

IIR's 5th Annual West Coast Program for
Venture Capital Private Equity Tax Practices

THE INDIAN PRIVATE
EQUITY STORY

NISHITH DESAI | OCTOBER 23, 2006 |

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INDIA ADVANTAGE



- World's largest democracy
- GDP growth rate for 2005-06: 8.1%
- Inflation rate for 2005-06: 4.1%
- Rising young population
- Parliamentary form of Government
- World-class recognition in IT and biotechnology
- Services sector contributing approximately 54% to GDP
- Largest English speaking nation in the world
- India-China, rising powers in Asia
- India could emerge as the world's fastest growing economy by 2020
- Bold and independent judiciary

Eleventh Plan may target 10% growth

PM chairs Plan Panel meet today to set rate

RUPESH JANVE

New Delhi, 17 October

The Planning Commission might make a pitch to Prime Minister Manmohan Singh tomorrow for a 10 per cent GDP growth target during the Eleventh Five-Year Plan period.

Singh, who is also the chairman of the Planning Commission, has more than once talked of raising the growth bar to 10 per cent per annum. Double-digit GDP growth will be a quantum leap over the 8 per cent set by the Atal Bihari Vajpayee-led NDA government.

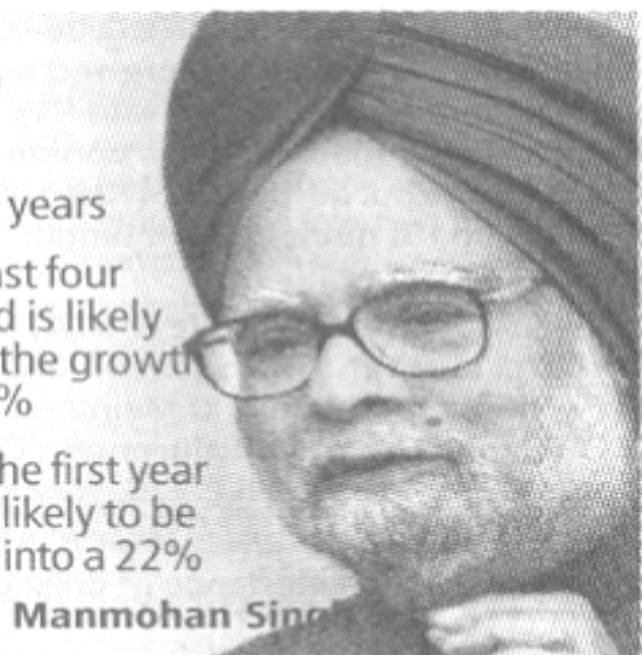
At a meeting of the full Planning Commission here tomorrow, the growth target for the Eleventh Plan is likely to be

GROWTH PLANS

- Meeting will take note of the accelerated growth in recent years
- Average growth rate in the last four years of the Tenth Plan period is likely to be a little over 8%, taking the growth rate for the Tenth Plan to 7.2%
- Gross budgetary support for the first year of the Eleventh Plan period is likely to be Rs 210,728 crore, translating into a 22% increase over 2006-07

the bar higher. The first draft of the approach paper in July had targeted a growth rate of 8.5 per cent for the Eleventh Plan.

The meeting will take note of the accelerated growth in recent



Manmohan Singh

growth rate for the Tenth Plan to 7.2 per cent. However, this is below the targeted 8 per cent rate.

The commission, which has discussed options of starting the Eleventh Plan in 2007-08

Pvt equity investment touches \$5.4 b, in 9 months

Our Bureau

Chennai, Oct. 10

Private equity firms have invested about \$5.4 billion in India during the first nine months of 2006, according to a study by Venture Intelligence, a Chennai-based research service focused on private equity and venture capital.

The quarter ended September 2006 witnessed private equity firms invest \$1,984 million across 100 deals, the study revealed. The amount invested during July-September quarter was marginally higher than the earlier

Top PE Investments: Jul-Sep 2006

Top PE Investments: Jul-Sep 2006			
(\$ million)			
Company	Sector	Amount	Investors
Quattro BPO Solutions	BPO	100	Olympus Capital
Centurion Bank of Punjab	Banking	90.7	Bank Muscat, ICICI Ventures
UTI Bank	Banking	80	ChrysCapital
Aryan Coal Benefications	Mining	66	Warburg Pincus
Gujarat Pipavav Port	Ports	65.2	31, others

Source: Venture Intelligence

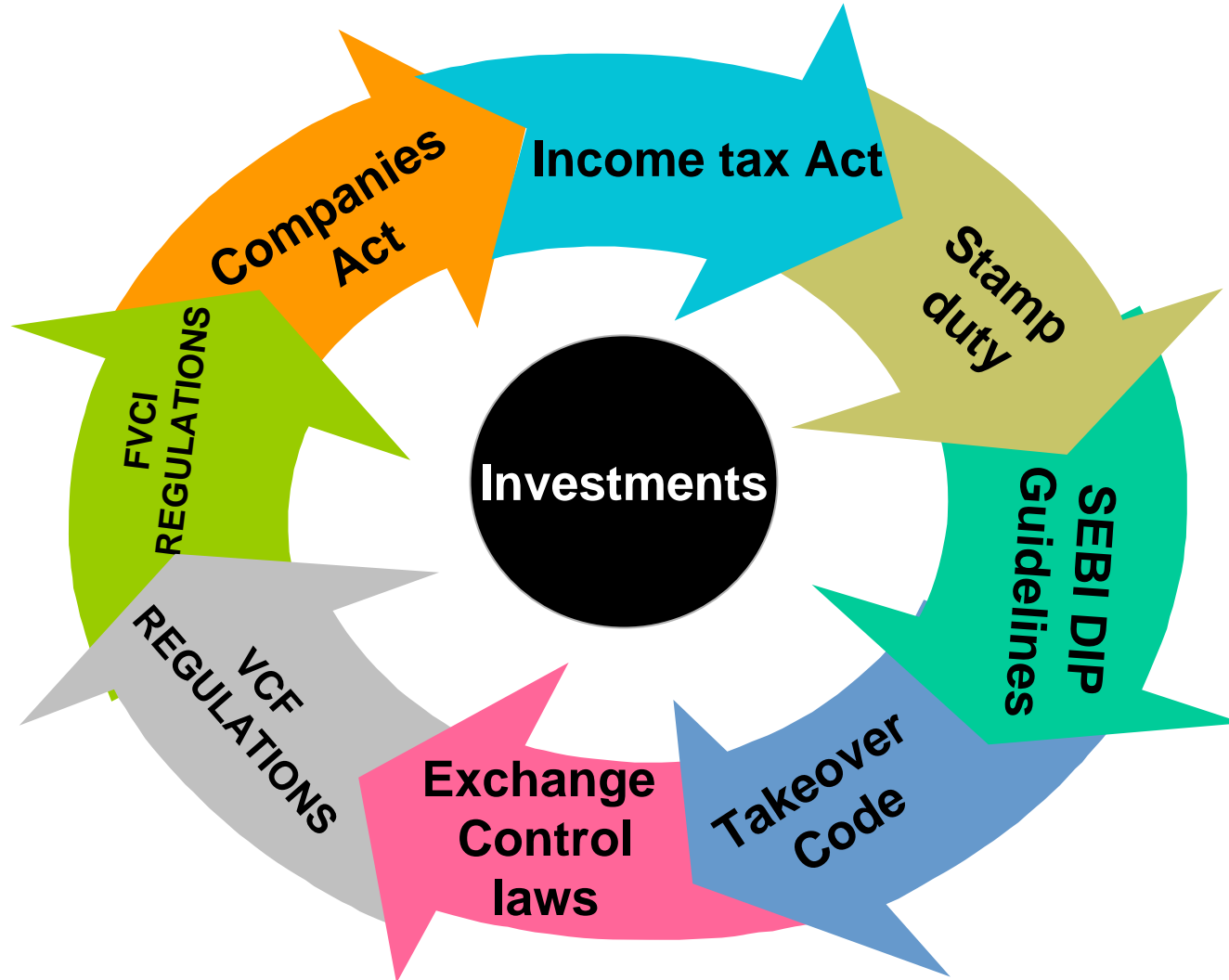
quarter. "With the October-December quarter being a traditionally strong quarter for private equity investments in India and with real estate investments being

opened up further, we can expect to close the year with over \$7 billion in investments," said Mr Arun Nataraajan, Founder & CEO, Venture Intelligence, in a press re-

lease. With 32 deals worth about \$317 million, information technology and IT-enabled services re-emerged as the favourite industry among private equity investors during the latest quarter. The manufacturing industry followed with 14 deals worth \$289 million.

Other industries that attracted significant private equity investor attention during the quarter include healthcare and life sciences, BFSI (banking, financial services and insurance), food and beverages, and textiles and garments, says the release.

KEY LEGISLATIONS



MODES OF INVESTMENT

- Foreign Direct Investor (FDI)
- Foreign Institutional Investor (FII)
- Foreign Venture Capital Investor (FVCI)
- Non-resident Investor (NRI)

FDI REGIME

- 100% foreign investment permitted in most sectors on automatic basis except:
 - Banking (74%)
 - Telecom services (74%)
 - Civil Aviation (49%)
 - Insurance (26%), etc.
- Certain sectors where FDI is prohibited:
 - Atomic Energy
 - Lottery business
 - Gambling and Betting
- Certain sectors where there are minimum capitalisation requirements:
 - Non-banking financial services activity (19 activities – fee based and fund based)
 - Real estate construction and development projects

FDI REGIME

- RBI Pricing guidelines applicable for
 - transfer of shares by a non-resident to an Indian resident; and
 - transfer of shares by an Indian resident to a non-resident
- Allotment of shares on preferential basis shall be as per the requirements of the Companies Act, 1956, which will require special resolution in case of a public limited company
- In case of listed companies, valuation of shares issued on a preferential basis shall be as per the SEBI guidelines as follows:
 - The issue price shall be either at:
 - (a) The average of the weekly high and low of the closing prices of the related shares quoted on the stock exchange during the six months preceding the relevant date; or
 - (b) The average of the weekly high and low of the closing prices of the related shares quoted on the stock exchange during the two weeks preceding the relevant date.
- In case of unlisted companies, valuation shall be done in accordance with the guidelines issued by the erstwhile Controller of Capital Issues

FII REGIME

- A single FII cannot hold more than 10% of the Indian company and aggregate holding capped at 24% / sectoral caps
- Investment in listed and unlisted securities
- No co-mingling of proprietary and client funds
- 100% debt funds – capped on total debt exposure: US\$ 2 bn
- Types of sub-accounts – broad based, proprietary, foreign corporation, foreign individual
- FIIs cannot issue participatory notes to unregulated entities

FVCI REGIME

- Introduced in 2000 for foreign Private Equity/VC investors
- SEBI registration – Optional
- FVCI can also invest into VCF for downline investments in the VCU
- Registration takes 4-6 weeks, application fees (US\$ 5,000) and registration fees (US\$ 20,000)

- **Benefits**
 - Free entry and exit pricing
 - Liberal lock-in conditions post IPO
 - QIB status

- **Investment Conditions/Restrictions**
 - Min 2/3rd in unlisted equity shares or equity linked instruments of VCU / max 1/3rd in IPO of a VCU, debt or debt instruments of a VCU in which VCF has already invested by way of equity
 - Appoint local custodian/bank in India

- **Negative List for investment by FVCI**
 - NBFCs (excluding NBFCs which are registered with the RBI and have been categorized as hire purchase companies or equipment leasing companies)
 - gold financing
 - activities not permitted under the Industrial Policy of the Government

VCF REGIME

- Introduced in 1996 for Domestic Private Equity/VC investors
- Each Scheme launched or fund set up by a VCF shall have firm commitment from investors for contribution of at least Rs 5 Crores (approx USD 1.1 mn) before the start of operations of the VCF
- VCFs treated as pass-through for tax purposes
- **Investment Conditions/Restrictions**
 - Min 2/3rd in unlisted equity shares or equity linked instruments of VCU / max 1/3rd in IPO of a VCU, debt or debt instruments of a VCU in which VCF has already invested by way of equity
 - VCF cannot invest more than 25% of the corpus of the Fund in one VCU
- **Negative List for investment by VCF**
 - NBFCs (excluding NBFCs which are registered with the RBI and have been categorized as hire purchase companies or equipment leasing companies)
 - gold financing
 - activities not permitted under the Industrial Policy of the Government

NRI REGIME

- NRI , NRI owned companies (OCB's) cannot invest through the FII route
- NRI's can invest through the following schemes:
 - Regulation 5(3) – purchase of shares or convertible debentures of an Indian company on a stock exchange under Portfolio Investment Scheme and purchase on non-repatriation basis other than under Portfolio Investment Scheme
 - Regulation 5(4) – purchase of securities other than shares or convertible debentures of an Indian company
 - Regulation 5(7) – invest in all SEBI approved exchange traded derivative contracts out of INR funds
- Press Note 2 (2005) restrictions on real estate not applicable to NRI's
- NRI's can acquire immovable property in India
- Restrictions on transfer of shares by an NRI:
 - between an NRI and an NRI is freely permissible
 - NRI to Non residents needs prior permission of the FIPB
 - NRI to residents needs prior permission of the FIPB

INDIAN TAX OVERVIEW

- Domestic company : 33.66%; Foreign company : 41.82%
- Dividend distribution tax : 14.025%
- Capital gains tax : on exit or restructuring – 0% to 40% (long/short term)
- Withholding taxes: nagging problems
- The above taxes could **increase** on account of:
 - **Minimum Alternate Tax** : 10% on book profits
 - **Fringe Benefits Tax** : 33.66% on specified value of certain fringe benefits provided to employees, payable by the employer
 - **Transfer pricing**: New regulations, strict penalties (up to 300% of the tax sought to be evaded by way of concealment of income or furnishing of inaccurate particulars), transfer pricing adjustments not covered by the tax holiday
 - **Business Connection** : Tricky issues
- The above taxes could **decrease** on account of:
 - Use of **tax incentives** available under the local tax laws
 - Use of **tax treaties** entered into by India with foreign countries

TAXATION OF FDI /FVCIs

The FDI Investors / FVCIs are taxed as normal foreign investor

Type of Income	Tax*
Dividends	0%
Interest income	20%** / 40%
Long term capital gains	0%*** / 10%**** / 20%
Short term capital gains	10%*** / 40%
Business income	40%

* These rates are exclusive of the currently applicable surcharge on tax and education cess

** If borrowing is in foreign currency

*** If sale is made through a stock exchange and Security Transaction Tax levied

**** If sale is made off the stock exchange

TAXATION OF FIIs

Special regime for FIIs under section 115AD of Income-tax Act, 1961 (“ITA”)

Type of Income	Tax*
Dividends	0%
Income from securities	20%
Long term capital gains	0%** / 10%
Short term capital gains	10%** / 30%
Business income	20%*** / 40%

* These rates are exclusive of the currently applicable surcharge on tax and education cess

** If sale is made through a stock exchange and Security Transaction Tax levied

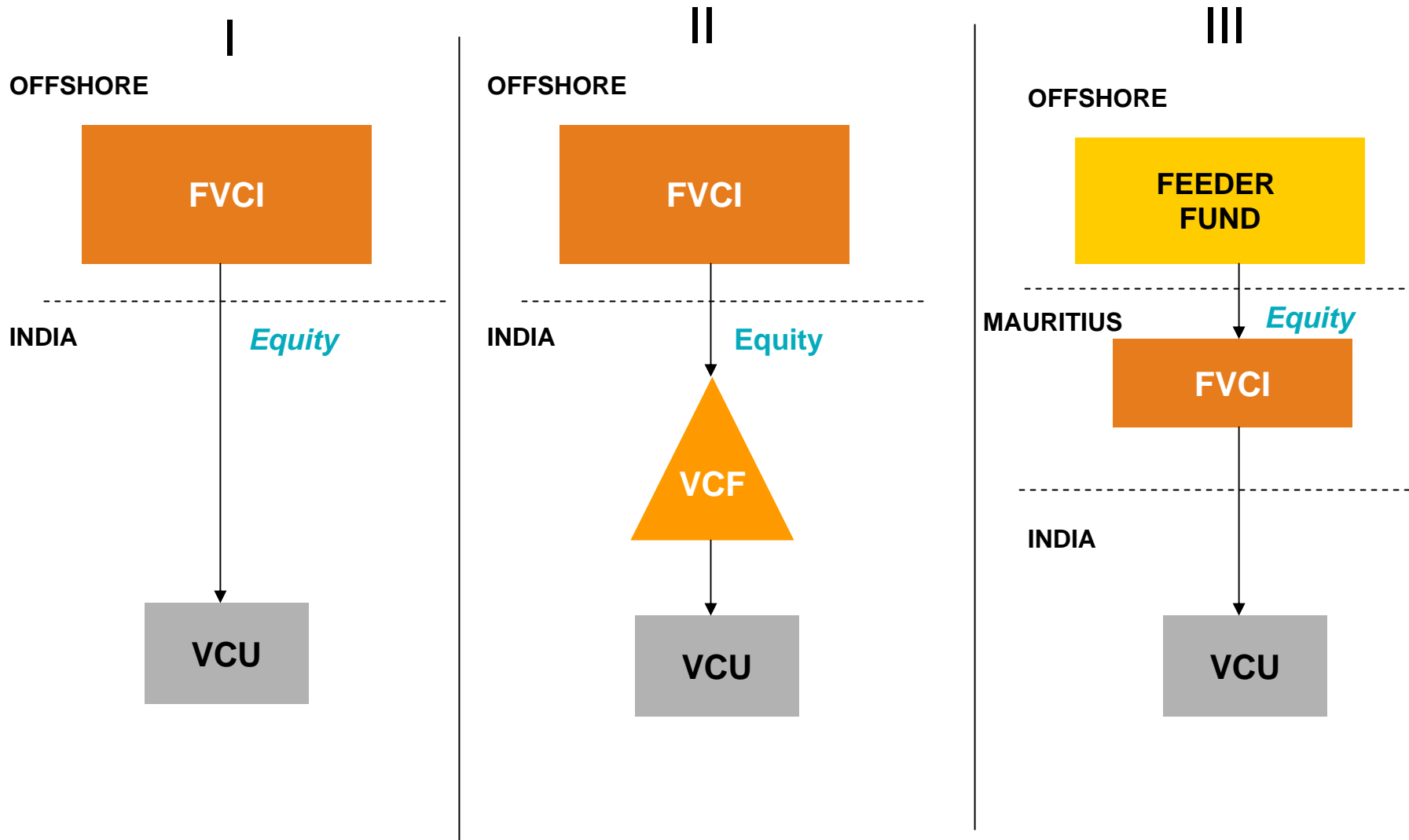
*** There is an ambiguity as regards whether the income earned by an FII would be taxable at the rate of 20% or 40%

TAXATION OF VCFs

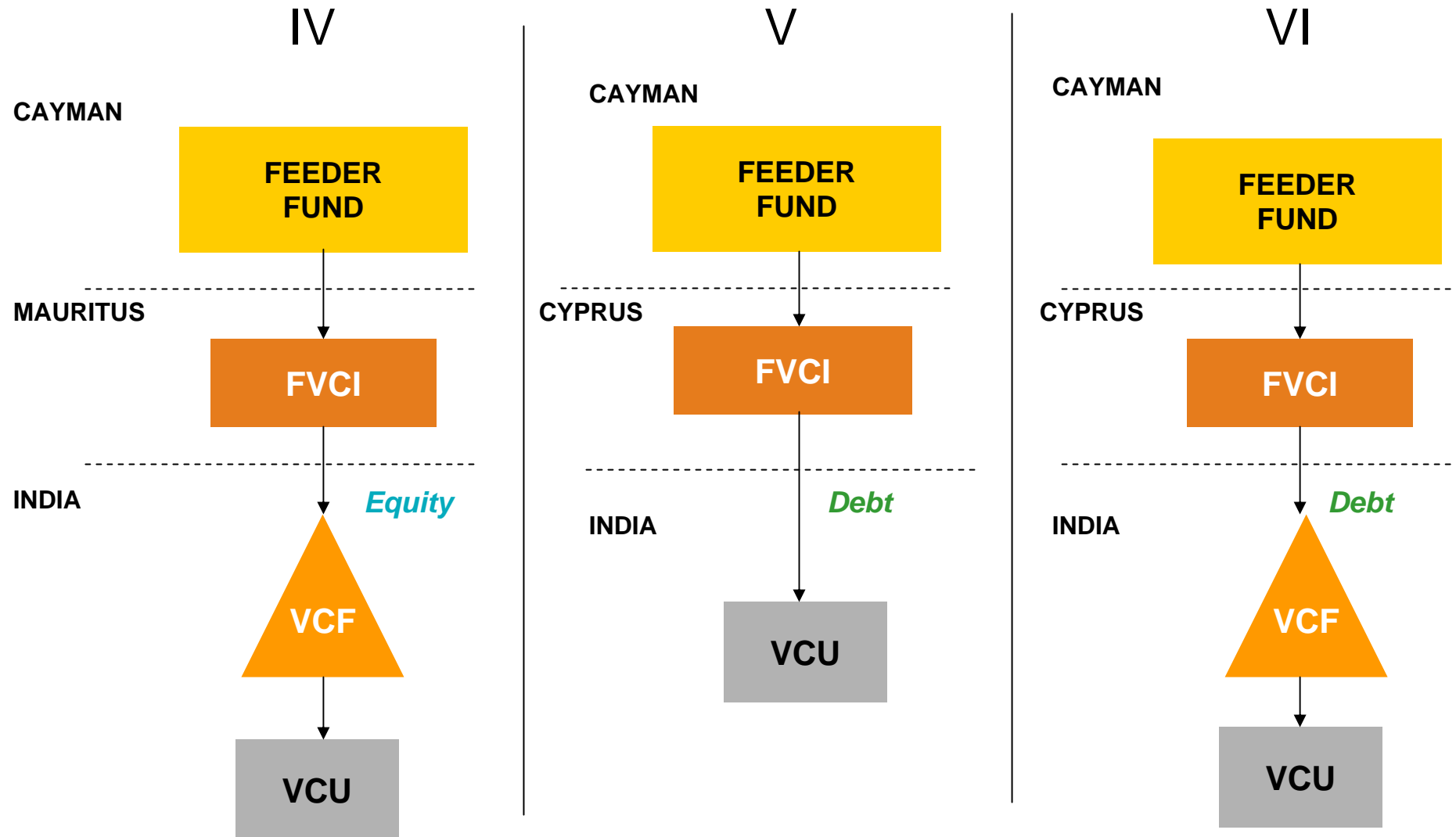
Special regime for VCFs under sections 10(23FB) and 115U of the ITA

- **Section 10(23FB) of the ITA:** exempts “Any income of a venture capital company or a venture capital fund set up to raise funds for investment in a venture capital undertaking”
- **Section 115U(1) of the ITA:** “Notwithstanding anything contained in any other provisions of this Act, any income received by a person out of investments made in a venture capital company or a venture capital fund shall be chargeable to income-tax in the same manner as if it were the income received by such person had he made investments directly in the venture capital undertaking”
- **Section 115U(3) of the ITA:** “The income paid by the venture capital company or a venture capital fund shall be deemed to be of the same nature and in the same proportion in the hands of the person receiving such income as it had been received by, or had accrued to the venture capital company or the venture capital fund, as the case may be, during the previous year”

TYPICAL STRUCTURES



TYPICAL STRUCTURES...



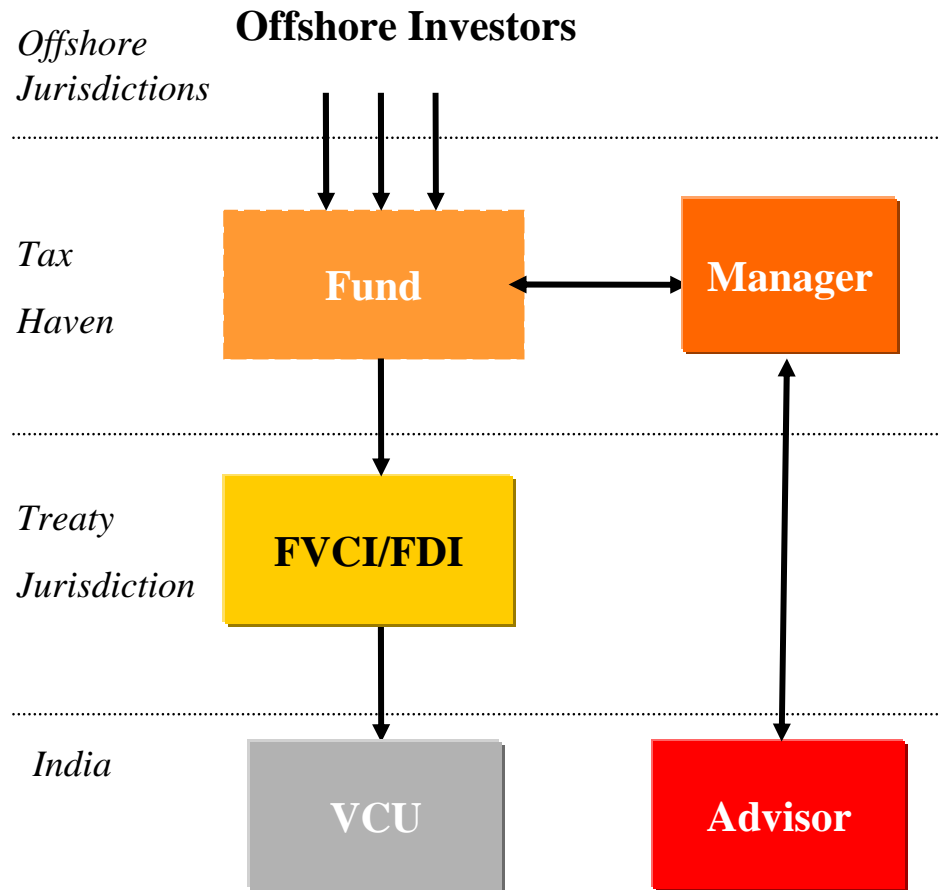
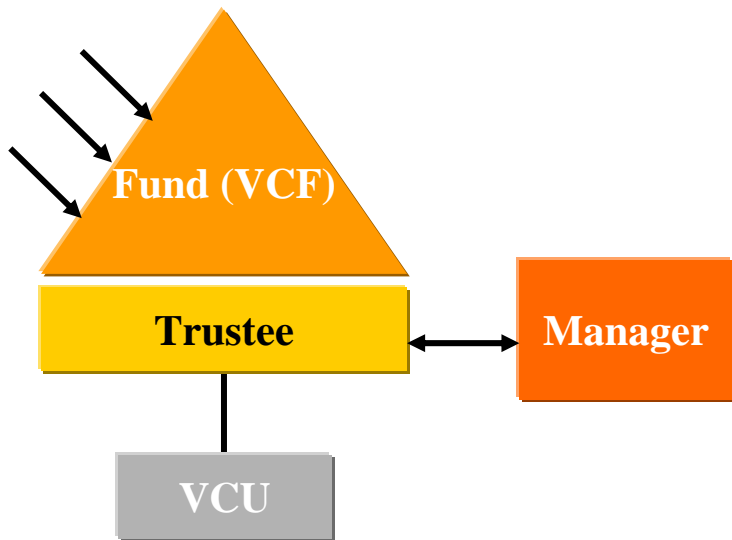
TAX STRUCTURING

Commonly considered jurisdictions for SPVs

- *Singapore*: No tax on incoming or outgoing dividends. CECA with India
- *Netherlands*: Participation exemption - no tax on incoming dividends and on sale of shares of the subsidiary
- *Cyprus*: International Business Company regime. No tax on dividends and capital gains received and no withholding tax on dividends and interest distributed
- *UK*: Substantial shareholding (based on % of holding and length of ownership) – underlying tax credit is available
- *Mauritius*: GBC 1 regime, effective 3% tax. Tax credit available in India for underlying taxes in respect of dividends. Credit in India for taxes “payable”

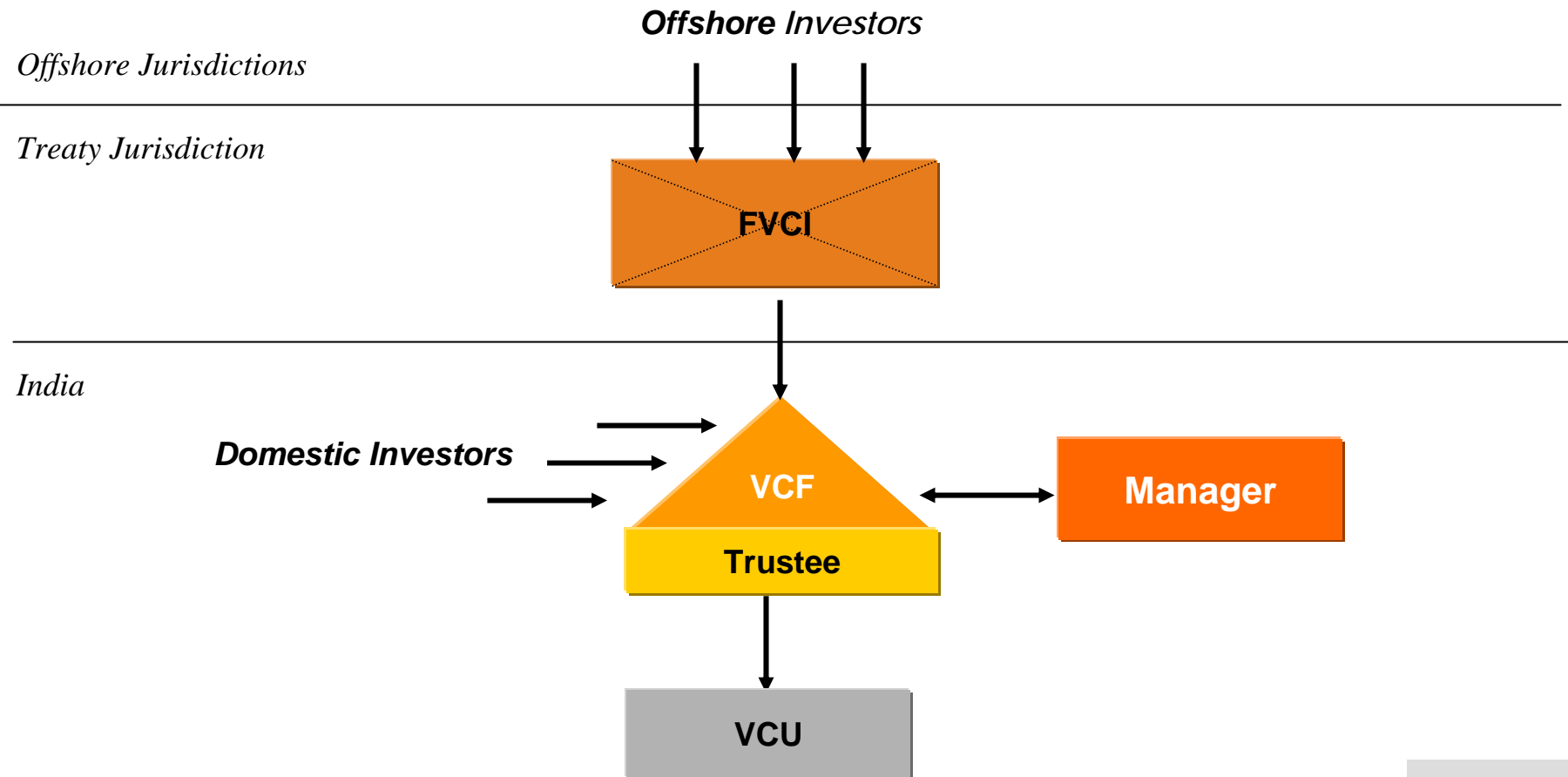
TAX STRUCTURING...

Alternative 1: Pure Domestic and Offshore Structures



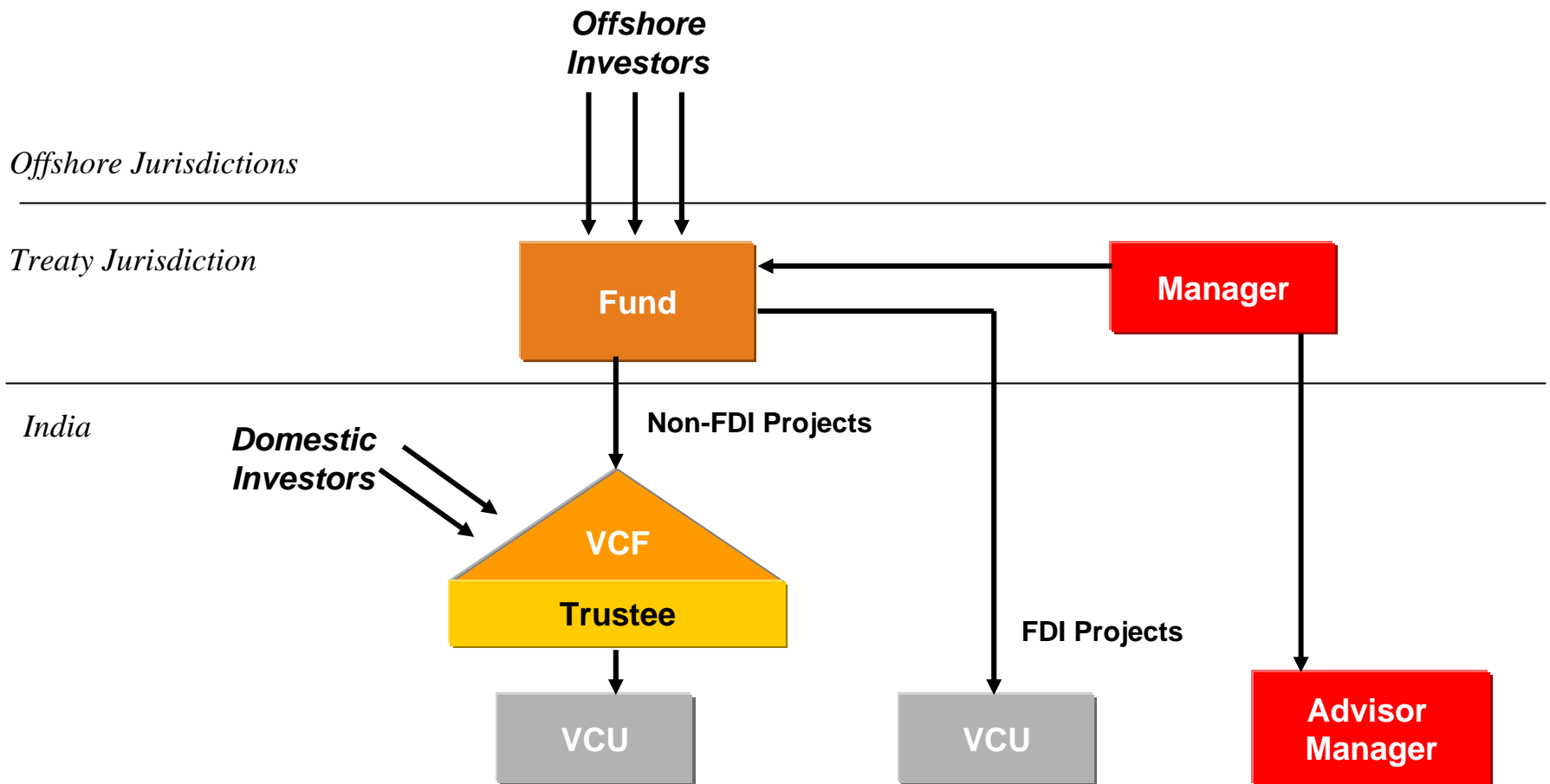
TAX STRUCTURING...

Alternative 2: Unified Structure

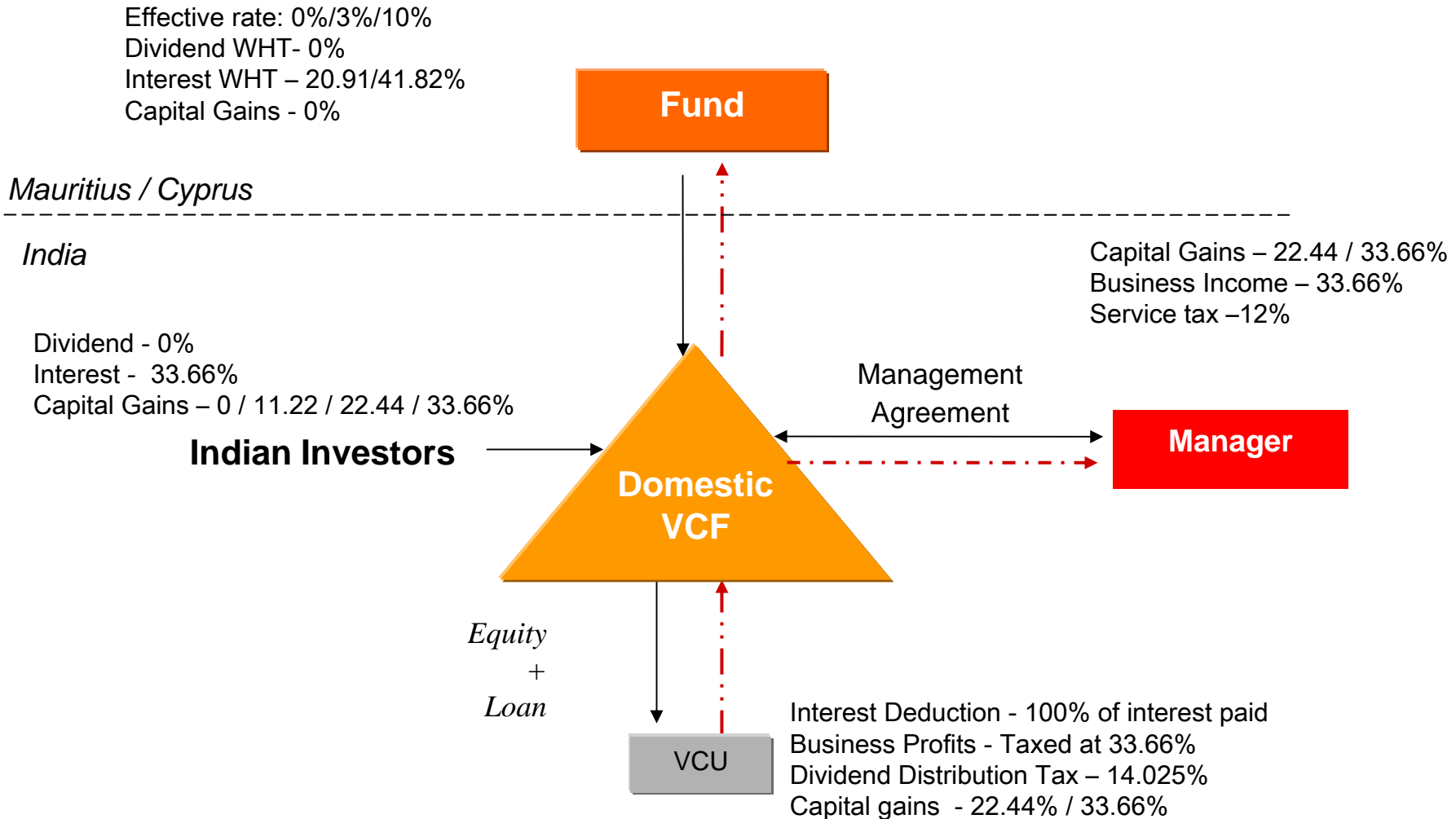


TAX STRUCTURING...

Alternative 3: Co-investment Structure



Tax Implications



ADVANCE RULINGS

CLARITY AND CERTAINITY ?

Authority for Advance Ruling

- Special mechanism under ITA
- Chairman – retired judge of Supreme Court
- Ruling is binding on applicant and tax authorities
- To be effective until change in law / facts
- No appeal against ruling

Time: 3-6 months

Burning Issues

FVCI

- Secondary purchase by FVCIs
- FVCI approval in real estate
- PCC in Mauritius – issues

FII

- Sub account registration
- NRI Investment
- P-Note Investment
- Hedge Fund Investment
- Capital gains v/s Business Income



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Thank You

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