

### ***Foreign Portfolio Investors (FPIs) can invest in Security Receipts***

#### **Background**

To assist banks and financial institutions in addressing challenges on account of mounting bad loans and non-performing assets, the Government has introduced several reforms for the Asset Reconstruction sector, including implementation of the Insolvency and Bankruptcy Code.

FPIs have been permitted to invest in Security Receipts (SRs) issued by a securitisation trust (ARC Trust) set up by an Asset Reconstruction Company (ARC). Given the increasing interest from FPIs in SRs, we have highlighted below key regulatory and tax aspects that merit attention.

#### **Key Regulatory Aspects**

- Foreign investment in ARCs is permitted up to 100% under the automatic route.
- FPIs are permitted to invest up to 85% of each tranche of SRs issued by the ARC Trust (15% mandatorily required to be held by the ARC).
- FPI investment in SRs to be within the overall limit for FPI investment in corporate debt prescribed from time to time.
- Restrictions applicable to FPI investments in corporate bonds such as three year residual maturity period requirements, cap of 20% in investments in bonds with residual maturity below one year, investor wise limit (50%) in any single issue and portfolio wise concentration limit (20%) do not apply to investments by FPIs in SRs.

#### **Key Tax Aspects**

There are specific regimes in the income tax law for both, taxation of securitisation trusts and investors in SRs, and for taxation of FPIs.

#### ***Taxation of ARC Trust / investors in SRs***

Broadly:

- Income of an ARC Trust from the activity of securitisation is exempt from tax.
- Income accruing or arising to or received by an investor (holding SRs) from an ARC Trust shall be chargeable to income tax as if it were income accruing or arising to or received by such investor had the investments by the ARC Trust made directly by the investor.
- Income paid or credited by the ARC Trust is deemed to be of the same nature and in the same proportion in the hands of investor of the ARC Trust, as if it had been received by, or had accrued or arisen to, the ARC Trust.
- Any income arising to or received by the ARC Trust but not distributed to SR investors shall also be deemed to have been credited to such investor in the same proportion in which the investor would have been entitled to such income had the same been distributed during the financial year.
- The trustees of an ARC Trust are obliged to withhold taxes in respect of income payable to non-resident investors in the ARC Trust at the applicable 'rates in force' at the time of credit of such income or at the time of payment thereof, whichever is earlier.

#### ***Taxation of FPIs***

There are specific provisions dealing with taxation of FPIs. More particularly, income received by an FPI 'in respect of securities' is subject to tax at the rate of 20% (plus applicable surcharge and cess). No deduction is allowable in respect of expenses incurred for earning such income.

### *Aspects to be considered*

Generally speaking, the ARC Trust and the FPI (as an investor) could be in the receipt of the following cashflows:

- Principal repayment (up to the extent of cost of acquisition of underlying loan)
- Interest income from the underlying loan
- Upside income (over and above the cost of acquisition, excluding interest component)
- Capital gains on transfer or redemption of SRs

The taxability of the above receipts in the hands of the FPI needs to be evaluated after considering the specific regimes of taxation of both, securitisation trusts/investors in SRs and FPIs. More particularly, the following aspects merit attention:

### *Nature of income and taxability thereon*

- At the outset, characterisation of the amounts distributed by the ARC Trust need to be determined i.e. do they represent principal repayment of loans or have an income element?
- Where the amounts distributed by the ARC Trust are in the nature of income, characterisation and tax treatment thereto needs to be ascertained. For example, where the amount distributed represents 'upside' income, can such income be regarded as 'business income' from tax perspective? If so, how would such 'business income' be taxable under the domestic law and under tax treaties (where the investor is entitled to tax treaty benefits)? Can such 'upside income' be regarded as 'income in respect of securities' in the hands of the FPI and thus, taxable @ 20% (plus surcharge and cess) under the domestic tax law? Are expenses incurred in connection with earning income deductible?
- Where the amounts distributed by the ARC Trust are in the nature of 'interest' income, how would such 'interest' be regarded under the domestic law and under tax treaties?
- Given the obligation on a Trustee of the ARC Trust to withhold applicable taxes, what are the roles, responsibilities and obligations on investors?
- Where an investor is entitled to tax treaty benefits, can the Trustees consider the same for withholding tax purposes?
- Do the provisions of General Anti Avoidance Rules need to be considered where investors are entitled to tax treaty benefits?
- Would investors get credit for taxes withheld? Can the taxes withheld be adjusted against other income/tax liability of investors?
- In case of under-recovery of loans, can the 'loss' flow through to the investors? Are these losses available for set-off against other income earned by the investors?
- How can investors achieve certainty on tax outcomes?

### *Redemption / Transfer of SRs*

- Is redemption / transfer of SRs taxable? Would redemption / transfer of SRs at par or at a premium alter the tax consequences? Would the analysis differ where income has already been taxed in the hands of the investors? Is there a taxability in the hands of the investors where the transfer is undertaken at a negotiated price which is lower than the Fair Market Value?

There are several issues and nuances with respect to taxation of investors in SRs, especially since the law and the interpretation thereto are evolving.

If your interest lies in a specific area or subject, do advise us so we can send you only the relevant alerts. For any additional information, please reach out to your PwC relationship manager or write in to

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With Best Regards  
PwC TRS Team

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