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Tax shadow over VC funds

They will have to pay tax on income from past investments too

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STARTING April 1, 2007, venture capital funds (VCFs) will have to pay tax on income — whether interest or capital gains — earned from their past investments in firms operating in a host of sectors ranging from manufacturing and real-estate to non-tech services.

By nature, VCFs invest in unlisted firms or start-ups (called venture capital undertakings (VCUs) in tax jargon) and exit a few years down the line after the firms stabilise their operations.

VCFs registered with Sebi enjoy the benefit of a pass-through status under the income-tax law: they don't pay tax on any income earned from investments made in a VCU. Sebi regulations define a VCU as a domestic company which has not listed its shares on the and is in the business of providing services, production or manufacturing that are not in the negative list of the Central Government. Venture funds are also not permitted to invest in financial services and gold financing.

The government has now proposed to limit the tax benefits to investments made by venture funds in nine select sectors from April 1, 2007. A VCU is being redefined as an unlisted company engaged in the business of biotechnology, information technology relating to software and hardware development, nanotechnology, seed research and development, R&D of new chemical entities in the pharma sector, dairy industry, poultry industry, production of bio-fuels and hotel-cum-convention centres with a capacity of at least 3,000.

According to officials, Sebi-registered VCFs which have until now invested in sectors other than those specified in the finance bill 2007 (and listed above) will cease to enjoy a tax exemption on income that accrues to them from these investments after April 1, 2007.

AD VENTURE

How they work

Venture funds invest in unlisted firms or start-ups Sebi-registered VCFs enjoy pass-through status under Income-Tax Act

What future holds

From April 1, definition of VCFs is limited to firms in nine select sectors VCFs which have invested in other sectors to pay tax Move to limit VC investment in realty

Domestic venture capital funds to feel the pinch more

The government has proposed to limit the tax benefits enjoyed by venture capital funds to nine select sectors from April 1, 2007. Income earned from past investments from sectors ranging from manufacturing and real-estate to non-tech services will now be taxed.

This means such VCFs will have to pay tax on income earned on investments made in equities prior to April 1, 2007. Officials said that the government has decided to curtail the tax benefits after getting reports of misuse of the tax benefits by several funds. It is another matter that the move will also help further discourage investment flows into real estate. In fact, some venture funds investing in India had revised their original charters to include investment in realty also as a permissible activity.

The tax exemption on income earned by Sebi-registered VCFs was introduced for the first time in the 1995-96 Budget. An exemption was available to dividend income or long-term capital gains of a VCF on investments made in equity shares in a venture capital undertaking (VCU). The idea was to encourage the setting up of pooled vehicles for risk capital financing.

In 2000-01, the government extended the tax exemption to any income of a VCF or a Venture Capital Company set up to raise funds for investment in a VCU. All Sebi-registered VCFs enjoyed the passthrough status.

Today, there are several funds which operate as pooled vehicles for collecting funds from the investors and invest in a wide spectrum of industries. Many of these funds, which do not invest in accordance with the Sebi regulations, do not register with Sebi as VCF. Therefore, they are not eligible for exemption under Section 10 (23FB) of the Income Tax Act. Such funds, if set up in the form of specific trusts, enjoy the passthrough under Sections 160-164 of the Act.

According to Shefali Goradia, head, international taxes, Nishith Desai Associates, the implications of the proposed amendment are likely to be far-reaching, for domestic VCFs. Foreign funds investing in India directly into the Indian portfolio companies will not be impacted by the proposal as most of these funds have been set up in tax neutral jurisdictions like Mauritius and will continue to enjoy tax exemption on capital gains tax under the Double Tax Avoidance Agreements.

However, those funds which follow a unified structure and invest through a domestic Sebi registered VCF, may have an uncertain fate till there is clarity on the acceptability of pass-through for domestic trusts under the general tax regime under Sections 160-164 of I-T Act.

"It is not advisable in the taxation statute to introduce provisions that take away benefits mid-course as investors would have made their decisions on the basis of the prevailing law at that time. Such proposals would amount to breach of promissory estoppel," said Sudhir Kapadia, partner KPMG.

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