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THE INDIAN PRIVATE EQUITY & VENTURE CAPITAL ASSOCIATION

To,
Shri Jayant Sinha
Minister of State for Finance
Ministry of Finance, North Block,
New Delhi, India

11th March 2015

Dear Sir,

Sub - Proposed amendments in the Union Budget 2015-16 impacting private equity industry

At the outset, we would like to congratulate the Ministry of Finance led by the Hon'ble Finance Minister, Shri Arun Jaitley on the steps announced in the budget for beginning a journey towards sustained growth and macro-economic stabilization. The proposal to defer General Anti-Avoidance Rulesby two years and clarifications on indirect transfer provisions have been welcomed by the investor community.

From a private equity sector perspective, the proposalsin the Finance Bill 2015 (Bill) relating to tax 'pass through' for Category I and II Alternative Investment Funds (AIFs)and specific provisions to mitigate business connection and tax residency of offshore funds in India, on account of fund management from India, are a step in the right direction.The purpose of this letter is to provide recommendations on the above and other proposals relevant to the private equity sector, which if implemented will help in stepping up the ability of this sector to mobilise higher resources and make higher investments in small and medium enterprises, infrastructure and social projects and new ventures/ start-ups.

1. Tax 'Pass Through' for AIFs

1.1 Section 10(23FBA) (clause 7 of the Bill) read with section 115UB (clause 32 of the Bill) proposes to provide that any income of AIFs, other than the income chargeable under the head 'Profits and gains of business or profession', would be exempt in the hands of the AIFs and be taxable in the hands of the investors on a pass through basis.

Issue	Recommendation
The characterization of income from investments in securities as capital gains or business income has always been a vexed issue with only guiding principles provided in a CBDT instruction/ circular. In absence of a clear provision to treat the income of AIF's as capital gains, there is high probability of the tax authorities characterising the gains from investments by AIFs as 'business profits' and thereby taxing the AIFs income at the fund level i.e. effectively, no tax 'pass through'.	Amend the definition of capital asset under section 2(14) of the Income-tax Act, 1961 (Act) to include investments held by AIF in accordance with the applicable regulations of Securities and Exchange Board of India.

1.2 Sub-section (2) of section 115UB (Clause 32 of the Bill) proposes that net loss incurred by the AIF would not be passed onto investors i.e. loss can be carried forward and set-off only at AIF level.

Issue	Recommendation
The proposal will result in additional tax outflow for investors who could have used the loss as a set-off against their individual taxable income. Additionally, unutilised losses of the AIF at the end of its term would lapse on winding down/ liquidation.	Delete sub-section (2) of proposed section 115UB to extend tax 'pass through' to losses. Alternatively, provide that unutilised losses of the AIF on liquidationshall be passed on to the unit-holders.

1.3 Section 194LBB (clause 46 of the Bill) proposes a withholding tax at 10% by the AIF on the income (other than income taxable at AIF level) payable to investors.

Issue	Recommendation
The proposal will result in tax withholding on exempt income i.e. long term capital gains on listed securities, dividend and buyback proceeds.In the case of non-resident investors availing benefit under a tax treaty, the tax withholding will result in a cash trap. Further, where an investor in the AIF is also an AIF, the proposal would lead to two levels of tax withholding.	Amend the proposed section 194LBB to exclude tax withholding on the following income payable to investors - • Any exempt income. For e.g. long term capital gains on listed securities, dividend, buyback proceeds. • Income which is subject to beneficial treatment under a tax treaty (withholding to be applied based on the provisions of the tax treaty, where more beneficial). • Income payable to an investor who is an AIF.

2. <u>Specific provisions to mitigate business connection and tax residency of offshore funds in India, on account of fund management from India</u>

2.1 Sub-section (1) of section 9A (clause 6 of the Bill) proposes to provide that in case of an eligible investment fund, the fund management activity carried out through an eligible fund manager shall not constitute a business connection of the said fund in India.

Issue	Recommendation
While the Budget speech states that "mere presence of fund manager in India would not constitute a PE of offshore fund resulting in adverse tax consequences", sub-section (1) of section 9A simply clarifies that fund management activity in India shall not constitute a business connection in India of the offshore fund.	Proposed section 9A to further clarify that fund management activity in India shall not constitute a permanent establishment in India of the offshore fund.

2.2 Sub-section (3) of section 9A prescribes 13 conditions which an offshore fund needs to satisfy in order to qualify as an 'eligible investment fund'.

Issues	Recommendations
The requirement in clause (e) for the offshore fund to have 25 members would not be fulfilled where the fund invests into India via intermediate holding company/ies, although the fund itself may have more than 25 members. Additionally, sovereign wealth funds, university funds, etc., may stand excluded.	Simplify the conditions in light of the fact that most of the funds will find it extremely challenging to meet the onerous conditions.
The requirement in clause (f) for any member along with the connected person not having participation interest of more than 10% would not be satisfied where the fund has few large investors holding more than 10%.	
The requirement in clause (g) for aggregate participation interest of ten or less members along with their connected persons shall be less than 50% would not be satisfied where the fund has less than 10 institutional investors comprising the total corpus.	
The requirement in clause (k) for the fund not controlling and managing any business in/from India, would not be satisfied in case of buy-out funds which typically acquire controlling stake in investee companies.	

2.3 Sub-section (4) of section 9A prescribes the conditions which a fund manager needs to satisfy in order to qualify as an 'eligible fund manager'.

Issues	Recommendations
The requirement in clause (a) for the fund manager to not be a connected person of the fund may be difficult where the fund manager is owned by the Sponsor or its Associate	Clarify that this clause shall not be applicable where the fund manager is owned by the Sponsor or its Associate.
The requirement in clause (d) of the fund manager not being entitled more than 20% of the profits of the fund, results is capping of the profits of the fund manager which is based on commercial arrangement.	Delete clause (d) of sub-section (4) of section 9A, since this condition is already taken care of in clause (m) of sub-section (3) of section 9A.

3. Place of Effective Management (POEM)

3.1 Section 6 (clause 4 of the Bill) proposes that a company incorporated outside India shall be considered to beresident in India in any previous year, if its place of effective management, at any time in that year, is in India.

Issue	Recommendation
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.	Delete the words 'at any time in that year' from clause (ii) sub-section (3) of section 6 of the Act.

4. No Minimum Alternate Tax (MAT) on capital gains arising to Foreign Institutional Investors (FIIs)

4.1 Section 115JB (clause 29 of the Bill) proposes that capital gains arising to a FII from transactions in securities (other than short term capital gains on which Securities Transaction tax is not chargeable), will be excluded in computing the MAT liability of the FII.

Issue	Recommendation
Rationalising the applicability of MAT provisions only for capital gains derived by FIIsimplies that MAT applies to foreign companies having no presence in India. This will severely impact private equity funds who have been investing in India for several decades under the Foreign Direct Investment and Foreign Venture Capital Investor route.	Amend section 115JB to clarify that MAT should apply only where (and to the extent) the foreign company, is required to prepare profit and loss account in accordance with the Companies Act

We sincerely thank you for providing us an opportunity to meet you and discuss the high priority areas where immediate clarity is sought by the private equity sector.

The aforesaid measures will send a positive signal to the investor community and also boost the confidence of domestic and offshore funds. We are happy to engage with you or the Department of Revenue on any of the above issues.

We appreciate your attention in this regard and would request you to consider the above recommendations.

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Thank You.

Respectfully,

For **Indian Private Equity & Venture Capital Association of India**

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