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VENTURE CAPITAL AND PRIVATE EQUITY

Anjali Raghav
Asst.Prof, Dept. finance and Commerce, Galgotias University, India

Abstract:-*Over the past two decades, private equity has grown internationally at a dramatic pace to such an extent that the asset class has been both lauded as the saviour and vilified as the cause of our current economic malaise. Private equity including venture capital, hedge funds and buy-outs has shaped our economy. Their "above market" returns have attracted investments from pension funds, which was the most trusted and reliable avenue for our millions of elderly.*

Key words: **VC-** Venture Capital, **VCF -**Venture Capital Funds**, VCC-** Venture Capital Company**, VCU-** Venture Capital Units**, CCI-**Controller of Capital Issues

Review of Literature

Venture Capital Funds ("VCF") are a useful source of risk capital, especially for start-up ventures in the knowledge-intensive sectors. With a view to encourage venture capital related investments in India and to generally promote Indian start-ups companies, the Indian Government has provided various tax incentives to venture capitalists.

Venture capital focuses on investing in private, young, fast growing companies. If an entrepreneur is looking to start-up, expand; buy into a business, turnaround or revitalize a company, venture capital funds could help do this. Venture capital funds are a form of "risk capital" that is invested in the business where there is a substantial element of risk in relation to generation of cash flows and creation of profits.

Venture capital funds are invested in the company in the form of long term, committed equity rather than loan which compensates investor with the higher rate of returns for the risk borne by him.

The mode of obtaining Venture capital is substantially different from raising long-term debt or loan from a lender. In long-term loans, lenders have legal right to interest on loan and repayment of the principal amount, irrespective of the success or failure of the business. The venture capitalist being the shareholder of the company will get returns on his investment only if his venture generates profits. The growth and the profitability of the ventures are the determinants of the returns. This return is generally earned when the venture capitalist "exists" by selling its shareholding in the business.

1.Introduction: Emergence of Venture Capital in India

The emergence of venture capital in India is from 70's when committee laid by Late Shri R.S Bhatt was formed to find out the ways to meet a void in conventional financing for funding start-up companies based on absolutely new innovative technologies. The reason which came into light of such companies was unavailability of financial support or the funding was inadequate which resulted into their mortality. The committee recommended starting of venture capital industry in India. In mid-80's three all India financial institutions viz IDBI, ICICI, IFCI started investing into the equity of small technological companies.

Government of India decided to systematize venture capital industry in Nov, 1988 and announce guidelines in the parliament. Controller of capital issues implemented these guidelines known as CCI for venture capital. These guidelines issued by CCI were too much confined. It proposes investment regarding venture capital to be made in companies based on innovative technologies started by first generation entrepreneur. This made the investment regarding venture capital highly risky. Several private initiatives were taken in the same direction. At the same time World Bank selected 6 institutions to start venture capital investment in India. This included TDICICI (ICICI), RCTC (now known as IFCI Venture Capital funds ltd.)GVFL,Canbank Venture Fund,APIDC and ILF (now known as Pathfinder).

Later on, in the year 1995 Government of India invited foreign finance companies to make investments in India and in 1996 government announced guidelines to regulate the venture capital industry.

During 1997, the fast emergence of IT industry made Venture Capital industry more significant. It was due to interdependent relationship between venture capital and IT industry. Venture Capital has got more prominence as a major source of funding for the rapidly growing IT industry. After that Indian Venture Capital has changed their focus to IT and telecom industry. The information derived from the year 1999-2001 shows that recession has knocked the wind out of Venture Capital industry. Resulting into the closedown or winding up of the joint venture operations. Gradually all of them changed their focus to existing successful firms for their growth and expansion. Later on Venture Capital firms also got engaged into funding buyouts, privatisation and restructuring of firms. In the current scenario just a few firms are taking the risk of investing into the start-up technology based companies.

1.1.Business Attractions for Venture Capitalists

It is being clearly signified that venture capitalists prefer to invest in “entrepreneurial business. “Well that does not represents small or new business rather it is more about the investments aspirations and potential for growth. Venture Capital investors are interested in companies with the relatively high growth prospects which are managed by experienced and ambitious teams who are capable of turning their business plan into reality.

1.2.Investment procedure of Venture Capital investors

The proposals for investment either directly or through financial intermediaries are received by Venture Capital. The Venture Capital investment process begins with the desk research on a deal. In the case deal reveals interest towards Venture Capital funds; the Management team is requested to present the business model of company, unique aspects of business, future prospects and the investment proposal. After discussion with the management team, Venture Capital investor finds the deal as investible propositions, a document containing terms of proposed investment known as term sheet is being devised and negotiated with promoters for their concurrence. Once the final concurrence of entrepreneurs is being received regarding the investment proposals the Venture capital funds take up the venture for detailed examination. The detailed due diligence of project is carried out by Venture Capital funds themselves or assigned to independent advisors. This is being undertaken in order to critically examine the legal, business and financial aspects of proposed investment. In the entire process of critical examination, Venture Capital funds also assess the requirement of funds, stages and the proportion of investment and other related investment turning point. The company interested in investing as expected to render all the possible co-operation to Venture capital fund/independent advisor who is carrying out due diligence of its venture and explain material transactions undertaken by the company in the past.

Further, once the due diligence regarding findings and in process of getting internal approvals for investment is being successfully done, Venture Capital funds may modify certain conditions as appropriate for investment in the company and accordingly negotiate also referred to as promoters. If the entrepreneurs accepts the revised terms or conditions, Venture Capital funds issue letter of intent for investment and require investee companies to complete the formalities for availing investment. In order to obtain approval of Government and other statutory approvals, for facilitating investment certain formalities are required to be incorporated like execution of legal agreements by promoters/investee companies, passing of requisite board/Company's resolution.

Thereafter, once the stipulated conditions regarding the venture capital funds are being achieved the companies in turn undertake investment in the company. Venture Capital funds regularly monitor the functioning of investee companies and give inputs or strategic plans and guide companies for optimizing their performance. Venture Capital funds also pursue the investee companies to orient their business plans and achieve performance targets to qualify for bringing out IPOs and get listed on stock exchanges for providing exit from investment to Venture Capital funds. The process of investment and level of participation of Venture Capital funds in management of Venture indicated above is illustrative and may vary depending on merits of a Venture or Strategy of a Venture Capital fund.

1.3.Tax incentives offered by Government of India

With a view to encourage venture capital related investments in India and to generally promote Indian start-ups companies, the Indian Government has provided various tax incentives to venture capitalists.

Under the existing venture capital tax regime, a Securities and Exchange Board of India ("SEBI") registered Venture Capital Fund ("VCF") has been accorded a pass-through status under section 10(23FB) read with section 115U of the Income-tax Act, 1961 ("the Act").

According to section 10(23FB), any income earned by VCF from investments in venture capital undertakings ("VCU") would be exempt from tax. VCF has been defined to mean:

- A trust operating under a trust deed registered under the provisions of the Registration Act, 1908, or operating as venture capital scheme made by the Unit Trust of India; and
- Registered with and satisfy the conditions prescribed by SEBI

Further, as per recently enacted law by Finance Act 2007, only income earned from investments made into VCU by VCF would be eligible for tax exemption under section 10(23FB). Further, the erstwhile definition of VCU (which was in line with SEBI regulations) has been replaced with, and currently defined to mean domestic company whose shares are not listed in a recognised stock exchange in India and which is engaged in business of following specified nine sectors:

- Nanotechnology;
- Information technology relating to hardware and software development;
- Seed research and development;
- Bio-technology;
- Research and development of new chemical entities in the pharmaceutical sector;
- Production of bio-fuels;
- Building and operating composite hotel-cum-convention centre with seating capacity of more than three thousand; or
- Developing or operating and maintaining or developing, operating and maintaining any infrastructure facility as defined in the Explanation to clause (i) of sub-section (4) of section 80-IA; or
- Dairy or poultry industry.

The Act also contains special provisions in section 115U dealing with the taxation of income received by investors from VCF. As per such provisions, income received by the investor out of investments in VCF shall be chargeable to income-tax in the same manner as if such person (i.e the investor) had directly made investments in the VCUs. Thus, the charge of tax is triggered on the <u>receipt of income</u>. Further, sub-sections (2) and (3) of section 115U of the Act also refer to VCF making <u>payment</u> of such income to the investors.

In view of the above, it is clear that section 115U contemplates 'actual payment' and 'receipt' of income. Hence, if the Fund reinvests its income and does not distribute it, then it would not be taxable in the hands of investor under section 115U of the Act; such income would be taxable in the hands of investors only in the year in which it would be actually paid.
Further, the income distributed by VCF to its investors will not be subject to any withholding tax or dividend distribution tax under the Indian domestic tax laws.

Eligibility of tax exemption in certain specified investments (i.e, Mutual Fund Units and Unlisted shares subsequently listed)

Gains from non-eligible VCUs/ Mutual Fund Units

Section 10(23FB) as it was originally enacted exempted any income earned by a VCF <u>*set-up*</u> <u>to raise funds for investment in VCUs.</u>

Under these erstwhile provisions, based on a plain reading of the provisions, one could argue that so long as the primary purpose of setting-up the VCF is to make investments in VCUs and so long as it has made substantial amount of investment in VCUs, the fact that the VCF has also made investments in non-VCUs, say, Mutual Fund Units, the same should not disentitle the VCF from claiming an exemption under section 10(23FB).

However, as mentioned earlier, as per the recent amendment made by Finance Act 2007, the exemption is now available to only to "<u>income from investments in VCU</u>". Given this,
It is likely that income from Mutual Funds may not be eligible for exemption under section 10(23FB), and taxability of such income would be governed by general principles (refer Para 3 outlining the taxability in case of trusts).

Also, it may be inferred that income from investment made in undertakings engaged in businesses other than specified nine sectors would not be entitled to pass through benefit of section 10(23FB) and the income received from such investments would be governed by general principles.

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2.1.1. Gains from Unlisted securities (which subsequently got listed on the stock exchange)

As mentioned earlier, under the provisions of section 10(23FB), VCU has been defined to mean a domestic company whose shares are not listed on a recognised stock exchange in India and engaged in specified business sectors. Given the above definition, an issue that arise is whether the exemption under section 10(23FB) would be available where the investments were made in unlisted shares of Indian company, which subsequently got listed on the stock exchange.

It may be relevant to mention here that similar issue arose when section 10(23FB) was originally enacted by Finance Act, 2000 when VCU was defined on similar lines. In that case, the Finance Bill, 2001 clearly recognized that the exemption of income under section 10(23FB) could have been denied in the said situation[1], and therefore Explanation 2 was inserted by Finance Act, 2001 with effect from April 1, 2001 (retrospectively) to section 10(23FB) to clarify that the exemption would be available even in such cases. In other words, as per the retrospective amendment, where the investment in shares of an unlisted company are subsequently listed on the recognized stock exchange in India, the exemption under section 10(23FB) would not be jeopardized.

The following arguments support the position that benefit of section 10(23FB) should continue to be applicable for investments made in shares of an unlisted company, which subsequently got listed.

- The investment is initially made in an unlisted company and the fact of its subsequent listing cannot change the character of the investment as having been made in a VCU, and accordingly, the benefit of section 10(23FB) should be allowed.
- The explanation inserted by Finance Act 2001 providing the benefit of exemption stated that it was “for the removal of doubts”. Having regard to the above, it appears that the Explanation is a clarificatory provision and its deletion would not affect the provision in law that a VCF shall not lose exemption if it has invested in an unlisted company and sells the shares after the company is listed.
- Given the legislative history/ intent of the provisions to promote investment in VCUs, an adverse view would defeat this objective and act as disincentive, since exemption in respect of such VCUs would not be eligible if such VCUs were listed.

Given the above and the legislative intent, it could be argued that exemption should be available in respect of investments in unlisted companies (which are subsequently listed), provided other conditions to qualify as a VCU as per the recent amendment are satisfied. However, in the absence of such specific explanation in the recent provisions (as introduced by Finance Act 2001, when similar provisions prevailed earlier), it is likely that the exemption if claimed would be challenged by the revenue authorities.

[1] Notes to Clauses/ Explanatory Memorandum to Finance Bill, 2001 – “If the shares of such venture capital undertaking get listed subsequently in a recognized stock exchange and the initial investment made continues, the venture capital company and venture capital fund may lose exemption by virtue of this Explanation.”

2.2. Income Characterisation upon distribution

Section 115U provides that income paid by the VCF will be deemed to be of the same nature and in the same proportion in the hands of the person receiving the income as it had been received by or had accrued to the VCF during the relevant previous tax year.

Based on the literal interpretation of the above provision, it appears that the characterization of income in the hands of the investors would be based on the proportion of income earned by VCF under each source of income during the previous year in which the income is distributed. However, such an interpretation may lead to some absurd consequences.

For instance, where the VCF has earned (say) only dividend income in first 2 years of its investments and no distribution is made by it to the investors in those years, and in Year 3, it earns insignificant amount of short-term capital gains, and the entire income (including the income earned in first 2 years) is distributed by it to the investors, the entire income received by the investors would be taxed as short-term capital gains although most of the distribution made was out of the dividend earned by VCF from investments made in VCUs. Such a result would lead to absurd and perhaps unintended consequences.

Accordingly, a better view would be to adopt any reasonable basis, such that the income earned by the Fund retains the same characterization in the hands of the investor, over the period of the Fund.

Some of the industry practices to resolve the above issue have been discussed below:

- Proportionate basis: Income characterisation is determined in the hands of the investors by taking a proportion of actual income distribution vis-à-vis the cumulative total income earned by the VCF till the year of distribution; or
- ‘First-in First-out’ (“FIFO”) basis: Under this methodology, income characterisation is assigned/ allocated to the actual income distribution on the assumption that an income which is earned first gets distributed first.

It may be important to note that under each of the above method, to achieve consistency and rationality, the amount/ income characterisation already distributed to the investors may have to be adjusted from the amount of total income of the VCF, for the purpose of making similar computations in subsequent years of distribution. It would also be advisable that appropriate disclosure in Form 64 is made accordingly.

K&S Comments: The adoption of proportionate basis for income characterisation may be considered appropriate as against a FIFO basis, since income when pooled loses its character of being derived from a particular income stream.

2.3. Taxability of erstwhile eligible income post amendment by Finance Act 2007

As mentioned earlier, as per provisions of section 115U, income received by a person out of investments made in VCF shall be chargeable to income-tax in the same manner as if it were the income received by such person had he made the investments directly in the VCU. The meaning of VCU has been assigned to, as defined under section 10(23FB). Given the recent amendment to restrict the definition of VCU to specified nine sectors, an issue arises regarding the treatment/ taxability of income earned prior to the amendment (ie, prior to March 31, 2007), and in respect of which exemption under section 10(23FB) was claimed under the pre-amendment regime.

On a literal reading of the current provisions of section 10(23FB) of the Act (post amendments by the Finance Act, 2007) read with provisions of section 115U of the Act, it would appear that provisions of section 115U may not be applicable in relation to the distributions by VCF on or after April 1, 2007 from investments made in eligible VCUs - which have now become ineligible as per amended definition. In other words, while the benefit of section 10(23FB) has been claimed in respect of certain income in earlier years, the same would not be covered by provisions of section115U at the time of distribution (since such income would not be from VCUs as per the amended definition).

If such a view is adopted, taxability would be governed by general principles, under which, it could be argued that distribution of income by trust to beneficiaries would not be liable to tax since the same may constitute capital receipt. However, this appears to be unintended, and accordingly, a reasonable view would to apply the provisions of section 115U of the Act for distributions made by the VCF out of the surplus relating to period/s prior to March 31, 2007, and offer to tax such income on a receipt basis.

K&S Comments: Application of Section 115U of the Act on distribution of income accumulated up to 31 March 2007 would in our view be appropriate.

1. General overview of the taxability of trusts under domestic tax legislations

Under Indian domestic tax laws, taxability of a trust is governed by the provisions of section 160 - 166 of the Act. The objective of these provisions is to catch income at the earliest point in time and tax profits where they are found, instead of waiting for them to reach the persons who are beneficially entitled thereto[2]. As per the above provisions, the following principles emerge, in the context of irrevocable trust[3]:

- Where trust is irrevocable, income earned by the trustee under the trust deed would be taxable in trustee's hands, in the capacity of a representative assessee of the beneficiaries, on an "accrual" basis[4]. However, the assessing officer has an option to tax either the trustees (in their representative capacity) or the individual beneficiaries directly[5].
- The tax on such income is levied upon and recovered from trustee in like manner and to the same extent as it would be leviable upon and recoverable from the person represented by him (ie, the beneficiaries).
- In the event any income received by the trustee on behalf of the beneficiaries were to include profits and gains of business, then tax shall be charged on the whole of the income in respect of which the trustee is liable in representative capacity, at the maximum marginal rate[6].
- In case of a discretionary Trust [ie, where the shares of the individual beneficiaries are not known/ not stated explicitly under the Trust deed], the income received by the Trustee on behalf of the beneficiaries is required to be taxed at the maximum marginal rate.

K&S Comments: You may want to include that on general principles of trust taxation, the effect may be as under, if regard be had to Supreme Court judgement in Nizam's case (108 ITR 555).

[2] Page 8740 of "Law of Income-tax" by Sampath Iyengar, Volume 5, 10th edition
[3] In case of a revocable trust, under the clubbing provisions, income would be taxed in the hands of transferor.
[4] Section 161(1) of the Act
[5] Section 166 of the Act
[6] Section 161(1A) of the Act

- A trustee is liable in the same manner in which the beneficiary would have been liable - This rule, with regard to rate of tax, stands modified to the extent of applicability of Section 161(1A) of the IT Act.
- Theoretically, a trustee may be required to file as many returns as there are beneficiaries of the trust; each assessment is independent of any other assessment.
- The beneficiary can still be taxed directly; he is not absolved of his liability.
- If the liability is discharged by either the trustee or the beneficiary, there can be no duplicated assessment.
- The trustee may practically not submit the return if the tax liability has been discharged by the beneficiary independently.
- As per the scheme, a trustee is assessed in the like manner in which a beneficiary is assessed. There is no specific guidance, though it is arguable that a beneficiary should be assessed in the same manner as trustee. In the instant case, the exemption could have been claimed only by the VCF and not by the beneficiary in his own right, since beneficiary is not a SEBI registered VCC/VCF.

While the above are the general proposition, a question can still arise whether the law wants to treat VCF as a separate assessable entity, on the lines of a mutual fund. Section 115-U of the IT Act may appear to suggest that the law wants to provide pass through as a specific concession/provision, while treating VCF to be a separate person. To that extent, general principle may not apply. Section 115-U has significance to the extent it provides that the VCF beneficiary may be presumed to be a direct investor in the VCU.

3.1 Ability to voluntarily adopt a position that beneficiaries should be liable to tax

As mentioned earlier, in case of an irrevocable trust, the income earned by the Fund/ trust would be taxable in the hands of Trustees as a "representative assessee" of the beneficiaries by virtue of section 161(1) of the Income-tax Act, 1961. Given these express provisions, an irrevocable trust cannot opt to disregard the liability of the trustee as a “representative assessee” on the basis that the beneficiaries of the trust would offer the income for tax.

However, in view of provisions of section 166 of the Act, we understand that a common industry practice is to offer the income to tax in the hands of the beneficiaries as and when the income accrues to the trust. This position also finds support from the following arguments/ practical/ administrative difficulties in the context of assessment of trust income in the hands of the Trustee in representative capacity:

- Where income is directly taxed in the hands of the beneficiaries, the objective of a trust is not defeated because so far as the revenue is concerned, there would be no effective loss of revenue if the income was offered in the hands of the beneficiaries as and when accrued to the trust.[7]
- There may be various procedural/ computational/ practical issues that the trustee may have to deal with, in a situation where they were to offer the income to tax, in their representative capacity. For instance, from computation perspective, the trustee would also need to consider all exemptions, abatements, deductions and relief that the beneficiary would have been entitled to, had he been assessed directly.
- The assessment of beneficiaries’ share of income could also pose jurisdictional issues in so far as the authority assessing the return filed by the representative assessee is concerned. It is likely that the authority exercising jurisdiction over the beneficiaries

[7] CIT v Marsons Beneficiary Trust (1991) 188 ITR 224 (Bom)

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themselves (whose income is being subject to tax in trustee's hands) would be different vis-à-vis the jurisdiction of the representative assessee.

Given the above, in the event a position to offer the income in the tax of beneficiaries' hands directly is adopted, as a risk mitigation approach, it would be advisable for the fund/ trustee to obtain a declaration from the beneficiaries that the income would be offered to tax by them in their respective return of income.

It may also be noted that, if the department chooses to assess the beneficiaries under section 166 of the Act, it may not, in respect of the same income, once again assess the trustees.[8]

K&S Comments: Where the trustee taxpayer adopts a position that since income is taxed in the hands of the beneficiary, it should not be again assessed in its (trustee) hands in the capacity of a "representative assessee", the taxpayer would need to maintain adequate documentation to substantiate this fact (even perhaps requiring to maintain a copy of the beneficiary's tax return evidencing the fact that the beneficiary has offered such income to tax). Where for instance, some of the beneficiaries do not offer income from the fund to tax, it would be appropriate and administratively convenient for the Revenue authorities to recover tax on such income from the trustee taxpayer.

4.1. Income characterization of carried interest payments

In case of XYZ India Fund, carried interest is structured as distribution out of the net proceeds of the Fund on certain specified class of units ("specified class") issued to the Investment Manager or employees or directors of Investment Manager, against capital contributed by the respective investor. This is the general industry practice which is followed by various private equity players/ venture capital funds.

We understand the capital contributions received from such units would also be invested in the VCUs, along with contribution received from general investors. As a holder of such units of specified class, the investment manager/ employees would be distributed income earned by VCF from investments made in various undertakings. Such distributions would be contingent on the income earned by VCF and would be distributed in the specified manner.

Accordingly, it could be argued that the income received from such specified class of units would also be taxable in the hands of the specified investors, on a similar basis as it would be generally taxable in the hands of other general investors (ie, upon distribution in respect of eligible income of SEBI registered funds, and on an accrual basis, for non-eligible income).

However, it may be relevant to mention that there is an exposure that the Revenue authorities, especially at the lower levels, may take a view that income received by the investment manager (ie, ABC Ventures in our case) in respect of specified class units is in substance part of management fees, and accordingly, subject the same to tax as business income in the hands of ABC Ventures.

K&S Comments: Though this aspect is yet to be judicially tested and hence likely to be contested, the position adopted appears to be a reasonable application of the provisions of the IT Act.

[8] Trustees of Chatturbhuj Raghavji Trust v. CIT (1963) 50 ITR 693 (Bom), CIT v Miss Gargiben Trust (No. 1) and others (1981) 130 ITR 479 (Bom)

4.2. Income Characterisation on gains from disposal of securities - "Business income" or "Capital gains".

Characterization of income from sale of securities (ie, as business or capital gains) in the hands of a VCF has always been debatable, given that VCF typically realize gains on investments in the ordinary course of their activities. Generally, an organized and systematic activity of purchasing and selling securities is likely to be regarded as a business activity, and gains in such cases would be in the nature of business income.

In terms of principles, where securities are considered as "stock-in-trade", the resultant gains arising on transfer of such securities are considered as "business income", and where securities are held as a "capital asset", the gains on transfer would be regarded as "capital gains". However, in practice, determining whether securities are held as "stock-in-trade" or "capital asset" is a highly factual exercise (to be supported by factual documentation) and there are number of judicial precedents on this issue.

The Central Board of Direct Taxes ["CBDT"] has issued Circular No 4/ 2007 dated June 15, 2007 [updating an earlier instruction 9 issued by CBDT on the same subject] laying down the tests for making a distinction between shares held as stock-in-trade and shares held as investment. As per this circular and based on various judicial precedents on this subject, the following factors could be considered as relevant for determining whether gains are in the nature of capital gains or business income. It may be mentioned that none of the factors on its own is decisive but all of them taken together would generally be relevant for deciding this issue.

- Motive/ object for the purchase of securities
- Period of holding
- Nature, magnitude and frequency of transactions
- Use of borrowed funds vis-à-vis surplus funds
- Circumstances responsible for sale
- Relation of the relevant transaction to the normal business of the assessee
- Marketability of the securities
- Accounting treatment in the books for the amount invested as stock-in-trade or investment in capital assets and profit/loss on sale

As may be noted from above, the circular merely summarizes the principles laid down in several earlier judiciary judgments on characterization of income but does not lay down any objective test for characterization of income. Importantly, the Circular recognises that an assessee could have two portfolios viz., investment portfolio, comprising of securities which are to be treated as capital assets and trading portfolio, comprising of stock-in-trade which are to be treated as trading assets.

Given the above, determination of characterization of income on sale of securities would be a fact sensitive assessment. We understand that the Fund proposes to adopt a position to treat the gains as "capital gains" (in line with the industry practice). In this regard, it would be important that the Funds maintain adequate facts/ documentation to support this position.

[9] No 1827 dated August 31, 1989

K&S Comments: Agree with the view taken. Having regard to the nature of VCF investments that are long term in nature, it may be appropriate to consider such income streams as "capital gains".

Conclusion

Technically, venture capital is just a subset of private equity. But if you take a look beneath the surface, you'll see that they're significantly different. The term "private equity" refers to money invested in private companies, or companies that become private through the investment. Private equity firms are generally interested in the companies which have been already established. The companies may be declining or not generating the expected profits due to inefficiency. Private equity firms buy such companies and streamline their operations to increase revenues and get various tax benefits. Venture capital firms, on the other hand, mostly invest in start-up ventures in the knowledge intensive sectors with high growth potential. Private equity firms generally buy 100% stake in the companies in which they invest due to which the companies comes under the total control of the firm after the buyout. Since they invest in already established and mature companies the chances of absolute losses from such an investment are minimal. Whereas, venture capitalists invest in 50% or less of the equity of the companies as venture capital funds are the risk capital. Most of the Venture capital firms spread their funds and invest in different companies to hedge against the unpredictable chances of failure or success. Private equity firms can buy companies from any industry, while venture capital firms are limited to start-ups in technology, biotechnology and clean technology. Private equity firms also use both cash and debt in their investment, but venture capital firms deal with equity only.