

VC INVESTMENTS INTO INDIA

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Introduction

Venture capital and private equity funds are becoming increasingly popular routes of foreign investment into India. Venture capital funds (“VCF”) are professional money managers who provide risk capital to businesses. They assume various forms; however, they all share the common trait of making investments in privately held companies at an early stage on the belief that the investee companies have the potential to provide them a very high rate of return on the investment made.

Structuring Venture Capital Funds

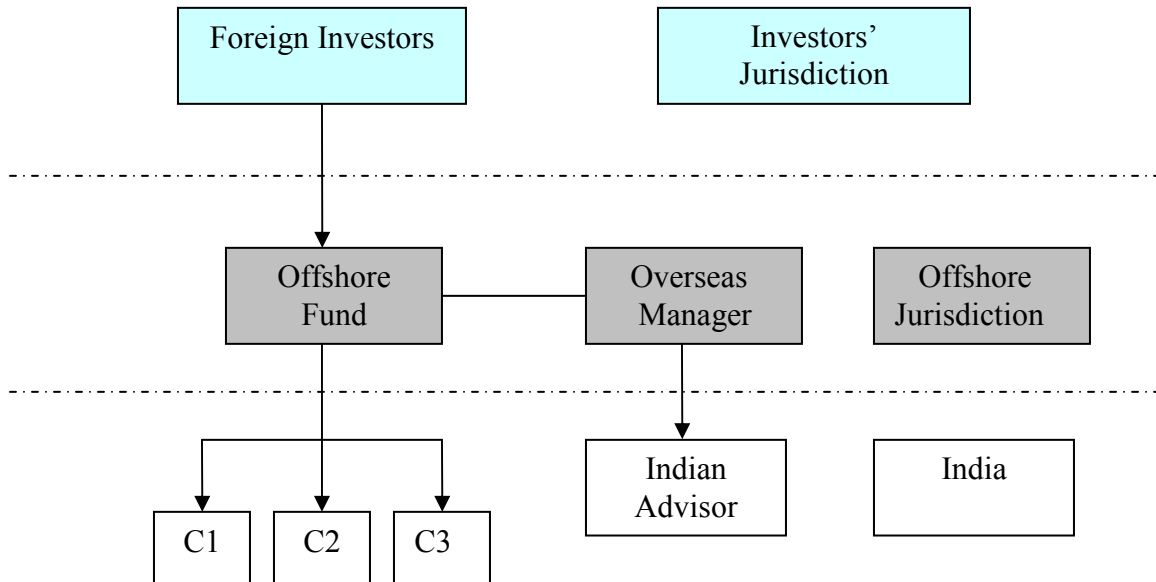
The three (3) most common types of venture capital funds are as follows:

Domestic Funds

For domestic funds (i.e., where the funds are going to be raised in India), the structure most commonly used involves the establishment of a domestic investment vehicle which pools funds from the investors, and also a separate investment advisor for carrying on asset management activities and identifying possible investee companies. The domestic investment vehicle is either a trust or company. It is pertinent to note that unlike in the US or the UK, India does not recognize limited partnerships. Due to operational flexibility, trusts have been the most favoured option for domestic VCFs.

Offshore Funds

Here, an investment vehicle in the form of a limited liability company or limited liability partnership organized in an offshore tax favorable jurisdiction makes portfolio investments into Indian companies. Mauritius, which has a favorable tax treaty with India, is routinely used to locate the investment vehicle (see discussion below). Usually, there is an offshore manager to administer the assets of the fund, and an investment advisor in India for identifying deals and prospective investment opportunities.

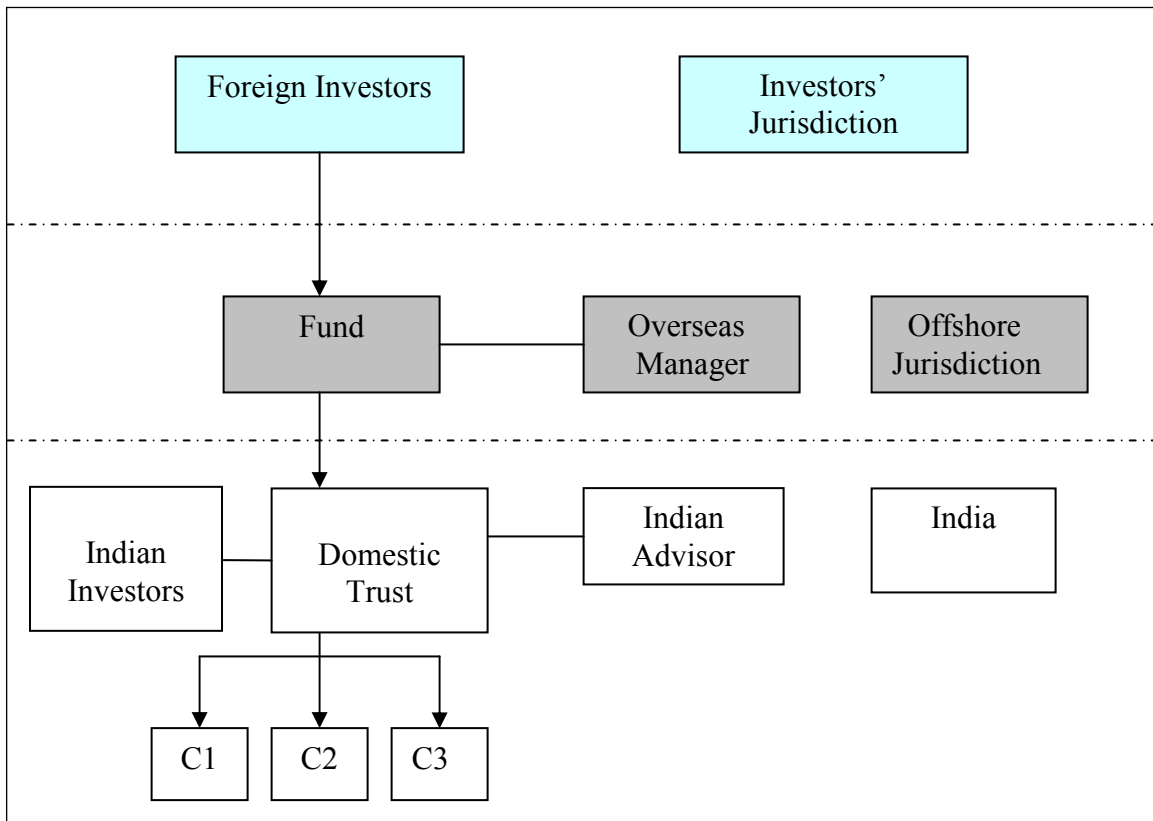


However, in such a structure, the relationship between the Indian advisor, the overseas manager and the offshore fund must be structured very carefully. This is important so as to avoid a situation where the offshore fund is deemed to have a permanent establishment (“PE”) in India, which can have adverse tax implications.

Unified Funds

This structure is generally used where domestic investors are also expected to participate in the fund. In this structure, a domestic investment vehicle is established in India preferably as a trust (alternatively, as a company) in addition to the offshore fund. This domestic trust is registered with the Securities Exchange Board of India as a venture capital fund.

The domestic investors directly contribute to the domestic trust, whereas overseas investors pool their investments into the offshore fund, which, in turn, invests in the domestic trust. The portfolio investments are made by the trust, which will generally have a domestic manager or advisor.



This structure is preferred from a tax perspective as well. As the Indian advisor is not connected with the offshore fund directly and it draws its compensation from the domestic trust, the chances of the Indian advisor being considered as the offshore fund's PE are fairly slim.

Taxation of Venture Capital Funds and Investors

Domestic Investors

Income earned by a domestic SEBI registered VCF (whether a trust or a company) from an investment in a venture capital undertaking is exempt from tax. (Section 10(23 FB) of the Income Tax Act, 1961 (the "Act").) Such VCFs have been accorded a "pass through" status, i.e., the investors in the VCF are directly taxed on any income distributed by the VCFs as though the investors have made direct investments in the portfolio companies. (Section 115U of the Act.) However, to avail this "pass through" status, the VCF's investments must be made in domestic companies whose shares are not listed on any recognized stock exchange in India.

Further, the domestic investee companies must only be engaged in the following activities:

- (a) dairy or poultry industry;
- (b) nanotechnology;
- (c) information technology relating to hardware and software development;
- (d) seed research and development;
- (e) biotechnology;
- (f) research and development of new chemical entities in the pharmaceutical sector;
- (g) production of bio-fuels; or
- (h) building and operating composite hotel-cum-convention centers having a seating capacity of more than 3000 persons.

The tax treatment of the income that is subject to “pass through” status will depend on the nature of the income. Dividend income is tax free in the hands of shareholders, but is subject to a dividend distribution tax of 16.99 % payable by the company distributing the dividend. Otherwise, capital gains tax is charged on the sale of shares of the investee companies. Shares held for 12 months or more are subject to long-term capital gains tax.

Long-term capital gains tax is chargeable at the rate of 20% in case of a gain on transfer of unlisted shares. In case of listed shares, long-term capital gains tax is exempted provided Securities Transaction Tax (“STT”) is paid on such sale.

Short-term capital gains on sale of unlisted shares is chargeable to tax depending on the type of assessee, i.e., for individuals, the rate varies between 10% to 30% and for corporate bodies, the rate is 30% for domestic companies and 40% for foreign companies. On sale of listed shares, the tax rate for short-term capital gains is 15%.

The above rates are further subject to a surcharge at the rate of 10% for residents and 2.5% for foreign bodies, and an education cess of 3%.

In the event where the VCF invests in securities which are listed on recognized stock exchanges, it will have to bear the STT. Purchase or sale of equity shares settled by way of actual delivery or transfer of the shares is subject to STT at the rate of 0.125%. For sale of shares settled otherwise than by actual delivery or transfer, STT is levied at 0.025%.

Offshore Investment Jurisdictions

There is no specific tax exemption for foreign venture capital investors (“FVCI”). However based on the jurisdiction from which the FVCI invests in India, it can avail the benefits in the corresponding Double Taxation Avoidance Agreement (“DTAA”) that India may have with that jurisdiction. (Section 90 of the Act.)

On account of its favorable tax treaty with India, Mauritius has become the most popular jurisdiction for investing into India. Specifically with respect to capital gains, the India-Mauritius DTAA exempts capital gains earned by a resident of Mauritius from tax in India.