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Firms use dual structure to raise cash, get tax benefits

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Mumbai: As private equity (PE) and venture capital (VC) deal-making gathers pace, PE firms are trying to raise cash, both in India and overseas, to purchase stakes in companies hungry for capital after last year's downturn in the alternative investment market.

Double advantage: (left) Renuka Ramnath, founder, Multiples Alternate Asset Management (Photo: Kedar Bhat/Mint); and Alok Gupta, MD, Axis Private Equity

Alternative investors such as PE and VC firms also stand to derive tax benefits by using the so-called dual structure, in which they raise separate domestic and offshore funds for investment in Indian firms.

The alternative is a unified structure, which requires offshore funds to register in India as a foreign venture capital investor (FVCI) or through the Foreign Investment Promotion Board (FIPB) and put money in a domestic trust that makes the final investment.

Kaizen Management Advisors Pvt. Ltd is using a dual-structure fund to raise a $120 million (Rs531.6 crore) offshore fund and a Rs300 crore domestic fund. Multiples Alternate Asset Management, promoted by former ICICI Venture's head Renuka Ramnath, which had announced the first closure of its fund at $250 million earlier this month, also used a dual structure in which the domestic portion was anchored by the Indian Overseas Bank and Andhra Bank, and the international portion by Canada Pension Plan Investment Board (CPPIB) and CDC Group.

In the recent past, ICICI Venture, Kotak Private Equity and HDFC Property Ventures have also adopted a dual structure for their funds. "In today's time it is imperative for funds to have both pools of capital—domestic and offshore," said Siddharth Shah, principal at Mumbai-based legal and tax consulting firm Nishith Desai Associates.

For Sandeep Aneja, managing director of Kaizen, a dual fund structure offered convenience. "On your home turf it's easier to raise capital because there is a lot more liquidity among HNIs (high networth individuals) and retail investors now," he said.

A dual structure allows one part of the fund to invest in sectors the other part can't. So, while the foreign fund has to comply with foreign direct investment (FDI) rules and cannot invest in some sectors, the domestic fund can.

"Also, domestic funds cannot invest in certain negative sectors (such as non-banking financial services, and gold mining) or in listed space through secondary shares, while offshore funds may still be able to invest in these opportunities under the FDI route directly," said Shah.

Alok Gupta, managing director, Axis Private Equity Ltd, said firms also prefer the dual structure to take advantage of the tax structures in different jurisdictions as well as favourable tax treaties.

"Also if there are two countries involved you, don't want to be taxed at all levels. To avoid multiple taxation, a separate fund for offshore and domestic investors is preferred," he said.

"In a unified structure, there is an Indian regulatory and tax exposure, which some of the foreign investors are not comfortable with," said Jai Mavani, executive director, KPMG India Pvt. Ltd.

Until 2007, Indian general partners (GPs, or managing partners) looking to raise money from international limited partners (LPs, key backers of PE or VC funds) typically followed the unified fund structure. However, in a budget proposal that year, the tax pass-through status of domestic VC funds was withdrawn for all but a handful of sectors.

In tax terminology, a pass-through means the business entity itself need not pay taxes since all taxable income is passed through to owners or members.

So, if a VC fund invests in the nine specified sectors, including biotechnology, information technology—hardware and software—and seed research, it does not have to pay any tax on the gains realized. But LPs in these funds have to now pay the tax. This also increased the risk that an offshore fund's income, invested in a domestic fund could then be taxed at the trust level. "Since then there has been some pressure on PE funds to mitigate this risk of taxation," said Shah.