Private equity: breaking borders
In his speech on the Union Budget 2013, the Finance Minister emphatically stressed on the importance that Foreign Direct Investment (FDI) inflow could play in mitigating the ever-increasing current account deficit.

Private Equity (PE) has been a significant source of risk capital for the Indian industry, especially in the last decade. The risk undertaken by PE investors is greater than the risk of investing in listed securities, which provide easy liquidity through a stock exchange. In India, the potential impact of the PE industry on economic development is amplified by the scarcity of capital available with the entrepreneurial class.

The PE industry in India is clearly in transition. After a period of deceleration, which began in the second half of 2011 and continued into 2012, there are signs of positive changes. Mirroring the industry trend in many other parts of the world, exit planning and portfolio management has become the focal point of PE strategy.

Currently, the regulatory and tax framework for PE funds needs suitable amendments to facilitate the smooth inflow and repatriation of capital from the country. The government needs to put in place a simple and robust framework that does not cast unnecessary compliance burden on foreign investors. The government needs to work on eliminating multiple levels of taxation, simplifying tax payment and ensuring certainty in tax laws to lure foreign investors to India.

In spite of regulatory and tax challenges, PE funds have continued to maintain their faith in India. However, given the tax and regulatory constraints, a significant portion of the funds that are intended to be invested in India are pooled in offshore vehicles. The country could benefit immensely from funds dedicated for local investments being pooled in India. For the country to compete with global financial hubs, the government needs to formulate a conducive foreign investment policy that gives foreign investors a sense of comfort while choosing India as a location for pooling such funds.

In this report, we have highlighted the benefits of creating an environment that is conducive to pooling funds in India, as well as the steps that could be considered by relevant authorities to address the lacunae in the policy framework. This would go a long way in developing India’s fledgling alternative investment fund industry.

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Ernst & Young LLP (India)
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Background

PE investments have been a part of India’s growth story for years, during which time we have seen a multitude of events shaping the investment climate. The country’s growing global stature, a far more open economy, coupled with positive indications of reforms and perception of value residing within the fabric of the economy, have encouraged investment input.

The beginning of 2012 marked a positive turnaround for the investment industry in India, with stock markets signaling an uptrend. Despite increasing interest rates, a weakening rupee and lower GDP estimates, the economic outlook remained stable throughout the year. The year eventually ended on a positive note with the Indian stock markets reaching an 18-month high.

Despite global fears such as the US fiscal cliff, domestic political instability and slowing reform initiatives, the Indian domestic consumption market, driving on its growing entrepreneurial cadre, still holds an allure for PE investors.

The second half of the year 2012 witnessed a significant number of government reforms, which encouraged economic recovery. This fueled investor confidence, especially by mitigating the turbulence around tax policies created during early 2012. It is, therefore, an imperative that Indian policy makers continue giving the right message to investors for enhancing funds flow into our economy. At this juncture, it is vital to understand that PE investment is essential to spur India’s targeted growth rate.

This report is an effort toward understanding trends and the relative importance of PE investments in the Indian economic scenario, as well as the much-needed regulatory initiatives to further strengthen this sector, paving the way for the pooling of funds in India.
Private equity – a key source of capital for corporate India

Sector trends

PE firms invested about US$ 7,537 million in India over 415 deals in 2012 compared to US$ 9,641 million they invested across 446 deals during the previous year, a fall of 21.8% in terms of value.

The total investments by PE firms over the past five years in India now stands at about US$ 39.8 billion across 1,820 transactions.

India-dedicated funds have raised about US$ 9,883 million in the last three years. A majority of these funds have been raised by India based fund-managers or by Indian investment professionals. Inspite of this, given the regulatory and tax framework currently prevalent in India, a significant proportion of the capital has been raised in funds located outside India.

PE investments across sectors

During 2006 through 2012, PE funds have invested in various sectors, including those that require risk capital, thereby providing the necessary capital to Indian entrepreneurs. India being a country that is in desperate need of revamping its infrastructure, this sector attracted the maximum investments in recent times. Since India has also been a major outsourcing hub, information technology and IT-enabled services (IT & ITES) also received significant investment from PE funds. The health care and life sciences industry, which is another field requiring a major fillip, saw substantial investments flowing into the sector from PE funds. The banking and financial service sector also remains one of the sought-after investment segments, and it witnessed significant investments (refer to the adjacent chart).

Composition of PE deal value (US$m) by sector (2006–2012)

<table>
<thead>
<tr>
<th>Sector</th>
<th>Value (US$m)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Aerospace and defence</td>
<td>20</td>
</tr>
<tr>
<td>Cement and building products</td>
<td>113</td>
</tr>
<tr>
<td>Miscellaneous</td>
<td>295</td>
</tr>
<tr>
<td>Oil &amp; Gas</td>
<td>336</td>
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<tr>
<td>Chemicals</td>
<td>362</td>
</tr>
<tr>
<td>Agriculture</td>
<td>434</td>
</tr>
<tr>
<td>Travel</td>
<td>526</td>
</tr>
<tr>
<td>Textiles</td>
<td>650</td>
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<tr>
<td>Education</td>
<td>808</td>
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<tr>
<td>Business services</td>
<td>879</td>
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<tr>
<td>Metals &amp; Mining</td>
<td>954</td>
</tr>
<tr>
<td>Pharmaceuticals</td>
<td>1,088</td>
</tr>
<tr>
<td>Logistics</td>
<td>1,594</td>
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<tr>
<td>Automotive</td>
<td>2,041</td>
</tr>
<tr>
<td>Healthcare</td>
<td>2,222</td>
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<tr>
<td>M&amp;E</td>
<td>2,309</td>
</tr>
<tr>
<td>Industrial products</td>
<td>3,127</td>
</tr>
<tr>
<td>RCP</td>
<td>4,237</td>
</tr>
<tr>
<td>Technology</td>
<td>5,942</td>
</tr>
<tr>
<td>Telecommunications</td>
<td>8,089</td>
</tr>
<tr>
<td>RE</td>
<td>8,860</td>
</tr>
<tr>
<td>FS</td>
<td>8,884</td>
</tr>
<tr>
<td>Infrastructure</td>
<td>11,392</td>
</tr>
</tbody>
</table>

Source: VCCEdge and Ernst & Young research
M&E - Media and entertainment, RCP - Retail and consumer products, RE - Real estate, FS - Financial services
Private equity investment vs Initial Public Offering (IPO)

The Indian economy is indeed in need of long-term capital. In the last few years, PE investments remained one of the major sources to meet this requirement. The economic downturn since 2008 has lowered public sentiments. As a result, raising public money remains a concern for Indian industries. Rising inflation over the last few years has meant that disposable income of the general public for investment in public equity has significantly reduced. At the same time, PE funds have accounted for more than double the funds raised through IPOs during the last five years (refer to the adjacent chart).

Stage of investment

PE investors are mostly attracted to growth investments that bring a two-pronged benefit in terms of return on equity (for investors) and the much-needed capital for expansion and growth plans (of the investee company). While PE investments have been recorded across various stages, the majority have been focused around the growth stage (refer to the adjacent chart).
With the potential of investments in Indian industries remaining high and primary sources of financing in India virtually drying up owing to high inflation, coupled with elevated interest rates, the only viable option available with Indian industries is to turn to PE investments, which has proven to be a viable source of funding in the last few years.

The growth of the Indian economy has been hampered by the extreme poverty in many parts of the country, the appalling pre-modern infrastructure and lack of investment in core sectors. India is poised to become the second largest economy in the world by 2050. With India requiring about USD 1 trillion to be spent on infrastructure in the next five years, PE investments need to be encouraged to bridge the gap between the need of the Indian economy and the ability for public funds to meet the same. Public and institutional investment in such sectors is limited due to several risk factors. In such an environment, the only investors that would bring in the necessary capital and management expertise would be from PE funds. This is evident from the fact that only US$1.3 billion was raised through IPOs (excluding IPOs by public sector undertakings) in 2012, compared with US$1.1 billion in 2011 owing to the weak securities market and lack of domestic investor confidence. In such falling times, PE funds have stepped in to support companies looking to fund growth and expansion.
Pooling of foreign capital in India

Historically, a substantial majority of the capital raised from foreign investors for PE investment in India by India-based fund-managers/by Indian investment professionals have been raised in fund vehicles domiciled in overseas jurisdictions (predominantly in Mauritius). Due to a combination of some of the following regulatory/tax reasons and commercial drivers, such funds have historically not been raised in Indian domiciled fund vehicles:

- A majority of funds in India are established in the form of trusts. The Government of India’s foreign investment policy has not provided an automatic approval route for foreign investment in Indian trusts. As a result, an India-domiciled fund that seeks to raise capital offshore would require multiple approvals, which become commercially unviable. In this scenario, a typical fund structure would involve the set up of a foreign “feeder” fund that raises capital from multiple investors. This feeder fund, in turn, can make investment in the India-domiciled fund after obtaining the necessary approvals.

- The Securities and Exchange Board of India (Venture Capital Funds) Regulations, 1996 (now repealed) [VCF Regulations], the framework under which most India-domiciled PE funds were set up, had significant asset-side regulations with substantial restrictions on the nature of investments to be made by a registered fund. In comparison with offshore funds investing in India directly, India-domiciled PE funds were uncompetitive, given that Indian fund managers looking after India-domiciled PE funds were forced to tailor their investment strategies in compliance with VCF Regulations.

- Specific regulatory/tax incentives are available for offshore funds that register under the SEBI regulations for foreign venture capital investors and foreign institutional investors. Foreign funds are able to appropriately structure themselves by establishing in or investing from jurisdictions that provide an exemption in India on capital gains derived from their investment activities and concessional rates on interest income. The governments of Mauritius, Singapore and Cyprus have entered double tax avoidance agreements (tax treaty) with India and provide such an exemption to entities that qualify for benefits under the respective tax treaties. In most of these jurisdictions, special regimes are available for structuring funds/investment companies that exempt investment gains from taxation under domestic tax laws. Therefore, effectively, the fund is able to pass on investment gains to its investors without any (or significant) incidence of tax in India and the country where the PE fund is formed.

- Significant tax uncertainties dampen the enthusiasm of investors eyeing India-domiciled PE funds. The tax policy/framework for taxation of the fund/investors has not been stable, and several tax uncertainties continue to prevail under the existing tax law.

The government needs to put in place a suitable policy that encourages fundraising in India-domiciled fund vehicles and suitably considers and addresses all of the drivers discussed above. The policy would prove effective only if all of the aspects are addressed through changes in Indian tax law and regulations. A piece meal approach will not yield the intended results.

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1 This aspect has been substantially addressed with the introduction of the SEBI (Alternative Investment Funds) Regulations, 2012 in May 2012.
Benefits of pooling of foreign capital in India-domiciled funds:

Some of the significant benefits of pooling foreign capital in India-domiciled funds:

- A significant initiative of the government has been to target round tripping of monies of Indian investors from tax havens. In a scenario, where the pooling of funds in India is encouraged, the KYC mechanism would check the round tripping of funds.

- A favorable environment for pooling funds in India could help accelerate the growth of the overall fund industry. This would help create employment opportunities in the fund management industry and encourage talent to stay in the country and contribute to economic growth.

- A booming alternative investment fund industry could help develop several ancillary services such as trusteeship services, custodial services and fund administrators.

- A rational tax and regulatory regime for risk capital could help in developing an onshore investment industry that provides the necessary capital for developing sectors and helps entrepreneurs expand their businesses.

- It is likely to bring parity, from a tax perspective, among India-dedicated funds set up in tax heaven jurisdictions and those established in India.

- It could improve returns on capital employed by investors by saving transactional cost and, thereby, helping in promoting larger investments in Indian securities.

- By promoting the pooling of funds in India, uncertainty with regard to tax and regulatory implications could be minimized. This could help improve investor confidence to a larger extent.

In a nutshell, the pooling of funds would certainly have a spillover effect on the Indian economy, the benefits of which will be seen in the long run.

Key enablers for pooling foreign investor capital in India-domiciled funds

Broadly, enabling the pooling of foreign investor capital in India-domiciled funds would entail addressing the following key aspects:

- A framework permitting direct investment by foreign investors in India-domiciled funds without any approval requirements/significant administrative constraints

- A pass-through system of taxation for fund vehicles, coupled with a tax regime that provides tax outcomes for investors that are comparable with those provided by common offshore fund raising jurisdictions for India-dedicated funds (viz Mauritius, Singapore, Cyprus)

- Other direct and indirect tax policy/incentives specifically designed for the PE funds sector

Each of these areas is elaborated in the sections that follow.
The Securities and Exchange Board of India (SEBI) has, in May 2012, introduced a comprehensive legal framework in the form of SEBI (Alternative Investment Funds) Regulations, 2012 [AIF Regulations] repealing the over 15-year old VCF Regulations.

AIF Regulations were introduced to allow fund managers the flexibility to design fund products to cater to wider investor demand/risk profiles, to provide targeted concessions to certain funds, as well as to bring within the ambit of regulation all types of domestic pooling vehicles.

The key highlights of the AIF Regulations are summarized below.

- Under the AIF Regulations, all kinds of pooling vehicles, excluding some listed ones, are required to mandatorily obtain registration and comply with the investment and other conditions.
- Various new asset classes have been recognized and are provided the required investment flexibility pertaining to their investment objectives with minimal regulation. Accordingly, AIFs have been categorized as under:

<table>
<thead>
<tr>
<th>Category I AIF</th>
<th>Category II AIF</th>
<th>Category III AIF</th>
</tr>
</thead>
<tbody>
<tr>
<td>Funds that invest in startup or early-stage ventures or social ventures or Small and Medium Enterprises (SMEs) or infrastructure or other sectors or areas that the government or regulators consider as socially or economically desirable. Includes VCFs, SME funds, social venture funds, infrastructure funds and such other AIFs, as may be specified.</td>
<td>Funds that do not fall in Category I and III AIF and that do not undertake leverage or borrowing other than to meet the permitted day-to-day operational requirement. Includes private equity funds and debt funds.</td>
<td>Funds that employ diverse or complex trading strategies and may employ leverage, including through investment in listed or unlisted derivatives. Includes hedge funds.</td>
</tr>
</tbody>
</table>

- Limited Liability Partnerships (LLP) have been recognized as a structure for setting up AIFs and as investee companies for investments by AIFs.
- No investment restrictions have been specified for Category II AIFs, besides the mandate to “primarily” invest in unlisted securities.
- The regulatory concessions, under the SEBI (Issue of Capital and Disclosure Requirement) Regulations, 2009 and SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011 (which were hitherto available to all funds registered under the VCF Regulations), are now only available to a Category I AIF.
The AIF Regulations already provide flexibility for AIFs to raise capital from domestic and foreign investors in an Indian AIF. However, there is a need to define a foreign investment policy for foreign investment in AIFs. The foreign investment policy should ideally provide:

- Foreign investment in SEBI-registered AIFs (and in feeder fund vehicles constituted in India to invest in AIFs) should be allowed under the automatic approval route. Therefore, investment in and transfer/redemption of investment in AIFs should not require Government of India/Reserve Bank of India approvals. This automatic approval route should be available irrespective of the legal constitution of the AIF, i.e., whether the AIF is constituted as a trust, LLP, company or other body corporate.

- The investment activities of AIFs having foreign investment should be subject to the sectoral foreign investment policy issued and updated by the Department of Industrial Policy and Promotion. Therefore, foreign investment should not be permitted in an AIF that proposes to invest in sectors where direct foreign investment is prohibited.

- The downstream foreign investment restriction that presently applies to an LLP having foreign investment should be made inapplicable to a SEBI-registered AIF constituted as an LLP.

- SEBI-registered foreign venture capital investors should be permitted to invest in Category I AIFs without complying with the sectoral restrictions that are presently being imposed in approval letters at the time of the grant of registration.

- AIFs having foreign investment that propose to make portfolio investments in Indian-listed securities (secondary market acquisition) should be mandatorily required to comply with the norms prescribed by SEBI under the SEBI (Foreign Institutional Investors) Regulations and the corresponding Reserve Bank of India regulations.

- AIFs proposing to make investments in non-convertible debt instruments/securities should comply with the norms applicable for foreign investment in Indian debt instruments/securities.

- Regulations with regard to pricing the investment/sale of securities should not apply to AIFs so long as the investment is not in an entity/person associated with the sponsor/manager of the AIF.

- Foreign investment in AIF management entities should be specifically included in the list of activities in which foreign investment is permitted in the non-banking financial services sector. Furthermore, the activities of an AIF manager should be included in the defined list of non-fund-based activities that attract the minimum capitalization requirement of USD 0.5 million irrespective of the level of foreign ownership in the AIF management entity.

There is a requirement for the sponsor of the AIF to make a minimum capital commitment to the AIF under the AIF Regulations. In the context of a foreign-owned Indian sponsor/manager, such capital commitment should be permitted under the automatic approval route without the application of sectoral limitations under the FDI policy.
In 1995, India recognized the importance of VCFs as an important instrument for promoting the growth of new enterprises involving substantial risk. To incentivize this category of funds and in line with the internationally accepted practice of providing pass-through tax treatment for collective investment vehicles, the Finance Act 1995 inserted section 10(23F) in the Income-tax Act, 1961 (Act) to accord a pass-through tax treatment to VCFs for income earned from investment made in the equity shares of a venture capital undertaking (VCU). Income thus earned was only taxable in the hands of the investors of the VCF.

Subsequently, section 10(23F) was replaced by section 10(23FA) and later by section 10(23FB) of the Act. The intent of the legislature to provide pass-through tax treatment to VCFs remained consistent until the Finance Act 2007 amended section 10(23FB) to restrict the pass-through treatment to income earned by a VCF from investment in VCU s engaged in nine specified sectors.

Section 10(23FB) was again amended by the Finance Act 2012 following several representations from the industry to remove the sector restrictions that were introduced in 2007. This amendment was widely regarded as a step in the right direction, though few concerns remained around the manner in which section 10(23FB) and other corresponding provisions were amended.

Following the introduction of the AIF Regulations and the consequent repeal of the VCF Regulations in May 2012, a tax code for the taxation of AIFs has now become essential to provide tax certainty to AIFs and its investors. The Finance Act, 2013 has restricted the pass-through tax treatment to the VCF sub-category of Category I AIFs. This is “more restrictive” than the pass-through tax status envisaged under the AIF Regulations, which extended to all Category I AIFs. This creates significant uncertainties/inefficiencies in the manner in which the other sub-categories/categories of AIFs will be taxed, as discussed in the following section.
Trust taxation ambiguities

The majority of PE funds in India are constituted in the form of trusts, as against the universally followed practice of constituting PE funds as partnerships. The choice in India is principally tax driven, since a trust is the only legal entity form in India that conceptually provides a pass-through tax treatment on income earned from trust property.

Having said that, the provisions for the taxation of trusts contained in sections 160 to 166 of the Act are historical ones that have not been designed in the context of the taxation of collective investment vehicles.

While the provisions of section 161(1) of the Act impose tax liability in respect of a trust’s income on its trustee in a representative capacity, the trustee, in turn, is required to determine the tax liability “in a like manner and to the same extent” had the tax been recoverable from beneficiaries directly. This section applies where the individual shares of the beneficiaries are determinate and known. Given the manner in which collective investment pools such as PE funds are constituted, there can be complexities in determining whether the trust is determinate or not.

PE funds typically have a large number of beneficiaries. In that context, it becomes virtually impossible administratively for the trustee to determine, at an individual beneficiary level, the amount of taxes payable on the fund’s income (which is typically in the nature of capital gains and interest income apart from exempt dividend income) after considering the various deductions, exemptions, set-off provisions, special rates of taxes for certain beneficiaries, tax treaty benefits, etc., to which the beneficiary may be entitled.

Even if the trustee is able to estimate the tax liability beneficiary wise, there is significant uncertainty on whether the tax authorities would accept the computation of taxable income and tax liability, given that the trustee may have placed significant reliance on voluntary statements and declarations provided by beneficiaries.

Hence, in practice, the trustees of the funds usually discharge tax liability to the maximum extent, i.e., without considering any of the aforesaid illustrative benefits. As a result, in some cases, the amount may well exceed the actual tax liability that the Indian tax authorities would have collected had the income to be charged to tax in the hands of the beneficiaries (the excess on which would technically be refundable to beneficiaries).

On the other hand, there are several industry participants that follow the practice of requesting beneficiaries to discharge tax payable on income earned by a PE fund based on income accrual statements provided to beneficiaries at periodic intervals. Practically, in such cases, trustees face a challenge in asserting claim on the non taxation of income in their hands despite the provision of sufficient documentation evidencing tax payment by beneficiaries.

The beneficiaries of funds also face challenges in explaining the tax position of income from such funds in the absence of a specific provision in the tax law to deal with the taxation of income from VCF/AIF trusts. This is despite an administrative circular issued by the tax authorities that clarifies that once the choice is made by the department to tax either the trustee or the beneficiary of a trust, it is not open to the tax officer to assess the other at the same time. However, the language of the tax provisions clearly suggests that this is a unilateral option given only to the tax officer to determine whether the income of a trust should be assessable to tax at the trust level or at the investor level.
Framework for taxation of income earned by PE funds

To mitigate such practical challenges and to incentivize the pooling of foreign capital directly in Indian fund vehicles, a separate code for the taxation of AIFs is required. We have discussed some of the key elements of the framework.

Pass-through system of taxation for India-domiciled AIFs

The current provisions create differential regime for the taxation of income earned by Category I AIFs—venture capital funds sub-category as against that earned by Category I (other sub-categories), Category II and III AIFs. While some of the sub categories of the Category I AIFs are pass-through entities for tax purposes, multiple levels of taxation in other categories/sub-categories would create a strong disincentive for setting up/attracting investment in such pooled investment vehicles.

In this regard, several committees have greatly emphasized the importance of providing fiscal neutrality to AIFs, as income is taxed in the hands of the final recipient and the intermediary body is considered a pass-through entity.

The pass-through status granted to SEBI-registered AIFs would put India at par with other countries, where the tax pass-through is automatically available in the form of choice of various entities available such as limited partnerships and limited liability companies.

To make the setting up of pooled investment vehicles in India competitive with funds set up in favorable tax jurisdictions, the pass-through tax treatment should apply irrespective of the legal status of the fund vehicle – company, trust or LLP. A pass-through system should ensure that tax collected on the fund’s income is no more than the tax that would have been payable had the investor injected funds directly in the investee company/asset.

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2 From investments in VCUs

3 The K.B. Chandrasekhar Committee Report dated 8 January 2000, The Advisory Committee on Venture Capital set up under the Chairmanship of Dr. Ashok Lahiri in its report issued in the year 2003
Mode of discharge of taxes
As highlighted above, it is critical that a multiple level of taxation should be avoided, and there should be a simple and clear mechanism for the discharge of taxes by the AIF/beneficiaries. This would even ensure that there is no leakage of revenue and that credit for taxes paid is granted to the correct tax payer.

To achieve the above objective, tax may be withheld on the distribution of income by the trustee to beneficiaries. Withholding tax would ensure that beneficiaries would be able to claim credit for such taxes in their individual tax return should they need to claim credit/refund for the taxes paid. Even from a tax authority standpoint, this mechanism would control the discharge of taxes at a single point.

No withholding tax on income earned by the AIF
Currently, there is no exemption from withholding tax on payments made to AIFs. However, the tax rules provide that in the case of a trust where the beneficiaries are liable to tax on the income received by the trust, the payer can deduct tax directly in the name of the beneficiaries on the provision of the specified details of the beneficiaries by the trustee to the payer. However, in the case of AIFs having a large number of investors, compliance with these rules for each and every payment can be very onerous on the payers and the trustee of the AIF.

In cases where AIFs are granted the pass-through tax status, withholding tax on payments would result in tax leakage, since AIFs would be a tax neutral vehicle and beneficiaries are taxable in their individual capacity. To mitigate this concern, any payment to a SEBI-regulated AIF should be exempt from withholding tax provisions. Since the trustees would discharge taxes to be paid by beneficiaries (through the withholding mechanism discussed in the above section), there should not be any loss to revenue even if there is an exemption from withholding tax on payments to AIF.
Tax exemption on long-term capital gains on the transfer of unlisted securities

As discussed in the earlier sections, AIFs play a key role in providing patient capital to Indian entrepreneurs. The risk undertaken by investors in an AIF is greater than that from investing in listed securities, which provide easy liquidity through a stock exchange.

The current tax provisions exempt tax on long-term capital gains earned on the transfer of listed securities, held for a period exceeding 12 months, on which securities transaction tax has been paid. The Government of India should consider extending the scope of this section to include capital gains earned by AIFs on the transfer of shares of unlisted companies that are held over the long term. To mitigate any perceived misuse of the provision, the holding period to qualify as long-term capital gains could be extended suitably (to 24 or 36 months).

Block/Accelerated assessment procedures

Typically, the lifespan of the AIF ranges from 5 to 7 years. At the end of this period, the entire residual capital/income earned by the AIF is distributed among its investors. Accordingly, after the closure of the AIF, it would not have resources for the payment of additional tax liability, if any. Any tax liability at this stage could prejudice the trustee/fund manager, which may become liable for the tax due in the event of the inability to reclaim the same from investors. To streamline the scrutiny audit procedures for AIFs, the tax authorities should mandatorily provide a confirmation indicating the final amount of taxes due to be paid by the AIF before the final distribution by the AIF, based on information provided. Such a confirmation should be provided consequent to a fast-tracked assessment of income of the AIF modeled along the provisions that currently apply to the assessment of the shipping business under section 172 of the Act.
Income derived by foreign investors in SEBI-registered AIFs should be exempt from tax or be taxed at a highly incentivized tax rate

As discussed earlier, one of the drivers for raising foreign investment in offshore funds is the ability to structure the fund so as to earn income and gains from investment in India with minimal/nil incidence of tax in India. In our view, so long as India continues to have tax treaties that legitimately enable the structuring of offshore funds to achieve this outcome, fund managers would continue to want to launch funds offshore. Therefore, for India to encourage the launch of funds in India that directly raise foreign capital, the following recommendations on the taxation of income/gains will be essential:

**Capital gains**
Capital gains earned by foreign investors in SEBI-registered AIFs should be exempt from tax. The exemption should act as a strong deterrent for fund managers to raise India-dedicated funds from overseas jurisdictions.

**Interest**
Interest income derived by SEBI registered AIFs from investment in Indian-rupee denominated debt should be taxed at 5% as applicable to foreign institutional investors and qualified foreign investors.

As such, considering the fact that a vast majority of funds investing in India implement structures that result in the above tax outcomes, implementing these recommendations should be revenue neutral from a fiscal perspective.

**Abatement on service tax**
Currently, service tax at 12% (plus education cess) compounds the various charges incurred by the AIF on services sought by the AIF from its service providers, viz., manager, legal advisor, accounting, valuations. Compared with the offshore funds raised in offshore jurisdictions, this is a significant incremental cost for the AIF and directly impacts net returns derived by foreign investors.

To make the AIF competitive with offshore funds, the government should grant service tax abatement on the basis of the ratio of foreign investors to domestic investors in the AIF, i.e., treat services provided by Indian service providers to AIFs as exported to the extent it relates to foreign investor capital. Such a beneficial treatment would be in line with other jurisdictions that impose tax on services (e.g., Singapore).

**Concluding remarks**
The Indian economy has witnessed a declining growth at 5%-5.5% in the current year. However, the silver lining is the general consensus emerging among economists that India would grow at 6.5% to 7% in 2013, as well as some sort of business recovery and increased demand on the back of reduction in interest rates and cooling down of inflation. The importance of PE as a source of capital for companies in the nascent stage of development cannot be ignored. Furthermore, the pragmatic approach of the Finance Minister to keep the fiscal deficit for the current year below 4.8% of the GDP would result in sending the right signals to the larger investor community. The above factors, if supplemented with the requisite changes in the regulatory and tax framework, could result in the inflow of capital in India and serve as a harbinger of good news for emerging companies in the country.

It is a well-accepted fact that the PE industry is emerging as the single-largest differentiator in the economic landscape of India. In fact, it is in a position to take on the mantle of the lead character in the India growth story. However, if adequate reforms are not put in place, it could be relegated to the sidelines, taking a toll on both the country and the PE industry.
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Ambawadi
Ahmedabad - 380 015
Tel: + 91 79 6608 3800
Fax: + 91 79 6608 3900

Bengaluru
12th & 13th floor
“UB City”, Canberra Block
No.24 Vittal Mallya Road
Bengaluru - 560 001
Tel: + 91 80 4027 5000
+ 91 80 6727 5000
Fax: + 91 80 2210 6000 (12th floor)
Fax: + 91 80 2224 0695 (13th floor)
1st Floor, Prestige Emerald
No. 4, Madras Bank Road
Lavelle Road Junction
Bengaluru - 560 001
Tel: + 91 80 6727 5000
Fax: + 91 80 2222 4112

Chandigarh
1st Floor, SCO: 166-167
Sector 9-C, Madhya Marg
Chandigarh - 160 009
Tel: + 91 172 671 7800
Fax: + 91 172 671 7888

Chennai
Tidel Park, 6th & 7th Floor
A Block (Module 601,701-702)
No.4, Rajiv Gandhi Salai, Taramani
Chennai - 600113
Tel: + 91 44 6654 8100
Fax: + 91 44 2254 0120

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Oval Office, 18, iLabs Centre
Hitech City, Madhapur
Hyderabad - 500081
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NH-49, Maradu PO
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Kolkata
22 Camac Street
3rd floor, Block ‘C’
Kolkata - 700 016
Tel: + 91 33 6615 3400
Fax: + 91 33 2281 7750

Kochi
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22 Camac Street
3rd floor, Block ‘C’
Kolkata - 700 016
Tel: + 91 33 6615 3400
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Mumbai
14th Floor, The Ruby
29 Senapati Bapat Marg
Dadar (W), Mumbai - 400028
Tel: + 91 22 6192 0000
Fax: + 91 22 6192 1000
5th Floor, Block B-2
Nirlon Knowledge Park
Off. Western Express Highway
Goregaon (E)
Mumbai - 400 063
Tel: + 91 22 6192 0000
Fax: + 91 22 6192 3000

Pune
C-401, 4th floor
Panchshil Tech Park
Yerwada
(Near Don Bosco School)
Pune - 411 006
Tel: + 91 20 6603 6000

NCR
Golf View Corporate Tower B
Near DLF Golf Course
Sector 42
Gurgaon - 122002
Tel: + 91 124 464 4000
Fax: + 91 124 464 4050

6th floor, HT House
18-20 Kasturba Gandhi Marg
New Delhi - 110 001
Tel: + 91 11 4363 3000
Fax: + 91 11 4363 3200

4th & 5th Floor, Plot No 2B, Tower 2, Sector 126,
NOIDA 201 304
Gautam Budh Nagar, U.P. India
Tel: + 91 120 671 7000
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C-401, 4th floor
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