Private equity investments in India: a legal and structural overview

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The Indian private equity scenario has undergone a sea change over the last five years or so. There has been a considerable interest, both domestic as well as international, in the private equity sector which is evident from the fact that the total private equity funds (more commonly understood in the Indian context as venture capital funds (VCF)) committed to investments in India has increased exponentially. The following table gives the statistics of growth of the venture capital industry in India.

Year	US $ million
1996	20
1997	80
1998	150
1999	320
2000	750
2001*	1200
2008*	10000

**estimates*

Source: NASSCOM: Study on Indian Capital Industry

Though these numbers may not look substantial when compared to funds committed in other countries like the US and Israel, they go a long way in demonstrating the rise of private equity investments in India.

Structuring of venture capital funds

Structuring of private equity or venture capital funds in India requires special considerations from the regulatory and tax perspective. This article endeavours to demystify the legal and regulatory concerns surrounding the private equity funds in India.

Domestic funds

For domestic venture funds (in which the funds are raised within India), the structure that is most commonly used is that of a domestic vehicle for the pooling of funds from the investors and a separate investment adviser for carrying on asset management activities. For the domestic vehicle, there are two options viz a trust or a company. India at present does not have a limited partnership structure which is a common choice in countries like the US.

The ‘trust’ structure has been more commonly used since the company structure does have some drawbacks mostly arising from the provisions of the Companies Act, 1956 which may conflict with some of the basic underlying principles of venture capital investments. Some of these concerns are:

- Difficulty in return of capital: Redemption of securities by companies (ie buyback of securities) can be made only out of profits or proceeds of a fresh issue of securities. Furthermore, the buyback of securities by a company in any one financial year is restricted to a maximum of 25% of its total paid-up capital. This restriction restrains the ability of a venture capital company to return the capital to its investors if the investments made by it are sold at a loss.
- Difficulty in distributing returns: A company can declare dividends only if the company has profits. There are also statutory requirements whereby if the dividends declared are more than 10% of the par value (ie nominal value) of the shares, a certain portion of the distributable profits would have to be transferred to general reserve.
- Difficulty in termination: At the time of termination of the fund, if the fund is structured as a company, winding up procedures are extremely time consuming and also requires high court approval. This could make the winding up process quite cumbersome.

Though some of the above shortcomings of the ‘company’ structure can be addressed by carefully structuring the investment instruments, Indian venture capitalists have found the ‘trust’ structure to be more favourable as it offers them more flexibility.

Offshore funds

Commonly there are two alternatives available to offshore investors participating in Indian venture capital investments. The offshore investors can either use an ‘offshore structure’ or a ‘unified structure’.

Offshore structure

Under this structure an investment vehicle, which could be a LLC or an LP organized in a jurisdiction outside India, makes investments directly into Indian portfolio companies. There would generally be an offshore manager for managing the assets of the fund and an investment advisor in India for identifying deals and to carry out preliminary due-diligence on prospective investment opportunities. The structure is depicted in figure 1.

Unified structure

This structure is generally used where domestic (ie Indian) investors are expected to participate in the fund. Under this structure, a trust or a company is organized in India. The domestic investors would directly contribute to the trust whereas overseas investors pool their investments in an offshore vehicle and this offshore vehicle invests in the domestic trust. The portfolio investments are made by the trust. The trust would generally have a domestic manager or an adviser. The offshore fund may also have its own offshore manager/adviser. This structure also enables the domestic manager to draw its share of carry directly from the trust. The structure is depicted in figure 2.

The regulatory framework

In India, both domestic and offshore venture capital funds investing in India are regulated by the Securities and Exchange Board of India (SEBI). Until recently, SEBI only regulated the domestic VCFs vide its SEBI (Venture Capital Funds) Regulations, 1996 (as amended by SEBI (Venture Capital Funds (Amendment)) Regulations 2000) (VCF Regulations). However, in September 2000, SEBI announced a new set of guidelines enabling foreign venture capital and private equity investors to register with itself. The new guidelines are called the SEBI (Foreign Venture Capital Investors) Regulations, 2000 (FVCI Regulations).

The SEBI (Venture Capital Funds) Regulations, 1996

Under the VCF Regulations, a venture capital fund can be organized either in the form of a trust or as a company. Though the guidelines do not appear to make registration with SEBI mandatory, SEBI has made its intention clear to regulate all domestic VCFs.

The VCFs are permitted to invest only in venture capital undertakings (VCUs) which are not engaged in activities which have been classified under the negative list which broadly includes undertakings engaged in real estate business, non-banking financial services, gold financing etc. Furthermore, the VCU has to be a domestic company whose shares are not listed on a recognized stock exchange which means that domestic VCFs are not permitted to invest in securities of foreign companies.

Eligibility criteria

For registering as a VCF, the VCF Regulations, require, inter alia, that:

- the main objective of the VCF (whether a company or a trust) should be to carry on the activity of a venture capital fund;
- the constituting documents (memorandum and articles of association in the case of a company and the trust deed in case of a trust) should contain a prohibition from making an invitation to the public to subscribe to its securities. However, it should be noted that VCF Regulations do permit domestic VCFs to list their securities after a period of 3 years from the date of issuance of these securities; and
- in the case of a trust seeking registration, the eligibility criteria prescribed requires that, the instrument of trust should be registered under the provisions of the Registration Act, 1908 of India.

Investment conditions and restrictions

SEBI has prescribed certain investment restrictions on the VCF both in terms of acceptance of contributions as well as for making downline investments in portfolio companies. These are as follows:

- Minimum investment to be accepted from any investor should be Rs 500,000 (approximately $11,500) except in the case of employees, principal officers or directors of the VCF, employees of the manager of the VCF where lower amounts may be accepted.
- Minimum firm capital commitments from its investors should be Rs 50 million.
- A VCF is not permitted to invest more than 25% of its corpus in any one VCU and atleast 75% of its investible funds are required to be invested in unlisted equity shares or equity linked instruments: Provided, if the VCF wants to gain the tax benefits, it will have to exit from such investments within a period of one year from the date of listing of the shares of the VCUs on a recognized stock exchange in India.
- A VCF may also invest up to 25% of its investible funds by way of: (i) subscription to an initial public offering of a VCU

whose shares are proposed to be listed on a recognized stock exchange subject to a lock in period of one year; or (ii) in debt or debt instruments of a VCU in which it has already made an investment by way of equity.

- A VCF is also not permitted to invest in associated companies which have been defined to mean companies which exercise control over the VCF or where VCF exercises control over the companies.

The mandatory exit clause in respect of unlisted investments has generated very strong negative reactions among the venture capital community in India and overseas and have demanded that in order to foster growth of venture capital industry in India, such restrictive clauses should be removed from the VCF Regulations. The Finance Minister has also made press statements in which he has indicated that this clause will be deleted in the near future.

The SEBI (Foreign Venture Capital Investor) Regulations, 2000

An FVCI has been defined under the FVCI Regulations to mean an investor incorporated or established outside India, which proposes to make investments in venture capital fund(s) or venture capital undertakings in India and is registered under these Regulations.

Unlike the VCF Regulations which seem to make it mandatory for VCFs to register with the SEBI, the FVCI Regulations does not make it mandatory for an offshore venture capital investor to register with SEBI as an FVCI. Also, the SEBI's intention is really not to regulate the FVCIs but to monitor the foreign investments coming into the domestic venture capital sector.

Eligibility criteria

In order to determine the eligibility of an applicant, SEBI would consider, inter alia, the applicant's track record, professional competence, financial soundness, experience, whether the applicant is regulated by an appropriate foreign regulatory authority or is an income tax payer or submits a certificate from its banker of its or its promoter's track record where the applicant is neither a regulated entity nor an income tax payer. The applicant can be a pension pund, mutual fund, investment trust, investment company, investment partnership, asset management company, endowment fund, university fund, charitable institution or any other investment vehicle incorporated and established outside India.

Investment conditions and restrictions

The investment restrictions applicable to FVCI are similar to those applicable to VCFs under the VCF Regulations (as listed above) except for the following:

- no minimum corpus or capital commitment requirement for FVCIs;
- no minimum individual contribution prescribed under the FVCI Regulations;
- no mandatory exit clause in respect of investments by an FVCI in unlisted securities; and
- for determining the maximum investment in a single VCU (ie 25% of the corpus), the funds earmarked for India will be taken into consideration.

The FVCI Regulations make it mandatory for a FVCI to appoint a domestic custodian for the purpose of custody of securities and for entering into an arrangement with a designated bank for the purpose of opening a special non-resident Indian rupee or foreign currency account. SEBI acts as a nodal agency for all necessary approvals including the permission of the Reserve Band of India for opening of the bank account.

In addition to the above investment conditions and restrictions, there are certain reporting and disclosure requirements that need to be satisfied by a registered FVCI on an continuing basis.

Taxation

Domestic VCFs

Domestic VCFs are entitled to tax benefits under Section 10(23FB) of the Income Tax Act, 1961 (ITA). As per this section, any income earned by a SEBI registered VCF (which could be a trust or a company) set up to raise funds for investment in a venture capital undertaking is exempt from tax. This section has to be read with Section 115U of the IT Act which gives SEBI registered VCFs a pass-through status whereby the investors in the VCF are directly taxed on any income distributed by the VCFs as though the investors have made direct investment in the portfolio companies. The taxation of such income in the hands of the investors will depend on the nature of income which will remain the same as in the hands of the VCFs. The taxability of income in the hands of the investors based on the nature of income are summarized in figure 3.

The above tax rates may be reduced under Double Taxation Avoidance Treaty (Tax Treaty) between India and the foreign country in which the investors are residing.

FVCI

There is no specific tax exemption available for the income earned by a FVCI. However, the way the Section 10(23FB) is worded, there is a possibility that even the FVCI would be entitled to the benefits available to domestic VCFs mentioned above. In the event that the FVCI avails of the exemption under Section 10(23FB), the investors in a FVCI would become liable to tax on the income earned by the FVCI as per the provisions of Section 115U.

As per the provisions of Section 90(2) of the ITA, a non-resident investor investing from a country with which India has a tax treaty, would have an option to be taxed as per the provisions of the tax treaty or ITA, whichever is more beneficial. In light of this, the FVCI investing through a tax treaty jurisdiction may be in a position to elect to take tax benefits available under the tax treaty in which case the Sections 10(23FB) and Section 115U of the ITA should not be applicable. For example, if the FVCI is incorporated in Mauritius, the Indian capital gains tax on the income earned by the FVCI on its investments in India can be eliminated under the India-Mauritius Tax Treaty provided the FVCI does not have a “permanent establishment” in India. The investors in FVCI may also not be taxable in India.

On account of its favourable tax treaty with India, Mauritius has become a favourite jurisdiction for investing into India. As a matter of fact, Mauritius has become the largest investor into India. In order to structure the FVCI through Mauritius and in order to be eligible to avail the benefit under the India-Mauritius Tax Treaty, careful structuring is extremely crucial. There have been instances in the past where the use of Mauritius as a conduit for investing into India has been looked upon unfavourably by the Indian tax authorities. In the case of NatWest, the Authority for Advance Rulings (AAR) had denied a ruling on the grounds that use of Mauritius was merely for tax avoidance and the AAR need not rule on an application which is prima facie for avoidance of tax. However, careful structuring of an investment can reduce the risk of denial of Tax Treaty benefits. There has been a ruling in case of AIG followed by DLJ, wherein the AAR granted the benefits of India-Mauritius Tax Treaty and observed that if there was a commercial justification for setting up an SPV and then if the same was established in Mauritius, that per se should not result in denial of a ruling and benefits under the India-Mauritius Tax Treaty. In addition to the commercial justification, it is also important to ensure that the structure does not expose the FVCI to a “permanent establishment” (PE) in India. Under the India-Mauritius Tax Treaty, if the FVCI were held to have a PE in India, the income attributable to such PE would be subject to tax in India. There is a fair amount of subjectivity involved in the determination of a PE and hence very careful thought has to be given while finalizing structure, especially to the management of the FVCI.

Conclusion

The venture capital regime is still evolving and the government is quite upbeat on the future prospects of the venture capital industry in India. India continues to offer great investment opportunities in the knowledge sectors and these sectors are likely to attract lot more venture capital funds, both domestic and offshore. The regulators have also made their intentions clear that they are willing to go an extra mile to facilitate such inflow of venture capital investments into the country. As per the projections made by National Association of Software Services Companies, by year 2008 the total venture capital inflow into India is likely to touch $10 billion. For venture capital investors, this may be the opportune time to look at India as an attractive investment destination.

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