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Ministry of Finance  
North Block  
New Delhi, India

RE: Follow-Up to ICI/ICI Global Meeting on  
Tax issues for Cross-Border Fund Investments

May 21, 2014

Dear Dr. Shome:

Thank you for meeting with my industry colleagues, BMR & Associates LLP, and me to discuss income-tax issues of concern to members of the Investment Company Institute\(^1\) and ICI Global.\(^2\) We appreciate greatly the time that you, Mr. Sunil Gupta, Ms. Pragya Saxena, and Dr. VK Singh spent with us and the forthright and informative discussion.

We traveled from the United States to emphasize the fund industry's unique need, due to the daily pricing of each fund's shares, for tax certainty. Essential components of tax certainty include: rules that are clear and disseminated to assessing officers; adherence by assessing officers to those rules and to judicial precedent; and a prohibition on retrospective application of legislative amendments. The tax certainty we seek will improve investor confidence, enhance the funds' investment experience, and promote cross-border portfolio (non-controlling) investment in India.

The enclosed Annexure A responds directly to the discussion we had on four specific tax policy issues raised with you during our meeting. Each of the issues that we discussed, described in Annexure B, is of great importance to our members that are making substantial Indian investments. Also enclosed, as Annexure C, is the letter that we sent to Mr. Joshi, Director General of Income Tax (International Tax) regarding tax administration issues that we discussed directly with him.

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\(^1\) ICI is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds ("ETFs"), and unit investment trusts ("UITs"). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of $16.8 trillion and serve over 90 million shareholders.

\(^2\) ICI Global is a global fund trade organization based in London; members include regulated U.S. and non-U.S. based funds publicly offered to investors in jurisdictions worldwide. ICI Global seeks to advance the common interests and to promote public understanding of global investment funds, their managers, and investors. Members of ICI Global manage total assets of $1.4 trillion in non-U.S. funds.
The four issues discussed in Annexure A are: (1) the tax status of foreign business entities; (2) fund reorganizations involving business trusts; (3) the taxation of asset managers when an Indian executive oversees offshore employees; and (4) the taxation of offshore funds managed by Indian-based investment advisers. Other important issues that we discussed, for which no additional detailed information is necessary, include the taxation of indirect transfers and the general anti-avoidance rule (“GAAR”).

1. **The Tax Status of Foreign Business Entities.** Our October submission (Annexure B) explained the difficulties that U.S. funds have when they are organized as business trusts under the laws of one of the United States (such as Massachusetts). We recognize that Indian law does not have a provision that allows a business trust to file its Indian tax returns as a “company.” As explained in Serial 1 of Annexure A, however, section 2(17)(iv) of the IT Act allows the Central Board of Direct Taxes (“CBDT”) to notify “an institution, association or body, whether incorporated or not and whether Indian or non-Indian, which is declared by general or special order of the CBDT to be a company.” Serial 1 explains the operation of funds that are organized in the U.S. as business trusts, the rationale for them filing in India as companies, and why extending company treatment to funds organized as business trusts does not put other trusts at a comparative disadvantage in India.

We submit that the CBDT should exercise its authority under section 2(17)(iv) of the IT Act and clarify that bodies such as business trusts should be treated as companies.

2. **Fund Reorganizations Involving Business Trusts.** A related issue involves reorganizations of business trusts. As explained in our October submission, funds organized as business trusts are taxed as corporations under U.S. law. These reorganizations, which are tax-free in the U.S., are undertaken to address business and corporate governance issues. Serial 2 of Annexure A explains in greater detail, (1) the reasons for these reorganizations, (2) the tax-free treatment of these reorganizations in the U.S. as corporate mergers, (3) the Indian tax problem faced by any such U.S. fund that reorganizes, (4) that the problem is so severe that some funds do not reorganize, and (5) that funds that reorganize, after divesting their Indian securities, sometimes do not reinvest in India. Importantly, as we discussed, these reorganizations are not being done for tax reasons.

We urge an amendment to the IT Act to treat these reorganizations, which are tax-free in the U.S., as tax-free in India.

3. **The Taxation of Asset Managers When An Indian Executive Oversees Offshore Employees.** Indian law, as explained in our October submission, discourages India-based asset managers from promoting Indian executives to oversee employees of offshore-based companies because of adverse Indian tax consequence concerns. These concerns include having India treat the offshore-based company for which the Indian executive provides oversight support as having a permanent establishment (“PE”) in India. One consequence of this PE treatment would be allocating to India a disproportionate amount of the offshore-based company’s taxable income. Other countries, such as
Singapore and Hong Kong, that rapidly are becoming significant financial centers provide far more favorable tax treatment for asset managers. Serial 3 of Annexure A describes our concerns in greater detail.

We urge an amendment to Indian tax law, such as by an administrative circular, clarifying that this oversight of offshore-based company employees will not cause the offshore-based company to have a PE in India.

4. **The Taxation of Offshore Funds Managed By Indian-Based Investment Advisers.** A related issue involves the tax treatment of an offshore fund managed by an Indian-based investment adviser. Our October submission explained our concern that India would treat an offshore fund that is managed by an Indian-based adviser as an Indian fund with a permanent establishment in India (and therefore as subject to 40 percent corporate tax in India or 30 percent tax for non-corporate entities on all of its income (on a net basis), whether earned inside or outside of India). Because offshore funds are unwilling to risk being treated as Indian funds, as explained in Serial 4 of Annexure A, fund managers will not locate an investment adviser in India. We understand that a circular is being prepared to clarify that an offshore fund will not be treated as an Indian fund in this situation.

We urge that the anticipated circular be issued promptly.

5. **The Taxation of Indirect Transfers.** The Indian legislation retrospectively taxing “indirect transfers” – in response to the Indian Supreme Court’s ruling in the *Vodafone* case – is very troubling for the fund industry. Our concerns about this issue were discussed in Serial 10 of our October submission. We appreciate the recommendations made previously by the Expert Committee chaired by you (and which included Mr. Gupta) in the draft report on indirect transfers. Specifically, we support strongly the recommendation that any legislative change to the taxation of indirect transfers not have retrospective application. “Clarificatory” legislation with 52-year retroactive effect, such as that promulgated in response to *Vodafone*, is extremely harmful to investor confidence. We also support strongly the recommendation that non-resident investors in a foreign institutional investor (“FII”) not be taxable in India in relation to investments made by the FII in India. We further support the limits recommended in the application of the indirect transfer rule to FIIs themselves. We understand that a circular is being prepared to clarify that non-resident investors in an FII will not be subject to the indirect transfer rule.

We urge that the anticipated circular be issued promptly. The other recommendations of the Expert Committee also should be adopted.

6. **GAAR.** We appreciate all of the recommendations made previously by the Expert Committee chaired by you (and which included Mr. Gupta) in the final report on the GAAR. One essential recommendation, that we support strongly, is that all investments existing on the date the GAAR provisions commence be grandfathered so that the GAAR provisions are not invoked on exit (such as on the sale of such investments). We also support strongly the recommendation that the FII is the
taxable unit for taxation in India and that, as a result, all non-resident investors in the FII are excluded from the GAAR’s purview; such non-residents include persons holding offshore derivative instruments (commonly known as Participatory Notes) issued by the FII.

We urge that the Expert Committee’s recommendations be adopted by the Ministry and announced in a circular.

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Once again, thank you for meeting with us. If we can provide you with any additional information, please do not hesitate to contact me or our Indian tax advisors: BMR & Associates LLP at your convenience.

Yours faithfully,

/s/ Keith Lawson

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Enclosures:  
Annexure A: Detailed response to four specific issues that are being faced by Foreign Institutional Investors that conduct portfolio investments in Indian securities.

Annexure B: Letter to Mr. Manohar, Officer on Special Duty to the Adviser to the Finance Minister, dated October 22, 2013, including 12 issues discussed in Annexure A to that letter.

Annexure C: Letter to Mr. NC Joshi, Director General of Income Tax (International Tax), dated May 21, 2014, regarding tax administration issues.

cc:  
Mr. Sunil Gupta [Joint Secretary, Tax Planning & Legislation Division (TPL-II), CBDT]  
Ms. Pragya Saxena [Joint Secretary, Tax Planning & Legislation Division (TPL-I), CBDT]  
Dr. VK Singh [Director, Foreign Tax & Tax Research Division, CBDT]
ISSUE 1
Tax Status of Foreign Business Entities in India

1. THE GENESIS OF THE ISSUE
Investment funds may be organized as different types of entities in their home country. For example, in the U.S., investment funds may be organized under state law as either corporations or trusts. The fund house launching an investment fund decides upfront on the state forum and the legal structure to be used for setting-up a new fund, after weighing the pros and cons associated with various state laws for each type of legal form. One key consideration today is the relative flexibility to respond to changing circumstances and market conditions. Convenience factors, such as on-line registration systems, also can influence organizational structuring choices. Many fund houses prefer the same state law and legal form for all of their funds; this consistency, which helps simplify legal processes and compliance procedures, can be the determinative factor.

The differences between different state laws and legal forms today are relatively minor, though important. One benefit of a statutory framework for fund organizations (compared to the common law framework under which U.S. funds first were organized) is the legal certainty that comes from complying with a well-defined statute; this benefit arises whether the statute provides for a corporate or trust form of organization.

The differences between the corporate and trust forms of organization likewise are relatively minor, though important. Depending on the state law, certain fund transactions (such as mergers, certain reorganizations, and liquidations) may be undertaken without a shareholder vote under either form of organization. The annual shareholder meeting requirement was one factor that initially caused funds organized as Massachusetts business trusts to consider other forms of organization. Certainty that an investor’s liability is limited to his or her amount invested (which is the standard rule for corporations) is one factor favoring a corporate or statutory trust model compared with the common law business trust model (where this limitation is not explicit).

How is a Massachusetts Business Trust (‘MBT’) established?

The MBT is an unincorporated business created by a legal document (a declaration of trust) and used in place of a corporation or a partnership for the transaction of various kinds of business with limited liability. An MBT is not necessarily one that is operated in the state of Massachusetts.

An MBT gives its trustees the legal title to the trust property to administer it for the advantage of its beneficiaries who hold equitable title to the trust’s property. A written declaration of trust specifying the terms of the trust, its duration, the powers and duties of the trustee, and the interests of the beneficiaries is essential for the creation of the business trust. The beneficiaries receive certificates of beneficial interest as evidence of their interest in the trust; these certificates are freely transferable. A MBT is provided with the right to contract and to obtain legislatively constructed business
organization advantages without attaining permission to enter into a business activity. The property of the business trust is managed and controlled by trustees who have a fiduciary duty to act in the best interest of the trust beneficiaries. Profits and losses resulting from the use and investment of the trust property are shared proportionally by the beneficiaries according to their interests in the trust.

History of the MBT

The business trust made its debut in the State of Massachusetts in 1827. As a result, a U.S. business trust today is often colloquially referred to as a MBT in legal circles. The method of transacting business in commercial enterprises originated in Massachusetts as a result of negative laws prohibiting certain business-related activities without a special act of the legislative or in other words, without “permission” of the state. So, the business trust was created under the common law right to contract to obtain legislatively constructed business organizations advantages but without having to gain “permission” to enter into a business activity and suffer under the burdens and restrictions that are placed on “statutorily constructed organizations.”

How are mutual funds set up in the U.S.?

In the U.S., a mutual fund typically is organized under state law either as a corporation or a business trust. The three most popular forms of organization are the MBT, the Maryland Corporation, and the Delaware Statutory Trust (‘DST’). A few mutual funds are set up as other forms of organizations and with other domiciles. (Refer Fig 1)

![Most Popular forms of U.S. Mutual Funds (Fig 1)](image)

Source: Percentage of funds, year-ended 2012 as is depicted in the ICI Fact book.
MBTs are the most popular of these trusts, largely as a result of history. The very first mutual fund was formed as an MBT, which was a popular form of organization at the time for pools that invested in real estate and public utilities. The fund, the Massachusetts Investors Trust, provided a model for other funds to follow, leading to widespread use of the MBT throughout much of the industry's early history. Developments in the late 1980s gave asset management companies other attractive choices. In 1987, Maryland amended its corporate statute to align with interpretations of the Investment Company Act of 1940 concerning when funds are required to hold annual meetings, thereby making Maryland corporations more competitive with the MBT as a form of organization for mutual funds. In 1988, Delaware – already a popular domicile for U.S. corporations – adopted new statutory provisions devoted specifically to business trusts (since renamed statutory trusts). As a result of these developments, many mutual funds created in the last 25 years have been organized as Maryland Corporations or DSTs.

Mutual funds have officers and directors (if the fund is a corporation) or trustees (if the fund is a business trust). The fund’s board or trustees play a pivotal role as regards the oversight and accountability of the fund. Unlike other companies, a mutual fund typically is externally managed, it is not an operating company, and it has no employees in the traditional sense. Instead, a fund relies on third parties or service providers – either affiliated organizations or independent contractors – to invest the fund’s assets and carry out other business activities. These service providers include: Sponsors, Board of Directors/Trustees, Investment Managers, Administrators, Principal Underwriters, Transfer Agents, Custodians, Auditors etc.

How are U.S. mutual funds taxed in the U.S.?

U.S. mutual funds whether organized as MBTs, DSTs, or corporations, are all treated as corporations for U.S. tax purposes and are subject to special tax rules set forth in subchapter M of the Internal Revenue Code (‘IRC’). Unlike most corporations, mutual funds generally can eliminate the tax due on their income or capital gains at the entity level, provided they meet certain gross income and asset requirements and distribute all of their income to their investors.

Subchapter M of the IRC applies to investment companies that meet certain requirements to be treated as Regulated Investment Companies (‘RICs’). To qualify as a RIC under Subchapter M, at least 90 percent of a mutual fund’s gross income must be derived from certain sources, including dividends, interest, payments with respect to securities loans, and gains from sale or other dispositions of stocks, securities or foreign currencies. In addition, at the close of each quarter of the fund’s taxable year, at least 50 percent of the value of the fund’s total net assets must consist of cash, cash items, government securities, securities of other funds, and investments in other securities which, with respect to any one issuer, represent neither more than 5 percent of the assets of the fund nor more than 10 percent of the voting securities of the issuer. Further, no more than 25 percent of the fund’s assets may be invested in the securities of any one issuer (other than government securities or the securities of other funds), the securities (other than the securities of the other funds) of two or more issuers which the fund controls and are engaged in similar trades or businesses, or the securities of one or more qualified publicly traded partnerships.
If a mutual fund satisfies the gross income and asset tests to qualify as a RIC, and distributes at least 90 percent of its income (other than net capital gains) so that it qualifies for Subchapter M treatment, the fund is taxed only on the income and capital gains that it retains; these amounts are taxed at regular corporate tax rates. Therefore, mutual funds typically distribute each year all of their income and capital gains to eliminate a tax that would reduce investor returns.

The IRC also imposes an excise tax unless a fund distributes by December 31st at least 98 percent of its ordinary income earned during the calendar year, and 98.2 percent of its net capital gains earned during the 12-month period ending on October 31st. Mutual funds typically seek to avoid this charge—imposed at a 4 percent rate on the “undistributed” amount—by electing to distribute their income currently.

Business Trusts are treated as corporations for U.S. Federal tax purposes. There are no U.S. tax differences between investment funds that are organized as corporations, MBTs, or DSTs.

How are investors in U.S. mutual funds taxed in the U.S.?

Investors in U.S. mutual funds are ultimately responsible for paying tax on a fund’s earnings, whether they receive the distributions in cash or reinvest them in additional fund shares/interests. Tax will not be due currently, however, if the fund shares are held through tax-deferred retirement accounts or variable annuities. In addition, the income earned by funds from investing in the bonds of state and local governments is exempt from tax at the Federal level (although generally taxable at the State level unless the bonds are issued by the investor’s own state government).

Mutual funds make two types of taxable distributions to investors: ordinary dividends and capital gain dividends. Ordinary dividend distributions come primarily from the income (interest and dividends) earned from the securities held in a fund’s portfolio and net short-term capital gains, if any, realized from the sale of the fund’s portfolio securities held for one year or less; funds reduce their ordinary dividend distributions by the amount of fund expenses. These distributions must be reported as dividends on an investor’s tax return and generally are taxed at the investor’s ordinary income tax rate. The maximum tax rate on “qualified dividend income” received from a U.S. corporation — income that was taxed at the corporate level before being distributed to the corporation’s shareholders — is 20 percent. Funds that receive qualified dividend income may distribute those amounts, taxable at the 20 percent top rate, to their shareholders.

Long-term capital gains distributions represent a fund’s net gains, if any, from the sale of securities held in its portfolio for more than one year. Long-term capital gains are taxed at a maximum rate of 20 percent. A lower rate applies to some taxpayers.

To help mutual fund investors understand the impact of taxes on the returns generated by their investments, the Securities and Exchange Commission (‘SEC’) requires mutual funds to disclose
standardized after-tax returns for one-, five-, and ten-year periods. After-tax returns, which accompany before-tax returns in fund prospectuses, are presented in two ways:

- After taxes on fund distributions only (pre-liquidation)
- After taxes on fund distributions and an assumed redemption (post liquidation)

An investor who sells mutual fund shares/interests usually incurs a capital gain/loss in the year of transfer; an exchange of shares/interests between funds in the same fund family also results in a capital gain/loss. Any capital loss can be offset against other capital gains that may be earned by the investor from his investments in other mutual fund shares/interest, or stocks, bonds or other securities.

The above taxing framework for the U.S. mutual fund and/or the investors in such mutual fund applies equally, irrespective of the legal form of the mutual fund (i.e., irrespective of whether the mutual fund is established as a corporation or a business trust).

**Eligibility of All U.S. Funds – including Business Trusts – for tax treaty benefits**

All U.S. funds – including those organized as statutory or business trusts – that meet the RIC requirements qualify for treaty benefits as persons, residents, and the beneficial owners of their income. Business Trusts also are formally recognized in the India-U.S. tax treaty.

1. **Person**

Paragraph 1(e) of Article 3 (General definitions) of the India-U.S. tax treaty defines a “person” to include “an individual, an estate, a trust, a partnership, a company, any other body of persons, or other taxable entity.” A fund organized as a business trust is regarded as a “person,” as defined in Article 3 of the India-U.S. tax treaty, because it is a trust, it is treated as a company, and it is a taxable entity.

2. **Resident**

Paragraph 1 of Article 4 (Residence) of the India-U.S. tax treaty defines a “resident” to mean “any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, citizenship, place of management, place of incorporation, or any other criterion of a similar nature, provided however that:

(a) This term does not include any person who is liable to tax in that State in respect only of income from sources in that State; and

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(b) In case of income derived or paid by a partnership, estate or trust, this term applies only to the extent that the income derived by such partnership, estate or trust is subject to tax in that State as income of a resident, either in its hands or in the hands of its partners or beneficiaries.”

Since the income earned by the Business Trust is liable to tax at the trust level – and is taxed, upon distribution, to the trust’s investors, the trust is regarded as tax resident in the U.S.

3. Beneficial Ownership

The Treasury Department’s Technical Explanation of the Convention, in discussing the “beneficial ownership” requirement of Article 10 (Dividends) or Article 11 (Interest) provides that “The term ‘beneficial owner’ is not defined in the Convention; it is, instead, defined by domestic law of the Contracting States. A nominee or agent which is a resident of a Contracting State may not claim the benefits of this Article if the dividend is received on behalf of a person who is not a resident of that Contracting State. However, dividends received by a nominee for the benefit of a resident would qualify for the benefits of this Article.”

Unfortunately, the term “beneficial owner” is not defined in the IT Act. Hence, from an Indian context, one has to rely on general taxing principles while interpreting this term. Business Trusts, as discussed above, retain full control over their income and are not transparent. This is because while the value of a Business Trust’s units includes the value of any income (such as dividend, interest, or capital gain) earned by the Business Trust, a unit holder has no right of receipt of that income until a dividend with respect to that income is declared. If an investor sells his units before the dividend is declared, the investor is not entitled to the dividend. Conversely, if an investor buys units after the income is earned but before the dividend is declared, the investor is entitled to the dividend. Moreover, the U.S. tax and securities laws prevent items of income or tax benefit from being allocated specially to individual unit holders. All unit holders in a Business Trust are entitled to an equal share of any tax treaty benefit received by the Business Trust. In addition, a Business Trust does not act as an agent for its investors. Thus, Business Trusts are the beneficial owners of their income.

4. Recognition of Business Trusts in Article 10 (Dividends) of the India-U.S. tax treaty

Paragraph 2 of Article 10 (Dividends) of the India-U.S. tax treaty provides as follows:

“2. However, such dividends may also be taxed in the Contracting State of which the company paying the dividends is a resident, and according to the laws of that State, but if the beneficial owner of the dividends is a resident of the other Contracting State, the tax so charged shall not exceed:
(a) 15 percent of the gross amount of the dividends if the beneficial owner is a company, which owns at least 10 percent of the voting stock of the company paying the dividends;

(b) 25 percent of the gross amount of the dividends in all other cases.

Sub-paragraph (b) and not sub-paragraph (a) shall apply in the case of dividends paid by a United States person which is a Regulated Investment Company. Sub-paragraph (a) shall not apply to dividends paid by a United States person which is a Real Estate Investment Trust, and sub-paragraph (b) shall only apply if the dividend is beneficially owned by an individual holding a less than 10 percent interest in the Real Estate Investment Trust. This paragraph shall not affect the taxation of the company in respect of the profits out of which the dividends are paid.”

The Treasury Department’s Technical Explanation of the Convention, clarifies that “the second and third sentences of paragraph 2 relax the limitations on source country taxation for dividends paid by U.S. Regulated Investment Companies and Real Estate Investment Trusts. Dividends paid by Regulated Investment Companies are denied the 15 percent dividend rate and subjected to the 25 percent portfolio dividend rate regardless of the percentage of voting shares held by the recipient of the dividend. Generally, the reduction of the dividend rate to 15 percent is intended to relieve multiple levels of corporate taxation in cases where the recipient of the dividend holds a substantial interest in the payer. Because Regulated Investment Companies and Real Estate Investment Trusts do not themselves generally pay corporate tax with respect to amounts distributed, the rate reduction from 25 percent to 15 percent cannot be justified by the ‘relief from multiple levels of corporate taxation’ rationale. Further, although amounts received by a Regulated Investment Company may have been subject to U.S. corporate tax (e.g., dividends paid by a publicly traded U.S. company to a Regulated Investment Company), it is unlikely that a 10 percent shareholding in a Regulated Investment Company by an Indian resident will correspond to a 10 percent shareholding in the entity that has paid U.S. corporate tax (e.g., the publicly traded U.S. company). Thus, in the case of dividends received by a Regulated Investment Company and paid out to its shareholders the requirement of a substantial shareholding in the entity paying the corporate tax is generally lacking.”

Given the above, if a Business Trust (which is recognized as a Regulated Investment Company for U.S. tax and regulatory purposes) were to distribute dividends to its unit holders who are Indian tax residents, as per Article 10 (Dividends) of the India-US tax treaty, the Business Trust would need to withhold tax in the U.S. at the rate of 25 percent on such dividends declared to its unit holders who are Indian tax residents.

Since, a Business Trust (which is recognized as a Regulated Investment Company for U.S. tax and regulatory purposes) is treated like a corporation, under U.S. Federal tax law as well as for the
purposes of Article 10 (Dividends) of the India-U.S. tax treaty, then India should allow such a Business Trust also to be treated as a corporation for Indian income-tax purposes.

2. THE VARIATION WITH THE INDIAN TAX LAW
The Indian tax law requires every person to determine its taxing status based on its legal status. This determination needs to be done up front at the very beginning (i.e., at the time of seeking a tax registration: PAN from the Indian Revenue authorities), as well as throughout the life of the taxpayer (i.e., at the time of filing its tax return in India). For example:

- While paying advance tax, every taxpayer has to disclose its legal status (i.e., corporate or non-corporate) and discharge its tax liability accordingly;
- While withholding tax, every payer needs to determine the legal status of the payee (i.e., whether corporate or non-corporate) and deduct tax at source at the applicable tax rates;
- While filing a tax return in India, every taxpayer needs to complete its own tax return by using the proper tax return form (i.e., whether for corporate or non-corporate filers) and have the said return submitted within the stipulated deadlines (which could be different for corporate and non-corporate tax payers).

Some of the key reasons for the above determination emanate from the fact that the Indian tax law provides different bases of taxation for different types of taxpayers. For example:

- Corporate tax payers are subject to higher tax rates vis-à-vis non-corporate tax payers.
- The due date for filing corporate tax returns is different from that for non-corporate taxpayers.
- Sometimes fiscal benefits are afforded to only certain types of taxpayers.

Confusion has arisen for U.S. mutual funds that are established in the U.S. as state law trusts, and which file their tax returns in their home country (i.e., the U.S.) as corporations, regarding (i) the tax return that the investment fund should file in India and the timing of the filing; and (ii) the tax rate that the fund should pay in India (i.e., the rate applicable to corporate taxpayers or the rate applicable to non-corporate taxpayers). Are the funds corporate or non-corporate entities? They file corporate tax returns in the U.S. but might be required to adopt a contrary position in India and file as non-corporate entities.

Hence, the question whether such investment funds are to be treated as corporations or trusts for Indian tax purposes has arisen repeatedly.

Certainty regarding the tax rate and filing status of investment funds, for reasons noted above, is crucial for investment funds and their investors. Conclusive guidance that is adhered to by all tax officials regarding such administrative issues will make the investment environment in India more attractive.
3. THE INDIAN MUTUAL FUND EXPERIENCE
Currently, the Securities and Exchange Board of India (‘SEBI’) mandates every domestic mutual fund that is set-up in India, to be established as a trust under the Indian Trust Act, 1882. The legal form of an Indian mutual fund is similar to that of a U.S. mutual fund that is organized under state law as a trust. However, unlike U.S. mutual funds that have the option of being established as corporate entities in the U.S., Indian mutual funds do not have the option of being set up as corporate entities.

The Indian tax law exempts all income earned by mutual funds in India from tax in the hands of the mutual fund1. Equity Oriented Funds (‘EOFs’) are exempt from paying any Distribution Tax on income distributed to their unit holders. However, Non-Equity Oriented Funds are required to pay a Distribution Tax (ranging from 25 percent to 30 percent) on income distributed to their unit holders.2 The income received by unit holders from the mutual fund is exempt from tax in the hands of the unit holders.3

An investor who sells mutual fund units usually incurs a capital gain/loss in the year of transfer; an exchange of shares/interests between funds in the same fund family also results in a capital gain/loss. Any capital losses can be offset against other capital gains that may be earned by the investor from his investments in other mutual fund shares/interest, or stocks, bonds or other securities. Depending on the investment focus of the mutual fund, the investors in such mutual fund could be subject to varying tax rates on their capital gains income. For example, investors in EOFs are required to pay a de minimis Securities Transaction Tax (‘STT’) at the time of redemption of their mutual fund units, the resultant LTCGs that they realize are exempt from tax in their hands, and the resultant STCGs that they realize are taxed in their hand at a flat rate of 15 percent; investors in Non-EOFs do not pay any STT, but are required to pay tax at the rates of 20 percent on their LTCGs realized and pay tax at their residuary tax rate on their STCGs realized.

Principle of reciprocity

The U.S. does not tax a foreign investment fund that conducts only portfolio investments in the U.S. capital markets as a U.S. taxpayer with tax filing requirements. The only U.S. taxes that are imposed on a foreign investment fund are the withholding taxes that apply to dividends paid by U.S. companies to non-U.S. investors. The statutory withholding rate on these payments is at most 30 percent. No U.S. tax generally is imposed on interest payments or gains from the sale of securities.

India is one of the few countries that taxes foreign portfolio investors on their Indian-sourced income and mandates that such investors file annual tax returns in India. We are not asking the Indian Government to stop taxing foreign portfolio investors or stop requiring them to file annual tax returns

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1 Section 10(23D)
2 Chapter XVII-E
3 Section 10(35)
in India thereby reporting their Indian-sourced income. All we are seeking is a level playing field for U.S. investment funds that are constituted as business trusts (be they MBTs or DSTs, etc.) and which are treated as corporations in the U.S., for federal income-tax purposes, to continue with this position for Indian income-tax purposes.

4. SUGGESTIONS
Because mutual funds that are formed as state law trusts (whether business trusts or statutory trusts) are in all respects subject to taxation as corporations under the U.S. income tax laws applicable to RICs, India could issue guidelines on the following lines:

- **First**, either (i) allow such investment funds to be treated as, and to file as, corporations for Indian tax purposes or (ii) confirm that such investment funds should file their tax returns in India based on the form of their organization in their home country.
- **Second**, confirm that where an investment fund historically has been filing its returns in India as a corporation or as a trust, based on any of the above beliefs, then it should continue to do so and pay its Indian income tax on this basis.

The above guidelines would help an investment fund know its tax status for India purposes (i.e., whether it should register as a corporation or as a trust), especially at the time of applying for a PAN card. It also is of particular importance because Indian tax rates differ for corporations and trusts. Additionally, it would reduce any risks that may be faced by funds that have been genuinely filing their tax returns in India on a particular basis, of having their returns being declared as invalid.

There is a provision in the IT Act, i.e., section 2(17)(iv), which allows the CBDT to notify “any institution, association or body, whether incorporated or not and whether Indian or non-Indian, which is declared by general or special order of the CBDT to be a company.” Hence, there is a provision in the IT Act that can be used as a mechanism to address the issue, without having to amend the provisions of the IT Act. Hitherto, the CBDT have not notified any class of taxpayers under this provision, and the CBDT could consider using this provision to help resolve the issue.
 ISSUE 2  
Fund Reorganizations, which are Tax-Free in their Home Country

 1. THE GENESIS OF THE ISSUE
Fund reorganizations occur for many different business and regulatory reasons. Under U.S. law, for example, fund reorganization may involve multiple funds or a single fund. When two funds are merged, the assets of the funds (which have comparable investment objectives) are combined; the investors in the remaining (successor) fund have a proportionate interest in each asset that previously was held by each of the predecessor funds. When a single fund is reorganized, there is no change in the assets, ultimate investors, fund manager or in some instances the directors/trustees of the predecessor fund and the successor fund. All such reorganizations, whether involving one or multiple funds, are treated as “tax neutral” in the U.S. and in many/most other jurisdictions.

The tax issue for funds seeking to reorganize involves the potential tax consequences if Indian securities are held in any of the affected portfolios. Specifically, the possibility of Indian tax, to the extent the portfolio consists of Indian securities, can prevent a transaction from occurring or cause the Indian securities to be sold before the transaction and perhaps not reacquired after the transaction occurs.

 2. WHY DO FUNDS MERGE?
Fund managers merge funds to increase economies of scale and enhance investor returns. Mergers may occur after one fund manager acquires another or when a single fund manager determines that investors would benefit from the merger of two of its funds. Following the acquisition of one fund manager by another, the fund offerings will be reviewed and comparable funds will be merged. Typically, when a single fund manager merges two of its own funds, the fund with a narrow investment objective, that has not generated sufficient investor interest, will be merged into a fund with a comparable, but broader, investment objective.

 3. WHY DO U.S. INVESTMENT FUNDS REORGANIZE THEMSELVES FROM A CORPORATE STRUCTURE TO A TRUST STRUCTURE?
Reorganizations in the U.S. of a single fund may occur either to effect a change in form (such as from corporate to trust form), a change of jurisdiction (such as from Maryland to Delaware), or to change the trust under which the fund is constituted, or a combination of these. These single-fund reorganizations typically occur because of state law innovations that improve fund governance and make a particular form or jurisdiction more attractive than it previously had been.

Some states in the U.S., such as Delaware, have codified the common law principles regarding the existence and structure of statutory trusts. Once created, the statutory trust is recognized as a separate legal entity. Hence, a Delaware Statutory Trust (DST) is a statutory legal entity that is created by the execution of a governing instrument and the filing of a Certificate of Trust with the Delaware Secretary of State. The governing instrument is an agreement entered into between one or more trustees and one
or more persons who are to own equity interests in the DST. Only one trustee is required in order to create a statutory trust. The trustee (or, if there is more than one trustee, at least one of the trustees) must be either: (i) a natural person who is a resident of Delaware; or (ii) an entity that has Delaware trust powers. There are a number of banks in Delaware that can provide the requisite Delaware trustee services.

A DST is similar to a corporation in that the beneficial owners of the trust have no greater liability than that of a stockholder in a corporation. That is, if the governing instrument does not provide to the contrary and if the beneficial owners comply with the formalities of the governing instruments, with few exceptions, their liability is limited to the amount of their required investment. The law of a DST is drafted into the trust instrument, and provides full flexibility to eliminate governance procedures that are obligated under the corporate form; this has been one of the great attractions of the trust form. For example, the trust instrument can be drafted to dispense with routine shareholder meetings. Similar to a corporation, the law provides that, once formed, a DST has perpetual existence and is not terminated by the death, incapacity, dissolution, termination or bankruptcy of a beneficial owner, or the transfer of a beneficial interest. However, all of the foregoing may be altered by the terms of the governing instrument.

4. WHY DO U.S. INVESTMENT FUNDS SHIFT THE PLACE OF THEIR TRUST REORGANIZATION?

U.S. mutual funds, as noted in our submission on Issue 1 (Tax Status of Foreign Business Entities in India), initially were formed as Massachusetts business trusts. Over the years, a number of developments led funds to consider other forms of organization. In addition to the developments discussed in Issue 1, there was some uncertainty, particularly in states other than the one in which a fund was organized, regarding the legal rights and responsibilities of a fund’s investors vis-à-vis the fund and its trustees.

Statutory business trust statutes, as noted in Issue 1, address certain potential difficulties with operating a fund as an MBT. In addition, these statutes can eliminate many of the uncertainties associated with common law trusts. The Delaware Statutory Trust Act (‘Delaware Act’), which was enacted in 1988, provides, among other things, that the business trust is a separate legal entity and that the personal liability of the beneficial owners are limited to the same extent as stockholders in a Delaware Corporation. Under the Delaware Act, the rights, obligations, and liabilities of the trustees and the beneficial owners of the trust can be varied to suit investors’ needs. The Delaware Act contains specific provisions that make it attractive for use by RICs, including the authorization of separate portfolios.

Given the above, some investment funds that initially were organized as MBTs, for example, reorganized themselves into DSTs. This would essentially entail migrating the investment fund from its existing state to the State of Delaware and to be set up as a DST under the Delaware Statutory Trust Act. In each of these instances there is no change in the assets, ultimate investors, fund manager or in
some instances the directors/trustees of the predecessor fund and the successor fund. Such reorganizations are treated as “tax neutral” in the U.S. and in many/most other jurisdictions.

5. HOW ARE SUCH REORGANIZATIONS TREATED IN THE U.S.?

Under U.S. Federal income-tax law (the Internal Revenue Code or IRC), a fund organized as a trust (be it an MBT or a DST) is treated as a RIC and taxed (as discussed in Issue 1) as a corporation for U.S. tax purposes under the IRC subchapter M rules. Hence, any fund reorganization that involves a trust is treated as tax neutral in the U.S. (so long as it meets the requirements under the IRC for a tax-free reorganization), as it enjoys the same tax neutrality that is afforded to corporations.

6. THE VARIATION WITH THE INDIAN TAX LAW

A U.S. fund holding Indian securities in its investment portfolio that undergoes such a reorganization in the U.S. encounters several significant tax issues in India. We have listed these below:

- **First**, India treats the reorganization as a taxable transfer of all Indian assets from the predecessor fund to the successor fund. This results in an unnecessary capital gains tax leakage for the predecessor fund.
- **Second**, securities that are held by the predecessor fund for more than one year lose their status as long-term capital assets. This loss of status will result in short-term capital gains being triggered in the hands of the successor fund should the successor fund decide to sell any part of its portfolio within one year of the reorganization taking effect.
- **Third**, any accumulated capital losses on Indian securities held by the predecessor fund are “lost” upon the reorganization and cannot be used by the successor fund.
- **Fourth**, under the IT Act, (i) the successor fund cannot file tax returns on behalf of the predecessor fund; and (ii) practical challenges arise in having the predecessor fund file its tax return in India and represent its case before the Indian Revenue authorities after the fund has shut down, as there is no one available to sign the last tax return of the predecessor fund or represent the predecessor fund’s case, as and when it comes up for hearing before the Indian Revenue authorities.

7. THE INDIAN MUTUAL FUND EXPERIENCE

In India, all SEBI registered mutual funds operate under the trust structure as is mandated under the SEBI (Mutual Fund) Regulations, 1996. Unlike in the U.S., mutual funds in India do not have the option of being set up as corporate entities. Hence, the foregoing issue of reorganizations of mutual funds in India from one legal form to another, wherein the fund adopts a trust structure does not exist in an Indian context, as the Indian regulations do not allow for it.

Having said that, it is pertinent to note that mutual funds in India nevertheless can reorganize. Their reorganizations, however, typically are of the following kinds:

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• Mergers of two or more mutual fund schemes when one mutual fund house is acquired by another mutual fund house.
• Consolidation of two or more mutual fund schemes that have similar attributes, as has been stipulated by SEBI in the past.¹

In both these instances, the mutual fund houses combine their schemes (which are managed by a trust set up in India) by transferring the assets and liabilities of the predecessor fund to the successor fund; the unit holders in the predecessor fund are given units in the successor fund in exchange for their units in the predecessor fund. Such combinations or mergers involving Indian mutual fund schemes that use the trust structure do not trigger any Indian income-tax implications for the mutual fund schemes because, under the IT Act, any income of a SEBI registered mutual fund is exempt from tax in India as per section 10(23D) of the IT Act. The unit holders in the predecessor fund suffer tax consequences as the exchange of units of one fund for another is regarded as a taxable ‘transfer’ under the IT Act and such unit holders become liable to pay capital gains tax on such transfer depending on the nature of the units they hold and the period for which they held the units. More recently, SEBI, in its Board meeting held on February 13, 2014, approved a Long Term Policy for Mutual Funds in India. One of the tax incentives related proposals that SEBI has recommended to the Indian Government are to not regard the merger/consolidation of equity mutual funds schemes as taxable ‘transfers’, thereby exempting them from capital gains taxation, as is the case with merger/consolidation of Indian companies.²

Hence, our request is for a level playing field to be provided for U.S. mutual funds that undergo reorganizations under the home country, based on the home country law, and which are treated as tax neutral in the U.S. and other countries worldwide. Our request is based on the tenet that even when Indian mutual funds undergo mergers in India, they do not suffer any Indian tax consequences.

Principle of reciprocity

As we have pointed out in Issue 1, the U.S. does not tax a foreign investment fund that conducts only portfolio investments in the U.S. capital markets as a U.S. taxpayer. Because the foreign fund is not treated as having a permanent establishment in the U.S., its only U.S. tax liability, like that of any other non-U.S. portfolio investor in U.S. securities, is the withholding tax on dividends paid by U.S. companies.

A non-U.S. fund making portfolio investments is not required to file a U.S. tax return. Consequently, were an Indian mutual fund to reorganize its operations in India, such a reorganization would not trigger U.S. tax implications. No tax would be due even if, as part of the reorganization, U.S. securities held by one fund were transferred to another fund.

¹ SEBI/MFD/CIR No. 05/12031/03 dated June 23, 2003; SEBI/Cir/IMD/DF/15/2010 dated October 22, 2010.
² PR No. 12/2014.
India is one of the few countries that taxes foreign portfolio investors on their Indian-sourced income and mandates that such investors file annual tax returns in India. We are not asking the Indian Government to stop taxing foreign portfolio investors. All we are seeking is a level playing field for U.S. funds that are organized as trusts, treated as RICs, and therefore taxed as corporations, or that wish to reorganize themselves as trusts, to be exempted from their Indian tax liability arising on account of such one-off reorganizations. This same treatment is provided when an Indian mutual fund reorganizes itself in India; it neither triggers income-tax implications for itself in India (because all of its income is exempt from tax in India under section 10(23D) of the IT Act), nor does it trigger income-tax implications for itself in the U.S. as the U.S. does not tax Indian mutual funds on the gains from their U.S. portfolio investments.

8. TAX NEUTRALITY AFFORDED UNDER THE IT ACT
We wish to submit that the IT Act does contain certain provisions that treat as “tax neutral” mergers involving two or more entities, subject to certain conditions. Comparable exemptions that already exist in the IT Act include mergers between Indian companies,3 mergers between foreign companies wherein shares of an Indian company are transferred,4 demergers of Indian companies,5 demergers of foreign companies wherein shares of an Indian company are transferred,6 conversions of sole proprietorship concerns or firms into companies,7 and conversions of companies into LLPs.8

The IT Act should be amended to exempt reorganizations of investment funds from capital gains tax if the reorganizations are treated as “tax neutral” in the home country. The exemption should be agnostic to the legal form of the investment fund. For example, if a U.S. investment fund were to reorganize itself from one corporate form to another, it could claim exemption under the current provisions of section 47(via) of the IT Act. However, if the U.S. investment fund uses a trust structure, it will not be able to claim exemption under the IT Act, just because it is not a corporation; hence, our request for a change to be brought about in the Indian domestic tax law to set right this anomaly, which causes such unintended consequences.

9. HARDSHIP THAT IS FOLLOWED BY THE U.S. INVESTMENT FUNDS
U.S. investment funds that are organized as trusts, treated as RICs, and taxed as corporations, and that hold Indian securities have three options in regards to reorganization.

- Option 1 (Which is the least preferred): Funds can reorganize while holding Indian securities.
  This is the least preferred option as it potentially creates a tax liability for the fund. Also, capital

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3 Sections 47(vi) and 47(vii) of the IT Act.
4 Section 47(via) of the IT Act.
5 Sections 47(vib) and 47(vid) of the IT Act.
6 Section 47(vic) of the IT Act.
7 Sections 47(xiii) and 47(xiv) of the IT Act.
8 Section 47(xiii) of the IT Act.
loss carry forwards, if any, will not be available to the reorganized fund. There also are costly and complicated reporting and filing requirements.

- Option 2 (Which is undesirable for the funds): Funds choose not to reorganize due to the undue hardship to the funds and, consequently, to their shareholders.

- Option 3 (Which also is undesirable for the funds and could harm the Indian capital markets): Funds sell all of their Indian holdings prior to reorganization. After reorganization, funds determine if India still is an appropriate investment. Some funds will invest their proceeds from the liquidation of their Indian holdings in other countries or will not reinvest fully in India for reasons such as time constraints and market fluctuation.

Hence, we need a mid-path solution that addresses the funds’ concerns and is not inconvenient to them. If such a solution were to be provided, through tax neutral treatment to investment funds that reorganize themselves, more reorganizations would take place with no loss of fresh investment into the Indian capital markets.

10. SUGGESTIONS
To address these concerns, we recommend the following:

- First, the IT Act should be amended to exempt reorganizations of investment funds from capital gains tax if the reorganizations are treated as “tax neutral” in the home country. Comparable exemptions already exist in the IT Act for numerous types of reorganizations, but these exemptions do not currently apply to trust structures.

- Second, in case of a reorganization that is treated as “tax neutral” in the home country, the IT Act should allow a successor fund to take into consideration: (i) the cost of acquisition of the shares acquired by it from the predecessor fund; and (ii) the period of holding of the shares of the predecessor fund, while computing the successor fund’s capital gains tax liability. Similar provisions exist in the IT Act in case of mergers and demergers of Indian companies, conversions etc.\(^9\)

- Third, the IT Act should be amended to allow capital losses incurred by a predecessor fund to carry over to a successor fund that acquires the predecessor fund’s assets in a reorganization that is “tax neutral” in its home country. This treatment is consistent with international norms.

- Fourth, the provisions of the IT Act\(^10\) that allow a successor entity that earns “business income” to address tax filings and other obligations of its predecessor entity should be extended to investment funds and tax filings associated with capital gains of a predecessor fund.

\(^9\) Sections 2(42A) and 49 of the IT Act.

\(^10\) Section 170 of the IT Act.
ISSUE 3
Taxation of Asset Managers where an Indian Executive oversees Offshore Employees

1. THE GENESIS OF THE ISSUE
All investment funds that invest into India undertake their investment-related activities from overseas. These investment-related functions are performed by a fund manager company (‘FMC’), which also is located overseas. The FMC houses the investment professionals, including the key individual(s) who are designated as the Fund Manager(s) of the investment fund. Some of our members have group entities on the ground in India that provide non-binding investment related advice to the FMC, for which the Indian entity is compensated on an arms’ length basis by the FMC. All investment decisions – including in which scrips to invest, at what price, in what quantity/amount, and when, as well as when to sell, at what price, and in what quantity/amount – all are taken by the FMC overseas.

Current Structure (Fig 2)

As can be seen from the above diagram, the investment fund (which is typically registered with SEBI as an FII/sub-account), earns income from its Indian investments (which are in the nature of profits from sale of Indian securities, dividends, interest, etc.). The investment fund reports such income to tax in India as capital gains and/or income from investments, in accordance with the provisions of the section 115AD of the IT Act. Where the investment fund may be eligible to claim the beneficial provisions of a tax treaty, they usually do so. There are a few investment funds (in numbers) that report their above
Indian-sourced income to tax in India as 'Business Profits,' which they claim as tax exempt in India under Article 7 of their respective tax treaties, the position of these funds is that they do not have a Permanent Establishment ('PE') in India and/or no part of their income is attributable to a PE in India (if such entities were held to be treated as having a PE in India).

Over the years, most of our members' groups have made significant strategic investments in India. For example: some groups have set up domestic mutual fund operations in India; some groups have set up equity research outfits, BPOs, and KPOs in India. All these entities in India provide support to their overseas group entities. The nature of services that are rendered vary depending on the capabilities that are built in the Indian entities and the type of services that are required by the overseas group. Today, some of these teams that are based in India are large in numbers and have experienced personnel who not only understand the Indian markets, but also other global markets. Some of the teams house experienced sector analysts who are familiar with constituents of their respective sectors both in India as well as overseas.

Sometimes, the investment professionals who manage global investment funds regularly consult with these experienced India-based personnel; the information sought includes which sectors to focus on and which companies to invest in within a sector (either in India or overseas).

Given their domain knowledge, experience, and skill sets, some of the India-based individuals are well positioned to oversee the activities of their offshore counterparts who are actively involved in managing the investment-related activities of global investment funds. We have provided below a flow chart of the desired operating structure:

*Desired Structure (Fig 3)*
Our members generally do not permit an employee located outside of India to report to an Indian-based supervisor, for the fear that their companies (not doing business in India) will be deemed to have a PE in India solely because of the supervision from within India. This could cause unintended consequences for both the investment funds and the FMCs. For example -

- Investment funds that treat their Indian-sourced income (which comprises of 'Business Profits' as per the relevant tax treaty) as exempt from tax in India, because they do not have a PE in India or no part of their income is attributable to a PE in India, are concerned that the Indian Revenue authorities (especially at the lower level) may seek to disagree with this position. The authorities instead may contend that an India-based supervisor who is involved in the investment-related decisions of the investment fund should be regarded as a PE of the investment fund in India. Under this position, consequently, the investment fund’s ‘Business Profits’ that are attributable to its Indian operations would be taxable in India on a net income basis at the rate of 40% for a corporate entity or 30% for a non-corporate entity.

- Investment funds that report their Indian-sourced income from sale of Indian securities as ‘capital gains’ and pay capital gains tax in India are concerned that the Indian Revenue authorities (especially at the lower level) may contend that their income ought to be regarded as ‘Business Profits’ as opposed to ‘capital gains’. This contention would be based on the intention with which the investment funds purchase Indian securities, the frequency of their trades, and/or their trading pattern and holding periods. The authorities then could use the above arrangement to contend that such investment funds should be taxable on such ‘Business Profits’ in India on a net income basis at the rate of 40% for a corporate entity or 30% for a non-corporate entity on accounts of having a PE in India (i.e., by virtue of the role that is played by the Indian supervisor).

- FMCs also are concerned that the Indian entity that houses/employs the Indian supervisor could be held to be an extension of the FMC; accordingly, a part of the fund management fee that is earned by the FMC overseas could be held to be taxable in India on a net income basis at the rate of 40% for a corporate entity or 30% for a non-corporate entity.

Notwithstanding the above, some of our members also are concerned that the Indian transfer pricing authorities may assert that substantially more income should be attributed to India than what the FMC’s country of operation will respect. These transfer pricing disputes would lead to income effectively being double-taxed by both the FMC’s home country and India.

2. THE VARIATION WITH THE INDIAN TAX LAW
We understand that India takes the view that the activities of the investment fund as well as those of the FMC can be held to be taxable in India as a PE, even if those activities do not include approval for investments. We urge the Indian Government to reconsider this approach and allow a greater degree of freedom for the investment fund and the FMC. The Indian supervisor (who is based in India) and
employed by an Indian entity, would operate within certain pre-existing constraints put in place by the investment fund or the FMC.

There is uncertainty over whether the investment fund and/or the FMC would have a PE in India under such an arrangement. This is despite the fact that the activities of the Indian supervisor (who is based in India) is housed/ring-fenced within another legal entity, which will be compensated on an arms’ length basis using transfer pricing principles.

In the case of ‘Taxation of Services’ the OECD Model Commentary on Article 5 notes that:

“42.14 Some States, however, are reluctant to adopt the principle of exclusive residence taxation of services that are not attributable to a permanent establishment situated in their territory but are performed in that territory. These States propose changes to the Article in order to preserve source taxation rights, in certain circumstances, with respect to the profits from such services. States that believe that additional source taxation rights should be allocated under a treaty with respect to services performed in their territory rely on various arguments to support their position.

42.15 These States may consider that profits from services performed in a given state should be taxable in that state on the basis of the generally-accepted policy principles for determining when business profits should be considered to have their source within a jurisdiction. They consider that, from the exclusive angle of the pure policy question of where business profits originate, the State where services are performed should have a right to tax even when these services are not attributable to a permanent establishment as defined in Article 5. They would note that the domestic law of many countries provides for the taxation of services performed in these countries even in the absence of a permanent establishment (even though services performed over very short periods of time may not always be taxed in practice).

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42.18 It should be noted, however, that all member States agree that a State should not have source taxation rights on income derived from the provision of services performed by a non-resident outside that State. Under tax conventions, the profits from the sale of goods that are merely imported by a resident of a country and that are neither produced nor distributed through a permanent establishment in that country are not taxable therein and the same principle should apply in the case of services. The mere fact that the payer of the consideration for services is a resident of a State, or that such consideration is borne by a permanent establishment situated in that State or that the result of the services is used within the State does not constitute a sufficient nexus to warrant allocation of income taxing rights to that State.” (emphasis added.)

India has provided comments on the OECD Model Commentary, reflecting Indian domestic law:
“35. India does not agree with the interpretation given in paragraphs 42.14 and 42.15 that a service permanent establishment will be created only if services are performed in the source State. It is of the view that furnishing of services is sufficient for creation of service permanent establishment.

36. India does not agree with the interpretation given in paragraphs 42.18 and 42.46; it is of the view that taxation rights may exist in a State even when services are furnished by the non-resident from outside that State. It is also of the view that the taxation principles applicable to the profits from sale of goods may not apply to the income from furnishing of services.”

Separately, the OECD Model Commentary states that, where a person is authorized to negotiate all elements and details of a contract in a way that binds the enterprise, he can be said to exercise the authority to conclude contracts on behalf of the enterprise. This would hold true even if the contract were signed by another person in the State in which the enterprise is situated, or if the first person has not formally given a power of representation. However, the mere fact that a person has attended or even participated in negotiations in a State between an enterprise and a client will not be sufficient, by itself, to conclude that the person has exercised in that State an authority to conclude contracts in the name of the enterprise.

In this context, India does not agree with the interpretation of the OECD Model Commentary; it is of the view that the mere fact that a person has attended or participated in negotiations in a State between an enterprise and a client can, in certain circumstances, be sufficient, by itself, to conclude that the person has exercised in that State an authority to conclude contracts in the name of the enterprise. India is also of the view that a person who is authorized to negotiate the essential elements of the contract, and not necessarily all the elements and details of the contract, on behalf of a foreign resident can be said to exercise the authority to conclude contracts.

In the arrangement that is contemplated by our members, it is pertinent to note that the Indian entity that employs the Indian supervisor would earn a fee for its services rendered to the investment fund and/or the FMC. Such fee would be determined based on transfer pricing principles, and would be taxed in the hands of the Indian entity on a net income basis at the rate of 30%. However, further guidance is needed to assure foreign investors of consistency in India’s approach to transfer pricing principles. This is because, if the Indian Revenue authorities were to contend that the Indian entity were not compensated adequately on an arms’ length basis, they also then could seek to contend that such Indian entity creates a PE for the investment fund and/or the FMC; on this basis, the authorities could seek to attribute some amount of income earned by the investment fund (if such income were held to be in the nature of ‘Business Profits’ and not ‘Capital Gains’) as well as some amount of income that is earned by the FMC overseas to be attributable to such PE in India. Consequently, both such incomes could be held to be taxable in India on a net basis at the rate of 42% – which would be catastrophic for the investment fund and the FMC.
In addition to the above risks, the Direct Tax Code 2010 (‘DTC’), which is expected to be enacted in the near future, has sought to expand the scope of the ‘residency test’ that is to be adopted for a foreign corporate taxpayer to ascertain whether such entity is a tax resident of India; the DTC would do so by bringing within the Indian residency net both those entities that are ‘wholly owned and managed from India’ and those entities that are ‘effectively controlled and managed from India.’ Given this, having an arrangement where an India-based employee oversees or supervises the activities of employees based overseas within the FMC could result in such FMC and/or the investment fund being regarded as being ‘effectively controlled and managed from India.’ Consequently, such an investment fund/FMC could be regarded as being tax resident in India and then would become taxable in India on its global income.

Resolving all of the above issues, is paramount for India (and the city of Mumbai in particular) to be able to position itself in the international markets as a leading fund management centre.

3. THE LOSS TO INDIA
These concerns have very real (and highly negative) consequences for individuals who live, or wish to live, in India. Specifically, India-based employees are not promoted to certain important managerial and supervisory roles within their organisations unless they agree to leave India. This results in an exodus of talent from India to competitive jurisdictions, such as Singapore, Hong Kong, Dubai, London, etc., where such professionals then relocate with their families.

Hence, aside from the fact that some of India’s best talent lands up migrating overseas for want of better career prospects, there also is a huge financial loss to the Indian Government in terms of its ability to collect additional taxes from both: (i) these talented individuals (by way of their personal income-tax); as well as (ii) their respective Indian employers (by way of corporation tax for the services such employees would have rendered had they remained in India).

Resolving this issue will provide: (i) career growth opportunities for India-based asset management professionals who wish to remain resident in India; and (ii) additional tax revenue to the Indian Government.

4. SUGGESTIONS
To address these concerns, we recommend the following:
• First, we recommend that India adopt the international norms approved by the OECD for determining PE status. Under these rules, the worldwide profits of an offshore entity are not taxed solely because an onshore-based supervisor oversees an offshore employee. Instead, an onshore entity (which is the employer of the onshore-based supervisor) generally will receive cost plus mark-up for the services/supervision provided by the onshore-based supervisor. Such fee earned by the onshore entity will be the only local-sourced income subject to local taxation.
• **Second**, we aver that it is imperative for our members to obtain certainty that such an arrangement does not create a PE risk for either the investment fund in India or the FMC in India. We could work with the Indian Government to define the set of activities that would be ‘safe’ to undertake in India on a continuous basis and to develop a ‘safe harbour’ margin to be paid to the Indian entity to allow for such an arrangement to co-exist.

• **Third**, we submit that, if the DTC were to be enacted in the near future, then proper provisions would need to be introduced into the new tax law to make unequivocally clear that having such an arrangement with an Indian entity would not result in any way in the investment fund or the FMC being regarded as being *effectively controlled and managed from India*; hence, not tax resident in India.
 ISSUE 4  
Taxation of Offshore Funds managed by India-based Investment Advisers

1. THE GENESIS OF THE ISSUE
Similar to the issue discussed in Issue No. 3, our members generally do not permit a non-Indian investment fund to be managed from India by an Indian investment advisor or sub-advisor. Specifically, our members are concerned that such a non-Indian investment fund will be deemed to be “controlled” from India and thereby have a taxable presence in India. If the investment fund has a taxable presence, all of its income will be subject to Indian tax.

In fact, right from the launch of the domestic mutual fund regulations in 1996, SEBI allowed asset management companies (‘AMCs’) of mutual funds set up in India also to manage monies of offshore funds. In 2000, SEBI also permitted domestic portfolio managers to manage the monies of FIIs/sub-accounts. However, there has been very little response to these regulatory developments because of the huge tax uncertainty that would be brought about to the offshore fund/FII/sub-account; specifically, the offshore fund/FII/sub-account could be taxable in India on its worldwide income on a net basis at the rate of 40% for a corporate entity or 30% for a non-corporate entity.

Hence, even though the Indian regulatory framework has provided domestic AMCs and domestic portfolio managers with a level playing field vis-à-vis their global peers, this liberalization has been one that remains a liberalization on paper. SEBI’s liberalization has not been translated into reality because of the above tax uncertainty for the foreign clients of such AMCs and portfolio managers.
2. THE VARIATION WITH THE INDIAN TAX LAW
Similar to the issue discussed in Issue No. 3

3. THE LOSS TO INDIA
The above concerns lead to fewer opportunities for India-based portfolio managers. This results in lower business revenue and lesser income on which India can impose tax. Indian employees’ careers, Indian AMC’s business prospects, and India’s tax revenues would all be enhanced by adopting a tax policy consistent with international norms.

4. SUGGESTIONS
We recommend that India clarify that a non-Indian investment fund will not be deemed to have a PE in India simply because of the activities undertaken and services provided by the Indian-based fund managers.
Dear Mr. Joshi:

Thank you for meeting with my industry colleagues, BMR & Associates LLP, and me to discuss tax issues of concern to members of the Investment Company Institute1 and ICI Global.2 We appreciate greatly the time that you, Mr. Sharma, and Mr. Ray spent with us and the forthright and informative discussion.

We traveled from the United States to emphasize the fund industry's unique need, due to the daily pricing of each fund's shares, for tax certainty. Essential components of tax certainty include: rules that are clear and disseminated to assessing officers; adherence by assessing officers to those rules and to judicial precedent; and a prohibition on retrospective application of legislative amendments. The tax certainty we seek will improve investor confidence, enhance the funds' investment experience, and promote cross-border portfolio (non-controlling) investment in India.

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1 ICI is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds ("ETFs"), and unit investment trusts ("UITs"). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of $16.8 trillion and serve over 90 million shareholders.

2 ICI Global is a global fund trade organization based in London; members include regulated U.S. and non-U.S. based funds publicly offered to investors in jurisdictions worldwide. ICI Global seeks to advance the common interests and to promote public understanding of global investment funds, their managers, and investors. Members of ICI Global manage total assets of $1.4 trillion in non-U.S. funds.
Investment funds, as we discussed, encounter tax administration issues in India that are not present in other countries in which the funds invest. These issues are both general, affecting the industry generally because of current administrative procedures, and specific to individual funds. We appreciate greatly your offer to help our members resolve individual bottlenecks in the tax administration process; to that end, I have asked ICI’s and ICIG’s members to contact you directly with their specific instances of concern.

Our more general concerns with Indian tax administration are attributable to several factors, including the process by which issues are identified for audit, the manner in which the issues are developed, the legal impossibility of settling without a judicial decision, and the appeal by the Indian Revenue Authority (“IRA”) of taxpayer-favorable decisions without any apparent analysis of the costs and benefits of the appeal. The changes we suggest would enhance significantly investor confidence in the Indian markets.

As a preliminary matter, we must observe that the Authority for Advance Rulings (“AAR”) process does not provide fund investors with the tax certainty that you have acknowledged is important to them. Specifically, the AAR process, while perhaps useful if a business is contemplating a major transaction that is not time-critical, is not helpful if a fund is making an at-the-moment investment decision. First, the transactions funds undertake are decisions to purchase specific securities in current market conditions. By the time an AAR could be requested, and received, the investment potential of a given security and/or the overall market conditions most likely would have changed materially. Second, even if the transaction could be undertaken after receiving an AAR (such as a transaction involving a specific type of security for which a concessional tax rate has been provided – but which the fund will not buy without the certainty), the AAR is binding on the Indian Revenue Authority only if it decides not to appeal the AAR in the courts. Thus, the AAR process does very little to provide the tax certainty that the funds require.

Turning to administrative matters, we appreciate that India has changed its procedures so that a computer, rather than a person, picks taxpayers and issues for audit. While this change in procedures eliminates one bias, it creates another. Specifically, a fund transaction continually will be selected for audit – even after the fund has (1) succeeded in convincing the IRA agent not to assess on the issue or (2) prevailed in litigation -- unless the computer criteria are changed.

The computer-selection process might not be so problematic if assessing officers weighed more carefully the costs and benefits of raising and pursuing an issue. The industry’s impression is that a driving factor in assessments is the amount of revenue assessed, rather than the probability of collecting that revenue. Looking only to the assessed amount, rather than also to the likely collected amount, leads to considerable expense for both the government and taxpayers. The resulting waste of resources would be ameliorated if assessing officers were instructed to take a balanced view of the issue (including, most importantly, the probability of collection once the litigation process has been completed). Providing circulars instructing revenue officers on issues that the IRA no longer wishes to pursue also would be beneficial.
The next problematic step, from a tax administration standpoint, is the legal prohibition on settling a tax dispute – absent a court decision – once an issue has been assessed. This prohibition effectively forces an investor either to pay a tax that it believes is not due or to endure years of litigation if it cannot convince the assessing officer not to assess the tax in the first instance. An assessing officer, however, has little time to evaluate issues, ask for and receive information from taxpayers, and then make considered assessment decisions. This timing difficulty arises because each officer, we understand, is responsible for approximately 240 cases. Of course, one of the reasons for all of these cases is that issues cannot be settled after they have been assessed. If more cases were settled, assessing officers could make more informed decisions about the remaining cases.

Clearly, the legal prohibition on settling an issue after an assessment is made plays a substantial role in the inefficient administration of Indian tax laws. Settlements are not, as was suggested, “plea bargain arrangements.” Instead, they are utilized widely around the globe as an effective way to resolve disputes without lengthy and expensive litigation. A properly-negotiated settlement is based upon a careful analysis by both parties of the costs and benefits of litigating an issue.

We urge you to encourage the Ministry of Finance’s policymakers to support legislation to permit tax disputes to be settled administratively after an issue has been assessed. Appropriate review safeguards could be provided to ensure that settlements are based upon reasoned determinations and not on other factors. This change would be an easy way to enhance the confidence of cross-border investors who have capital available to further India's growth.

If our suggestions are adopted, the substantial costs imposed on both the Indian government and on taxpayers will be reduced substantially. Further cost savings would arise if decisions by the Indian government to appeal cases decided for taxpayers were based on the costs and benefits of proceeding rather than on a desire to “keep an issue alive.”

Once again, thank you for meeting with us. We appreciated the opportunity to provide you with our perspective on the tax administration difficulties facing cross-border investors seeking to invest in India. The suggestions we have made, we submit, would improve investor confidence substantially. If we can provide you with any additional information, please do not hesitate to contact me or our Indian tax advisors: BMR & Associates LLP at your convenience.

Yours faithfully,

/s/ Keith Lawson

Keith Lawson
Senior Counsel - Tax Law
Investment Company Institute and ICI Global
May 21, 2014

Dr. Arvind Mayaram  
Secretary, Department of Economic Affairs  
Ministry of Finance  
North Block  
New Delhi, India

RE: Follow-Up to ICI/ICI Global Meeting on  
Tax Issues for Cross-Border Fund Investments

Dear Dr. Mayaram:

Thank you for meeting with my industry colleagues, BMR & Associates LLP, and me to discuss tax issues of concern to members of the Investment Company Institute¹ and ICI Global.² We appreciate greatly the time that you spent with us and the forthright and informative discussion.

We traveled from the United States to emphasize the fund industry’s unique need, due to the daily pricing of each fund’s shares, for tax certainty. Essential components of tax certainty include: rules that are clear and disseminated to assessing officers; adherence by assessing officers to those rules and to judicial precedent; and a prohibition on retrospective application of legislative amendments. The tax certainty we seek will improve investor confidence, enhance the funds’ investment experience, and promote cross-border portfolio (non-controlling) investment in India.

The enclosed Annexures A and B (our May 2014 letter to Dr. Shome and our October 2013 letter requesting the meeting with Dr. Shome) respond directly to the discussion we had with you during our meeting. Each of these issues – including the tax status of foreign business entities; fund reorganizations involving business trusts; the taxation of asset managers when an Indian executive oversees offshore employees; and the taxation of offshore funds managed by Indian-based investment advisers – is of great importance to our members that are making substantial Indian investments. Also

¹ ICI is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (“ETFs”), and unit investment trusts (“UITs”). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of $16.8 trillion and serve over 90 million shareholders.

² ICI Global is a global fund trade organization based in London; members include regulated U.S. and non-U.S. based funds publicly offered to investors in jurisdictions worldwide. ICI Global seeks to advance the common interests and to promote public understanding of global investment funds, their managers, and investors. Members of ICI Global manage total assets of $1.4 trillion in non-U.S. funds.
enclosed as Annexure C is a letter that we sent to Mr. Joshi, Director General of Income Tax (International Tax) regarding tax administration issues.

We request your support for the recommendations we make in our letter to Dr. Shome. We crafted our recommendations to address Indian tax issues that are particularly problematic for cross-border portfolio investors that require tax certainty.

We appreciate your observation that guidance will be issued clarifying that an offshore fund will not be treated as an Indian fund with a permanent establishment in India (and therefore as subject to 40 percent corporate tax or 30 percent tax for a non-corporate taxpayer) simply because it is managed by an Indian-based investment adviser. This clarification will be most welcome by investment funds.

We also request your support for the tax administration recommendations we make in our letter to Mr. Joshi. The Authority for Advance Rulings (“AAR”) process, as we explain in our letter to Mr. Joshi, does not provide the tax certainty that funds need when they are making decisions each day whether to invest in specific Indian securities.

Our more general concerns with Indian tax administration are attributable to several factors, including the process by which issues are identified for audit, the manner in which the issues are developed, the legal impossibility of settling without a judicial decision, and the appeal by the Indian Revenue Authority (“IRA”) of taxpayer-favorable decisions without any apparent analysis of the costs and benefits of the appeal.

Our most significant tax administration recommendation is to permit tax disputes to be settled administratively after an issue has been assessed. A properly-negotiated settlement, based upon a careful analysis by both parties of the costs and benefits of litigating an issue, would benefit both the Indian government and taxpayers. We urge your support for this sensible change that would enhance the confidence of cross-border investors who have capital available to further India’s growth.

* * *

Once again, thank you for meeting with us. If we can provide you with any additional information, please do not hesitate to contact me or our Indian tax advisors: BMR & Associates LLP at your convenience.

Yours faithfully,

/s/ Keith Lawson

Keith Lawson
Senior Counsel - Tax Law
Investment Company Institute and ICI Global
Enclosures:  
Annexure A: Letter to Dr. Shome, Adviser to the Finance Minster, dated May 21, 2014, including the detailed response to four specific issues discussed with Dr. Shome that are being faced by Foreign Institutional Investors that conduct portfolio investments in Indian securities.

Annexure B: Letter to Mr. Manohar, Officer on Special Duty to the Adviser to the Finance Minster, dated October 22, 2013, including 12 issues discussed in Annexure A to that letter.

Annexure C: Letter to Mr. NC Joshi, Director General of Income Tax (International Tax), dated May 21, 2014, regarding tax administration issues.
October 22, 2013

Mr Navneet Manohar  
Officer on Special Duty to  
Adviser (MoS) to the Finance Minister  
New Delhi  
India

Dear Sir,

Re: ICI/ICI Global Meeting with Dr. Shome’s forum to exchange views on the tax issues faced by Foreign Institutional Investors (“FIIs”) that conduct portfolio investments in Indian securities

The Investment Company Institute (“ICI”) is a national association of U.S. investment funds including mutual funds, closed-end funds, exchange-traded funds, and unit investment trusts. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their investors, directors, and advisers. The ICI has represented the fund industry on regulatory, legislative, and industry initiatives that affect funds and their shareholders since 1940. Members of ICI manage total assets of U.S.$15.2 trillion and serve more than 90 million investors.

ICI Global (“ICIG”) is the global association of regulated funds publicly offered to investors in leading jurisdictions worldwide. ICIG seeks to advance the common interests and promote public understanding of global investment funds, their managers, and investors. ICI organized ICIG in 2011 as the only industry body focused exclusively on globally-distributed funds. ICIG is based in London; its Hong Kong office opened in 2012.

The investment fund members of ICI and ICIG make significant portfolio (non-controlling) investments in Indian companies.¹ Our members’ investment funds are widely regarded by international peers as global leaders in terms of their approach to governance, investment policies, the scale of their assets, and their solid performance.

Our members’ funds are organized in different forms in different countries. Regardless of form, the income of these funds effectively is taxed only at the investor level. In the United States, for example,

¹ U.S. funds, for example, hold approximately U.S.$5 billion of Indian securities.
although the funds are taxable as domestic corporations, they may deduct the income that they
 distribute to their investors (so long as several registration, asset, and income tests are met). If the funds
distribute each year all of their income, they have no corporate-level taxable income. Instead, all of the
funds’ income is taxed when received by the funds’ shareholders.

Many fund managers, located both within the U.S. (i.e., ICI’s members) and outside the U.S. (i.e., ICIG’s members), have indicated that India would be a much more attractive investment location if
additional clarity and certainty were provided on certain tax issues. Changes to India’s tax treatment of
non-Indian fund management companies, moreover, would allow these firms to place highly-skilled
employees in India and to promote employees already there.

It appears to us that the current tax policy and tax administration in India are not aligned; this
misalignment is one of the key contributors to the lack of clarity and uncertainty regarding how tax gets
administered in India. In situations where different interpretations are possible, the Indian Revenue
authorities usually focus on potential tax collections and interpret the tax law aggressively. Further,
communication with the Indian Revenue authorities sometimes proves to be difficult. The courts in
India generally have been reliable and fair enforcers of Indian tax law; this process, however, results in
very frequent, drawn out, and time consuming legal battles between taxpayers and the Indian Revenue.

Investment funds need tax certainty. Unlike other companies, a fund generally must determine every
day the value of each asset held and each fund liability (including taxes attributable to fund
investments). These determinations are necessary so that the fund can price each day the value of each
fund share. This daily share price – used for daily purchases and sales – is known as the “net asset value”
or “NAV” of the fund’s shares.

Indian tax issues that affect funds and their investors make it difficult for investment funds to have the
requisite certainty regarding the fund’s NAV. This uncertainty, which creates a negative investment
experience, can cause funds to seek alternative investments outside of India and/or to not create funds
that invest exclusively in India. This negative experience may divert substantial investment from India.

Accordingly, to boost investor confidence, the Indian Government should remove any ambiguity in the
current tax law. Tax authorities, moreover, should be directed to take a more balanced view on tax
issues that reflect both the taxpayers’ interests and the revenue’s interests.

We submit that our suggestions, summarised in Annexure A, will strengthen investor confidence and
enhance the stability of the Indian capital markets. The additional portfolio investment and
employment arising from these changes will benefit the Indian economy substantially.

We would be pleased to meet with Dr. Shome and the forum that has been provided to discuss these
issues and then provide a detailed follow-up memorandum. Our four senior member team is coming
from the U.S., especially to meet with Dr. Shome and share our perspectives. We would very much
appreciate if Dr. Shome could spare around an hour for this meeting and share his thoughts on some of the issues that ICI, ICIG, and their members wish to draw to his attention.

We thank you for your co-operation and support in the matter, and look forward to hearing from you.

Yours faithfully,

/s/ Keith Lawson

Mr. Keith Lawson
For the ICI and ICIG
Authorised Signatory

Keith Lawson
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Enclosures:  Annexure A:  The list of tax issues that are being faced by Foreign Institutional Investors that conduct portfolio investments in Indian securities
Annexure A

The list of tax issues that are being faced by Foreign Institutional Investors (“FIIs”) that conduct portfolio investments in Indian securities

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SERIAL NO. 1

1. Issue
Fund Reorganisations, which are Tax-Free in their Home Country

2. Industry/sector involved
FIIs

3. Tax involved
Income tax

4. Revenue impact, if estimated
Not known

5. Genesis of the issue
Investment funds often need to reorganise themselves in their home jurisdiction to address various business and regulatory issues that may arise in the home jurisdiction. These issues include maximising investor returns by merging two funds or reorganising a fund under a local law that provides more favourable governance procedures. This is particularly a problem when the reorganisation involves (i) shifting from a corporate structure to a trust structure (such as shifting from a Maryland Corporation structure to a Delaware Trust structure) or (ii) shifting the place of trust organisation of the fund (for example, shifting from a Massachusetts trust structure to a Delaware trust structure). In each of these instances there is no change in the assets, investors, directors/trustees, or fund manager of the predecessor fund and the successor fund. Such reorganisations are treated as “tax neutral” in the U.S. and in many/most other jurisdictions.

An investment fund that undergoes such a reorganisation in its home country, and which inter-alia holds Indian securities as part of its investment portfolio, encounters several significant tax issues in India. We have listed these below:

- **First**, India treats the reorganization as a taxable transfer of all Indian assets from the predecessor fund to the successor fund. This results in an unnecessary capital gains tax leakage for the predecessor fund.

- **Second**, securities that are held by the predecessor fund for more than one year lose their status as long-term capital assets. This loss of status will result in short-term capital gains being triggered in the hands of the successor fund should the successor fund decide to sell any part of its portfolio within one year of the reorganization taking effect.

- **Third**, any accumulated capital losses on Indian securities held by the predecessor fund are “lost” upon the reorganization and cannot be used by the successor fund.

- **Fourth**, under the IT Act, (i) the successor fund cannot file tax returns on behalf of the predecessor fund and (ii) practical challenges arise in having the predecessor fund file its tax return in India and represent its case before the Indian Revenue authorities after the fund has shut down.
6. Different views observed in application of law/regulation etc., if any
None

7. Suggestions
To address these concerns, we recommend the following:

- **First**, the IT Act should be amended to exempt reorganizations of investment funds from capital gains tax if the reorganizations are treated as “tax neutral” in the home country. Comparable exemptions already exist in the IT Act for numerous types of reorganizations; examples include mergers between Indian companies,\(^2\) mergers between foreign companies wherein shares of an Indian company are transferred,\(^3\) demergers of Indian companies,\(^4\) demergers of foreign companies wherein shares of an Indian company are transferred,\(^5\) conversions of sole proprietorship concerns or firms into companies,\(^6\) and conversions of companies into LLPs.\(^7\)
- **Second**, in case of a reorganization that is treated as “tax neutral” in the home country, the IT Act should allow a successor fund to take into consideration (i) the cost of acquisition of the shares acquired by it from the predecessor fund and (ii) the period of holding of the shares of the predecessor fund, while computing the successor fund’s capital gains tax liability. Similar provisions exist in the IT Act in case of mergers and demergers of Indian companies, conversions etc.\(^8\)
- **Third**, the IT Act should be amended to allow capital losses incurred by a predecessor fund to carry over to a successor fund that acquires the predecessor fund’s assets in a reorganization that is “tax neutral” in its home country. This treatment is consistent with international norms.
- **Fourth**, the provisions of the IT Act\(^9\) that allow a successor entity that earns “business income” to address tax filings and other obligations of its predecessor entity should be extended to investment funds and tax filings associated with capital gains of a predecessor fund.

8. Whether represented earlier
No

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\(^2\) Sections 47(vi) and 47(vii) of the IT Act.

\(^3\) Section 47(via) of the IT Act.

\(^4\) Sections 47(vib) and 47(vid) of the IT Act.

\(^5\) Section 47(vic) of the IT Act.

\(^6\) Sections 47(xiii) and 47(xiv) of the IT Act.

\(^7\) Section 47(xiib) of the IT Act.

\(^8\) Sections 2(42A) and 49 of the IT Act.

\(^9\) Section 170 of the IT Act.
SERIAL NO. 2

1. Issue
Taxation of Asset Managers where an Indian Executive oversees Offshore Employees

2. Industry/sector involved
FIIs

3. Tax involved
Income tax

4. Revenue impact, if estimated
Not known

5. Genesis of the issue
Our members generally do not permit an employee located outside of India to report to an Indian-based supervisor. Specifically, our members are concerned that their companies (not doing business in India) will be deemed to have an Indian permanent establishment (“PE”) solely because of the supervision from within India. One consequence is the concern that India would assert that substantially more income should be attributed to India (such as through transfer pricing) than the fund management company’s country of operation will respect. These transfer pricing disputes lead to income effectively being double-taxed by both the asset manager’s home country and India.

These concerns have very real (and highly negative) consequences for individuals that live, or wish to live, in India. Specifically, Indian-based employees are not promoted to certain important managerial and supervisory roles within their organisations unless they agree to leave India. Resolving this issue will (i) provide career growth opportunities for Indian-based asset management professionals who wish to remain resident in India and (ii) additional tax revenue to the Indian Government.

6. Different views observed in application of law/regulation etc., if any
None

7. Suggestions
We recommend that India adopt the international norms approved by the OECD for determining PE status. Under these rules, the worldwide profits of an offshore entity are not taxed solely because an onshore-based supervisor oversees an offshore employee. Instead, an onshore entity (which is the employer of the onshore-based supervisor) generally will receive cost plus mark-up for the services/supervision provided by the onshore-based supervisor. Such fee earned by the onshore entity will be the only local-sourced income subject to local taxation.

8. Whether represented earlier
No
SERIAL NO. 3

1. Issue
Taxation of Offshore Funds managed by India-based Investment Advisers

2. Industry/sector involved
FIIs

3. Tax involved
Income tax

4. Revenue impact, if estimated
Not known

5. Genesis of the issue
Similar to the issue discussed in Serial No. 2, our members generally do not permit a non-Indian investment fund to be managed from India by an Indian investment advisor or sub-advisor. Specifically, our members are concerned that such a non-Indian investment fund will be deemed to be “controlled” from India and thereby have a taxable presence in India. If the investment fund has a taxable presence, all of its income will be subject to Indian tax.

This concern leads to fewer opportunities for Indian-based portfolio managers. The result is lower business revenue and less income on which India can impose tax. Indian employees’ careers, Indian asset management firms’ business prospects, and India’s tax revenues would all be enhanced by adopting a tax policy consistent with international norms.

6. Different views observed in application of law/regulation etc., if any
None

7. Suggestions
We recommend that India clarify that a non-Indian investment fund will not be deemed to have a PE in India simply because of the activities undertaken and services provided by the Indian-based fund managers.

8. Whether represented earlier
No
SERIAL NO. 4

1. Issue
Audit Issues

2. Industry/sector involved
FIIs

3. Tax involved
Income tax

4. Revenue impact, if estimated
Not known

5. Genesis of the issue
Audit-level tax officials in India process pending tax cases extraordinarily slowly when compared to global standards, especially when it comes to processing rectification applications, orders giving effect to appellate orders, tax refund claims, etc. One investment fund received a large refund after more than ten years arguing its position at administrative and judicial levels. The on-going litigation resulted in significant professional fees. Furthermore, the refund was paid about three years after the favourable ruling from the Income Tax Appellate Tribunal (“ITAT”); interest was paid only in part.

Tax officials force issues that have been well settled in the ITAT or High Courts to be fully retried when they next arise. These issues include (i) taxability of broken period interest earned by FIIs, (ii) taxability of interest accrued but not due at the financial year end, (iii) mode of computing interest on default and deferment in payment of advance tax, and (iv) setting off a 15% short-term capital loss (“STCL”) against a 30% short-term capital gain (“STCG”) before offsetting it against a 15% STCG.

The lack of efficient tax administration structures and procedures prevents the industry from working effectively with the tax authorities. India’s inconsistent handling of legal matters frustrates investment managers’ expectations; the high, extra administrative costs discourage otherwise attractive investments.

6. Different views observed in application of law/regulation etc., if any
None

7. Suggestions
Binding tax guidance, such as that issued by the U.S. IRS and Treasury Department, would help ensure consistent handling of legal tax matters. Moreover, compensation and evaluation systems for tax officials must not treat gross tax collections as an indicator of good performance. Such systems encourage tax officials to ignore established points of tax law and to attempt to collect improper taxes.

8. Whether represented earlier
No
SERIAL NO. 5

1. Issue
Transfer Pricing Issues

2. Industry/sector involved
FIIs

3. Tax involved
Income tax

4. Revenue impact, if estimated
Not known

5. Genesis of the issue
The asset management industry experiences serious problems regarding the application of transfer pricing rules in India. For example:

• First, the industry’s experience is that the higher margins earned by high-end service providers also are expected from service providers offering only basic services.\(^{10}\)

• Second, Bilateral Advance Pricing Agreements (“APAs”) between India and other jurisdictions cannot be successfully negotiated in the present negative climate where the Indian Competent Authority office is unable to conclude cases. The U.S. specifically has indicated it will not enter into APA negotiations with India.

By providing certainty regarding most transfer pricing issues, and swift resolution of issues when disputes arise, India will be able to enhance its global competitiveness. Without resolution, increased wage inflation coupled with demands for increased margins to be paid to Indian companies may result in multinationals considering other jurisdictions for their outsourcing operations.

6. Different views observed in application of law/regulation etc., if any
None

7. Suggestions
To address these concerns, we recommend the following:

• First, India should update its transfer pricing practices to be consistent with OECD principles.

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\(^{10}\) While Safe Harbor rules may give taxpayers certainty regarding the acceptable transfer pricing mark-ups in India, these mark-ups are unacceptable to offshore jurisdictions, as the margins prescribed are too high. Consequently, the taxpayer’s exposure merely has been shifted from India to another jurisdiction. These too-high margins also could distort a multinational group’s global transfer pricing policy.
• Second, the safe-harbor rules notified for transfer pricing prescribe a very high mark-up for the information technology sector (i.e., Net Cost Plus mark-up (“NCP”) of 20% - 22%) and knowledge process outsourcing sector (i.e., NCP of 25%); these markups should be reduced.

• Third, the proposal to create safe-harbor rules for transfer pricing should consider the acceptability of the safe-harbor margins in the context of the acceptability of those margins by offshore jurisdictions.

• Fourth, the APA mechanism should provide amnesty – for applicants that apply for an APA and later decide to withdraw the application (for whatever reason) – against the transfer pricing authorities using any sensitive data that the applicant may have shared as part of the APA process.

8. Whether represented earlier
No
SERIAL NO. 6

1. Issue
Dispute Resolution Panel (“DRP”)

2. Industry/sector involved
FIIs

3. Tax involved
Income tax

4. Revenue impact, if estimated
Not known

5. Genesis of the issue
Offshore investment funds and asset managers have not found the DRP to be an efficient and independent forum to resolve disputes between taxpayers and the Indian Government, especially those relating to transfer pricing matters; foreign investors are left with the impression that the DRP has been ineffective in accomplishing its objectives.

Previously, taxpayers could only approach the Commissioner of Income Tax (Appeals) (“CIT(A)”) for relief against adverse orders that were passed by the Assessing Officers (“AO”). However, given that there was no time limit within which the CIT(A) had to adjudicate on an appeal, matters would remain pending before the CIT(A) for very long periods. With the introduction of the DRP and the statutory requirement for the DRP to pass its order within 9 months of a draft order being passed by the AO, the DRP became an attractive forum for taxpayers to redress their grief. However, taxpayers in our experience seldom receive tax relief from the DRP; consequently, taxpayers must pursue the matter in further appeal to the ITAT.

6. Different views observed in application of law/regulation etc., if any
None

7. Suggestions
Today, most taxpayers view the DRP as a forum in which to appear before they can fast track their cases to the ITAT, which is the appellate authority where they believe they have a reasonable chance of receiving justice. Hence, the suggestion is for the DRP to have a more balanced approached while adjudicating matters relating to taxpayers.

8. Whether represented earlier
No
SERIAL NO. 7

1. Issue
Taxability of Interest earned on Indian Government Securities.

2. Industry/sector involved
FIIs

3. Tax involved
Income tax

4. Revenue impact, if estimated
Not known

5. Genesis of the issue
Confusion exists regarding the applicability of the new concessional tax rate of 5% on interest earned on Indian Government Securities. Specifically, Indian legal and tax advisors have noted that interest earned by FIIs may be ineligible for the new rate as intended, owing to a “technical anomaly” that exists in the IT Act. Rather, either the statutory rate of (i) 20%, or even worse, the normal rate applicable to non-residents (i.e., 40% in the case of corporate taxpayers and 30% in case of non-corporate taxpayers) or (ii) the tax treaty rate of approximately 15% may continue to apply to FIIs that earn interest on Indian Government Securities.

The technical anomaly lies in the fact that to qualify for the new concessional tax rate of 5% (as is prescribed in section 194LD of the IT Act) or the statutory rate of 20% (as is prescribed in section 115AD of the IT Act), the Government Security has to be a security as defined in section 2(b) of the Indian Securities Contract (Regulation) Act, 1956 (“SCRA”); this section defines a Government Security to be one that has the features mentioned in Section 2(2) of the Indian Public Debt Act, 1944 (“PDA”). The Government of India has since issued the Government Securities Act, 2006 (“GSA”), which came into effect on December 1, 2007; post this date, all issuances of Government Securities are done under the GSA. The GSA applies to Government Securities created and issued by the Central Government/State Government whether before or after the commencement of the GSA. Hence, the GSA applies to all Government Securities created and issued even before December 1, 2007. The PDA has ceased to apply to Government Securities to which the GSA applies.\(^\text{11}\)

Since the IT Act still draws reference to the SCRA and the PDA in sections 194LD and 115AD, as opposed to the new GSA, doubts have arisen on whether Government Securities that are covered under the GSA would qualify for the concessional 5% tax rate (up to May 31, 2015) and thereafter qualify for the statutory rate of 20% under section 115AD of the IT Act.

Indian Government Securities will be more attractive to FIIs if the FIIs are assured of the above tax rates, as they will receive a higher after-tax return.

6. Different views observed in application of law/regulation etc., if any
   None

7. Suggestions
   Because of this technical anomaly, we recommend that the Indian Government provide a clarification that the lower rate of 5% will apply to FIIs until May 31, 2015; thereafter, the statutory rate of 20% as is prescribed in section 115AD will apply (subject to tax treaty relief if any). If necessary, a legislative amendment may also be brought about to the IT Act.

8. Whether represented earlier
   No
SERIAL NO. 8

1. Issues
Whether “rupee denominated bonds” as is specified in section 194LD of the IT Act includes debentures, commercial paper, etc., issued by Indian companies.

2. Industry/sector involved
FIIs

3. Tax involved
Income tax and Withholding tax

4. Revenue impact, if estimated
Not known

5. Genesis of the issue
Section 194LD of the IT Act prescribes the new concessional tax rate of 5% for FIIs who invest in “rupee denominated bonds” of an Indian company, and earn interest on such bonds during the period June 1, 2013 to May 31, 2015. This concessional rate is subject to the interest payable on the bond not exceeding the rate of interest that has been notified by the Indian Government in its notification no 56/2013/3 No 149/81/2013-TPL dated July 29, 2013.

The term “rupee denominated bonds” is not defined in section 194LD. Doubts have arisen whether securities that have been issued by an Indian corporate to FIIs that are in the nature of “debentures” or “commercial paper,” etc., are covered within the term “rupee denominated bonds.” Indian corporates also are unclear on whether to extend the concessional tax rate of 5% to FIIs at the time of tax withholding on interest. The reason for the ambiguity is explained below.

The terms “bonds” and “debentures” are not defined in the IT Act, though the two are recognised separately in different sections in the IT Act. Other Indian statutes also recognise the terms “bonds” and “debentures” separately; examples include the Indian Companies Act, 1956, the SCRA, and the Foreign Exchange Management Act, 1999.

It also is pertinent to note that there are various instances in the IT Act wherein certain tax benefits that are applicable to “bonds” have been made available to “debentures” as well, and vice versa; for

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12 Section 10(15)(iv)(h); Section 47(x); Proviso to Section 48; Section 49(2A); Section 54EA.

13 Section 2(12) of the Indian Companies Act, 1956.

14 Section 2(h) of the SCRA.

15 Section 2(za) of the Foreign Exchange Management Act, 1999.
example, (1) there are more than 150 notifications issued under the proviso (ii)(b) of section 193 of the IT Act wherein exemption from tax withholding which is strictly technically applicable to “debentures” also have been made available to “bonds” issued by Indian public sector companies, and (2) there are a few notifications issued under section 80CCF of the IT Act wherein certain benefits that are granted to investors in long-term infrastructure “bonds” also have been made available to bonds that are issued in the nature of secured and redeemable “debentures.”

6. Different views observed in application of law/regulation etc., if any
None

7. Suggestions
We believe the intent of the Indian Government was to grant the concessional tax rate of 5% to all “rupee denominated” securities that are issued by Indian corporates to FIIs that satisfy the interest cap condition prescribed by the Indian Government. Because the Government’s intention was to include investments that are made by FIIs in Indian corporate debt securities that are not in the nature of “bonds” alone, the Government should issue a clarification in this regard.

8. Whether represented earlier
No
1. Issue
Tax Status of Foreign Business Entities

2. Industry/sector involved
FIIs

3. Tax involved
Income tax

4. Revenue impact, if estimated
Not Known

5. Genesis of the issue
Investment funds may be organised as different types of entities in their home country. For example, in the U.S., investment funds may be organised either as corporations or as business trusts. In either case, such investment funds are treated as corporations under the U.S. income tax laws. The question whether such funds are to be treated as corporations or trusts for Indian tax purposes has arisen repeatedly. This leads to confusion regarding (i) the tax return that the investment fund should file in India and the timing of the filing and (ii) the tax rate that the fund should pay in India, i.e., the rate applicable to corporate taxpayers or the rate applicable to non-corporate taxpayers.

Certainty regarding the tax rate and filing status of investment funds, for reasons noted above, is crucial for investment funds and their investors. Conclusive guidance that is adhered to by all tax officials regarding such administrative issues will make the investment environment in India more attractive.

6. Different views observed in application of law/regulation etc., if any
None

7. Suggestions
Because funds formed as business trusts are in all respects subject to taxation as corporations under the U.S. income tax laws applicable to regulated investment companies, India could issue guidelines on the following lines:

- **First**, either (i) allow such investment funds to be treated as, and to file as, corporations for Indian tax purposes or (ii) confirm that such investment funds should file their tax returns in India based on the form of their organization in their home country.
- **Second**, confirm that where an investment fund historically has been filing its returns in India as a corporation or as a trust, based on any of the above beliefs, then it should continue to do so and pay its Indian income tax on this basis.
The above guidelines would help a fund know its tax status for India purposes (i.e., whether it should register as a corporation or as a trust), especially at the time of applying for a PAN card. It also is of particular importance because Indian tax rates differ for corporations and trusts. Additionally, it would reduce any risks, that may be faced by funds that have been genuinely filing their tax returns in India on a particular basis, of having their returns being declared as invalid.

8. **Whether represented earlier**

No
1. Issue
Taxation of Indirect Transfers

2. Industry/sector involved
FIIs

3. Tax involved
Income tax and Withholding tax

4. Revenue impact, if estimated
Not known

5. Genesis of the issue
The Indian Government’s attempt to attack specific transactions by “clarifying” provisions included in the IT Act has caused substantial uncertainty for investment funds. Following the Indian Supreme Court’s ruling in the Vodafone case, legislative changes were made to override the Supreme Court’s ruling. These changes subject to Indian tax any transfer of shares or interests in an offshore company to the extent that such shares or interest derive their value (directly or indirectly) substantially from Indian assets. The changes capture certain overseas merger and acquisition (“M&A”) transactions that relate to Indian assets. No exemptions (including with respect to purchase and sale of an investment fund’s securities) are provided, however, if the value of such investment fund is substantially derived from Indian assets.

The 52-year retroactive effect of the indirect transfer provisions is causing enormous harm to foreign investors’ confidence in India as a stable investment location. Investment funds possibly could be forced to pay tax on transactions that occurred many years ago – resulting in thousands of NAV determinations made over many years that did not reflect Indian tax now determined to be due. Investment funds also possibly could be forced to withhold tax on redemption of their shares. These uncertainties can have a particularly detrimental impact on investment funds that invest a substantial portion of their allocable cash in Indian securities. This issue, consequently, could result in a detrimental impact on portfolio investments into India.

6. Different views observed in application of law/regulation etc., if any
None
7. Suggestions
We recommend that the Indian Government announce promptly that the indirect transfer provisions will not apply to FIIs or their investors. Dr. Shome's Expert Committee agrees that this clarification is of high importance.¹⁶

8. Whether represented earlier
No

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¹⁶ See Section 4.9 of the draft report of Dr. Partha Sarathi Shome's Expert Committee on "Retrospective Amendments relating to Indirect Transfers."
1. Issue
General Anti-Avoidance Rules ("GAAR")

2. Industry/sector involved
FIIs

3. Tax involved
Income tax

4. Revenue impact, if estimated
Not known

5. Genesis of the issue
GAAR is so broadly defined in the IT Act that it creates substantial uncertainty. While the GAAR may have been directed at a particular transaction, such as investing through a specific country, its scope is not so limited. Indeed, the guidelines for applying the GAAR are still ambiguous, as they provide very little relief to FIIs given that the guidelines stipulate:

(i) GAAR will not apply to FIIs that do not seek any tax treaty benefits and invest in Indian listed and unlisted securities with the prior permission of the concerned regulatory authorities; and

(ii) GAAR will not apply to an investor in an FII, in relation to any investment made by it by way of offshore derivative instruments or otherwise, directly/indirectly, in a FII.

However, it still is unclear how the various triggers for GAAR – i.e., (i) the main purpose test, (ii) the absolute rights test, (iii) the misuse/abuse test, (iv) the commercial substance test, and (v) the bona fide test – will be administered by the IRA. The monetary threshold for determining the tax benefit availed of and triggering the GAAR is very low, i.e., prescribed at INR 30 million (i.e., U.S.$500,000).

Applicability of GAAR when Special Anti-Avoidance Rules exist either in the Indian domestic tax law or tax treaty still remains open and requires clarification.

Investment funds cannot calculate their NAV with precision if the GAAR may be asserted against transactions that they have every reason to believe are appropriate. This uncertainty makes investments outside India more attractive on an after-tax basis vis-a-vis investments in India.

6. Different views observed in application of law/regulation etc., if any
None
7. Suggestions
We welcome the move on the part of the Indian Government to accept the recommendations of Dr. Shome’s Expert Committee regarding GAAR’s applicability to investment funds. However, much still needs to be done in the area of GAAR to bring about clarity and certainty on how GAAR is to be implemented by the IRA.

We recommend that the Indian Government clarify the following issues on a priority basis to ensure that FIIs do not refrain from making additional investments in India or divest themselves from existing Indian investments. Either action would result in the Indian capital markets experiencing substantial disruption.

- **First**, provide clarity on how the various triggers for GAAR – *i.e.*, (i) the main purpose test, (ii) the absolute rights test, (iii) the misuse/abuse test, (iv) the commercial substance test, and (v) the bona fide test – will be administered by the IRA.

- **Second**, increase the monetary threshold for determining the tax benefit availed of and triggering the GAAR so as to ensure that low value transactions do not come within the purview of GAAR.

- **Third**, provide clarity on applicability of GAAR when Special Anti-Avoidance Rules exist in either the Indian domestic tax law or tax treaty.

- **Fourth**, consult with the FII community before finalizing any of the above; this consultation will enable FIIs to explain their unique situation.

8. Whether represented earlier
No
SERIAL NO. 12

1. Issue
Intimations issued under section 143(1) of the IT Act very often do not include details of capital losses carried forward by the FIIs

2. Industry/sector involved
FIIs

3. Tax involved
Income tax

4. Revenue impact, if estimated
Not known

5. Genesis of the issue
Most computer-generated intimations that are received by investment funds from the Indian Revenue authorities, under section 143(1) of the IT Act, do not take on record capital losses that may have been incurred by the funds during the said Assessment Year or for prior Assessment Years, and which the funds have properly claimed in their income tax returns filed for carryforward benefit purposes. This is despite the fact that the intimations have a designated space for disclosing “returned income/loss” and “assessed income/loss.”

Because the “assessment income/loss” makes no mention of the capital losses that are disclosed and carried forward, the taxpayers believe that their “returned losses” are not being considered for assessment purposes; the taxpayers consequently must file rectification applications and sometimes appeals against the intimations received. This process, in turn, adds unnecessary costs that are incurred by the investment funds for having their India tax matters resolved properly.

In parallel, it also culminates into additional unnecessary work for the Indian Revenue authorities; this work includes having to pass rectification orders and give effect to appellate orders that may be passed. This results in a colossal waste of time for taxpayers and the Indian Revenue authorities.

6. Different views observed in application of law/regulation etc., if any
None

7. Suggestions
A proper process should be put in place to ensure that the computer-generated intimations issued under section 143(1) of the IT Act consider all loss claims that are properly made by taxpayers.

8. Whether represented earlier
No