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An Update on Structuring Investments in India

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Many U.S. and other foreign investors are evaluating alternatives for investments into software development, business process outsourcing ("***BPO***") and other service companies in India because of the higher valuations for service companies on India's stock exchanges (in comparison with Nasdaq) and the relaxation of India's currency exchange controls. The primary structures for investing in India are:

- Investment in a U.S. company with a services fulfillment subsidiary in India;
- Direct investment in an India company from outside India (usually through a Mauritius subsidiary for tax reasons);
- Investment in a U.S. company that invests in a Mauritius subsidiary that in turn invests in a service fulfillment subsidiary in India; and
- Direct investment in an India company 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;
- Ease of IPO exit including any currency exchange restrictions;
- Ease of acquisition by the likely set of acquirors as an exit strategy;
- Likelihood of an acquisition of the Indian subsidiary rather than acquisition at the U.S. parent level;
- Location of "market pull" for the investee company; and
- Customer and employee preferences in dealing with a U.S. holding corporation as compared to an Indian company with a U.S. subsidiary.

Valuation and ease of exit for investors are the most important considerations. Historically, many India-related investments by U.S. investors in the high tech related services spaces have been structured as an investment in a U.S. corporation, the "front end," which then establishes and capitalizes a subsidiary in India, which is the "back end" for fulfillment for the operations of the U.S. company. The U.S. "front end" approach has been used because of the valuations on and ease of using Nasdaq, being acquired in the U.S. and because the company's primary market is the U.S. In the past, concern over the India currency exchange controls for repatriation of investor proceeds has also been why a U.S. company has been used as the investee company. Other reasons include that sales employees in the U.S. are more comfortable being granted options under a U.S. stock option plan with conventional liquidity than possible liquidity in India under an India stock option plan and customers may prefer to contract with a U.S. company with meaningful assets on the balance sheet.

Presently, the feasibility of using an Indian company as the primary investee company has increased because of the higher valuations for service companies on Indian stock exchanges and relaxed India currency exchange controls. The U.S. company which creates the U.S. market pull is the subsidiary of the Indian company in this case. The other structuring considerations are still relevant but valuation is the key driver.

To hedge on the exit strategy, a structure can be used in which a Mauritius holding company holds all the shares of both the U.S. and India entities. This structure provides flexibility in the exit strategy and takes advantage of the fact that Mauritius does not tax capital gains. This structure

may be impractical in most cases from a business operating standpoint.

Investment Through Mauritius

The primary benefit under the India-Mauritius tax treaty (the "***Treaty***") is there is no capital gains tax in either India or Mauritius on the sale of the shares of the Indian company by a Mauritius company. Otherwise, the proceeds of a sale of shares in an Indian company are taxed in India even if the seller is not a tax resident of India. The Mauritius approach to investing in India is most applicable when the Indian company is the primary exit vehicle for investor liquidity. This approach can also provide a tax benefit when an acquisition might occur at the Indian subsidiary level rather than at the U.S. parent level. In this case, the U.S. parent company establishes an intermediate Mauritius subsidiary between itself and the India subsidiary.

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 of a dividend tax (presently 12.5%) by the Indian company that declares the dividend.

Under the Mauritius approach, an offshore company regulated by the Mauritius Offshore Business Activities Act 1992 ("***MOBAA***") 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 MOBAA authority;
- 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 residence as well as beneficial ownership according to *Union of India vs. Azadi Bachao Andolan*, 2003 SOL 619. The benefits of the Treaty would apply even when a Mauritius entity is established primarily for investment into India. The 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. company to the India company. A wire directly from the U.S. to India is an investment by the U.S. company not the Mauritius company. The Board of Directors of the Mauritius company should approve the investment and funds wired to the Indian company from the Mauritius company. All of such actions take time and documentation in order to comply with corporate governance requirements.

The effective management of the Mauritius company must not be from India in order to have the benefit of the Treaty. Whether the effective management of a company is in India or Mauritius or elsewhere is a question of fact.

Business income is taxed in India if the U.S. or Mauritius company has a "permanent establishment" in India which generates income. Having an India subsidiary is a necessary but not sufficient condition to avoid permanent establishment status. There are several recent tax rulings that need to be considered in avoiding permanent establishment status. If the Mauritius company is in the business of investing in securities in India as its primary objective, then the profits arising from the sale of such investments will be treated as business income in India if the Mauritius company has a permanent establishment in India. Under Ruling 442 of 1998 of the India Tax Authority for Advance Rulings, activities such as the Mauritius company engaging an Indian firm for providing custodial services or being an investment adviser that has no decision making authority will not by themselves constitute a permanent establishment. Investment decisions must, however, be made outside of India.

The U.S. parent company of an Indian subsidiary that only provides backend fulfillment services for the U.S. parent is usually not deemed to have a permanent establishment in India. However, the Indian subsidiary's activities may sometimes constitute a permanent establishment. For example, if the India subsidiary exercises authority to conclude contracts, secure orders or deliver goods on behalf of the parent. A recent tax ruling, Circular No. 1 of 2004 of the Central Board of Direct Taxes dated January 2, 2004, has created the risk that a U.S. parent which has a permanent establishment in India will be taxable in India to the extent of profits arising from activities performed by the subsidiary that are deemed to be "core revenue generating activities" of the U.S. parent. This risk can be minimized by arms length, transfer pricing based arrangements for services that an India subsidiary provides to the U.S. company. Currently, there is no income tax in India on export revenues from software and BPO activities rendered from a "Software Technology Park Unit," which means there is no tax even if the parent corporation is a permanent establishment. The

Government of India has indicated that it will announce measures to minimize the tax impact of income from BPO and other outsourcing activities which are taxable as a result of applying the “core revenue generating activities” principle. These measures are expected to be announced in June 2004.

Investment Through a Venture Capital Fund

A venture capital fund, which registers in accordance with SEBI guidelines and complies with specified investment restrictions will receive pass through tax benefits (no capital gains or withholding tax on dividends). 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.

At this time, the best business course of action is likely to not register in India as a venture capital fund unless having a fund in India is necessary for relationship or political reasons. This will reduce regulatory requirements and maintain investment flexibility.

GOI and Other Investment Approvals

The most complex set of approvals needed for investment in India is registration as a foreign venture capital fund in India with the Security and Exchange Board of India (“***SEBI***”). This can take up to ten 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;
- When the investing company has a joint venture in India in the same line of business; or
- When the investment falls within a list of industries (such as real estate, banking, insurance) in which overseas investments are subject to some restrictions. Software, integrated circuit design, bioscience (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 six weeks. No time estimates are possible for proposed investments in the third category.

Conclusion

The primary considerations in selecting an investment structure for India are valuation and ease of exit for investors. India’s strength in providing low cost business services, the valuation of such businesses on India’s stock exchanges and currency exchange liberalizations are causing investors to consider more India centric investments. Investment in a company with an exit strategy in India can be made via Mauritius to take advantage of the Treaty within the constraints described above.

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