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2006 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 investments into software development, business process outsourcing, drug discovery and other tech and non-tech companies based in India. In the IT, life sciences and related sectors, many U.S. and India venture capitalists still make early stage investments into a U.S. company which has a subsidiary in India for fulfillment. This structure is changing as more companies consider an IPO in India on the Bombay Stock Exchange. Services companies usually have higher valuations in India than in the U.S. Private equity investments and investments in infrastructure and business segments other than services companies tend to be direct investments into India. U.S. venture capitalists are more willing to directly invest into later stage Indian companies regardless of the business segment because there is less risk. A number of mezzanine stage investments have been made directly into India when the IPO was near.

The primary structures for investing in India are:

- Investment in a U.S. company with a services fulfillment subsidiary in India;
- Investment in a Caymans or Mauritius company with a services fulfillment subsidiary in India;
- Direct investment in an India company from outside India (usually through a Mauritius or a Cyprus subsidiary for tax reasons);
- 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, 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;
- Investor "comfort" with the limitations on preference shares under the India Companies Act of 1956, as amended (the "***Companies Act***"); and
- Location of "market pull" for the investee company.

Exit valuation and ease of exit for investors are the most important considerations. Many early stage 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" is the marketing and sales engine. This approach has been used because of the ease of being acquired in the U.S. and because the company's primary market is the U.S. Other reasons include the comfort of U.S. investors with such a structure and concern over having all of the investment proceeds be in India subject to the India currency exchange controls. This structure is changing because of the India IPO factor discussed below.

India IPO Factor

The Bombay Stock Exchange ("*BSE*") has become an important market for liquidity. Listing requirements for "overseas companies," however, make it impossible for a young, fast growing company to IPO on the BSE unless it is an India domestic company. 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. Requirements for a BSE listing by an overseas company include an average

revenue of at least U.S. $500M 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 requirements so that the deal is saleable) are minimal and even these requirements can be waived.

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 BSE as a domestic company.

While in the past, entrepreneurs had the flexibility of starting with a California or Delaware corporation, and then reincorporating the parent entity off-shore through an "inversion" transaction once the business plan was validated, this alternative has become very expensive due to changes in the U.S. tax laws. Following the enactment of the 2004 Tax Act, the ability to reincorporate a U.S. parent company structure off-shore via an inversion transaction is severely limited. While not impossible, an inversion transaction today typically is not economically feasible absent a significant capital infusion from new third-party investors or an unrelated foreign acquirer. 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 parent structure should be formed at the outset.

Companies Act Factor

One often overlooked factor by investors is the lack of certainty regarding investor protections under the Companies Act. Unlike under Delaware law, there is uncertainty as to enforceability of preference share and other financing provisions. 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.

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.

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, there are no court decisions that confirm that such provisions are enforceable.

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 a 11.2% 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 22.44% rate for shares held for more than a year and at 33.66% 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.

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 of a dividend tax (presently 14.03%) 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 residence as well as beneficial ownership according to *Union of India vs. Azadi Bachao Andolan*, 2003 SOL 619.

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 because its activities are determined to be the business of investing/trading in securities within India, then the profits arising from the sale of such securities 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, 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. Investment decisions must, however, be made outside of India. In addition, the effective

management of the Mauritius company must not be from 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, income on the sale of the securities of India investments by the Mauritius company would not be taxable in India.

The U.S. parent company of an Indian subsidiary that provides only 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 cause the parent to be a permanent establishment. For example, if the India subsidiary exercises authority to conclude contracts, secure orders or deliver goods on behalf of the parent. 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.

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 (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.

There are two additional advantages of investment through a SEBI registered fund. Upon an IPO in India all shares held pre-IPO are locked in for one year. This lock in does not apply to shares held by SEBI registered VC funds. 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 software companies); or

- 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 in selecting an investment structure for India are exit valuation and ease of exit for investors. Many early stage 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. This structure is likely to change at least for services companies if the Bombay Stock Exchange continues to perform well because service companies tend to have higher valuations in India than the U.S. Investment in a company with an exit strategy in India can be made via Mauritius or Cyprus to take advantage of the tax benefits described above. A company that may want to go public on the Bombay Stock Exchange should incorporate offshore outside the U.S. in a structure that enables it to become an Indian domestic company without triggering the U.S. tax inversion rules.

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