livemint.com
THE WALL STREET JOURNAL.

- Posted: Wed, Apr 14 2010. 11:38 PM IST

New tax norm may spook PE party

CBDT notification defining fair value may put PE funds off Indian companies as costs are likely to escalate

N. Sundaresha Subramanian and Shraddha Nair

Mumbai: Private equity (PE) and venture capital (VC) deals in India may be hit once a Central Board of Direct Taxes (CBDT) formula to determine the fair market value of shares for calculating tax comes into effect after the finance Bill is passed in Parliament.

Finance minister Pranab Mukherjee in his February Budget had proposed that a firm which buys shares at a price lower than the fair market value of such shares will have to pay tax on the difference between the two. He did not define fair value.

DEAL BREAKER?

THE NEWS
The Central Board of Direct Taxes has notified the calculation methodology for computing fair market value in different capital market transactions.

THE IMPLICATION
This definition will be used to compute taxable income for transfer of shares in PE deals and PIPE investments.

THE OUTLOOK
PE and PIPE deals may get more expensive and time-consuming.

The board issued a notification on 8 April saying the fair market value of unlisted shares will be calculated based on a formula that uses the net asset value methodology, based on the difference between assets and liabilities appearing on the balance sheet.

The CBDT notification also clearly establishes the fair value formula for PIPE (private investment in public enterprises). For such transactions, the fair value of shares will be the lowest price quoted on any recognized stock exchange on the valuation date.

Entities which buy shares at lower than the fair value are liable to pay tax on such discounts. Foreign VC investors will have to pay 42% tax on the difference while domestic entities will have to shell out 33%. The proposal will also affect corporate restructuring deals if shares are transferred free or at rates below the fair market value.

According to Parul Jain, partner at law firm Nishith Desai Associates, this is a way of accelerating the tax rates in such transactions, but PE firms are not convinced and they say the fair value formula will spoil the price discovery process.

“At present, these entities are liable for capital gains tax at the time of exit. Now, a tax element is being introduced at the time of purchase also,” said Jain.

Praveen Chakravarty, managing director, BNP Paribas Securities India Pvt. Ltd, said price discovery is the function of the capital market and “saying I can’t do deals below fair value will disturb this process. If a promoter is offering a discount, he is convinced that there’s some value the investor is bringing to the table”.

Hetal Gandhi, managing director, Tano India Advisors Pvt. Ltd, said “if the fund has to pay tax, then this would mean the end of PE investments in listed stocks”.

PE deals are picking up steam after a lull of two years. According to Venture Intelligence,

a research service focused on PE and mergers and acquisitions, PE firms invested about $2 billion across 56 deals during the quarter ended March 2010—the highest in the last six quarters.

In the corresponding quarter in the previous year, $620 million was invested in 58 deals.

PE deals could be hit as tax and compliance costs will go up substantially. For instance, if the fair value is determined as $100 and a foreign PE investor gets it for $50, he will have to shell out $21 as tax. Again when he exits for, say $150, he will have to pay a capital gains tax, pushing up the tax outgo on the whole transaction.

Recently, Catamaran Venture Fund, VC fund promoted by N.R. Narayana Murthy, invested Rs28 crore in shares of SKS Microfinance Ltd at a substantially discounted price of Rs300 a share while a PE fund Tree Line Asia Master Fund invested Rs60 crore at Rs636 a piece. Once the new norm comes into effect, such deals will be taxed.

According to Chakravarty of BNP Paribas Securities, taxing such deals is as good as saying deals of this kind can't be done. He is one of the founding members of Mumbai Angels Network, an investor group that looks for investment opportunities in start-ups.

Alok Gupta, managing director and chief executive officer, Axis Private Equity Ltd, said the move would have an adverse impact in special situations.

"In some cases the company may be in distress but this is not fully reflected in the balance sheet. If the price is lower than the calculated fair market price, the PE firm will end up paying tax in addition to taking stake in a loss-making company," he said.

In PIPE deals, things could get even more complicated, especially if the Street gets wind of the deal before it is struck, said Gupta. "The price may go up because of my investment and I need to pay tax on that increase."

Rakesh Sony, director, Motilal Oswal Private Equity Advisors Pvt. Ltd, says the fair value concept may not impact a classical PE situation. "If I am valuing the company today, I am doing it at a future valuation. We always pay more than the book value per share. Under normal circumstances, nobody will give value to the PE lower than the book value," he said

Jain of Nishith Desai said the rules require reliance to be placed on the value of assets as per the balance sheet without specifying whether the balance sheet needs to be audited. "Considering that tax authorities may question the manner in which valuation has been done in the event it is based on unaudited results, this rule may result in requirement of additional audit for the company at the time of investment, thus increasing the cost and time of the transaction," he said.

According to Tano India Advisors' Gandhi, the government should have exempted all investors registered with the capital market regulator and any other acceptable global financial authority from this.

n.subramanian@livemint.com

Copyright © 2007 HT Media All Rights Reserved