

2007 Update to Structuring Venture Capital and Other Investments in India

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Many U.S. and other foreign investors are evaluating alternatives for structuring investments into software development, business process outsourcing, drug discovery and other tech and non-tech companies based in India. Historically, in the IT, life sciences and related sectors, many U.S. and India venture capitalists made early stage investments into a U.S. company which had a subsidiary in India for fulfillment. Many current early stage investments, however, have been made directly into India as more companies consider an IPO on the Indian capital markets because of higher valuations for business process outsourcing (“BPO”) and other service companies. Private equity investments and investments in infrastructure and business segments other than services companies almost always are direct investments into India.

Several recent U.S. initial public offerings of Indian BPO companies: Exl Service Holdings (Nasdaq: EXLS) and WNS Holdings Ltd. (NYSE: WNS), and the pending Genpact IPO on the NYSE are causing a reconsideration of this stock exchange valuation factor. Clearly, valuations will fluctuate over time and the market today with the best initial valuations not being the best even a few months later. When there is a structuring opportunity in an investment, however, the best approach may be investing into a corporation in a location offshore to both India and the U.S. (such as the Cayman Islands) so the choice of stock exchanges can be made at the time of a transaction. An offshore corporation can also provide greater certainty for the enforceability of investor protections than can direct investment in an India private limited company.

The primary structures for investing in India are:

- Direct investment in an India company from outside India (usually through a Mauritius or a Cyprus subsidiary for tax reasons);
- Investment in a U.S. company with a services fulfillment subsidiary in India;
- Investment in a Cayman Islands or Mauritius company with a services fulfillment subsidiary in India; and
- Direct investment in an India company from outside India through a venture capital fund registered with the Securities and Exchange Board of India.

The primary business considerations in determining how to structure such an investment are:

- Relative valuations in the U.S. and India capital markets for the type of investment in question, particularly a services business;
- Ease of IPO exit including any currency exchange restrictions, the impact of Sarbanes-Oxley in the U.S. and overseas company listing requirements in India;
- Ease of acquisition by the likely set of acquirors as an exit strategy; and
- Investor “comfort” with the limitations on preference shares under the India Companies Act of 1956, as amended (the “Companies Act”).

The Stock Market Factor

As indicated, the two recent U.S. IPOs and the pending Genpact IPO illustrate that valuations for Indian BPO companies which have substantial revenues can have competitive or better valuations on U.S. stock exchanges than India exchanges at least at the present time. The key factors in such valuations are amount of revenue (revenue “bulk”), rate of revenue growth and profit margins. The current valuations for EXLS and WNS are about 5-6 times revenue annual run rate on a trailing basis. Annual revenues need to be at least \$100M on an annual basis to have such multiples. The multiples could be higher for a business with more revenue “bulk”.

The Bombay Stock Exchange and the National Stock Exchange (“BSE” and “NSE”) listing requirements for “overseas companies” make it impossible for a young, fast growing company to list on either exchange unless it is an India domestic company. Requirements for a BSE/NSE listing by an overseas company include an average revenue of at least U.S. \$500M per year for the three years prior to the offering and five years of profitability with 10% dividends

paid each year. Technical listing requirements for an India domestic company (as opposed to an investment bankers business performance requirements so that the deal is saleable to the public market) are minimal and even these requirements can be waived.

The U.S. Tax Factor

A company that may want to go public in India should incorporate offshore outside the U.S. at the outset as part of a structure that enables it to be or become an Indian domestic company without triggering the U.S. tax inversion rules described below. Corporate structures used to provide flexibility with respect to the BSE include a direct investment into an Indian company or having a Mauritius or Cayman Islands (“CI”) company as the top-tier or “parent” company. Investments are made in the CI company and the Indian subsidiary is the operating company. A CI company is preferred by some investors because of the track record of such companies being used for China-focused investments. Many Chinese businesses that are CI companies have gone public on Nasdaq. Global venture capitalists have become comfortable with these CI structures and many U.S. venture capitalists also understand and use these structures. This structure can be inverted on a tax-free basis such that the India company becomes the holding company and may go public on an Indian stock exchange as a domestic company.

The alternative of starting a business as a California or Delaware corporation, and then reincorporating the parent entity off-shore through an “inversion” transaction once the business plan is validated, has become very expensive under the U.S. tax laws. Following the enactment of the 2004 Tax Act, while not impossible, an inversion transaction today typically is not economically feasible.

In most cases, an inversion transaction will be disregarded for U.S. tax purposes, resulting in the new foreign parent company being characterized as a U.S. corporation for U.S. tax purposes. In addition, the new “anti-inversion” rules can impose a substantial tax penalty with respect to the unexercised options of certain “insiders” of the management team. These anti-inversion rules have proven to be very frustrating for a number of our clients seeking to pursue IPOs outside the U.S. Therefore, entrepreneurs must carefully consider whether an offshore structure should be created at the outset.

Companies Act Factor

One often overlooked factor by investors is the lack of certainty regarding investor protections under the

Companies Act. A venture capital investor may not have voting control of a company while private equity investors almost always get control. There is uncertainty under the Companies Act as to enforceability of preference share and other control provisions unlike under Delaware law. In addition, minority shareholder rights are much stronger in India. Even a strong majority ownership by an investor may not be enough to control actions and avoid disputes.

There are two basic alternatives for early stage direct investments in India; structuring the investment by use of preferred shares which requires taking a risk on the enforceability of voting rights or using common shares with enforceable voting rights but with a risk on the enforceability of a liquidation preference. Voting rights are usually not an issue in a mezzanine financing when IPO liquidity is near because control is not necessary or feasible in this situation.

A preference share by definition receives a preference over the common shares as to dividends and in the event of a “winding up.” “Winding up” is dissolution of the company in a specific manner which does not necessarily include an acquisition. The Companies Act permits a preference to the proceeds of an acquisition. Other investor protection rights, including participation rights, may be provided to the preference shareholders by incorporating them in the articles of association and in a shareholder agreement. There is no simple and clearly enforceable way to implement antidilution protection for investors because the Companies Act may treat a change in the conversion ratio for preference shares as an issuance of shares at less than par value which is prohibited.

Under statutory provisions, preference shareholders have voting rights only on actions that “directly affect” their rights. There are no recent court decisions which interpret “directly affect” but older decisions held that the preference right itself must be altered rather than an indirect change that affects the enjoyment of the rights. Section 90(2) of the Companies Act provides that the statutory limitations on preference share voting rights do not apply to a private company unless it is a subsidiary of a public company. The definition of public company in Section 3 of the Companies Act, is, however, broader than a company listed on a stock exchange. It includes a company that does not have any restrictions on transfer of its shares in its articles of association. The narrow interpretation of “directly affect” could also be applied by analogy in the case where investor protections are not precisely defined in a private company financing.

As an alternative to purchasing preference shares, voting control can be established by purchasing a majority of common shares. While investors' common shares can be provided a liquidation preference in a shareholders agreement and the provision incorporated in the company charter, there are no court decisions that confirm that such provisions are enforceable.

A hybrid structure under which the investor gets both equity shares (typically with differential voting rights) for a small portion of the investment and preference shares for the bulk of the investment is becoming increasingly popular.

Effective May 1, 2007, India's Exchange Control regulations were amended to provide that preference shares which are not fully convertible to common stock will be treated as borrowings and, therefore, subject to the strict guidelines applicable to external borrowings in respect of both amount and end-use. This rules out the use of optionally convertible or partially convertible preference capital and creates some new structuring challenges that need to be resolved on a case by case basis.

The articles of association may designate a number of directors to be elected by each class of shares so an investor may establish control at the Board level if it has the leverage to do so.

Investment Through Mauritius

Presently, in India there is no capital gains tax on sales of shares of an Indian company held over one year and sold through a stock exchange and an 11.33% capital gains tax on such sales if the shares in an Indian company are held for less than a year. Sales of shares in a private company, *i.e.*, a company not listed on a stock exchange, are taxed at a 22.66% rate for shares held for more than a year and at 33.99% for shares held for less than a year. The Mauritius approach to investing in India, detailed below, is therefore most advantageous when the Indian company is the primary exit vehicle for investor liquidity and such exit is a sale when the company is private. The benefit of the capital gains tax exemption would not apply if the Mauritius company is formed with the objective of trading in securities, as opposed to long term investment in operating companies.

Thanks to the India-Mauritius tax treaty (the "Treaty") the India tax on sales of shares of an Indian company can be avoided if the seller is a Mauritius company so long as the Mauritius company does not have a "permanent establishment" in India. In other words, there is no Indian tax on sales of shares in an Indian company by a Mauritius

company that does not have a permanent establishment in India regardless of whether the shares are of a company listed on a stock exchange or of a private company and regardless of the holding period. Otherwise, the proceeds of a sale of shares in an Indian company are taxed in India unless the shares are sold through a stock exchange and have been held for at least one year.

While there is a lower tax rate on dividends for Mauritius tax residents under the Treaty, corporate dividends declared by an Indian company are presently not taxed in the hands of the recipient upon payment in India of a dividend tax (presently 17%) by the Indian company that declares the dividend.

Under the Mauritius approach, a Global Business Company Category 1 (formerly known as an Offshore Company), regulated by the Mauritius Financial Services Development Act 2001, is formed to make the investment(s).

Certain requirements must be met in order to receive a Mauritius tax residency certificate for purposes of the Treaty including:

- Two local directors approved by the Mauritius Financial Services Commission;
- Bank account in Mauritius; and
- Compliance with Mauritius corporate formalities.

The tax residency certificate is sufficient evidence for India tax authorities to accept the status of Mauritius tax residence according to *Union of India vs. Azadi Bachao Andolan*, 2003 SOL 619.

The Indian government is advocating changes in the Treaty which would reduce the tax benefits of using Mauritius. As of February 2007, Mauritius has agreed to have tax residency certificates be effective for only one year at a time and to impose new undertakings as a condition for issuing a certificate:

- Two directors resident in Mauritius at all times;
- Resident directors of "appropriate caliber" who can exercise independence of mind and judgment;
- All meetings of the Board held, chaired and minuted in Mauritius;
- All accounting records kept at the company's registered office in Mauritius at all times; and

- All of a company's banking transactions channeled through a bank account in Mauritius.

A U.S. investor should not underestimate the legal and operating requirements of the Mauritius structure. For example, funds to be invested in or loaned to the India subsidiary should be wired first to the Mauritius company prior to investment in India as opposed to a wire transfer of funds directly from the U.S. investor to the India company. A wire transfer directly from the U.S. to India is an investment in the India company by the U.S. company not the Mauritius company. The Board of Directors of the Mauritius company should approve the investment and funds should be wired to the Indian company from the Mauritius company. All such actions take time and documentation in order to comply with corporate governance requirements.

Business income of any non-Indian company is taxed in India if such non-Indian company has a "permanent establishment" in India which generates such income. This result obtains regardless of where the non-Indian company is formed, *i.e.*, Mauritius, Cyprus, Singapore or the United States. Having an India subsidiary is a necessary but not sufficient condition for a Mauritius company (as well as any other non-Indian company) to avoid permanent establishment status. If a Mauritius company is deemed to have a permanent establishment in India and its activities are determined to be the business of trading in securities within India (on the basis of guidelines put forth in circular 4 of 2007), then the profits arising from the sale of such "stock-in-trade" will be treated as business income in India (not as capital gains). There are several recent tax rulings that need to be considered in avoiding permanent establishment status. Under Rulings 442 and 566 of the India Tax Authority for Advance Rulings ("AAR"), activities such as the Mauritius company engaging an Indian firm for providing custodial services for securities or being an investment adviser that has no decision making authority will not by themselves constitute having a permanent establishment in India. Investment decisions must, however, be made outside of India. In addition, the effective management of the Mauritius company must not be carried out in India. Whether the effective management of a company is in India or Mauritius or elsewhere is a question of fact. If there is no permanent establishment in India, business income on the sale of the securities of India investments by the Mauritius company is not taxable in India.

An Indian subsidiary that provides only backend fulfillment services for the U.S. parent usually will not cause the U.S.

parent to be deemed to have a permanent establishment in India. The Indian subsidiary's activities may, however, sometimes cause the parent to have a permanent establishment in India. For example, if the India subsidiary exercises authority to conclude contracts, secure orders or deliver goods on behalf of the parent. The implication of the India subsidiary being treated as a permanent establishment of the parent is that it causes the global income of the parent derived from the activity in India to be taxed in India, and not merely the amount billed by the subsidiary for services rendered to parent.

In the case of *Morgan Stanley & Co v. DIT*, the AAR examined whether a U.S. company had a permanent establishment in India under the Treaty based on (1) outsourcing certain services to its subsidiary in India and (2) deputation of personnel to the subsidiary. The personnel deputed to India were engaged either for providing stewardship services to the Indian company or to work under the control of the Indian company.

The AAR held that the outsourcing activity by the U.S. company to its subsidiary did not result in the parent having a permanent establishment in India. The AAR, however, held that the deputation arrangement in India would result in a permanent establishment of the parent. Therefore, the income deemed to have been derived by the U.S. company from the deputation activity in India would be taxable in India.

Until March 31, 2009, income arising from export revenues from software and BPO activities rendered from a "Software Technology Park Unit," is liable to be taxed only at the minimum alternative tax rate of 11.33% instead of the normal corporate tax rate of 33.99% provided the transactions between parent and subsidiary are at arms length prices. It is not clear whether this benefit will be extended beyond March 31, 2009.

Investment Through Cyprus

Another alternative would be to route investment into India through Cyprus rather than through Mauritius. India and Cyprus are also parties to a tax treaty. The tax treatment for capital gains from the sale of shares in an Indian company held by a Cyprus holding company is the same as through Mauritius so long as the Cyprus company does not have a "permanent establishment" in India. There is no capital gains tax in either India or Cyprus on the sale of the shares. Cyprus has a slight economic advantage over Mauritius when an investment is by way of a mix of equity and debt.

The interest payable to the Cyprus company is subject to a withholding tax of 10% instead of the normal rate of 20% for interest paid out of India. The withholding tax in India on interest payable to a Mauritius company is 15% so there is a slight economic advantage to using Cyprus if there is a major debt component of the investment. The disadvantage of using a Cyprus holding company is there is less precedent on the requirements for tax residency.

A Cyprus company will be deemed to be a tax resident only if its management and control is in Cyprus. Companies managed and controlled from outside of Cyprus do not receive any benefits under the Cyprus-India tax treaty. Whether the effective management of a company is in India or Cyprus or elsewhere is a question of fact.

Investment Through Singapore

As with Mauritius and Cyprus, the primary benefit under the India-Singapore Double Taxation Agreement (the “Agreement”); which became effective on August 1, 2005, is no capital gains tax in either India or Singapore on the sale of the shares of the Indian company by a Singapore company so long as the Singapore company does not have a “permanent establishment” in India. The requirements for Singapore tax residency are much greater than in Mauritius or Cyprus. The Singapore company must satisfy expenditure requirements and likely have sustainable and continuous business operations in Singapore. Annual expenditures on operations in Singapore must be at least \$200,000 (SGD) in the 24 months immediately prior to when the gains are realized.

Investment Through a Venture Capital Fund

A venture capital fund, which registers in accordance with the Securities and Exchange Board of India (“SEBI”) guidelines and complies with specified investment restrictions will receive pass through tax benefits on certain types of investments (no capital gains or withholding tax on dividends). The investments that qualify for pass through benefits are:

- Biotechnology
- Information technology relating to hardware and software development
- Nanotechnology
- Seed research and development
- Research and development of new chemical entities in the pharmaceutical sector
- Dairy industry

- Poultry industry
- Production of bio fuels
- Hotels/convention centers of a certain description and size

Other than investment, the permitted activities of a fund, however, are limited. No services such as incubation services may be provided. A separate entity would be needed in order to provide such services. There may also be restrictions on where the fund can raise money.

There are two additional advantages of investment through a SEBI registered fund. Upon an IPO in India, all shares held pre-IPO are locked up for one year. This lock up requirement does not apply to shares held by SEBI registered VC funds provided such shares have been held for at least one year prior to the IPO. Secondly, there is a proposal to treat nominee directors of SEBI registered funds as independent directors under the corporate governance guidelines for listed companies which could help in complying with the guidelines.

GOI and Other Investment Approvals

Registration as a foreign venture capital fund in India with SEBI can take up to eight weeks.

Government of India (“GOI”) approval for direct investments from Mauritius or elsewhere is required in the following situations:

- When the investment is by way of purchase of outstanding shares of an Indian company from shareholders as opposed to purchasing newly issued shares of the issuer (the purchase of shares that meet pricing and other guidelines specified by the GOI would not need prior approval if the investment is otherwise freely permitted);
- When the investing company has a joint venture in India in the same line of business (this restriction does not apply to investment in software companies); and
- When the investment falls within a list of industries (such as real estate, banking, insurance, telecom) in which overseas investments are subject to some restrictions and guidelines. Real estate investments that meet the guidelines can be made without prior approval. Software, integrated circuit design, biotech (other than the manufacture of certain types of drugs) and BPO services are not on the restricted list.

GOI approvals for investment proposals for the first two categories above can take up to eight weeks. No time estimates are possible for proposed investments in the third category.

Conclusion

The primary considerations are exit valuation and ease of exit for investors if there is a structuring opportunity for an investment. A company that wants to have maximum flexibility to choose the stock market with the highest valuations for service companies at the time of a liquidity event should be incorporated offshore outside both the U.S. and India. This offshore structure also includes more certainty for the enforceability of investor protections.

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