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CBDT clarifies rules for India-centric sub-funds

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Mumbai: The income tax (I-T) provisions relating to tax in India on indirect transfer of shares situated in the country will not apply to investors in offshore 'feeder fund' structures, where 'carve-out' conditions are met. This was clarified by the Central Board of Direct Taxes (CBDT) in a circular issued on Wednesday.

In other words, the conditions in Explanation 7 to section 9(1) should be met by the investors (ie: unit holders) of the offshore feeder fund. They should have no management control and a shareholding of less than 5% in the offshore master fund. Feeder funds typically pool money from investors and feed that into a master fund, which is registered as a foreign portfolio investor (FPI) for investments in Indian securities.

When investors sell their units in the feeder fund, there will be no tax trigger in India, even if the master fund derives substantial value from shares in India, explains CBDT. On the other hand, India-dedicated sub-funds will be impacted as no carve-out relief will be available from tax provisions relating to indirect transfers. "This will impact India's attractiveness for foreign investments," says an investment manager attached to an offshore fund.

To address issues raised by FPIs such as offshore funds, the CBDT had set up a working group. Based on the comments of this group, it has now issued a circular in the forms of FAQs, containing 19 clarifications. "The FAQs largely reiterate the law on indirect transfer. No relief is given to investors trading shares in an offshore listed company, despite concerns around lack of administrative framework to withhold Indian tax," says Shefali Goradia, tax partner, BMR & Associates.

On sale of units held in feeder funds, the investors will not be covered by indirect transfer provisions and will not face tax in India, if they meet the carve-out conditions. This is irrespective of the fact that the value of assets in India (shares of Indian companies) held by the master fund, constitute more than 50% of its global assets and exceed Rs 10 crore.

India-centric sub-funds will not have such an advantage. CBDT illustrates: If fund X, which is an offshore fund in country A, allocates 10% of its corpus for India-centric investments and sets up a sub-fund for this purpose in a favourable tax jurisdiction, then irrespective of the shareholding of the ultimate investors, the indirect transfer provisions will apply to fund X. This is because the value of the shares held by it in the sub-fund derive their value substantially from shares located in India, clarifies the CBDT.

"The clarifications take a pro-revenue stance. Compared to global funds with relatively smaller India allocations, the clarifications put India-focused structures at a higher risk of tax-related disputes and increased compliance costs," says Richie Sancheti, head (investment funds) at Nishith Desai Associates.

Multi-tier structures could face tax at various levels with related challenges of tax withholding. Girish Vanvari, tax leader at KPMG India, sums it up, "A more pragmatic approach could be taken to attract foreign investments into the country."