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Key Trends in the Technology Sector in India: A Quick Snapshot

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Set out below is a quick snapshot of some of the key trends that we have noticed in the technology sector in India over the past few months.

The "marketplace" model and its applicability to the online retail and streaming sectors

The ongoing digital revolution in India backed by higher internet and smartphone penetration, increasing quality of internet and changing consumer behavior is expected to take the country's internet economy's worth to a whopping USD 250 billion by 2020. The upwards growth trajectory is attributed in most part to the online retail and, thereafter, the online streaming services.

What is interesting is that notwithstanding the regulatory hurdles put in place for these sectors by the Government, they have attracted significant foreign investment over the years. This is particularly true in case of the online retail sector with Walmart's acquisition of Flipkart being a classic example.

Foreign investment in retail has strongly been opposed by the traditional brick and mortar stores and even organized local retailers primarily on the ground that smaller players will not be able to compete with big multinationals, and that this would ultimately lead to loss of livelihood. Political will has also generally been sporadic largely for reasons of protectionism and appeasement of the voter base.

Until 2015, the foreign direct investment (***FDI***) policy of India was at best unclear in relation to the online retail sector. Whilst it dealt with B2B e-commerce and B2C e-commerce, no mention was made of the online marketplace model and whether foreign investment in such marketplaces was permitted. The sector, therefore, witnessed a number of foreign investments which were made in the twilight zone. These investments, however, were subsequently subject to significant scrutiny by several retail associations and also the regulators – though nothing concrete ever came out of these.

To address the lacuna, the Government introduced a press note in 2016 to "clarify" the rules on foreign investment in e-commerce entities. Pursuant to the press note, 100 per cent. foreign investment in e-commerce entities was recognized as being permitted under the automatic route in the marketplace-based model of e-commerce where the marketplace e-commerce entity merely provided an information technology platform to facilitate sale of products of various brands on its platform but did not own the inventory. Foreign investment in

an e-commerce entity which owned inventory of the goods, which were directly sold to end customers, was not permitted. Further, marketplace e-commerce entities having foreign investment were required to follow certain operational guidelines, which, amongst other things, prohibited sales of more than 25 per cent. being made through the same vendor group and influencing of sales prices by the e-commerce entity.

In order to comply with the requirements of the press note, while at the same time retain some level of control over the quality of the products being sold on their platforms, entities like Flipkart and Amazon tweaked their business models to adopt a split structure, viz. wholesale and a more customer facing marketplace. The wholesale arm sold products to certain preferred sellers, who, in turn, listed these products on the marketplace platforms for sale to end-customers.

Offline retailers claimed that marketplace e-commerce entities were simply paying lip service to the requirements and not following them in spirit. It was said that these entities were indirectly engaging in inventory-based e-commerce. Subsequently, the Government issued another press note in late-2018 to further "clarify" the already existing regime. The 2018 press note, amongst other things, restricted control over inventory by the e-commerce entity (in addition to ownership), sales by affiliated sellers and exclusive arrangements with sellers, all to ensure that e-commerce entities operate on a pure play marketplace model wherein they merely act as an intermediary between sellers and buyers. The most controversial amongst these was the restriction on having control over inventory. Though varying interpretations are given to this requirement, the interpretation that has commonly been adopted is that sellers cannot purchase more than 25 per cent. of their overall purchases from a marketplace e-commerce entity or its group entities. This hit the Flipkart kind of model directly and so was initially resisted by e-commerce entities. However, press reports suggest that Flipkart has finally come around and complied with the requirement by putting in place intermediaries between its wholesale arm and the preferred sellers. By doing so, it appears that the preferred sellers on the platform will not directly be sourcing products from the marketplace e-commerce entity or its group entity – a simple "fix" which ensures that the business model complies with the letter of the law. Offline retailers have questioned the fix and made several complaints to the Government alleging violation of the FDI policy by Flipkart and Amazon. The Government, on its part, has sent out RFIs to the e-commerce players and has been engaging with them to better understand the structure adopted by them and identify any violations of the policy.

In so far as foreign investment in the online streaming services is concerned, there has been ambiguity on whether the provisions of the FDI policy dealing with "e-commerce" would apply to such entities. The view which is commonly taken is that this is not the case. The thrust of the FDI Policy is to regulate activities of e-commerce entities that are engaged in the buying and selling of <u>goods</u> and any "allied" services, and not entities engaged only in providing services. This is further supported by the fact that the FDI Policy, in the same vein, says that the sale of services through e-commerce will be under the automatic route.

In fact, we know from our interactions with the officials of the foreign investment department that they also realize the need to de-link the provisions applying to foreign investment in entities engaged in the sale of goods through e-commerce as opposed to entities engaged in providing services through e-commerce, nothing concrete has come about so far clarifying their stand. It can be expected that the issue will be tackled as part of the wider e-commerce policy that is due to be issued in the second half of 2020 (noting, however, that the draft e-commerce policy, which was circulated in February 2019 and which is being re-worked now, did not address this issue as such). However, till such time that this new policy is issued, the position remains unclear and market participants are proceeding on the basis that till such time their businesses remain unregulated.

Merger control filing in respect of investment in digital businesses

A proposal has recently been made to introduce additional merger control filing thresholds based on the 'size of a transaction' or its 'deal value'. This recommendation has been proposed in order to capture transactions involving non-traditional businesses, specifically those in the digital markets, which may be asset-light and may not generate significant revenues and, therefore, escape merger scrutiny as they do not meet the more traditional asset and turnover based thresholds. Similar amendments were carried out to the merger control regimes in Germany and Austria in order to assist them in adapting to the digital economy.

Whilst the fine print for operationalising this is still awaited, there are a number of questions this proposal gives rise to. For instance, the 'size of the transaction' threshold under the German and Austrian merger control regimes requires the target to have "significant activities" in the country where the merger filing is to be made. If a similar regime is introduced in India, clarity would be required on how the presence of "significant activities" would be measured and whether determination of the nexus would be with respect to assets, turnover, user base or some other factor. In addition, most of the transactions in the digital markets are global in nature. In such cases, it remains to be seen how a part of the deal size would be attributed to India for enterprises to determine if their transaction triggers a merger control filing requirement. Accordingly, changes to the Indian merger control regime to provide for a transaction size / deal value threshold would need to be clear and specific in order to avoid any confusion or misinterpretation.

Opportunities in the digital payments sector

Backed by the current government's impetus towards a "cashless society" / "digital India", India is currently witnessing a paradigm shift from a largely cash-based transactions economy to digital payment methods, and the number of digital transactions in India are expected to increase four fold by December 2021. According to a Credit Suisse report, it is estimated that the total digital payment market in India will grow to USD 1 trillion by 2023 led by the growth in mobile payments.

Prepaid payment instruments such as mobile wallets are one of the most popular digital payment methods. Whilst mobile wallets initially gained popularity in India as a result of demonetization in 2016, their sustained popularity has resulted from a host of factors including the increasing use of smartphones, decreasing data prices and customer convenience. Mobile wallets are regulated by the Reserve Bank of India (the ***RBI***) and generally speaking, entities proposing to operate a mobile wallet are required to obtain a licence from the RBI and meet certain eligibility requirements including in relation to minimum capitalization. A shift towards digital payments has also been facilitated by the introduction of public infrastructure for mobile payments in the form of the Unified Payment Interface (***UPI***), a system that allows seamless real time transfer of funds across different payment platforms by powering multiple bank accounts into one mobile application. Along with mobile wallets, UPI has emerged as a leading choice of digital payments in India and is likely to witness an annual growth of over 100 per cent. in the period leading up to 2021. Some of the key regulatory hurdles faced by mobile wallet providers in recent times has been the enforcement of stringent Know Your Customer (***KYC***) requirements (requiring an additional step of physical customer verification before onboarding customers) and the data localization norms (*discussed in detail below*).

Mobile wallet providers are currently in talks with regulators to introduce a more cost-effective online verification alternative that will allow mobile customers to use mobile wallets without being burdened by physical KYC requirements. It is interesting to note that mobile wallet providers have also now started integrating UPI as a payment option on their platforms. The integration of UPI has allowed them to circumvent the regulatory hurdle in relation to KYC requirements as UPI links bank accounts for which customers have already completed a verification process.

Whilst these requirements may have proved to be an initial setback for mobile wallets, the regulatory regime continues to encourage digital payment systems in India. The RBI has introduced consumer protection guidelines to secure digital transactions as well as interoperability guidelines (which will be implemented in a phased manner) under which users of different wallets will be able to transact with one another using UPI.

Currently, the Indian digital payments landscape is dominated by Paytm and Phone Pe. These payment wallets are backed by prominent international players (noting that fintech companies such as these are permitted to have 100 per cent. foreign direct investment without any government approval). Whilst Alibaba and SoftBank have invested in India's largest digital payments company, Paytm, Walmart recently acquired a majority stake in Phone Pe's parent company, Flipkart. Given the popularity of Phone Pe, recent news reports suggest that it is being hived off into a separate entity in order for it to raise capital independently to meet its growing needs. Phone Pe is said to be in discussions with Tencent and Tiger Global to raise around USD 1 billion and is looking at a valuation of at least USD 7 to 8 billion. Other prominent players in the digital payments market include Google Pay, which will soon compete with Whatsapp's UPI based payment platform that is set to launch in India later this year.

Data localisation requirements

Data localisation has assumed increasing significance in India since it was introduced as a key feature of the Personal Data Protection Bill (the ***PDP Bill***) in July 2018 (which seeks to overhaul the current data protection regime). In accordance with the data localisation requirement under the PDP Bill, one copy of all personal data is required to be held on a server located in India and certain categories of "critical personal data" (which will be notified by the government from time to time) can only be processed in India. The data localisation requirements under the PDP Bill are intended to give jurisdictional control over such data to the Indian authorities to enable better law enforcement and promote the growth of the digital ecosystem in India. However, it has met with a lot of international criticism and the EU and the US have both said that such moves are discriminatory and create significant trade barriers. Given such strong pushback re the data localization requirements, it is being reported that the Prime Minister's office will be taking a final call on this issue after consultation from various ministries of the government.

In April 2018, the RBI also issued a circular requiring all payment gateways along with their service providers / intermediaries / third party vendors and other entities in the payment ecosystem to store payment related data locally in order to enable "better monitoring" and "unfettered access" to the payment related data of Indian customers. Payment related data includes full end-to-end transaction details and information collected / carried / processed as part of the payment instructions. The RBI has also clarified that in case the processing of transactions is done abroad, the data should be deleted from the systems abroad and brought back to India not later than the one business day or 24 hours from payment processing, whichever is earlier. Whilst Indian payment system providers such as Paytm have welcomed the move, foreign payment systems providers have been strenuous in their resistance to this requirement. However, gradually players like Paypal and Whatsapp have started affirming their commitment to comply with these requirements.

Push towards electric vehicles (EVs)

Whilst the first concrete decision to incentivise EVs in India was taken way back in 2010, a massive and sustained push towards electric mobility has only come about under the current government. A number of incentives are being put in place to propel adoption of EVs and develop its manufacturing eco-system, with some of the key ones being:

- implementation of the Faster Adoption and Manufacturing of Hybrid and Electric Vehicles in India Phase II (***FAME 2***) scheme with effect from 1 April 2019. The FAME 2 scheme envisages a total financial outlay of INR 100 billion (approx. USD 1.4 billion), to be used over

a period of three years, for encouraging electrical mobility. Currently, approx. INR 86 billion (approx. USD 1.2 billion) is earmarked for providing "demand incentives" to consumers in the form of an upfront reduced purchase price, mainly in case of certain commercial hybrid and electric vehicles which meet the specified localization requirements. The cost of such incentives is reimbursed to the manufacturer by the government. Further, funds worth approx. INR 10 billion (approx. USD 140 million) have been allocated for assistance in setting up the EV charging infrastructure;

- reduction in the rate of goods and services tax on EVs and chargers to 5 per cent. from 12 per cent. and 18 per cent. respectively; and
- provision of income tax benefits to EV buyers on the interest paid on loans taken for purchase of EVs.

The government is also contemplating a timeframe for compulsory transition of internal combustion engine vehicles, starting with two and three wheelers, to EVs, and requiring the taxi aggregators (such as Uber) to convert around 40 per cent. of their fleet to EVs by April 2026.

Given that a substantial chunk of the total production cost of an EV can be attributed to the batteries powering it, the government also recognizes that there is a massive opportunity in marketing India as a hub for indigenous battery production. Currently, almost all EVs in India run on imported batteries (mainly Chinese) and the Indian government appears to be quite wary of being caught up in an import dependent model. Accordingly, there is an emphatic focus on localizing the production of EV batteries - an opportunity the country lost out on while transitioning to solar panels, mobile phones and laptops. This is also evident from the government's move to increase import duty on EV parts.

The government seems to have a plan of setting up at least four Tesla-style giga factories to manufacture batteries with an investment of around USD 4 billion. It is also being reported that the government is likely to offer a plethora of incentives to battery manufacturers such as concessional financing options and tax rebates. With a considerable foreseeable strategic push on new approaches and technologies in all aspects of EV technologies, in addition to EVs and battery manufacturing, assembly, storage and recycling facilities can be expected to become sunrise industries in themselves.

Against this backdrop, this sector has already started seeing significant interest from international investors. Hyundai Motors and Kia Motors recently announced that they plan to invest approx. USD 300 million in the EV initiative of SoftBank backed Indian taxi aggregator - Ola. Japan's Panasonic and Toshiba and South Korea's LG Chem are also looking to set up assembly and possibly battery manufacturing facilities in India.

Angel tax

Start-ups, particularly tech start-ups, looking to raise investments often benchmark the valuation at which the investments should be made against the "fair market value" of the enterprise. In fact, in terms of the Indian exchange control regulations, foreign investments cannot be made at a price lower than the fair market value. In most cases, fair market value is calculated using the discounted cash flow method wherein the value is derived based on the "future projections" made by the company.

In the recent past, tax authorities have increasingly been challenging valuations at which investments have been received by start-ups. By the time the tax authorities come to scrutinizing an investment, over a year or more has passed, thereby giving the authorities the benefit of hindsight to compare the projections that were originally made by the start-up with the actuals at the time of scrutiny. Where the start-up has not performed as was projected, the valuation is thrown down the gauntlet by the authorities. This analysis is undertaken by the tax authorities under the aegis of what is known as the "angel tax" regime. Under the angel tax regime, monies raised by unlisted companies from resident investors or onshore funds (other than VC funds),

which are in excess of the fair market value, are treated as income in the hands of the company and are, accordingly, subject to tax. Once a determination is made by the tax authorities that the valuation was in fact inflated, they seek to impose tax on the amount raised in excess of the fair market value.

The Government as part of its initiative to boost the start-up ecosystem has taken successive steps to grant an exemption from the angel tax regime to "eligible" start-ups. As part of the latest notification that was issued in February this year, several limits were relaxed to include an even wider gamut of start-ups within the ambit of eligible start-ups. Companies can now be classified as a start-up for up till 10 years from their incorporation, up from the earlier seven years. Whilst earlier to be classified as an eligible start-up, a company should not have had an annual turnover of more than INR 250 million, this limit was increased to INR 1 billion. Once a company is recognized as an eligible start-up, issue sizes of up till INR 250 million raised by it are eligible for exemption. In order to avail the exemption, a simple declaration is required to be given by the company to the authorities at the time of the issuance. The declaration, the Government has clarified, should be summarily accepted by the tax authorities with scrutiny of the contents of the declaration being the exception.

Recently in August 2019, the Government announced a blanket relaxation from angel tax for eligible start-ups. Whilst a formal implementation of the announcement is awaited, it seems what it would mean is that once a start-up is recognized as an eligible start-up by the Government, no separate declaration in terms of the February notification will need to be given by it for each issuance.

With respect to a foreign investor, although the angel tax regime does not apply to it as such, the key point to be mindful of is a potential tax hit on the investee company in respect of onshore investments received by it, which tax hit will ultimately have to be borne by the foreign investor as well in proportion to its shareholding.

We are closely monitoring developments regarding this and if would like any further information on any aspect of this note, we would be happy to assist.

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