Overview of VCFs

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About Venture Capital

Venture Capital can mean:

- Providing seed
- Start up
- First stage Financing
- Funding for expansion of companies not having access to public securities

- **Venture Capital** is a form of "risk capital".- High Risk High return!
  - Capital that is invested in a business with substantial element of risk relating to the future creation of profits and cash flows.
  - Risk capital is invested as shares (equity) rather than as a loan and the investor requires a higher "rate of return" to compensate him for his risk

Contd.

Venture Capital provides
long-term,
committed share capital, to help companies grow and succeed.

If an entrepreneur is looking to start-up, expand, buy-into a business, buy-out a business in which he works, turnaround or revitalize a company, venture capital could help do this.

Obtaining venture capital is substantially different from raising debt or a loan from a lender.

- Lenders have a legal right to interest on a loan and repayment of the capital, irrespective of the success or failure of a business.

As a shareholder, the venture capitalist's return is dependent on the growth and profitability of the business. This return is generally earned when the venture capitalist "exits" by selling its shareholding in the business.

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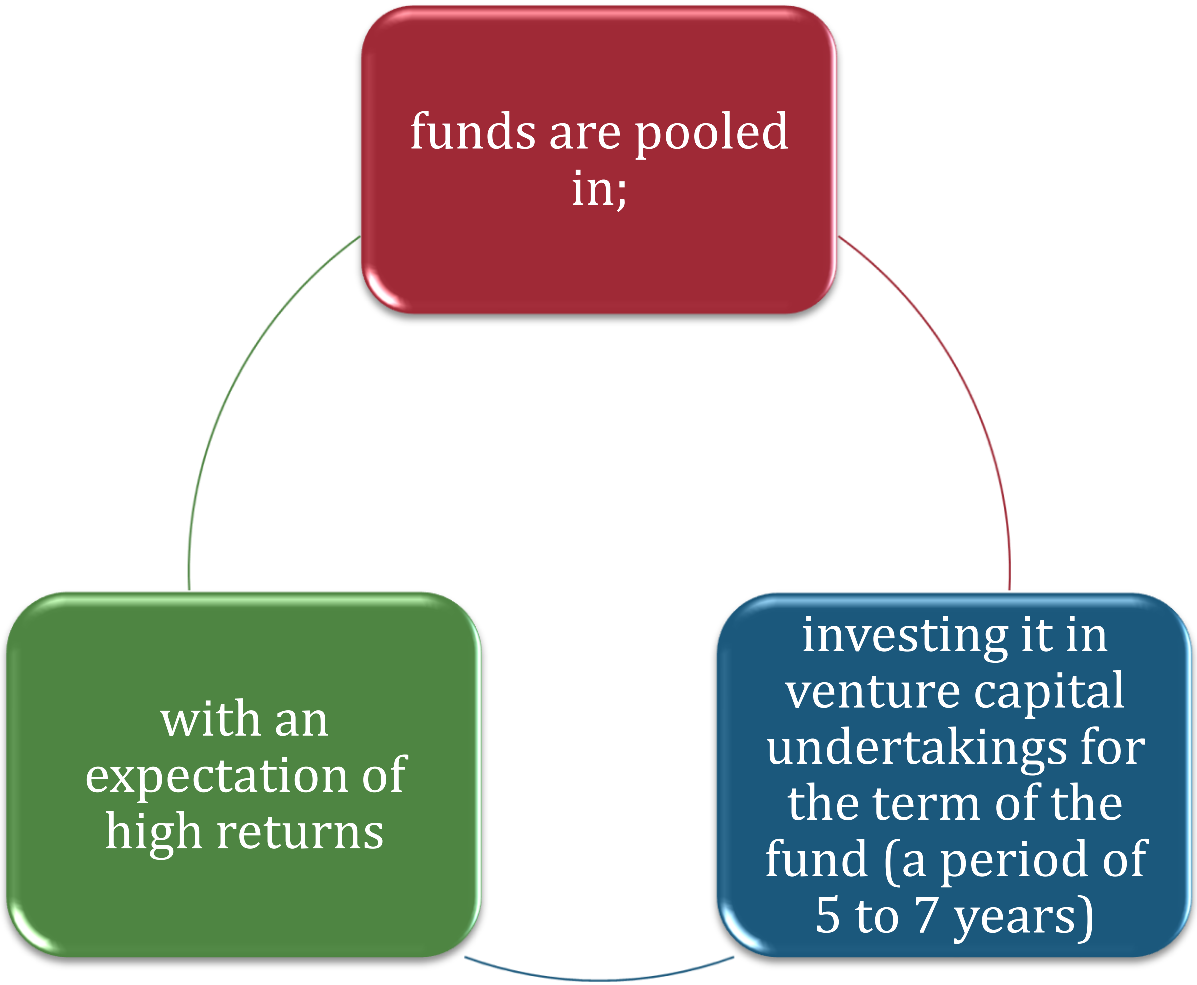
→to protect the funds of the investors against the risk of losses, venture capital fund provides its expertise, undertake advisory function and invest in the 'patient capital' of the undertaking – equities.

→it had been a popular source of funding in many countries and served as a lucrative bait to create a similar industry in India as well.

Venture Capital Financing is a process whereby:



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Section 2(m) of SEBI (Venture Capital Fund) Regulations, 1996 defines a VCF as:

- a corpus of funds created by raising funds in a specific manner to be invested in a manner as specified in the regulations;
  - **this means any activity beyond the periphery of what is laid in the charter is prohibited.**
- a VCF can be created in the form of a
  1) trust;
  2) company;
  3) a body corporate.
  - **this means that no matter what the form of a VCF is the core substance shall remain the same.**
- the VCF is segregated into “schemes” in which the funds are invested which relates to investing the money into venture capital undertakings
- a VCF raises money from the investors in the form of “units” to be invested in these schemes.

Evolution of VCF in India

- The concept came in India decades after than that in USA, UK, Europe etc.
- **1973-** A committee on Development of Small and Medium enterprises highlighted the need to foster VC as a source of funding new entrepreneurs and technology.
- **1988-**The Government announced Controller of Capital Issues These focused on a very narrow description of Venture Capital and proved to be extremely restrictive and encumbering, requiring investment in innovative technologies started by first generation entrepreneur. This made investment in VC highly risky and unattractive.
- At about same time World Bank arranged for VC awareness seminar, giving birth to players like: TDICI, GVFL, Canbank and Pathfinder.
- Along with other reforms Govt decided to liberalise VC industry and abolish CCI
- Technology Development and Information Company of India Ltd. (TDICI), an equal joint venture of ICICI and UTI, was the first organization to begin its venture capital operations in India.
  - It was called VECAUS (Venture Capital Units Scheme)- started with an initial corpus of Rs.20 crore and was completely committed to 37 small and medium enterprises. The first project of TDICI was loan and equity to a computer software company called Kale Consultants.

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- **1990-** Other VCFs were established like the Gujarat Venture Finance Limited (GVFL), Andhra Pradesh's AP Industrial Development Corporation (APDIC) and the Canara Bank Venture Capital Fund
- **1993-** Venture capital community in India formalized with the formation of the Indian Venture Capital Association.
  - Indian Venture Capital Industry suffered several set-backs as there was no tax pass-through for investors' capital gains as was common internationally
- **1996-** The regulatory environment of the industry was defined by the SEBI (Venture Capital Fund) Regulations, 1996.

Contd..

- **1997 –** VC Regulations got considerable boosted by IT Revolution as the Venture Capitalist became prominent founders of IT and telecom Industry.
- **2000-** With the recommendations of the Chandrasekhar committee and SEBI (Foreign Venture Capital Investor) Regulations, 2000 VCF fostered growth in the Industry.
  - Introduction of the Finance Act, 2000 fuelled the growth of VCF by giving it a pass through status by insertion of section 10(23FB) and 115U in Income Tax Act.
- **2004-** VCF/FVCI permitted to invest in NBFC registered with RBI and engaged in equipment leasing
- **2000-2007-** VCF industry has had an upswing. The VCF investments in India amounted to US$1 billion in 2000 and investments of US$ 7.5 billion by 2006 and the first nine months of 2007 has seen investment of US$ 7.77 billion.

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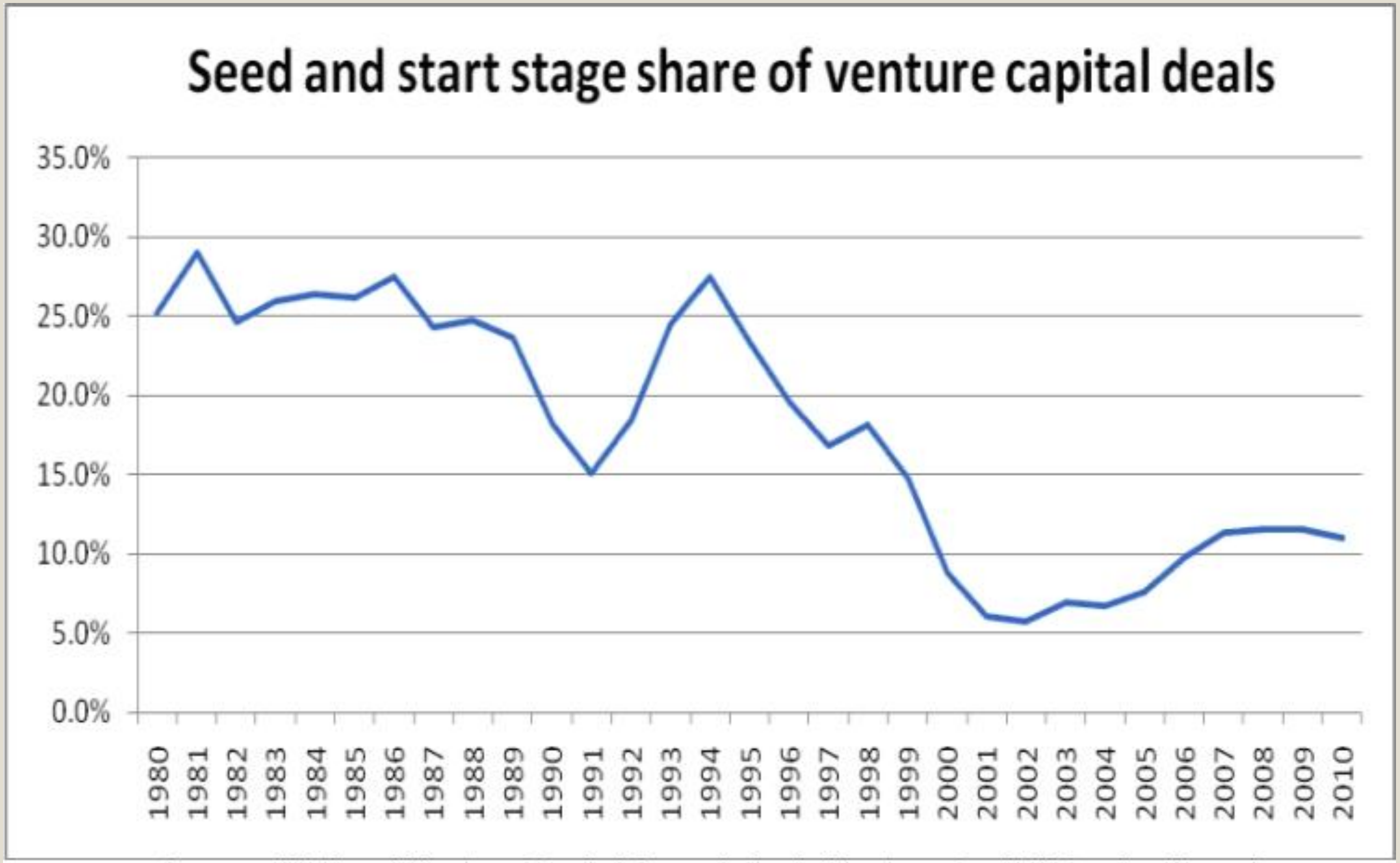

Source: National Venture Capital Association's Venture Capital Yearbook, various years

Who will invest in Venture Capital?

- Venture Capital raises money both domestically and across the world

Kinds of Investors-

- **Angel Investors-** High net worth investors having appetite for high risk and higher returns;
- **Institutions with diversified portfolios** like pension funds, insurance companies etc;
- **Fund of Funds**

How does it work?

Generally the investments are made in pre determined number and type of companies. Some investments might miserably fail, some break even while some will give highest returns

Venture Capital do not avoid risk but manage by balancing the portfolio (primarily a diversification of risk)

At the end of life cycle of funds the returns are distributed among investors. Returns if higher than expected minimum, it is shared between Asset Management Company (AMC) and investors in a pre determined ratio

Regulatory Framework

A venture capital funding based organisation is regulated under the following government authorities and provisions relating to it.

SEBI	RBI(FEMA)	INCOME TAX ACT

FEM (Transfer or Issue of Security by person Resident Outside India) Regulations, 2000

SEBI (VCF) Regulations ,1996	SEBI (FVCI) Regulations, 2000	SCRA, 1956	SEBI (SAST) Regulations, 2011

regulation in ndia

VCF Regulation

- VCF are regulated by the SEBI (Venture Capital Fund) Regulations, 1996
- any company or trust proposing to carry on activity of a VCF shall get a grant of certificate from SEBI as per the regulations
- A certificate of registration is obtained from SEBI in accordance with the regulations as per section 12 (1B) of the SEBI Act

ELIGILBILITY CRITERIAS FOR REGISTRATION

Company:

- -Main object as business of VC in MoA
- -prohibition to make invitation for public subscription
- -director/principal officer/employee not to be involved in any litigation in securities market
  - -as the same will have a bearing on the applicant
- - director/principal officer/employee not being convicted of any offence
- -if it is a fit and proper person

Trust:

- -the trust deed duly registered under the Registration Act, 1908
- -main object to carry on the business of VC
- -the directors of trustee company or its trustee not to be involved in any litigation in securities market
- -the directors of trustee company or its trustee not being convicted of any offence
- -if it is a fit and proper person

Body Corporate:

- -set up or established under laws of Central or State Legislature
- -applicant permitted to carry on the business of VC
- -Same as in case of company/trust

in trust form vis-à-vis ompany

Setting up a VCF in a trust form is beneficial for the following reasons:

✓ It is easy to form and has minimum compliance requirement;

✓ Liquidation of the funds in case of company structure would be a long drawn process, whereas in case of a trust it would be simpler to dilute the trust;

✓ Distribution of the returns on maturity or at the end of the tenure of the fund will be simpler in case of trust form than in case of company structure;

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- ✓ Repatriation of the capital in the event of losses would be difficult in company form of structure as company cannot redeem equity or preference shares unless out of profits or fresh issue of shares.

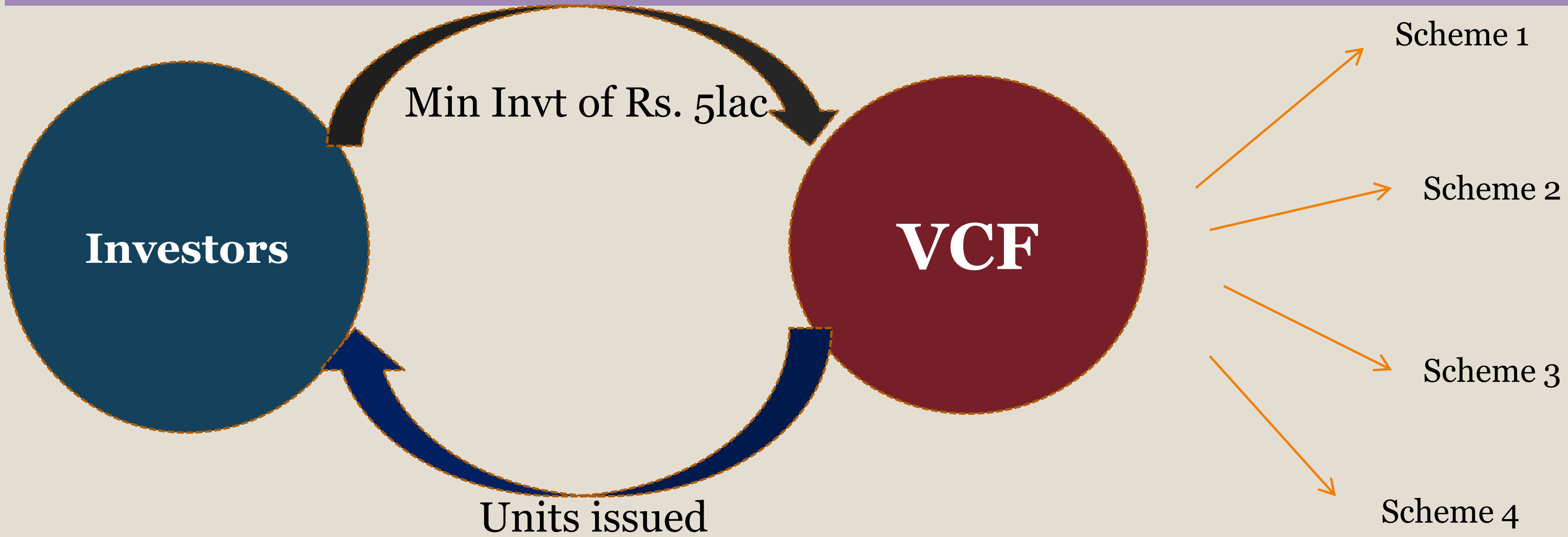
INVESTMENT CONDITIONS AND RESTRICTIONS

Minimum Investment in VCF [Reg 11]

- VCF raises money from investors
  - **Residents (Indians)**
  - **Non-Residents (non-Indian)**
    - **In form of "units"**
      - Defined under Reg 2(l) as-***"unit"*** *means beneficial interest of the investors in the scheme or fund floated by trust or shares issued by a company including a body corporate;*
- No VCF in form of company/trust to accept any investment below Rs. 5lac
- Each fund set up by VCF to have firm commitment from the investors of atleast Rs. 5 crore before start up of operations

Analysis and Structure

- Though the VCF can be formed by way of Trust or Company or Body Corporate, but the beneficial interest lies with the investors.
- Therefore, in case of a company the funds raised cannot be used for any other purpose and the unit holders become the beneficiaries reducing the status of the company to have only fiduciary interest of the fund and therefore, no matter what form of VCF but the essence is that of a Trust
- **STRUCTURE:**



Investment Restrictions

VCF to

- ***Disclose*** investment strategy at the time of registration

VCF

- ***Not*** to invest more than 25% of the corpus of fund in one venture undertaking

VCF can

- Invest in securities of foreign companies ***subject to*** complying with guidelines/conditions issued by RBI

VCF

- Shall ***not*** invest in Associate Companies

Investment Structure

- Investment
  - 33.33% of the investible funds as per below:
    - Subscription to IPO of a VCU proposed to be listed
    - Debt instrument s of undertakings in which VCFs has equity invt.
    - Preferential allotment of listed companies subject to lock in of 1 (one) year
    - SPVs created by VCFs
    - Equity linked instruments of a weak company/sick listed company
  - Atleast 66.67% of the funds to be invested in unlisted equity shares and equity linked securities

General Obligations

- VCFs received monies in its fund only through Private Placement [Reg 15]
- VCFs to- [Reg 16]
  - Issue a placement memorandum containing terms and conditions along with details of trustees/directors/fund manager/AMCs/proposed corpus/minimum amount to be raised
  - Enter into contribution/subscription agreement with the investors/tax implications etc.
- VCFs to file such memorandum and agreement with the Board along with report on money actually collected from the investor

Contd..

- VCFs not to issue advertisements inviting offers from the public [Reg 14]
- No VCF can get listed till the expiry of 3 years from the date of issuance of units [Reg 13]
- VCFs to maintain books of accounts for a minimum period of eight years and intimate the Board where the same is maintained [Reg 20]
- VCFs to cooperate with Investigating or Inspecting Officer in event of Investigation and Inspection if ordered under Reg 25 [Reg 27]

\egistration enefits

The benefits available from securing a VCF registration are as follows:

- **The VCF will:**
- not be subject to the one year pre- IPO lock-in period,
- -provided it held the shares for a period of at least one year as on the date of filing the draft prospectus with the SEBI;
- qualify for the exemption under the Takeover Code for inter se transfers between the VCF and the promoters;
- exemped from merger control provisions contained in the Competition Act, 2002; and
- be eligible for tax pass through available for such part of the income of the VCF which is from investments in a venture capital undertaking which complies with the conditions laid down in Section 10(23FB) of the IT Act7.

SEBI (Foreign Venture Capital Investor) Regulations, 2000

- Introduced to regulate and facilitate foreign venture capital and private equity into India
- **Definition:**

"Foreign Venture Capital Investor" means an investor incorporated and established outside India, is registered under these Regulations and proposes to make investment in accordance with these Regulations; [Reg 2 (g)]

REGISTRATION:

- Application to be made in Form A alongwith application fee [Reg 3]
- Eligibility Criterias [Reg 4]

- Foreign Venture Capital Investors (FVCI) to get registered under SEBI and have Certificate of Registration [Reg 7]

INVESTMENT CRITERIA [Reg 11]:

Invest total funds committed in one VCF

Disclosure of Invt strategy to the Board

Disclose the duration of life cycle of the funds

Make investment as:

66.67% in equity linked instruments

33.33% by means in the next table:

33.33% as:

Subscription to IPO of VCU proposed to be listed

Debt instrument s of VCU in which FVCI already made investments.

Preferential allotment subject to lock in of 1year

Equity shares of a weak/sick company

SPVs

Benefits of Registration to FVCI

- SEBI (SAST) Regulations, 2011 do not get attracted in case of transfer from FVCI to promoters if there is a pre existing agreement between the promoters and FVCI
- Eligible to participate in Initial Public Offering through Book-building subject to compliance of SEBI (FVCI) Regulation
- Exemption to FVCI having held shares for a period of one year prior to the date of filing of the draft prospectus with SEBI under SEBI (ICDR) Reg, 2009 in case of IPO where the entire pre-issue share capital of a company going in for an initial public offering is locked in for a period of one-year from the date of allotment in the IPO.
  - this would essentially allow the FVCI to exit from their investments post listing;

Contd..

- Tax pass through status for investment in 9 sectors
- Exemption from taking prior Government approval in case foreign investor has an existing joint venture and technology transfer/trademark agreement in the same field
- Permitted to invest their entire corpus in a VCF under automatic route;

✓ Exempted from taking prior governmental approval even if seeking to invest in company engaged in the "same" field of activity under the National Industrial

✓ Classification 1987 Code, (As per Press Note 1 (2005 Series) issued by the Ministry of Commerce and Industry, Government of India)

Explanation: any other company in which the FVCI already had an investment prior to January 12, 2005, the date on which Press Note 1 (2005 Series) was notified;

VCF under Takeover code

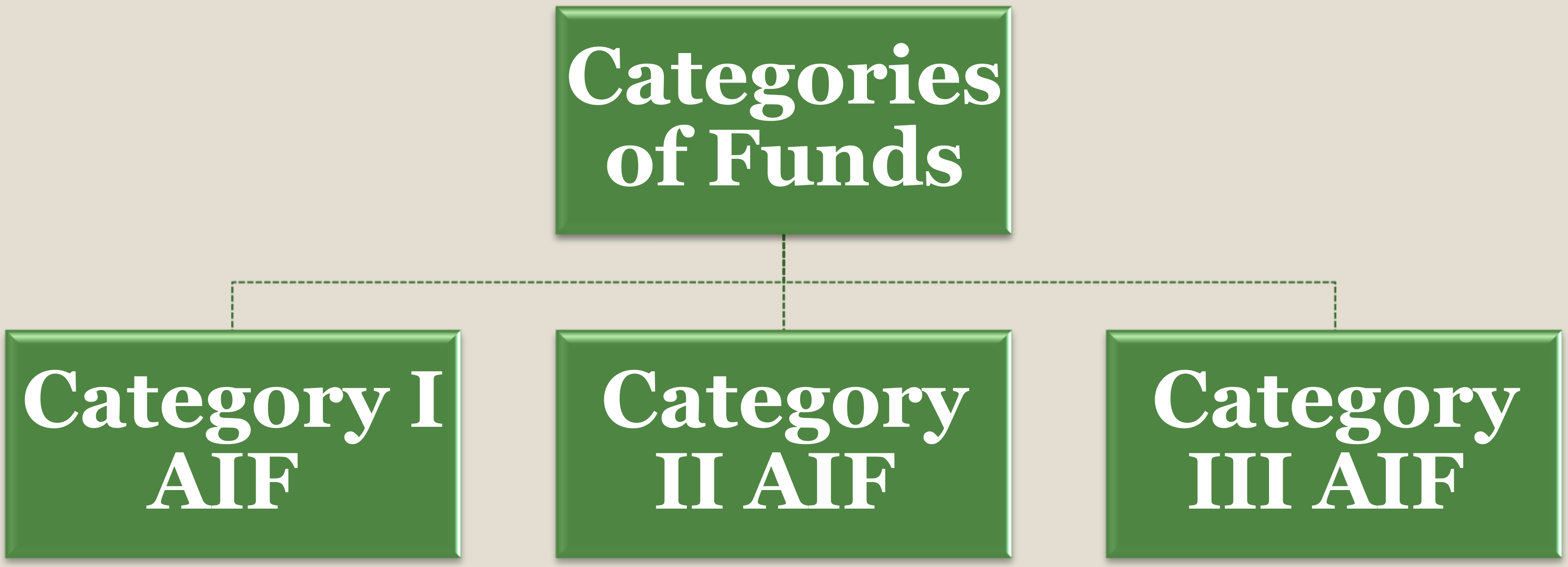
- Exemptions from making open offer under sub-reg (2) of Reg 3 in case of an acquisition of shares from a *registered* VCF or a FVCI pursuant to an agreement between VCF or FVCI and the promoters [Reg 10 (4) (f)]
- Exemption from pricing guidelines – free entry and exit pricing.

New regulation on Alternative investment funds(AIF)

- SEBI has proposed to frame AIF Regulations, 2012 to extend the perimeter of regulation to unregulated funds and ensure systemic stability, increase market efficiency and encouraging formation of new capital.
- Upon these regulations becoming operative, SEBI (Venture Capital Funds) Regulations, 1996 shall be repealed.
- However, existing VCFs shall continue to be regulated by the VCF Regulations till the existing fund or scheme managed by the fund is wound up.
- The guidelines are silent on the impact of AIF Regulations on FVCIs. However, the concept paper on proposed alternative investment funds regulations issued by SEBI on August 1, 2011 proposed to retain the FVCI Regulations and not subsume these in the AIF Regulations-though there was an added proposal to amend the FVCI Regulations so as to FVCIs to invest in different AIFs such as SME Fund, Social Venture Funds in addition to Domestic VCFs.
  - Presently, FVCIs are allowed to invest 100% of their investible funds in SEBI Registered VCFs-lets see what's in store for the FVCIs in the AIF Regulations.

Categories of funds under SEBI AIF Regulations

- The Regulation seeks to cover all types of funds broadly under the following 3 categories:



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Category I AIF

- those AIFs with positive spillover effects on the economy;
- this shall include VCFs, SME Funds, Social Venture Funds and Infrastructure Funds.
- these funds shall be close ended, shall not engage in leverage and shall follow investment restrictions as prescribed for each category

Category II AIF

- those AIFs for which no specific incentives or concessions are given by the government or any other Regulator;
- these shall not undertake leverage other than to meet day-to-day operational requirements as permitted in these Regulations;
- shall include Private Equity Funds, Debt Funds, Fund of Funds and such other funds that are not classified as category I or III.
- these funds shall be close ended, shall not engage in leverage and have no other investment restrictions.

Category III AIF

- those AIFs which Funds including hedge funds that are considered to have negative externalities such as exacerbating systemic risk through leverage or complex trading strategies.
- these funds can be open ended or close ended,
- may engage in leverage subject to limits as may be specified by the Board.
- category III funds shall be regulated through issuance of directions regarding areas such as operational standards, conduct of business rules, prudential requirements, and restrictions on redemption;

Salient Features of AIF Regulations

The AIF Regulations:

- shall be applicable to all pooled investment vehicles other than Mutual Funds, CIS Schemes, Family Trusts, ESOP Trusts, Employee Welfare Trusts, holding companies, funds managed by Asset Reconstruction Companies, Securitisation Trust or any such pool of funds which is directly regulated by any other regulator in India;
- shall have a minimum corpus of Rs. 20 crores;
- shall not accept from an investor an investment of value less than Rs. 1 crore;

Contd..

- The fund or any scheme of the fund shall not have more than 1000 investors;
- The manager or sponsor shall have a continuing interest in the AIF of not less than 2.5% of the initial corpus or Rs.5 crore whichever is lower and such interest shall not be through the waiver of management fees;
- Units of AIF may be listed on stock exchange subject to a minimum tradable lot of Rs. 1 crore. However, AIF shall not raise funds through Stock Exchange mechanism.

FUND STRUCTURES

Types of Structures

FOUR main widely used structures

- Pure Domestic Structure
- Pure Off Shore Structure
- Master Feeder (Unified Structure)
- Co-investment

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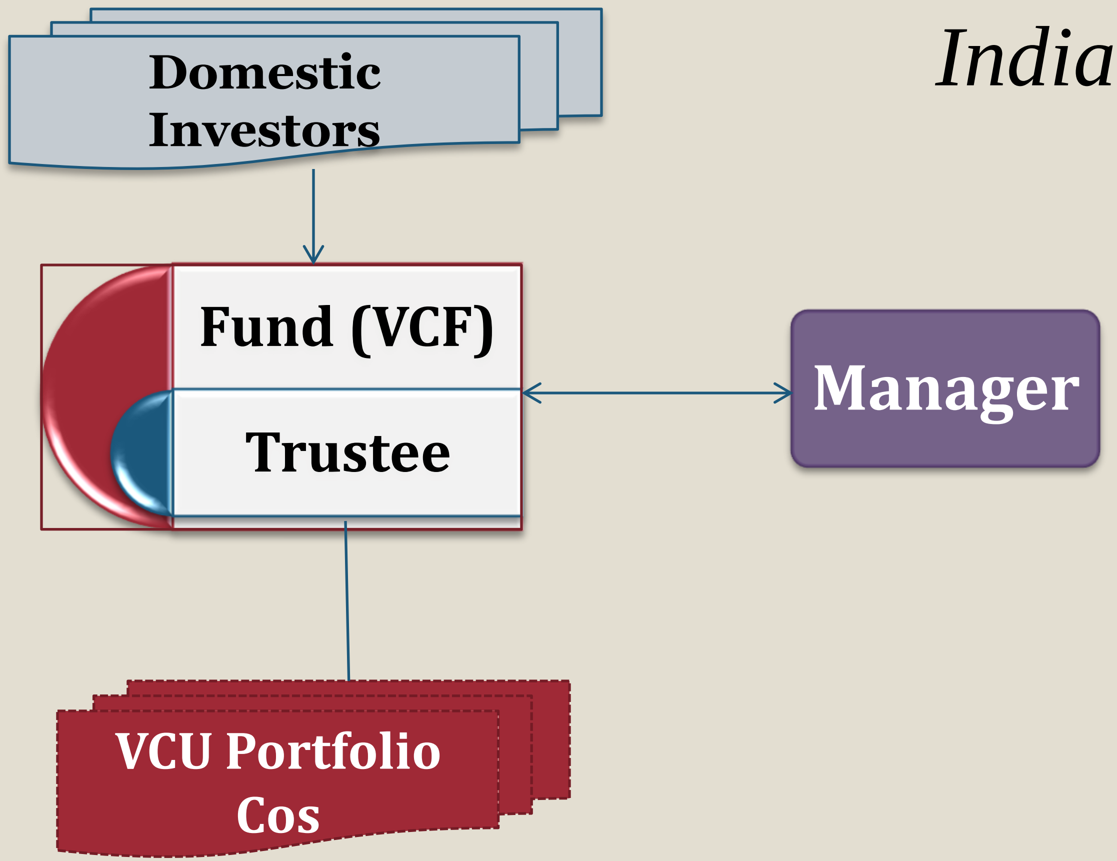

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- Domestic investment fund settled as a contributory trust, vide a registered trust deed
- Trustees appoint an investment manager under the IMA appointed by trustees
- contribution agreements between the investors and the trustees
- investors contribute towards units of the trust
- Registration as a VCF depending on investment objective (i.e. sector of investment, manageability of restrictions)

Advantages and drawbacks of Pure Domestic Structure

Factors for selection of this structure:

- Used in cases where fund managers are looking to raise capital only from domestic investors
- Usually part of a larger 'co-investment' structure, for sponsors to make their 'sponsor commitment'

Factors against selection of this structure:

- only a single close of domestic investors can be held due to tax considerations under this scheme
- No foreign capital can be raised for investment

Documentation and approvals for Pure Domestic Structure

Documentation:

- ✓ Private Placement Memorandum
- ✓ Trust Deed (between Settlor and Trustee)
- ✓ Investment Management Agreement (between the Trustee and the Investment Manager)
- ✓ Contribution Agreement(s) (between the Investors, the Trustee and the Investment Manager)

Approvals:

- ✓ Private Placement Memorandum
- ✓ Trust Deed (between Settlor and Trustee)
- ✓ Investment Management Agreement (between the Trustee and the Investment Manager)
- ✓ Contribution Agreement(s) (between the Investors, the Trustee and the Investment Manager)

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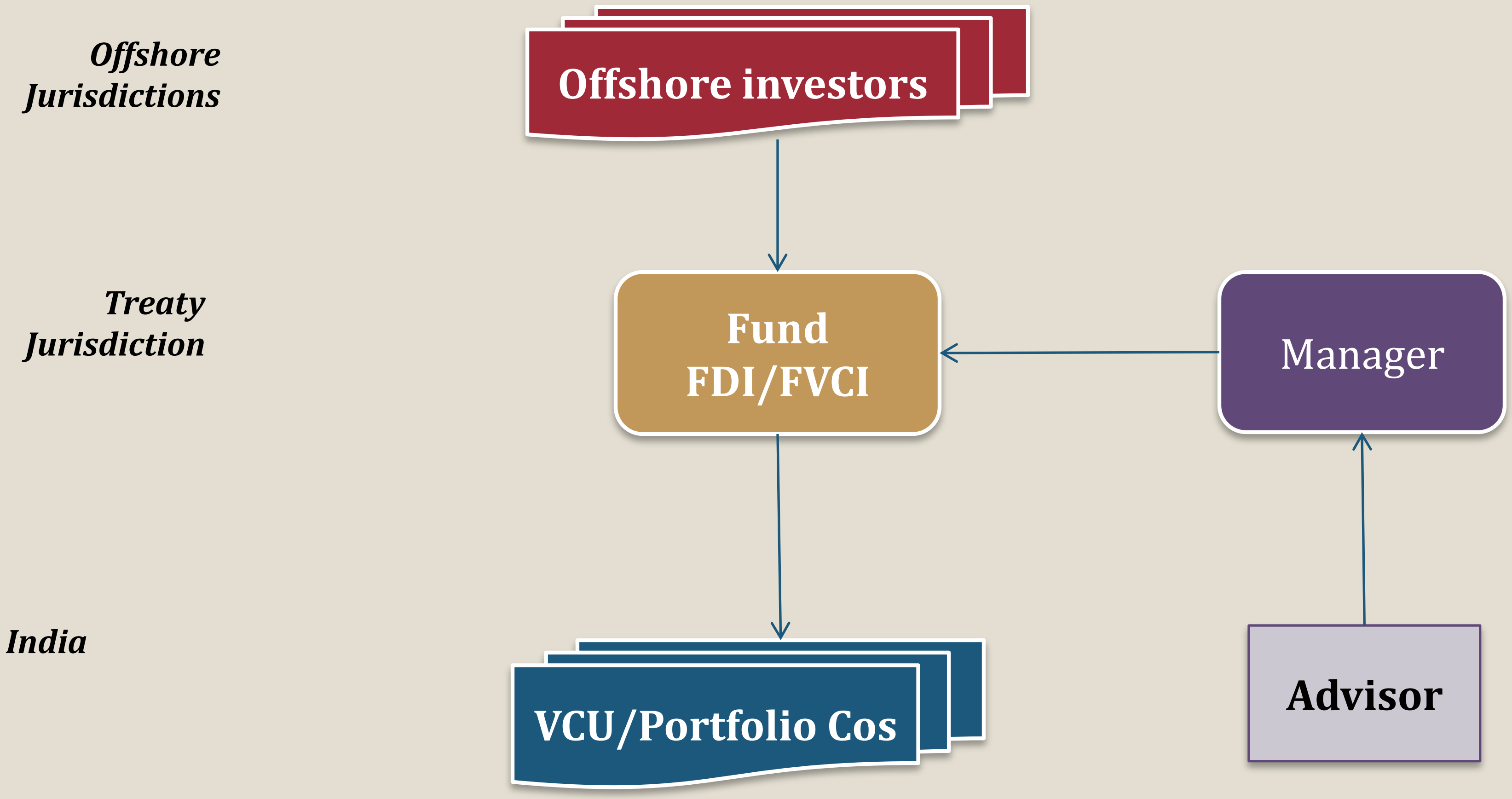

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- Offshore pooling vehicle organized (as a trust, company, or LLP) in a tax favourable jurisdiction, vide a Constitution Document (or SHA, trust deed, LPA)
- investment manager appointed under the IMA by Board of the fund company (or the trustee in case of a trust, or GP of an LP)
- Investors enter into subscription agreements with the fund to make commitments
- India focused funds usually have an advisory presence in India

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Factors for selection of this structure:

- Fund managers raising capital from offshore investors
- Investment decision making is genuinely offshore
- Advisory presence only ‘eyes and ears’ in India, with no decision making powers and effective management offshore
- Carry and management shares can be held in a tax efficient and in regulatory compliance
- Can have multiple closings (typically over a 1 year period)

Factors against selection of this structure:

- Unless actual offshore presence, adverse tax implications may affect the fund
- Holding of carry and management shares is subject to regulatory risk

Documentation and approvals for Pure Offshore Structure

Documentation:

- Private Placement Memorandum
- Constitution of the Fund (and Shareholders' Agreement, depending on method adopted) and Constitution of the Investment Manager (if not already incorporated)
- Investment Management Agreement (between the Fund and the Investment Manager)
- Subscription Agreement (between the Investors, the Fund and the Investment Manager)
- Investment Advisory Agreement (if Indian presence, between Indian Advisor and the Investment Manager)

Approvals:

- Offshore: Registration in offshore jurisdiction
- Either invest under the FDI route or obtain FVCI registration with SEBI
- FIPB approval, if applicable (Press Note 1 (2005), in case of foreign ownership)

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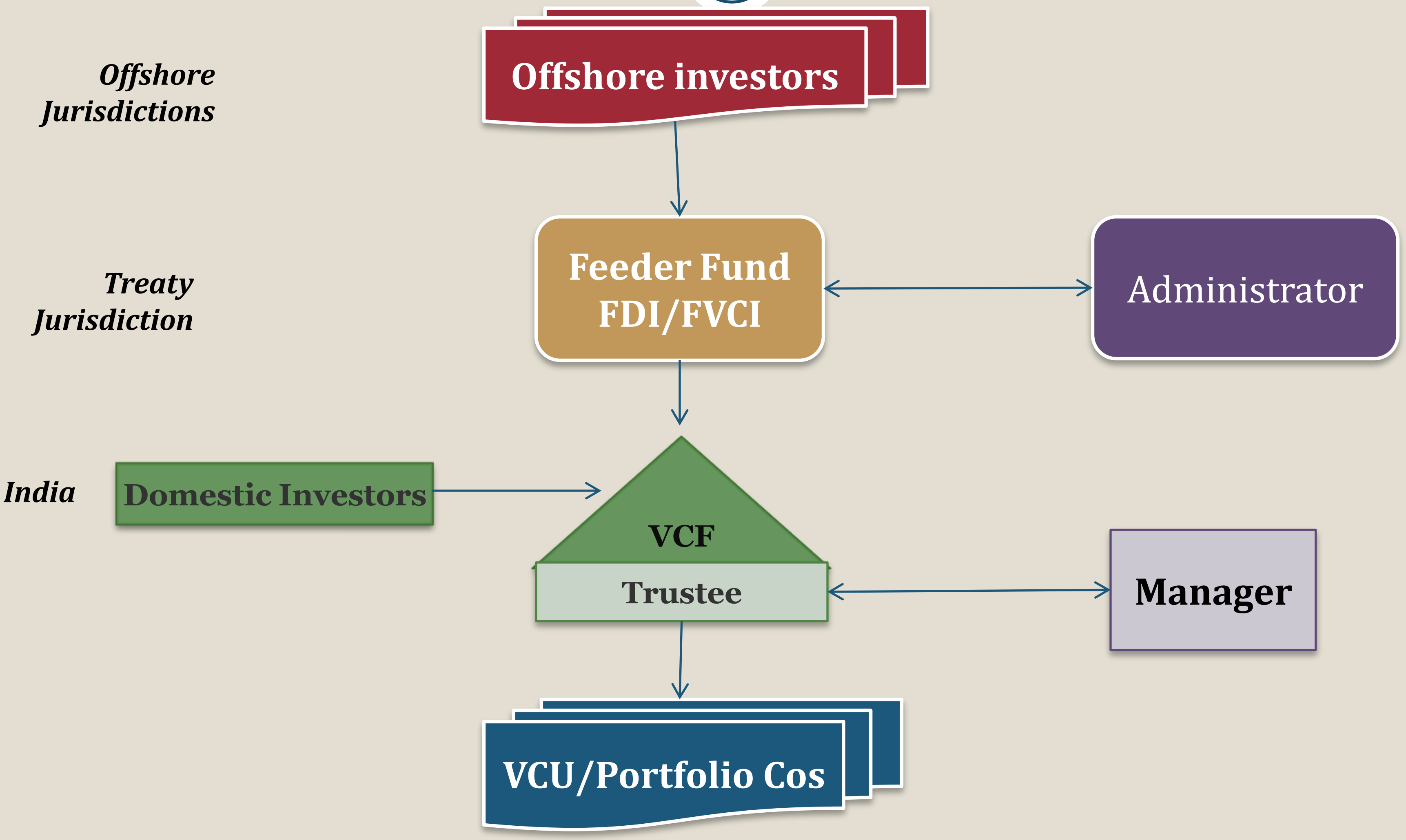

Offshore Jurisdictions
Offshore investors
Treaty Jurisdiction
Feeder Fund FDI/FVCI
Administrator
India
Domestic Investors
VCF
Trustee
Manager
VCU/Portfolio Cos

▸ aster ▸ eeder structure

- Typically:

- ✓ a 'master' fund is settled as a contributory trust vide a registered trust deed
- ✓ Offshore fund / company acts as a 'feeder' vehicles to the master fund
- ✓ offshore investors enter into subscription agreements with the offshore fund / company making commitments
- ✓ The offshore fund / company has the sole purpose of making investments into the 'master' fund
- ✓ domestic investors enter into contribution agreements with the trustees of the master fund
- ✓ The trustees of the 'master' fund appoints an investment manager under the IMA
- ✓ The master fund makes investments into portfolio companies

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Factors for selection of this structure:

- Domestic fund managers with little or no offshore presence
- Raising both domestic and foreign capital
- Carry and management units can be held without complications in India
- No ‘cherry picking’ concerns

Factors against selection of this structure:

- Regulatory approvals required (FVCI/FIPB) for investment by the offshore feeder into the master fund could delay the process
- In case of an actual foreign partner, management fees will be subject to Indian ‘business income’ tax
- Could subject offshore investors to Indian tax uncertainties
- Cannot have multiple closings at the master (and domestic feeder) level
- Uncertain tax rules exposes feeder to taxation in India
- If classified as business income, taxed in India if offshore entity said to have permanent establishment in India

Documentation and approvals for Master-Feeder Structure

Documentation:

- ✓ Private Placement Memorandum
- ✓ Constitution of the Offshore Feeder
- ✓ Trust deed(s) of the Master Fund and Domestic Feeder
- ✓ Investment Management Agreement (between the Fund and the Investment Manager)
- ✓ Contribution Agreement(s) (between the Feeders and the Master and between the Investors and the Domestic Feeder)
- ✓ Subscription Agreement (between the Investors and the Offshore Feeder)

Approvals:

- ✓ Offshore: CoI, GBL-1, TRC
- ✓ FVCI registration / FIPB approval (for investment of Offshore Feeder into Master)
- ✓ FIPB approval for Investment Manager (Press Note 1 (2005), in case of foreign ownership)
- ✓ FIPB approval for subscription to units of master fund and for any sale / transfer of such units

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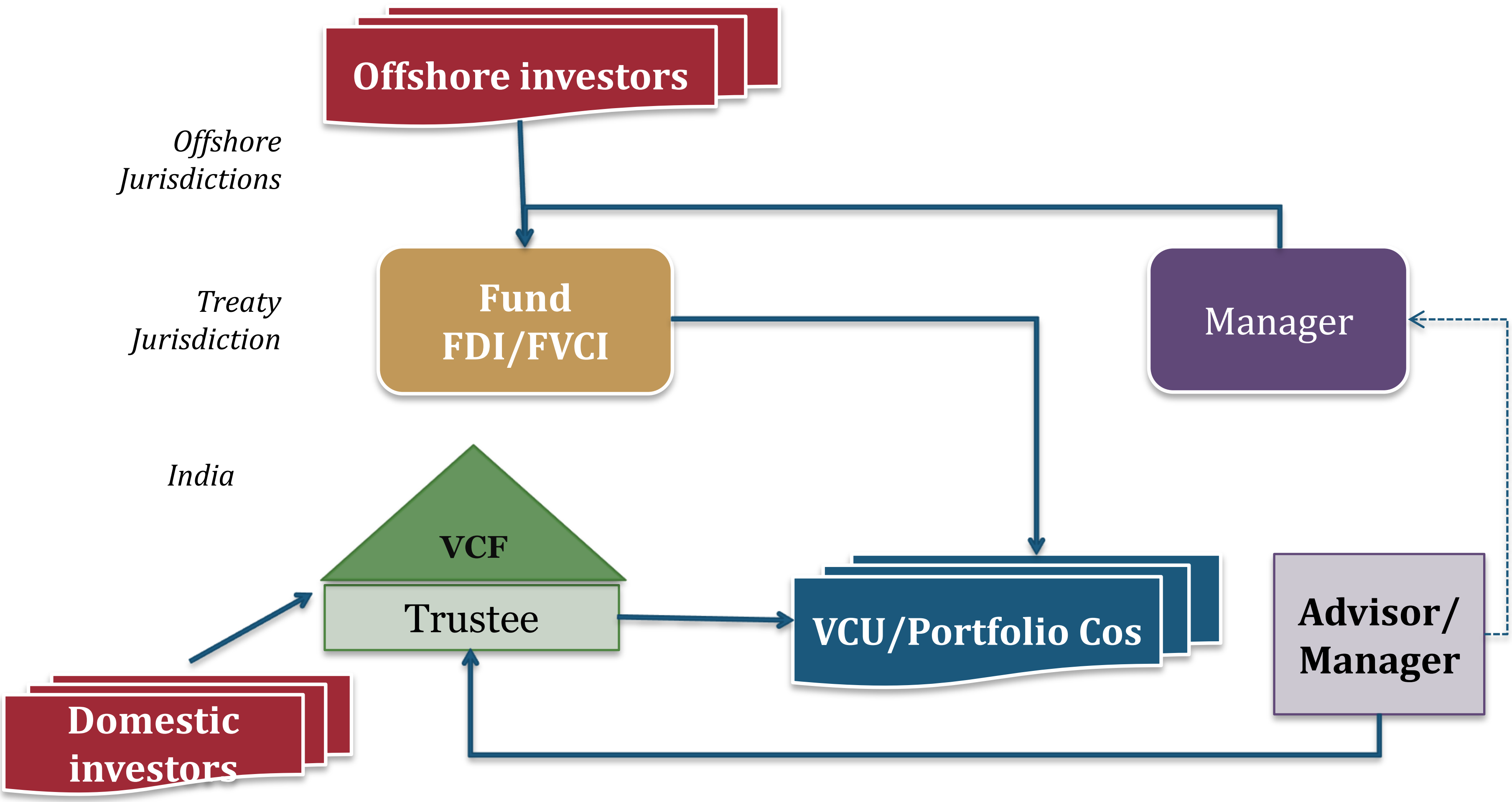

o- nvestment tructure

- Typically:
  - ✓ An offshore fund is established (in the same manner as a pure offshore fund) in a tax favourable jurisdiction, with an offshore investment manager
  - ✓ A domestic fund is established (in the same manner as a pure domestic fund) in India, with a domestic investment manager
  - ✓ The domestic investment manager acts as a non discretionary investment advisor to the offshore investment manager
  - ✓ The offshore and domestic funds make investments into portfolio companies on a ‘co-investment’ basis (depending on tax analysis, such co-investment being an obligation or an option)
  - ✓ Investments by the funds are made pro-rata their capital commitments

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nvest ment t r uct ur e

Factors for selection of this structure:

- Raising both domestic and foreign capital
- Offshore investors insulated from uncertainty of taxation of Indian Trusts
- From timing perspective, this structure works better

Factors against selection of this structure:

- Cherry picking concerns exist.
- Offshore fund has the risk of being classified as association of person and taxed in accordance with Indian tax laws
- If classified as business income, taxed in India if offshore entity said to have permanent establishment in India
- Substance requirement more strict for offshore investors
- Offshore manager has risk of having a service permanent establishment

Documentation and approvals for Co-Investment Structure

Documentation:

- ✓ Documentation will be an aggregate of documents for the Pure Offshore and Pure Domestic structures
- ✓ Additionally, may have a co-investment agreement

Approvals:

- ✓ Approvals will also be an aggregate of approvals for the Pure Offshore and Pure Domestic structures

TAXATION

Taxation aspect

- Prior to Finance Act, 2007 registered VCFs enjoyed pass through status on income from all their investments;
- Finance Act 2007 changed the definition of VCU under which benefit of pass through status is restricted to 9 sectors only;
- Section 10(23 FB) of the Income Tax Act, 1961
  - ✓ 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.

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- Section 115U of the Income Tax 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.
    - ✓ Therefore they are only allocating the funds for which they receive management fees
  - ✓ to avail this “pass through” status, the VCFs investments must be made in domestic companies whose shares are not listed on any recognized stock exchange in India

Scenario Post Budget 2012-13

- The Union Budget 2012-13 has made some key changes in the Income Tax Act, 1961 to the provisions relating to income of Venture Capital Funds from the venture capital undertakings, the proposed changes are:

- **Relaxation under Section 10(23)(FB) of the IT Act**
- **Payment of tax by investors on accrual basis by investor**
- **Exemption under section 68 of the Income Tax Act, 1961**
- **Taxability of non-residents**

PROPOSED CHANGES IN DETAILS

Relaxation under Section 10(23)(FB) of the IT Act

- This Section provided for exemption from inclusion in income (for the purposes of taxation) from investment into a VCU, only if the investment by the VCU is in the specified 9 exempted sectors;
- nanotechnology; information technology relating to hardware and software development; seed research and development; bio-technology; research and development of new chemical entities in the pharmaceutical sector; production of bio-fuels; building and operating composite hotel-cum-convention centre with seating capacity of more than 3000; development, operating and maintenance of any infrastructure facility; and dairy or poultry industry
- it has been proposed to do away with the restrictions on the VCFs for tax exemption only from the specified 9 sectors and opening it to all sectors

  --subject to the negative list specified in the SEBI VCF Regulations, 1996.
- Hence, any income of a VCF derived from its investment into a VCU, without limitation to any sector, will be exempt from tax in the hands of the VCF.
- **this relaxation would open up investments in other sectors that are also vital to the economy of the country**

Contd..

- **Reciprocal effect of relaxation under 10(23)(FB)** Currently, approval is granted to a Foreign Venture Capital Investor for making investments only in the 9 sectors.
  --This seems to be linked to Section 10(23)(FB), although no specific provision in the SEBI FVCI Regulations or the IT Act has been made in this regard.
- It is likely that with the proposed amendment in the said section, relaxation may also be given to a FVCI for making investments in India (whether in a VCF or otherwise), subject of course to the restrictions placed under the SEBI FVCI Regulations.

Payment of tax by investors on accrual basis by investor

- Section 115U of the Income Tax Act, 1961 provides for indefinite deferral of taxation in the hands of the investors which was taxable when distributed to the investors by the VCFs, i.e., income from the VCU was taxable in the hands of the beneficiaries/ investors as if the investment was directly made in the VCU by the beneficiaries.
- It has now been proposed accrual based taxation for the investors, which means investors to be taxed as and when income arises/ accrues is received by the VCF/ VCC rationalizing the pass through status conditions.

Contd..

- **Implication of Payment of tax by investors on accrual basis by investor :**

- This provision may not be so much in the interest of a VCF as well as an investor as:
- the investor will be liable to pay tax on an annual basis (primarily on the dividend income during the term of the VCF) even though such income may not be received by the investor annually;
- By virtue of the foregoing, the VCFs may be required (by investor demand) to make distributions on an annual basis.

  -- This may curtail the reinvestments of income by a VCF and could result in less return than expected at the end of the VCF term. The financial structuring of a VCF may need to undergo changes and responsibility of maintaining records may further arise.

Introduction of a new clause under section 56(2) of the Income Tax Act 1961.

- A new clause is proposed to be introduced under section 56(2) of the IT Act to curb tax avoidance- this provides that the issue of shares in excess of fair value by closely held companies, is proposed to be made taxable in the hands of the issuer

  --this would mean share premium received by the private company over the fair market value on subscription of shares is proposed to be taxable in the hands of the issuer company.

- However, specific exemption has been carved out where the consideration for issue of shares is received by a venture capital undertaking from a venture capital company or a venture capital fund.

Exemption under section 68 of the Income Tax Act, 1961

- satisfactorily explaining the sources of funds of the shareholder, in the case of closely held companies, would not apply if the shareholder is a well regulated entity, i.e. a Venture Capital Fund, Venture Capital Company registered with the Securities Exchange Board of India (SEBI)
- While there are certain exemptions granted to the venture capital funds specifically, VCFs/ VCCs shall no more be exempt from dividend distribution tax and TDS provision/ withholding tax.

Taxability of non-residents

- **The Finance Bill 2012 has proposed amendments which are likely to have far reaching effects on the foreign direct investments in India including FVCIs**
- The following explanations have been added in Section 9(1) – income deemed to accrue or arise in India:
  - *(iii) the expression through shall mean and include and shall be deemed to have always meant and included by means of, in consequence of or by reason of; and*
  - *(iv) an asset or a capital asset being any share or interest in a company or entity registered or incorporated outside India shall be deemed to be and shall always be deemed to have been situated in India, if the share or interest derives, directly or indirectly, its value substantially from the assets located in India.*

Contd..

- amendments in Section 9 with respect to *Income deemed to accrue or arise in India* have broadened the definition of "capital asset or asset" to mean "*an asset or a capital asset being any share or interest in a company or entity registered or incorporated outside India shall be deemed to be and shall always be deemed to have been situated in India, **if the share or interest derives, directly or indirectly, its value substantially from the assets located in India.**"*
  - this would have an impact on foreign venture capital investors, with investors raising eyebrows on the taxability issue.
  - section 9 read with Section 149(1)(c) will have a retrospective effect on the applicability of the provisions of Section 9, it would act as a two edged sword for the FVCIs.

Contd..

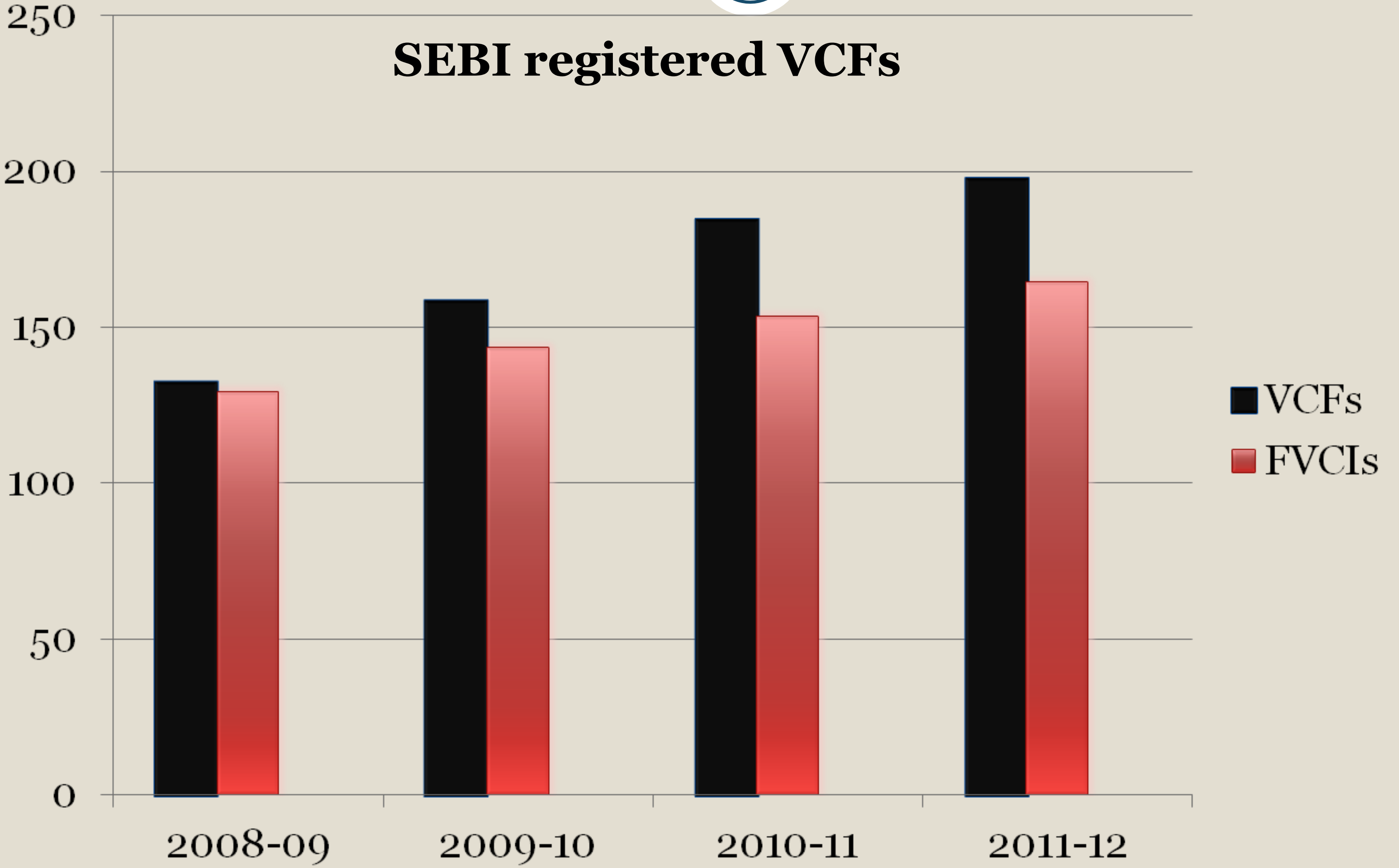
- The Budget proposes insertion of a fresh Chapter X-A on the General Anti-Avoidance Rule, which may apply to any step or part of the arrangement

  -- this puts the onus on the taxpayer to establish the bona fide purpose of an arrangement.

  - this would mean the GAAR provisions having a treaty override provision could spell trouble for offshore funds thus supremacy of provisions IT Act prevailing of DTAAs conflicting with the nature and spirit of DTAAs.

- From offshore fund structures and FVCIs perspective it would be interesting to see whether applicability of Section 9 and GAAR provisions would impact the flow of funds and investments and in turn on the industry

Little Statistics



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- **Assets under the custody of custodians:**

Foreign Venture Capital

Year	NO.	Amount (Rs. In crore)
2008-09	73	16579
09-10	115	17604
10-11	144	24002
11-12*	150	25590

*indicates as on last trading day of Sep 2011

Is VCF an NBFC?

- NBFCs as defined under the Reserve Bank of India Act, Chapter IIIB, section 45I-
  - "non-banking financial company" means–a non-banking institution which is a company and which has as its principal business the receiving of deposits, under any scheme or arrangement or in any other manner, or lending in any manner

✓ The definition of deposits **includes receipt of money** by the way of deposits or loan or in any other form but **does not include amount raised by the way of share capital**. So in light of the above definitions it becomes clear that **a VCF is not an NBFC**. Also the VCF regulations have in a very clear cut way defined how a venture capital could raise money and make investments. Besides the various statutory requirements for NBFCs under Section 45IA and other sections are not applicable to VCFs.

✓ The industry has a great potential for growth and the recent amendments and regulatory changes are only an indication that the Venture Capital Industry in India is moving in the direction of growth but there continues to be room for development.


Thank You!