IVCA

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THE INDIAN PRIVATE EQUITY & VENTURE CAPITAL ASSOCIATION

To **5th February, 2015**

Mr. Manoj Joshi
Joint Secretary
North Block, Ministry of Finance
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Dear Sir,

Recommendations for Amendments Needed to Promote Fund Management Activities in India
Submitted by the Indian Private Equity & Venture Capital Association (IVCA)

Background

1. Offshore Funds invest in India using the Foreign Direct Investment (FDI) / Foreign Portfolio Investor (FPI) / Foreign Venture Capital Investor (FVCI) routes. Typically, a fund structureinvolves pooling of funds by multiple investors into fund vehicle(s) which then invests, directly or indirectly, into shares and other securities. A fund manager (an entity separate from the fund) is responsible for implementing the fund's investment strategy and manages its day-to-day portfolio operations.

2. The exposure of fund management activity in India creating a 'business connection' or a 'permanent establishment' (PE) of the offshore fund in India has been one of the biggest roadblocks for the growth of the Indian alternative asset fund management industry. Briefly, the presence of offshore fund managers in India, or appointment of a fund manager based in India, could create a business connection or a PE of the offshore fund in India, in certain circumstances. In such a case, the income of the offshore fund to the extent attributable to the operations in India could be taxed in India. Further, if the offshore fund is a non-corporate entity, it could also result in the offshore fund being regarded as a tax resident of India. In such a case, the global income of the offshore fund could be exposed to tax in India. All this discourages Offshore Funds from shifting the fund operations to India / appointing qualified and experienced Indian fund managers.

3. An amendment was made in Finance Act (No. 2) 2014 to provide that securities held by FPIs from investment in securities in accordance with the applicable regulations of the Securities and Exchange Board of India (SEBI) should be treated as capital assets and resultantly any gains arising therefrom should qualify as capital gains. However, a similar clarification was not provided for Offshore Funds which invest under the FDI or the FVCI route i.e. private equity funds, real estate funds, infrastructure funds amongst others, which requires a similar clarification.

4. While the amendment is welcome, it does not provide complete certainty to fund managers to move their operations to India on account of the following:

   (a) The Indian Revenue Authorities (IRA) could contend that the activity carried out by the fund manager in India gives rise to a business connection for the offshore fund in India. This could potentially create undesirable tax risks for the offshore fund and the investors therein.

   (b) There is also a risk of the IRA denying the capital gains tax exemption available to the fund under the tax treaties with India on account of Article 13(2) of the tax treaties (eg. India-Singapore tax treaty, India-Mauritius tax treaty, India-Netherlands tax treaty, etc). Article 13(2) of these tax treaties provides that gains arising from alienation of movable property forming part of the business property of a PE which a resident of one country has in India may be taxed in India. Accordingly, where a fund is considered to have a PE in India due to the presence of the fund manager in India, the IRA could contend that the assets of the fund (being the securities) constitute business property of the PE in India and hence not grant the fund the exemption provided by the capital gains clause under the tax treaty.

   (c) There also exists an exposure that the IRA may consider the fund to be a 'resident' in India on account of management of all or part of the activities of the fund by the fund manager in India.

   (d) The amendment as discussed above, does not cover funds (i) other than FPIs which invest into India and (ii) global funds (i.e. those investing in jurisdictions besides India) whose fund managers wish to base their fund management wholly/ partly in India.

Benefits to India from the location of the fund manager in India and practices in other countries

5. Many countries in Asia (e.g. Singapore and Hong Kong) and also mature economies like the United Kingdom have recognized the importance of developing the fund management industry in their respective jurisdictions, from the perspective of achieving economic growth and attracting fund management talent.

6. Factors that support fund managers domiciling in a centre like Hong Kong, Singapore or United Kingdom include the quality of communications and supporting infrastructure, supporting business services such as brokerage and custody, availability of quality legal and accounting services, a reasonable regulatory environment, low tax rates and a clear tax regime, and the potential demand for their products from the individuals and businesses in the economy.

7. The Singapore authorities have expressly targeted the development of 'fund management' as a key element of the financial sector. A range of tax incentives are provided by the Singapore

Government to encourage international fund managers to set-up their base in Singapore. Similarly, Hong Kong has also provided various incentives to offshore fund managers with an aim to promote Hong Kong as an international asset management centre.

8. By providing clarity on issues relating to business connection/ PE and residential status of Offshore Funds, India could benefit immensely since it would provide a sense of comfort to fund managers for choosing India as the base for investment managers. Further, this will also result in senior fund managers to be based in India, thereby leading to more employment and taxes.

   Additionally, in the long run, clarity on the tax issues would encourage fund managers to directly pool long term capital of investors into funds domiciled in India. This has the potential of switching substantial foreign investment commitment presently raised by funds domiciled in offshore jurisdictions as commitments to funds based in India.

Recommendations

Elimination of business connection or PE or tax residency for Offshore Funds/Non-resident investor in India

9. In light of above, it could be provided that a fund manager based in India [providing discretionary or non-discretionary investment advisory/ fund management services whether directly or indirectly to offshore fund(s)] will not create a business connection or PE or tax residency for the Offshore Fund/ non-resident investor in India.

Eligible Advisors & Managers

10. Further, it could also be provided that in order identify the category of Offshore Fund/ non-resident investor to which the provisions are intended to be applied, the fund manager/ advisor may be any entity which is registered (or exempted from registration) with SEBI as under–

    (i) An Investment Advisor under the SEBI (Investment Advisors) Regulations, 2013.
    (ii) Portfolio Manager under the SEBI (Portfolio Managers) Regulations, 1993.
    (iii) Any fund manager, by whatever name called of a mutual fund, alternative investment fund or any other intermediary or entity registered with SEBI.

Capital Gain Characterisation to be Extended to a Broader Range of Investing Entities

11. Additionally, the amendment made in the Finance Act (No. 2) 2014 (refer para 3) on 'capital gain' characterisation should be extended to all non-resident investors advised/ managed, directly or indirectly, by a fund manager/ advisor entity based in India (for this purpose the fund manager/ advisor entity could be defined as per the suggestion in para 10 above).

Specific Amendments Recommended

12. Accordingly, the following amendments could be made in the provisions of the Income-tax Act, 1961–

(a) No business connection/ PE of any non-resident investor managed by an Indian fund manager/ advisor

Section 9 of the Act, to be amended to provide that management of all or part of the activities of any non-resident investor directly or indirectly by a fund manager/ advisor based in India (for this purpose a fund manager/ advisor could be defined as per the suggestion in para 10 above) will not result in creation of a business connection or a PE (as defined under section 92F(iii)(a) of the Act or the relevant tax treaty) of the non-resident investor in India.

(b) Tax residency for any non-resident investor in India

Section 6 of the Act to be amended to provide that any non-resident investor, irrespective of its legal status, shall not be considered to be a resident in India solely by reason of its fund manager/ advisor being based in India (for this purpose the fund manager/ advisor could be defined as per the suggestion in para 10 above).

(c) Characterisation of investment as 'capital asset'

Section 2(14) of the Act to be amended to provide that securities held by any non-resident investor, where such investor is managed/advised, directly or indirectly, by a fund manager/ advisor based in India (for this purpose a fund manager/ advisor based in India could be defined as per recommendation in para 10 above) should be treated as capital assets and resultantly any gains arising therefrom should qualify as capital gains.

Respectfully,

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