Funds Management

Tax and Regulatory Issues

March 2017

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Contents

Investment Routes – An Overview

Type of Funds – Domestic

Sr. No.	Particulars	Mutual Fund	Alternative Investment Fund
1	Type of investor	Retail investors	Sophisticated, knowledgeable, institutional investors
2	Maximum no. of investor per scheme	Limitless	1000
3	Minimum contribution per investor	Not specified	INR One crore
4	Minimum corpus per scheme	Not specified	INR 20 crores
5	AMC/ Sponsor stake in scheme	Not required	Sponsor/ manager to have a continuing prescribed contribution
6	Investment by non-resident	FPI and NRI may invest in Mutual Fund	Any non-resident, subject to conditions
7	Units acquired by non-resident	Not treated as foreign investment into the investee company	Not treated as foreign investment if the Sponsor and the Investment Manager is Indian "owned and controlled"

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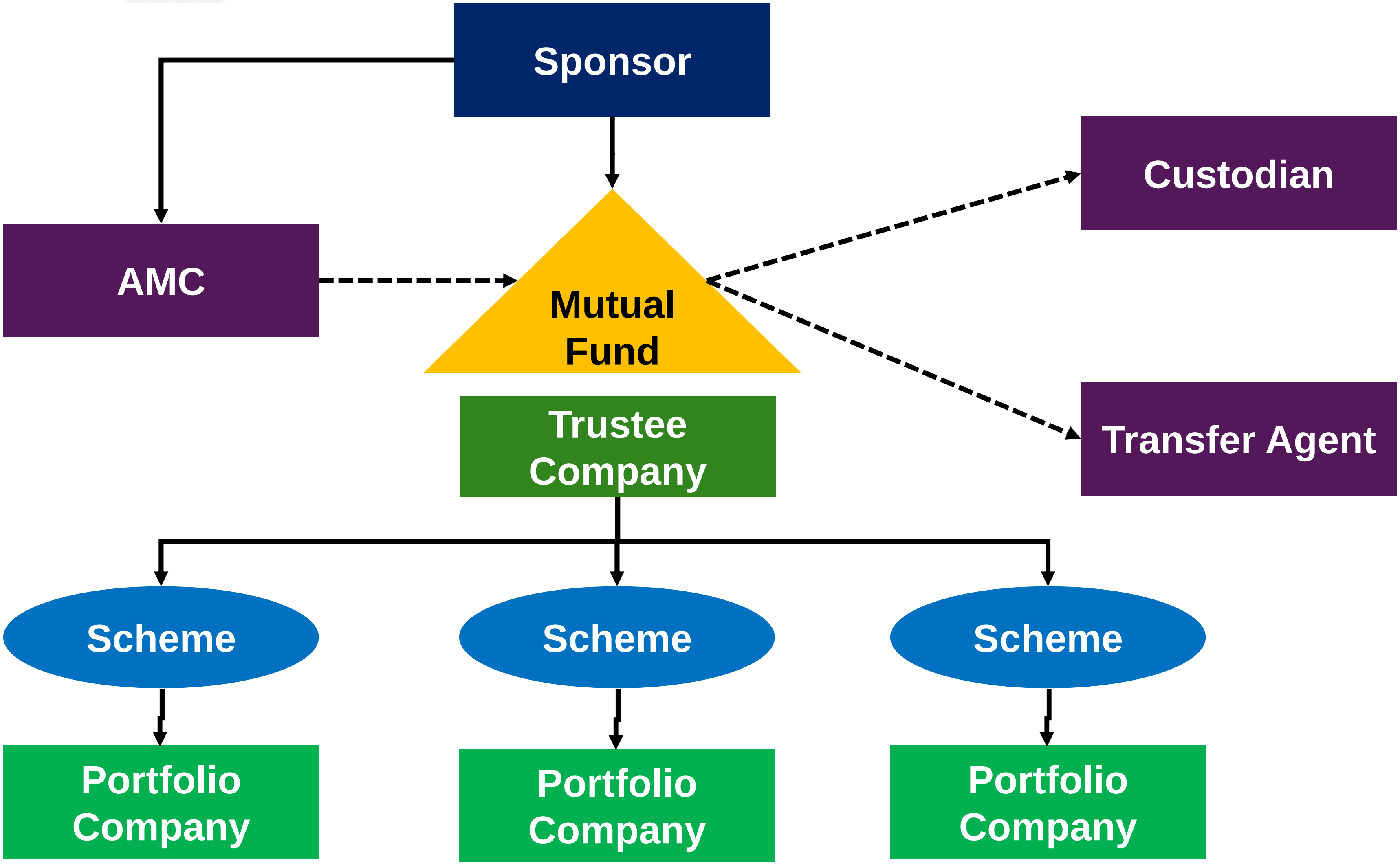
Typical Mutual Fund Structure



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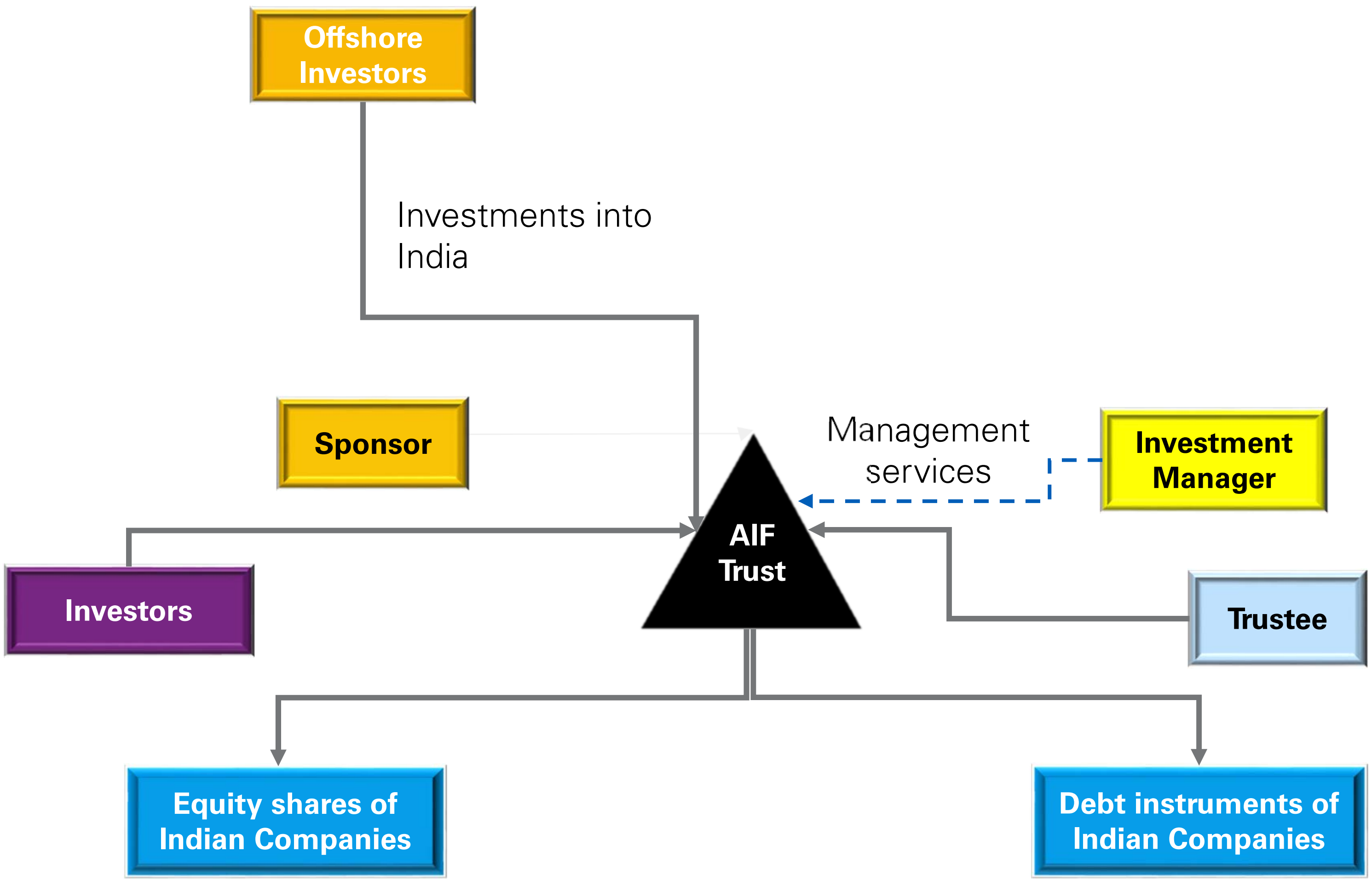
Typical AIF Structure



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Foreign Investment In India - An Overview

Foreign Investments

FDI

- Long-term strategic investment
- 100% automatic route in most sectors

FPI

- Portfolio investment (either short-term or long-term)
- Individual FPI holding limit – 10% while aggregate FPI limit 24% - raised up to Sectoral cap

FVCI

- Strategic investment
- Allowed in 10 sectors
- Exemption from pricing guidelines

Others

- P-Notes
- GDR / ADR
- FCCB
- FCEB
- ECB (including long-term infra bonds and masala bonds)

Investment under these routes can be made through various instruments

The permissibly of investment in some of the instruments may be subject to certain conditions

Different investment routes necessary to ensure flexibility to make different investments

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Key Tax Developments And Issues

Key Tax Developments And Issues

Debt investments	• Concessional WHT of 5 per cent on interest payable to FPIs on rupee denominated bonds/ government securities extended up to 30 June 2020 • Concessional WHT of 5 per cent on interest payable on loans and bonds extended up to 30 June 2020
CCPS conversion	• Conversion of CCPS into equity shares to be tax neutral • Fate of past conversions ?
Masala bonds	• Concessional WHT of 5 per cent on interest extended to Rupee Denominated (Masala) Bonds issued overseas • Offshore transfer between non-residents not taxable
Safe harbor norms	• Relaxation given that in the year of winding up, the fund need not meet the corpus requirement • More relaxation needed to make safe harbour norms implementable

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Key Tax Developments And Issues

Taxation of dividend	• Dividend income in excess of INR 10 lakh taxed in case of all resident except domestic company and certain funds, trusts, etc • Does Mutual Fund suffer the above tax?
Clarification on LTCG rate for unlisted shares	• Clarification on retrospective application of concessional tax rate of 10 per cent on LTCG on sale of shares in a private company
Anti-abuse provisions for listed shares	• LTCG exempt only if the acquisition of share is chargeable to STT • Exceptions to be notified like IPO / FPO / Bonus etc. • Concern whether genuine cases protected u/s 10(38) list

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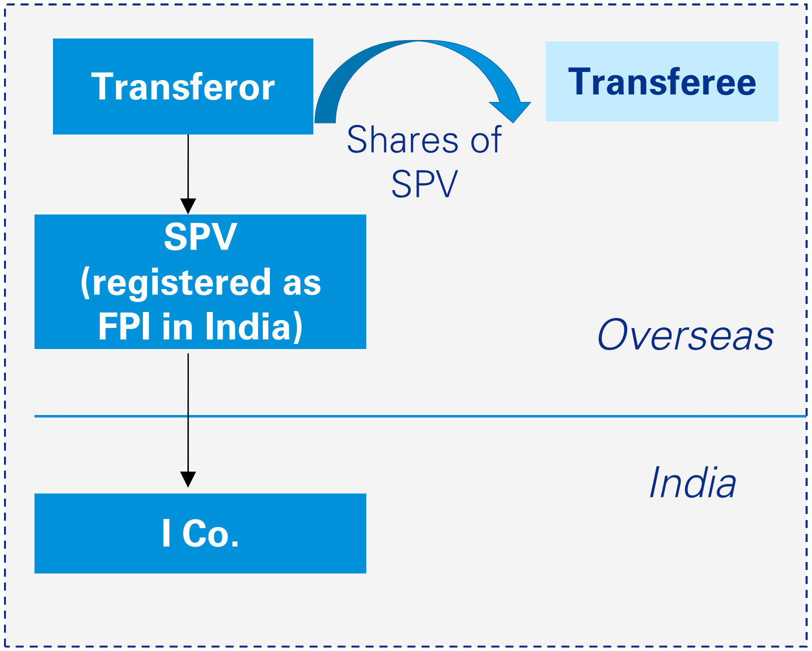
Indirect Transfer Tax



Proposed

- Indirect transfer provisions not to apply to FPI Category I and II
- Provision not to apply in case of redemption of shares / interests outside India due to redemption of investment in India - chargeable to tax in India (as mentioned in Budget speech)

The indirect transfer provisions state that :

- if the capital asset situated outside India
- derives its value substantially (i.e. 50 percent or more) from assets located within India

such asset shall be deemed to be situated in India and consequently its transfer liable to tax in India.

The provisions shall not apply where:

- Value of Indian asset does not exceed INR 100 million on a specified date
- The transferor neither holds more than 5 per cent of the total voting power / share capital, whether directly or indirectly, of the offshore entity whose shares are being sold nor does it hold management rights or control in such offshore company

Issues –

- Applicability of indirect transfer in case of Category III FPI ?
- Exemption from indirect transfer not extended to other foreign players like Private Equity, AIF, etc

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Renegotiation of Tax Treaties

- Shift to source-based taxation on capital gains from sale of shares from residence-based, albeit with a certain level of transitional relief

- Capital gains from sale of Debt/ Government securities, Derivatives (futures and options), units of mutual funds are not impacted by the amendment in tax treaty (subject to fulfilment of GAAR provisions)

- Similar amendment specified in case of Singapore and Cyprus tax treaty as well. Position on capital gain tax is summarized as under -

Acquired on or before 31 March 2017 and transferred anytime subsequently	Fully Grandfathered i.e., Not taxable
Acquired on or after 1 April 2017 and transferred before 1 April 2019	Taxable at the rate of 50 per cent of domestic tax rates subject to fulfilment of LOB conditions
Acquired on or after 1 April 2017 and transferred after 31 March 2019	Taxable as per domestic laws of India

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Other Articles Update - Mauritius

Interest Income

- Beneficially owned by bank carrying on bonafide banking business arising on debt-claim existing on or before 31 March 2017 – ***Grandfathered***
- Beneficially owned by Mauritius resident (including banks) to be taxed at 7.5 per cent with effect from 1 April 2017

Fees for Technical Services (FTS)

- Similar to definition as provided under domestic law – no make available
- FTS taxable at 10 per cent

Permanent Establishment (PE)

- PE definition expanded to include service PE – threshold of more than 90 days in any 12 month period

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AIF Taxation – Overview And Issues

Taxation mechanism (Other than business income)	• Tax pass through status to AIFs (Cat I and II) for capital gains and interest income • Income earned by an investor in an AIF chargeable to income-tax in the same manner as if the investments had been made directly by the investors. Such income is exempt from tax in the hands of AIFs • No tax pass through status for Cat III AIFs
Taxation mechanism (business income)	• Business income taxable at AIF level • Correspondingly such income exempt from tax in the hands of the investor • Characterization between business income and capital gain – CBDT Circular 6 of 2016
Obligation to withhold taxes	• AIF to withhold tax on non business income at the following rates : ➢ 10 percent for resident investors ➢ Rates in force for non-resident investors; no tax to be withheld on exempt income. • Does tax need to be withheld on dividend income paid to resident investors

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AIF taxation - Overview

WHT on income received by AIF	Income received by AIFs not to suffer any WHT by portfolio / investee companies
Distribution tax	No distribution tax on income paid / distributed by AIFs
Carry forward of losses	• Losses to be carried forward at AIF level for set off in future years. • Investors can not avail set-off of losses to reduce their tax liability

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GAAR Provisions

Main purpose of an arrangement* is to obtain a tax benefit

AND

- Not at arm's-length
- OR
- Misuse/abuse of domestic tax laws
- OR
- Lacks commercial substance
- OR
- Not for bona-fide purposes

Impermissible Avoidance Arrangement

Consequences

Primarily, onus to prove on revenue which is to be rebutted by assessee

- Disregard / combine / re-characterize whole / part of the arrangement
- Disregard corporate structure
- Denial of Treaty benefits
- Re-assign place of residence / situs of assets or transaction
- Re-allocate income, expenses, relief, etc.
- Re-characterize equity- debt, income, expenses, relief, etc.

Effective from 1 April 2017 (financial year 2017-18)

Investments made before 1 April 2017 are grandfathered

**An arrangement is presumed to have been entered into, or carried out, for the main purpose of obtaining a tax benefit, if the main purpose of a step in, or a part of, the arrangement is to obtain a tax benefit, notwithstanding the fact that the main purpose of the whole arrangement is not to obtain a tax benefit*

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POEM

RESIDENCE RULE

- Conventional Residence Rule – Foreign Co. (F Co.) becomes Indian resident only if control and management is situated wholly in India
- Section 6(3) post amendment vide Finance Act, 2016:

A company is said to be resident in India in any previous year, if:

(i) it is an Indian company; or

(ii) its place of effective management, in that year, is in India

For the purposes of this clause, "place of effective management' means a place where key management and commercial decisions that are necessary for the conduct of business of an entity as a whole are, in substance, made

- **Once a Company is resident in India, its global income would be taxable in India**
- CBDT had issued draft guiding principles for determination of POEM on 23 December 2015. Further, CBDT issued final guiding principles on 24 January 2017

Significant expansion of Residence Rule impacting taxation of foreign companies

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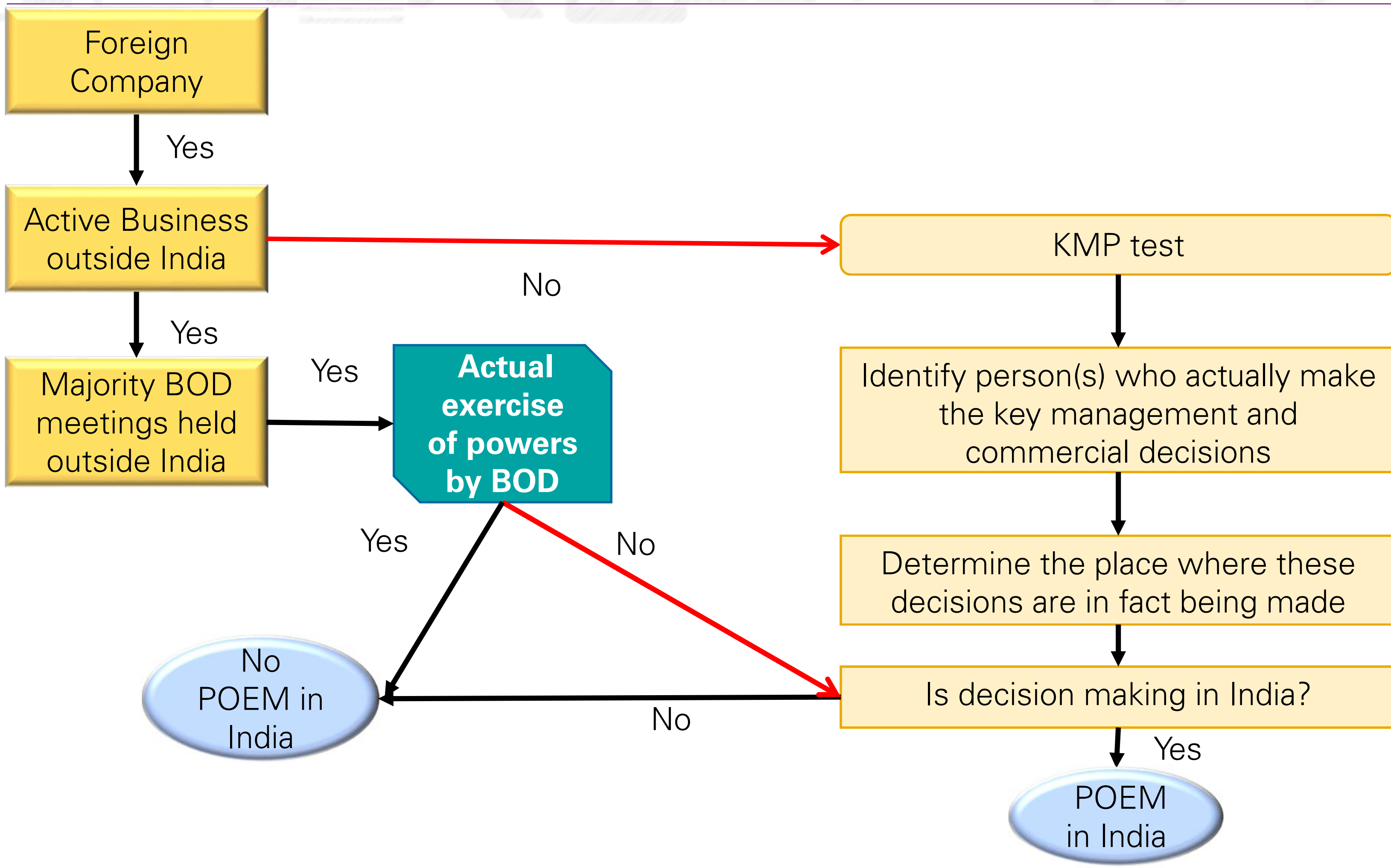
CBDT Guidelines



Place where decisions taken are more important than its place of implementation. Also, substance would be conclusive rather than the form. Decisions in substance taken in India to attract POEM in India

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Key recent developments – regulatory

Key Policy Reforms – Budget announcements

Ease of Doing Business	Regulatory
Online registration of Market intermediaries	Abolition of FIPB
Single window clearance for new portfolio investors	QIB status to select NBFCs
FDI Relaxation Expected	Listing and trading of Security Receipts/ARC

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Key Regulatory changes via notification

FPI investment in debt securities	FPIs permitted to invest into following instruments • Unlisted NCDs/ bonds • Securitized debt instruments
FDI in other financial services	• FDI permitted beyond 18 specified NBFC activities • FDI under automatic route allowed for all other regulated financial services • Minimum capitalisation norms eliminated
Investment - ARC	• SARFAESI Act recently amended to permit a person to hold controlling stake in an ARC • ARC to mandatorily hold at least 15% of each tranche / class of SRs of each scheme • FPIs permitted to invest upto 100% (effectively 85%) in each tranche of SRs of ARC Trust

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