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PE-VC club still faces an identity crisis

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MUMBAI: Amid a muted recovery, low-risk appetite and sporadic deals, a motley crowd of venture capitalists and private equity investors met over dinner at a South Mumbai hotel on Tuesday evening to discuss two things: their identity and future. After being around for decades and having put in over $40 billion, they are struggling to cobble together a definition for themselves, while trying to figure out what life holds for them if the new tax code becomes a reality, two years down the line.

For the first time, Indian authorities are looking for a formal definition of a venture capital (VC) fund — a description that can be incorporated in the proposed FDI Act that promises to do away with multiple agencies and a plethora of press notes. But interestingly, the VC community is yet to craft a definition that's acceptable to the government.

"We have defined a VC as a patient capital with a long-term horizon of 7-10 years and a provider of growth capital... but the authorities have not agreed to this," said Indian Venture Capital Association (IVCA) president Mahendra Swarup, which represents close to 80% of the industry in value terms.

The government, perhaps, is fishing for a more realistic description since regulations allow quick exit for such funds. Under Sebi rules, a VC which steps in as an investor a year before a company goes for an IPO, can sell the stock soon after the company is listed.

However, finding an appropriate definition is a lesser worry for VCs. They are more anxious to make their point to the finance ministry on the draft tax code. The Association has hired the audit and consultancy firm PwC to make representations to the government with regard to code proposals. "PwC will look into all the issues... I strongly feel that the government will not do something that will impact investment into India," said Mr Swarup.

But there are concerns which may be difficult to downplay. Spelling this out, Punit Shah, executive director of PwC, said: "High capital gains taxes and widely-worded general anti-abuse provisions are key concerns for the private equity industry, which could adversely impact foreign investments." An appropriate dilution and administration of these provisions, said Mr Shah, would be necessary to ensure that FDI flow in the country is not adversely impacted.

Besides capital gains tax, the new code has put a question mark on the use of tax havens like Mauritius, where most VCs float a company and open a bank account for investing in Indian firms. While investors, including VCs, have received some assurance from the government that the treaties could be renotified to keep them alive, there could be lingering uncertainties. For instance, the government can always use the general anti-avoidance rule to scrap the tax benefits that Mauritius entities enjoy under the tax treaty between India and Mauritius. Under the anti-avoidance rule, Indian authorities can 'look through' the treaty if they spot transactions and structures which lack commercial substance and have been orchestrated to take advantage of the tax benefit.

Interestingly, the code proposals, if implemented, could also impact outbound investment — a possibility that has not crossed many minds. According to Siddharth Shah, head of corporate and securities practice at law firm Nishith Desai Associates, the code could make it difficult for Indian corporates to enter Africa.

"While the world and India have always viewed Mauritius as a tax-favourable base for

non residents to invest in India, for an increasing number of Indian corporates who have identified the potential of Africa, Mauritius could offer a very effective platform on account of its MFN status, investment protection treaties as well as favourable tax treaties with several African countries."

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