue of bonus shares under section 45(2). The position in this regard is as follows:

(i) Where one type of share is converted into another type of share (including conversion of debentures into equity shares), there is, in fact, no 'transfer' of a capital asset within the meaning of Section 2(47) of the Income-tax Act, 1961. Hence, any profits derived from such conversion are not liable to capital gains tax under Section 45(1) of the Income-tax Act. However, when such newly converted share is actually transferred at a later date, the cost of acquisition of such share for the purposes of computing the capital gains shall be calculated with reference to the cost of acquisition of the original share of stock from which it is derived.

In determining the holding period of the newly converted share at the time of transfer, the period for which the share was held before the conversion, should also be included.

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Annexure 2

Circular No. 6/ 2016

Government of India
Ministry of Finance
Department of Revenue

North Block, New Delhi, the __th of _____, 2016.

Sub: Issue of taxability of surplus on sale of investments of - Capital gains or Business income – additional instructions in order to reduce litigation – reg.-

Sub-section (14) of section 2 of the Income-tax Act, 1961 ('Act') defines the term "capital asset" to include property of any kind held by an assessee, whether or not connected with his business or profession, but does not include any stock-in-trade or personal assets subject to certain exceptions. As regards shares and other securities, the same can be held either as capital assets or stock-in-trade/trading assets or both. Determination of the character of a particular investment in shares or other securities, whether the same is in the nature of a capital asset or stock-in-trade, is essentially a fact-specific determination and has led to a lot of uncertainty and litigation in the past.

2. Over the years, the courts have laid down different parameters to distinguish the shares held as investments from the shares held as stock-in-trade. The Central Board of Direct Taxes ('CBDT') has also, through Instruction No. 1827, dated August 31, 1989, Circular No. 4 of 2007 dated June 15, 2007 and Circular No. 6 of 2016 dated February 29, 2016, summarized the said principles for guidance of the field formations.

3. It is highlighted that the application of these principles could be made to the facts of an individual case. In this background, while recognizing that no universal principal in absolute terms can be laid down to decide the character of income from sale of shares and securities (i.e. whether the same is in the nature of capital gain or business income), CBDT, further instructs that the Assessing Officers in holding whether the surplus generated from sale of investments of investment fund (The expression 'Investment fund' shall have the

meaning assigned to it in clause (a) of the Explanation 1 to section 115UB) would be treated as Capital Gain or Business Income, shall take into account the following—

(*a*) Where the assessee itself, irrespective of the period of holding the shares and securities, opts to treat them as stock-in-trade, the income arising from transfer of such shares/securities would be treated as its business income,

(*b*) In respect of investments held by the 'investment fund' for a period of more than 12 months immediately preceding the date of its transfer, if the assessee desires to treat the income arising from the transfer thereof as Capital Gain, the same shall not be put to dispute by the Assessing Officer. However, this stand, once taken by the assessee in a particular Assessment Year, shall remain applicable in subsequent Assessment Years also and the taxpayers shall not be allowed to adopt a different/contrary stand in this regard in subsequent years;

(*c*) In all other cases, the nature of transaction (i.e. whether the same is in the nature of capital gain or business income) shall continue to be decided keeping in view the aforesaid Circulars issued by the CBDT.

4. It is, however, clarified that the above shall not apply in respect of investments by the investment fund where the genuineness of the transaction itself is questionable, such as bogus claims of Long Term Capital Gain/Short Term Capital Loss or any other sham transactions.

5. It is reiterated that the above principles have been formulated with the sole objective of reducing litigation and maintaining consistency in approach on the issue of treatment of income derived from transfer of investments by the investment fund. All the relevant provisions of the Act shall continue to apply on the transactions involving transfer of investments by the investment fund.

Annexure 3

Further to the circular no 4 of 2002 dated 16 July 2002, the following class of persons (in section 10) could be considered for no tax withholding:

(21) any income of a research association for the time being approved for the purpose of clause (ii) or clause (iii) of sub-section (1) of section 35:

(23A) any income (other than income chargeable under the head "Income from house property" or any income received for rendering any specific services or income by way of interest or dividends derived from its investments) of an association or institution established in India having as its object the control, supervision, regulation or encouragement of the profession of law, medicine, accountancy, engineering or architecture or such other profession as the Central Government may specify in this behalf, from time to time, by notification in the Official Gazette:

(23AAA) any income received by any person on behalf of a fund established, for such purposes as may be notified by the Board in the Official Gazette, for the welfare of employees or their dependants and of which fund such employees are members

(23B) any income of an institution constituted as a public charitable trust or registered under the Societies Registration Act, 1860 (21 of 1860), or under any law corresponding to that Act in force in any part of India, and existing solely for the development of khadi or village industries or both, and not for purposes of profit, to the extent such income is attributable to the business of production, sale, or marketing, of khadi or products of village industries:

(23BBF) any income of the North-Eastern Development Finance Corporation Limited, being a company formed and registered under the Companies Act, 1956 (1 of 1956):

(23BBG) any income of the Central Electricity Regulatory Commission constituted under sub-section (1) of section 76 of the Electricity Act, 2003 (36 of 2003);

(23BBH) any income of the Prasar Bharati (Broadcasting Corporation of India) established under sub-section (1) of section 3 of the Prasar Bharati (Broadcasting Corporation of India) Act, 1990 (25 of 1990);

(23C) any income received by any person on behalf of—

(iiiaa) the Swachh Bharat Kosh, set up by the Central Government; or

(iiiaaa) the Clean Ganga Fund, set up by the Central Government; or

(iiiad) any university or other educational institution existing solely for educational purposes and not for purposes of profit if the aggregate annual receipts of such university or educational institution do not exceed the amount of annual receipts as may be prescribed; or

(iiiae) any hospital or other institution for the reception and treatment of persons suffering from illness or mental defectiveness or for the reception and treatment of persons during convalescence or of persons requiring medical attention or rehabilitation, existing

solely for philanthropic purposes and not for purposes of profit, if the aggregate annual receipts of such hospital or institution do not exceed the amount of annual receipts as may be prescribed; or (iv) any other fund or institution established for charitable purposes which may be approved by the prescribed authority, having regard to the objects of the fund or institution and its importance throughout India or throughout any State or States; or

(v) any trust (including any other legal obligation) or institution wholly for public religious purposes or wholly for public religious and charitable purposes, which may be approved by the prescribed authority, having regard to the manner in which the affairs of the trust or institution are administered and supervised for ensuring that the income accruing thereto is properly applied for the objects thereof;

(vi) any university or other educational institution existing solely for educational purposes and not for purposes of profit, other than those mentioned in sub-clause (iiiab) or sub-clause (iiiad) and which may be approved by the prescribed authority; or

(via) any hospital or other institution for the reception and treatment of persons suffering from illness or mental defectiveness or for the reception and treatment of persons during convalescence or of persons requiring medical attention or rehabilitation, existing solely for philanthropic purposes and not for purposes of profit, other than those mentioned in sub-clause (iiiac) or sub-clause (iiiae) and which may be approved by the prescribed authority:

(23D) subject to the provisions of Chapter XII-E, any income of—

(i) a Mutual Fund registered under the Securities and Exchange Board of India Act, 1992 (15 of 1992) or regulations made thereunder;

(ii) such other Mutual Fund set up by a public sector bank or a public financial institution or authorised by the Reserve Bank of India and subject to such conditions as the Central Government may, by notification in the Official Gazette, specify in this behalf.

(23EE) any specified income of such Core Settlement Guarantee Fund, set up by a recognised clearing corporation in accordance with the regulations, as the Central Government may, by notification in the Official Gazette, specify in this behalf:

(26BBB) any income of a corporation established by a Central, State or Provincial Act for the welfare and economic upliftment of ex-servicemen being the citizens of India.

(44) any income received by any person for, or on behalf of, the New Pension System Trust established on the 27th day of February, 2008 under the provisions of the Indian Trusts Act, 1882 (2 of 1882);"