

Tax Hotline

December 26, 2016

INDIA'S TAX REGULATOR "CLARIFIES" INDIRECT TRANSFERS: ADDS TO THE MORASS OF INVESTOR WOES

- CBDT recently released clarifications on questions raised by stakeholders on various issues relating to indirect transfer provisions, particularly in the context of offshore PE/VC funds and FPIs.
- CBDT's approach appears to ignore the practical issues arising from the indirect transfers and sticks to strict interpretation of the current rules.
- Requests from industry players for exemptions and carve outs go unheeded. Responses given by the CBDT remain silent on various other issues.

Recently, on December 21, 2016, the Central Board of Direct Taxes ("CBDT") released a circular¹ ("Circular") containing responses to questions raised by various stakeholders (including foreign portfolio investors ("FPIs"), private equity ("PE") / venture capital ("VC") investors etc.) in the context of the applicability of the indirect transfer provisions under the Indian Income Tax Act, 1961 ("ITA"). While the Circular was intended to provide clarity on the circumstances in which the indirect transfer provisions are to be applied, it fails to address the concerns of various stakeholders, chiefly FPIs, with regard to issues like potential double and triple taxation, onerous compliance requirements, and lack of tax neutral foreign corporate restructurings. The Circular does little to provide certainty and is disappointing and regressive in its impractical stance.

BACKGROUND

Section 9 of the ITA contains provisions under which income, upon the fulfilment of certain conditions, accruing to a foreign (non-Indian) resident is deemed to accrue in India and is accordingly brought within the Indian tax net. In order to overcome the impact of the Supreme Court of India's ruling in the Vodafone case², the Finance Act, 2012 amended the aforesaid Section 9³ with retrospective effect to provide that if an asset, being a share or interest in a company or entity⁴ registered or incorporated outside India, derives its value, directly or indirectly, substantially from an asset situated in India, the gains arising from the transfer of such share or interest would be taxable in India.

Due to the expansive scope of and language used in the amended provisions, a number of concerns were raised by stakeholders including FPIs and PE / VC investors, which led to the mandate of the Shome Committee⁵ being expanded to examine the applicability of the indirect transfer provisions, particularly in the context of FPIs operating in India. The Shome Committee's report ("Report") considered a number of stakeholder submissions and suggested a number of amendments / clarifications to Section 9. However, it was only three years later that the Finance Act, 2015 further amended the provisions of Section 9 to incorporate some of the Shome Committee's recommendations.

The amendments included the insertion of Explanation 6 to Section 9(1)(i) which clarifies that to "substantially derive value" means that (i) the value of the Indian assets must exceed INR 10 crore; and (ii) represent at least 50% of the value of assets owned by the foreign company whose shares are being directly or indirectly transferred ("Explanation 6 Conditions"). Explanation 7 to Section 9(1)(i) was also inserted which provides a carve out for transfers of shares of a foreign company deriving substantial value from Indian assets by investors who hold less than 5% of the interest in such foreign company ("Explanation 7 Carve Out"). However, the amendments failed to clarify a number of issues and concerns were raised, especially by foreign investors.

Assuming Explanation 6 Conditions are met and the Explanation 7 Carve Out cannot be satisfied, the following diagram illustrates a typical situation in which indirect transfer provisions are attracted in the case of redemption requests upon FPIs.

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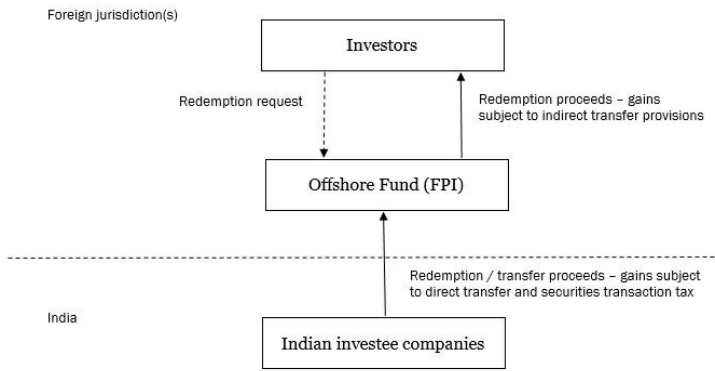
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THE CIRCULAR

On June 15, 2016, the CBDT had constituted a working group to examine the issues raised by stakeholders with regard to the applicability of the indirect transfer provisions. After considering the comments of the working group, the CBDT has, through the Circular, set out its responses to the public's concerns. We have discussed below some of key clarifications issued by the CBDT, which are particularly relevant for offshore funds investing in India. While the bulk of the queries were with respect to FPIs, the interpretations used by CBDT will be relevant for PE / VC funds investing in India as well.

Redemptions by Investors in Offshore Funds registered as FPIs

In order to get exposure to Indian capital markets, various offshore funds are registered as FPIs with the Securities and Exchange Board of India ("SEBI") and are accordingly, investing directly in listed Indian companies. Such funds are typically open-ended allowing for frequent subscriptions and redemptions by investors in the fund on the basis of periodic net asset value ("NAV") calculations.

In this context, a clarification was sought as to whether indirect transfer provisions would apply to redemptions made by investors in such a fund when the fund has been paying applicable taxes on its transactions in listed securities. The CBDT has clarified that where Explanation 6 Conditions are satisfied, redemption by investors of their shares in the fund will be taxable in India unless the investors are covered by the Explanation 7 Carve Out.

It is relevant to note that FPIs are already subject to (short term) capital gains tax and securities transaction tax ("STT") on gains earned on the transfer of listed Indian securities. Subjecting gains derived by investors at the time of redemption of their shares in the fund amounts to economic double taxation of the same income. Moreover, it is unwarranted that gains derived by the investors are subject to taxation, when the FPIs themselves may be exempt even under domestic law. To the extent investors are subject to tax in their home jurisdictions arising on the gains from redemption, there may be economic triple taxation, especially in cases where the availability of tax credits may be limited or non-existent. The Circular fails to address this aspect of multiple levels of taxation on the same income, and simply cites the Explanation 7 Carve Out. Such a situation is undesirable if India wishes to portray itself as a serious destination for global capital.

Further, the comments indicate a failure on the CBDT's part to appreciate the nuances in the matter at hand. For instance, distributions by a fund on the redemption of its units are typically made out of accumulated profits; or return of capital invested. Under Section 2(22) of the ITA, any distributions from 'accumulated profits' by way of 'reduction of capital' of a company are characterized as 'dividend' income and not as capital gains. Further, in Circular No.4 of 2015 dated March 26, 2015, CBDT clarified that an offshore distribution of dividends would not result in a tax liability under Section 9(1)(i) read with Explanation 5.⁶ Therefore, even in a situation where an investor is not covered by the Explanation 7 Carve Out, distributions made out of accumulated profits to such investor may not be subject to tax in India. The clarification provided in the Circular does not get into such analysis, despite it being clear that the funds industry is grappling with difficulties in understanding the applicability of indirect transfer provisions, as this has also been highlighted as a concern by the Alternative Investment Policy Advisory Committee constituted by SEBI.⁷

Master-Feeder Structures

Master-feeder structures represent another prevalent model for global platforms accessing Indian listed opportunities. In such structures, monies from the offshore investors are pooled in feeder funds set up in different offshore jurisdictions which in turn pool monies in a master fund set up in an offshore jurisdiction. The master fund is then registered as an FPI with SEBI in order to invest in listed Indian companies.

Redemption requests, even by small shareholders in feeder funds, can set in motion a series of capital redemptions and multiple levels of taxation. The Circular has clarified that in case the ultimate shareholder satisfies the Explanation 7 Carve Out requirements, he would not be subject to taxation on indirect transfers. By implication, the large investors could be subject to tax. Moreover, in order to satisfy the request of such a shareholder, the feeder and master funds may be required to undertake capital redemptions and be subject to multiple levels of taxation on indirect and direct transfers respectively, although the initial request arose from an investor satisfying Explanation 7 Carve Out conditions. The Circular does little to relieve the funds from multiple levels of taxation that may be suffered at (i) the time of sale of Indian shares by the master fund, (ii) the time of redemption of shares of the master fund by the feeder funds, (iii) the time of redemption of shares by investors (holding 5% or more in the master fund) in the feeder fund and (iv) taxation of investors on gains arising from redemption of units of the feeder fund in the investor's home jurisdiction.

Considering that India's capital pool, especially in the capital markets, predominantly comprises capital contributed by foreign funds, it is essential for the government to create / maintain a stable and reasonable tax regime. Funds are required to constantly consider the valuations of their portfolio securities and the benefits of continuing to hold them. Excessive tax burdens can seriously impact valuation and reduce investor demand for Indian securities. Reduced demand could reduce prices of securities, harm Indian companies and their investors and resultantly, the economy as a whole.

The Circular discusses a situation where an offshore fund allocates 10% of its corpus for India investments and sets up an India focused sub-fund for investing exclusively in Indian securities where none of the investors hold more than a 5% stake in the parent offshore fund. The Circular concludes that the indirect transfer rules will apply to the gains derived by the fund on sale / redemption of shares of the sub-fund since the value of shares in the sub-fund substantially derive their value from Indian assets. The Circular further states that such will be the case irrespective of the shareholding of the ultimate investors.

The Circular does nothing to address the primary concern of investors, which is the possibility of economic double taxation. The response ignores the practical and commercial realities of fund structuring, which require multiple considerations from various jurisdictions to be reconciled, and essentially subjects portfolio investors to an additional level of tax due to the structure adopted to invest in the Indian market. In other words, had the investors directly invested into the sub-fund, gains made by investors satisfying Explanation 7 Carve Out conditions on redemption of their shares should not have been subject to the indirect transfer tax. Another way to look at this would be if the offshore fund had directly invested into India, then the Explanation 6 Condition would likely not have been met and again the investors, including the larger investors, would not have been subject to indirect transfer tax on redemption of their shares in the fund. However, merely because the investment is routed through a sub-fund that has an India focus (which may have been done for several commercial reasons), gains arising on the redemption by the parent offshore fund of shares in the sub-fund would be subject to tax in India under the indirect transfer rules. This goes against the grain of the legislative intention behind the indirect transfer provisions and the recommendations of the Report.

Offshore Listed Funds

The Circular deals with a scenario involving an offshore fund listed on a foreign stock exchange which satisfies the Explanation 6 Conditions, and where the investors in such offshore fund keep changing due to regular trading on the foreign stock exchange. The Circular clarifies that the investors in the offshore fund would be liable to tax on the gains arising from sale of their shares in the offshore fund due under the indirect transfer provisions unless they can avail of the Explanation 7 Carve Out. Again, the rigid approach adopted here by the CBDT is extremely disappointing and one that disregards the commercial considerations behind the entities being listed outside India. There has previously been discussion, including in the Report, about excluding listed companies from the ambit of the indirect transfer provisions; however, the CBDT has chosen to disregard any such recommendations.

Although the above clarification was in the context of funds, the Indian revenue will likely adopt the same interpretation in case of offshore listed corporates which satisfy the Explanation 6 Conditions. Further, in case of listed entities, while CBDT may choose to adopt a technical approach, practical enforcement is questionable. Interestingly, Indian rules also impose obligations on foreign buyers to withhold tax where the foreign seller may be subject to tax in India. Considering how these trades are undertaken, it is practically impossible for these obligations to be imposed. An effort on CBDT's part to take a deeper dive into some of these aspects would have been appreciated.

Valuation Considerations

The Circular has discussed a case where a fund satisfies the Explanation 6 Conditions on the 'specified date'⁸ but the value derived from Indian assets falls to 47% of the fund's total asset value on the date of the actual transfer. The Circular clarifies that the indirect transfer provisions would still apply owing to the definition of 'specified date'. The clarification provided by the CBDT brings along with it levels of absurdity. In an M&A situation where the shares of an Indian company are sold and the gains are subsequently up-streamed by the Seller company post the sale, even such up-streaming can be brought within the Indian tax net, even though at the time of such up-streaming, there were no Indian assets held by the Seller and in fact, the Seller may have discharged taxes in respect of the sale of shares of the Indian company.

Another important valuation-related issue pertains to the reporting obligations imposed on Indian companies under Section 285A of the ITA read with the recently introduced Rule 114DB of the Income Tax Rules, 1962. These provisions impose onerous reporting obligations on the Indian company with foreign investors, in respect of reporting indirect transfer transactions.⁹ A specific clarification was sought in respect of Indian public companies with investments from various FPIs (some of whom may be listed) whose shares witness frequent churn and whose India exposure can vary with investments in multiple investee companies, and how the Indian investee company can be required to assess and comply with the provisions mentioned above. The CBDT has responded stating that the practical implementation of the newly introduced Section 285A and Rule 114DB is first to be seen. This amounts to an absolute shirking of responsibility of the regulator in respect of the issues created by it in the first place. It also points to an implicit acceptance of the immense practical difficulties that the industry faces by virtue of the onerous obligations imposed by the provisions. The response of the CBDT is highly discouraging and offers little in the way of guidance to real problems faced by businesses. Greater clarity on this aspect should be forthcoming from the revenue authorities.

Corporate Reorganizations

Under Section 47 of the ITA, certain corporate re-organization transactions specified therein are not regarded as transfers for the purpose of charging capital gains tax. For instance, Sections 47(via) and 47(vic) exempt, upon satisfaction of certain conditions, transfer of Indian assets as part of overseas amalgamations and demergers involving foreign companies. Similar to these, Section 47(viab) and 47(vicc) exempt the indirect transfer of Indian assets as part of an overseas amalgamation or demerger, provided certain conditions are satisfied.

In this regards, the Circular clarifies that the exemption under Section 47 (viab) only applies to foreign amalgamating companies holding shares of an offshore company substantially deriving its value from shares of an Indian company. The exemption does not extend to shareholders of an amalgamating foreign company. As such, in case of an offshore fund satisfying Section 6 Conditions merging into another offshore fund, the investors of the former fund may not rely on Section 47 (via) and could be subject to indirect transfer provisions. Similar would be the case in any other corporate re-organization.

The Circular also states that the exemption available to amalgamations under Section 47 is restricted to foreign corporate entities and does not extend to foreign non-corporate entities. Therefore, both foreign non-corporate entities

and their investors can be subject to indirect transfer provisions. It is counterintuitive to state that in case of foreign corporate re-organizations, resulting in an indirect transfer of assets, there is an exemption extended to the entities undergoing re-organization, but not for the shareholders. Further, it is even more absurd if placed against the fact that a direct transfer in case of corporate re-organization can be exempt for both the entities and the shareholders, but the same situation does not arise for an indirect transfer.

Retrograde positioning on retrospectivity

Another concern on which a clarification was sought in the Circular and which has gone unheeded relates to FPIs being treated as 'representative assessee' or 'assessee in default' for failure to withhold tax when such FPIs, in accordance with the position of law as existing at the time of redemption / transfer, did not withhold tax on payments to meet redemption requests. The Shome Committee had recommended that (i) no person should be treated as an assessee in default or a representative assessee of a non-resident, on account of the retrospective nature of the amendments to Section 9, for relying on the existing position of law at the time of a transaction involving the transfer of shares of a foreign company having underlying assets in India, to not withhold tax; and (ii) that in all cases where a demand of tax is raised on account of the retrospective amendment, no interest should be charged in respect of such demand and no penalty should be levied in respect of the income brought to tax¹⁰. These recommendations were made on the basis that any alternate course of action would result in the imposition of a burden of impossibility of performance and cause undue hardship to the taxpayer.

Unfortunately, the CBDT has failed to address real and problematic issues relating to retrospective amendment, merely stating the provisions of the ITA shall apply. Such clarifications by the CBDT are retrograde and at odds with the Government's much touted "non-adversarial" and "business friendly" approach to taxation.

CONCLUSION

The Circular has stirred up a hornet's nest for offshore investors, especially for the funds industry, which has been struggling with the lack of guidance on the issue of taxation relating to indirect transfers. The clarifications seem to be out of line with other recent progressive measures towards encouragement of the development of the funds industry such as deeming income arising from sale of listed shares and securities held for more than 12 months as capital gains (and not as business income, unless the assessee treats it as business income) and introduction of safe harbour provisions for offshore fund management from India.

The issue of indirect transfer has been an irritant to the industry, particularly given the host of related unaddressed issues that it brings with it. In all of the cases mentioned in this scenario, the CBDT clarifications are excessively myopic, literal and show up a lack of appreciation of the practical issues and dichotomies sought to be highlighted by the industry players. Problematically, the Circular is indicative of a lack of understanding of different types of businesses within the fund industry (close-ended vs. open-ended, listed vs. unlisted), differentiation of investor categories, differences in investment strategies and commercial realities such as fund structuring, fund operations and global restructurings.

The Circular is not reflective of 'ease of doing business' in India and is a regressive step which will result in the era of 'tax terrorism' coming back in. The Government's move can seriously dent the image of India as a preferred 'investment destination'. It is urged that the Government and revenue authorities be more receptive of serious issues raised by stakeholders as opposed to providing straitjacketed responses which do not further the cause of the industry.

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You can direct your queries or comments to the authors

¹ Circular No.41 of 2016

² The Supreme Court, in *Vodafone International Holdings BV v. Union of India*, had held that gains arising from the transfer of shares of a foreign company (resulting in the indirect transfer of shares of an Indian company) would not be subject to capital gains tax in India.

³ Explanation 5 to Section 9(1)(i) of the ITA.

⁴ The usage of the word "company" shall be deemed to include reference to "entity" and the usage of the word "share" shall be deemed to include reference to "interest" and / or "unit" unless the context otherwise requires.

⁵ The Shome Committee was constituted to receive comments and undertake widespread consultations from stakeholders and vet and rework the general anti-avoidance rule ("GAAR") guidelines.

⁶ The relevant part of Circular No.4 of 2015 reads as follows: "*Declaration of dividend by such foreign company outside India does not have the effect of transfer of any underlying assets located in India. It is therefore clarified that the dividends declared and paid by a foreign company outside India in respect of shares which derive their value substantially from assets situated in India would not be deemed to be income accruing or arising in India by virtue of the provisions of Explanation 5 of Section 9(1)(i) of the Act.*"

⁷ The Second Report of the Alternative Investment Policy Advisory Committee issued by SEBI on December 1, 2016 has specifically recommended that indirect transfer provisions should not apply when the indirect transfer is directly or indirectly a consequence of transfer of capital assets situated in India or when the redemption of shares does not alter the ownership of the transferor in the transferee.

⁸ Sub-paragraph (d) of Explanation 6 of Section 9(1)(i) defines "specified date" to mean the—

(i) date on which the accounting period of the company or, as the case may be, the entity ends preceding the date of transfer of a share or an interest; or

(ii) date of transfer, if the book value of the assets of the company or, as the case may be, the entity on the date of transfer exceeds the book value of the assets as on the date referred to in sub-clause (i), by fifteen per cent.

⁹ This aspect has been recognised by the Second Report of the AIPAC, which has suggested relaxations for small shareholder transactions and simplification of reporting requirements.

It is also important to note that the Shome Committee had pointed out that taking value at any time preceding 12 months is an onerous compliance burden on the taxpayer and taking value at last balance sheet date may not reflect the actual value on the date of transfer, and thus may provide scope for manipulation. The Committee had stated that a preferable approach would be that fair market value of assets may be determined based on the last balance sheet date of the foreign company and appropriate adjustments may be made for significant change/activity, if any, between the last balance sheet date and the date of transfer.

¹⁰ Penalties levied being referred to in respect of Section under section 271(1)(c) (for concealment of income) and 271C (for failure to deduct tax at source)

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