

Indirect transfer provisions: CBDT clarifies in case of redemption of share or interest outside India

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In brief

Under the provisions contained in section 9(1)(i) of the Income-tax Act, 1961 (Act), all income accruing or arising, whether directly or indirectly, through or from any business connection in India, or through or from any property in India, or through or from any asset or source of income in India or through the transfer of a capital asset situated in India, shall be deemed to accrue or arise in India. Explanations 5, 6 and 7 of section 9(1)(i) further define the scope of the said provision.

The Central Board of Direct Taxes (CBDT) has clarified that the provisions of section 9(1)(i) read with Explanation 5 thereof shall not apply in respect of income accruing or arising to a non-resident on account of redemption or buy-back of its share or interest held indirectly in the specified funds, if such income accrues or arises from or in consequence of transfer of shares or securities held in India by the specified funds and such income is chargeable to tax in India.

This news alert summarises the clarification issued by the CBDT on the indirect transfer provisions.

In detail

Background

After the introduction of Explanation 5 to section 9(1)(i) of the Act, many investment funds [including private equity funds and venture capital funds (VCFs)] had expressed concerns that owing to the extant indirect transfer provisions, multi-tier non-resident investment funds investing in India, suffer multiple taxation of the same income:

- i) at the level of the fund in India in the form of short-term capital gains/business income; and
- ii) at the upper level of investment in the fund

chain on subsequent redemption or buy-back.

In the budget speech on 01 February, 2017, the Finance Minister granted exemption to Category I and Category II Foreign Portfolio Investors (FPIs) from the indirect transfer provisions, with effect from 01 April, 2015 (second proviso to Explanation 5 of section 9(1)(i)).

Issue

Multi-tiered investment structures generally give rise to situations wherein a non-resident holds share or interest indirectly in an Investment Fund or VCF or Venture Capital Company (collectively referred to as "specified funds" in the circular).

When these specified funds transfer the shares or securities held by them in India, it would result in income that would be subject to tax in India.

Further, when the non-resident investors in upstream vehicle outside India would consequentially redeem its shares or interest, applying provisions pertaining to indirect transfer to such redemption, may lead to multiple taxation of the same income.

Clarification

The CBDT has clarified that such provisions shall not apply in respect of income accruing or arising to a non-resident on

account of redemption or buy-back of its share or interest held indirectly (i.e. through upstream entities registered or incorporated outside India) in the specified funds if:

- i) such income accrues or arises from or in consequence of transfer of shares or securities held in India by the specified funds and such income is chargeable to tax in India; and
- ii) is applicable only in those cases where the proceeds of redemption or buy-back arising to the non-resident do not exceed the *pro-rata* share of the non-resident in the total consideration realised by the specified funds from the said transfer of shares or securities in India.

It has been clarified further, that,

a non-resident investing directly in the specified funds shall continue to be taxed as per the extant provisions of the Act.

The takeaways

Specified funds include VCFs, Venture Capital Company and Investment Funds.

Investment Funds have been designated to have the same meaning as Explanation 1 of section 115UB of the Act, i.e., will mean any fund established or incorporated in India in the form of a trust or a company or a limited liability partnership or a body corporate, which has been granted a certificate of registration as Category I or Category II Alternative Investment Fund (AIF) and is regulated under the Securities and Exchange Board of India (Alternative investment Funds)

Regulations, 2012.

Thus, the exemption has been granted only in case of unified structures where the securities of the Indian entity are transferred by AIF/ VCF and not to offshore funds in general.

Further, the exemption will be restricted to ***pro-rata*** share (of the non-resident) in the total consideration realised by the specified funds from the said transfer of shares or securities in India, i.e., the proceeds of redemption or buy-back arising to the non-resident should not exceed its share in the total consideration.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact your local PwC advisor

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