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ALL IN A NAME

VC fortunes hinge on earnings category

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THE worst isn't over for venture capital funds (VCFs). The million-dollar question before funds now is the rate at which their earnings wiill be taxed. Will it be 10% that stock investors pay on "capital gains" or, will the IT assessing officer use his discretion and treat the earnings as "business income" and slap a 30% tax?

There is no straight answer to this: while one may argue that VCFs buy stocks with the clear purpose to invest and hold on for a few years, it is also perceived that trusts are set up for the "business of investment" and hence what they earn is business income. More so, since VCFs invest in unlisted stocks, where long-term gains are also taxed. A 30% tax could deal a body blow to VCFs, making them significantly less attractive as invesment vehicles. The tricky issue has cropped up even as funds are finding it difficult to come to terms with the new proposal that brings most VCFs under the tax net.

"This will be an issue in trust taxation. Appropriate safeguards should be taken in terms of documentation and conduct of the trust activities that the gains are not characterised as business profit," feels Punit Shah, head of banking & financial services at RSM & Co.

Till now, a VCF was considered a "taxtransparent entity", where the trust did not pay tax and only the investors in the fund were liable to pay taxes directly on the income received by them from the fund. According to Finance Bill 2007, only those VCFs which invest in specified sectors (like biotechnology, R&D, dairy and poultry industry) would enjoy tax exemption. Mr Shah also feels that appropriate care should be taken in drafting documentation to ensure that the trust is a determinate trust (ie, beneficiaries and their shares are known) to ensure there is no double taxation. According to Daljit Titus, Sr Partner, Titus & Co, "there is a definite tax risk. There have been 18-19 tax litigations on this issue and three have been won by the tax authorities."

Picture still hazy on VCF taxation

There is no blanket approach that is possible here. "The authority for advanced ruling in the case of ICICI-TCW ruled that ICICI was carrying on a business activity. But in another case, AIG private equity fund's operations were not considered as business activity," says Siddharth shah, head, fund practice, Nishith Desai Associates.

Some believe there is no problem. "VCFs are usually engaged in investing through the primary market route. They also invest largely in unlisted securities and even when they do invest in publicly-listed companies, they usually get a board seat, contribute to the management of the company and remain invested for at least 1-3 years. Their activity has to be taken as investment and not stockin-trade," said Gautam Nayak, past president, Bombay Chartered Accountants Society (BCAS) .

However, in the current environment where the government seems to be of a mindset that venture fund and private equity are business activity, the fear is that the tax authorities may challenge many funds to prove otherwise. There are many real estate funds that are picking up equity as well as lending, and it may become very hard for the fund to argue that it is not a "business". In countries like Singapore, venture capital investing is indeed taken as a business activity.

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