Investment Funds: Monthly Digest

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FINANCE BILL, 2019: KEY HIGHLIGHTS FOR TAXATION OF ALTERNATIVE INVESTMENT FUNDS AND IFSC UNITS (JUNE-JULY 2019 EDITION, PART II)

INTRODUCTION:

On July 5, 2019, the Indian Finance Minister presented the first Budget of the newly formed government for financial year 2019-20. The Government sought to introduce few relaxations to the extant tax regime affecting alternative investment funds ("**AIFs**") and units operating in International Financial Services Centres ("**IFSCs**") such as the IFSC in Gujarat International Financial Tec-City ("**GIFT City**"), which is currently the only IFSC in India. Pursuant to the delivery of the Budget and introduction of certain amendments thereafter, the Finance Bill, 2019 ("**Finance Bill**") has been passed by the Parliament of India.

Assuming the proposals of the Finance Bill will be enacted, we seek to analyse key measures provided therein regarding the taxation of AIFs and IFSC Units. We shall also analyse a circular issued by the Central Board of Direct Taxes ("**CBDT**") 2 days before the presentation of the Budget, regarding the taxation of offshore investments made by AIFs.

With respect to alternative investment funds ("**AIFs**") in particular, the Government has aimed to address certain long-standing aspects towards alignment of the taxation of alternative investment funds in India with global practices. Further, in a similar vein, the Government has also proposed to provide further thrust to units operating in IFSCs, including AIFs located therein.

I. ALTERNATIVE INVESTMENT FUNDS:

We have provided the key proposals of the Finance Bill regarding the taxation of AIFs in India under the Income-tax Act, 1961 ("**ITA**") below:

1. **Revisions to Angel Tax Provisions**

Proposal:

Section 56(2)(viib) of the ITA provides that where a company, not being a company in which the public are substantially interested, receives any consideration, from a resident, for the issuance of shares that exceeds the face value of such shares, the aggregate consideration received for such shares as exceeds the fair market value ("**FMV**") of the shares shall be charged to tax. However, this provision does not apply to consideration for issuance of shares received: (i) by a venture capital undertaking from a venture capital company or a venture capital fund; or (ii) by a company from a class or classes of persons as may be notified by the Government in this behalf.

The definition of venture capital fund only includes Category I AIFs ("**Cat I AIFs**"). Accordingly, venture capital undertakings are exempt from Section 56(2)(viib) only in respect of investments by Cat I AIFs. With a view to facilitate venture capital undertakings to receive funds from Category II AIFs ("**Cat II AIFs**") as well, the Finance Bill proposes to amend Section 56(2)(viib) to exempt venture capital undertakings from its applicability in respect of investments received by Cat II AIFs.

Analysis:

This is a welcome move by the Government as it is likely to boost investments by Cat II AIFs in venture capital undertakings. Further, most AIFs are set up as Cat II AIFs and therefore, this amendment will effectively benefit most of them. Going forward, the Government should consider extending this exemption in respect of all regulated entities since the intent behind Section 56(2)(viib) is to prevent tax abuse which is unlikely in case of regulated entities.

2. **Pass through treatment extended to losses of AIFs**

Proposal:

The Finance Act, 2015 had extended the tax pass through status to Cat I and Cat II AIFs. As per the existing provisions, any income, barring business income, earned by such AIFs would be exempt in the hands of such AIFs, and taxable directly in the hands of its investor(s) in the same manner and proportion as it would have been, had such investor received such income directly and not through such AIFs. With respect to the losses incurred by such AIFs, whether in the nature of business losses or otherwise, the same could be set-off or carried forward by such AIFs. However, losses suffered by such AIFs (not being in the nature of business losses) could not be passed through to its investors for them to claim set-off of such losses against income earned by them.

In order to address the above anomaly, the Finance Bill has proposed to allow losses incurred by such AIFs (not being in the nature of business losses) to be passed through to its investors to be able to set-off or carry forward such losses while computing their income. However, in order to avail such pass-through benefit, such investors should have held units in the AIF for a period of more than 12 (twelve) months. Therefore, if an investor holds units for a

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period of less than 12 (twelve) months, it should not be able to set-off or carry forward its losses.

Further, the Finance Bill has also proposed to insert a new sub-section under Section 115UB of the ITA whereby, accumulated or unabsorbed losses (not in the nature of business losses) of such AIFs as on March 31, 2019 would be passed through to its investors to be carried forward / set-off against their income, *provided that* the investor was a holder of units of the AIF as on March 31, 2019. Such losses could be carried forward and accordingly set-off by investors from the year in which the loss first occurred subject to the period of limitation provided with respect to set off and carry forward of losses under the ITA.

Analysis:

The above seeks to address a longstanding request by the industry and helps align investor level taxation in investment funds with global practices. However, there seems to be an anomaly in respect of the pre-condition in relation to the 12 months holding period whereby, to avail the pass-through benefit of losses (not being in the nature of business losses) at the AIF level, applicable to investors that acquire units of an AIF on or after April 1, 2019, would not be applicable to investors holding units as on March 31, 2019, who have been accorded the set-off / carrying forward loss pass-through status. The legislative intent behind such distinction seems unclear and leaves scope for varied interpretation amongst the managers and investors of AIFs.

3. **Taxability of offshore investments by non-residents through AIFs**

Clarification:

Section 5(2) of the ITA imposes source-based taxation on non-residents whereby, income received or arising or deemed to be received or arising to a non-resident in India would be subject to tax in India. Therefore, income received by a non-resident becomes chargeable to tax either when it 'is received' or is 'deemed to be received' in India by him or when it 'accrues' or 'arises' or is 'deemed to accrue or arise' to him in India during the previous year.

Where an AIF receives investments from a non-resident investor, and uses such capital contributions to make overseas investments, the issue of whether or not the income earned by the non-resident from such offshore investments through the AIF could be deemed to be a direct investment by a non-resident, and hence not subject to tax in India under Section 5 of the ITA, was previously unsettled.

In this regard, 2 days prior to the presentation of the Budget, the CBDT issued a circular on July 3, 2019[1] to 'clarify' that such income received by non-residents from offshore investments made through Cat I and Cat II AIFs would not be subject to tax in India under Section 5(2) of the ITA. Further, the circular also clarified that any losses suffered from such offshore investments, being an exempt loss, shall not be allowed to be set-off or carried forward against the income of the Cat I and Cat II AIF.

Analysis:

The aforementioned clarification provides fiscal neutrality as it eliminates double taxation of the income earned by the non-resident both at the India level and in its country of residence. Further, this would ensure that India based pooling vehicles are not put at a disadvantage compared to global standards.

II. INTERNATIONAL FINANCIAL SERVICES CENTRES

In an endeavor to build a robust financial services centre in the country, the Finance Bill has made proposals to incentivize the operations in IFSCs. Currently, the only operational IFSC is GIFT City. Certain key proposals in respect of IFSCs in the Finance Bill are discussed below.

1. **Widening of exemption on capital gains**

Proposal:

Currently, non-residents are exempted from capital gains tax on transfer of GDRs, rupee denominated bonds ("**RDBs**") and derivatives on a stock exchange in an IFSC. The Finance Bill proposes to extend such exemption to other securities which may be notified by the Central Government, thereby widening the ambit of exemptions which may be provided.

The Finance Bill has also exempted income from the aforesaid transfers arising to non-resident investors of Category III AIFs ("**Cat III AIFs**") located in an IFSC, deriving income solely in convertible foreign exchange and having all units held by non-residents except for the units held by the sponsor or manager.

Analysis:

The permissibility to extend exemption through notification is an enabling provision for the Government to meet further industry demands. The proposal may be viewed positively for the signalling it provides to non-resident investors of Cat III AIFs in IFSC and will hopefully assist such AIFs in their offshore fund raise. However, considering that the exemption is extended only to non-residents, the Finance Bill need not have added the additional condition that the Category III AIFs should have exclusively non-resident investors apart from the sponsor and the manager. Such a condition could potentially cut off access to IFSC-based Category III AIFs to resident investors, otherwise permitted to invest under the Liberalised Remittance Scheme, whose presence in the AIF would endanger the exemption provided to non-resident investors as discussed above.

2. **Exemption from tax on distributions**

Proposal:

A company operating from an IFSC and earning income solely in the form of foreign convertible exchange is currently exempt from Dividend Distribution Tax ("**DDT**") in respect of the dividend paid out of the current income earned from its operations in the IFSC.

However, to facilitate commercial flexibility for dividend distributions from units operating in IFSCs, the Finance Bill proposes an amendment to the ITA whereby a unit operating from an IFSC will now be exempt from DDT in respect of dividends distributed from income accumulated by such unit from its operations in the IFSC from April 1, 2017.

Similar to DDT, the Government had introduced a tax on distributions made by mutual funds in 2018. The Finance

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Bill has proposed to exempt distributions by mutual funds located in IFSCs, deriving income solely in convertible foreign exchange and having solely non-resident unit holders. Further, unlike for Cat III AIFs, it has not been clarified that units held in respect of sponsor commitment by sponsors of mutual funds should not be reckoned towards determining whether the mutual fund is composed solely of non-resident unit holders.

Analysis:

By providing exemptions on distributions of income, along with existing exemptions on current income, the Finance Bill has taken positive steps towards greater achievement of real tax neutrality, which is a benchmark that IFSCs are judged against.

In respect of the exemption for distributions made by mutual funds, it should be clarified that in reckoning whether the mutual fund is composed solely of non-resident unit holders, the units held in respect of sponsor commitment (as regulatorily mandated) by resident sponsors should not be taken into account.

– Blanche Dsouza & Srikanth Vasudevan
You can direct your queries or comments to the authors

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[1] Available at https://www.incometaxindia.gov.in/communications/circular/circular_no_14_2019.pdf

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