Funds Hotline

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PRIVATE EQUITY FUNDS: NEW CODE, NEW ISSUES!

Regulators have turned a Nelson's eye to the Indian Private Equity ("**PE**") industry. The Finance Act 2007's provision of withdrawing the blanket tax 'pass-through' (except for nine select sectors) for SEBI registered VCFs ("**VCFs**") under section 10 (23FB) is one such move prompted by an incorrect notion that limiting the 'pass-through' to certain sectors would encourage PEs to infuse capital into those specific sectors. Despite investors in PE funds paying tax directly on receipt of income, tax authorities believed that the PE industry was unnecessarily enjoying a special tax exemption. This is of little consequence, as in any case, most PE funds are set up in the form of trusts and would in most cases enjoy a pass-through treatment.

In the draft Direct Taxes Code, 2009 ("**Code**") currently in circulation for public comments, the Government appears to have reviewed afresh the changes suggested by the Finance Act, 2007. In a welcome move, the Code seeks to exempt VCFs from liability to pay income tax thus fulfilling the industry's long standing demand of bringing VCFs on par with mutual funds. While the initial cheer on the re-introduction of the much coveted 'pass-through' status is understandable, a finer reading of the Code reveals potential pitfalls.

Mutual Fund vs. 'mutual fund'

The Code identifies a VCF under an umbrella term 'mutual fund' (though similar sounding, it is broader than the term 'Mutual Fund' as per the SEBI (Mutual Funds) Regulations). The Code exempts income in respect of units of a 'Mutual Fund' from tax, while income from a VCF (which is classified under the umbrella term 'mutual funds') is not tax exempt. Aligned with the larger objective of simplifying tax laws, a prudent approach would have been to use different terminology for "SEBI registered Mutual Funds" and "SEBI registered VCFs" instead of defining them both as mutual funds with alphabet case as the differentiator!

Investor level taxation unclear

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 characterization 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), characterization of income in the hands of investors would be the same as that in the hands of the trust. To clear any ambiguity, however, it is imperative for the Code to 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 per cent 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 are read along with the provisions of dividend distribution tax ("**DDT**"). The Code provides that no DDT (currently taxed at an effective rate of 17 per cent) 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. Thus, while on the first blush it appears to benefit VCFs, in reality, investors receiving dividend income from the VCF would end up having to pay tax on such dividends at the regular applicable rates (up to 31 per cent). 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 per cent (in case of a resident deductee). The prime question that arises is - "Who would be responsible for withholding such taxes?". Would it be the portfolio company distributing dividend, or would it be the VCF itself? This would be supplanted by the administrative hassle on claiming tax credit, arising from a mis-match in the name appearing on the TDS certificate (which in most probability would 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.

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. Until now while tax was withheld in the name of the VCF, the investors would be required to claim the credit. Further, there is ambiguity with respect to deduction of expenses incurred by the VCF in the hands of the investors, which remains unaddressed.

Treaty eligibility?

With VCFs being regarded as 'persons not liable to pay income tax' under the Code whether a VCF is eligible to tax treaty benefits on its investments made outside India is unclear. This would be specifically so because such entities which are not liable to tax may not be considered as 'residents' eligible to claim tax treaty benefits. Hence, income of

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a VCF on investments made outside India could lead to unintended tax consequences.

VCFs have been change agents bringing in global best practices including corporate governance to India Inc. Their role should not be undermined and the need of the hour is to do away with the tax uncertainty the industry faces today. While the re-incorporation of pass-through is laudable, there are pressing issues that appear to have been bypassed and in urgent need for correction. Then, and only then, will confidence be restored.

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- Siddharth Shah & Bijal Ajinkya

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