KPMG

Private Equity

Union Budget 2017–18

Post-Budget sectoral point of view

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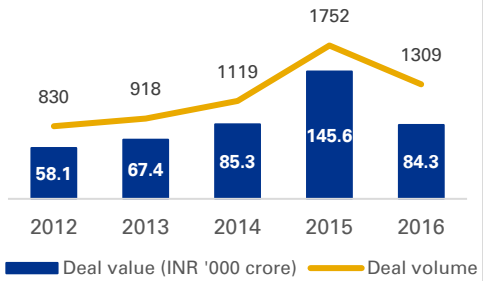
Setting the context

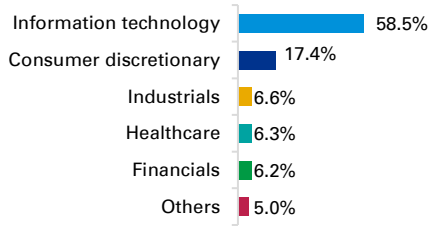
Where are we

Figure 1: PE/VC investments in India: 2012-2016



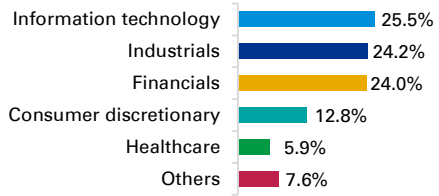
Source: Annual Deal Report 2017, VCCedge, January 2017

Figure 2: Deal volume by sectors (2016)



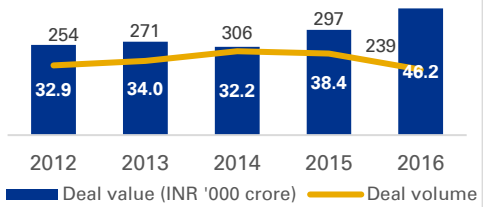
Source: Annual Deal Report 2017, VCCedge, January 2017

Figure 3: Deal value by sectors (2016)



Source: Annual Deal Report 2017, VCCedge, January 2017

Figure 4: PE/VC exits in India: 2012-2016



Source: Annual Deal Report 2017, VCCedge, January 2017

The Private Equity (PE) and Venture Capital (VC) industry remained India-focused throughout 2016 despite a tepid macro-economic situation. India witnessed atleast 50 big ticket investments with deal values higher than USD50 million.[1] The political and economic turmoil in Europe, including Brexit, rising oil prices and increased risk premium for technology/internet sector investments affected the sentiments of foreign investors, who form the lion's share of PE investors in the country.

Information technology companies, backed by a number of tech-based start-ups, dominated the PE/VC deals statistics, accounting for a large share of deal volumes and deal values in 2016. Last year, the government laid out key policy changes to promote foreign investments. It relaxed Foreign Direct Investment (FDI) norms for the trading of Indian food products, airline industry, e-commerce companies, asset reconstruction companies, etc. These policy changes are likely to result in strong investor activity in these areas in the next few years.

The PE/VC industry remained busy with fund raising activity as the industry raised USD4.2 billion across 39 funds. This momentum continued from 2015, which saw USD5.7 billion raised across 43 funds. With an estimated dry-powder of over USD7 billion at their disposal, 2017 could be a record year for PE/VC investments in India.[2] A number of investors have already initiated talks with potential targets to deploy their capital.

Historically, exits have been a challenge across the PE/VC industry in India. But the industry witnessed highest value of exits in 2016 in the past five years.[3] M&A and open market transactions accounted for maximum PE/VC exits.[3] Initial Public Offerings also contributed to the exits.

The PE/VC industry has been one of the key pillars to India's growth, providing the country with significant capital investment. Strong start-up funding by these firms have led to some of the Indian companies earning the status of unicorns and challenging their established global counterparts for market share. The announcements in the Union Budget 2017 have further added to investor confidence and are expected to help regain the investment momentum in the near term.

[1] VCCedge database, accessed on 31 January 2017
[2] Deals in 2017: Time to deploy the dry powder, Livemint, http://www.livemint.com/Companies/mCxh8fxvTAoV8DzL62D9KJ/Deals-in-2017-Time-to-deploy-the-dry-powder.html, accessed on 31 January 2017
[3] Annual Deal Report 2017, VCCedge, January 2017

Key challenges

Valuation markdown: India recorded peak investment activity in 2015 followed by a cautious approach in 2016. PE/VC firms were focussed more on sustainability, profitability and unit economics in 2016, as opposed to valuation in 2015. This led to a fall in overall investments, with a number of start-ups and e-commerce companies finding it slightly more difficult to raise capital. The year also saw several marquee investors marking down the valuations of quite a number of companies, which were considered to be unicorn investments a couple of years ago. Due to the markdown, the PE/VC firms may find it tougher to make profits from the exiting investee companies. The year also witnessed a number of shutdowns, leading to investment write-offs.

Tax and regulatory challenges: The overall investment landscape has witnessed a number of positive policy changes by the current administration to boost investments into the country. A few challenges still remain and were widely expected to be resolved in the Union Budget 2017. For instance, the Central Board of Direct Taxes (CBDT) had issued a circular stating that the investors of Foreign Portfolio Investors (FPIs) could fall within the ambit of the provisions of taxation of indirect transfers.[4] Sensing the adverse investor sentiment, this circular was however put on hold. In another development, the investors expressed a lot of concern regarding the implementation of the GAAR (General Anti-Avoidance Rules) and the impact on the fund industry. Whilst the Safe Harbour Rules were introduced to encourage offshore fund managers to relocate to India, some of the prescribed eligibility conditions are cumbersome and practically difficult to comply. Further, although the CBDT also issued a circular in January 2017 providing the guiding principles on determining Place of Effective Management (POEM), compliance with the same from the financial year 2016-2017 is a major concern given that end of financial year is just round the corner.

Government's stance

The government has put a lot of focus on bringing foreign investments into the country and making it easier to do business in India. During 2016, the government had eased FDI rules in a number of sectors including aviation, e-commerce and pharmaceuticals. The government has also renegotiated the bilateral tax treaties with Mauritius, Cyprus and Singapore, whereby investments made upto 31 March 2017 have been grandfathered and income arising on transfer of such investments would continue to be not taxable in India under the existing tax treaties.[5] [6] [7]At the same time, the government has also provided a roadmap for taxation of income from investments made from 1 April 2017. The government has also provided clarity in a number of tax-related concerns such as the determination of POEM, characterisation of gains from listed and unlisted securities as capital gains, period of holding for convertible debentures, etc. In the backdrop of these reforms and to boost the investment climate, a pro-investor budget was expected from the government.

Expectations

In light of numerous measures undertaken by the government in the tax and regulatory landscape during 2016, the PE/VC firms were expecting a number of key reforms in the Union Budget 2017. Some of the key expectations included:

- **Clarification on indirect transfer provisions:** The intent of introducing provisions to tax indirect transfers was to bring within ambit overseas transfers resulting in transfer of control of the underlying Indian entity. The existing provisions result in double taxation of same income in case of multi layered structures on account of cascading effect. Following a recent circular issued by the CBDT, foreign

[4] Clarifications on Indirect Transfer provisions under the Income Tax Act. 1961, Central Board of Direct Taxes, Government of India, http://www.incometaxindia.gov.in/communications/circular/circular41_2016.pdf, accessed on 2 February 2017
[5] India and Singapore Sign a Third Protocol for Amending the Double Taxation Avoidance Agreement (DTAA), Central Board of Direct Taxes, Government of India, http://www.incometaxindia.gov.in/Lists/Press%20Releases/Attachments/578/India-Singapore-Sign-Third-Protocol-Amending-DTAA-30-12-2016.pdf, accessed on 2 February 2017
[6] Sub : Signing of Revised Double Taxation Avoidance Agreement between India and Cyprus – regarding, Central Board of Direct Taxes, Government of India, http://www.incometaxindia.gov.in/Lists/Press%20Releases/Attachments/551/Signing-of-Revised-Double-Taxation-Avoidance-Agreement-between-India-and-Cyprus-18-11-2016.pdf, accessed on 2 February 2017
[7] Subject: Protocol for amendment of the Convention for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and capital gains between India and Mauritius – reg, Central Board of Direct Taxes, Government of India, http://www.incometaxindia.gov.in/Lists/Press%20Releases/Attachments/468/Press-release-Indo-Mauritius-10-05-2016.pdf, accessed on 2 February 2017

investors were worried with regards to the applicability of the indirect transfer provisions.[4] The government however acted proactively and issued another circular putting the earlier circular on hold.[8] To address the concerns, it is expected that the threshold limit for triggering the indirect transfer provisions should be increased to atleast 26 per cent from the current level of 5 per cent. Further, given the unique operational structure of FPIs, they should be exempt from the TDS (tax deducted at source) obligations. Also, it is expected that the indirect transfer provisions should not be applicable in case of corporate restructurings. The onerous reporting obligations casted on Indian companies need to be relaxed given the practical difficulties in certain situations

- **Clarity on capital gains taxation for unlisted securities:** In a major tax relief for PE/VC firms investing in start-ups, the government acted proactively and clarified that income arising to Category I and II Alternative Investment Funds (AIFs) from transfer of unlisted shares would be considered as 'capital gains'. It would not be treated as business income even if it results in transfer of control or management of the underlying portfolio company. This circular had resolved a long standing concern of the domestic AIF industry. The industry bodies expected the Union Budget 2017 to permanently clarify any further concerns in this regard and provide a pass-through status to all kinds of incomes earned by AIFs
- **Tax pass-through status for category III AIFs:** At present, a tax pass-through status is granted only to Category I and II AIFs. The industry bodies expected the government to extend this benefit to Category III AIFs as well
- **Clarity on GAAR implementation:** The General Anti-Avoidance Rules (GAAR) are applicable from the financial year 2017-2018. In January 2017, the CBDT issued a circular providing certain clarifications on implementation of GAAR by way of FAQs. As a process, the PE community expects the government to come out with a larger number of examples covering different situations under which GAAR will be invoked. Though such illustrations may not delve into minute details, they would help in providing an objective guidance on the applicability of GAAR thereby reducing the subjectivity in invocation of such provisions
- **Removal of Angel Tax:** Recently, tax notices were issued to a number of start-ups asking them to pay tax on the higher premium received by such start-ups benchmarked against their marked down valuations in the recent funding rounds. This form of "angel tax" resulted in angel investors and start-up industry bodies forming a coalition and making representations to address this issue
- **Deferral of applicability of POEM guidelines:** Given that the final POEM guidelines have just been issued, the PE community expected the applicability of POEM to be deferred appropriately so as to provide adequate time to the taxpayers to analyse the final guidelines and the impact thereof
- **Bankruptcy code implementation:** The government had taken a welcome step in 2016 by enacting the bankruptcy and insolvency code. The code, once enabled could prove a strong promoter for consolidation activity. Investors expect the Union Budget 2017 for providing further clarity regarding enabling the same
- **Easing of the Safe Harbour qualifying norms:** As stated earlier, some of the prescribed eligibility conditions under the Safe Harbour Rules are cumbersome and practically difficult to comply. PE/VC firms also expected further relaxation in the conditions relating to investor diversification, threshold of participation interest of a single investor in the fund, etc. to make it easier for the offshore fund managers to relocate to India
- **Start-up investment boost:** The industry expected the government to follow up on its 'Start-Up India' initiative launched last year. Investors expected an increase in the duration of tax holidays for start-ups to seven years. Further, as start-up investments are risky, the industry wanted the period of long-term capital gains for unlisted securities to be lessened from the present levels of 24 months
- **Service tax to be paid on management fees:** Industry bodies had pointed out the need to relax the levy of service tax on portion of management fees charged by the domestic fund managers and attributable to funds raised from the offshore investors. With the roll out of the goods and services tax (GST) expected soon in 2017, the service tax rate is likely to increase. In contrast to this, the management fees charged by the offshore fund managers are outside the purview of service tax. This

[8] Circular No. 41/2016 [F. No. 500/43/2012-FT&TR] dated 21'12'2016', Central Board of Direct Taxes, Government of India, http://www.incometaxindia.gov.in/communications/circular/circular4_2017.pdf, accessed on 2 February 2017

is likely to act as a deterrent to offshore fund managers looking to relocate to India. Hence, the industry expected the government to provide a relaxation on levy of service tax on the portion of management fees attributable to funds raised from the offshore investors.

Key policy and tax proposals

Key announcements

Relief for investors of Category I and II FPIs from Indirect Transfer provisions

- Specific carve outs from the applicability of the indirect transfer provisions provided to non-residents who have invested directly or indirectly in SEBI-registered FIIs or Category I and II FPIs
- The Finance Minister in his Budget Speech clarified that the indirect transfer provisions shall not apply in case of redemption of shares or interests outside India as a result of or arising out of redemption or sale of investment in India which is chargeable to tax in India. However, no proposal to this effect is provided in the Finance Bill, keep this matter pending clarification.

Clarity provided on the taxation of convertible preference shares

- Conversion of preference shares into equity shares from 1 April 2017 not to be regarded as a taxable transfer
- Period of holding of preference shares to be considered for determining the period of holding of the resultant equity shares
- Cost of acquisition of convertible preference shares to be considered as the cost of acquisition of the resultant equity shares.

Extension of concessional tax rate in case of foreign currency borrowings and rupee denominated bonds

- Sunset clause for concessional tax rate of 5 per cent as available in case of interest income from foreign currency borrowings and rupee denominated bonds extended from 30 June 2017 to 30 June 2020.

Taxability of Masala Bonds

- Concessional tax rate of 5 per cent even extended to interest income earned on rupee denominated bonds issued outside India, more popularly known as the Masala Bonds
- Transfer of such bonds by one non-resident to another non-resident not to be regarded as a taxable transfer
- Relief in respect to gains arising on appreciation of rupee against a foreign currency at the time of redemption of such rupee denominated bonds extended to secondary holders.

Retrospective amendment for providing lower capital gains tax rate for non-residents

- The beneficial tax rate of 10 per cent available to non-residents in case of capital gains arising from transfer of shares of companies not being companies in which the public is substantially interested clarified to be applicable retrospectively from the financial year 2012-2013.

Preventing abuse of long term capital gains exemption

- Exemption under Section 10(38) of the Income-tax Act in respect of LTCG arising from transfer of listed equity shares to be available only if such equity shares were acquired on or after 1 October 2004 and such an acquisition was chargeable to Securities Transaction Tax (STT)
- To protect the interests of investors in genuine cases where STT could not have been paid (viz. IPO, bonus, rights issue, etc.), the government to notify types of acquisitions for which the condition of levy of STT would not be applicable.

Period of holding for land and building reduced

- The period of holding for qualifying as a long term capital asset reduced from 36 months to 24 months in the case of land and buildings.

Taxation of capital gains in case of a joint development agreement (JDA)

- Capital gains arising due to an individual or Hindu undivided family (HUF) from transfer of land and / or building under a JDA to be taxable in the year in which the certificate of completion is issued
- Stamp duty value on the date of issue of such certificate plus any monetary consideration if any received deemed to be the full value consideration
- Monetary consideration received under JDA to be subject to tax withholding at rate of 10 per cent
- The aforesaid beneficial regime not to be available in case the individual or HUF transfers his share in project to any person prior to the date of issue of said certificate of completion. In such a case, capital gains to be determined as per the normal computation mechanism and taxed in the year of transfer.

Widening of scope of taxability of income from receipt of properties below fair value

- Purview of chargeability to tax on receipt of 'any sum of money or property' for NIL consideration or for consideration less than the fair market value (FMV) now extended to all categories of assessee and all types of properties except in case of specified carve outs.

Deemed consideration in case of transfer of unlisted shares below FMV

- In case of transfer of unlisted shares at a price which is lower than the FMV (as determined in a manner to be prescribed) of such shares, such FMV to be considered as the full value consideration in the hands of the transferor for the purpose of computing capital gains.

Ambit of tax on domestic dividends widened

- Ten per cent additional tax on dividends in excess of INR 10 Lakhs per annum now applicable in case of all resident assessees except domestic companies and specified trusts, funds, institutions, etc.

Thin Capitalisation norms introduced

- Deductibility of interest (exceeding INR 1 Crore) paid by an Indian company (or permanent establishment (PE) of a foreign company in India) to its associated enterprise not resident in India for computing business income to be restricted to 30 per cent of such Indian company's or such PE's earnings before interest, taxes, depreciation and amortisation (EBITDA) or interest paid or payable to the associated enterprise, whichever is less
- Such disallowance not applicable in case of an Indian company or PE of a foreign company engaged in banking or insurance business.

Tax benefits to eligible start-ups to promote Start-up India

- Period for availing 100 per cent tax holiday in case of eligible start-ups relaxed to three consecutive years out of seven years (as against five years earlier) beginning from the year of incorporation of such a start-up
- Eligible start-ups allowed to carry forward losses incurred during the initial seven years following the year of incorporation as long as all the shareholders who held shares in the year in which loss was incurred, continue to hold shares in the year in which such losses are proposed to be set-off.

Reduction in corporate tax rate of MSMEs

- Corporate tax rate in case of domestic companies having a total turnover / gross receipts during financial year 2015-2016 not exceeding INR 50 Crores reduced to 25 per cent.

Period for which MAT and AMT credit available extended

- MAT and Alternative Minimum Tax (AMT) credit available up to fifteenth year (as against tenth year earlier) from the end of relevant assessment year

- MAT provisions for computation of book profits aligned with the provisions of Indian Accounting Standards (IND-AS).

Base year for indexation purpose shifted

- FMV as on April 1, 2001 to be considered as cost of acquisition in respect of capital assets prior to April 1, 2001
- Cost of improvement to include only capital expenses incurred on or after April 1, 2001.

Limited relaxation of Safe Harbour Rules for Fund Managers

- Condition of monthly average corpus of atleast INR 100 Crores not applicable in case the fund is wound up during the financial year.

Clarification with respect to interpretation of terms used in bilateral tax treaties

- Terms not defined in bilateral tax treaties but defined in the Income-tax Act, such terms to have the meaning as defined in the Income-tax Act and any explanation given to it by the government,

Easing of FDI norms / other regulatory proposals

- Foreign Investment Promotion Board (FIPB) to be phased out in the financial year 2017-2018
- Further liberalisation of the FDI policy under consideration and necessary announcements to be made in due course
- Systemically important non-banking financial companies regulated by the Reserve Bank of India and meeting a prescribed net worth requirement to be categorized as Qualified Institutional Buyers for participation in IPOs
- Listing and trading of Security Receipts issued by a securitisation company or a reconstruction company under the SARFAESI Act on SEBI registered stock exchanges to be permitted
- Common application form for registration, opening of bank and demat accounts, and issue of PAN will be introduced for FPIs
- Affordable housing to be provided infrastructure status.

Impact

The announcements of the Union Budget 2017 are expected to have the following impact:

- The relaxation in applicability of the indirect transfer provisions is a welcome move for the investors investing in India through the participatory notes (P-notes). The existing provisions relating to taxation of indirect transfers resulted in unintended consequence of multiple levels of taxation in FPI structures. The clarity provided by the Union Budget 2017 is in line with the demand of the investor community
- Extension of sunset clause in respect of concessional tax rate of 5 per cent in case of foreign currency borrowings and rupee denominated bonds and also extending such concessional tax rate to masala bonds is a positive move which could provide a thrust to Indian bond market and also help Indian companies in further accessing foreign markets for raising debt at a cheaper cost
- Measures such as the reduction in the period of holding for qualifying as long term capital asset, relaxation in conditions for availing tax holiday for affordable housing, etc. would promote real estate sector. Introduction of specific provisions for taxability in case of JDA could help minimize genuine hardships faced by the land owners
- Given that many PE/VC Firms make investment in convertible preference shares of Indian companies, providing tax neutrality to conversion of preference shares into equity shares could provide tax certainty
- Abolition of FIPB and proposal to further relax FDI policy is likely to make India more attractive as an investment destination for the global investors
- Given that book profits computed based on IND-AS compliant financial statements is likely to be different from the book profits computed based on existing Indian Generally Accepted Accounting

Policies (GAAP), the alignment of MAT provisions with those of IND-AS to determine book profits could help mitigate the anomalies associated with transition to IND-AS

- Proposal to permit the listing and trading of security receipts issued by a securitisation company or a reconstruction company under the SARFAESI Act on recongnised stock exchanges can enhance capital inflows into the securitisation industry and also help to deal with non performing assets (NPAs) of banks.

Unfinished agenda

What remains

Whilst the proposals as presented by the Finance Minister to provide tax clarifications are steps in the right direction, the following key expectations of the PE/VC industry remain unaddressed:

- Deferral of POEM to provide adequate time to analyse the impact of the final POEM guidelines
- Increasing the threshold limit for trigger of indirect transfer provisions from the existing level of 5 per cent in order to carve out overseas transfer not resulting in change in control or management of underlying Indian entity
- Relaxations were also expected in the conditions relating to investor diversification and threshold of participation interest of a single investor in the fund to make Safe Harbour Norms practically implementable
- Tax pass-through status for Category III AIFs
- Removal of Angel Tax
- Relief to AIFs from withholding tax obligation on the distribution of exempt income to resident investors or on distribution to resident investors who are exempt from tax.

What is expected going forward

Overall, the Union Budget 2017 is a fine balancing act on three aspects – fiscal prudence, electoral populism and growth impetus. It also eased investor concerns by not increasing the period of holding for listed shares to qualify as long-term capital assets. As indicated by the Finance Minister in his Budget speech, further tax clarifications and pro-investor policies are expected to be announced in the near future. This can enhance investor confidence and build on the investment momentum.

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