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by Roshni Shanker and Nishchal Joshipura

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India's Income Tax Authority for Advance Rulings (AAR) has ruled that the reorganization of an investment vehicle that results in the conversion of unit trusts into subfunds of open-ended investment companies (OEICs) doesn't result in capital gains tax liability in India under section 45 of the Indian Income Tax Act, 1961 (ITA).

The ruling will have a favorable impact on overseas funds investing in India that seek to reorganize their existing fund vehicles outside India. However, a ruling by the AAR is binding only on the applicant and the tax authorities, and only in relation to the questions raised by the applicant and the facts of the case.

Facts

The applicant, Citicorp Trustees Pvt. Ltd., was a limited company and a tax resident of the United Kingdom. The applicant was acting as a trustee for a group of funds that included the Invesco Perpetual Global Smaller Companies Fund. The Invesco funds were managed by Invesco Funds Managers Ltd., also a tax resident of the United Kingdom. The funds were constituted as unit trusts under various deeds, primarily for the purpose of providing a profit-earning investment vehicle for investors. The applicant was registered as a foreign institutional investor with the Securities and Exchange Board of India (SEBI) and was invested in Indian securities under the SEBI Regulations, 1995. The transactions involving the purchase or sale of securities in India were carried out through brokers, and the applicant had no branch office or place of business in India.

To take advantage of the flexibility, transparency, cost, and services available under the U.K. Financial Services Authority regulations, it was decided to convert the unit trusts into subfunds of OEICs. In 2003 the Invesco funds were reorganized so that the assets of each unit trust were divided into two distinct funds: a liquidation fund and a unit holder's fund. Each unit holder was given shares on the basis of one share for one unit, and, consequently, every unit was deemed to be cancelled, and the trust deeds ceased to have effect.

There was no payment of consideration by the OEICs to the unit trusts, and the applicant continued to be the owner of shares in Indian companies as before. The only difference was in the nomenclature of the applicant as the owner — that is, before the reorganization, the applicant acted as a trustee of the Invesco funds, and after the reorganization it acted as the depository of the OEICs. Thus, there was no change in the beneficial ownership of the assets of the unit trusts, which included the Indian securities.

The reorganization was eligible for tax exemption under U.K. tax law, and the applicant had notified SEBI of the change in nomenclature for purposes of continuity of the operations in India.

The applicant sought an advance ruling from the AAR to determine if, because the transaction was a reorganization, the applicant was subject to taxation in India under the ITA or under the double tax treaty between India and the United Kingdom.

Ruling Pronounced

The Directorate of Income Tax (International) did not dispute the facts stated by the applicant. However, it held that the transaction fell within the definition of a transfer under section 2(47)[1] of the ITA, and that, consequently, taxable capital gains would arise under section 9(1)(i) of the ITA on the transfer of a capital asset situated in India, unless the following conditions were satisfied:

- as trustee of the unit trusts, the applicant was the owner of the Indian securities;
- as depository of the OEICs, it still was the owner of the Indian securities;
- the arrangement strategy was tax-exempt in the United Kingdom; and
- the applicant was permitted, under the U.K. regulations, to act as depository and trustee.

After examining the definition of transfer under section 2(47) of the ITA, the AAR held that there was neither any sale nor any exchange or extinguishment of any right in the shares held by the applicant in Indian companies under section 2(47) of the ITA, because the transfer was of the assets in the United Kingdom and did not result in the transfer of the Indian securities.

Regarding the first two conditions mentioned above, the AAR observed that there was no change in the ownership of the Indian securities and that the reorganization merely resulted in a change in the status of the applicant from a trustee of the unit trusts to that of a depositary of the OEICs. The AAR also considered a letter from SEBI stating that it had "no objection" to the proposed change in the name and status of the applicant from a trustee to a depositary of the Invesco funds.

Addressing the third and fourth conditions, the AAR observed that the applicant, by producing a letter from the U.K. Inland Revenue, had substantiated that the reorganization was tax-exempt in the United Kingdom, and that by producing the extracts of the U.K. Financial Services Authority register,[2] the applicant proved that it was registered as a financial services authority and had the necessary permission to act as a trustee and a depository.

In light of those findings, the AAR held that there was no liability under the ITA regarding the reorganization. It also held that because there was no liability under the ITA, the double tax treaty between India and the United Kingdom would not, per se, create any tax liability for the applicant in India regarding the reorganization.

Conclusion

Because India is gaining a reputation as one of the world's more attractive investment destinations, the ruling should benefit several overseas funds that seek to invest in India. It also will benefit existing overseas funds that want to reorganize their investment vehicles to achieve greater flexibility in structuring their investments in India.

An interesting aspect of the ruling is that the AAR did not discuss any of the landmark judicial precedents on the definition of transfer under section 2(47) of the ITA because the Directorate of Income Tax did not deem the reorganization to be in the nature of a transfer of Indian securities by virtue of the transfer being in the nature of a sale or exchange or extinguishment under section 2(47). ◆

♦ *Roshni Shanker and Nishchal Joshipura, Nishith Desai Associates, International Legal & Tax Counselors, Mumbai*

[1]Section 2(47) of the ITA deals with the definition of transfer, which includes the sale, exchange, or relinquishment of the asset or the extinguishment of any rights therein.

[2]The register is a public record of financial services firms and other bodies that fall under its regulatory jurisdiction, as defined in the U.K. Financial Services and Markets Act, 2000, which came into force on December 1, 2001.