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Foreign Portfolio Investors in India – Recent tax developments

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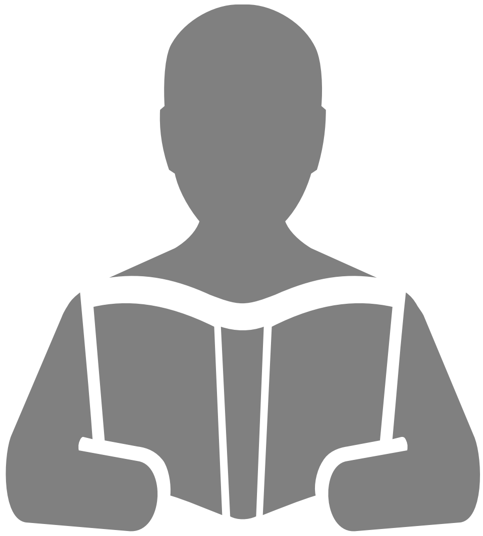

1. Minimum Alternate Tax ('MAT')

As per the Indian tax law, long term capital gains are exempt from tax and short term capital gains are taxable at 15% if the shares have been traded on the stock exchange. Interest received by Foreign Portfolio Investors ('FPIs') from investment in Government securities and rupee denominated corporate bonds is subject to a concessional tax rate of 5%, subject to the fulfilment of certain conditions.

Recently, in case of few corporate FPIs, the Indian Revenue issued show cause notices during the course of the tax audit for FY12, on why tax should not be levied as per the MAT. As per the relevant provisions, corporations that pay tax which in aggregate is less than 18.5% of their book profits have to pay a minimum tax of 18.5% of their book profits.

A large number of FPIs, as well as industry bodies, took up this issue with the Finance Minister before the tax audit was finalised. Pursuant to the representations made, the Finance Bill 2015 has amended the MAT provisions to exclude capital gains earned by FPIs from the ambit of MAT. However, these provisions are proposed to be effective from 1 April 2015 only.

The Indian Revenue is therefore taking a position that MAT applies to corporate FPIs for all income (including capital gains) up to 31 March 2015 and to all income (other than capital gains) from 1 April 2015 onwards. Audit for FY12 has been completed on this basis. Notices are also being issued for past years which extend up to 7 past years.

The action of the Indian Revenue has been a matter of huge concern to the foreign investors and many of them are considering disputing this levy at an appropriate forum.

The levy of MAT on FPIs has also received wide coverage in local and overseas media. In a recent media interview, the Finance Minister appeared to justify levy of MAT for past years on FPIs and seems to have left the issue to be decided by the courts.

2. Offshore transfers

Under the Indian tax law, income accruing or arising, directly or indirectly, through the transfer of a capital asset situated in India is taxable in India. A clarification was introduced in the tax law in the year 2012, with retrospective effect from 1 April 1961, deeming a share or interest in an offshore entity to be situated in India if the share or interest derives, directly or indirectly, its value substantially from assets located in India. As a corollary, gains arising from transfer of shares or interest in such an offshore entity would be taxable in India. Furthermore, in the Indian context, the word *transfer* has an extended meaning whereby transactions such as redemption or buyback of shares/units could be regarded as a transfer.

The Finance Bill 2015 proposes to set a threshold to be 50% of the fair market value of total assets and value of overseas asset greater than INR 100 million for the word *substantially*. Certain exclusions are provided for offshore restructuring and to small shareholders[1].

Accordingly, the offshore funds investing more than 50% of their assets in India are likely to be impacted. It is important for them to examine whether they have any withholding tax obligations in India when they redeem shares/units of their shareholders/unit holders.

3. General Anti-Avoidance Rules ('GAAR')

GAAR was introduced in the year 2012 to empower the Indian Revenue to declare an arrangement as an impermissible avoidance arrangement if it was entered into with a main purpose of obtaining tax benefit and if it, amongst others, lacks or is deemed to lack commercial substance, or does not have a bona fide purpose.

The GAAR provisions would apply where the tax benefit (to all the parties in aggregate) from an arrangement in a relevant year exceeds INR 30 million. Certain exemptions are provided to investors investing, directly or indirectly, in offshore derivative instruments (such as Participatory Notes).

The Finance Bill 2015, has proposed to defer the implementation of GAAR provisions from 1 April 2015 to 1 April 2017. It is also proposed that GAAR provisions will only apply prospectively to investments made on or after 1 April 2017.

4. Safe harbour provisions for offshore funds investing in the Indian capital market

The Finance Bill 2015 proposes to provide full-fledged safe harbour rules for the location of asset managers in India. These changes have been brought to encourage offshore fund managers who are of Indian origin and managing offshore funds to relocate to India.

It is proposed that fund management activity carried out through an eligible fund manager shall not constitute a 'business connection' of that fund in India. Also, an offshore fund shall not be considered as being resident in India merely because the fund manager undertaking the fund management activities is situated in India.

These safe harbour benefits will be available to offshore funds and fund managers who fulfil certain specified conditions. The key conditions specified in this regard include diversified holdings at the offshore fund level and registration of the fund manager with the appropriate authority in India.

[1] holding not more than 5% of the total share capital or total voting power and not having any right of management and control

5. Concessional rate of income-tax on interest income from specified debt securities

Under the Indian tax law, interest income is subject to a concessional withholding tax of 5%, if such interest is (1) payable on or after 1 June 2013 but before 1 June 2015 and (2) is in respect of investment made in a government security and rupee denominated bond of an Indian company whose coupon rate does not exceed the prescribed rate.

The Finance Bill 2015 has proposed to extend this concessional tax rate to interest payable up to 30 June 2017.

However, please note that, at this stage, it appears that this concession may be negated by the Indian Revenue due to applicability of MAT provisions to corporate entities.

6. Information on foreign remittances

Currently, any person responsible for paying to a non-resident any sum chargeable to tax is required to furnish information relating to the payment of such sums. The Finance Bill 2015 proposes to extend the above requirement to sums which are not chargeable to tax as well. Non-compliance with this requirement shall attract penalty of INR 100,000.

Illustratively, this could require reporting of any payments made by FPIs to the investment manager even if the investment manager is located outside India. The form for reporting such payments is yet to be prescribed.

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