PE investment in India

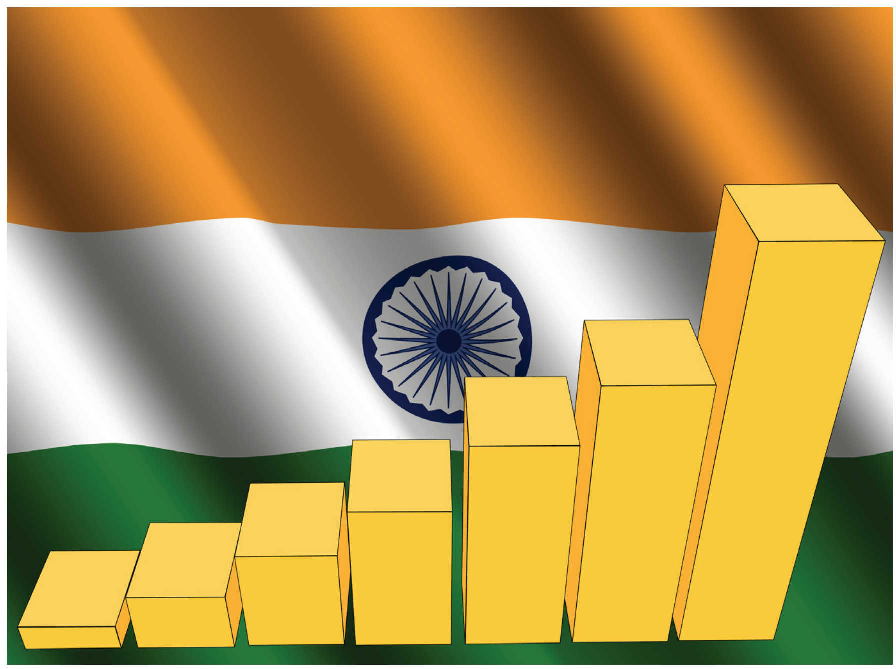
Looking to invest in India? Here is an overview of structuring issues and investment routes you'll need to understand to get started

By Rajeev Dewan

India is the largest democracy in the world, and with its consistent growth, performance and skilled labour force, it provides a promising investment opportunity. In particular, the progressive liberalization of governmental policies, a rapidly expanding services sector and increased foreign direct investment have all contributed to a strong economy with enormous potential.

As a result of these and other factors, this is an exciting time to be involved in the private equity industry in India, as large global private equity investors are either setting up India-dedicated funds or increasing allocations for Indian investments in their global portfolios.

In 2007, prior to the onset of the global financial crisis, it is estimated that approximately 300 firms had a presence in the Indian market, while investment peaked at US$11 billion. In Canada, the Canada Pension Plan Investment Board (CPPIB) recently made its first investment in India through a $100-million investment in a fund focused on investing in India. The CPPIB is one of the world's largest private equity investors with approximately $129 billion of assets under management.



Structuring investments

Offshore Investment Vehicles and Double Taxation Treaties

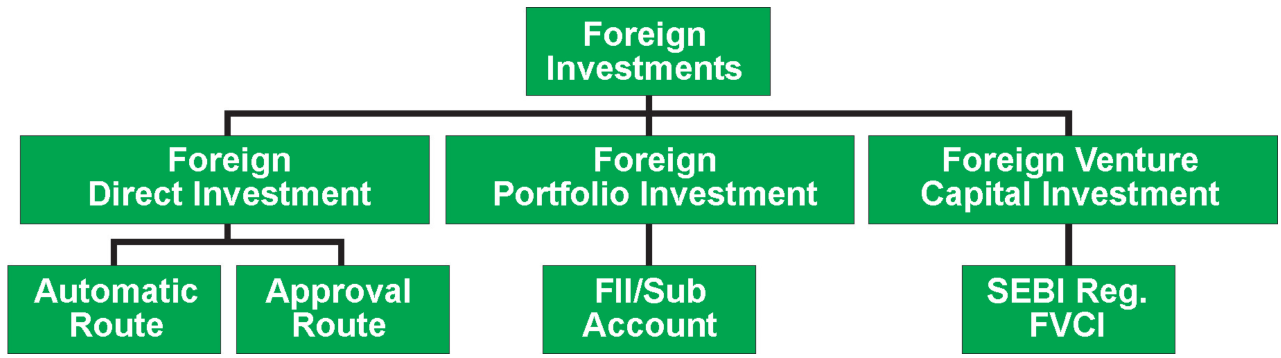
Foreign investment into India has been primarily structured through the use of an entity established in a jurisdiction with a favourable tax treaty with India. In this respect, a number of jurisdictions have been used to structure inbound investment, including Cyprus, the Netherlands, Mauritius and Singapore.

While Singapore and Cyprus offer comparable benefits under their tax treaties with India, certain provisions in those treaties have placed those jurisdictions at a disadvantage in comparison to Mauritius. For example, India's double taxation treaty with Singapore has a stringent limitation of benefits clause that has deterred foreign investors from adopting Singapore as the jurisdiction in which to establish an entity for inbound investment into India. In Cyprus, there is some ambiguity in its tax treaty with India in respect of its residency requirements, which has discouraged some foreign investors from utilizing this jurisdiction.

Currently, Mauritius is the preferred jurisdiction for investing in India, mainly because Mauritius has an advantageous double taxation avoidance agreement with India (the Indo-Mauritius DTAA) that permits foreign investors significant tax benefits in relation to returns on their Indian investments. The primary benefit of the Indo-Mauritius DTAA is that there is no capital gains in either India or Mauritius on the sale of the shares of an Indian company by a Mauritius company, as this treaty provides that capital gains on Indian securities held by Mauritius persons are taxable only in Mauritius. Mauritius has a zero per cent applicable capital gains tax rate.

For an entity to avail itself of the benefits of the Indo-Mauritius DTAA, it will need to satisfy a number of criteria. It will have to be tax resident of Mauritius, i.e. have a valid tax resident certificate issued by the competent tax authorities in Mauritius;

Foreign Investment Routes into India



it should not be a tax resident of India, i.e. its control and management should be exercised from outside of India; and it should have some substance and not simply act as a conduit entity, i.e. central administration, accounts and resident directors in Mauritius, etc.

Typically, foreign investors will establish and provide capital to a corporation referred to as a General Business License – Category 1 Company in Mauritius. Depending on which route is followed for investing into India (see chart above) additional entities will likely be established in Mauritius and possibly India itself. This is especially the case as recent amendments to India's foreign investment regulations provide that any investment made by an Indian company – owned and controlled by resident Indians – in India is not considered foreign investment.

Careful structuring is required to mitigate the risks that an entity established in Mauritius is not considered a permanent establishment by India and is therefore potentially exposed to Indian tax liabilities. This is an issue because Indian capital gains tax is avoidable only to the extent that the Mauritius entity is not permanently established in India, which is ultimately a question of fact for the Indian tax authorities.

Utilizing an entity established in Mauritius does have its challenges as some investors are not familiar with Mauritian law. As a result, some structures have been created whereby a parent entity to a Mauritius entity is established (where investors allocate their capital for investment) in an offshore jurisdiction where such investors have more comfort and familiarity with the applicable laws.

Foreign investment routes

Private equity investment in India generally follows one of the following routes:

Foreign direct investment: A private equity investor may invest into India either directly through an offshore entity, or through an Indian subsidiary. Any investment that the foreign investor makes, i.e. equity shares, convertible securities, etc., through this route would be subject to India's foreign investment regulations. These regulations set out the limitations on foreign investment in certain sectors in India. This route is considered the default route and is applicable to all foreign investors. Investment through this route may be done through either the automatic route or the approval route.

Under the automatic route, a foreign investor would be able to invest in a sector in India without any prior governmental or regulatory approval, such as hotel and tourism. However, any investment done through this route is subject to certain pricing guidelines under the foreign investment regulations, which govern the pricing in transactions between foreign investors and resident Indian investors in any Indian equity securities. An investment in a sector in India, for example broadcasting, which does not qualify under the automatic route will at the very least require the approval of the Indian government and the Foreign Investment Promotion Board.

Registration as a foreign institutional investor: Private equity investors could seek registration with the Securities Exchange of India (SEBI) as foreign institutional investors (FII). The FII concept was established to permit investments in Indian public market securities by foreign investors. In this respect, an FII is essentially limited to investing in certain securities, including securities of companies listed on a recognized stock exchange in India, domestic mutual funds in India – whether listed on a recognized stock exchange in India or not – and certain types of debt and government securities.

The FII registration provides some advantages over the foreign direct investment route, as an FII has the flexibility to buy and sell securities at prevailing market prices, without obtaining prior regulatory approval.

However, FIIs are restricted in respect to the percentage of equity of an Indian company that they may own. The two principal criteria for qualifying as a FII are that the entity seeking registration must be appropriately regulated by a foreign regulatory authority and the entity must have a minimum operating track record of one year.

Rather than seeking registration as an FII, a foreign investor registered as a sub-account of an FII would allow it to make similar investments through a registered FII, subject to certain restrictions.

Registration as a foreign venture capital investor: A foreign investor could also seek registration with SEBI as a foreign venture capital investor (FVCI) for the purpose of investing in private Indian companies. This would typically be done through a wholly-owned subsidiary of an offshore entity, because of the potential for Indian tax liability for investors in an offshore entity making the investment in India.

In examining the application for registration as an FVCI, SEBI would generally examine whether the applicant is “fit and proper.” This process involves examining the applicant's track record in the industry, its financial soundness, whether it is regulated by a foreign regulatory authority, etc. It is important to highlight that the same entity cannot qualify as both an FII and an FVCI. As a result, an offshore entity established for investing in India will create separate subsidiaries for FII and FVCI investing.

The FVCI route offers a number of benefits: an exemption from the pricing guidelines prescribed by the Indian foreign investment regulations which regulate the pricing for the purchase and sale of Indian securities; an exemption from a statutory one-year lock-up which would otherwise apply to a foreign investor in the event of an IPO of their investee company in India; and an exemption from certain tender offer provisions in respect of the transfer of shares in an Indian company by the FVCI.

However, a number of restrictions are imposed on an FVCI, including a requirement to invest two-thirds of its capital in private Indian companies; a prohibition from buying securities in the Indian public market, although a FVCI is permitted subscribe to IPOs of Indian companies as a result of being classified as a qualified institutional buyer under SEBI regulations; and a restriction from purchasing more than 25 per cent of the capital of a single Indian company.

In making private equity investments into India, Canadian investors will need to be mindful of not only the applicable foreign investment restrictions in India, but also what kind of investment vehicle they wish to establish or invest in to facilitate these investments.

Rajeev Dewan is a senior associate at Weir Foulds LLP.