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Wary of Indian tax rules, PE players run for cover

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MUMBAI: Scared over changing tax rules, private equity investors are now looking at insurance solutions for taking care of this new risk.

A growing number of overseas investors, especially private equity funds, which put money in Indian companies, are buying tax-liability insurance covers, which provide protection to them in the event of uncertainty in the application of tax laws by India's tax department.

The interest has escalated after the revenue department slapped a claim for capital gains tax of $2 billion on Vodafone for its $11.2-billion purchase of shares from Hutchison — a transaction which was structured overseas.

Indian insurance industry officials say that more overseas investors are now seeking solutions which will ensure that a sale or transaction is clean and reduces their contingent tax claims.

Recently, a PE investor based in Mauritius was about to conclude a sale to another PE firm, its investment in an Indian IT company. The only hitch in the deal was the uncertainty over the company's tax liabilities. The PE investor, with the help of an MNC insurance broker, took out a cover that would take care of any loss in investment arising out of changes in the tax laws.

In another case, an international PE fund which was in the process of liquidating its assets, including those in India, had acquired some contingent liabilities, as a result of previous divestments. However, the fund manager wanted to make a final distribution to its limited partners and wind up the fund. The way out was to buy a tax-liability cover internationally before liquidating and distributing its assets. The policy remained the only asset of the fund.

"There is a fair amount of interest in this product from private equity funds," said Sanjay Kedia, MD & country head, Marsh India. Internationally, the policy can be purchased either by the company's parent or investor in the company.

"The investors have an insurable interest in the tax liability of the company to the extent of their shareholding," he added. Marsh globally arranges for such covers as it has an expertise in tax liability insurance in the global market.

According to Bijal Ajinkya, partner and head - tax practice, Nishith Desai Associates, there is a lot of uncertainty over tax in PE transactions. "We are seeing a lot of negotiations stuck on the issue of who will bear the tax liability, which is rather unfortunate because rather than negotiate on who bears the tax, parties should be negotiating on the transaction." While investors do not have a problem with the tax system, it is the uncertainty and varying interpretations that is bothering them.

Recent media reports said that seven envoys of some of the G-8 countries had protested to the Indian government against what they termed as the growing unpredictability of India's tax policies. The protest as well as the interest in tax liability insurance products come at a time when the government is keen on introducing a new tax law to replace the over four-decade-old Income Tax Act.

The draft direct tax code, which seeks to simplify the country's tax laws, was unveiled in August this year and the government hopes that it will come into force by fiscal 2011-12 after Parliament approves it.

According to Mr Kedia, if instead of the overseas buyers, the Indian company was to buy such a tax liability cover, this cover could be renewed even after the shareholding of the company changed hands. However, if this product is to be purchased locally, it needs to be approved by the local regulator for the insurance company issuing that product.

Internationally, such covers are available and there is reinsurance capacity and interest for India exposures also available, said Mr Kedia. “The only option in such cases is to have either an escrow arrangement, to cover the potential liability through insurance, or to obtain a certificate from the tax authorities,” he added.

Considering that transactions can be opened up for assessment for up to the next seven years, the investor will have to buy the cover for at least seven years. What we have heard is that the cost of insurance is quite high and can go up to 6% of the anticipated tax liability.