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Online Gaming:
India Briefing

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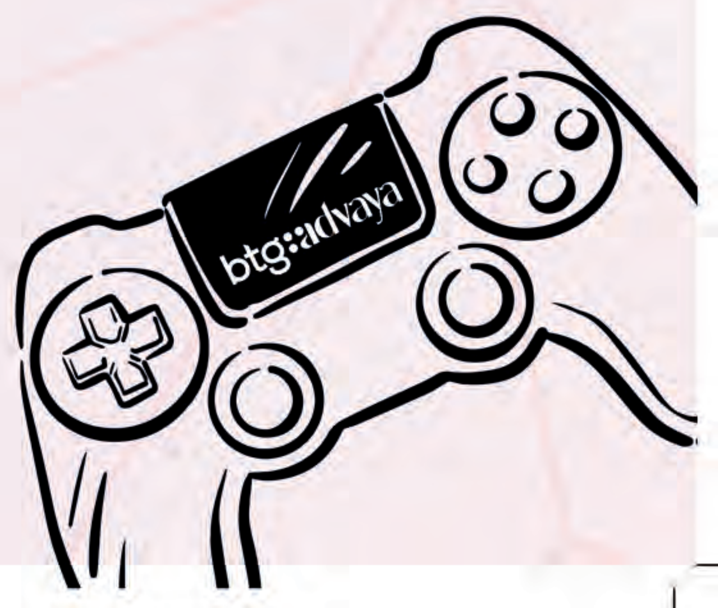

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The Current State of Play

In a 2019 letter to its shareholders, video streaming giant Netflix said that in terms of screen time, it competed with (and lost to) the hit game Fortnite more than with HBO.[1] With user generated content, multiple formats of audio and audio-visual products, and increasing internet bandwidth, the most precious commodity remains consumer attention. The years following Netflix's statement prove it – the global gaming industry grew at a CAGR of over 38% in 2020 amidst the pandemic to reach a value of USD 229 billion in 2021[2] and is estimated to reach a value of USD 546 billion by 2028.[3] As on date, India has more than 70 million gamers spread out across mobile, console, and PC platforms.

India has been one of the epicenters of this gaming explosion across the world. In the dynamic landscape of India's thriving media and entertainment sector, the online gaming segment has emerged as a powerhouse, where innovation, engagement, and economic potential converge. Recent years have witnessed a surge in online gaming's popularity, propelled by a growing population that is still very young, and factors such as widespread smartphone penetration, enhanced Internet connectivity, and development of local gaming content tailored to Indian preferences. The Indian online gaming segment has grown at a CAGR of 28% over the last 3 years to reach INR16,428 crore in FY23.[4] Notably, the gaming phenomenon transcends beyond metropolitan areas, finding its impetus in the consistent growth of Tier 2 and 3 geographies and demographics.

Despite its rapid ascent in terms of game consumption, India's online gaming segment constitutes a mere 1.1% of the global online gaming revenue.[5] Advertisement-led monetization holds significance in India, as the paid user base is predominantly concentrated within the RMG (real money gaming) segment. With the anticipated increase in supply of world-class titles, advent of cloud gaming and expanding scale of game development studios, India is poised to mark its presence not only as a consumption hub but also as a monetization hub. (The online gaming segment has historically attracted substantial investor interest with investments worth INR 22,931[6] crore from both domestic and global sources between FY20 and FY24 YTD.

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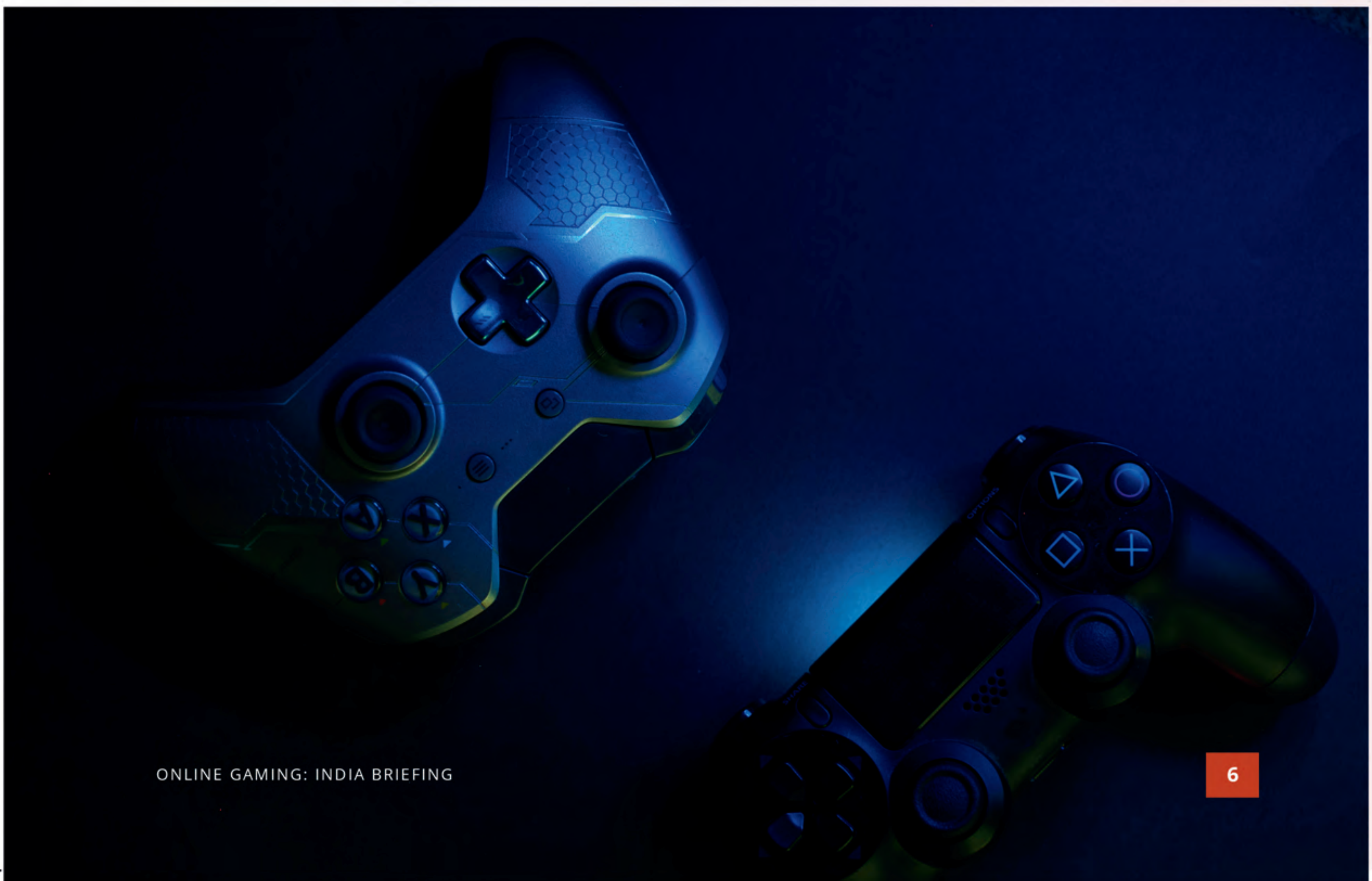
Regulatory Landscape – A Tale of 2 Ecosystems



The biggest obstacle to realizing India's potential lies in the lack of a bespoke, coherent framework of governance or regulation for the gaming sector. This is a result of policymakers' historical lack of interest in the area, and a paucity of understanding the new market's dynamics. In the previous year 2023, most notably, changes in taxation and content regulation blunted growth of this segment in India. **For the segment to truly thrive, a stable regulatory and legal framework is imperative. Uncertainties can impede the realization of its full potential and hinder rapid scalability.**

To better understand the nuances of the status and prospects of the gaming sector in India, we have provided a broad overview of the regulatory and legislative landscape of the online gaming sector in the country – in 2 ecosystems.

Part I –
India as a Market for Games

(A) Regulation of Games of Chance

Games of chance, when played for monetary stakes, constitute betting and gambling in India's colonial era Public Gambling Act, 1867. Given division of legislative powers in the Constitution of India is an added complication, since betting and gambling falls under the jurisdiction of States, governed by state-specific gaming and police laws. This has led to a complex regime country-wise, with States differing wildly on how to regulate games.

Games of chance are prohibited in most Indian states, falling within the old adage of *res extra commercium*. However, states like Nagaland, Sikkim, Meghalaya, and Goa permit certain forms of chance-based games as licensed activities. While these laws apply to physical/offline betting and gambling, their application to online betting and gambling is debated. Online games transcend state's territorial boundaries, making the enforcement of these laws challenging.

(B) Regulation of Games of Skill

Until recently, skill-based games were generally allowed as an exception (e.g., betting on Horseracing). In the past 3-4 years, States including Tamil Nadu, Andhra Pradesh, Karnataka and Telangana have enacted laws to prohibit games of skill played for monetary stakes. As a result, skill game formats like rummy, poker and fantasy sports were effectively banned in these states.

Upon judicial challenge, these laws failed the test of constitutionality and were consequently read down by several high courts. In separate decisions of the high courts of Madras, Karnataka and Kerala, the regulation of games of skill under betting and gambling laws was held to be legally untenable. These decisions have created a regulatory vacuum around games of skill.

(C) A Unified Regime?

India's Central Government announced online gaming rules in April 2023 to establish an unambiguous and self-governance framework for regulating the skill-based gaming sub-segment.[7] By adopting a unified approach, the recently notified online gaming rules have brought in some clarity to players in this space.

The online gaming rules further establish a framework for regulating the online gaming segment, including the mechanism for verifying an online real money game as a permissible online real money game. These rules call for setting up Self Regulating Bodies (**SRBs**) which are empowered to declare an online real money game as permissible. However, the formation of SRBs is delayed because the Ministry of Electronics and Information Technology (**MeitY**) is in the process of seeking consensus from various ministries[8] and addressing concerns around independence of regulatory bodies.

'Gaming' India's indirect tax regime

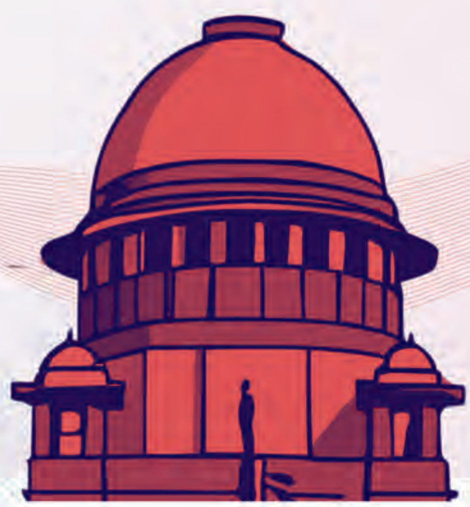
In August 2023, amendments were made to Indian tax laws to specify that 'actionable claims' offered by RMG platforms would be taxed at 28% on full-face value of deposits. Before October 01, 2023, the RMG companies followed a practice of paying 18% tax on platform fees, also known as Gross Gaming Revenue (**GGR**).

So far, the department has issued tax demand notices to the tune of INR1-1.5 lakh crore to more than 40 RMG companies.[9] Industry stakeholders suggest that the amendment has impacted the unit economics of RMG companies bringing down profitability, and affecting investor sentiment. If the 28 % GST is levied on Contest Entry Amount, the tax revenue in five years is expected to decrease by 58 percent to 72 percent compared with the current regime. Based on such analysis, the legitimate industry size may shrink by 33x to 43x in the next five years, significantly affecting the domestic industry, including small players and start-ups in this space.[10]

This illustrates that a more thoughtful approach to taxation, and other controls, for the online gaming sector is the need of the hour. We must account for industry dynamics, consumer affordability, substitutability, and competitiveness, to help maintain a sustainable and thriving online gaming ecosystem in India.

Update

In April 2024 the Hon'ble Supreme Court of India transferred to itself 27 writ petitions which are pending across nine State High Courts, challenging the levy of 28% tax. The court had also sought a response from the Directorate General of Goods and Services Tax Intelligence in this issue. The petitioners also include leading online gaming companies such as Dream 11, Games 24x7, and Head Digital Works. Presently the Apex Court is in the process of hearing detailed arguments in the matter.



Part II – Games Development Outsourcing to India

India has traditionally offered significant cost-competitiveness and skilled workforce for IT development, and an increasing number of games developers are looking to outsource key working components to India.

The Economics of Games Development

Games are now extremely ambitious in terms of overall quality, presentation, graphics, story and structural realism. While most of the world's population is still playing on mobile, the growth in the number of PC and console players who demand higher production value have led to game budgets of USD 50 million or more. Game development in India is leveraging this increase in costs to attract international outsourcing by allowing game publishers to save money.

Apart from lower talent costs, game publishers benefit by hiring Indian game designers and developers for any of the 3 stages of game development, including -

1. **Pre-production** - Outsourcing works such as creation of various game assets, level designing and creation, programming, etc.
2. **Production** - Outsourcing the creation of final concept arts, character modeling, character AI and animation, etc.
3. **Testing and QA** - Game development requires a lot of time to be devoted to Testing as consumer backlash can hurt the overall reception of the game in an adverse way. Since games need to be tested over a wide variety of formats, platforms, handsets (in case of mobile games), outsourcing these tasks can save considerable time for the publishers.

India boasts of some of the world's leading game development companies such as Octro, PLaySimple, Lakshya Games, Juego Studios, Abhiwan Technologies, Hdata Systems to name a few. These companies are offering cutting edge game development software and solutions to the world's leading gaming companies such as EA Sports, Riot Games, Blizzard etc.

India is an increasingly attractive destination for global gaming giants for a number of reasons:

1. Presence of one of the world's largest youth populations
2. World's second largest Internet user-base
3. Popularity of multiple payment models
4. Availability of skilled, creative, and comparatively cheaper talent
5. Huge skill-base across IT, QA and Design, and Arts
6. World-class infrastructure
7. Major development centers such as Microsoft, Nvidia, UbiSoft, Electronic Arts, Disney, Sony, etc. have already set up shop in India.

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What to Know While Setting Up In India

(A) Incorporating a NewCo in India

Incorporating a new entity in India is a document intensive process, requiring detailed disclosures from prospective shareholders and directors. It also involves submission of underlying documents that are to be: (a) notarized and apostilled/consularised (depending on the country of execution of documents), and/or (b) signed in wet ink. If all documents are promptly provided (including signed, notarized/apostilled docs), and per our experience, one should be able to incorporate an India Sub within 10-12 weeks.

(B) Investment Restrictions

The approval route for investment is typically applicable for foreign investment into companies carrying on business in certain identified sectors or up to certain limits, prior approval of the Government of India is required. In our experience, gaming and technology related outsourcing falls within sectors such as IT/ITES, where 100% foreign investment is allowed.

However, for a non-resident entity either registered in any of the countries that share a land border with India, or whose ultimate beneficial owners are individuals situated in such countries that share a land border with India, investments can only be made with prior government approval. This includes direct investments from China, Hong Kong, etc., and also instances where the investment is made by EU or US private equity funds or pooled investment funds that have such participation. Such approvals take between 8-10 months, and are granted on a discretionary basis. Alternate investment models may be available to such entities who want to invest in India, including service contracts.

(C) Anti-Trust Laws

The Competition Act, 2002, as amended from time to time ("**Competition Act**") has been enacted in India with a view to prevent practices which have an adverse effect on competition and to promote and sustain competition in markets. A 'Combination' (not meeting the Exemption (set out below) or falling within the categories specified in the regulations issued under the Competition Act) is to be mandatorily notified to the Indian competition regulator.

At present, there is a '*de minimis*' or 'target' exemption in force which exempts any transaction where the target enterprise (whose shares, assets, voting rights or control is being acquired or the entity being merged or amalgamated) either has assets of less than INR 4.5 Billion (equivalent to USD 54 million) in India OR turnover of less than INR 12.5 Billion (equivalent to USD 151 million) in India ("Exemption"), from notifying the regulator.

(D) Withholding Taxes

Withholding tax compliance is quite stringently monitored by Indian tax authorities. A buyer (say) is required to withhold tax from the consideration payable to the vendor, deposit the same with the Indian tax authorities and undertake various compliances which include obtaining a Tax Deduction Account Number, filing of a withholding tax return and providing a withholding tax certificate to enable tax credit of the same to the vendor(s). Default in withholding tax and/or the compliances could lead to liability on the buyer for the withholding tax amount, interest at 12% per annum and a penalty up to 100% of the tax amount for the buyer.

(E) Indirect Tax Considerations

The nuances of Indian tax implications and documentation requirements can significantly influence the overall structure of a transaction and if not factored at an early stage of structuring, they can lead to significant delays and unexpected tax costs, ultimately undermining the strategic goals of the deal. It's therefore essential for stakeholders to adopt a proactive approach to these Indian tax issues from the very beginning.

Similar to China and Australia, India imposes capital gains tax and withholding tax obligations even on indirect transfer of Indian assets.

Indirect transfer involves sale or transfer of shares of a foreign company that holds assets in India. Primarily, it means that even if a foreign company sells its shares in another foreign company, Indian tax authorities can deem that as a transfer of assets situated in India, triggering capital gains tax obligation for the selling shareholders and withholding tax obligation for the buying shareholders.

Endnotes

1 https://s22.q4cdn.com/959853165/files/doc_financials/quarterly_reports/2018/q4/FINAL-Q418-Shareholder-Letter.pdf

2 https://www.fortunebusinessinsights.com/gamingmarket105730#:~:text=The%20global%20gaming%20market%20size,growth%20of%2038.24%25%20in%202020.

3 *Ibid*

4 As per the letter written by E-Gaming Federation (EGF) and the Federation of Indian Fantasy Sports (FIFS) to the GoI; industry discussions; EY FICCI report 2023 - Windows of opportunity; EY analysis

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10 Deloitte Report: Analysis of impact of GST on Online Gaming: file:///Users/btglegal/Downloads/in-tax-GST-on-online-gaming-06.07-noexp.pdf

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