

Tax Sops for Specified Funds in IFSC - Paving the Way for Relocation of Global Funds

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Background

The concept of International Financial Services Centre (“IFSC”) was conceived with a view to bring in financial services activities currently being undertaken from offshore jurisdictions to India by offering state-of-the-art infrastructure, fiscal incentives and regulatory framework comparable to that provided by popular offshore financial centres such as Singapore, Dubai, London etc. IFSC is a dedicated territory in a Special Economic Zone on Indian soil and approved as such by the Central Government. Gujarat International Finance Tec-City (GIFT City) in Gandhinagar, Gujarat is approved as India’s first and only IFSC. Units in IFSC are considered as non-residents under the Foreign Exchange Management Act, 1999 (“FEMA”). Here, it is important to note that the residential status for tax purposes continues to be determined as per the otherwise applicable provisions of the Income-tax Act, 1961 (“the IT Act”).

The recent past has seen commendable efforts from the International Financial Services Centres Authority (“IFSCA”) and the Ministry of Finance for incentivising global financial players, especially alternative investment funds (“AIFs”), to migrate to IFSC. Both Indian and foreign sponsors are now eligible to set-up AIFs in IFSC. The Reserve Bank of India had, very recently, permitted contribution by an Indian Party acting as Sponsor to an AIF in overseas jurisdiction (including IFSC) under automatic route subject to compliance with other conditions for overseas investment in financial services sector. Further, an AIF in IFSC is eligible to make investments in IFSC, abroad as well as in India. However, since an AIF in IFSC would be considered as a non-resident from FEMA perspective, investment in India is permitted either under Foreign Direct Investment (FDI) or Foreign Portfolio Investment or Foreign Venture Capital Investment (FVCI) route.

[From a tax perspective, since Category I and Category II AIFs are accorded pass through status under the IT Act with their income being taxed only at the investor level as if the investor had directly made the investment, any income of non-resident investors of Category I and Category II AIFs in IFSC from offshore investments is not taxable in India\[1\].](#) Accordingly, investment through a Category I or Category II AIF in IFSC vis-à-vis any other offshore jurisdiction does not result in any additional tax burden for non-resident investors in India. However, in case of Category III AIFs, while gains arising to funds in other jurisdictions like Singapore, Dubai etc. and their investors are not taxable in these jurisdictions, Category III AIFs in IFSC would have been taxable in India in respect of such gains in absence of a stipulated pass-through status. Thus, there was a need for relaxing the taxation of Category III AIFs in IFSC to bring them at par with offshore funds. This article outlines the tax sops offered to specified Category III AIFs in IFSC and highlights certain aspects which require further clarification.

Specified Funds under the IT Act

The beneficial provisions under the IT Act are only applicable to a Category III AIF in IFSC which qualifies as a “specified fund”. A “specified fund” means a fund established or incorporated in India in the form of a trust or a company or limited liability partnership (LLP) or a body corporate which -

- (i) has been granted a certificate of registration as a Category III AIF and is regulated under the SEBI (Alternative Investment Fund) Regulations, 2012 or the IFSCA Act, 2019;
- (ii) is located in any IFSC; and
- (iii) has all the units (other than units held by Sponsor / Manager) being held by non-residents.

In addition, investment division of a banking unit of a non-resident located in IFSC and registered as Category - I Foreign Portfolio Investor (“FPI”) is also considered as “specified fund”.

Typically, Category III AIFs intending to invest in India would get themselves registered with SEBI as an FPI. Accordingly, even for tax purposes, the attempt has been to align the taxation of specified funds with those of FPIs.

Special Regime for Taxation of Specified Funds

A Sponsor / Manager of an existing AIF in India may act as a Sponsor / Manager of an AIF in IFSC either by setting up a branch or incorporating a company / LLP in IFSC. However, new Sponsor / Manager needs to incorporate a company / LLP in IFSC. Accordingly, effectively, a Sponsor / Manager in IFSC would qualify as a tax resident of India.

The residential status of a trust is typically determined basis the residential status of the beneficiaries and / or the trustees and / or basis the control and management of the trust. The beneficiaries of a specified fund would be a combination of non-resident investors and resident Sponsor / Manager in IFSC. Considering that the specified fund shall be controlled and managed by a Manager in IFSC qualifying as a tax resident of India, the specified fund may also be considered as a tax resident of India. In such case, the specified fund shall not be entitled to any treaty benefits.

Generally, units in IFSC are eligible for a 10-year tax holiday under section 80LA of the IT Act in respect of their business income. Accordingly, specified funds classifying their investments as business assets should be eligible deduction u/s 80LA in respect of income from such assets. Specified funds are also exempted from the levy of Minimum Alternate Tax (MAT) / Alternate Minimum Tax (AMT). In this regard, it is pertinent to note that any securities held by a specified fund registered as FPI would be deemed to be capital assets u/s 2(14) of the IT Act and such funds should not be eligible u/s 80LA. This necessitated a separate exemption for such funds, specifically with respect to income from investments made abroad, to bring such funds at par with offshore funds in other jurisdictions.

Section 10(4D) of the IT Act provides for income of specified funds which shall not be chargeable to tax in India. The following incomes of a specified fund are exempt from taxation under section 10(4D) of the IT Act:

(i) Income arising as a result of transfer of capital assets, being FCCBs, GDRs, rupee denominated bond of an Indian company, derivatives, foreign currency denominated bond, units of mutual fund / business trust / AIF and foreign currency denominated equity share of a company, on a recognised stock exchange in IFSC and where the consideration for such transaction is payable in convertible foreign exchange.

(ii) Income arising as a result of transfer of securities (except shares in a company resident in India) – This would cover all listed as well as unlisted securities of foreign entities as well as Indian entities (except shares of Indian resident company).

(iii) Income (interest, dividend, distribution from mutual funds etc.) from securities issued by non-resident (not being a permanent establishment of a non-resident in India) – The essential condition in this case is that the income should not otherwise accrue or arise in India. Accordingly, in case of interest income earned on investment in debt securities of a foreign company where the debt is utilized by the foreign company for the purpose of its business in India, the interest income may be said to accrue or arise in India and thus, not eligible for exemption u/s 10(4D) of the IT Act.

(iv) Income from securitisation trust which is chargeable under the head “Profits and gains of business or profession”.

Further, the concessional regime u/s 115AD (which governs taxation of income of FPIs) has now been extended to specified funds. The rate of taxation u/s 115AD for various incomes of specified funds is outlined below:

(i) Interest on rupee denominated bonds of an Indian company or government securities or municipal debt securities referred to in section 194LD shall be taxable at 5%.

(ii) Income received in respect of securities (other than units of mutual fund referred to in section 115AB) shall be taxable at 10%. This would include interest and dividend income from securities issued by residents and by non-residents where such income otherwise accrues or arises in India. Correspondingly, withholding tax is applicable on such income at the rate of 10% u/s 196D of the IT Act. It may be noted that such income of FPIs is otherwise taxable u/s 115AD at 20% and to that extent, specified funds have been accorded a more favourable tax treatment vis-à-vis FPIs.

(iii) Short-term capital gains arising on transfer of securities shall be taxable at 30%.

(iv) Long-term capital gains arising on transfer of securities shall be taxable at 10%.

The exemption u/s 10(4D) and the concessional taxation u/s 115AD are applicable only to the extent of income attributable units held by non-resident (not being a permanent establishment of a non-resident in India). The CBDT has, recently notified Rules 21AI and 21AJ for this purpose and the same has been discussed in succeeding paragraphs.

A single level taxation has been provided for specified funds. Any income of a unit holder from a specified fund or on transfer of units in a specified fund is exempt from taxation u/s 10(23FBC) of the IT Act. The said exemption should also cover income in India of investors arising on account of indirect transfer provisions. In case of investors in a specified fund registered as Category – I FPI, the indirect transfer provisions are in any case not applicable. Further, the exemption u/s 10(23FBC) is not restricted to non-resident investors and such exemption should also be available to a resident Sponsor / Manager, being unit holders of the specified fund.

The tax incentives mentioned above are provided under the IT Act itself. Accordingly, the specified fund should be eligible for the same without the requirement of fulfilling onerous conditions such as principal purpose test, limitation of benefits test etc. otherwise applicable under tax treaties.

Rules for Computation of Income Attributable to Non-Resident Investors ff Specified Funds

The computation of income attributable to units held by non-residents^[2] as per Rule 21AI and Rule 21AJ is summarized below:

Income	Proportion of income attributable to non-resident unit holders
Rule 21AI - Computation of income attributable to non-resident unit holders exempt u/s 10(4D)	
Income arising as a result of transfer of specified capital assets on a recognised stock exchange in IFSC	Aggregate of daily AUM of the AIF held by non-resident unit holders / Aggregate of daily total AUM of the AIF
Income arising as a result of transfer of securities (except shares in a company resident in India)	The aggregate is to be considered from the date of acquisition of asset / security to the date of transfer of the asset / security
Income from securities issued by non-resident Income from securitisation trust which is chargeable under the head "Profits and gains of business profession".	AUM of AIF held by non-resident unit holders as on date of receipt of income / Total AUM of the AIF as on date of receipt of income
Rule 21AJ - Computation of income attributable to non-resident unit holders eligible for taxation u/s 115AD	
Income received in respect of securities (including interest on rupee denominated bonds, government securities and municipal debt securities)	AUM of AIF held by non-resident unit holders as on date of receipt of income / Total AUM of the AIF as on date of receipt of income
Short-term or long-term capital gains of the specified fund	Aggregate of daily AUM of the AIF held by non-resident unit holders / Aggregate of daily total AUM of the AIF The aggregate is to be considered from the date of acquisition of asset / security to the date of transfer of the asset / security

It may be noted that there is no restriction on units being held by a permanent establishment of a non-resident in India order to qualify as a specified fund as per the definition. However, the exemption u/s 10(4D) and concessional regime u/s 115AD is available only in respect of income attributable to units held by non-resident (not being PE of a non-resident in India).

Since all unit holders (except the Sponsor / Manager) of the specified shall be non-residents of India, effectively only the Sponsor / Manager would not be entitled to benefit u/s 10(4D) and u/s 115AD in respect of income on units held by it in the specified fund. Currently, a specified fund even with a single resident investor (other than Sponsor / Manager) would not be eligible for concessions u/s 10(4D) and section 115AD. Since a formula for determining the income attributable to non-resident unit holders has already been prescribed, the government could consider granting the said benefit, to specified funds with resident investors as well while restricting the benefit to the extent of income attributable to non-resident investors.

Relocation of Offshore Funds to IFSC

In addition to the above, offshore funds have also been provided exemption from any potential tax incidence which may arise in India in course of their relocation to IFSC in the near term.

Relocation refers to transfer of assets of the original fund or of its wholly owned special purpose vehicle to a resultant fund in IFSC on or before 31 March 2023 where the consideration for such transfer is discharged in the form of share / unit / interest in the resultant fund to shareholder / unit holder / interest holder on a proportionate basis or to the original fund. The transfer of capital assets by the original fund to the resultant fund in IFSC as well as transfer of share / unit / interest in the original fund against receipt of share / unit / interest in the resultant fund in IFSC shall not be considered as transfer u/s 47 of the IT Act. Accordingly, any income arising in India on account of trigger of indirect transfer provisions in course of relocation should also not be taxable either for the original fund or the investors.

The cost of assets for the original fund shall continue for the resultant fund and cost for investors of share / unit / interest in the original fund shall be the cost for investors of share / unit / interest in the resultant

fund. Similarly, the period of holding of assets of the original fund would be carried forward to the resultant fund and the period of holding of investors of share / unit / interest in original fund shall be aggregated while determining the period of holding of share / unit / interest in the resultant fund.

Further, any capital gains on further transfer by the resultant fund or specified fund of shares of a company resident in India, which were transferred from the original fund to the resultant fund in course of relocation, shall also be exempt provided that the gains were not chargeable had the relocation not taken place. Thus, the investments held by original fund which were otherwise grandfathered under tax treaties shall continue to be grandfathered for the resultant specified fund.

Also, a company whose shareholding pattern has changed on account of such relocation shall be exempted from the applicability of section 79 and shall be entitled to carry forward and set-off its loss despite the change in shareholding. The transaction of relocation has also been exempted from the applicability of gift taxation u/s 56(2)(x) of the IT Act.

To facilitate such relocation, SEBI has permitted [\[6\]](#) FPIs for a one-time off-market transfer of securities to the resultant fund without prejudice to any provisions of the IT Act and FEMA. It may also be noted that the IFSCA has waived the requirement relating to maintenance of minimum continuing interest by the Sponsor / Manager in case of relocation of a fund to IFSC.

Other Incentives for Funds in IFSC

In addition to the tax incentives mentioned above, the fund manager shall in IFSC shall also be eligible for a 10-year tax holiday in respect of management fees and other business income. However, the fund manager may be subject to MAT / AMT and tax on dividend in case the fund manager is constituted as a company. Further, GST shall not be applicable on the management fees.

Non-resident investors in a specified fund are also exempted from the requirement of obtaining PAN in India provided that such investors do not earn any income (other than from specified fund) in India and tax thereon has been deducted at source and certain prescribed details are furnished to the specified fund.

Aspects Requiring Further Clarification

(i) Exemption u/s 10(4D) in case of indirect transfer

Section 10(4D) exempts income arising as a result of transfer of any securities (other than shares of a company resident in India). Basis a literal interpretation, such exemption should also extend to any taxability arising in India on transfer of shares of a foreign entity deriving value substantially from assets located in India. However, this may not be intended since income directly arising on transfer of shares of Indian company is excluded from the scope of exemption. Accordingly, it may be expressly clarified whether exemption u/s 10(4D) would also cover income arising in India on trigger of indirect transfer provisions.

(ii) Eligibility of specified funds to exemption of interest under section 10(15)(ix) of the IT Act

Section 10(15)(ix) of the IT Act exempts interest income payable to a non-resident by a unit in IFSC in respect of monies borrowed on or after 1 September 2019. While offshore funds would be eligible for the said exemption, specified funds in IFSC may not be eligible where they qualify as tax residents of India. The exemption u/s 10(15)(ix) should be extended to interest income payable to other units in IFSC as well.

(iii) Eligibility of specified funds to concessional tax rate of 4% u/s 194LC on interest on bonds listed on recognised stock exchanges in IFSC

Section 194LC of the IT Act provides for concessional withholding tax at 4% on interest payable to a non-resident by an Indian company in respect of monies borrowed by it from a source outside India by way of issue of any long-term bond or rupee denominated bond listed only on a recognised stock exchange in IFSC. However, since section 194LC is subject to the condition that the rate of interest is within the all-in-

cost ceiling under External Commercial Borrowings (ECB) Regulations, it is debatable whether only debt investments made under the ECB route are eligible u/s 194LC. A specified fund would typically invest in bonds of Indian company listed in IFSC under FEM (Debt Instruments) Regulations, 2019 and not under ECB route. In such case, it may be expressly clarified whether a specified fund investing in bonds of an Indian company listed in IFSC under FEM (Debt Instruments) Regulations, 2019 would also be eligible u/s 194LC. Further, the benefit u/s 194LC is also questionable where a specified fund in IFSC qualifies as a tax resident since the benefit u/s 194LC is available only to non-residents

(iv) Section 9A benefit for funds in IFSC

Considering the ambiguity regarding residential status of a specified fund set up in IFSC, the government should consider covering funds set up in IFSC as eligible investment fund for safe harbour u/s 9A of the IT Act. This is also in line with the recommendations under the third report of the Alternative Investment Advisory Policy Committee.

(v) GAAR

Existing offshore funds contemplating relocation to IFSC have expressed concerns over applicability of GAAR since a favourable tax regime in IFSC is one of the main purposes such funds are considering relocation. A specific exemption from the applicability of GAAR to such funds would help in providing better tax certainty to such offshore funds. Alternatively, substance requirements for safe harbour from GAAR may be specified.

(vi) Carry forward of losses of original fund to resultant fund in case of relocation

Provisions for carry forward of any losses accumulated by the original fund in its jurisdiction to the resultant fund may further encourage relocation of funds with accumulated losses to IFSC.

Concluding Remarks

The efforts in terms of creating a conducive taxation regime for AIFs in IFSC are in the right direction. While tax neutrality is one of the key aspects in relocation of foreign funds, commercial objectives of the fund and operational feasibility is equally important. IFSC offers a low-cost operational environment with a huge talent pool in terms of human resources. Further, in case of an India focussed fund, setting up the fund in IFSC would also bring fund management closer to the investment opportunities and facilitate portfolio monitoring. Similarly, setting up presence in IFSC can facilitate collaboration with Indian investors seeking to invest funds abroad.

IFSC has huge potential for shaping the future of fund management in India. With the introduction of the above tax relaxations, the government has created a level playing field in India for offshore funds. While the government measures to promote IFSC have created a lot of traction among the global fund management industry, it would be interesting to observe how these tax measures reap in the near future in terms of actual re-domiciliation of offshore funds to IFSC.

[1] CBDT Circular No. 14/2019 dated 3rd July 2019

[2] Reference to non-resident unit holders shall not be construed as non-resident (not being PE of a non-resident in India)

[3] AUM refers to assets under management viz. the closing balance of the value of assets or investments of the specified fund as on a particular date.

[\[4\]](#) "Original fund" means a fund established or incorporated or registered outside India, which collects funds from its members for investing it for their benefit and fulfils the following conditions, namely:—

- (i) the fund is not a person resident in India;
- (ii) the fund is a resident of a country or a specified territory with which an agreement referred to in sub-section (1) of section 90 or sub-section (1) of section 90A has been entered into; or is established or incorporated or registered in a country or a specified territory as may be notified by the Central Government in this behalf;
- (iii) the fund and its activities are subject to applicable investor protection regulations in the country or specified territory where it is established or incorporated or is a resident; and
- (iv) fulfils such other conditions as may be prescribed.

[\[5\]](#) "Resultant fund" means a fund established or incorporated in India in the form of a trust or a company or a limited liability partnership, which—

- (i) has been granted a certificate of registration as a Category I or Category II or Category III Alternative Investment Fund, and is regulated under the Securities and Exchange Board of India (Alternative Investment Fund) Regulations, 2012 made under the Securities and Exchange Board of India Act, 1992 (15 of 1992) or International Financial Services Centre Authority Act, 2019 (50 of 2019); and
- (ii) is located in any International Financial Services Centre as referred to in sub-section (1A) of section 80LA

[\[6\]](#) SEBI/HO/FPI&C/P/CIR/2021/0569 dated 1 June 2021