March 31, 2016

Mr. Jayant Sinha  
The Minister of State for Finance  
Ministry of Finance  
138, North Block  
New Delhi  
India

Re: Foreign Investment Fund Tax Issues with:
- the new tax framework for encouraging offshore funds to appoint India-based Fund Managers and
- the Minimum Alternate Tax (MAT) issue for the pre-April 1, 2015 period.

Honourable Minister,

On behalf of the members of the Investment Company Institute (ICI)¹ and ICI Global (ICIG),² we would like to meet with you and your colleagues to discuss issues of concern to large Foreign Institutional Investors (FIIs). Specifically, we would like to discuss (1) the Indian Government’s new India-Based Fund Manager (IBFM) tax regime that is designed to encourage FIIs to appoint fund managers based in India and (2) remaining challenges with the MAT issue for the period prior to April 1, 2015.

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¹ The Investment Company Institute is a leading, global association of regulated funds, including mutual funds, exchange-traded funds (ETFs), closed-end funds, and unit investment trusts (UITs) in the United States, and similar funds offered to investors in jurisdictions worldwide. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. ICI’s U.S. fund members manage total assets of $16.9 trillion and serve more than 90 million U.S. shareholders.

² The international arm of the Investment Company Institute, ICI Global serves a fund membership that includes regulated funds publicly offered to investors in jurisdictions worldwide, with combined assets of US$18.4 trillion. ICI Global seeks to advance the common interests and promote public understanding of regulated investment funds, their managers, and investors. Its policy agenda focuses on issues of significance to funds in the areas of financial stability, cross-border regulation, market structure, and pension provision. ICI Global has offices in London, Hong Kong, and Washington, DC.
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My colleague Susan Olson, Chief Counsel for ICI Global, will represent the industry (as I have scheduling conflicts that will prevent my attendance, before the Indian Parliament resumes on April 25 and then takes up the Union Budget); we are working with our members to identify tax experts who will accompany Susan, and our Indian tax advisors from BMR& Associates LLP, to the meeting. We would be grateful if you could grant us an appointment when Susan will be in New Delhi on April 18th and 19th.

Background

The investment funds offered by our members provide individuals with professional management and asset diversification at reasonable cost. By pooling investors’ cash, the funds promote investment, capital formation, and economic growth. Because the typical fund is held by tens or hundreds of thousands of investors, who are permitted to purchase or sell fund units daily at the fund’s net asset value (NAV), certainty regarding a fund’s potential tax liabilities is essential.

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. Although the funds are organized in different forms in different countries, in all cases the income of these funds effectively is taxed only at the investor level. Preventing fund-level tax is essential if the funds are to remain competitive with direct investment.

Although the investment fund members of ICI and ICIG make significant portfolio (non-controlling) investments in Indian companies, the portfolio managers for these funds do not reside in India. Three Indian-specific tax concerns effectively force these managers, many of whom are Indian nationals, to reside outside of India (e.g., in Singapore).

First, concerns exist that allowing a portfolio manager to reside in India might cause the fund itself to be deemed an Indian-resident fund subject to Indian tax. This fund-level concern is important as the non-Indian funds are structured to meet the legal, regulatory and tax requirements of their home jurisdictions and not the requirements of India.

Second, part of the income that is earned by the fund from its non-Indian investments could be held to be taxable in India because of the activities conducted by the IBFM in India on the fund's behalf.

Third, concerns exist that allowing a portfolio manager to reside in India might subject the entire operation of a fund manager to tax in India. The potential tax controversies arising from two countries potentially treating the fund managers’ worldwide operations as wholly taxable within their borders is a significant disincentive to retaining Indian-based portfolio managers.

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3 U.S. funds, for example, hold approximately 68.5 billion (USD) of Indian securities. An additional 66.5 billion (USD) of Indian securities are held by European funds.
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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 various 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.

The IBFM Tax Regime Issue

The ICI and ICIG (along with the Indian asset management industry and others) for several years have been seeking from the Indian Government a specific tax regime that will encourage offshore funds to appoint IBFMs; this regime would enable these funds to gain from the expert knowledge of such fund managers who are based in India. Such a regime, properly implemented, would encourage fund managers that moved from India to more fund-manager-friendly jurisdictions (e.g., Singapore, London, and Hong Kong) to return. Without the clarity provided by a properly-implemented regime, managers will continue to manage offshore funds that invest globally (including in India) from abroad. The relocations away from India – caused by the desire to avoid potentially adverse Indian tax consequences – has resulted in a talent drain for India to the benefit of other countries.

We appreciate that the Indian Government has been keen to resolve this issue; the last three Union Budgets have tried to develop a taxing framework that will encourage offshore funds to appoint IBFMs who will undertake fund management activities for offshore funds investing globally (including in India). The Memoranda to the Finance (No. 2) Bill, 2014, the Finance Bill, 2015, and the Finance Bill, 2016, highlight the directional thinking and commitment of the Indian Government towards this cause. In fact, in the Memorandum to the Finance Bill, 2015, the Honourable Finance Minister clearly articulated the context with which the IBFM tax regime has been introduced in the Indian Income-tax Act, 1961 (‘Act’), and how the Honourable Finance Minister envisioned the IBFM tax regime to be in line with “international best practices”.4

The following objectives of the IBFM tax regime are clear from the aforesaid Union Budget papers, particularly the Memorandum to the Finance Bill, 2015:

- To ensure that activity of fund management for offshore funds does not constitute a ‘business connection in India’ (for the purposes of the Act) or a ‘permanent establishment (‘PE’) in India’ (for the purposes of the applicable tax treaty).

- To ensure that profits made by offshore funds from investments outside India are not brought within the ambit of the Indian taxing net by virtue of a fund management setup in India.

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4 We have enclosed the Honourable Finance Minister’s speech, including the Memoranda to the Finance (No. 2) Bill, 2014, the Finance Bill, 2015, and the Finance Bill, 2016, in Annexure C, for your convenience.
• To ensure that offshore funds are not considered to be tax resident in India, by virtue of their fund management activity being undertaken in India.

• To relocate the fund management activity to India, especially given that a large number of fund managers are of Indian origin and are managing investments of offshore funds in various countries, and also to create increased employment opportunities in India.

• To generate incremental tax revenue for the Indian Government (from the taxation of fees earned by such fund managers and from the taxation of the relocated fund management professionals).

• To adopt international best practices for the proposed tax framework for IBFMs.

We appreciate the effort made by two recent developments to address our concerns. Specifically, we welcome the introduction of:

• The new section 9A in the Act, with effect from April 1, 2015, by the Finance Act, 2015; and

• The new Rules 10V, 10VA and 10VB, in the Income-tax Rules, 1962 (IT Rules), that have been recently notified by the Central Board of Direct Taxes (CBDT)⁶, and which shall come into force once they are published in the Gazette of India.

Nevertheless, significant concerns remain. Failure to meet any one of these requirements, for example, will result in non-compliance and all of the tax burdens that have kept the industry outside of India. To the extent that fund managers would be forced every day to determine whether investment or investor limits were applied – with no ability to correct errors – the requirements are very problematic. We also are concerned that ambiguities regarding how these requirements will be applied likewise will cause fund managers to remain offshore.

The proposed regime, we submit, remains so complex and costly that our members most likely will not seek to comply with the IBFM tax regime. Instead, they will maintain their existing practice of requiring portfolio managers to reside outside of India – with all of the attendant detrimental effects, including potential revenue loss, for India.

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⁵ Notification No: S.O. 1101(E) dated March 15, 2016.

⁶ In these Rules, the CBDT have (i) prescribed additional conditions that relate to the main conditions that are provided for in section 9A, with the objective of simplifying the main conditions prescribed in section 9A, (ii) provided for a new approval route mechanism whereby an offshore fund may at its option apply to the CBDT for a ruling as regards its eligibility to qualify for the IBFM tax regime thereby enabling the offshore fund to achieve certainty on the issue, and (iii) prescribed the forms through which various reporting need to be done for qualifying for the aforesaid tax amnesty scheme.
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For this well-intentioned regime to achieve its beneficial objectives, we make the following suggestions (which are described in greater detail in Annexure A). Our suggestions will align the tax rules with existing regulations advanced by the Securities and Exchange Board of India (SEBI) and the Reserve Bank of India (RBI), and eliminate detailed tax requirements that will hamper substantially fund managers’ IBFM tax regime compliance efforts.

To address our concerns, we suggest that the number of conditions imposed on the IBFM tax regime under section 9A of the Act (i.e., as many as 17) be reduced or modified substantially. Further, we note that the Central Board of Direct Taxes (CBDT) in Rule 10V of the IT Rules, has prescribed 10 conditions that relate to these 17 main conditions, with the objective of simplifying the conditions prescribed in section 9A. Non-satisfaction of even one condition contained either in section 9A or Rule 10V, by either the offshore fund or the IBFM, as noted above, could have particularly adverse results for the fund.

Aligning the tax rules with the SEBI regulations and the RBI regulations will simplify greatly IBFM tax compliance efforts. SEBI, as you may know, has made a concerted effort in recent years to improve India’s competitive position vis-à-vis other financial centers and investment opportunities. Among other things, SEBI and RBI have done away with most conditions and restrictions, which were on lines similar to the ones included in section 9A(3), and have liberalized the foreign investment regime to encourage more capital flows into India. The restrictions, as discussed in Annexure A, are:

- non-tax related;
- contradictory to the conditions that have been stipulated by SEBI and the RBI;
- impossible in many cases to comply with;
- very broadly worded and open to wide interpretation;
- onerous; and
- costly.

To the extent that the Indian Government is concerned with deleting any of the conditions that we have identified, we suggest that the conditions be merged into a single condition that all investments by the offshore fund shall be in accordance with its applicable home and host country regulations.

**The MAT Issue**

The MAT issue, as you know, created extraordinary concerns within the global fund industry. We appreciate greatly all of the steps taken recently to restore investor confidence. The Indian Government’s introduction of the new Explanation 4 in the MAT provision in the Act (i.e., section 115JB), with effect from April 1, 2001, through the Finance Bill, 2016 is particularly welcome. This guidance, however, must be clarified to remove uncertainties relating to the MAT exemption’s application to some funds in treaty countries (for which tax residency status may be uncertain) and to funds resident in countries with which India does not have an income tax treaty (which may have some
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limited registration responsibilities in India (e.g., procuring a Permanent Account Number (PAN)).
To resolve these concerns, Explanation 4 must be clarified as explained in Annexure B.

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If you have any questions, please do not hesitate to contact Susan Olson (susan.olson@iciglobal.org or
1-202-326-5813) or me.

Thank you.

Yours faithfully,

Keith Lawson

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Attachments

cc: Mukesh Butani
    Bobby Parikh
    Russell Gaitonde
Annexure A

Issue 1: The tax issues that remain with the IBFM tax regime

Challenges with the IBFM tax regime

1.1 First and foremost, the IBFM tax regime prescribes too many conditions in section 9A of the Act, (i.e. as many as 17 in all): 13 conditions applicable to the offshore fund and 4 conditions applicable to the IBFM. Further, in Rule 10V of the IT Rules, the CBDT have prescribed 10 conditions that relate to these 17 main conditions, with the objective of simplifying the conditions prescribed in section 9A. Non-satisfaction of even 1 condition contained either in section 9A or Rule 10V, by either the offshore fund or the IBFM, could result in the following adverse tax consequences devolving on the offshore fund:

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<tr>
<th>Sr No</th>
<th>Cause</th>
<th>Effect</th>
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<tr>
<td>1</td>
<td>The offshore fund would then be regarded as having a ‘business connection in India’ under the Indian domestic tax law, and / or a ‘PE in India’ as per a tax treaty (where applicable). This problem would persist, even if the IBFM were an ‘unrelated party’ and an independent person.</td>
<td>Consequently, a portion of the income earned by the offshore fund from investments made outside India could become taxable in India if it is held to be attributable to the fund management activities of the IBFM in India.</td>
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<td>2</td>
<td>In India, a non-corporate tax payer (such as a partnership, a business trust etc.) is regarded as being Indian resident under the Indian domestic tax law, if even a part of the ‘control and management of its affairs’ is situated in India during the year. By appointing an IBFM, an offshore fund that is established as a non-corporate tax payer, could be held to be an Indian tax resident under the Indian domestic tax law.</td>
<td>Consequently, the offshore fund would be taxable in India on its global income, i.e. even income earned by the offshore fund from investments made outside India would become taxable in India.</td>
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These are serious material consequences. Hence, an offshore fund would want reasonable clarity and certainty that these consequences would not arise to it, before it takes the decision of relocating its fund management activities to India and the current set of onerous conditions simply do not provide this clarity and certainty.
1.2 **Second**, most of the conditions that have been stipulated in sub-section (3) of section 9A (which need to be satisfied by the offshore fund), and sub-section (4) of section 9A (which need to be satisfied by the IBFM), are:

(i) **“non-tax related”** conditions and they **“contradict the conditions that have been stipulated by the Indian regulators”**, such as the Securities and Exchange Board of India (‘SEBI’), and the Reserve Bank of India (‘RBI’), who regulate and actively monitor the activities of such offshore funds (when they invest in India), the IBFMs (when they operate from India), and Indian resident investors (who may choose to invest in the offshore funds). Over the years, even SEBI and the RBI have done away with most conditions / restrictions, which were on lines similar to the ones included in section 9A(3), and have liberalized the foreign investment regime to encourage more capital flows into India.

(ii) **“impossible to comply with”** by some offshore funds, because of the manner in which the offshore fund:

   a. is constituted and regulated / unregulated in its home country; and / or
   b. is mandated to operate in its home country.

(iii) **“very broadly worded”**, such that they could be open to wide interpretation, which could result in misunderstanding(s) with the Indian tax authorities, which could culminate in unnecessary disputes with the tax authorities. This could arise despite the new ruling mechanism that has been provided for in Rule 10VA of the IT Rules.

(iv) **“onerous”** and **“costly”** for an offshore fund that wishes to appoint an IBFM, as it would need to put in place an elaborate tracking and reporting system that will ensure compliance with each and every condition stipulated in section 9A and Rule 10V. This would put such an offshore fund at a competitive disadvantage vis-à-vis an offshore fund that does not have an IBFM.

1.3 **Third**, and at a very high level, we believe that the below conditions that have been prescribed in the new IBFM tax regime should be deleted and / or modified, so as to enable offshore funds that wish to appoint IBFMs, comply with the regime:

**Part A: Conditions relating to the offshore fund that need to be deleted:**

(i) **“Relating to the residence or place of incorporation / establishment of the fund”**: Clause (b) of section 9A(3) provides that the offshore fund should be a tax resident of a country or specified territory with whom India has signed a tax treaty, or is incorporated / established in a country or specified territory to be notified by the Central Government. The current clause (b) of section 9A(3) should be dropped, as
the Indian regulatory framework that covers offshore funds that wish to invest into India, be it (1) the SEBI (Foreign Portfolio Investor) Regulations, 2014 that apply to Foreign Portfolio Investors (‘FPIs’) that invest in Indian listed securities, or (2) the SEBI (Foreign Venture Capital Investor) Regulations, 2000 that apply to offshore funds that predominantly invest in Indian unlisted securities and who wish to avail of certain regulatory benefits that are granted to SEBI registered Foreign Venture Capital Investors (‘FVCIs’), do not impose any conditions / restrictions on such investors having to be tax residents of a country or specified territory with whom India has signed a tax treaty, or having to be incorporated / established in a country or specified territory that is to be notified by the Indian Government. Where the Indian regulators do not wish for foreign investment to come into India from certain countries, they provide for such restrictions in their regulations. For example, the RBI in its Exchange Control Regulations, forbids foreign direct investment into India under the automatic route from Pakistan and Bangladesh. Similarly, SEBI in its FPI regulations disqualifies an entity from securing an FPI license, if it is a resident of a country identified in the public statement of the Financial Action Task Force (‘FATF’) as a jurisdiction having a strategic Anti-Money Laundering or Combating the Financing of Terrorism deficiencies to which counter measures apply, or a jurisdiction that has not made sufficient progress in addressing the deficiencies or has not committed to an action plan developed with the FATF to address the deficiencies. Since Iran and North Korea are on the FATF watch list, entities from these countries do not qualify for an FPI license, and are consequently not allowed to invest in Indian listed securities.

Given the aforesaid, we request that clause (b) of section 9A(3) be deleted.

(ii) “Relating to the investor base of the fund”: Clauses (c), (e), (f), and (g) of section 9A(3), and their corresponding sub-rules (1), (2), (3) of Rule 10V, impose restrictions on:

- whether Indian residents can invest in the offshore fund, and to what extent\(^1\)
- broad-basing of the investors in the fund, in terms of (i) the minimum number of investors that need to be present in the fund\(^2\), and (ii) the maximum percentage ownership of such investors in the fund\(^3\).

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\(^1\) The aggregate participation or investment by Indian residents in the offshore fund, directly or indirectly, and on a look through basis, cannot exceed 5% of the corpus of the fund.

\(^2\) The offshore fund should have a minimum of 25 investors who are, directly or indirectly, and on a look through basis, not connected persons.

\(^3\) Any investor along with its connected persons, shall not have participation interest, directly or indirectly, in the fund that exceeds 10% of fund. The aggregate participation interest, directly or indirectly, of 10 or less members along with their connected persons in the fund, shall be less than 50%.
The current clauses (c), (e), (f), and (g) of section 9A(3), and their corresponding subrules (1), (2), (3) of Rule 10V, should be dropped as the Indian regulatory framework applicable to offshore funds investing into India, be it the SEBI (FPI) Regulations, or the SEBI (FVCI) Regulations, or the Indian Exchange Control Regulations, no longer impose such conditions on their constituents. Just to articulate:

(1) Previously, Indian residents were not allowed to invest overseas. However, the Indian Exchange Control Regulations, were amended in 2000 and 2004, by way of introduction of the FEMA (Transfer or issue of any Foreign Security) Regulations, 2000 and 2004, and the Liberalized Remittance Scheme ("LRS"), which permit Indian residents to invest overseas (including in offshore funds), subject to complying with certain conditions (in terms of quantum of investments that can be made, countries in which such investments can be made\(^4\), need for an approval from the RBI in some cases, make reportings to the RBI etc.).

(2) Previously, SEBI allowed only offshore funds and their offshore fund managers that were regulated by an appropriate foreign regulatory authority to invest in Indian listed securities, subject to the offshore fund being "broad-based"\(^5\). However, SEBI has done away with this requirement in the SEBI (FPI) Regulations, and now allows offshore funds that are unregulated, and that are not "broad-based" to procure a Category III FPI license, thereby allowing them to invest in Indian listed securities.

(3) Under the SEBI (FVCI) Regulations, SEBI never required, and even till today, SEBI does not require that the offshore fund should be "broad-based".

Separately, since the IBFM tax regime seeks to cover even offshore funds that invest entirely outside India, but which are managed by an IBFM that is based in India, having such conditions in section 9A(3) would severely constrain the activities of such offshore funds, as their home countries (in which they are incorporated / established / registered), and their host countries (in which they invest) may not impose such conditions / restrictions.

\(^4\) For example, an Indian resident individual is not allowed to invest, directly or indirectly, in a Mauritius entity under the LRS window.

\(^5\) As per the SEBI FII Regulations, 1995, a fund was regarded as being "broad-based" if it had a minimum of 20 investors (previously this was 50 investors), with no single investor owning more than 49% (previously this was 10%) of the capital / units of the fund. These tests were applied on a "look through" basis. Currently, under the SEBI FPI Regulations, SEBI requires a fund to be "broad-based" (i.e. have a minimum of 20 investors, with no single investor owning more than 49% of the capital / units of the fund), on a "look through" basis; the "broad based" test is relevant only for those offshore funds that wish to procure a Category II FPI license, such that they will be subjected to lesser KYC requirements when compared to Category III FPIs.
Moreover, the compliance tests that would need to be developed and maintained to prevent potential violations would be costly and otherwise unnecessary. Failure to satisfy these requirements, even for one day, potentially could cause failure under the IBFM tax regime.

Given the aforesaid, we request that clauses (c), (e), (f), and (g) of section 9A(3), and their corresponding sub-rules (1), (2), (3) of Rule 10V, be deleted. However, if the Indian Government were uncomfortable with this proposition, then we would request that the said clauses be merged into a single condition that all investments by the offshore fund should be in accordance with its applicable home country regulations and host country regulations.

(iii) “Relating to investment diversification by the fund”: Clause (h) of section 9A(3) provides that an offshore fund shall not invest more than 20% of its corpus in any entity. This condition applies to all offshore funds that wish to appoint IBFMs, irrespective of whether they wish to invest in India or outside India, and the aforesaid investment restriction will also apply to non-Indian investments.

The current clause (h) of section 9A(3), should be dropped as the Indian regulatory framework that covers offshore funds that wish to invest in India, be it the SEBI (FPI) Regulations, or the SEBI (FVCI) Regulations, or the Indian Exchange Control Regulations, do not impose such conditions on their constituents. Previously, the SEBI (FVCI) Regulations forbade a FVCI from investing more than 25% of its corpus in a single Indian portfolio company; however, SEBI deleted this investment diversification condition in 2004. Separately, since the IBFM tax regime seeks to cover even an offshore fund that invests entirely outside India, but which may be keen to appoint an IBFM, having such a condition in section 9A(3) would severely constrain the activities of such an offshore fund, as its home country (in which it is incorporated / established / registered), and its host countries (in which it invests) may not impose such conditions / restrictions.

As noted immediately above, the compliance tests that would need to be developed and maintained to prevent potential violations would be costly and otherwise unnecessary. Failure to satisfy these requirements, even for one day, potentially could cause failure under the IBFM tax regime.

Given the aforesaid, we request that clause (h) of section 9A(3), be deleted. However, if the Indian Government were uncomfortable with this proposition, then we would request that the said clause be amended to provide that all investments to be made by the offshore fund should be in accordance with its applicable home country regulations and host country regulations.
(iv) “Relating to the maximum investment that can be made by a fund in a single portfolio company”: Clause (k) of section 9A(3) and its corresponding sub-rule (4) of Rule 10V provides that an offshore fund shall not carry on or control and manage, directly or indirectly, any business in India, and for the purpose of this clause an offshore fund will be regarded as controlling or managing a business in India if it owns more than 26% of the capital or voting power or interest in that entity.

The current clause (k) of section 9A(3) and its corresponding sub-rule (4) of Rule 10V should be dropped, as the Indian regulatory framework addresses this issue, where there is a need for such regulation. For example, the SEBI (FPI) Regulations provide that a single FPI or FPI Group shall not own more than 10% of the total paid-up capital of an Indian company; this investment restriction is in sync with international norms that generally govern FPIs. The RBI imposes certain conditions on the maximum foreign investment that can be made by foreign investors (whether strategic or financial) in Indian companies that operate in certain sectors, such as requiring them to procure a prior Government approval, or subjecting the investment to sectoral caps / restrictions, or capitalization norms, or other terms / conditions; over the years, through the liberalizations that have taken place in the Foreign Direct Investment (‘FDI’) policy of the Government of India and the Indian Exchange Control Regulations, even these conditions / restrictions have been done away with or diluted significantly in most cases, with the exception of a few sectors that are considered sensitive from an economy perspective. Hence, imposing the aforesaid condition in the Indian tax law, is unnecessary and avoidable.

Once again, the compliance tests that would need to be developed and maintained to prevent potential violations would be costly and otherwise unnecessary. Failure to satisfy these requirements, even for one day, potentially could cause failure under the IBFM tax regime.

Given the aforesaid, we request that clause (k) of section 9A(3) and its corresponding sub-rule (4) of Rule 10V be deleted. However, if the Indian Government were uncomfortable with this proposition, then we would request that the said clause be amended to provide that all investments to be made by the offshore fund should be in accordance with its applicable home country regulations and host country regulations.

(v) “Relating to the fund corpus size”: Clause (j) of section 9A(3) provides that the monthly average of the corpus of the offshore fund shall not be less than INR 1 billion (i.e. approximately, US$ 15 million6). This condition applies to all offshore funds that

6 We have assumed an exchange rate of US$ 1 = INR 66.66

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wish to appoint IBFMs, irrespective of whether they plan to invest in India or outside India.

The current clause (j) of section 9A(3), should be dropped as the Indian regulatory framework [be it the SEBI (FPI) Regulations, or the SEBI (FVCI) Regulations, or the Indian Exchange Control Regulations], does not impose such a condition on an offshore fund that wishes to invest in India, and it welcomes an offshore fund irrespective of its corpus size and / or India commitment. Separately, since the IBFM tax regime seeks to cover even an offshore fund that invests entirely outside India, but which is keen to appoint an IBFM, having such a condition in section 9A(3) would severely constrain the activities of such an offshore fund, as its home country (in which it is incorporated / established / registered), and its host countries (in which it invests) may not impose such conditions / restrictions.

Given the aforesaid, we request that clause (j) of section 9A(3), should be deleted. However, if the Indian Government were uncomfortable with this proposition, then we would request that the said clause be amended to provide that all investments to be made by the offshore fund should be in accordance with its home country regulations and host country regulations.

(vi) "Relating to activities to be performed by the fund in India": Clause (l) of section 9A(3) provides that an offshore fund shall neither engage in any activity which constitutes a 'business connection in India' nor have any person acting on its behalf whose activities constitute a 'business connection in India' other than the activities being undertaken by the IBFM on behalf of the fund.

The current clause (l) of section 9A(3) should be dropped, as it severely constrains the ability of an offshore fund to outsource some of its activities to India, such as fund accounting, fund administration etc., irrespective whether such activities are performed by third party service providers, or entities that belong to the same group as the offshore fund, or even the IBFM, as by putting in place such an arrangement the offshore fund would be regarded as having a 'business connection in India' and would not be able to satisfy this condition. Separately, under the Indian regulatory framework, an offshore fund is required to open a cash and custody account in India with a local banker and custodian to undertake its investment activities in India, and it is also required to engage a SEBI-registered stock broker in India to undertake any investment activities on the Indian stock exchanges. Such types of arrangements create a 'business connection in India' for the offshore fund, and would make it impossible for the offshore fund to satisfy this condition.

Given the aforesaid, we request that clause (l) of section 9A(3), should be deleted. However, if the Indian Government were uncomfortable with this proposition, then
we would request that the said clause be amended to provide that the aforesaid arrangements do not fall within the purview of clause (l) of section 9A(3).

Part B: Conditions relating to the offshore fund that need to be modified:

(vii) “Relating to remuneration to be paid to the IBFM”: Clause (m) of section 9A(3) and its corresponding sub-rule (5) of Rule 10V provides that the remuneration paid by the offshore fund to the IBFM in respect of the fund management activity undertaken by the IBFM should not be less than the arm’s length price (which is to be determined as per the Indian transfer pricing regulations).

The current clause (m) of section 9A(3) and its corresponding sub-rule (5) of Rule 10V, seems to work on the presumption that the offshore fund will directly contract with the IBFM and will pay the fund management fee directly to the IBFM. Satisfying this condition may be a challenge, as most offshore funds appoint an offshore fund manager who will undertake the fund management activity for the offshore fund; the offshore fund manager may then appoint other fund managers in host countries (such as the IBFM) to manage a portion of the assets of the offshore fund (such as the India allocation). In such an instance, the IBFM will receive its compensation from the offshore fund manager and not from the offshore fund. Additionally, there are some foreign jurisdictions (such as Luxembourg) that mandate that offshore funds that are set-up in their country (e.g. Luxembourg SICAVs) have to mandatorily appoint a fund manager that is also based in that country (i.e. Luxembourg); such a fund manager has the flexibility to then appoint other fund managers who may be based overseas (subject to receiving an approval from the Luxembourg regulator), and who will help manage the assets of the fund. In such a situation, it would be impossible for the offshore fund to satisfy this condition.

Uncertainty also may arise if any concern exists that a negotiated fee could be challenged under the arms' length standard. This uncertainty – which would cause failure under the IBFM tax regime if the challenge were successfully – could prevent funds from moving portfolio managers back to India.

Given the aforesaid, we request – at a minimum – that clause (m) of section 9A(3) and its corresponding sub-rule (5) of Rule 10V, be amended to allow for the IBFM to be compensated on an arm’s length basis by the offshore fund or its offshore fund manager. Removing this provision entirely, or providing another penalty less severe than IBFM tax regime failure, would be the industry’s preferred approach.

(viii) “Relating to attaining certainty on the remuneration to be paid to the IBFM”: Rule 10VA of the IBFM tax regime allows an offshore fund to approach the CBDT for a ruling on its eligibility to claim the benefits of section 9A of the Act. Likewise, the
Indian transfer pricing regulations, provide for an Advance Pricing Agreement (‘APA’) to enable two related parties to seek certainty on the arm’s length compensation for a particular transaction.

Doubts have arisen as to whether an offshore fund that appoints an IBFM which is not a related party as per the Indian transfer pricing regulations, will be able to procure certainty from the CBDT on the issue of arm’s length compensation to be paid to its IBFM. This issue needs to be clarified in Rule 10VA of the IT Rules and / or the Indian transfer pricing regulations.

Moreover, as the compensation arrangement will change with market conditions, funds may be required to seek rulings repeatedly. This process also might impair the attractiveness of the IBFM tax regime.

(ix) “Relating to seeking an approval from the CBDT for the offshore fund”: Sub-rule (7) of Rule 10VA of the IT Rules provides that the CBDT may grant its approval to an offshore fund as regards the fund’s eligibility to claim the benefits of section 9A, subject to “such conditions as the CBDT may deem fit”.

Doubts have arisen as regards what conditions the CBDT may impose in the approval it would grant to an offshore fund under Rule 10VA of the IT Rules. The CBDT should clarify its position on this issue.

Part C: Conditions relating to the IBFM that need to be deleted:

(x) “Relating to remuneration to be paid to the IBFM”: Clause (d) of section 9A(4) provides that the IBFM and its ‘connected persons’ shall not be entitled, directly or indirectly, to more than 20% of the profits arising to the offshore fund from the transactions that are carried out by the offshore fund through the IBFM.

The aforesaid clause, which seems to cap the fee that can be paid by an offshore fund to its IBFM, suffers from various ambiguities, which need to be addressed. For example:

- If the offshore fund were to incur net losses because of overall market performance, but has to pay the IBFM compensation for the fund management activity, which is typically expressed as a percentage of AUM, would the IBFM be in breach of the 20% fee cap condition, on the basis that the fee cap is 0 (in this case), because it is to be computed on a profit base of 0?
- If the offshore fund were to outsource other functions such as fund accounting, fund administration etc. to its IBFM or to any entity that belongs to the same group as the offshore fund, would the 20% fee cap condition need to consider even the fees paid to the IBFM and / or the fund’s group entities in India,
thereby limiting the fees that can be paid to the IBFM for the fund management activities that are undertaken by the IBFM?

Given the aforesaid, we request that clause (d) of section 9A(4), should be deleted, because, so long as the IBFM is compensated fairly, there ought not to be any loss to the Indian exchequer.

Part D: Conditions relating to the IBFM that need to be modified:

(xii) “Relating to the relationship between the offshore fund and the IBFM”: Clause (a) of section 9A(4) provides that the IBFM should neither be an employee of the offshore fund, nor a ‘connected person’ of the fund.

The current clause (a) of section 9A(4) needs to be suitably amended to remove the condition that the IBFM should not be a ‘connected person’ of the offshore fund. The term ‘connected person’ is broadly defined in section 102 of the Act⁷, and can also cover an entity that belongs to the same group as that of the offshore fund. Given that the IBFM tax regime was introduced with the objective of encouraging fund managers who are based outside India and who manage offshore funds that invest globally, to relocate to India, such individuals would logically be housed in their group’s Indian fund management entity. Hence, if such Indian fund management entity, which will act as the IBFM for the offshore fund, were to be regarded as a ‘connected person’ of the offshore fund, then the IBFM will not be able to satisfy this condition.

Given the aforesaid, we request that clause (a) of section 9A(4), should be amended to delete the restriction that the IBFM should not be a ‘connected person’ of the offshore fund.

(xii) “Relating to the regulation of the IBFM”: Clause (b) of section 9A(4) provides that the IBFM should be registered as a fund manager or an investment advisor in accordance with the SEBI Regulations.

SEBI - which is the securities market regulator in India and the regulator for financial services intermediaries in India (be it FPIs, Domestic Mutual Funds, Portfolio Managers, Investment Advisers, Stock Brokers, Merchant Bankers etc.), - licenses and regulates those fund managers and investment advisers that render such services in India to clients that are based in India and overseas. SEBI does not grant licenses to

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⁷ “Connected person” means any person who is connected directly or indirectly to another person and includes –

(a) ……………..
(b) …………….

-- A-10 --
fund managers and investment advisers who will only service clients that are based outside India. Hence, it might be difficult for certain IBFMs who propose to render fund management activities to clients that are only based overseas, to procure such a license from SEBI. Consequently, such IBFMs will not be able to satisfy this condition.

Given the aforesaid, we request that clause (b) of section 9A(4), should be amended to provide that the IBFM should be licensed and regulated in India in accordance with the "applicable" Indian regulatory framework.

1.4 **Fourth**, it appears that, through the restrictions that are stipulated in the IBFM tax regime, the Indian tax authorities are seeking to resolve other issues / challenges that they may be facing, which are in spirit really "non-tax related". For example, the long-standing concern of the Indian tax authorities to resolve the problem of "round tripping", would be best resolved by making the requisite changes to the Indian regulatory framework, and making the concerned Indian regulatory authority (such as the RBI, in this case) responsible for ensuring compliance with the spirit of the Indian regulations. This probably explains why the Indian Government has introduced a condition that restricts the aggregate participation or investment by Indian residents in the offshore fund, directly or indirectly, and on a look through basis, to a maximum of 5% of the corpus of the fund. However, by introducing such conditions / restrictions, which contradict the provisions of the SEBI Regulations and the Indian Exchange Control Regulations, the Indian tax authorities are (i) constraining the activities of offshore funds that may wish to appoint IBFMs, and (ii) increasing the burden of compliance to be followed by such offshore funds, thereby increasing the cost of operation for such offshore funds. Such measures make the IBFM tax regime unattractive to offshore funds that may be keen to appoint IBFMs.

1.5 **Fifth**, if Indian Government believes that it needs to have a prescriptive IBFM tax regime, so as to ensure that the Government will be able to procure the necessary tax related information from an offshore fund and the investors in such a fund, it would be worth mentioning that the Government ought to be able to procure such information through the large network of Double Taxation Avoidance Agreements (‘DTAAs’) and Tax Information Exchange Agreements (‘TIEAs’) that the Indian Government has signed with other foreign Governments. For example, India has currently signed around 92 DTAAAs, 16 TIEAs with other foreign Governments, and 1 DTAA with a specified territory outside India. Thus, a lack of information flow ought not to be a concern for the Indian Government.

1.6 **Sixth**, it appears that by introducing some of the other "non-tax related" conditions, such as the "broad-basing tests", the "investment diversification test", the "minimum corpus test", etc. the

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8 The term "round tripping" is not defined and is generally understood to mean the act of sending money overseas through various channels (such as investments in foreign companies etc.), which is re-routed into India by way of foreign investment.
Indian Government may be wanting to attract selective offshore funds to appoint IBFMs. At the outset, we recommend that the IBFM regime should be in sync with the regulatory framework that is currently in place in India, and so long as an offshore fund is allowed to invest in India, and complies with applicable Indian regulations, the offshore fund should be allowed to also appoint an IBFM. However, if the Indian Government believes otherwise, and wishes to have separate regimes that differ with each other: i.e. one for offshore funds that wish to invest in India, and another for offshore funds that wish to appoint IBFMs that manage such funds and which invest globally (including in India), we would respect this decision of the Indian Government’s.

Moreover, we do not believe that the Government should try to achieve this objective by introducing conditions / restrictions in the Indian tax law. Though, most of these conditions / restrictions go against “international best practices”, if the Indian Government were keen to have such a regulatory framework in India, it would be advisable for the Government to cast the obligation of registering, licensing, and monitoring the activities of such offshore funds that wish to appoint IBFMs on an appropriate Indian regulatory authority (for example, SEBI, in this case), as the regulator is best positioned to write-up the appropriate law / regulation that will help facilitate the IBFM regime, and thereby help the Indian Government achieve its objectives. In our opinion, trying to achieve “non-tax related” objectives, by introducing amendments to the Indian tax law and making the Indian tax authorities responsible for monitoring and tracking these objectives of the Indian Government’s, would not be a best practice and could hinder the overall IBFM regime.

*International best practices*

1.7 One of the key objectives that was laid out by the Honourable Indian Finance Minister when he introduced the IBFM tax regime before the Indian Parliament in 2015, was that the scheme was to be in line with “international best practices”. Countries such as the UK, Japan, Singapore, Hong Kong, and the U.S., which are known to be great fund manager jurisdictions, have also enacted provisions in their domestic tax laws to provide tax amnesty to offshore funds and investors in such funds, where the offshore fund appoints a fund manager that is based in their country. However, the tax amnesty schemes that are provided by these countries are simple schemes that are easy to operate and monitor, with just 4 to 6 conditions to be satisfied. Some of the key conditions / restrictions that may be imposed by some of these countries, include the following:

(i) that the offshore fund should not have a presence in the source state;
(ii) that tax residents in the source state are allowed to invest in the offshore fund, but not up to 100% of the offshore fund;
(iii) that the fund manager must be economically independent from the offshore fund and acting in the ordinary course of its business; and
(iv) that the offshore fund should not be able to influence or restrict the decision making abilities of the fund manager.

Given the large number of conditions that have been imposed by the Indian Government in the IBFM tax regime, most of which are “non-tax related” conditions, it would be fair to say that the IBFM tax regime is not in line with “international best practices”.

1.8 For your convenience, we have provided in Annexure D, some colour on how other countries such as the UK, Singapore, Japan, and HK, have been able to run successful fund manager regimes by keeping their respective tax laws simple and easy to comply with.

Interpretation challenges that are present in section 9A of the Act and Rule 10V of the IT Rules

1.9 If the Indian Government is unable to accept our aforesaid recommendations, we humbly request that the Government then resolve, on a priority basis, the following ambiguities that are still prevalent in the IBFM tax regime:

(i) Section 9A(3) provides that for an offshore fund to qualify for the IBFM tax regime, it must be a “fund established or incorporated or registered outside India, which collects funds from its members for investing it for their benefit and fulfills the following conditions, namely:…..”

The aforesaid section does not provide any guidance on how the term ‘fund’ is to be interpreted. Additionally, the aforesaid section does not cover fund management arrangements that involve omnibus accounts that are currently managed by some of our members and which is permitted by SEBI under the SEBI (FPI) Regulations. Hence, this clause needs to be appropriately amended to facilitate the above.

(ii) It is unclear whether the “investor base tests” that are prescribed in clauses (c), (e), (f) and (g) of section 9A(3), need to complied with on a daily basis or otherwise. It is also unclear on what base should the individual investor test of 10% and the group of investors test of 50% be applied, under clauses (f) and (g) of section 9A(3).

(iii) It is unclear whether the “investment diversification test” that is prescribed in clause (h) of section 9A(3), which mandates that the offshore fund not invest more than 20% of its corpus in any entity, should be applied on a daily basis or otherwise, and what would happen in the case of an offshore fund where it satisfied this condition at the time of making the investment but subsequently, the corpus of the fund shrinks such that the fund would then be in breach of this condition.
(iv) In Rule 10V(1), which allows for “a look-through approach” to be followed by applying the “investor base tests”, it is unclear:

1. how the term ‘institutional entity’ is to be interpreted to qualify for the “look-through approach”;
2. whether an insurance company or a Sovereign Wealth Fund (SWF) or a Foreign Government etc. which may be an anchor investor in the offshore fund will satisfy the condition of being “set-up solely for the purpose of pooling funds and investment thereof”, so as to qualify for the “look-through approach”;
3. whether an anchor investor in the offshore fund that may not be regarded as a tax resident because of that country’s domestic tax law or legal framework (e.g., a Luxembourg SICAV) will qualify for the “look-through approach”.

(v) In Rule 10V(2), which corresponds to clause (c) of section 9A(3) of the Act, and which requires monitoring of the 5% Indian resident investor limit, it is unclear:

1. how the term ‘multilateral agency’ is to be interpreted to qualify for the safe harbour provision, as such an entity could be an investor in the offshore fund;
2. how a ‘Pension Fund’ and a ‘University Fund’ would qualify for the safe harbour provision, as they are usually not regulated by a securities market regulator or a banking regulator in their home country, which is pre-requisite for them to meet the ‘appropriately regulated investor test’; and, as such an entity could be an investor in the offshore fund.

Conclusion

1.10 In sum, an offshore fund would want reasonable clarity and certainty that by appointing an IBFM it will not run the risk of being (i) regarded as having a ‘business connection in India’ or have a ‘PE in India’; and (ii) regarded as being an Indian tax resident. Additionally, it would not want any part of its foreign sourced income to become taxable in India on account of the aforesaid. The current set of onerous conditions that are prescribed in section 9A of the Act, read with Rules 10V, 10VA, and 10VB of the IT Rules, simply do not provide this clarity and certainty.

1.11 Hence, we humbly request the Indian Government to re-examine the IBFM tax regime, and keep the tax law simple by deleting (where required) and amending (where required) the various “non-tax related” conditions that we have discussed in paragraph 1.3 above. The IBFM tax regime should operate in a manner such that it is easy to comply with for the offshore fund as well as the IBFM, and that the two do not have to put in place onerous tracking and reporting systems, purely to ensure compliance with conditions that are imposed by the Indian tax authorities; because, such an operating construct would discourage offshore funds from
exploring the IBFM regime, and will unnecessarily increase their costs of compliance. This will then be in sync with the Indian Government’s intention of enacting a tax regime that is in line with “international best practices”.

-- A-15 --
Annexure B

Issue 2: The MAT issue for the period prior to April 1, 2015

2.1 We welcome the recent move on the part of the Indian Government to introduce the new Explanation 4 in the MAT provision in the Act (i.e. section 115JB), with effect from April 1, 2001, through the Finance Bill, 2016.

2.2 Clause (i) of the Explanation seeks to exempt those taxpayers from the levy of MAT, who are tax residents of countries or specified territories with which India has signed a tax treaty, and which do not have a PE in India.

2.3 Clause (ii) of the Explanation seeks to exempt those taxpayers from the levy of MAT, who are residents of countries or specified territories with which India has not signed a tax treaty, and which are not required to seek registration under any law for the time being in force relating to companies.

2.4 Explanation 4, however, suffers from the following two ambiguities that must be addressed to provide the relief intended by the Indian Government. Specifically:

- Clause (i) of Explanation 4 provides that the treaty-country exemption does not apply unless the taxpayer is regarded as a tax resident in the treaty country. Because the typical investment fund does not pay tax itself— with all tax borne by the fund investors — questions sometimes arise regarding whether such funds (e.g., Luxembourg SICAVs) should be treated as tax residents in their country of domicile. Any fund treated as a corporate for domestic tax purposes, we submit, should be treated as a tax resident and therefore covered by Clause (i). This clarification—which is entirely consistent with the Indian Government’s intent—should be made on a priority basis.

- Clause (ii) of Explanation 4 is worded very broadly and excludes any company that is a tax resident of a country or specified territory with which India has not signed a tax treaty and “which is required to seek registration under any law for the time being in force relating to companies.” Doubts have arisen as to how the aforesaid italicized text is to be interpreted, i.e., whether it applies only to the provisions of the Indian Companies Act (be it the Companies Act, 1956 or the Companies Act, 2013) or also to other Indian laws applicable to foreign companies for which registration may be required. One such example would be the Indian Income-tax Act, 1961, which requires a foreign company to seek registration with the Indian tax authorities by virtue of procuring a Permanent Account Number (PAN); the PAN enables the company to invest in Indian securities and open cash and custody accounts in India to make such investments. If the italicized language covers laws other than the Companies Act, such foreign companies technically would not qualify for the MAT exemption that Explanation 4 is intended to provide. Consequently, Clause (ii) also should be appropriately amended on a priority basis to make unequivocally clear that it refers only to seeking registration under the Indian Companies Act.
Annexure C

The Indian Union Budget 2014, which was presented before the Indian Parliament on
July 10, 2014

Section I: The Finance Minister’s Speech

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VI FINANCIAL SECTOR

Capital Market

Para 124. Financial sector is at the heart of the growth engine. Globalization helps channelize
external savings to India to bridge the resource gap but also renders the financial sector vulnerable to the
vagaries of the global economy. We have seen this in the recent past in ample measure. It is essential to
strengthen and modernize the legislative regulatory framework. There are some important
recommendations of the Financial Sector Legislative Reforms Commission like the enactment of the Indian
Financial Code which is considered necessary for better governance and accountability. It will be my
endeavor to complete the ongoing process of consultations with all the stakeholders expeditiously on this. It is
also essential to have a modern monetary policy framework to meet the challenge of an increasingly complex
economy. Government will, in close consultation with the RBI, put in place such a framework.

Para 125. While the impact of the above measures will be felt in the medium term, towards the same
objective, I propose to:

i. Advise financial sector regulators to take early steps for a vibrant, deep and liquid corporate bond
market and deepen the currency derivatives market by eliminating unnecessary restrictions.

ii. .......

iii. .......

iv. .......

v. .......

vi. Clarify the tax treatment on income of foreign fund whose fund managers are located in India to
resolve a long-standing problem. Details will be present in Part B.”

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“Part B
XI. TAX PROPOSALS

“Para 188. Madam Speaker, I shall now present my tax proposals.

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Para 201. Foreign Portfolio Investors (‘FPIs’) have invested more than Rs 8 lakh crore (about 130 billion US$) in India. One of their concerns is uncertainty in taxation on account of characterization of income. Moreover, the fund managers of these foreign investors remain outside India under the apprehension that their presence in India may have adverse tax consequences. With the view to put an end to this uncertainty and to encourage these fund managers to shift to India, I propose to provide that income arising to foreign portfolio investors from transaction in securities will be treated as capital gains.”

Section II: The Memorandum to the Finance (No. 2) Bill, 2014

“Characterisation of income in case of Foreign Institutional Investors

Section 2(14) of the Act defines the term ‘capital asset’ to include property of any kind held by an assessee, whether or not connected with his business or profession, but does not include any stock-in-trade or personal assets as provided in the definition.

The foreign portfolio investors (referred as foreign institutional investors in the Act) face a difficulty in characterization of the income arising from transaction in securities as to whether it is capital gain or business income. Further, the fund manager managing the funds of such investor remains outside India under the apprehension that its presence in India may have adverse tax consequences.

Therefore, in order to end this uncertainty, it is proposed to amend the Act to provide that any security held by foreign institutional investor which has invested in such security in accordance with the regulations made under the Securities and Exchange Board of India Act, 1992 would be treated as capital asset only so that any income arising from transfer of such security by a Foreign Portfolio Investor (‘FPI’) would be in the nature of capital gain.

This amendment will take effect from 1st April, 2015 and will, accordingly, apply in relation to the assessment year 2015-16 and subsequent assessment years.

[Clause 3]”
The Indian Union Budget 2015, which was presented before the Indian Parliament on
February 28, 2015

Section I: The Finance Minister’s Speech

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“Part B

Madam Speaker

“Para 94.  I now turn to my tax proposals.

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Para 108.  The present taxation structure has an inbuilt incentive for fund managers to operate from
offshore locations. To encourage such offshore fund managers to relocate to India, I propose to modify the
Permanent Establishment (PE) norms to the effect that mere presence of a fund manager in India would
not constitute PE of the offshore funds resulting in adverse tax consequences.

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“ANNEXURE TO PART-B OF THE BUDGET SPEECH

4.  B. Job creation through revival of growth and investment and promotion of ‘domestic
‘manufacturing’ and ‘Make in India’.

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1.1  With a view to facilitate relocation of fund managers of offshore funds in India, it is proposed to
modify the permanent establishment (PE) norms.

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-- C-3 --
Section II: The Memorandum to the Finance Bill, 2015

“Fund Managers in India not to constitute business connection of offshore funds

The existing provisions of section 9 of the Act deal with cases of income which are deemed to accrue or arise in India. Section 9(1)(i) provides a set of circumstances in which income is deemed to accrue or arise in India, and is taxable in India. One of the conditions for the income of a non-resident to be deemed to accrue or arise in India is the existence of a business connection in India. Once such a business connection is established, income attributable to the activities which constitute business connection becomes taxable in India. Similarly, under Double Taxation Avoidance Agreements (DTAAs), the source country assumes taxation rights on certain incomes if the non-resident has a Permanent Establishment (PE) in that country.

Further, section 6 of the Act provides for conditions under which a person is said to be resident in India. In the case of a person other than an individual, the test is dependent upon the location of its ‘control and management’.

In case of off-shore funds, under the existing provisions, the presence of a fund manager in India may create sufficient nexus of the off-shore fund with India and may constitute a business connection in India even though the fund manager may be an independent person. Similarly, if the fund manager located in India undertakes fund management activity in respect of investments outside India for an off-shore fund, the profits made by the fund from such investments may be liable to tax in India due to the location of fund manager in India and attribution of such profits to the activity of the fund manager undertaken on behalf of the off-shore fund. Therefore, apart from taxation of income received by the fund manager as fees for fund management activity, income of off-shore fund from investments made in countries outside India may also get taxed in India due to such fund management activity undertaken in, and from, India constituting a business connection. Further, presence of the fund manager under certain circumstances may lead to the off shore fund being held to be resident in India on the basis of its control and management being in India.

There are a large number of fund managers who are of Indian origin and are managing the investment of offshore funds in various countries. These persons are not locating in India due to the above tax consequence in respect of income from the investments of offshore funds made in other jurisdictions.

In order to facilitate location of fund managers of off-shore funds in India a specific regime has been proposed in the Act in line with international best practices with the objective that, subject to fulfillment of certain conditions by the fund and the fund manager.
(i) the tax liability in respect of income arising to the Fund from investments in India would be neutral to the fact as to whether the investment is made directly by the fund or through engagement of Fund manager located in India; and
(ii) that income of the fund from the investments outside India would not be taxable in India solely on the basis that the Fund management activity in respect of such investments have been undertaken through a fund manager located in India.

The proposed regime provides that in the case of an eligible investment fund, the fund management activity carried out through an eligible fund manager acting on behalf of such fund shall not constitute business connection in India of the said fund. Further, it is proposed that an eligible investment fund shall not be said to be resident in India merely because the eligible fund manager undertaking fund management activities on its behalf is located in India. This specific exception from the general rules for determination of business connection and ‘resident status’ of off-shore funds and fund management activity undertaken on its behalf is subject to the following:-

(1) The offshore fund shall be required to fulfill the following conditions during the relevant year for being an eligible investment fund:
   (i) the fund is not a person resident in India;
   (ii) the fund is a resident of a country or a specified territory with which an agreement referred to in sub-section (1) of section 90 or sub-section 1 of section 90A has been entered into;
   (iii) the aggregate participation or investment in the fund, directly or indirectly, by persons being resident in India does not exceed five percent of the corpus of the fund;
   (iv) the fund and its activities are subject to applicable investor protection regulations in the country or specified territory where it is established or incorporated or is a resident;
   (v) the fund has a minimum of twenty-five members who are, directly or indirectly, not connected persons;
   (vi) any member of the fund along with connected persons shall not have any participation interest, directly or indirectly, in the fund exceeding ten percent;
   (vii) the aggregate participation interest, directly or indirectly, of ten or less members along with their connected persons in the fund, shall be less than fifty percent;
   (viii) the investment by the fund in an entity shall not exceed twenty percent of the corpus of the fund;
   (ix) no investment shall be made by the fund in its associate entity;
   (x) the monthly average of the corpus of the fund shall not be less than one hundred crore rupees and if the fund has been established or incorporated in the previous year, the corpus of fund shall not be less than one hundred crore rupees at the end of such previous year;
   (xi) the fund shall not carry on or control and manage, directly or indirectly, any business in India or from India;
(xii) the fund is neither engaged in any activity which constitutes a business connection in India nor has any person acting on its behalf whose activities constitute a business connection in India other than the activities undertaken by the eligible fund manager on its behalf;

(xiii) the remuneration paid by the fund to an eligible fund manager in respect of fund management activity undertaken on its behalf is not less than the arm’s length price of such activity.

(2) The following conditions shall be required to be satisfied by the person being the fund manager for being an eligible fund manager:

(i) the person is not an employee of the eligible investment fund or a connected person of the fund;

(ii) the person is registered as a fund manager or investment advisor in accordance with the specified regulations;

(iii) the person is acting in the ordinary course of his business as a fund manager;

(iv) the person along with his connected persons shall not be entitled, directly or indirectly, to more than twenty percent of the profits accruing or arising to the eligible investment fund from the transactions carried out by the fund through such fund manager.

It is further proposed that every eligible investment fund shall, in respect of its activities in a financial year, furnish within ninety days from the end of the financial year, a statement in the prescribed form to the prescribed income-tax authority containing information relating to the fulfillment of the above conditions or any information of document which may be prescribed. In case of non-furnishing of the prescribed information or document or statement, a penalty of Rs 5 lakh shall be levied on the fund.

It is also proposed to clarify that this regime shall not have any impact on taxability of any income of the eligible investment fund which would have been chargeable to tax irrespective of whether the activity of the eligible fund manager constituted the business connection in India of such fund or not. Further, the proposed regime shall not have any effect on the scope of total income or determination of total income in the case of the eligible fund manager.

These amendments will take effect from 1st April, 2016 and will, accordingly, apply in relation to the assessment year 2016-17 and subsequent assessment years.

[Clauses 6, 71 & 75]"
Section I: The Finance Minister’s Speech

"Part B

Madam Speaker

"Para 116. I shall now present my tax proposals.

"ANNEXURE TO PART-B OF THE BUDGET SPEECH

1. Measures to boost the Financial Sector

1.5 It is proposed to modify the conditions of special taxation regime for off shore funds under section 9A of the Income-tax Act so as to provide that a fund registered or set up in a country notified by the Central Government will also be eligible for the said regime. It is also proposed to provide that the condition of not having control and management of any business or not carrying on any business by the fund will be applicable only to activities in India and not from India.

Section II: The Memorandum to the Finance Bill, 2016

"Modification in conditions of special taxation regime for off shore funds Section 9A.

Section 9A of the Act provides for a special regime in respect of offshore funds. It provides that in the case of an eligible investment fund, the fund management activity carried out through an eligible fund manager acting on behalf of such fund shall not constitute business connection in India of the said fund.

-- C-7 --
Further, an eligible investment fund shall not be said to be resident in India merely because the eligible fund manager undertaking fund management activities on its behalf is located in India. The benefit under section 9A is available subject to the conditions provided in sub-sections (3), (4) and (5) of this section.

The sub-section (3) of section 9 provides for the conditions for the eligibility of the fund. These conditions, inter-alia, are related to residence of fund, corpus size, investor base, investment diversification and payment of remuneration to fund manager at arm’s length. In respect of residence of the fund, the condition is that the fund has to be resident of a country or territory with which India has entered into a Double Taxation Avoidance Agreement (DTAA) or Tax Information Exchange Agreement (TIEA). In respect of activities of fund, there is a restriction that the fund shall not carry on or control and manage, directly or indirectly, any business in India or from India and shall neither engage in any activity which constitutes a business connection in India nor have any person acting on its behalf whose activities constitute a business connection in India other than the activities undertaken by the eligible fund manager on its behalf.

Representations had been received stating that there are many instances where a fund may not qualify as a tax resident of a country on account of domestic tax laws or legal framework of the country. The global structure of these funds had been based on applicable legal and regulatory framework of their country of incorporation and cannot be modified in respect of any investment made in a particular country. Examples of large pension funds or mutual funds from USA or SICAVs (open ended collective investment schemes) from Luxembourg had been cited. It has been stated that India would still be able to collect information regarding fund under the applicable DTAA or TIEA as under the agreements with many of the countries, information can be exchanged in respect of persons who may not be resident of the country. It had been further represented that the conditions relating to restriction on fund carrying on business or controlling fund managing business in India or from India restricts the flexibility of operation for funds and focus should be on nature of activities undertaken in India.

In order to rationalize the regime and to address the concerns of the industry, it is proposed to modify these conditions to provide that the eligible investment fund for the purposes of section 9A, shall also mean a fund established or incorporated or registered outside India in a country or a specified territory notified by the Central Government in this behalf. It is also proposed to provide that the condition of fund not controlling and managing any business in India or from India shall be restricted only in the context of activities in India.

The amendments will take effect from 1st April, 2017 and shall apply to the assessment year 2017-18 and subsequent assessment years.

[Clause 6]"
Annexure D

International best practices

The United Kingdom

UK legislation exempts certain non-UK incorporated funds from becoming UK tax residents even if the central management and control of the fund is carried out in the UK. The conditions to be satisfied by the non-UK fund are as follows:

- The fund is a corporate entity
- The fund is not incorporated in the UK or treated as a UK authorised unit trust
- The fund is treated as resident in its foreign state for the purpose of any tax imposed on income; and
- The fund is a UCITS authorised in a foreign state, or is an AIF has which is authorised or registered in a foreign state, or is not authorised or registered but has its registered office in a foreign state

Singapore

An offshore fund that is managed by a Singapore-based fund manager is exempt from Singapore tax on specified income from designated investments, provided the offshore fund is a qualifying fund. Specified income refers to profits, gains, dividends and interest from designated investments. Designated investments include traditional investments such as stocks, shares, securities, bonds, deposits, futures contracts etc.

A qualifying fund is one that:

- Is not 100% beneficially owned by Singapore investors including Singapore resident individuals, Singapore resident corporate entities and Singapore-based permanent establishments of non-residents,
- Does not have a Singapore presence, and
- Can only be in the form of companies, trusts or individual accounts.

A qualifying investor also enjoys tax exemptions on income derived from qualifying funds. A qualifying investor is:

- An individual investor
- A bona fide non-resident non-individual investor that:
  - does not have a Singapore presence or business activity (other than a fund manager), or
  - has a Permanent Establishment in Singapore but does not use funds from its operation in Singapore to invest in the qualifying fund.
- Certain specified Singapore government entities
- A Singapore resident corporate investor that owns not more than 30% or 50% (if the fund has 10 or more investors) of the qualifying fund.
Hong Kong

Hong Kong provides for an offshore funds (including SPVs) profit tax exemption. The exemption applies to profits derived from “specified transactions” carried out through “specified persons”.

“Specified transactions” are transactions that offshore funds typically perform being securities, futures contracts, foreign exchange contracts, foreign currencies and exchange-traded commodities transactions as well as deposit-making other than by way of a money-lending business and includes transactions in securities of private companies, including non-Hong Kong private entities.

"Specified Persons” includes those entities that are licensed or registered in Hong Kong.

Offshore private equity funds that engage in “specified transactions”, where such specified transactions are not managed by “specified persons” can avail of the exemption, provided the following conditions are satisfied:

- They have more than four investors;
- The capital commitment made by investors must exceed 90% of aggregate capital commitments; and
- The portion of net proceeds arising from the fund’s transactions to be received by the originator must not exceed 30%.

Japan

Japan-based fund managers of foreign funds must satisfy the following conditions so that they are not considered as a permanent establishment of an offshore fund:

- Legally independent;
- Economically independent; and
- Acting for the foreign fund in the ordinary course of its business.

Existence of one or more of the following will give rise to a PE of the offshore fund:

- The Japan-based fund manager’s decision-making abilities are restricted by the foreign fund manager;
- The Japan-based fund manager and foreign fund manager, foreign investment manager or foreign general partner share a majority of officers or employees;
- The Japan-based fund manager does not receive remuneration which corresponds to assets invested under an investment or agency agreement, or investment income; or
- If the Japan-based investment manager exclusively deals with the foreign fund, it is restricted from diversifying its business or soliciting other clients without altering the way it conducts its business.

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