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Chartered Accountants

Private Equity

Recent Trends, Developments and Challenges

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Table of Contents

Private Equity – Recent trends, developments and challenges

Private Equity ("PE") in India has evolved significantly over the past two decades. Starting in the late 1990s, PE industry provided an alternative source of financing for local businesses accustomed to limited credit options from banks or approach public equity markets to underwrite their growth ambitions.

Today, PE capital is accepted more readily by Indian entrepreneurs as a source of strategic capital that can play a transformational role in the growth of their businesses by bringing in required new capabilities and discipline unavailable from other forms of capital.

The PE industry has been a stable source of capital despite many challenges, including navigating through weak economy, performance setbacks, complex regulatory environment, and dynamic legal framework. The industry has learned and evolved from its experiences, and now it understands the nuances of working effectively in the local environment. In this note we have tried to capture the recent trends, developments and challenges faced by the PE industry.

1. Renegotiation of India-Mauritius Tax Treaty

Mauritius route has traditionally been a favourite destination among India-focused funds and offshore investors for structuring their investments into India, accounting for about 40 percent of total foreign inflows into India followed by Singapore & Netherlands.

The main attraction is the capital gains tax exemption in India under the India-Mauritius Double Tax Avoidance Agreement ("India-Mauritius DTAA") which provides that any capital gains arising to a Mauritius resident from sale of shares/securities will be taxable only in Mauritius. And, since Mauritius does not levy capital gains tax, such transactions could result in a zero capital gains tax liability for the investor.

However, On May 10, 2016, India and Mauritius signed a Protocol amending the Double Taxation Avoidance Agreement between India and Mauritius ("India-Mauritius DTAA" or "DTAA"). The most significant amendment being the phasing out of the capital gains exemptions on alienation of shares of Indian companies held by Mauritian residents.

The changes on taxing capital gains are as follows:

- Shares acquired prior to April 1, 2017

Investment in shares before April 1, 2017, shall be grandfathered and taxed as per the unamended provisions of the treaty, even if these shares are alienated after April 1, 2017.

- Transition phase – Shares acquired on or after April 1, 2017 and alienated on or before March 31, 2019

The Protocol provides for a relaxation in respect of capital gains arising to Mauritius residents from alienation of shares between April 01, 2017 and March 31, 2019. The tax rate on any such gains shall not exceed 50% of the domestic tax rate in India. This benefit shall only be available to such Mauritius resident who satisfies the LOB test i.e (a) not a shell/conduit company and (b) satisfies the main purpose and bonafide business test.

- Shares acquired on or after April 1, 2017 and sold on or after April 1, 2019

Capital gains tax benefit for sale of shares of an Indian company which are acquired on or after April 1, 2017 and sold on or after April 1, 2019 will not be available. Capital gains arising from such sale will be fully taxable as per the Indian Income Tax Act, 1961.

- LOB Clause

According to the LoB clause, a shell / conduit company in Mauritius will not be entitled to claim benefit of reduced tax of half the applicable rate during the period April 1, 2017 to March 1, 2019. A bright-line test which prescribes the threshold to claim this benefit has been provided i.e. the total expenditure on operations in Mauritius should not be less than Rs 2,700,000 (US $40,000) in the immediately preceding 12 months.

1.1. <u>All is not lost</u>

- Post amendment it is not that the arbitrage is not possible at all, if the investment is made in equity instruments, possibly not, but if the investment in other debt instruments like debentures the position, so far as capital gains in concerned, remains the same.

- It is also pertinent to note that, taxing rights have been allocated to India only so far as alienation of shares in a company is concerned, interestingly, there is no mention of other form of securities or other form of entities for example an interest in a LLP. Given the recent liberalization of foreign direct investment in LLPs, this is another tax efficient investment avenue that may be explored going forward.

- Further, before the renegotiated India-Mauritius DTAA, the lowest tax withholding on Interest pay out was 10 percent. However, Mauritius has successfully renegotiated a rate of 7.5 percent, which is significantly lower than India’s treaties with Singapore (15 percent) and Netherlands (10 percent). This amendment comes as a welcome move in the private debt space. Accordingly, given that transfer of debt instruments falls under the residuary clause and not under the category of equity shares coupled with low tax withholding cost of 7.5 percent on the interest pay out, Mauritius can emerge as an interesting jurisdiction for investments by way of debt instruments.

- Further, the investors may also evaluate and include structured debt while investing into India. The Government has been increasingly liberalising the structured debt route. A classic example of a structured debt instrument is the bonds issued by Indian companies to the category three foreign portfolio investors which are technically bond from a tax perspective, in as much as, whatever is paid over and above the principle will be tax deductible for Indian company therefor giving tax optimisation, however, in substance the bond will function as equity. So there are two components, one being the interest and other being the redemption premium.

- While the position in respect of taxation of capital gains marks a change that would lead to higher tax cost on an absolute basis, however, the corresponding rationalizations under Indian domestic law may ease the tax impact of such transactions and promote debt investments through Mauritius. For eg, the Finance Act, 2016 reduced the rate of tax on short term capital gains arising out sale of unlisted shares of an Indian private company to 10 percent, when indexation benefits are not availed. This will reduce the overall tax impact on the Mauritius based investors. Additionally, a lower holding period of two years has been prescribed to be classified as a long term capital asset in case of unlisted shares.

- Overall, equity investments, especially hedge funds that generally adopt short term strategies, would be most affected by the amendment in the India-Mauritius DTAA, as short term capital gains taxes on the sale of listed securities over the stock exchange is subject to a 15 percent tax rate.

1.2. <u>Open ambiguities</u>

- Grandfathering has only been offered to “shares” and not to a broader set of investments. Accordingly, there is tax ambiguity related to convertible debentures acquired before April 1, 2017, whether the same will be grandfathered post-conversion into equity shares, and sold after April 1, 2017.

- Similarly, it is unclear as to what will be the tax impact on an investor who buys stocks of company A before April 1, 2017, receives shares of company B to which company A is merged after April 2017, and then books capital gains by selling the shares of B, say in 2018; while technically the investor received shares of B after the cut-off date, it was part of a share exchange scheme and by virtue of the holding in company A.

- In case of bonus shares where the original shares were acquired before April 1, 2017, however the bonus shares are issued post April 1, 2017, whether the grandfathering provisions will apply to the bonus shares.

- In a scenario where the investor deposits securities such as ADR and GDR (purchased before April 1, 2017) with the custodian bank to obtain shares after the cut-off date and sells the stocks in 2019. The questions that arise are whether capital gains from sale of shares (converted from ADR) are taxed? Also, whether the capital gains tax on sale of bonus shares issued post April 2017 against stocks which were bought before the cut-off date?

1.3. Working group

With a view to examine the consequential issues arising out of amendments to India-Mauritius DTAA and to clear the fog on the ambiguities arising out of the amendments, the Indian government has shown cognizance to the investor's concerns and has constituted a Working Group headed by Joint Secretary (FT&TR-II), CBDT and comprising of departmental officers and representatives of SEBI, custodians, brokerage firms and fund managers.

2. Impact on India-Singapore Tax Treaty

The change to the India-Mauritius DTAA will also have a domino effect on the India-Singapore Tax Treaty, because the India-Singapore Tax Treaty is *pari materia* to India-Mauritius DTAA which contains a specific provision which automatically terminates the capital gains tax exemption under the India-Singapore Tax Treaty if the India-Mauritius DTAA gives India capital gains taxing rights in respect of gains arising to a Mauritius resident from alienation of Indian shares.

Unfortunately, there is no tax certainty for Singapore based investors on the way forward since it is not clear whether grandfathering of pre-2017 investments will be possible under the India-Singapore tax treaty. While the Indian Government has remained silent on the grandfathering of pre-2017 investment, however, press reports suggest that Indian tax authorities are in talks to re-negotiate the India-Singapore tax treaty and the same may be on similar lines as India-Mauritius DTAA.

3. Renegotiation of India-Cyprus Tax Treaty

On November 1, 2013, vide a Press Release the Indian Ministry of Finance had notified Cyprus as a notified jurisdictional area under Section 94A of the Act vide Notification No. 86/2013 which had far reaching impact on the investors who had invested through Cyprus. However, on July 1, 2016, the Government of India announced that negotiation on the Tax Treaty between India and Cyprus ("India-Cyprus DTAA") had been completed to provide for source based taxation of capital gains and Grandfathering of investments made prior to April 01, 2017. This is a very significant development and will contribute to further develop the trade and economic links between India and Cyprus.

While the press release mentions the key amendments, one will have to wait for the fine print of the protocol to examine if there are other amendments to the India-Cyprus Tax Treaty. Further, it has been agreed between both countries that India will consider removal of Cyprus from the list of notified jurisdictional areas under the Act and initiate necessary procedures.

The change implies that if a foreign investor from Cyprus makes profit through investment in Indian shares, he should pay the capital gains tax in India, which is in line with a similar change in the India-Mauritius DTAA.

Reworking of the Tax Treaty with Cyprus is a continuation of the government's policy to plug the loopholes of Tax Treaties with India's investment source countries.

In contrast with the India-Mauritius tax treaty, which provides a two-year transitional period when the tax rates will be half of India's domestic rates with respect to investments that qualify the LOB criteria, there is no such provision with Cyprus.

In the past, Cyprus was more preferred by debt funds because of the low withholding tax of 10 percent on interest and interestingly Mauritius debt funds will now get a better treatment because of the 7.5 percent withholding tax rate under the revised India-Mauritius DTAA.

4. <u>GAAR and interplay with LOB</u>

GAAR provisions (contained in Chapter X A) were introduced in the Indian tax law by Finance Act 2012, however the Finance Act 2015 has postponed the implementation and the provisions are to be made applicable prospectively from Financial Year 2017-18 (ie, April 1, 2017). In a broad sense, GAAR will be applicable to arrangements/transactions which are regarded as 'impermissible avoidance arrangements' centered on the 'main purpose' test and will enable tax authorities, among other things, to re-characterize such arrangements/transactions so as to deny tax benefits.

Now the question arises as to the role of GAAR in the domestic law with regard to an LOB provision in the Tax Treaties. Whether GAAR complements the Tax Treaties or limits the application of Tax Treaties?

The principle of "pacta sunt servanda" incorporated in Article 26[1] of the Vienna Convention on the Law of Treaties, 1969 ("VCLT" or the "Convention") suggests that in case of conflict between the provisions of tax treaties and those of domestic law, the provisions of the tax treaties must prevail[2]. A conjoint and proper construction of Article 18[3], Article 26 and Article 31[4] of the VCLT suggests that

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[1] *Article 26.* "PACTA SUNT SERVANDA"-"*Every treaty in force is binding upon the parties to it and must be performed by them in good faith*".

[2] Exposure Draft on Framework of Indian GAAR by The Institute of Cost Accountants of India

[3] *Article 18.* OBLIGATION NOT TO DEFEAT THE OBJECT AND PURPOSE OF A TREATY PRIOR TO ITS ENTRY INTO FORCE – *"A State is obliged to refrain from acts which would defeat the object and purpose of a treaty when:*

(a) It has signed the treaty or has exchanged instruments constituting the treaty subject to ratification, acceptance or approval, until it shall have made its intention clear not to become a party to the treaty; or

(b) It has expressed its consent to be bound by the treaty, pending the entry into force of the treaty and provided that such entry into force is not unduly delayed."

[4] *Article 31*. GENERAL RULE OF INTERPRETATION – "*1. A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose."*

circumstances or situations like "tax abuse" may amount to abuse of the Convention itself and therefore such abusive transactions should be disregarded while granting benefits under the treaty[5].

OECD and UN model also support the above view. Further, the Shome Committee[6] has also provided its recommendations on this conflict and has concluded that in circumstances where the Tax Treaty itself contains anti-avoidance provisions, then such provisions should not be overridden by the domestic GAAR provisions by virtue of the Treaty override provisions. However, the same has not been incorporated in the domestic law.

5. <u>Place of Effective management</u>

Place of Effective Management ("POEM") is the internationally recognized test for determination of residence of a company incorporated in a foreign jurisdiction. POEM has been defined to mean "*a place where key management and commercial decisions that are necessary for the conduct of the business of an entity as a whole are, in substance made.*"

This new subjective framework introduces the possibility that a company could be construed to be an Indian company by virtue of the fact that majority control and management is exercised by Indian resident persons, or where some portion of shareholding of the offshore company is held by non-Indian investors and Indian promoters exercise significant ownership and control. Consequently, in case the POEM is determined in India, the worldwide profits of the offshore entity shall be taxable in India.

This becomes relevant where the offshore fund is controlled and managed by a team in India then the offshore fund can be treated as a resident in India and the global income of the Fund may get taxed in India at a higher tax rate.

For the purpose of determination of POEM it is the substance which would be conclusive rather than the form. The place, where key management decisions (for eg. decisions regarding the investment strategies) are taken would be more important than the place where the decisions are implemented. Any determination of POEM will depend upon the fact and circumstances of a given case and the principles will necessarily involve a holistic factual analysis.

6. <u>Permanent Establishment Issue</u>

Offshore funds investing in India have a potential tax exposure on account of having constituted a Permanent Establishment ("PE") in India. Offshore funds typically operate on an investment advisory

[5] Exposure Draft on Framework of Indian GAAR, supra note above
[6] Report on General Anti Avoidance Rules (GAAR) in Income tax Act, 1961, Expert Committee, 2012 *[the Prime Minister, in order to address the various concerns of GAAR, constituted an Expert Committee under the chairmanship of Dr Parthasarathi Shome to finalize the GAAR guidelines after consulting with various stake holders]*

model whereby an Indian advisor provides non-binding investment advice to an offshore manager which in turn manages the offshore funds in India.

Income of a non-resident is taxable in India, if his income is deemed to accrue or arise in India. Under the Indian tax laws, income of non-resident is deemed to accrue or arise in India, if it is earned through a business connection in India and the income which is attributable to such business connection is taxable in India.

Under a tax treaty scenario “Business Connection” is treated as equivalent of the concept of PE. The presence of fund managers or investment advisors in India may, in certain scenarios, be viewed as a PE of the offshore fund, thereby exposing the fund to additional tax liability. Consequently, if the fund manager who is based in India executes fund management activity for the offshore fund making investments outside India, the profits earned by such fund could be liable to tax in India due to his presence in India. Accordingly, offshore funds did not typically retain fund manager based in India, instead, many fund manager that manage India focused offshore funds, tend to be based outside India and only have an advisory relationship in India that provide recommendatory services.

To encourage fund manager of offshore funds in India to set up base in India, a new regime by way of section 9A was introduced by Fin;ance Act, 2015, which specifies that fund management activity undertaken in India by an eligible fund manager on behalf of an eligible offshore fund will not constitute a business connection for the offshore fund in India.

Key qualifying criteria for an eligible fund are as follows:

- The fund is a non-resident of India (location of the fund manager in India, in itself, will not result in the offshore fund being regarded as a resident in India).
- The fund must be resident of a tax treaty country.
- Indian residents cannot own/ participate in (directly or indirectly) more than five per cent of the corpus of the fund.
- The fund must be subject to investor protection regulations in the relevant overseas jurisdiction.
- The fund must have at least 25 members who are not connected persons.
- No individual member (including connected person) can hold 10 per cent or more in the fund.
- The aggregate participation interest of 10 or less members along with their connected persons shall be less than 50 per cent of the fund.
- The fund cannot invest more than 20 per cent of its corpus in any entity.

- The fund cannot invest in any associate entity.

- The monthly average corpus of the fund cannot be lower than INR1 billion (newly incorporated fund to satisfy the condition at the end of the financial year).

- The fund cannot carry on or control and manage any business in or from India.

- The fund does not undertake any other activity in India, which can result into a business connection in India.

- The fund must remunerate the fund manager on an arm’s length basis.

Key qualifying criteria for an eligible fund manager are as follows:

- The fund manager cannot be an employee or a connected person of the fund.

- Registration with SEBI under the applicable regulations.

- The fund manager is acting in ordinary course of his business.

- The fund manager is not entitled to more than 20 per cent profits earned by the fund from the transactions carried out by the fund through the fund manager.

This new regime employs a number of rigid criteria that would be difficult for PE funds and FPIs to follow.

7. Indirect Transfer

Under the Indian tax law, non-residents are taxable on Indian source income i.e. income that accrues or arise, or is deemed to accrue or arise, or is received, or is deemed to be received in India. In this regard, section 9(1)(i) of the Act provides the circumstances where income of a non-resident shall be deemed to accrue or arise in India.

Section 9(1)(i) specifies that “all income accruing or arising, whether directly or indirectly, through or from any business connection in India, or through or from any property in India, or through or from any asset or source of income in India, or through the transfer of a capital asset situated in India” shall be deemed to accrue or arise in India

After the landmark judgement of Supreme Court in case of Vodafone, an Explanation was introduced into the Act that clarified that an asset or capital asset, being any share or interest in a company or entity registered or incorporated outside India, shall be deemed to be situated in India if the share or interest derives its value, directly or indirectly, substantially from assets located in India. Therefore, under the current law, a transfer of shares of a foreign company deriving its value “substantially” from Indian assets, i.e. an indirect transfer of shares of an Indian company, shall be taxable in India.

After the abovementioned amendment, now the income tax authorities may seek to tax the transfer or redemption of shares in an India focused offshore fund by its investors notwithstanding that there is no transfer taking place in India, on the basis that the shares of the fund derive substantial value from India.

The Finance Act, 2015 provides that the share of a foreign company shall be deemed to derive its value substantially from assets (tangible and intangible) in India if on the specified date; the value of Indian assets (i) exceeds INR 100 million and (ii) represents at least 50 percent of the value of all assets owned by the foreign company. Furthermore the gain arising on transfer of a share or interest deriving, its value substantially from assets located in India will be taxed on a proportional basis based on the assets located in India vis a vis global assets, to ensure that only the value of Indian assets is taxed in India.

Accordingly, the offshore funds investing more than 50 percent of their assets in India are likely to be impacted. It is also important for them to examine whether they have any withholding tax obligations in India when they redeem shares/units of their shareholders/unit holders.

However certain exclusions are provided for offshore restructuring and to small shareholders. These are:

- Where the transferor of shares of or interest in a foreign entity, along with its related parties does not hold (i) the right of control or management; and (ii) the voting power or share capital or interest exceeding 5% of the total voting power or total share capital in the foreign company or entity directly holding the Indian assets (Holding Co).

- In case the shares or interest in the foreign company or entity which is transferred holds Indian assets indirectly and transferor, along with AEs does not hold (i) the right of management or control in relation to such company or the entity; and (ii) any rights in such company by which it can exercise control or management or voting rights exceeding 5 percent in the direct holding company or entity holding Indian asset.

8. Conclusion

The amendment does not mean that these jurisdictions have become completely irrelevant, nor does it mean that the investors needs to fold the structures in Mauritius or Cyprus, it just needs to be looked at more carefully and the questions to be answered are whether more substance has to be created in each of these jurisdictions and does it still make sense for an investor to go through this from an economic factor, cost and budget analysis. Going forward, Indian taxes may just be factored as an incremental cost and may accordingly form a part of the valuation methodology for investments while determining the rate of return etc.

The Indian revenue authorities are sending out a clear message to the investor community to invest directly instead of using a creative structure. Going forward, Treaty shopping will not be the most attractive tax planning strategy.

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