

**PERMANENT ESTABLISHMENT AUDIT  
ON STRUCTURAL AND OPERATIONAL ISSUES OF  
CANAAN VIII L.P.**

**Due Diligence Report  
(Preliminary Draft)**  
April \_\_\_\_, 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 Canaan India (defined below). 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 the relevant Tax Treaty provisions, provisions of Indian law, regulations and the judicial and administrative interpretations thereof, which are capable of being subsequently modified by the relevant 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 the health check on the structural and operational issues (from a Permanent Establishment perspective) of the Fund. The report should not be assumed to state general principles of law applicable to such investigations. This report is based on some assumptions/ understandings and if the facts are different from our assumptions / understandings, it could have material impact on our conclusions. This 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.

## **INDEX**

<b>EXECUTIVE SUMMARY .....</b>	<b>2</b>
<b>ASSUMPTIONS .....</b>	<b>2</b>
<b>DEFINITIONS .....</b>	<b>2</b>
<b>LIST OF DOCUMENTS EXAMINED.....</b>	<b>2</b>
<b>I. INTRODUCTION .....</b>	<b>2</b>
<b>II. CONCEPT OF BUSINESS CONNECTION AND PERMANENT ESTABLISHMENT .....</b>	<b>2</b>
<b>III. PE ANALYSIS OF STRUCTURE .....</b>	<b>2</b>
<b>IV. PE ANALYSIS OF FUND DOCUMENTATION .....</b>	<b>2</b>
<b>V. OBSERVATIONS ON THE OPERATIONAL ASPECTS .....</b>	<b>2</b>
<b>VI. ANALYSIS OF INFORMATION IN PUBLIC DOMAIN .....</b>	<b>2</b>
<b>VII. PE EXPOSURE: OPERATING GUIDELINES .....</b>	<b>2</b>
<b>VIII. CONCLUSIONS AND SUGGESTIONS.....</b>	<b>2</b>

## EXECUTIVE SUMMARY

Canaan India is engaged in the activity of providing investment research and analysis services to the Advisory Company of the Fund. It has approached Nishith Desai Associates to conduct an audit (from a Permanent Establishment perspective) on the structural and operational issues in connection with the Canaan VIII Entities (as defined below). [SH: PJ is this language fine wrt Canaan India authorizing NDA to conduct a health check on the fund? Do we need something else indicating that Canaan India was instructed by the Del advisor or something?]

Pursuant to this mandate, we commenced the exercise of conducting a thorough due diligence on the structure and operations of the Canaan VIII Entities in order to ascertain the risk to which they are exposed, of being regarded as having Permanent Establishments (“PE”) in India. To achieve this objective, we adopted the following process:

[Neha: Parul, we shall insert a diagram here representing the steps in undertaking this audit., similar to the one on the IDFC report.]

This report highlights our findings pursuant to the exercise of conducting an audit on the current structure and operations of the Canaan VIII Entities.

The Fund is constituted as a limited partnership in the Cayman Islands. It is managed by the Manager, a Delaware limited liability company, being the general partner to the Fund. The Manager has absolute authority to make investment and divestment decisions with respect to the Fund. The General Partner has appointed a Delaware corporation, as the Advisory Company to provide advisory services to the Fund. However, such delegation specifically excludes from its purview decisions relating to operations of the Fund, that is the investment and divestment decisions of the Fund. The Advisory Company has appointed Canaan India, an Indian private limited company as the Sub-Advisor to provide non-binding advice and perform other specified services. [They don't hv a Mauritius manager? We shud recommend setting up one if possible...also does the manager decide investment into Mauritius or into india?]

The Fund has set up Canaan Mauritius as a Mauritius based private company engaged in the activity of making investments into India. Canaan Mauritius is registered as an FVCI with the SEBI, India.

*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 Fund's structure and operations which need to be urgently addressed.*

*Please note that the capitalized terms used in the Report have been defined on page [•] and [•].*

### Observations

On perusal of all documents relating to the structure and operations of Canaan VIII Entities, we observe the following issues emerge which could create adverse tax consequences for the Canaan VIII Entities in India.

- It has been observed across various documents that the office of Canaan India is referred to as the 'Indian office' of the Canaan Group and not an affiliate entity set up in India to undertake specific operations. Such references undermine the status of the independent nature of Canaan India and rebut the stand the Canaan India operates independently.
- It has been observed that Mr. Alok Mittal is referred to as the 'General Partner of Canaan at India' or 'Managing Director, Canaan Partners', which indicates that Mr. Alok Mittal is associated with the Canaan Group and is not an employee of Canaan India. Such reference should be avoided so that Mr. Alok Mittal is not considered to have management powers with respect to the Fund. Similar approach should be employed for other personnel employed by Canaan India, including Mr. Harish Gandhi.
- The scope of services of the Sub-Advisor in the Sub-Advisory Agreement has been enumerated inclusively. The Sub-Advisory Agreement should be amended and the scope of activities of the Sub-Advisor should be enumerated in specific terms.

## **ASSUMPTIONS**

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

1. None of the Fund, the Manager, Advisory Company or Canaan Mauritius own or lease any office or place of business in India.
2. None of the Fund, the Manager, Advisory Company or Canaan Mauritius have any employees in India.
3. None of the Fund, the Manager, Advisory Company or Canaan Mauritius have any person located in India who has authority to make investment, divestment or management decisions for the Fund or Canaan Mauritius. All such decisions of the Fund and Canaan Mauritius are made by the Manager and the Board of Canaan Mauritius.
4. The Fund does not carry out any activity in India. All Indian investments are made by Canaan Mauritius.
5. The Fund has no agents/ employees/ personnel in India who operate or conclude contracts on behalf of the Fund.
6. The directors on the Board of the Advisory Company are not resident Indians and all Board meetings of the Advisory Company are held outside India.
7. The persons on the board of the Manager are not resident Indians and that all meetings of the 'managers' are held outside India.
8. Mr. Guy M. Russo is not a resident of India.

Aren't some of these what they would have asked us to opine on?

## **DEFINITIONS**

<b><u>Term</u></b>	<b><u>Definition</u></b>
<b>AAR</b>	means the Authority for Advance Rulings established under section 245-O of the Act.
<b>Act</b>	means the Income Tax Act, 1961, as amended from time to time.
<b>Advisory Agreement</b>	means the agreement entered into between the General Partner and the Advisory Company on November 19, 2007, as amended from time to time.
<b>Advisory Company</b>	means Canaan Management Inc., a corporation set up in Delaware.
<b>Advisory Fee</b>	means the fee payable to the Manager to the Advisory Company pursuant to Clause of the Advisory Agreement.
<b>Board</b>	means the board of directors of Canaan Mauritius
<b>Canaan Group</b>	refers to Canaan Partners, being the venture capital firm, being referred to collectively
<b>Canaan Mauritius</b>	means Canaan VIII Mauritius, incorporated as a private company in Mauritius.
<b>Canaan VIII Entities</b>	refers collectively to the Fund, the Manager, Canaan Mauritius and Canaan India
<b>Fund</b>	means Canaan VIII L.P. set up as a limited partnership in Cayman Islands
<b>FVCI</b>	means a foreign venture capital investor, registered with SEBI under the SEBI (FVCI) Regulations, 2000 .
<b>General Partner</b>	means Canaan Partners VIII LLC, set up as a limited liability company in Delaware.
<b>India-Mauritius Tax Treaty</b>	means the Convention between the Government of the Republic of India and the Government of Mauritius for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and capital gains.
<b>India-US Tax Treaty</b>	means the Convention between the Government of the Republic of India and the Government of United States of America for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and capital gains.

<b>Limited Partnership Agreement or LPA</b>	means the limited partnership agreement of the Fund
<b>Management Fee</b>	means the fee payable by the Fund to the Manager pursuant to the Clause 5.2.2 of the Limited Partnership Agreement.
<b>Material Documents</b>	[shall include]
<b>PE</b>	means permanent establishment.
<b>SEBI</b>	means the Securities and Exchange Board of India.
<b>Sub-Advisor or Canaan India</b>	means Canaan Advisors Private Limited, incorporated under the Companies Act, 1956.
<b>Sub-Advisory Agreement</b>	means an agreement entered into between the Advisory Company and Canaan India on July 19, 2006, as amended from time to time.



## **LIST OF DOCUMENTS EXAMINED**

In preparing this Report, we have examined the following documents:

1. Private Placement Memorandum dated June 30<sup>th</sup>, 2007
2. Limited Partnership Agreement dated November 19<sup>th</sup>, 2007
3. Form of Subscription Agreement draft of September 21, 2007
4. Advisory Agreement dated November 19<sup>th</sup>, 2007
5. Sub-Advisory Agreement July 19<sup>th</sup>, 2006
6. Constitution of Canaan VIII Mauritius dated December 7<sup>th</sup>, 2007
7. Certificate of incorporation of Canaan Mauritius dated September 13<sup>th</sup>, 2007
8. Tax Residency certificate of Canaan VIII Mauritius dated September 14<sup>th</sup>, 2007
9. Category 1 Global Business License for Canaan VIII Mauritius dated September 14<sup>th</sup>, 2007
10. Application for FVCI Registration filed by Canaan VIII Mauritius dated March 21<sup>st</sup>, 2008
11. SEBI Letter granting FVCI Registration to Canaan VIII Mauritius dated January 6<sup>th</sup>, 2009
12. List of Directors of Canaan VIII Mauritius
13. Notice and agenda for Board Meetings of Canaan Mauritius (as detailed below)
14. Minutes of Board Meetings of Canaan Mauritius (as detailed below)
15. Memorandum of Association of Canaan Advisors Private Limited Dated September 15<sup>th</sup>, 2008
16. Business Cards of
  - a. Alok Mittal
  - b. Harish Gandhi
  - c. Aniruddh Singh
17. Letter head of Canaan India.
18. Press releases (as detailed below)

### **Minutes of Board Meetings:**

- (i) Board Meeting held on September 25, 2008
- (ii) Board Meeting held on October 31, 2007
- (iii) Board Meeting held on December 7, 2007
- (iv) Board Meeting held on December 28, 2007
- (v) Board Meeting held on March 24, 2008
- (vi) Board Meeting held on May 22, 2008
- (vii) Board Meeting held on July 25, 2008
- (viii) Board Meeting held on August 25, 2008
- (ix) Board Meeting held on November 14, 2008
- (x) Board Meeting held on December 19, 2008
- (xi) Board Meeting held on January 23, 2009
- (xii) Board Meeting held on June 23, 2009
- (xiii) Board Meeting held on June 26, 2009
- (xiv) Board Meeting held on August 27, 2009

- (xv) Board Meeting held on September 8, 2009
- (xvi) Board Meeting held on December 3, 2009

**Press Releases:**

- (i) *'Canaan Partners, a 19-Year-Old Silicon Valley Venture Capital Firm, Opens an Investment Office in India'* dated June 6, 2006
- (ii) *'Yahoo and Canaan Partners invest US \$8.95 Million in BharatMatrimony'* dated August 2, 2006
- (iii) *'Canaan Partners Leads \$3.1 M Investment In Iyogi'*
- (iv) *'Canaan Partners Names Alok Mittal as Managing Director'* dated July 10, 2007
- (v) *'Canaan Partners Leads TechTribe's First Venture Investment Round'* dated July 25, 2007
- (vi) *'Canaan Partners Leads \$5.25 M Investment in Cellcast Asia'* dated August 21, 2007
- (vii) *'Canaan Partners Appoints Harish Gandhi as Executive Director'* dated January 15, 2008
- (viii) *'Canaan Partners Closes \$650 Million Canaan Fund VIII'* dated February 6, 2008
- (ix) *'UnitedLex secures US\$ 6 million in Series B funding led by Canaan Partners and Helion Venture Partners'* dated July 23, 2008
- (x) *'iYogi Secures \$9.5M in Series B Funding Led by SAP Ventures, with follow-on investment from Canaan Partners and SVB India Capital Partners'* dated July 24, 2008
- (xi) *'Canaan Partners and Accel India invest in Chakpak to build a Next-Generation Online Entertainment Community from India'* dated December 22, 2008
- (xii) *'Canaan Partners invests in mCarbon to accelerate consumer centric Value Added Services (VAS) for Telecom Operators'* dated February 10, 2009
- (xiii) *'Canaan Partners Appoints Former Yahoo! and Symantec Executive, Sharad Sharma, as Entrepreneur-in-Residence'* dated May 28, 2009
- (xiv) *'Canaan Partners invests in MotorExchange to Build a Unique Used Car Exchange Platform'* dated December 18, 2009

## I. INTRODUCTION

### THE FUND

The Fund was set-up in June 2007, as a limited partnership in the Cayman Islands. The primary investment focus of the Fund is to invest into privately held companies, in the technology and healthcare sectors in USA, Israel and India.

The Fund has set up Canaan Mauritius as a GBC 1 company in Mauritius. Canaan Mauritius is registered as an FVCI with SEBI in India, and is engaged in the activity of making investments into India.

The Fund is managed by the Manager, a limited liability company in Delaware, which is the general partner to the Fund. The Manager has appointed the Advisory Company, a corporation in Delaware to provide certain advisory services to the Fund. The Advisory Company has in turn engaged a Sub-Advisor in India, which is set up as a private limited company in India. The role of the Sub-Advisor is limited to providing non-binding advice to the Advisory Company and undertaking analysis as directed.

Shud we insert the structure chart here as well?

### INDIAN TAX EXPOSURE ANALYSIS FOR THE CANAAN VIII ENTITIES

In order to determine the Indian tax exposure for each Canaan VIII Entity, it would be relevant to examine the residence status of the respective entity, the activities carried on by such entity in India and whether India has a tax treaty with the country in which such entity is resident.

Under the Indian domestic law, non-residents are taxable only on Indian source income (Please see Section II for details). The business income of a non-resident is considered to have a source in India and is taxable in India if attributable to a 'business connection' of the non-resident in India. Capital gains earned by a non-resident are considered to be taxable in India if they are from transfer of a capital asset situated in India. However, if the non-resident is situated in a country with which India has a tax treaty, the provisions of the Act apply only to the extent they are more beneficial. Canaan Mauritius and the US based Manager / Advisory Company could thus choose to be treated under the provisions of the India-Mauritius or India-US treaty respectively.

Contained below is a brief description of the issue with respect to specific Canaan VIII Entities:

**Canaan Mauritius:** As per a beneficial provision contained in the India-Mauritius tax treaty, when Canaan Mauritius derives capital gains from the sale of an Indian company's shares, such gains would be taxable only in Mauritius and not in India. However, this benefit would not apply if Canaan Mauritius is deemed to have a 'PE in India.

Further, there is some ambiguity in India as to whether the income of a private equity fund should be characterized as capital gains income or business income. If Indian revenue authorities classify the income of Canaan Mauritius as business income, and if it is considered to be attributable to a PE of Canaan Mauritius in India, such income could be subject to tax in India at the rate of 42.23%.

**Manager / Advisory Company:** Additionally, in accordance with the provisions of the India-US Tax Treaty read along with Act, the operations of the Manager and the Advisory Company and their relation with the Sub-Advisor could create PE exposure for such entities in India.

**Fund:** As India does not have a tax treaty with the Cayman Islands, the Fund would continue to be governed by the provisions of the Act and the business connection test. However, as per our assumption that the Fund undertakes no activities in India, has no agents/ employees/ personnel in India who operate or conclude contracts on behalf of the Fund, or any other presence in India, there should be no tax exposure for the Fund in India.

In each of the situations above, if the relevant Canaan VIII Entity is considered to have a PE in India, its income could be taxable in India at the rate of 42.23% to the extent attributable to a PE. Therefore, it is vital to determine the extent of PE exposure to the relevant Canaan VIII Entities

In this context please note that the Indian tax exposure on account of business connection and PE are highly fact specific and subjective and can vary in accordance with the specific facts and circumstances of each case. However, it is possible to conduct a review of the documentation and operations to provide recommendations with respect to mitigation of Indian PE exposure.

In furtherance of this objective, **Canaan India** has engaged Nishith Desai Associates to conduct a thorough scrutiny of the current structure and operations of the Canaan VIII Entities, in order to ascertain the risk of the entities being considered to have a business connection or PE in India. The purpose of this report is to detail and analyze the findings of our due diligence exercise, as well as to discuss the broad parameters within which the Fund and Canaan Mauritius should operate in order to mitigate Indian tax exposure.

*We will first discuss the position in law on the business connection and PE concept, especially with regard to investment funds, so as to provide a basis for the findings in this report. We will then examine the structure of the Fund, both independently and as expressed in the Material Documents. As a third step, we will examine the operations of the Canaan VIII Entities, including the process of decision making, investment and divestment process, marketing of the Fund etc. We will then summarize our observations and detail some operational guidelines within which the activities of the Fund, Canaan Mauritius, the Manager, the Advisory Company and the Sub-Advisor should ideally be conducted.*

## **II. CONCEPT OF BUSINESS CONNECTION AND PERMANENT ESTABLISHMENT**

### **Not reviewing this section**

Taxation of income in India is governed by the provisions of the Act as amended annually by the Finance Acts. Under 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, it is first important to determine the residence status of the Canaan VIII Entities in India.

### **DETERMINING RESIDENTIAL STATUS**

Section 6 of the Act is the provision relating to the determination of residential status of a taxpayer.

Under section 6(2), a partnership is considered a resident of India unless the control and management of its affairs is situated wholly outside India during the relevant year. Therefore, as the Fund is set up as a partnership, it may be considered to be an Indian resident even if it's a fraction of its control and management is considered to be situated in India during the relevant year.

The rule for determining the residence of companies is contained in section 6(3) of the Act. As per section 6(3), an Indian incorporated company is considered resident in India. Further, a foreign incorporated company can be considered to be a resident in India if during the relevant year, control and management of its affairs is situated wholly in India. The term 'control and management' is referred to mean the central control and management as determined by the location where the board of directors of the company meets and takes decisions with respect to the operations of the company. This provision is relevant for the determination of the residency status of Canaan Mauritius, the Manager and the Advisory Company.

In Chapter V which deals with operational aspects, we have examined the impact of these provisions on the Indian residency status of the Canaan VIII Entities. Further, please refer to the operational guidelines in Section VII which provide recommendations for mitigating the possibility of the Fund / Canaan Mauritius being considered resident in India.

### **BUSINESS CONNECTION**

The income of non-residents may be subject to tax in India if it accrues or arises or is deemed to accrue or arise in India, or if it is received or is deemed to be received in India. Section 9 of the Act deems certain kinds of income to have an Indian source.

Under section 9(1), 'capital gains' are considered to have their source in India and are taxable in India if they arise directly or indirectly, through the transfer of a capital asset situated in India. However, as discussed above, there is some ambiguity in India as to whether the income of a private equity fund

should be characterized as capital gains income or business income<sup>1</sup>. If the private equity fund is considered to earn business income, such income may be taxable in India if it is attributable to a business connection of such fund in India. There is no exhaustive definition of “business connection” in the Act, and the term has been given an expansive interpretation by judicial pronouncements in the past. The expression ‘business connection’ essentially postulates a real and intimate relation between the trading activity carried on outside India and the trading activity within India, if the relation between the two contribute to the earning of income by the non-resident.<sup>2</sup>

Considering that the Fund is situated in the Cayman Islands with which India has no tax treaty, its taxation would be governed by the provisions of the Act. However, as per our assumption that the Fund undertakes no activities in India, has no agents/ employees/ personnel in India who operate or conclude contracts on behalf of the Fund, or any other presence in India, there should be no tax exposure for the Fund in India. In the event that the Fund is considered to have a business connection in India to which its business income is attributable, it could be taxable at up to 42.23% on such income.

## PERMANENT ESTABLISHMENT

Section 90(2) of the Act is a beneficial provision which states that, where the taxpayer is situated in a country with which India has a tax treaty, the provisions of the Act apply only to the extent that they are more beneficial. India has tax treaties with Mauritius and the USA. Therefore, the Manager, Advisory Company and Canaan Mauritius could choose to be governed by the beneficial provisions contained in the India-US and India-Mauritius tax treaties respectively.

Under Article 7(1) of the India-Mauritius Tax Treaty and India-US Tax Treaty, the business income of a non-resident is only taxable to the extent that it is attributable to a PE of the non-resident in India.

The PE source rule is expressed as an exhaustive list of factors, as compared to the “business connection” source rule contained in the Act, which has no exhaustive definition and which has been widely interpreted by Indian courts in the past. Therefore, there may be situations where a non-resident is considered to have a business connection in India, but no PE. In such a case the business income of the non-resident would not be taxable in India.

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<sup>1</sup> There have been differing judicial pronouncements in India in the past as to whether gains from transactions in securities should be taxed as “business profits” or as “capital gains”. However, these pronouncements, while laying down certain guiding principles have largely been driven by the facts and circumstances of the case. A pertinent ruling in this regard is the ruling delivered by the AAR in *ABC Equity Fund, In re* ([1997] 224 ITR 473) where a private equity fund, set up in Mauritius, was regarded as earning business income as it was undertaking the activity of investment in a business-like manner.

Please note that rulings delivered by the AAR are binding only on the taxpayer and the tax authorities, with respect to the transaction for which the ruling has been applied. AAR rulings are not binding on others however they do have persuasive value.

<sup>2</sup> *CIT Punjab v. R.D. Aggarwal & Company*, AIR 1965 SC 1526

Although the India-US Tax Treaty and India-Mauritius Tax Treaty provide a fairly comprehensive definition of the term PE, the question whether a particular activity of a foreign entity (set up in US or Mauritius) would result in an Indian PE, would depend on the facts and circumstances of each case. In the context of investment funds that invest into India from Mauritius, the question as to whether such funds would be deemed to have a PE in India depends on the structure and operations of such investment fund. For instance, let us consider a situation where a Delaware based investment advisor undertakes significant activities relating to the management of an offshore fund, and appoints a sub-advisor in India to identify investment opportunities and negotiate deals for an offshore fund. If such appointment grants the Indian sub-advisor (or the advisor's directors, officers, or employees) the authority to sign any contracts on behalf of the Delaware advisor / fund or bind the advisor / fund in any manner, there is a risk that the Indian sub-advisor may be regarded as the PE of the Delaware advisor / fund. Even where the advisor has no such authority to bind the fund but represents that it has such authority to do so, there may be a PE risk in India. Thus, to determine if a particular fund has a PE in India, one would have to conduct a detailed examination of the documentary and functional aspects of the investment activity carried on in India.

### THE DEFINITION OF PE

The term PE has been succinctly defined by the Andhra Pradesh High Court in the case of *CIT v. Visakhapatnam Port Trust*<sup>3</sup>, as follows:

*“In our opinion, the words ‘permanent establishment’ postulate the existence of a substantial element of an enduring or permanent nature of a foreign enterprise in another country which can be attributed to a fixed place of business in that country. It should be of such a nature that it would amount to a virtual projection of the foreign enterprise of one country into the soil of another country.”*

Article 5 lays down the rules with respect to PE<sup>4</sup>. As per the provisions of Article 5, and taking into consideration the structure and manner of operations of the Manager, Advisory Company and Canaan Mauritius, there are three tests that would required to be considered to ascertain whether there is a risk of it having a PE in India. These are:

- Fixed place of business PE
- Place of Management PE
- Agency PE

A brief discussion on each is contained below.

### FIXED PLACE OF BUSINESS PE

Article 5(1) of the India-US Tax Treaty and India-Mauritius Tax Treaty contain similar definitions of the term PE. As per these definitions, PE is defined as being ‘a fixed place of business through which the

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<sup>3</sup> 146 ITR 162 (AP).

<sup>4</sup> Please refer to Annexure C for the complete text of the Article 5 of the tax treaties relevant to Canaan group of entities

business of an enterprise is wholly or partly carried on'. Thus, the definition contains the following salient features<sup>5</sup>:

1. *The existence of a place of business, that is, a facility such as premises or in certain instances machinery or equipment;*
2. *This place of business must be 'fixed', that is, it must be established at a distinct place with a certain degree of permanence;*
3. *The carrying on of the business of the enterprise through this fixed place of business. This means that, persons who, in one way or another, are dependent on the enterprise (personnel) conduct the business of the enterprise in the state in which the fixed place is situated.*

Thus, an entity may have exposure to a Fixed Place PE if it has premises available at its disposal in India, through which its business is considered to be carried out. It is relevant to note that ownership is not a prerequisite for the fixed place PE and that it may be constituted even when a space is made available to the non-resident, irrespective of whether it is ownership.

It is common practice for offshore investment funds and investment managers to appoint investment advisors in India to provide services in the nature of identification and evaluation of investment opportunities and undertaking market research. To the extent that these advisors are independent entities whose premises are not at the disposal of the fund or its investment manager for carrying out the business of the fund and or activities of the investment manager, the investment advisor should not be regarded as the PE of the fund or the investment manager, under Article 5(1). Having said this, it is important to note that that funds sometimes work closely with Indian investment advisors and in such cases it is important to ensure that the arrangement between the fund and/or the investment manager, on one hand and the investment advisor, on the other hand, is not one that may attract the provisions of Article 5(1). *A list of operational guidelines is contained in this report to enable funds to be aware of the factors which may be relied upon by the tax authorities to allege constitution of a fixed place PE.*

## PLACE OF MANAGEMENT PE

Article 5(2) of the India-US Tax Treaty and India-Mauritius Tax Treaty contain an illustrative list of arrangements that may constitute a PE, one of which includes a 'place of management'. Therefore, if a non-resident has a place of management in India i.e. persons in India who are engaged in the management of the non-resident entity, such non-resident entity may be construed to constitute a 'place of management' PE in India.

Article 5(2) is an illustrative list and therefore, there has been some consensus amongst jurists such as Dr. Philip Baker<sup>6</sup> and Klaus Vogel<sup>7</sup> that, in order for PE exposure to exist under any of the items listed out under Article 5(2), the conditions of Article 5(1) must be satisfied. Having said this, please note that such stand could be litigious and come under the scanner of the revenue authorities. Therefore, it is generally

<sup>5</sup> Para 2, *Model Tax Convention on Income And Capital, OECD Committee of Fiscal Affairs – Volume I “Commentary on Article 5”*, OECD, Paris [July 2005]

<sup>6</sup> *Philip Baker, Double Taxation Conventions, Sweet and Maxwell, 2001, para 5B.14*

<sup>7</sup> *Klaus Vogel, Klaus Vogel on Double Taxation Conventions, Kluwer Law International (3<sup>rd</sup> ed) pg 295*



advisable that investment funds not have persons situated in India who are engaged in the management of the fund. *Please refer to the operational guidelines to understand the permissible scope of activities for persons situated in India.*

## AGENCY PE

Article 5(4) of the India-US Tax Treaty and India-Mauritius Tax Treaty contain similar provisions relating to the constitution of an Agency PE. This kind of PE deals with the presence in India, of persons authorized to take decisions on behalf of the offshore fund / manager etc. Typically, funds are found to have a PE in India by virtue of the provisions of this paragraph.

Under Article 5 (4), any person acting for or on behalf of an offshore enterprise, other than an agent of an independent status shall be deemed to be a permanent establishment of such offshore enterprise, if:

- (i) he has and habitually exercises an authority to conclude contracts in the name of the offshore enterprise, or
- (ii) he habitually maintains a stock of goods or merchandise belonging to the offshore enterprise from which he regularly fulfils orders on behalf of such offshore enterprise, or
- (iii) he habitually secures orders for such offshore enterprise..

Therefore, Article 5(4) may be triggered if an offshore entity has a person acting on its behalf in India, who has authority to conclude contracts on behalf of the offshore fund and habitually exercises such authority. An exception is contained for persons considered to be 'independent agents' under the provisions of Article 5(5).

Canaan Mauritius, the Manager or the Advisory Company may be exposed to PE risk under this paragraph if they have employees present in India who act on their behalf. In the context of offshore investment funds, it important to take note of such exposure when employees of the offshore entities are sent to India to meet with the promoters or directors of portfolio companies, to conduct due diligences on portfolio companies and undertake research on investment opportunities. Such aspects are to borne in mind while carrying on India specific activities. Similarly, if Canaan India is authorized to enter into contracts and who exercises this authority, there may be PE exposure under Article 5(4).

Some of the activities which could lead to exposure under Article 5(4) are: (i) when the decision invest or not is taken in India, or (ii) negotiations and finalization of the investment terms take place in India, or (iii) investment agreements or the term sheets are signed in India. Moreover, in the most recent update on the OECD Commentary, India has expressed its reservation in connection with the commentary relating to participation in negotiations. Please find the relevant paragraph reproduced below:

*"India... is of the view that the mere fact that a person has attended or participated in negotiations in a State between an enterprise and a client, can in certain circumstances, be sufficient, by itself, to conclude that the person has exercised in that State an authority to conclude contracts in the name of the enterprise. India is also of the view that a person, who is authorized to negotiate the essential elements of the contract, and not necessarily*

*all the elements and details of the contract, on behalf of a foreign resident, can be said to exercise the authority to conclude contracts.”*

In light of the above, it is possible that the revenue authorities in India could claim that the involvement of personnel of offshore funds and/or the investment manager even in preliminary negotiations would constitute a PE in India.

#### **ARTICLE 5(5) - EXCEPTION OF INDEPENDENT AGENT**

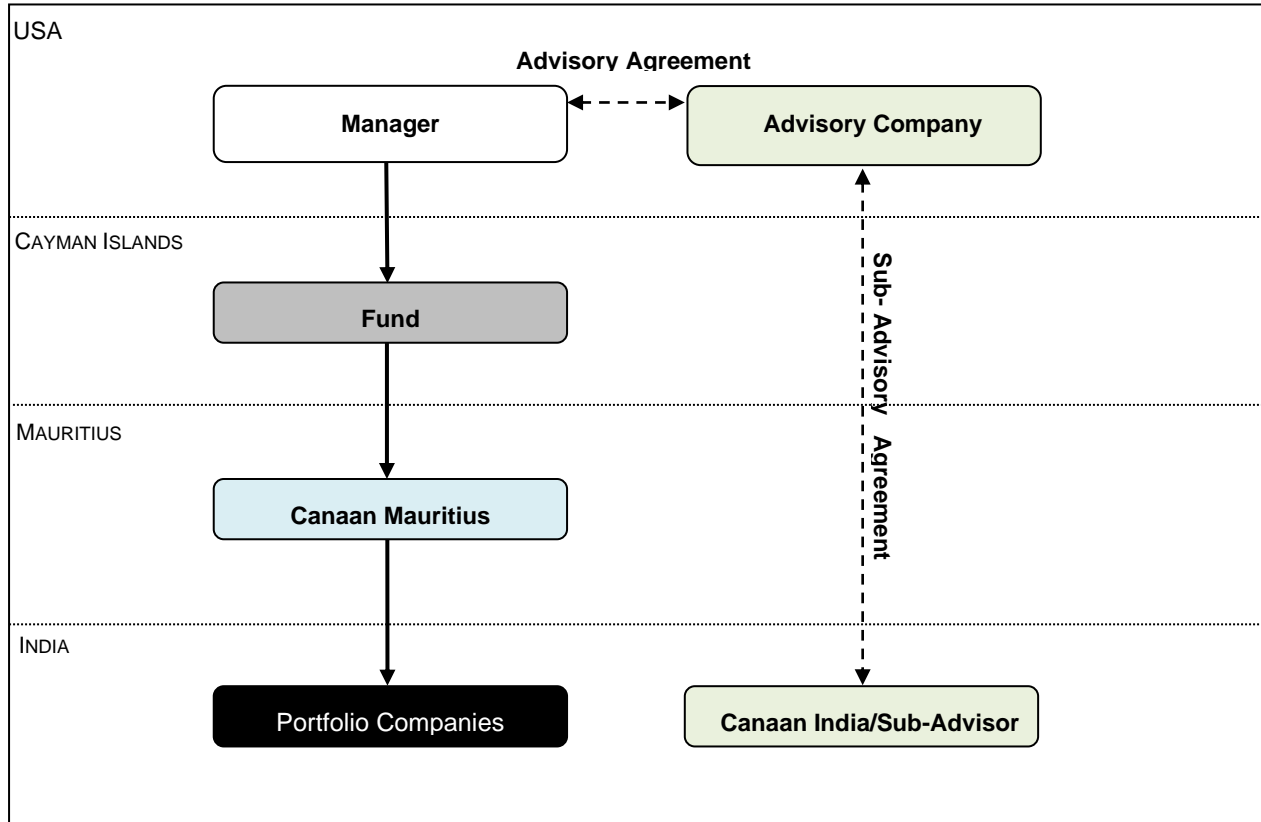
Article 5(5) of the India-US Tax Treaty and India-Mauritius Tax Treaty contain similar provisions relating to the ‘independent agent’, who is excluded from the purview of the dependent agent PE provisions in Article 5(4). Article 5(5) states that:

*“5. An enterprise of a Contracting State shall not be deemed to have a permanent establishment in the other Contracting State merely because it carries on business in that other State through a broker, general commission agent or any other agent of an independent status, where such persons are acting in the ordinary course of their business. However, when the activities of such an agent are devoted exclusively or almost exclusively on behalf of that enterprise, he will not be considered an agent of an independent status within the meaning of this paragraph.”*

Therefore, where an agent of an independent status provides services to a non-resident principal in the ordinary course of business, including other principals, he should not be construed to constitute a PE of the non-resident principal as described under Article 5(4). However, if the agent conducts his activities exclusively for the non-resident principal, i.e. it is economically wholly dependent on the non-resident principal it may not be regarded as an independent agent and relief under Article 5(5) may not apply to such arrangement.

Please note that there is not significant jurisprudence in India on the ‘independent agent’ exception, and that the exception has commonly been applied to persons such as brokers etc. Therefore, it is advisable to avoid falling within the substantive part of Article 5(4) rather than seek refuge under the exception. The list of operational guidelines provides details on the permissible list of activities which may be engaged in by representatives of Canaan Mauritius, the Manager or the Advisory Company, in India.

### III. PE ANALYSIS OF STRUCTURE



**LET'S DISCUSS THE STRUCTURE CHART**

**FUND STRUCTURE**

The Fund has been set up as an exempted limited partnership in Cayman Islands, to make investments into privately held companies in USA, India and Israel.

Canaan Mauritius is a Mauritius based 100% subsidiary of the Fund which has been set up as private company limited by shares. Canaan Mauritius has been granted a Category 1 Global Business License by the Financial Services Commission and a Tax Residency Certificate by the Mauritius Revenue Authority which is valid up to September 13, 2010. Canaan Mauritius is registered in India with SEBI as an FVCI under the FVCI Regulations, and is engaged in the activity of making investments into India.

**MANAGEMENT OF THE FUND**

The general partner of the Fund is the Manager, which is set up as a limited liability company in Delaware. The Manager is also registered as a foreign company in the Cayman Islands under the

Company Law (2007 Revision) of the Cayman Islands.

The management, policies and control of the Fund vest with the Manager. Thus, the final authority with respect to investment and divestment decisions of the Fund, including obligations pertaining to formulating investment policies and strategies are the responsibility of the Manager. As consideration for the services rendered by the Manager pursuant to the Limited Partnership Agreement, the Manager is entitled to receive a Management Fee. **Again, are they clear as to what decision the maager is making? May eb better to have a Mauritius manager as well...shud we call the manager as the GP? The GP-LP structure is not getting depicted properly**

The Manager has entered into an Advisory Agreement with the Advisory Company, a limited liability company in Delaware. As per the Advisory Agreement, the Advisory Company is required to fulfill all obligations of the Manager with respect to the Fund, as detailed in the Limited Partnership Agreement. However, the Advisory Company's role does not extend to involvement with the management, policies and control of the Fund, which continue to remain the responsibility of the Manager. The final decision making authority with respect to the operations and management of the Fund lies in the hands of the **General Partner**. In consideration for its services, the Advisory Company is entitled to receive an Advisory Fee. **Should use one term**

The Advisory Company has entered into a Sub-Advisory Agreement with the Sub-Advisor in India, as per which the Sub-Advisor is required to provide services in the nature of identifying and evaluating investment opportunities in sectors and industries identified by the Advisory Company. As consideration the Sub-Advisor is entitled to receive a reimbursement of costs and a 10% mark-up on such costs.

#### Observations

As per the structure described above, the Manager has delegated all its obligations to the Advisory Company under the Advisory Agreement, except in relation to the management / control and policies of the Fund. Therefore, the Advisory Company appears to enjoy wide authority in connection with the activities of the Fund as per the Advisory Agreement.

The Advisory Company has in turn engaged the Sub-Advisor to provide India specific advice to the Advisory Company. Under the terms of the Sub-Advisory Agreement, the scope of services of the Sub-Advisor are articulated in inclusive and not specific terms (Clause 2.3 of the Sub-Advisory Agreement), which leaves open the issue of activities which may be carried on by the Sub-Advisor. Considering the broad nature of authority given to the Advisory Company, it is important that the Sub-Advisor's role under the Sub-Advisory agreement be limited. In order to avoid Indian PE exposure, the Sub-Advisor should ideally be engaged only in research related activities or the provision of *non-binding advice and recommendations* to the Advisory Company. If the Sub-Advisor is considered to be a PE of the Advisory Company in India, there is a possibility of the PE risk flowing through to the Manager and the Fund, on account of the broad scope of power delegated to the Advisory Company. Therefore, it is vital to articulate the Sub-Advisor's obligations appropriately. **Shd we be more specific as to what all they shd include?**

Separately, the mandate given to the Advisory Company under the Advisory Agreement does not specifically authorize the Advisory Company to outsource its responsibilities to third persons. Considering that the Advisory Company has entered into an agreement with the Sub-Advisor with respect to India ~~specific investments, it maybe preferable to incorporate a specific authority in the Advisory Agreement~~ permitting the Advisory Company to delegate/outsource certain obligations to third parties. **Like what?**

## IV. PE ANALYSIS OF FUND DOCUMENTATION

### I. PRIVATE PLACEMENT MEMORANDUM

The PPM is the marketing document for the Fund and is circulated to select non-Indian investors to provide information with regard to the Fund. In this section we will provide a review of the language contained in the PPM along with proposals for amendments as may be required.

#### I. **Canaan VIII L.P.: Overview, Page 2**

*“In early 2006, Canaan opened an office in Gurgaon, India, a suburb of New Delhi. Full-time Investment Professionals were hired to source investments in both countries.”*

#### Observation

This statement suggests that the Sub-Advisor is the India ‘office’ of the Canaan Group i.e. an extension of the Canaan Group which has been set up to tap the Indian market. From a PE perspective, it is important that the Sub-Advisor be considered to perform its functions in an independent capacity as a service provider, rather than in the capacity of an office run by the Canaan Group in India.

We suggest the following alternative language: *“In early 2006, Canaan set up an Indian advisory company in Gurgaon, India, a suburb of New Delhi. The Indian company shall engage in the activities of research and analysis with respect to Indian companies, and shall recruit full time investment professionals for this purpose.”*

#### II. **Canaan VIII L.P.: Overview, Page 2**

*“In addition to the General Partners, the Fund’s investment team is augmented by one Managing Director and six Venture Partners, two Principals, four Investment Analysts, a Director of Finance and a Director of Marketing (collectively, the “Investment Professionals”).”*

#### Observations

The team of “Investment Professionals” includes one Managing Director, Mr. Alok Mittal, who heads the operations of the Sub-Advisor and an Investment Analyst, Mr. Mukul Singhal, who is employed by the Sub-Advisor. On a standalone basis this should not create any PE exposure for the Fund and the Manager. However, it is advisable to segregate the functions of the principals / management professionals with those of the Sub-Advisor or its personnel to the extent possible, in order to avoid any allegations with respect to the management and control of the Fund and/or the Manager being in India.

**Id just like to know a bit morw abt who the partners are etc**

#### III. **Investment Strategy: Overview, Page 5**

*“Second, the “hands-on” involvement of the Firm’s Investment Professionals has maximized the value of*

each portfolio company.”

#### Observations

Please see the comment above. As such there should not be PE exposure merely on account of the Sub-Advisor’s personnel providing services to the Fund and the Manager in relation to portfolio investments made by the Fund. However, from a PE perspective it is advisable to segregate the functions of the principals / management professionals with those of the Sub-Advisor or its personnel to the extent possible, in order to avoid any allegations with respect to the management and control of the Fund and/or the Manager being in India. **In nay case they shd not put it like this if the investment prof includes Indian guys**

#### IV. Investment Strategy: Deal Flow and Network, Page 7

“This presence has allowed the Investment Professionals to cultivate personal contacts and to develop an extensive business network comprised of entrepreneurs, industry veterans, consultants, lawyers, accountants, executive search professionals and other venture capitalists. **This network is expected to provide the Fund with strong deal flow and will serve to help meet portfolio company needs as they grow.**”

#### Observations

These statements imply that the Investment Professionals maybe engaged in the sourcing of deals and investment opportunities for the Fund. As discussed above, “Investment Professionals” has been defined to include one Managing Director (Mr. Alok Mittal, who heads the operations of Canaan India) and an Investment Analyst (Mr. Mukul Singhal who works with Canaan India). It is advisable that none of the personnel of Canaan India be considered to ‘source’ investments for the Fund as this could result in PE exposure for the Fund in India.

**[SH: PJ, in light of the stuff we discussed for IDFC do you think we should delete this? Are references to deal flow a problem?] yes that’s correct but at the same time we shud tryt o see if we can use a milder word than sourcing**

#### V. Investment Strategy: Evaluating Opportunities, Page 8

“While detailed due diligence is completed by the Investment Professionals with the most relevant skills for a particular opportunity, all companies make presentations to the entire group of Investment Professionals. This cross-discipline approach between technology and healthcare Investment Professionals allows for different perspectives to be voiced during the evaluation process and ensures that the entire Canaan team is involved in the investment decision.” **Lets disc**

#### Observations

As discussed above, the team of Investment Professionals includes two persons who are resident in India. While there should be no PE exposure on account of this statement on a standalone basis, **it is important that the Indian residents not have any veto rights in relation to the decision making process.**

**VI. Investment Strategy: Evaluating Opportunities, Page 8**

*“By maintaining offices on both coasts of the U.S. as well as, more recently, India and Israel, Canaan benefits from having a broad base of coverage to source and evaluate investment opportunities...This free exchange of information between offices allows all the Canaan Investment Professionals to be current on the issues that impact their target industries, including potential portfolio company competitors.”*

**Observations**

As discussed above, it is advisable that Canaan India should not be referred to as the Indian ‘office’ of the Canaan Group. From a PE perspective it is preferable that the Sub-Advisor be considered more as a third party service provider and not an Indian office of Canaan.

**VII. Investment Strategy: Active Investors, Page 8**

*“After an investment is funded, Canaan employs an active presence with its portfolio company in an effort to provide significant guidance and oversight. As such, the Firm typically assumes a board of directors seat so that it can leverage the Investment Professionals’ depth of operating and investing experience and network.”*

**Observations**

From a PE perspective it is important that the **Canaan Group** and/or the Fund should not be seen to have persons acting on their behalf in India in a pre-investment or post investment scenario. The underlined statements suggest that the Fund and/or the Manager may have persons present in India who discharge active responsibilities on behalf of the Fund, including through mentoring the management of investee companies. While it should be permissible for persons to be engaged in a fiduciary capacity as directors with Indian companies, suggesting that they represent the Fund in India could create PE exposure for the Fund in India. **Lets discuss**

**VIII. Canaan Investment Professionals: Active Investors, Page 8****Observations**

The inclusion of Mr. Alok Mittal and Mr. Mukul Singhal in the list of ‘Investment Professionals’ should not, on a standalone basis, create any PE exposure for the Fund and/or the Manager. However, as discussed above it is preferable that the responsibilities of the Sub-Advisor be segregated from the obligations of Manager with respect to the management of the Fund.

**II. LIMITED PARTNERSHIP AGREEMENT**

Our review of the Limited Partnership Agreement of the Fund is contained below:

**I. Clause 3.4.1, Clause 5.2.1.4**

*“Clause 3.4.1: The management, policies and control of the Partnership shall be vested exclusively in the*

*General Partner.” (the “General Partner” as defined in the Limited Partnership Agreement referred to in this Report as the “Manager”)*

#### **Observations**

These clauses indicate that the management, policies and control of the Fund vests solely with the Manager. This clause is favorable as it mitigates the possibility of the Fund being considered to be managed from India. **Need to discuss manager in mauritius**

### **III. ADVISORY AGREEMENT**

The Manager has entered into an Advisory Agreement with the Advisory Company in Delaware. Our review of the Advisory Agreement is contained below:

#### **I. Clause 3, Page 1**

*“3. Service Provider Duties: The Service Provider will comply with the GP’s obligations to provide services to the Fund in accordance with the Partnership Agreement. The parties hereto acknowledge that pursuant to Section 3.4.2 of the Partnership Agreement, that the GP shall remain liable to the fund for all acts and omissions of the Service Provider to the same extent as if the GP (rather than the Service Provider) undertook such actions or suffered such omissions. Notwithstanding the services provided by the Service Provider, the Service Provider acknowledges that it shall not be authorized to manage the affairs of, act in the name of or bind the Fund. The management policies and the operations of the Fund shall be responsibility of the GP acting pursuant to and in accordance with the Partnership Agreement and all decisions relating to Fund matters, including the selection and management of the Fund’s investment, shall be made by the GP acting pursuant to and in accordance with the Partnership Agreement.”*

#### **Observations**

By means of this Clause, the Manager has delegated all his responsibilities, with respect to the Fund, to the Advisory Company. There is an almost blanket delegation by the Manager. Pertinently, the Clause goes on to provide that the Advisory Company (defined as ‘Service Provider’ in the Advisory Agreement) shall not be authorized to manage the affairs of or bind the Fund. However, it would be worthwhile to further insert in this Clause, language to the effect that any person engaged by the Advisory Company, to render any service in connection with the Advisory Agreement, would **not** have the authority to manage the affairs of the Fund. Such insertion would in fact act as a double layer protection to the Fund from the operations of the Sub-Advisor and its various personnel being treated as activities of its PE in India. **Their relationship should be inly with advisor and not manager**

#### **II. Absence of Authority to Engage Another Advisor**

The Advisory Agreement does not specifically authorize the Advisory Company to engage third parties to assist or to outsource, part or all of, its obligation to provide services to the Manager. **Do we need that?**



### **Observations**

Since the Advisory Company has not been granted express permission to engage third parties, the arrangement between the Advisory Company and the Sub-Advisor may be questioned on the grounds of competence. It is advisable that the Advisory Agreement be amended to provide the Advisory Company the authority to engage sub-advisors or third parties, subject to limitations contained therein.

## **IV. SUB-ADVISORY AGREEMENT**

Advisory Company has entered into a Sub-Advisory Agreement with Sub-Advisor. Our review of the agreement is contained below:

### **I. Recitals B**

*Recital “(B) The Adviser is a company engaged in the business providing consultancy and advice in the field of management, organization, secretarial, administrative or legal activities, finance, accounting, commerce.”*

### **Observations**

As a general observation, it is advisable that terms such as ‘management, organization etc.’ be avoided while referring to activities or services to be performed by the Sub-Advisor, or any other personnel of the Sub-Advisor in India. Such language may aid revenue department in imputing ‘Place of Management’ PE for the Advisory Company and/or the Manager in India.

### **II. Clause 2.2**

*During the continuance of its appointment the Adviser shall render advice to the Company.”*

### **Observation**

It is preferable that the phrase “non-binding” be used as pre-fix to the term “advice”. Such insertion would be instrumental in characterizing the nature of services rendered by the Sub-Advisor as being recommendatory and non-binding in nature, thereby mitigating Indian PE risk.

### **III. Clause 2.3**

*“Without prejudice to the generality of clause 2.1, the Consultancy services to be performed by the Adviser shall include:*

- (a) Identifying and evaluating investment opportunities in India in industries and sectors identified by the Company;*
- (b) Carrying out detailed analysis on the specified and named companies in India as directed or required by the Company;*
- (c) Analyzing periodically the performance of specified Indian companies and providing reports to the Company.”*

### Observations

The scope of services of the Sub-Advisor is worded in an inclusive manner in the Sub-Advisory Agreement. As discussed above, the authority conferred upon the Advisory Company is very wide and therefore, it is advisable that any agreement entered into between the Advisory Company and the Sub-Advisor should specifically lay down the services to be rendered by the Sub-Advisor. This is typically the way we do it...lets discuss

If the Sub-Advisor is conferred with wide authority, as a result of which it is considered to constitute PE of the Advisory Company, there is a possibility of assumption of Sub-Advisor's authority to manage the Fund, flowing to the Fund through the Advisory Company and the Manager. This may be possible because of the wide authority conferred upon the Investment Advisor by the Manager.

#### IV. Execution of the agreement

### Observation

The Sub-Advisor Agreement has been executed by Mr. Guy Russo both on behalf of the Advisory Company and the Sub-Advisor.

[NDA Comment: We would like to understand the capacity in which Mr. Guy Russo has signed the agreement on behalf of both Advisor and Sub-Advisor. Is it in the capacity as Director of these companies?] typically you shd have separate ppl signed, so if we are revising the agreement then it may eb better we should also chk that the borads are not identiac

#### V. CONSTITUTION OF CANAAN MAURITIUS

The Constitution of Canaan Mauritius was adopted by Special Resolution on December 7<sup>th</sup>, 2007. Our review is contained below:

##### I. Clause 8(b), Page 3

*"The objects of the Company are... to carry on its affairs as an investment holding company"*

### Observations

It is advisable that the Mauritius entity not be referred to as an 'investment holding company', to ensure substance at the Mauritius level. [Neha: PJ, is this an issue?] not really

## V. OBSERVATIONS ON THE OPERATIONAL ASPECTS

In this section, we will analyse the operational aspects of the Canaan VIII Entities, with special emphasis of the operations of Canaan Mauritius, which is engaged in the activity of making investments into India.

### Residence of Canaan VIII Entities

As mentioned above, the Canaan VIII Entities could have an adverse tax exposure in India if they are considered 'resident' in India. While Canaan Mauritius, the Advisory Company and the Manager would be considered 'resident' if as conditions under Section 6(3) of the Act are fulfilled, that is, if the control and management of the affairs of the Canaan VIII Entities is wholly in India; the Fund being a limited partnership will be considered a resident if even partial control and management of its affairs is in India, in accordance with Section 6(2) of the Act.

- **Canaan Mauritius:** We understand that the Mr. Couldip Basanta Lala, Ms. Roobina Toorawa and Mr. Guy Russo are directors on the Board of Canaan Mauritius. While Mr. Couldip Basanta Lala and Ms. Roobina Toorawa are resident Mauritius directors; Mr. Guy Russo, is a US resident. Thus, there are no resident Indians on the Board of Canaan Mauritius. Further, we understand that all meetings of the Board of Canaan Mauritius are held and chaired in Mauritius.

As the Board of Canaan Mauritius is comprised of persons not being Indian residents and all meetings of the Board are held outside India, Canaan Mauritius should not be considered to be a resident in India.

**[Source:** Minutes of Board meetings (please refer to the List of Documents on page [•]); List of Directors and Secretary as of Feb. 2, 2010]

- **Advisory Company:** As per our assumption, the directors on the Board of the Advisory Company are not resident Indians and all Board meetings of the Advisory Company are held outside India. Please confirm if our understanding is accurate.

If the Board of the Advisory Company is comprised of persons not being Indian residents and all meetings of the Board are held outside India, the Advisory Company should not be considered to be a resident in India.

**[No Source]**

- **Manager:** We understand that the persons on the board of the Manager are the individual 'managers', as defined in the LLC Agreement. As per our assumption that the persons on the board of the Manager are not resident Indians and that all meetings of the 'managers' are held outside India, the Manager should not be considered to be a resident in India.

**[No Source]**

- **Fund:** We understand that none of the limited partners of the Fund are residents in India. Further, the management of the Fund vests with the Manager, a limited liability company in Delaware. We understand that all decisions with respect to the Fund are taken by the Manager outside India.

Consequently, since no part of control and management of the Fund lies in India, the Fund should not be considered a resident in India.

[Source: Clause 3.4 of the Limited Partnership Agreement]

Need to understand how flow of decuson takes place

### Management of Canaan VIII Entities – Presence of Personnel in India

As mentioned earlier, to mitigate the risk of Canaan Mauritius, the Manager or the Advisory Company being considered to have a PE in India, it is critical to ensure that no management activities relating to these entities are carried on in India by the Sub-Advisor or any person acting in a managerial capacity with respect to the said entities. The involvement of the Sub-Advisor in the investment decision making process is discussed in the section below.

It is also important for the Canaan VIII Entities to ensure that there are no persons situated in India who are engaged in the management of the offshore Canaan VIII Entities in India. In order to ensure that the tax authorities do not view the Fund and/or Canaan Mauritius as being managed from India, it is critical to ensure that the boards of the Manager/ Advisory Company, as well as the Board of Canaan Mauritius comprises of independent persons who are not Indian residents that have the ability to take decisions in the areas in which the Fund seeks to operate. Moreover, it must be ensured that any Indian members on the said boards (i) do not constitute a majority; (ii) do not have any veto right; and/or (iii) do not take management decisions and conclude investment contracts while in India.

As per the analysis provided above in the section on the residential status of the offshore Canaan VIII Entities, it does not appear that there are Indian residents on the boards of the said entities, or that board meetings are conducted in India. Therefore, the offshore Canaan VIII Entities should not be considered to be managed from India so as to create a Place of Management PE in India. [NDA Comment: In order for this analysis to be complete we would also need to examine the role played by Canaan India in the investment decision making process.] In Section VIII of this Report, we have also provided broad operating guidelines for the offshore Canaan VIII Entities to follow in order to mitigate Indian PE exposure.

### Canaan India's involvement in the Investment Process

[NDA Comment: We are still awaiting information to conduct an audit on the operations of the Fund. We would need to understand the manner in which deals are sourced, recommended and decisions taken with respect to those deals to be able to provide this analysis.]

## VI. ANALYSIS OF INFORMATION IN PUBLIC DOMAIN

In the recent past the revenue authorities in India have become aggressive while imputing Indian tax liability for non-residents. For this purpose revenue authorities place reliance on publically available documents bearing information about the affairs of a non-resident entity. For instance, in the *Vodafone*<sup>8</sup> case, the revenue department proceeded against the taxpayer on the basis of publically available information such as a regulatory application filed by Vodafone with the Foreign Investment Promotion Board.

Therefore, in order to evaluate the risk of tax exposure for the Canaan VIII Entities in India, it is pertinent to examine publically available information with respect to the Canaan VIII Entities.

For the purposes of this section, we have examined press releases, marketing material produced by the Canaan Group, regulatory filings and other information available on the internet etc. which relate to the affairs of the Canaan VIII Entities. Please see our analysis on the individual documents below. A general observation on all information available in public domain is provided at the end of this section.

### I. PRESS RELEASES & ONLINE INFORMATION

Upon examination of the press releases provided to us, the following issues appear to require addressal:

- **Indian “Office” of Canaan Partners:** Canaan India has been projected as the “firm’s Indian office in New Delhi”. This press release further mentions that, “with an office in place, Canaan will focus on early-stage investments, which offer greater growth potential”. Such statements imply that Canaan India functions as an Indian office of Canaan Partners rather than an independent service provider, which may create Indian PE exposure for offshore Canaan VIII Entities. It is preferable Canaan India be referred to as an Indian sub-advisor rather than an Indian ‘office’. Some of the specific press releases are referenced below:
  - *Canaan Partners, an established Silicon Valley venture capital firm that specializes in early-stage investing, today announced that it has opened its investment office in Gurgaon, India. .... With an office in place, Canaan will focus on early-stage investments, which offer greater growth potential.* (Reference: Press release dated June 6, 2006)
  - *“Mr. Mittal joined Canaan in March 2006 to launch the firm’s Indian office in New Delhi.”* (Reference: Press Release dated July 10, 2007)

- *“With full-service offices and dedicated investment professionals in Israel and India, Canaan offers the same insight and operational guidance to entrepreneurs internationally as we do locally.”*  
(Reference: <http://www.canaan.com/home/contact/>)

- **Reference to Indian Personnel Associated with Canaan Partners:**

Mr. Alok Mittal: Press releases refer to the Mr. Alok Mittal as the Managing Director/ General Partner of Canaan Partners, implying that Mr. Alok Mittal is engaged with the management of Canaan VIII Entities other than Canaan India. It is preferable that the press releases be specific that Mr. Mittal is engaged as the Managing Partner / Managing Director of Canaan India.

- *“This is the first time a global EIR is appointed out of India. Sharad’s ability to bridge U.S. operations with global markets is a great fit for Canaan,” said Alok Mittal, General Partner at Canaan.*  
(Reference: Press release dated May 28, 2009)
- *Canaan Partners, a \$2.4 billion global venture capital firm, today announced that Alok Mittal has become a Managing Director.*  
(Reference: Press release dated July 10, 2007)
- *Commenting on the investment, Alok Mittal, Managing Director of Canaan Partners in India, said, “techTribe’s community based referral recruiting model is a great example of innovation in the Web 2.0 space.”*  
(Reference: Press Release July 25, 2007)
- *“We are excited to partner with UnitedLex and are confident of building a great business here” said Alok Mittal, Managing Director, Canaan Partners.*  
(Reference: Press Release dated July 23, 2008)
- *“said Alok Mittal, Managing Partner at Canaan.*  
(Reference: Press Release dated Feb 6, 2008)
- *The ability to disrupt the market, most of which has a local base,” says Alok Mittal, Managing Director, Canaan Partners.*  
(Reference: Press Relapse dated September 19, 2009)  
([http://businesstoday.intoday.in/index.php?option=com\\_content&task=view&issueid=67&id=12720&sectionid=22&Itemid=1](http://businesstoday.intoday.in/index.php?option=com_content&task=view&issueid=67&id=12720&sectionid=22&Itemid=1))

Mr. Harish Gandhi: Mr. Harish Gandhi is referred to as the Executive Director with Canaan Partners, which suggests that his appointment is with Canaan Partners. It is advisable that Mr. Harish Gandhi is referred to as “Executive Director, Canaan India”.

- *“Canaan Partners...today announced the appointment of Harish Gandhi as Executive Director with the firm...Harish takes on the role of Executive Director*

*with Canaan Partners with extensive operational experience and skills in helping companies grow in the field of telecommunications in both India and USA. He has spent twelve.”*

(Reference: Press release dated January 15, 2008)

- *“Harish Gandhi, Executive Director of Canaan Partners, said, “I expect the market to grow at around 40-45 percent over the next three years”.*”

(Reference: Press Release dated October 13, 2009)

([http://www.siliconindia.com/shownews/Vcs\\_ready\\_to\\_tap\\_3G\\_space\\_in\\_India-nid-61996.html](http://www.siliconindia.com/shownews/Vcs_ready_to_tap_3G_space_in_India-nid-61996.html))

- *“Harish Gandhi, executive director, Canaan Partners, says his fund cannot diversify into new sectors at the moment as they have a small corpus and getting into a new sector could be more riskier due to a lack of expertise in new areas.”*

(Reference: Press release dated October 13, 2008)

(<http://www.livemint.com/2008/10/13221359/Venture-capital-cos-may-focus.html>)

- *“Harish Gandhi is an Executive Director at Canaan Partners, a global venture capital company focusing on early stage investments in the technology, telecom and services sector in India.”*

(Reference: <http://www.canaan.com/home/team/partner/harish-gandhi/>)

*Anirudh Singh:* The Canaan Partners website makes statements which indicate that Mr. Anirudh is associated with ‘Canaan Partners’ and not ‘Canaan India’. It is advisable to specify that Mr. Anirudh Singh is employed with the Sub-Advisor.

- *“Anirudh Singh joined Canaan Partners’ India office in December 2009 as an Investment Analyst. He currently helps support the firm’s Indian investments across a diverse range of sectors, including digital media and advertising, financial services, e-commerce, outsourcing, healthcare, telecom and energy/infrastructure.”*

(Reference: <http://www.canaan.com/home/team/partner/anirudh-singh/>)

*[This part has been left blank]*

## II. FVCI APPLICATION

### A. Clause 1.2, Page 1

The Fund is defined as the 'Beneficial Owner'.

#### Observation

It is advisable that Canaan VIII LP not be defined as the "beneficial owner" of the Mauritius entity. This is to protect the substance of the Mauritius entity, in light of recent Indian rulings such as the ruling of Bombay High Court in the matter of *E\* Trade*, where the Mauritius entity was disregarded and the provisions of the India-Mauritius tax treaty were not applied. **We shud check this with vik – maybe that is a requirement**

### B. Paragraph 1, Page 7

This paragraph mentions that the General Partner of the Fund has opened an office in Gurgaon, India in 2006. It is also mentioned that "*full-time investment professionals were hired to source investments in India*".

#### Observation

As discussed above, from an Indian PE perspective it is preferable to avoid references to any Indian office of the General Partner in India. As discussed in Section III of this Report, a mere office of a non-resident may be taken to be its PE in India and consequently, the income of the non-resident attributable to the activities of the PE may be taxed in India. Therefore, the FVCI Application should not assert existence of a Gurgaon office of the General Partner to mitigate Indian PE risk.

#### General Observation of information available in Public Domain

As a common observation on all documents available in the public domain, it is pertinent to note that references to Mr. Alok Mittal most often indicates a relationship of Mr. Mittal with the Canaan Group as the 'General Partner' and 'Managing Director', rather than as an employee of the Sub-Adviser. This could result in the revenue authorities imputing that Mr. Alok Mittal is a part of the investment team of and thus engaged in management activities relating to the Fund in general or Canaan Mauritius, in particular. **Also, he is making ref to the fund as 'we' etc etc . and what is our reccomendtaion here? We cannot undo what has already been done**

Further, the FVCI application makes a reference to the responsibility of the 'General Partners' to achieve the designated IRR. Reading the Press Releases with the FVCI application could result in the implication that Mr. Alok Mittal has an active role to play in the investment decisions of the Fund and Canaan



## VII. PE EXPOSURE: OPERATING GUIDELINES NOT REVIEWED

### I. Importance of establishing Substance in Mauritius

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 their tax liability. The Indian tax jurisprudence follows the rule of ‘form over substance’, which means that the determination of tax liability shall be based on the legal form of the transaction as opposed to the underlying intent or substance. Therefore, if the arrangement between the parties is that of an independent service arrangement, courts will not look beyond the form of the transaction into issues of substance unless the legal form appears to be a ‘sham’ or designed to subvert the law. This principle has been reiterated by the Supreme Court of India in the landmark case of *Azadi Bachao Andolan*<sup>9</sup>, which upheld the eligibility to India-Mauritius Treaty benefits to Mauritian resident entities with a valid tax residency certificate.

In the recent past however, the revenue authorities have been growing increasingly aggressive in their attempts to deny treaty benefits to Mauritius based companies. In doing so, they have often disregarded the well established jurisprudence of “form over substance” on the subject. For instance, recently in the *E\*Trade*<sup>10</sup> case, there was a sale of shares of an Indian listed company by a Mauritius tax resident entity, a transaction which, as per the Treaty, should have been subject to tax only in Mauritius. However, when the purchaser of the shares approached the revenue officer for a nil withholding tax certificate, the same was refused and the Director of Income Tax (“DIT”), in a summary proceeding, ruled that the Mauritius entity was “simply a façade” and the “capital gains may not have arisen to it but to its US parent”<sup>11</sup>. Several fundamental issues such as the denial of treaty benefits in gross violation of Circular 789<sup>12</sup> and the Supreme Court's decision in *Azadi Bachao Adolan* were conveniently unaddressed by the DIT under the pretext that they could only be resolved later only upon the conclusion of assessment proceedings. Thus, the net effect was that, without a proper representation being offered to E\*Trade, an amount of approximately INR 240 million was withheld as capital gains tax payable by E\*Trade. Considering the number of years taken to resolve a tax dispute in India, it may take up to a decade for E\*Trade to obtain a refund post assessment. In another case involving Vodafone<sup>13</sup>, 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.

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

<sup>9</sup>Union of India and Anr. v Azadi Bachao Andolan and Anr. 263 ITR 706 (SC)

<sup>10</sup> E\*Trade Mauritius Limited v ADIT & Ors WP. No. 2134 of 2008

<sup>11</sup>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.

<sup>12</sup> Circular 789 of 2000 issued by the Central Board Of Direct Taxes clarified, inter alia that a “Certificate of Residence” issued by the Mauritian Authorities would constitute sufficient evidence for accepting the status of residence as well as beneficial ownership for applying the India Mauritius Tax Treaty and holders of such a certificate would not be taxable in India on income from capital gains arising in India on sale of shares

<sup>13</sup> [2008] 175 Taxman 399 (Bom)

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 at the Mauritian level.

## II. **Checks and Balances built into the structure**

The Fund has been structured in a manner that the final legal authority with respect to all investment and divestment decisions relating to the Fund lies with the Manager, along with general supervision and rendition of other services to the Fund. The Manager has, *vide* the Advisory Agreement, delegated its duties with respect to the other services, with the exception of investment and divestment making authority. Further, the Sub-Advisor is appointed by the Advisory Company to provide services which are in the nature of identifying and evaluation of investment opportunities, periodical analysis.

This structure already has some checks and balances built in to mitigate of PE exposure. This is because the Manager retains with itself the most important function, that is, the decision to invest and divest. The role of the Advisory Company and Sub-Advisor is limited. Such arrangement mitigates the PE exposure for Canaan Mauritius as all investment and divestment decisions are taken outside India.

Further, the Sub-Advisory Agreement provides that the Sub-Advisor shall not have the power to act as an agent of the Advisory Company or to bind it in any manner. This should mitigate the risk of Canaan Mauritius, the Manager and the Advisory Company being managed from India and reduce the possibility of it having a place of management PE in India. This clause is crucial to mitigate the PE risk under Article 5(4).

## III. **Operating Guidelines**

We have provided herein guidance in the form of Do's and Don'ts, which may be followed in order to minimize the PE risk for the Fund in India. For the purpose of this guidance note, we have divided the discussion in two phases, namely;

- **PHASE I: Do's and don'ts to be followed on the incorporation and life of the Fund; and**
- **PHASE II: Do's and don'ts to be followed on exit made by the Fund from its investments in India.**

At the outset, please note that these are merely guidelines and no assurance is given that if these guidelines are followed a PE of Canaan Mauritius 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 PE exposure.

**PHASE I: Do's and don'ts to be followed on the incorporation and life of Canaan Mauritius****During the life of the Canaan Mauritius, the following should be taken into consideration:**

- Canaan Mauritius should, at all times, have at least two Mauritian directors on its Board. Persons qualifying as residents of India should not constitute a majority at any time nor have any veto rights in the exercise of its powers of the Board.
- Further, it is advisable that all major transactions be proposed by the Board and the Mauritian directors convene the Board meetings in Mauritius. Similarly, there should be at least one physical Board meeting per annum in Mauritius, wherein all directors are present, and at least four Board meetings annually should be conducted in Mauritius (including the physical board meetings).
- It is advisable that the Board of Canaan Mauritius and its employees should consist of persons capable of performing their functions.
- From an ongoing operations perspective, Canaan Mauritius may consider purchasing or renting office space, localizing one or more of its employees in Mauritius and incurring office expenses etc. in Mauritius. Further, a generic mailbox and a dedicated phone line answered in the name of Canaan Mauritius are also advisable.
- An Indian resident may be appointed as a director on the Board provided that the rest of the Board consists of non-Indian residents in majority.
- The employees of Canaan Mauritius, the Manager and the Advisory Company should work outside India. However, they may make short business visits to India in order to meet promoters /directors of portfolio companies, conduct research and due diligence activities. It is important to note that the role of the employees of such entities in India should be restricted to the collecting and analyzing information for the purpose of identifying investment opportunities in India. If required, they may also engage in preliminary negotiation activities, however, they should not be involved in the final negotiation process in India. All final stage negotiations and contract concluding activities should take place outside India, by personnel of such entities. The personnel of the Sub Advisor should not be involved in the negotiation process in relation to the terms of investment and/or divestment.
- The Board meetings of Canaan Mauritius should be held outside India and chaired from Mauritius. 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 or any member of the advisors in India to take unanimous investment decisions.
- A senior executive or director of the Sub-Advisor can take a position on the Board; however they should not become an executive director or an employee of Canaan Mauritius.

- No Indian director should sign documents on behalf of Canaan Mauritius, the Manager or the Advisory Company.
- No personnel of Canaan Mauritius or the Manager should not sign or conclude contracts in India. All investment agreements including terms sheets should be signed outside India. Even the cheque signing authority for bank accounts, on behalf of Canaan Mauritius should be exercised outside India.
- On finalization of an investment or divestment decision, appropriate paper trail should be maintained to show that all decisions and contract concluding activities including final negotiations have taken place outside India.

**Sub-Advisor should comply with the following guidelines to mitigate Indian PE risk:**

- Sub-Advisor should not be solely dependent on the fees from the Advisory Company. If possible, it should be engaged in advising other companies / funds in India or overseas and generate some revenue from them so as to demonstrate that the Sub-Advisor is not working exclusively for the Advisory Company. The Sub-Advisor may act for other funds within the same group or even as the Indian manager to other funds in India. Further, it is advisable that in practice around 10-15% of the suggestions of Sub-Advisor should be rejected by the Advisory Company in order to show that the advice rendered to it is non binding in nature.
- The premises of Sub-Advisor should not be at the disposal of its employees of the Manager or the Advisory Company.
- If the employees of the Manager or the Advisory Company are acting as the officers of Sub-Advisor, then it is not advisable that the employees use the business cards with the name of the Manager or the Advisory Company.
- The Sub-Advisor should be compensated on an arm's length basis by the Advisory Company for the services rendered by it.
- The role of the Sub-Advisor should be properly and clearly defined in the Advisory Agreement. The scope of services under such agreements should be restricted to the collection and analysis of information, based on which non-binding advice should be provided to the Advisory Agreement. The Sub-Advisor or any of its employee(s) or officer(s) should not have any authority to sign or conclude contracts or take any investment decisions on behalf of Canaan Mauritius, the Manager or the Advisory Company. The decision making process should be well documented with the Sub-Advisor only providing non-binding investment advice to Advisory Company outside India, which would evaluate and analyze such information and provide such analysis to the Manager for final decision making. Further, appropriate paper trail should be maintained to show that there has been an independent application of mind at each stage (i.e. on the non-binding investment advice sent by the Sub-Advisor together with record of how the final decision was made, and in the event any recommendations were made based on the investment advice provided by the Sub-Advisor, a record of recommendations accepted /

rejected by the Advisory Company). For example, this can be evidenced by showing that some recommendations were rejected along with the reasons for doing so.

## **PHASE II: DO'S AND DON'TS TO BE FOLLOWED ON DIVESTMENTS FROM INDIA**

- Canaan Mauritius should not have a fixed place of business (such as an office) in India from where they would be conducting their business activities. Even a hotel room can be construed as a fixed place of business. Any fixed premise within India constitutes a 'fixed place'. This place need not be owned by the non-resident, and need not be an entire structure. Even a few desks in some office or a few desks being at the disposal of the investment manager may cause a PE exposure for Canaan Mauritius, the Manager or the Advisory Company. Further, in case there are any employees of investment manager who are visiting India, they should not work out of a fixed place in India and no part of the premises of the Sub-Advisor should be at the disposal of these employees of the investment manager.
- Employees of Canaan Mauritius, the Manager Partner or the Advisory Company should always represent themselves as acting on behalf of such entities. They should not possess any business cards with Indian addresses, and should not maintain any permanent business address in India.
- On exit from investments in India appropriate paper trail should be maintained to show that all decisions and contract concluding activities including final negotiations have taken place outside India.
- Canaan Mauritius, the Manager or the Advisory Company (as applicable) should not sign or conclude contracts in India during the exit process. All investment (or divestment) agreements, including terms sheets should be signed outside India.
- No management and investment decisions should be taken by Canaan Mauritius, the Manager or the Advisory Company (as applicable) in India.

## VIII. CONCLUSIONS AND SUGGESTIONS

On perusal of all documents relating to the structure and operations of Canaan VIII Entities, the following issues emerge which could create adverse tax consequences for the Canaan VIII Entities in India.

- **References to Canaan India**

It has been observed across documents that Canaan India is referred to as the 'Indian office' of the Canaan Group and not an affiliate entity set up in India to undertake specific operations. Such references have been made in the PPM as well as press releases by the Canaan Group. (Please see specific documentation analysis above<sup>14</sup>)

Such references to Canaan India indicate that it is merely an office set-up to undertake the activities of the Canaan Group in India. These references undermine the status of the independent nature of Canaan India and could be picked up by revenue authorities to assert that (i) Canaan India is merely an office set up to further the activities of the Canaan Group; and (ii) that Canaan India carries on the business of the Canaan Group in India. This could result in PE exposure for Canaan in India.

**Recommendation:** *Canaan India should be referred to a company set up in India to undertake activities in the nature of identifying and evaluating investment opportunities. Reference to Canaan India should be in terms of being 'affiliated to Canaan Group'. Canaan India should be projected as an independent service provider set up to undertake business in India.*

- **References to the role played by Mr. Alok Mittal**

It has been observed across documents that Mr. Alok Mittal is referred to as the 'General Partner of Canaan' or "Managing Director, Canaan Partners" (please see specific documentation analysis above<sup>15</sup>). This implies that Mr. Alok Mittal is associated with the Canaan Group, and that his role is greater than being in a management position with respect to Canaan India.

Mr. Alok Mittal is also included in the list of 'Investment Professionals' in the PPM<sup>16</sup>, as per which his responsibilities include sourcing investment opportunities, evaluating such opportunities and mentoring investee companies.

**Recommendation:** *All references to Mr. Alok Mittal should be clear that his association is with Canaan India. Broad references to a relationship with the Canaan Group, in his capacity as a Managing Director / Investment Professional etc could result in PE exposure for the offshore Canaan VIII Entities in India.*

- **References to Mr. Harish Gandhi**

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<sup>14</sup> Please refer to page 18

<sup>15</sup> Please refer to page 27

<sup>16</sup> Please refer to page 18-19

It has been observed that Mr. Harish Gandhi is referred to as the 'Executive Partner, Canaan Partners' in a press release which indicates that Mr. Harish Gandhi is associated with the Canaan Group and is not an employee of Canaan India.

**Recommendation:** *Mr. Harish Gandhi should be referred to solely as being associated with Canaan India. Any mention of his relationship with the Canaan Group should be avoided.*

- **Scope of Services of Sub-Advisor**

The scope of services of the Sub-Advisor in the Sub-Advisory Agreement has been provided in an inclusive manner, thus leaving ample scope for interpretation as regards the scope of activities of the Sub-Advisor.

This language could lead the revenue authorities to claim that the Sub-Advisor is engaged in the management of the Manager or the Advisory Company.

**Recommendation:** *The scope of activities of the Sub-Advisor should be provided in specific terms and not inclusively. All permissible activities should be laid down in the Sub-Advisory Agreement. Further, it should be clarified that the advice provided by the Sub-Advisor is 'non-binding and recommendatory' in nature.*

- **Board meetings of Canaan Mauritius have we reviewed in detail the investment divestment process?**

**Recommendation:** *It is recommended that the Mr. Guy Russo attend at least such Board meetings of Canaan Mauritius where investment decisions are taken. This would add substance to the operations of Canaan Mauritius.*

In addition to taking a positive step towards rectifying the existing issues in the structural and operational aspects of the Canaan VIII Entities as enumerated hereinabove, it is essential that the Operating Guidelines, detailed in Section [•], be followed strictly to avoid any undesirable consequences.

It is extremely important that personnel of Canaan VIII Entities, especially those engaged in the operations of the Fund and Canaan Mauritius are aware of the various issues which could adversely affect the structure of the Fund and attach unwanted tax liability to the Canaan VIII Entities. As mentioned, it is essential to demarcate the activities of all the Canaan VIII Entities and ensure that neither Canaan India/Sub-Advisor, nor any of its employees have any role in the activities of the Fund and /or Canaan Mauritius, specifically the decisions relating to investments and divestments, including negotiating terms thereof. In addition, no management decisions relating to the Fund and/or Canaan Mauritius including concluding contracts should be undertaken in India.

- **Scope of Advisory Agreement**

The Advisory Agreement does not provide it the authority to delegate its functions or engage third parties to provide services. However, the Advisory Company has engaged the services of the Sub-Advisor to provide services in relation to Indian opportunities in India.

***Recommendation:*** *It is recommended that the Advisory Agreement be amended to provide the Advisory Company the authority to enter into such contracts, to ensure competency to enter into agreement.*