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Mint Explainer: Why Gift City is seeking tax parity with domestic mutual funds

Neha Joshi | 6 min read | 26 Jun 2024, 09:08 AM IST

Gift City in Gujarat was conceptualised as India's first International Financial Services Centre (IFSC) exchange to enable Indian entities to compete on an equal footing with offshore financial centres. (Aniruddha Chowdhury/Mint)

SUMMARY

Gift City is hoping this will attract more wealthy individuals to route investments through it into US markets without worrying about the US' hefty inheritance tax.

In May, the International Financial Services [...]thority, or IFSCA, the unified financial sector regulator at Gift City, sent a clutch of recommendations to the central government. One

Amid the recent pre-election debate on **inheritance tax**, Gift City emerged as a potential solution for wealthy Indians looking to invest in US markets while sidestepping the country's steep inheritance tax.

The US government levies a tax on heirs at a rate depending on the relationship with the deceased if the value of the assets inherited exceeds $60,000 at the time of an investor's passing. Indians investing in US markets via pooled vehicles through Gift City can avoid this tax for reasons explained below. But to make this route attractive to wealthy Indians, IFSCA is seeking tax parity for Gift City funds. *Mint* explains how this could work.

How can Gift City funds help bypass the US inheritance tax?

Indians have been investing in US markets through the Reserve Bank of India's liberalised remittance scheme, which allows investments of up to $250,000 a year in foreign-held securities. To avoid the US's inheritance tax, financial advisers suggest pooling investments in a Gift City fund that will invest in US markets.

The US inheritance tax applies to inherited assets located in the country, but this can be avoided if the investment in such assets is executed through pooled investment vehicles based in an offshore jurisdiction such as Gift City, explained Ketaki Mehta, a partner at Cyril Amarchand Mangaldas law firm.

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"The asset is held through the pooled vehicle (such as a family investment fund) and the inherited asset is the investment in the pooled vehicle. If (the pooled vehicle) invests solely in US strategies, it won't be taxed in the hands of non-US citizens as the underlying asset may be US securities but the firm investing it will be a foreign entity," Mehta said.

Gift City provides financial services such as i[illegible]al stock exchanges, banking units, brokers and intermediaries, insurers, and asset man[illegible] subscribe to it, without limiting the number of investors. But the potential double taxation is a deterrent.

That is why IFSCA is seeking parity in taxes imposed on Gift City funds and domestic mutual funds. The Gift City regulator has in a report to the Union government suggested that the Central Board of Direct Taxes amend the Income Tax Act to explicitly include 'securities held by investment funds registered with IFSCA' within the definition of 'capital asset' to bring parity with domestic mutual funds.

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IFSCA's working group report includes inputs from stakeholders in finance and law.

"Sebi-registered domestic mutual funds benefit from a pass-through tax mechanism, wherein all income is transferred to investors, who then pay taxes based on their respective tax brackets," said Deep Chandan, director at Katalyst Advisors.

"Conversely, pooled investment vehicles established in Gift City, such as family investment funds, and certain alternate investment funds (having a mix of Indian resident and/or non-resident investors), are subject to tax at the fund level," Chandan said. "This means that the fund itself incurs taxes on its income and gains prior to distributing any returns to investors. These disparities render said Gift City funds less appealing to investors."

Could this attract a reaction from the US government?

Chandan said that in terms of inheritance tax, the possibility of a reaction from the US government cannot be ruled out entirely.

"There may not be an immediate reaction from the US government given the relatively small-ticket investments from Gift City funds," Chandan said. "But in the long term, if the quantum of funds flowing to Wall Street through Gift City funds gains substantial momentum, then it is possible that the US government may respond accordingly."

Nilesh Tribhuvan, managing partner at Wh[illegible] dvocates & Solicitors, added that if a streamlined tax regime in India results in lower or no taxes on certain income, US residents may

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Some experts contended that the US may not be interested in subjecting small-ticket investments to its inheritance tax. Besides, wealthy Indians are already investing in US markets without relying on Gift City, they pointed out.

"I do not think the US would be interested in the smaller units being taxed through inheritance tax and react to such structures," said Kunal Savani, a partner at Cyril Amarchand Mangaldas. "In fact, if investments through the Gift City are encouraged into offshore markets (including the US), then those markets will get additional investments, which is more important."

Are there any domestic implications to allowing this?

A primary consequence of tweaking the regulations could potentially lead to a loss of tax revenue for the Indian government, said Ankit Jain, partner at tax and audit consultancy Ved Jain & Associates.

"Implementing tax regulations that allow for significant deferrals or exemptions might encourage more Indian investors to channel their funds to international markets, which could undermine the domestic economy by reducing available investment capital within India," he explained.

Jain also said that if Gift City family investment funds are taxed in the same manner as domestic mutual funds, payment of taxes applicable on such investments in India could be deferred until the funds are withdrawn for use.

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"Gift IFSC was on principle created as a jurisdiction to onshore offshore structures and capital, and not to necessaily act as a gateway to send money outside of India," said Radhika Parikh, head of Gift City office, Nishith Desai Associates.

"The recommendations made by IFSC are to incentivize retail investment by non-resident Indians and foreign nationals through the Gift IFSC."

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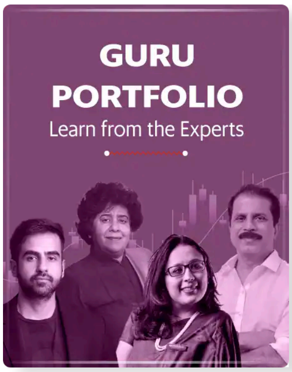

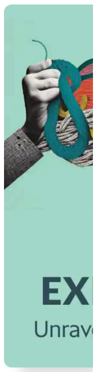

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