Private equity funds: New code, new issues

IN THE draft Direct Taxes Code, 2009 (Code) currently under review for public comments, the government seeks to exempt venture capital funds (VCFs) from the liability to pay income tax, thereby bringing VCFs on par with mutual funds. While the reintroduction of the much coveted pass-through status is a positive step, a finer reading of the Code reveals potential pitfalls.

'Mutual fund' vs 'mutual fund': By placing VCFs under the umbrella term, 'mutual fund' (as distinguished from 'Mutual Fund' under Sebi (Mutual Funds) regulations, it seems that income from a VCF unlike a Mutual Fund may not be tax-exempt. It would have been prudent to use terminology such as 'Sebi-registered Mutual Funds' and 'Sebi-registered VCFs', instead of using alphabet cases as a differentiating factor.

Investor-level taxation: The Code does not provide for the mechanism of taxation of investors in a VCF as Section 115U of the current tax laws does. There is no operational provision for taxation of income of a VCF in the hands of its investors. A definitional provision cannot be construed as a provision for the characterisation and taxability of income in the hands of investors in a VCF.

Some may argue that as most VCFs are set up as trusts and a trust is not a separate legal or a taxable entity (defined to include legal obligations under the Code), characterisation of income in the hands of investors will be the same as that in the hands of the trust. To clear any ambiguity, the Code should clearly articulate details on taxability of investors in a VCF, especially for such VCFs that are set up as a company. Further, the proposal of imposing up to 30% tax on all forms of capital gains is another dampener.

Confusion reigns supreme on the taxability of dividend income in the hands of investors in a VCF, especially when provisions regarding the classification of a VCF as an exempt entity is read along with the provisions of dividend distribution tax (DDT). The Code provides that no DDT (currently taxed at an effective rate of 17%) is to be levied on the distribution of dividend to pass-through entities such as VCFs. Further, only such dividends received on which DDT has been paid, are tax-exempt. While this appears to benefit VCFs, in reality, investors receiving dividend income from the VCF will end up having to pay tax on such dividends at the regular applicable rates (up to 31%).

It appears absurd that the tax authorities would have intended to increase the tax burden for investors in VCFs with respect to dividend income. To further add to this complexity, the third schedule of the Code provides that dividends on which DDT is not payable shall be subjected to a withholding tax at the rate of 10% (in case of a resident deductee). The prime question that arises is: Who will be responsible for withholding such taxes? Will it be the portfolio company distributing dividend, or the VCF itself? This will be supplanted by the administrative hassle on claiming tax credit, arising from a mismatch in the name appearing on the TDS certificate (which in most probability will be the name of the VCF, assuming that the portfolio company has to withhold) as opposed to the persons (i.e. the investor) claiming the credit.

However, the exemption from withholding taxes on interest income paid to VCFs as proposed by the Code will benefit VCF investors who so far encountered administrative roadblocks while claiming credit on tax withheld by portfolio companies on such income.

Lastly, with VCFs being regarded as 'persons not liable to pay income tax', it's unclear whether a VCF is eligible to tax treaty benefits on its investments made outside India. These are some of the pressing issues that need to be corrected.

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