

**TAX HEALTH CHECK ON STRUCTURAL AND OPERATIONAL ISSUES OF
KPB INVESTMENTS**

Due Diligence Report

Client-Attorney Privileged Communication

(Confidential Draft for Discussion Purposes)

June 2, 2010

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MUMBAI • SILICON VALLEY • BANGALORE • SINGAPORE • BASEL • NEW DELHI

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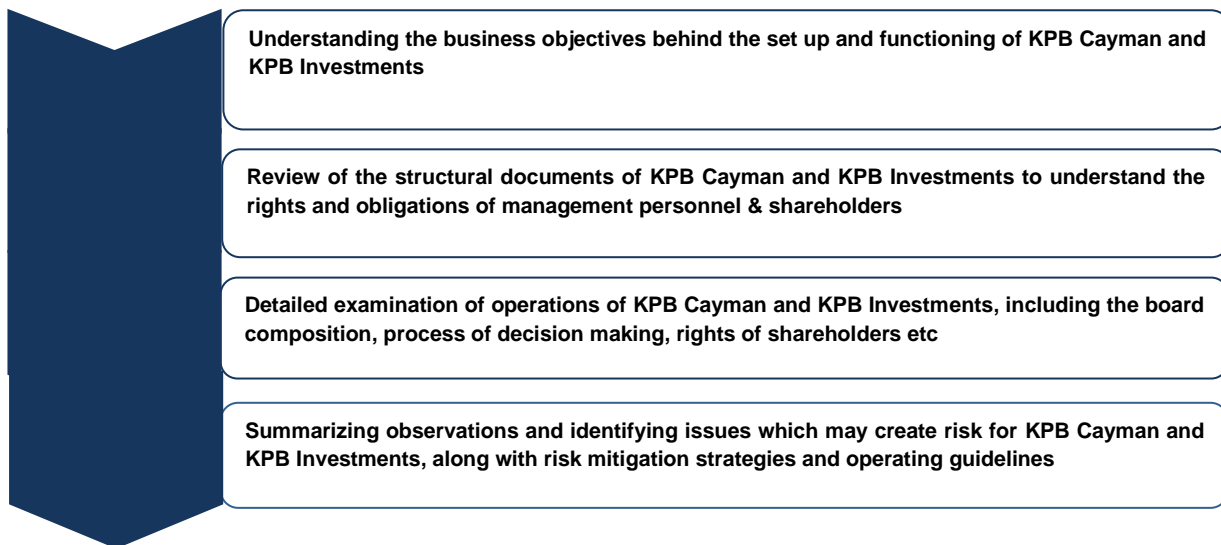
We acknowledge that this draft report has been issued by us for the benefit of the shareholders of KPB Investments and its Board of Directors. It shall not be relied upon by any other person for any other purpose, nor is it to be quoted or referred to in any public document or shown to, or filed with any government authority, agency or other official body without our consent. We are relying on relevant provisions of the Indian laws, regulations, and the judicial and administrative interpretations thereof, which are subject to subsequent modification by legislative, regulatory, administrative, or judicial authorities. Any such changes could have an effect on the validity of our conclusions. This report is specifically in connection with a health check on the structural and operational aspects of KPB Cayman and KPB Investments, to ascertain the risk that KPB Cayman or KPB Investments may be considered to be an Indian resident, or liable to tax in India on account of a presence in India. This report should not be assumed to state general principles of law applicable to such investigations. Our report is based on certain assumptions/ understandings and if the facts are different from our assumptions / understanding, it could have a material impact on our conclusions. Our report is based solely on the information contained in the documents examined by us. Our report is only with respect to Indian law, as we are not qualified to opine on laws of jurisdictions other than those of India. Statements, if any, made in respect of laws of jurisdictions other than India and laws other than the federal laws of India, should be revalidated from the respective local counsel or foreign counsel. The liability assumed by us will be restricted to the professional fees received by us in respect of this report.

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EXECUTIVE SUMMARY

This is with reference to our discussions in relation to potential Indian tax exposure for KPB Investments or KPB Cayman on account of these entities being treated as a 'resident' in India, or being considered to have a business connection in India.

In this regard, Nishith Desai Associates has been appointed to conduct an audit on structural and operational affairs of the entities from an Indian residence and business connection perspective. To achieve this objective, we adopted the following process:



While the findings of our exercise are discussed in detail in the report, we thought that it would be useful to provide a gist of the critical issues with regard to the structure and operations of KPB Cayman and KPB Investments:

- **Capital Calls:** Capital calls are currently sent to Mr. K.P. Balaraj, who is only a shareholder of KPB Investments. It is advisable that capital call notices should be addressed to KPB Investments and directly sent to KPB Investments at its registered address. The Board of KPB Investments should subsequently sanction such payment. No association whatsoever should be created between Mr. K.P. Balaraj as a shareholder and the investments of KPB Investments. Further, the Shareholders of KPB Investments should

not be sent copies of capital calls.

- **Release of Funds for investment:** The approval of Mr. K.P. Balaraj is currently required for the functioning of the bank account or HSBCnet system. This does not support the position that Mr. K.P. Balaraj is a mere shareholder. An alternative may be to require shareholder consent by Ordinary Resolution, for transfer of funds beyond a signified threshold limit. In addition, the Board could provide the shareholders with quarterly reports with respect to all bank transactions of KPB Investments.
- **Management:** The current Directors on the Board of KPB Investments are administrative directors, whose capabilities may be questioned by the Indian tax authorities. From a substance perspective, it would be beneficial for KPB Investments to have another non-resident Director who has some experience in the financial sector. This would strengthen the structure and showcase independent management of KPB Investments.
- **Indian residents as Chairpersons / with veto rights:** We understand that Mr. K.P. Balaraj was a director on the Board of KPB Investments. Going forward, it is advisable that no Indian residents should be present on the Board of KPB Investments. Even if such presence is required from a commercial perspective, it is important to ensure that the Indian resident Director has no casting vote / veto rights, and the Indian resident directors constitute a minority on the Board (excluding Mauritius directors for this purpose).

This has been observed even in relation to the management of KPB Cayman. In the minutes of KPB Cayman dated September 25, 2005, it is mentioned that Mr. K.P. Balaraj and Ms. Priya Balaraj were appointed as directors of KPB Cayman, simultaneous with the resignation of the other directors. As a consequence, the board of KPB Cayman comprised solely of two Indian resident individuals. . Further, Mr. K.P. Balaraj and Ms. Priya Balaraj have signed documents in relation to the management of KPB Cayman (for eg. the 'Written Resolution of The Directors' on May 10, 2000). From an optical perspective it is advisable to avoid such activities being carried on by Indian residents. If KPB Cayman is considered to be a resident of India, revenue authorities may seek to retrospectively affix tax liability with respect to KPB Cayman, even though it has now been liquidated.

- **Shareholder's rights:** As the sole Ordinary Shareholder, Mr. K.P. Balaraj has broad powers under the Constitution with respect to removal of Directors, amendment of Constitution etc. From an optical perspective it would be preferable to have at least one other Ordinary Shareholder in KPB Investments. This Ordinary Shareholder could be a resident or a non-resident of India. K.P. Balaraj could gift some of his Ordinary Shares to a close relative, such as his wife Ms. Priya Balaraj or his brothers, to achieve this objective. In addition, from an optical perspective KPB Investments could also issue certain number of Redeemable Preference Shares, so that such shareholders get some returns from the company. Persons holding Ordinary Shares in the company are not entitled to distributions from the company.

PJ Comment: IS this there in the Constitution? Bcos if the shareholders cant get dist and there are no redeemable shares, how would distribution flow work? Didn't understand this

- **Transfer of assets to KPB Investments:** The documentation relating to the transfer of assets from KPB Cayman to KPB Investments (Master Transfer and Substitution Agreement dated September 29, 2009 and Asset Transfer Agreement dated April 1, 2009) does not seem to create Indian tax exposure for KPB Cayman, KPB Investments or Mr. K. P. Balaraj. However, certain language contained in the Board minutes of KPB Investments seems to suggest that Mr. KP Balaraj received consideration for the transfer of assets by KPB Cayman to KPB Investments. This language could create tax exposure for Mr. K. P. Balaraj, who was an Indian resident at the point of transfer.

I. DEFINITIONS

AAR	means the Authority for Advance Rulings.
Act	means the Indian Income Tax Act, 1961.
Board	means the board of directors of KPB Investments.
Constitution	means the Constitution of KPB Investments.
Director	means any director who may be appointed on the Board of KPB Investments from time to time.
GBC 1	Global Business License – Category 1 issued by the Financial Services Commission, Mauritius.
GBC 2	Global Business License – Category 2 issued by the Financial Services Commission, Mauritius.
India-Mauritius Treaty	means the Agreement for Avoidance of Double Taxation and Prevention of Fiscal Evasion with Mauritius Double tax avoidance Agreement entered into between India and Mauritius.
KPB Cayman	means KPB Cayman, a company incorporated under the laws of Cayman Islands.
KPB Investments	means KPB Investments, a company incorporated under the laws of Mauritius.
Ordinary Shares	means ordinary shares of KPB Investments as defined in its Constitution.
Ordinary Shareholder	means holder of Ordinary Shares
Redeemable Participating Shares	means redeemable participating shares in KPB Investments as defined in its Constitution.
Sequoia Funds	means the various funds into which KPB Cayman and KPB Investments make / have made investments, excluding MBA, SA. Whats this?

II. ASSUMPTIONS

In preparation of this report, we have *inter alia*, relied on the following assumptions:

1. The board of KPB Cayman held no meetings in India.
2. KPB Cayman had no person present in India and acting on its behalf in India, except Mr. K. P. Balaraj and Ms. Priya Balaraj whose roles were limited to the factual description in this report.
3. KPB Cayman made no investments in India.
4. KPB Investments does not currently have any Indian resident as its director.
5. The Board of KPB Investments has held no meetings in India.
6. KPB Investments does not make investments in India.
7. KPB Investments has no person acting on its behalf in India.
8. Mr. K.P. Balaraj and Ms. Priya Balaraj are Indian residents.

III. DOCUMENTS REVIEWED

Structure Documents

1. Certificate of Incorporation of KPB Cayman dated September 25, 2000 ,issued by the Registrar of Companies, Cayman Islands
2. Tax Concessions Certificate issued by the Cayman Islands government on October 10, 2000
3. Written resolution of the directors of KPB Cayman signed on October 5, 2000
4. Written resolution of the initial subscribers of KPB Cayman dated September 25, 2000
5. Minutes of Board meeting of KPB Cayman dated September 25, 2000
6. Resignation of Mr. David Whittome as director of KPB Cayman dated September 25, 2000
7. Resignation of Ms. Susan Harper as director of KPB Cayman dated September 25, 2000
8. Register of officers of KPB Cayman
9. Register of directors of KPB Cayman
10. Register of members of KPB Cayman
11. Register of mortgages and charges of KPB Cayman
12. Certificate of Liquidation of KPB Capital dated February 15, 2010
13. Return of final winding-up meeting of KPB Cayman dated November 13, 2009
14. Resolution passed in shareholders meeting dated September 30, 2009
15. Master Transfer and Substitution Agreement dated September 29, 2009
16. Form of the Asset Transfer Agreement
17. Certificate of Incorporation of KPB Investments dated December 29, 2008 issued by the Registrar of Companies, Mauritius
18. Constitution documents of KPB Investments
19. Director's Register of KPB Investments as on April 9, 2010
20. Share Register of KPB Investments as on April 9, 2010
21. Minutes of Board Meetings of KPB Investments:
 - (i) Minutes of the Board Meetings of KPB Investments dated January 28, 2010
 - (ii) Minutes of the Board Meetings of KPB Investments dated January 20, 2010
 - (iii) Minutes of the Board Meetings of KPB Investments dated August 27, 2009
 - (iv) Minutes of the Board Meetings of KPB Investments dated August 25, 2009

- (v) Minutes of the Board Meetings of KPB Investments dated July 16, 2009
- (vi) Minutes of the Board Meetings of KPB Investments dated June 15, 2009
- (vii) Minutes of the Board Meetings of KPB Investments dated May 19, 2009
- (viii) Minutes of the Board Meetings of KPB Investments dated January 23, 2009

Other Documents

1. Questionnaire filled by Mr. K. Ramanathan received on April 28, 2010 (attached herewith as Annexure B)

Can we say that we have not had a chance to peruse the cons of the Cayman entity?

IV. INTRODUCTION TO THE TAXATION OF COMPANIES IN INDIA

NOT REVIEWED

This section is intended to provide a brief description of the legal regime relating to the taxation of resident and non-resident companies in India, so as to provide a basis for the findings in this report.

Taxation of income in India is governed by the provisions of the Act, as amended annually by the Finance Acts. Under section 4 read with section 5 of the Act, residents are subject to tax in India on their worldwide income whereas non-residents are taxed only on Indian source income i.e. income that accrues or arises in India, is deemed to accrue or arise in India or which is received or is deemed to be received in India. Therefore, in order to ascertain a company's Indian tax liability, determining whether it is a resident in accordance with the Act is the first step.

Determination of Residence

Under section 6(3) of Act, a company is considered a resident of India if it is (i) an Indian company incorporated in India, or (ii) in the case of a foreign company, if *'the control and management of its affairs is situated wholly in India'* during the relevant year. As KPB Cayman was incorporated in Cayman Islands and KPB Investments is incorporated in Mauritius, the two companies should not be considered resident in India under section 6(3)(i). Therefore, it would be relevant to examine the criterion specified in section 6(3)(ii), under which they may be considered resident in India if they are wholly controlled and managed from India.

The expression "control and management" is not defined in the Act, but has been examined by Indian courts in several cases. It is considered to refer to "the head and brain" of the company i.e. the location where board meetings are held and where substantial policy level decisions are taken with regard to the company. Pertinently, it is not equated to the place where one or more of the directors / shareholders normally reside, but where the board actually meets for the purpose of determination of key issues relating to the company¹. These decisions may be those pertaining to the expansion or reduction of business, raising of finances and their appropriation for specific purposes, the appointment and removal of staff etc.

If a company is considered resident in India, its worldwide income could be taxable in India at the rate of 42.23% for the respective years. Therefore, if KPB Investments is considered resident in India, its worldwide income could be taxable at 42.23%. Further, although KPB Cayman has been liquidated, tax authorities have the authority to reopen assessments in relation to the taxation of KPB Cayman for six (6) assessment years, prior to the current year – which would be from 2009-10 up to 2004-05. If assessments are reopened and KPB Cayman considered to be an Indian resident under section 6(3)(ii), its income could be taxable at 42.23% for the relevant previous years.

Taxation of non-residents

¹ *CIT v. Nandlal Gandadal* [AIR 1960 SC 1147]; *CIT v. Narottam and Pereira Ltd. v. CIT* [(1953) 23 Comp Cas 185 (Bom)]; *B. R. Naik v. Commissioner of income-tax, Bombay*, [(1945) 13I TR 124 (Bom)]

As discussed above, if a company is not considered to be resident in India under section 6(3), it is subject to tax only on Indian source income i.e. income that accrues or arises in India, is deemed to accrue or arise in India, is received in India or is deemed to be received in India. Section 9 of the Act deems certain income of non-residents to accrue or arise in India. Under section 9(1) of the Act the 'business income' of a non-resident is taxable in India if it accrues or arises, directly or indirectly, through or from any '*business connection*' in India. Therefore, in order to determine the taxability of the business income of KPB Cayman / KPB Investments for the relevant years, it would be relevant to examine the presence of a business connection for either company during the relevant years.

The term 'business connection' is wide in scope and has not been exhaustively defined in the Act. In section 9(1), it is stated that a business connection includes "any business activity carried out through a person who, acting on behalf of the non-resident has the authority to conclude contracts on behalf of the non-resident" in India. The term has also been given a wide meaning by judicial pronouncements which state that, business connection involves a 'real and intimate' connection between activities carried on by a non-resident outside India and activities in India, which yield profits or gains to the non-resident. Courts are in agreement that a stray or isolated transaction should not constitute a business connection, and an element of continuity is required.²

If KPB Cayman / KPB Investments are considered to have a business connection in India, either company could have its business income subject to tax in India at the rate of 42.23% in the relevant year, to the extent attributable to the business connection.

Here it is relevant to mention that, if the non-resident is situated in a country with which India has entered into a tax treaty, the provisions of the Act only apply to the extent they are more beneficial. As India has a treaty with Mauritius, Mauritius based companies typically choose to be governed by the beneficial provisions of the India-Mauritius tax treaty. However, the benefits of the treaty are available only to Mauritius GBC 1 companies, and not GBC 2 companies such as KPB Investments. Therefore, KPB Investments is not entitled to be governed by the provisions of the India-Mauritius Treaty and its tax liability would continue to be governed by the provisions of the Act. Additionally, KPB Cayman was incorporated in Cayman Islands and Indian does not have a tax treaty with Cayman Islands. Therefore, KPB Cayman would also continue to be governed by the provisions of the Act.

In the next section we will discuss the factual background and examine the exposure to KPB Cayman and/or KPB Investments, of being considered as resident in India or of having a business connection in India, on account of structural deficiencies.

² CIT v. R.D. Aggarwal & Co. AIR 1965 SC 1526

V. BACKGROUND & STRUCTURAL ANALYSIS

KPB CAYMAN:

In this section we have analyzed potential risk for KPB Cayman that may exist on account of the structural aspects of KPB Cayman in India

- **Form of the company:** KPB Cayman was set-up as a Cayman Islands based exempted limited liability company in September 25, 2000.

Observations

As discussed in Section IV of the report, if a non-resident is situated in a jurisdiction such as Cayman Islands, with which India does not have a tax treaty, the provisions of the Act apply to determine the tax liability of such non-resident in India. Thus, tax liability of KPB Cayman in India, if any, will be determined in accordance with the provisions of the Act.

KPB INVESTMENTS:

In this section we have analyzed potential risk for KPB Cayman that may exist on account of the structural aspects of KPB Investments in India

- **Form of the company:** KPB Investments is a Mauritius based private limited company incorporated on December 29th, 2008. The Company holds a GBC 2 license issued by the Financial Services Commission,

Observations

As discussed in Section IV of the report, if a non-resident is situated in a jurisdiction such as Mauritius, with which India has a tax treaty, the provisions of the Act apply only to the extent that they are more beneficial. However, under Mauritius domestic tax laws, only a company holding a GBC 1 license in Mauritius is considered as 'liable to tax' and therefore, eligible to tax treaty benefits. A GBC 2 is not eligible to tax treaty benefits. As a GBC 2, KPB Investments would not be entitled to the benefits of the India-Mauritius treaty with respect to its tax liability in India, which would continue to be governed by the Act.

While the importance of treaty benefits with respect to capital gains income may be not be relevant if KPB Investments does not make investments in India, the tax implications on the business income of KPB Investments will be ascertained with regard to the broader 'business connection' concept rather than the PE concept found under the India-Mauritius Treaty. PJ Comment: Is this similar for snj? Bcos the reason they may have incorporated as gbc2 may be to avoid 3% tax in Mauritius

- **Shareholders and Share Capital:** KPB Investments has Mr. K.P. Balaraj as the sole shareholder. Currently, the capital structure of the Company includes: 5,943,386 Ordinary Shares and no Redeemable Participating Shares.

Observations

Under Article 9 and Article 20 of the Constitution, the Ordinary Shareholders (and Redeemable Preference Shareholders) of the Company have the rights to:

1. Amend or revoke the Constitution, by a Special Resolution by the Ordinary Shareholders.
2. Remove a Director from office, by an Ordinary Resolution on: (i) breach of fiduciary duty towards the Company; or (ii) fraud, misconduct and/or negligence by a Director in discharge of his duties.

Recommendation: The rights exercised by Mr. K.P. Balaraj are exercised in his capacity as the sole shareholder of the Company holding all Ordinary Shares. Please note that it is recognized that the management of a company is distinct from the rights of shareholders of a company; however, as Mr. K.P. Balaraj is entitled to carry out significant changes in the Company such as removal of Directors, amendment of Constitution, etc. single handedly, it may be preferable from an optical perspective to have at least one other Ordinary Shareholder in the Company, who could be resident or non-resident in India. PJ Comment: this is not the reason why we recommend two shareholders. Cos end of the day the second one will also be an Indian resident. The reason is so that it is regarded as a company and hence control and mgt test wholly in India test shd apply

VI. ANALYSIS OF OPERATIONS OF THE COMPANIES

KPB CAYMAN:

In this section we have analyzed potential risk for KPB Cayman that may exist on account of operational aspects such as management activities in India, decision making authority with a person in India etc.

- **KPB Cayman: Board Composition & Board Meetings:** The board of KPB Cayman was comprised of Mr. K.P. Balaraj and Ms. Priya Balaraj, who were resident in India during the relevant point in time. As directors, we understand that Mr. K.P. Balaraj and Ms. Priya Balaraj took all decisions with respect to investments by KPB Cayman. However, these decisions were taken at board meetings held in the Cayman Islands. We understand that KPB Cayman has held no Board meetings in India.

Observations

As per the Minutes of the Board Meeting of KPB Cayman dated September 25, 2005 Mr. K.P. Balaraj and Ms. Priya Balaraj were appointed as directors of KPB Cayman while the other directors had resigned. Further, Mr. K.P. Balaraj and Ms. Priya Balaraj had signed KPB Cayman's 'Written Resolution of the Directors' on May 10, 2000. The presence of Indian residents as directors could result in KPB Cayman being treated as an Indian resident since it was being controlled by such Indian residents. Although KPB Cayman has undergone liquidation, its tax liability can be retrospectively affixed by Indian revenue authorities.

Recommendation: From an optical perspective, it is advisable that no Indian residents are appointed as directors on the board of an offshore company such as KPB Cayman. This is because the directors of a company are responsible for the management of the operations of the company. It could be contended by revenue authorities that the company is managed and controlled by Indian residents and that the company is thus wholly controlled and managed from India and resident in India.

However, please note that, as discussed in Section IV of this report, it is not the place of residence of the directors, but situs of the board meetings which should be considered to determine the control and management of a company.

PJ Comment: I think w shdoulf remove recos frm here cos this is a closed deal and there is no reco on how to change it. We should also say in the begniing that the purpose of analyzing the cayman entity is to look into tax exposure for the past and point out events which could lead to a taxable event. Also, just wondering whether we should say it should be regarded as Indian resident and he is required to pay tax for those years in India rather than saying that it may be.

KPB INVESTMENTS:

In this section we have analyzed potential risk for KPB Investments that may exist on account of operational aspects such as management activities in India, decision making authority with a person in India etc.

- **Past Board Composition: Functions of Mr. K.P. Balaraj as a director of KPB Investments:** Mr. K.P. Balaraj, being an Indian resident, was Director of KPB Investments from January 23, 2009 to March 30, 2010.

However, during this period, he attended no meetings of KPB Investments.

Observations

As the Board meetings were held in Mauritius, and as Mr. K.P. Balaraj did not attend a single meeting of KPB Investments, KPB Investments should not be considered to have been wholly controlled and managed from India during the relevant period. However, such arrangements are undesirable from an optical perspective, as the tax authorities could argue that an Indian resident is on the board of an offshore company would result in the company being controlled and managed from India considering the fact that the remaining two directors are Mauritius administrative directors.

- **Capital Call Process:** KPB Investments has made investments into various Sequoia Funds and is required to make capital contributions periodically on receipt of capital calls from such funds. Presently, all capital call notices are sent by email to Mr. K.P. Balaraj who forwards the same to KPB Investments. On receipt of notice from Mr. K.P. Balaraj, the Board sanctions such payments.

Observations

As per Article 18 of the Constitution, the Board has the sole responsibility with respect to the management of KPB Investments. Since Mr. K.P. Balaraj is no longer a Director, the issuance of capital call notice to him would be inappropriate from an optical perspective. This could be interpreted by tax authorities to allege that Mr. K.P. Balaraj is engaged in the management of KPB Investments.

Recommendation: It is advisable that capital call notices should be addressed to KPB Investments and directly sent to KPB Investments at its registered address. The Board of KPB Investments should subsequently sanction such payment. No association whatsoever should be created between Mr. K.P. Balaraj and the investments of KPB Investments.

- **Operation of bank accounts:** The income of KPB Investments is held in a bank account with HSBC Mauritius, and is used for all the transactions of KPB Investments. The operation of bank account requires the consent of a 'group A signatory' i.e. Mr. K. P. Balaraj, along with a 'group B signatory' being officers of International Financial Services Agreement³.

³ Board minutes dated January 23, 2009 and Board minutes dated June 15, 2009

Additionally, Mr. K. P. Balaraj and Ms. Rubina Toorawa operate HSBCnet System which provides online access to the bank accounts⁴.

Observations

Considering that Mr. K. P. Balaraj is only a shareholder (moreover a sole shareholder) and not engaged with the management of KPB Investments, it is inappropriate that he should have the right to authorize disbursement of funds from the bank account or operate the HSBCnet system.

Recommendation: It is advisable that Mr. K. P. Balaraj should not have such rights with respect to the functioning of the bank account or HSBCnet system of KPB Investments. An alternative may be to require shareholder consent by ordinary resolution, for transfer of funds beyond a signified threshold limit. Additionally, the Board could prepare and produce quarterly report with respect to all bank transactions of KPB Investments to the Shareholders.

- **Appointment of an “observer” on the Board:** Article 20 of the Constitution provides that the Shareholders shall have a right to appoint an “Observer” on the Board of KPB Investments.

Observations

Recommendation: There should be no issues if the Indian resident shareholders appoint an Observer on the Board of KPB Investments. However, if the Observer is an Indian resident such as Mr. K. P. Balaraj, the appointment should not confer any voting rights on him. Further, it is vital that the Observer should have limited powers with respect to KPB Investments and that his rights should be restricted to receiving notice and agenda for all Board meetings, the right to attend all Board meetings and the right to receive the minutes of the meetings. No management/veto powers should vest in the Observer.

- **Service Agreement:** The Board minutes dated January 23, 2009 provide that a service agreement was been entered into between International Financial Services Limited and Mr. K. P. Balaraj.

Observations

Recommendation: All the agreements between KPB Investments and third parties should be entered into by an authorized Director and not the shareholders.

- **Business Plan:** The business plan of KPB Investments has been signed by Mr. K. P. Balaraj with his Indian address.

Observations

Recommendation: Mr. K. P. Balaraj should avoid signing any documents relating to KPB Investments in his individual capacity as a shareholder or as a director, for reasons discussed above.

⁴ Board minutes dated May 19, 2009

VII. TRANSFER OF ASSETS TO KPB INVESTMENTS

- **Board minutes**

The Board Minutes of KPB Investments dated January 20, 2010 provide the following:

- (i) Mr. K.P. Balaraj injected USD 1,642,301 representing the cash balance of KPB Cayman in exchange for shares of KPB Investments; and
- (ii) *"It was noted that the consideration for the transfer of investments from KPB Capital and Mr. K. P. Balaraj to the Company would be principally in kind with a nominal cash payment of USD 100 to KPB Capital as required under the Asset Transfer Agreement dated 1 April 2009 and the difference would be satisfied by the issuance of Ordinary Shares to Mr. K. P. Balaraj in the capital of the Company."*

Observations

The Board Minutes dated January 20, 2010 give an impression that Mr. K. P. Balaraj was issued shares of KPB Investments in lieu of assets transferred by KPB Cayman. Additionally, the Board Minutes provide that Mr. K. P. Balaraj was issued shares of KPB Investments in lieu of the cash balance of KPB Cayman transferred to KPB Investments.

Such statements should be avoided as these statements pertain to look through the company (KPB Cayman, in this case) and attribute all assets of KPB Cayman to its shareholder, being Mr. K.P. Balaraj. Such statements could create tax exposure for Mr. K.P. Balaraj in India.

VIII. OPERATING GUIDELINES

• Importance of establishing substance in KPB Investments

In India, it has been recognized through a plethora of judgments that every person has the right to plan his affairs so as to mitigate its tax liability. Indian tax jurisprudence follows the rule of 'form over substance', which means that the determination of tax liability of any person shall be based on the legal form of the transaction undertaken as opposed to the underlying intent or substance. This principle has been reiterated by the Supreme Court of India in landmark case of *Azadi Bachao Andolan*⁵ where the form of the Mauritius entity was respected and benefits of the India Mauritius treaty allowed to entities with a valid tax residency certificate.

In the recent past however, revenue authorities have been growing increasingly aggressive with respect to the substance of Mauritius based companies. In doing so, they have often disregarded the well established jurisprudence on the subject. For instance, recently in the *E*Trade*⁶ case, there was sale of shares of an Indian listed company by a Mauritius tax resident entity, a transaction which, as per the India-Mauritius Treaty, should have been subject to tax only in Mauritius. The tax authorities refused to allow benefits, ruling that the Mauritius entity was "simply a façade" and the "capital gains may not have arisen to it but to its US parent". However, in a subsequent application made by *E*Trade Mauritius* to the AAR, the claim of the taxpayer with respect to eligibility to benefits under the India-Mauritius Treaty and the consequent exemption to capital gains income has been upheld.

In another case involving *Vodafone*⁷, the existence of the Mauritius subsidiary was looked through entirely. Revenue authorities sought to levy tax on the transfer of a foreign entity amongst two non-residents, merely because of the presence of an underlying Indian entity. There are also proposed legislative amendments which make it important to ensure substance, such as the general anti-avoidance rule proposed by the draft Direct Tax Code Bill, which allows revenue authorities to re-characterize taxpayer arrangements if it appears that they are motivated by the intention to avoid tax.

While there can be no certainty as to the application of the 'form over substance' principle, non-resident taxpayers can strengthen their case by ensuring that activities at the Mauritius level have substance and do not appear to be a mere 'sham', created for the purposes of tax avoidance. In this section we will discuss the structural protections already in place as well as the operational guidelines which would assist in establishing substance in KPB Investments. We will also recommend guidelines to ensure that KPB Investments is not considered to be wholly controlled and managed from India and a resident of India, and to protect against KPB Investments being considered to have a business connection in India.

Here is a list of factors which have in the past been considered to add to substance at the company level. We have examined such factors with reference to the structure and operations of KPB Cayman and KPB Investments:

- **Whether there is commercial justification to the transaction, separate from the tax objective?** As both KPB Cayman and KPB Investments made several investments into Sequoia and non-Sequoia funds, it could be considered to be an investment entity and so has a commercial justification for being established in favourable tax jurisdictions, such as Cayman Islands and Mauritius, respectively.

⁵Union of India and Anr. v. Azadi Bachao Andolan and Anr. 263 ITR 706 (SC)

⁶ *E*Trade Mauritius Limited v ADIT & Ors* WP. No. 2134 of 2008

⁷ [2008] 175 Taxman 399 (Bom.)

- **Whether the board of the company exercises sufficient decision making power?** It is important to have individuals, not being resident in India, as a majority on the board of an offshore company. Additionally, certain number of directors should have the capability to take decisions with respect to the management and operations of the company.

KPB Cayman, for example had Mr. K. P. Balaraj and Ms. Priya Balaraj as directors on the board. While such board composition evidences the capability to operate the company, since these individuals are Indian residents, it could create tax risk for KPB Cayman in India.

On the other hand, KPB Investments currently has Mr. Couldip Basanta Lala and Ms. Rubina Toorawa on the board. While these individuals are not Indian residents, the risk of KPB Investments being controlled and managed from India is low; however, this board composition does not evidence the capability to operate the company.

It is important to achieve the right balance between the two extremes.

- **Whether the company has any employees?** If KPB Investments appoints employees for decision making with respect to investments, this may add to substance at KPB Investments level. However, it is important to note that none of these employees should be resident in India.

We have provided herein guidance in the form of Do's and Don'ts, which may be followed in the context of KPB Investments, in order to minimize the tax risk. For the purpose of this guidance note, we have provided the discussion as below.

At the outset, please note that these are merely guidelines and no assurance is given that if these guidelines are followed a business connection of KPB Investments may not be constituted or sufficient substance in Mauritius will not be challenged. However, adherence to these factors in the past has assisted parties with establishing substance and mitigating tax exposure.

Do's and Don'ts for KPB Investments

During the life of KPB Investments, the following should be taken into consideration:

1. KPB Investments should, at all times, have at least two Mauritian Directors on its Board. Persons qualifying as residents of India should not constitute a majority on the Board at any time nor have any veto rights in the exercise of its powers of the Board.
2. An Indian resident may only be appointed as a Director on the Board if the rest of the Board consists of non-Indian residents in majority, excluding the administrative directors.
3. It is advisable that the Board of KPB Investments should consist of at least a few persons (or at least one such person if total number of Directors in Mauritius is two) capable of performing their functions. Appointment of capable employees also adds to substance at the Mauritius level.
4. All major transactions of KPB Investments should be proposed and ratified by the Board. It should be ensured that the Board is convened for its meetings by a Mauritius Director only.
5. There should be at least one physical Board meeting every year in Mauritius, wherein all Directors are present, and at least four Board meetings annually should be conducted in Mauritius (including the physical board

meetings). While it is possible for Indian residents to participate via video conference facility, it is important to keep in mind that there should not be any delegation of authority or veto rights in favor of any Indian resident to take unanimous decisions. No Indian resident should act as the 'Chairman' for a Board meeting.

6. The minutes of the Board meetings should be circulated to the Directors and the Observer, if any, after the conclusion of the meeting and not prior to that.
7. No Indian Director should sign documents on behalf of KPB Investments.
8. No contracts on behalf of KPB Investments should be concluded in India.
9. Bank operating instructions and cheque signing for bank accounts, of and on behalf of KPB Investments should be exercised outside India.
10. Books of account, board minutes and other documentation relating to the operations of KPB Investments should be kept outside India.
11. Capital calls should not be directed to an Indian resident. All capital calls should be addressed to KPB Investments.
12. There should be a mechanism in place for to meet any claw-back requirements from the Sequoia Funds. One option which could be explored is creating a reserve to meet future liabilities and contingencies of KPB Investments. A specified percentage of the investment proceeds received by KPB Investments could be transferred annually to provide for the reserve. The Constitution could be amended to provide for this mechanism.

IX. CONCLUSION

As per our analysis above, KPB Cayman had no establishment, place of business or activities in India. However, the directors on the board of KPB Cayman were resident Indian directors. Therefore, there is tax exposure for KPB Cayman in India. On the other hand, KPB Investments has no establishment, place of business or activities in India or anyone authorized to take decisions or conclude contracts on behalf of KPB Investments in India. Therefore, KPB Investments should not be considered to be a resident in India or a non-resident with a business connection in India. However, it would be important to build in checks to ensure substance at KPB Investments level, as per the operational guidelines specified above. Further, it would be important to ensure that Mr. K.P. Balaraj as shareholder is not considered to be in a managerial capacity with respect to KPB Investments in India.

ANNEXURE A: LIST OF SEQUOIA FUNDS

Investment in:	Jurisdiction
1. CBD Holdings	Cayman Islands
2. SC India Management II, LLC	Mauritius
3. SC India GF Management I, LP	Cayman Islands
4. SC India GF Principal Fund I	Cayman Islands
5. SC India Management III, L.P	Cayman Islands
6. SC India Principal Fund III L.P	Cayman Islands
7. SC XII Principal Fund	Cayman Islands
8. SC China GF Principal Fund	Cayman Islands
9. SC China Principal Fund II	Cayman Islands
10. SC India GF Management II, LP	Cayman Islands
11. Sequoia Capital India Operations LLC	Mauritius
12. Sequoia Capital Global Equity Fund	Cayman Islands
13. Investment in MBA-SA	BVI Islands

ANNEXURE B: QUESTIONNAIRE**QUESTIONNAIRE IN RESPECT OF THE PERSONAL HOLDING COMPANY (PHC)****Draft for discussions only****Client-Attorney Privileged Communication**

Name: K.P. Balaraj

Designation: MD

Company: Sequoia Capital India

Please answer the following questions –

I. PHC

1. When was the PHC set up and in which jurisdiction? What is the form of entity in which the PHC has been set up? Please also indicate as to who are the administrators along with contact details of the relevant individual(s).

Name	KPB Capital*	KPB Investments
Date of Incorporation	September 25, 2000	December 29, 2008
Jurisdiction	Cayman Islands	Mauritius
Type of entity	Corporation	GBC 2 entity
Administrators	The Walkers, Cayman Islands	IFS, Mauritius
Contact persons	Mr. Anthony Johnson	Ms. Reshmah & Ms. Shamilee

***The entity has now been liquidated and all the assets and liabilities has been transferred to KPB Investments- Master Transfer and Substitution Agreement is attached.**

2. Have any returns (whether tax related or otherwise) been filed with concerned authorities in India or in any other jurisdiction?

No

II. OWNERSHIP AND CONTROL & MANAGEMENT

3. Who are the existing shareholder(s) of the PHC? Please also let us know the residential status in India of each of the shareholders, and the jurisdiction of which each of these are resident (if not India).⁸

Name	KPB Capital	KPB Investments
Shareholders	K.P.Balaraj	K.P.Balaraj
Resident Status	At the time of incorporation was a US citizen in 2000 and later became an Indian citizen	Since incorporation of the entity, the shareholder is a resident Indian.

4. Describe the manner of acquisition of shares of the PHC (whether it was by way of subscription or purchase of existing shares) and the tax residential status of original shareholders at the time of such share subscription/ acquisition. What was the manner of acquisition of shares of the PHC by the shareholders? Was any amount remitted from India?

Name	KPB Capital	KPB Investments
Manner of acquisition of shares	Out of funds earned outside India	Out of funds earned outside India
Tax Resident Status	US tax filer.	Indian tax filer

5. Who are the existing director(s) of the PHC? (Please also let us know the residential status in India of each of the directors, and the jurisdiction of which each of these are resident (if not India).

⁸ In this regard, you may refer to a copy of the passport of the concerned individuals and their travel details during the relevant previous years.

Name	KPB Capital	KPB Investments
Existing Directors	The firm is liquidated. Prior to liquidation, KP and DMS, Cayman Island were directors	Mr. Couldip Basanta Lala Ms. Rubina Toorawa
Resident Status	Mauritius	Mauritius

6. Have there been any change of director(s)/shareholder(s) of the PHC since incorporation? If yes, who were the original director(s)/shareholder(s) and please provide the history of ownership and directorship since incorporation.
7. Where do the meetings of the board of directors of the PHC take place? ⁹ Have any meetings taken place in India? Were any meetings attended by persons by way of teleconference or videoconference from India? Were any of these meetings chaired from India?

Board Meetings were held in the respective jurisdictions. None of these meetings were either held in or chaired from India.

8. Are there any Indian resident individuals who are serving as 'observer' on the board of the PHC? If yes, what is the role of such 'observer'?
- No**
9. What the different rights of the shareholders of the PHC? ¹⁰

Voting rights, redemption rights etc.

10. Are there any specific authorities given to Indian resident individuals? (Irrespective whether such individual is a shareholder/ director of the PHC). ¹¹

Authorised Signatory to Main Bank Account.

Right to appoint Director / Observer.

11. Please provide the following corporate documents of the PHC –

⁹ This does not mean where one or more of the directors normally reside but where the board actually meets for the purpose of determination of the key issues relating to the company.

¹⁰ For example, power to appoint persons to serve on such boards of directors, investment committee, etc. arising by virtue of their status as shareholders of the PHC.

¹¹ This may include signing authority for general operations of the corporate bank account of the PHC, etc.

(a) Constitution; and **Draft attached**

(b) Sample/extracts of the minutes of the meeting of the board of directors and shareholders and resolutions passed. Sample attached

III. ASSETS AND SOURCES OF INCOME

12. Please provide an updated list detailing the assets held by the PHC. Please also indicate the jurisdiction in which each such asset is situated.¹²

Investment in:	Jurisdiction
CBD Holdings	Cayman Islands
SC India Management II, LLC	Mauritius
SC India GF Management I, LP	Cayman Islands
SC India GF Principal Fund I	Cayman Islands
SC India Management III, L.P	Cayman Islands
SC India Principal Fund III L.P	Cayman Islands
SC XII Principal Fund	Cayman Islands
SC China GF Principal Fund	Cayman Islands
SC China Principal Fund II	Cayman Islands
SC India GF Management II, LP	Cayman Islands
Sequoia Capital India Operations LLC	Mauritius
Sequoia Capital Global Equity Fund	Cayman Islands
Investment in MBA-SA	BVI Islands

¹² The monetary value of the assets need not be indicated.

13. Please provide details/ specifics of other investments (including capital calls for private equity funds, etc). **None**
14. Specifics of all the streams of Income (whether such income is sourced from India or other jurisdictions).¹³ –

Management Fee (now known as distribution of surplus by funds)

Dividend Distribution

Carried interest

Income from treasury operations

IV. REPATRIATION

15. Whether funds from the PHC (any part thereof) have been repatriated till date? If yes, please provide specifics of the date(s) and manner of such repatriation.

No

16. What are the long term objectives with respect to the PHC? (Holding up investments, retaining capital accrued from offshore sources, etc could be considered as such objectives).

As discussed with KP, NDA to suggest options

V. OTHERS

17. Let us know if there is any other information/issue/situation that you believe would be of relevance for our advice to you and has not /not adequately been captured in entirety.

Structure of the MBA-SA investment. As discussed with Mr.Bharat Shetty in Singapore over teleconference.

¹³ The monetary value of the income stream need not be indicated.