

US fund managers to Govt: withdraw your new tax on our fees

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Posted online: Friday, May 19, 2006 at 0000 hrs IST

NEW YORK, NEW DELHI, May 18

Reacting to the crash this evening, Finance Minister P Chidambaram rubbished a theory floating in the markets that a Cer Board of Direct Taxes (CBDT) release yesterday meant that foreign investors would be considered traders and taxed close to 41% of their income. He clarified there was no such plan.

But for over a month now, his officials have been sitting on a letter from the US mutual fund industry association, the Investment Company Institute, which raises questions regarding the tax burden of US fund managers in India and links it to India's "reliability" as an investment location.

On April 6, the ICI—representing over 9500 US mutual funds and investment trusts managing over \$9.25 trillion in assets—wrote to Arbind Modi, joint secretary in charge of tax policy and legislation at the Department of Revenue, questioning tax notices many US fund managers have received. Sources told The Indian Express that since early 2006, the Income Tax department has sent notices to several US mutual funds that they should withhold and remit tax "in excess of 40 per cent of the gross management fee paid to its manager with respect to the mutual funds' Indian securities."

In other words, a US-based fund manager investing in India alone would have to pay 40% or more of his/her management fee to India. (The fee, as per current industry norms, is 3-4% of the corpus.)

The CBDT is believed to have argued that these managers' services fall within the ambit of "technical services" and, therefore, their fees are taxable.

Such assertions, the ICI writes, "are inconsistent with accepted international norms and the efforts of the Ministry of Finance, the Securities Exchange Board of India (Sebi) and others to encourage foreign institutional investment in India."

"Disincentives," such as these, the ICI has said, could negatively impact "both individual Indian securities that have or could be expected to have US mutual funds as shareholders, and the broader Indian capital markets."

While arguing that no Indian tax liability should arise on fund managers' fees, the ICI wrote that even if these services are taxable, they would be exempt under the income tax treaty between the US and India.

The treaty only provides for taxing fees for services that involve transfer of knowhow and skills, which a fund manager does not do. Apart from the time and legal costs of engaging in litigation with the Indian tax authorities, the ICI fears that even a successful appeal could mean fund managers may have to wait "seven years or more" for recovering such taxed fees. About the impact of this move on portfolio investments from US funds into Dalal Street, ICI wrote that it was aware of "US mutual fund managers that are delaying decisions to invest in Indian until this tax issue is resolved."

"Absent a strong government signal," the ICI wrote, "FIIs may wonder whether additional novel attempts to impose tax will be pursued in the months and years to come."

Indeed, the implications of this go beyond US fund managers facing these orders. Said head of international tax litigation Nishith Desai Associates Bijal Ajinkya: "If these demands hold, despite the specialized language of the US-India tax treaties, none of India's tax treaties could protect fund managers. Moreover, this won't apply to mutual funds alone, but all categories of investors: pension funds, university endowments, hedge funds, insurance companies."

ICI's senior counsel (Tax Law), Keith Lawson told The Indian Express that ICI has had "some discussions with Anoop Misra, Economic Minister in the US Indian Embassy office," but has not yet received any acknowledgement or response from the Finance Ministry.