

Investment Funds: Monthly Digest

September 30, 2020

INCENTIVISING CATEGORY-III AIFS IN THE IFSC – A WELCOME MOVE! - SEPTEMBER 2020

The Alternative Investment Fund (“AIF”) industry in India has been evolving at a rapid pace and has invested over ₹1.5 lakh crore into Indian ventures as at June 30, 2020.¹ Further, over the last fifteen years, AIFs have provided nearly ₹10 lakh crore of risk capital to Indian businesses, funding several major investments across sectors such as industrial, retail, healthcare, digital consumer, and banking, financial services and insurance.²

While AIFs is seen as one of the most significant, growing and stable asset class in India, the fund management industry around the globe is still located in sophisticated offshore financial hubs Singapore, Hong Kong, Mauritius etc. on account of excellent infrastructure and ease of doing business. Further, offshore investors also prefer to pool their money outside India for investing in India to limit the administrative requirements at the offshore fund level itself.

ENCOURAGING AIFS THROUGH INTERNATIONAL FINANCIAL SERVICES CENTRE

In 2015, the Government of India (“GoI”) announced the establishment of Gujarat International Financial Tec-City (“GIFT City”), in Gujarat as India’s first International Financial Service Centre (“IFSC”). The IFSC in GIFT City seeks to bring to the Indian shores, those financial services transactions that are currently carried on outside India by overseas financial institutions and overseas branches / subsidiaries of Indian financial institutions

Subsequently, the Securities Exchange Board of India (“SEBI”) issued detailed guidelines i.e. SEBI (International Financial Services Centre) Guidelines, 2015 (“SEBI (IFSC) Guidelines”), to facilitate and regulate financial services relating to securities market in an IFSC to make India an international financial hub and onshore the fund management industry. The SEBI (IFSC) Guidelines regulate activities in relation to AIFs operating in IFSC and *inter-alia* sets out guidelines regarding eligible investors, permissible investments, criteria for sponsor / manager etc.

The current government has been taking various measures to operationalise the IFSC and has been providing various benefits to units set up in the IFSC. In this context, the Ministry of Law and Justice passed the Taxation and Other Laws (Relaxation and Amendment of Certain Provisions) Act, 2020 (“Taxation Act, 2020”)³ which seeks to *inter-alia* amend the Income-tax Act, 1961 (“ITA”), and the Finance Act, 2020. Amongst other amendments, the Taxation Act, 2020 provides tax incentive for Category-III AIFs located in the IFSC (“Category-III IFSC AIFs”) to encourage relocation of foreign funds to the IFSC. Pertinent to note that the Indian foreign exchange control regulations,⁴ consider an entity established in IFSC to be a person resident outside India.⁵ Therefore, a Category-III IFSC AIF would be required to obtain license under the relevant SEBI regulations⁶ in order to invest in India.

In this edition of the monthly digest, we have discussed the incentives provided under the Taxation Act, 2020 to Category-III IFSC AIFs and the possible issues in relation to Category-III IFSC AIFs in detail. Pertinent to note that these incentives are provided to a Category-III IFSC AIF established in form of a company or trust or a limited liability partnership of which all units are held by non-residents (other than units held by a sponsor or manager).

CURRENT ISSUES WITH CATEGORY III AIFS

Unlike Category- I and Category-II AIFs which have been accorded a pass-through status under Section 115UB⁷ of the ITA, characterisation of income of Category-III AIFs has been a controversial issue. As mentioned above, Category-III IFSC AIFs would be required to obtain an (additional) FPI license to invest in India. The issue of characterisation of income of Category-III AIFs is further exacerbated for Category-III IFSC AIFs (registered as FPIs) as the ITA provides that any security held by an FPI should be considered to be a capital asset.⁸ Accordingly, securities held by Category-III IFSC AIFs should be considered to be capital asset and any income arising on transfer of such security is taxable as capital gains (and not business income) under the ITA. In this regard, there appears to be an anomaly to the extent that while Category-III IFSC AIFs may claim tax holiday under section 80 LA of the ITA,⁹ the characterisation of income from transfer of securities is considered to be capital gains by virtue of obtaining an FPI license, rendering the tax holiday provisions useless.

AMENDMENTS TO THE ITA

The amendments by the Taxation Act, 2020 brings rest to the controversies in relation to characterization of income of Category-III IFSC AIFs by specifying the manner of taxation of Category-III IFSC AIFs as well as its investor and bringing the tax rates at par with those applicable to an FPI. This should ensure certainty in relation to tax treatment of income earned by Category-III IFSC AIFs and also reduce possibility of litigation in future. In this regard, the statement of objects and reasons of the Taxation Act, 2020 states that the amendments in relation to Category-III IFSC AIFs have been made to encourage relocation of foreign funds to the IFSC.

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• **Exemption to Category-III IFSC AIFs:** Currently, income from transfer of certain specified securities *inter-alia* being global depository receipts, rupee denominated bonds of an Indian company, derivatives, units of mutual funds, units of business trust, listed on a stock exchange located in IFSC is exempt from levy of capital gains tax. Therefore, the exemption was limited to income from transfer of specified securities listed on a stock exchange located in IFSC.

The Taxation Act, 2020 seeks to expand the scope of this exemption to the following income sources of Category-III IFSC AIF:¹⁰

- Any income accrued or arisen to, or received by a Category-III IFSC AIF as a result of transfer of securities (other than shares of an Indian company). This exemption should include income from transfer of debt securities or derivatives issued by Indian companies irrespective of whether they are listed on a stock exchange located in IFSC and income from transfer of securities (capital gains) from overseas investments made by Category-III IFSC AIFs;
- Any income (interest / dividend) from securities issued by a non-resident and where such income otherwise does not accrue or arise in India;
- Any income from securitization trust under head profits and gains from business and profession (“PGBP”) to the extent such income is attributable to units held by non-residents. This exemption should include income from upside on loans on securitisation by securitisation trust

These changes not only seek to bring Category-III IFSC AIFs at par with FPIs, but also provide certain additional incentives for investing through IFSC. For example, while capital gains earned by FPIs on transfer of debt securities or derivatives issued by Indian companies is subject to tax in India, such income has now been made exempt from tax in case of Category-III IFSC AIFs.¹¹ Similarly, income of Category-III IFSC AIFs in form of upside on securitisation by securitisation trust to the extent characterised as PGBP has also been made exempt from tax.

• **Exemption to unit holders of Category-III IFSC AIF:** Any income accruing or arising to or received by unit holders from Category-III IFSC AIF or on transfer of units in Category-III IFSC AIFs has been exempted from tax.¹²

Therefore, all distributions from Category-III IFSC AIFs to its unit holders and capital gains arising on exit from Category-III IFSC AIFs should be exempt from tax in India. From the perspective of investors, this exemption should ensure clarity and reduce chances of litigation in relation to their investment in Category-III IFSC AIFs. Pertinent to note that Category-I FPIs are granted exemption from application of indirect transfer provisions.¹³ Given that a Category-III IFSC AIFs would apply for registration as a Category-I FPI,¹⁴ indirect transfer provisions should not be applicable to them as well.

• **Tax rates for Category-III IFSC AIFs:** Section 115AD of the ITA provides a special regime for taxation of income of FPIs. The Taxation Act, 2020 has amended section 115AD of the ITA to provide flat rate of tax for income earned by Category-III IFSC AIFs (these relaxations apply only to the extent of income that is attributable to units held by non-resident investors). The table below captures the tax rates (exclusive of surcharge and cess) applicable to Category-III IFSC AIFs *vis-à-vis* FPIs:

Nature of income	Category-III IFSC AIFs (registered as FPI)	FPIs
Dividend	10%	20%
Interest under section 194LD	5%	5%
Interest	10%	20%
Long-term capital gains (including LTCG under section 112A)	10%	10%
Short-term capital gains under section 111A	15%	15%
Other short-term capital gains	30%	30%

As is evident from above, the tax rates for Category-III IFSC AIFs are now at par (except for dividend and interest income) with those applicable to FPIs. Further, dividend or interest income (other than interest under section 194LD) earned by Category-III IFSC AIFs have been put at a higher footing and are subject to tax at 10% vis-a-vis 20% for FPIs. Further, the surcharge rates applicable to FPIs should apply to Category-III IFSC AIFs as well. Given that a Category-III IFSC AIF would obtain an FPI license, an issue arises on whether the tax rates applicable to FPIs would apply to Category-III IFSC AIFs. Given that the intent of Gol is to incentivise Category-III IFSC AIFs, Category-III IFSC AIFs should be liable to tax on basis of the rate which is more beneficial to them.

• **Clarity on withholding obligation:** Given that characterisation of income of Category-III AIFs is controversial, there is lack of clarity on withholding tax obligation of investee companies as well. However, in relation to Category-III IFSC AIFs, the Taxation Act, 2020 has provided that the person responsible for paying any income (other than capital gains) to Category-III IFSC AIFs shall withhold tax at rate of 10% at the time of credit or payment, whichever is earlier. Section 196D further clarifies that no withholding is required to be done in relation to income which is exempt under section 10(4D) of the ITA.

The competitive tax regime enacted for Category-III IFSC AIFs under the Taxation Act, 2020, should provide a boost to onshore the fund management industry in India and should be a great impetus to IFSC. However, pertinent to note that these incentives are limited to Category-III IFSC AIFs of which all units are held by non-residents other than units held by a sponsor or manager. Also, from a regulatory standpoint, given that a Category-III IFSC AIF would be required to obtain an FPI license as well, it is unclear how provisions of FPI Regulations and AIF Regulations will work in parallel with each other. The amendments made by the Taxation Act, 2020 depicts the seriousness of the government in onshoring the fund management industry and should go a long way in encouraging fund managers to invest in India through IFSC. Given the political unrest and economic conditions due to the pandemic, the changes in relation to taxation of Category-III IFSC AIFs are very timely and should help build investor and industry confidence in IFSC.

¹ Data relating to activities of Alternative Investment Funds (AIFs), SEBI; available at: <https://www.sebi.gov.in/statistics/1392982252002.html>

² The fourth Alternative Investment Policy Advisory Committee Report dated July 23, 2018

³ The Taxation and Other Laws (Relaxation of Certain Provisions) Ordinance 2020 (**"the Ordinance"**) was promulgated on March 31, 2020, in order to ease compliance burden on taxpayers due to outbreak of COVID-19. The Taxation and Other Laws (Relaxations and Amendments of certain Provisions) Bill 2020 passed by Lok Sabha and Rajya Sabha seeks to replace the Ordinance. The Taxation Act, 2020 received assent from President of India on September 29, 2020

⁴ Foreign Exchange Management (International Financial Services Centre) Regulations, 2015 (**"FEMA (IFSC) Regulations"**)

⁵ Regulation 3 of FEMA (IFSC) Regulations

⁶ SEBI (Foreign Portfolio Investors) Regulations, 2019 (**"SEBI (FPI) Regulations"**)

⁷ Section 115UB of the ITA grants tax pass through status to SEBI registered Category-I / Category-II AIFs such that income (except business income) is exempt at the level of AIF and is taxable in hands of investor. Taxation of Category-III AIFs (established as trust) is governed by sections 161 to 164 of the ITA. Where the trust is specific / determinate, the trustee is assessed as a representative assessee on behalf of the beneficiaries and tax is levied on and recovered from them in a like manner and to the same extent as it would be leviable upon and recoverable from the beneficiaries. Further, section 161(1A) of the ITA provides that where the income of the representative assessee consists of profits and gains from business or profession, such income should be taxable in the hands of the trust at maximum marginal rate

⁸ Section 2(14) of the ITA

⁹ Section 80LA of the ITA provides that units of an IFSC can avail 100% deduction from its gross total income arising from business for which such unit has been established for any 10 consecutive years out of a period of 15 years, beginning with the year in which the requisite permission for the operation of the IFSC unit was obtained

¹⁰ Section 10(4D) of the ITA

¹¹ Income from transfer of securities (other than shares of an Indian company) by Category-III IFSC AIFs should be considered to arise in India. In this regard, the language of section 10(4D) is unclear on whether this exemption is qualified by the words 'and where such income otherwise does not accrue or arise in India'. Given the intention of amendments, it does not seem that the exemption is qualified by the accrue or arise condition

¹² Section 10(23FBC) of the ITA

¹³ Third proviso to Explanation 5 of section 9(1)(i) of the ITA

¹⁴ The SEBI (FPI) Regulations provide that an applicant established in IFSC shall be deemed to be appropriately regulated, for the purposes of the SEBI (FPI) Regulations. Accordingly, a Category-III IFSC AIF would apply for registration as a Category-I FPI

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