AIFs: A lot achieved, a few loose ends

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It was in January last year that the Prime Minister launched the *Stand-Up India Start-Up India* programme with an inspiring speech to entrepreneurs at a packed auditorium in New Delhi, and to millions of families on television.

Eighteen months on, one cannot but recognise that the government has walked the talk on its promises. There has been remarkable headway on policy changes to keep the start-up juggernaut rolling in India.

SIDBI, under the new Fund of Funds structure, has infused capital into over twenty new VC Funds, the ambit of the programme has been widened and the G-20 meeting in July lauded India's promotion of Start-Ups as exemplary.

Start-ups in India and the Alternative Investment Fund industry which supplies their lifeblood –risk capital, have also seen as many as 25 key policy and taxation changes that can act as a catalyst for this fledgling revolution.

Boost to 'Manage in India'

For the start-up revolution in India to throw up resilient ventures that can survive global competition, the primary requirement is a deep and sustainable pool of risk capital.

Until 2015, it was the ubiquitous foreign funds who met most of these capital needs. In fact, an analysis of VC/ PE data showed that only 5 per cent of the venture capital money in Indian start-ups came from domestic sources and 85 per cent of the Limited Partners (LPs) managed their India venture/ PE portfolios out of offshore locations.

But long-distance relationships don't really work in venture funding. Fund managers located in India are better-placed for a deeper understanding of the Indian business ethos, regulations and unique market opportunities in the country.

Therefore, in a bid to encourage domestic pooling of AIF funds and get more AIF managers to 'Manage in India', about half a dozen policy measures have been initiated since 2016. These have significantly enhanced ease of doing business for AIFs and opened up new sources of Rupee capital to this asset class.

To begin with, in November last year, the Finance Ministry, collaborating with RBI substantially relaxed the FDI ground rules for AIFs operating in India. The changes were threefold. AIFs putting money into India were allowed to receive contributions from overseas investors without prior FIPB approval. NRI investors, who remit about Rs 8 lakh crore annually into bank deposits, were also allowed entry into this new asset class.

In a critical change to the FDI regulation, downstream investments by India-sponsored and managed AIFs, even if they received dollar funds, were exempted from the complicated sectoral FDI caps and conditions.

This path-breaking policy change means that FDI-restricted sectors that were in need of capital no longer had to take recourse to multi-layered holding companies to source funds.

The industry's long-standing demand that domestic institutions with access to long-term money, such as pension funds and insurers be nudged to allocate some capital to AIFs was favourably considered too.

The National Pension System was allowed to offer AIFs on its menu last year. With the NPS rapidly gaining traction with retail investors as well as government employees, its assets under management crossed Rs 1 lakh crore last year. This can prove to be a source of patient and very sticky capital to the AIF industry.

Ease of doing business, and tax clarity

SEBI, on its part, proved that it was a listening regulator and constituted the Alternative Investment Policy Advisory Committee (AIPAC) committee, chaired by N.R. Narayana Murthy, to suggest a package of reforms to catalyse AIFs. The committee came up with a comprehensive and innovative package of measures spanning the operational, strategic and tax aspects of AIFs.

It is good to note that this report has not been allowed to gather dust. Many of its suggestions have swiftly been acted upon by the Finance Ministry.

Recognising that AIFs as suppliers of long-term risk capital deserved encouragement, pass-through benefits on taxation were extended to Category I and Category II AIFs.

Investment gains on unlisted shares, which most AIFs deal in, were made eligible for long-term capital gain taxation benefits, by reducing the holding period for such tax treatment from 3 years to 2 years. Ambiguities in the treatment of income were ironed out by clarifying the safe harbour status for fund managers and allowing the characterization of investment gains as capital gains, even in situations where AIFs held de jure management control.

In a landmark move that has required a great deal of political will, the government has also renegotiated the Double Taxation Avoidance Agreements with Mauritius and other low-tax regimes, to plug loopholes that allowed foreign investors to gain an unfair tax edge through the use of shell structures abroad. This change, taken with the recent BEPS initiative can be expected to lead to an unwinding of convoluted holding company structures prevalent in the industry and allow domestic AIFs to compete on a level playing field.

Finally, SEBI's decision in its June Board meeting, to waive the one-year lock-in period after the IPO, for Category II AIFs, is a landmark change. This will allow private equity funds to time their exits from investee firms to favourable markets and unlock greater value for investors by capitalising on post-listing gains in IPO stocks.

Walking the talk

The government has also shown itself to be quite ready to stand up and be counted, by lending a direct helping hand to start-ups.

The 2016 Budget laid down a clear definition of 'start-ups' and made them eligible for significant corporate tax concessions. In a significant giveaway, it was announced that start-ups that meet the specified criteria would be eligible for an income tax holiday for three consecutive years, during their first five years of operation.

In a boost to entrepreneurs and angel investors, the long-term capital gains arising out of sale of any asset, subject to a cap, when invested in specified funds or in their own start-ups, was exempt from tax for investors. In January, in a bid to encourage Angel Funds, SEBI allowed such funds to invest in five-year old start-ups, instead of three years. It shortened the lock-in requirement from three years to one year, and lowered the minimum ticket size for participation in Angel Funds from ¹ 50 lakh to ¹ 25 lakh. The upper limit for number of angel investors in a scheme was expanded from 49 to 200, allowing client diversification.

The government has also been quick to operationalise the $ 1.5 billion India Aspiration Fund under the auspices of SIDBI. This is a Fund of Funds designed to act as a catalyst for funnelling private capital into start-ups.

Set up jointly by the Government of India with RBI, it invests in venture capital funds that deploy at least twice its contribution or half of their own capital, whichever is higher, in MSMEs and early-stage enterprises. Thus, the fund has been enabled to create a multiplier effect on the start-up ecosystem. An interesting aspect is its collaborative approach to curating its investment bets. Funding proposals are independently vetted by an independent advisory panel that has been constituted by experts drawn from industry, IT and academia. This Fund has already deployed 20 per cent of its corpus in eligible venture funds.

This Fund is in addition to the Rs 40,000 crore ($ 6 billion) National Investment and Infrastructure Fund (NIIF), which aims to supply capital to infrastructure projects in India.

The impact of all these measures on the industry is there for all to see, with AIFs now attracting over ¹ 80,000 crore of commitments and the domestic pooling of AIF funds climbing 4X in 2016 over 2015.

Unfinished agenda

While all the above measures set the stage for exceptional growth in the AIF industry in the years ahead, a few loose ends remain, which deserve policy attention.

Shift to unit-based taxation: While many welcome changes have been implemented in the income tax treatment of AIFs in the last two years, a shift to a unit-based taxation system for this vehicle remains on the to-do list.

This can make the AIF vehicle substantially more attractive to investors. Under current tax laws, the costs incurred by investors in generating capital appreciation via AIFs are not deducted when computing 'income' for tax purposes. This is unfair, particularly because the cost component is quite significant in AIFs, because investors essentially commit to a blind pool and AIF managers take active efforts to identify, select, structure and manage investee firms. They take a hands-on role in their running too. This effectively means that an AIF typically deploys about 15-20 per cent of capital commitments towards management fees, professional fees to bankers, lawyers, accountants, administrators, operating partners and other service providers. The current system of taxation also means that net losses in AIFs, if any, cannot be set off by investors and usually lapse.

A shift from thepass-through taxation system at the fund level, to a unit-based taxation system can level the playing field between AIFs and other vehicles such as mutual funds and greatly contribute to the vehicle's popularity. This shift will also enable AIFs to list their units or make secondary transfers, with tax efficiency.

Clarity for banks/insurers: Capital for fund managers is the life blood of this industry. In this context, while mini *Gangotris* like the SIDBI Fund of Funds are useful, unlocking new sources of institutional capital flows are critical to open the floodgates.

While the insurance regulator IRDA has 'approved' investments in AIFs, the clause has an ambiguity that needs to be reworded. The rule requires investments made by insurance companies into AIFs (Category II) to be channelized into "SME, Infrastructure and Venture Capital Undertakings." However, these are Category I vehicles. As Category II AIFs account for nearly two-thirds of industry assets, this needs to be reworded, in line with the suggestions in the AIPAC report.

Similarly, RBI, in its master circular of July 1 2016, again mentions Category I AIFs. Sweeping Category II AIFs into its ambit will help banks–who have been the primary capital source for AIFs to reconsider this vehicle.

GST uncertainty: While the tax anomaly on capital gains is being sorted out, confusion on indirect taxes continues to dog domestic AIFs. Presently, overseas pooling vehicles do not pay service tax and current GST rules clearly exempt export of services from GST. However, pooling of dollars in AIFs managed by Indian

AMCs, and profits so exported, are not exempt from GST. This adds a stiff 18 per cent to the cost of management, and creates significant barriers to creating more AIFs. More noted foreign investors in AIFs, will mean more Indian FIs and HNIs gaining confidence to invest. If foreign monies continue to be pooled overseas, that's a straight opportunity loss for India. Ideally, SEBI should facilitate this change before the next budget.

Further, AMCs in this industry make their profits not from fees, but from "carry" based on the fund's financial success, which is a profit-sharing arrangement. Today, there are cases pending with the taxman where the erstwhile Service Tax authority has demanded Service Tax on the carry paid to the AMC by a Fund, arguing this is merely deferred management fees, and not a long-term profit. This has unleashed fresh turmoil on the industry, where the largest funds are managed by institutions like SIDBI, NIIF, True North, IDFC, ICICJ, Tata, Birla and TVS. This demand can effectively dismantle the basic business model, if further pursued by the GST Act. SEBI must lead the efforts to work with the GST Council to bring clarity to this issue.

AIF Industry Performance data: This is a crucial initiative that needs to originate from the industry itself. As AIFs are a relatively new asset class in India, FIs and HNIs are impeded by considerable fear and confusion about the performance of the industry. No reliable aggregated data is available on industry-level performance of AIFs in India. Here, AIPAC's second report has proposed a robust mechanism for creating an industry wide performance database (this can be on an anonymized to protect individual fund manager's privacy) using the CKYC (NSE Dot.Ex) and professional research agencies like PRIME and CRISIL. These partners are ready to help create this data ecosystem.

Proactive action by SEBI to convene these agencies and industry representatives to set this in motion, would be a welcome development.

Allowing angels to fly: SEBI has achieved a breakthrough in carving out Angel Funds as a separate category of AIFs. It has even made enabling amendments as suggested by the industry. Yet there hasn't been a pick up in this novel framework because of ambiguity on "Angel Tax". Income Tax rule 56 (2)(viib) permits the assessing officer to levy a presumptive tax at the maximum marginal rate of 30 per cent plus cess and surcharge, on companies raising capital, if the officer believes the pricing is "over valued." Correctly, category I AIFs are exempt from this provision. But as investments by Angel Funds don't have this exemption, many investors prefer Category 1 AIFs. This exemption should be extended to Category I Angel Funds.

Tying up these few loose ends may work wonders to launch both India's start up ecosystem and the AIF industry into an even higher growth trajectory. In fact, if these enablers are in place, a fund flow of $50 billion a year through the VC/PE route to Indian enterprises is quite an achievable target by 2025. The investment appetite exists, only the process needs to be made frictionless.