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New Indian Investment Fund Regulatory Structure Includes Tax Benefits

By Sunil Gidwani and Naitik Doshi

In 2015, the Government of India (GOI) announced the first International Financial Service Center (IFSC) in India, in the state of Gujarat known as "Gujarat International Financial Tec-City" (GIFT City). An IFSC provides a platform to undertake financial services transactions by overseas financial institutions and overseas branches or subsidiaries of Indian financial institutions in foreign currency in India, which at present are carried on outside India.

The banking, capital markets and insurance sectors in IFSC were until recently regulated by respective regulators—the Reserve Bank of India (RBI), the Securities and Exchange Board of India (SEBI), and the Insurance Regulatory and Development Authority of India (IRDAI). The capital market participants present in IFSC are the stock exchanges/commodity exchanges, clearing corporations, alternate investment funds (AIF), mutual funds, portfolio managers, etc., which were regulated by SEBI. Recently, the GOI has set-up a single window regulatory institution—International Financial Services Center Authority (IFSCA), from April 27, 2020, which is expected to accelerate the development of IFSC at GIFT City.

The IFSC Guidelines are framed to facilitate and regulate financial services relating to securities market in an IFSC and promote India as an International financial hub and fund management industry. In relation to AIFs operating in IFSC, the guidelines dealt with matters like eligible investors, permissible investments, criteria for sponsor/manager etc. AIFs are categorized into three categories, Category I and II are mainly for investment in unlisted securities in India, and Category III is for investments in the listed space. AIFs setup in an IFSC can invest in securities issued by companies incorporated in India or a foreign jurisdiction, securities listed in an IFSC, securities issued by companies incorporated in an IFSC and other permissible investments as per AIF Regulations. Any entity set up in an IFSC is treated as a non-resident under the Indian exchange control regulations. A Category III IFSC AIF proposing to invest in Indian (onshore) exchanges is considered at par with an offshore fund and hence is required to obtain registration under the relevant SEBI Foreign Portfolio Investors (FPI) regulations to invest in India.

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New tax framework for Cat III AIFs in IFSC

The GOI has taken various measures to operationalize the IFSC and has provided various incentives to units set up in the IFSC. In this context, GOI has recently introduced path-breaking changes in the Indian tax regime.

The recent amendments mentioned below, provide for the manner of taxation of Category III IFSC AIFs as well as its investors and bringing the tax rates at par with those applicable to an offshore fund investing in India under the FPI route.

Exemption to Category III IFSC AIFs and its investors:

Until now, the exemption was limited to income from the transfer of specified securities listed on a stock exchange located in IFSC. The amendment expands the scope of this exemption to include the following:

- Transfer of Indian securities (other than shares of an Indian company). i.e. transfer of debt securities or derivatives instruments issued by Indian companies that are listed on Indian stock exchanges.
- Any income from securities issued by a non-resident (not having a permanent establishment in India) and where such income otherwise does not accrue or arise in India.
- Any income from a securitization trust under the heading "profits and gains from business and profession."
- Transfer of offshore securities traded in IFSC exchanges.

These changes not only seek to bring Category III IFSC AIFs at par with FPIs, but also provide certain additional incentives for investing through IFSC. For example, while capital gains earned by FPIs on the transfer of debt securities or derivatives issued by Indian companies are subject to tax in India, such income has now been made exempt from tax in the case of Category III IFSC AIFs. Also, Category III IFSC AIFs have been exempted from the alternate minimum tax. These incentives are provided in respect to income attributable to units held in AIFs by non-residents.

Further, any income accruing or arising to or received by unit holders from Category III IFSC AIF or on transfer of units in Category III IFSC AIFs are exempted from tax. Accordingly, any distributions made by Category III IFSC AIFs to its unit holders would not be subject to withholding tax in India.

Below we compare the applicable taxes and other applicable provisions of Category III IFSC AIFs *vis-à-vis* FPIs investing directly into India.

As is evident from above, the tax rates for Category III IFSC AIFs are now at par or more beneficial (in certain cases) as compared to FPIs investing directly into India. Also, the investment manager set-up in IFSC would get 100% corporate tax exemption for 10 consecutive years out of a block of 15 years (from date of approval from regulator) in respect to income from business carried on in an IFSC.

The competitive tax regime provided for Category III IFSC AIFs should make IFSC very attractive and comparable to a fund jurisdiction at par with other popular fund jurisdictions like Luxembourg, Cayman, Ireland, Mauritius, Singapore, etc. It is also expected to provide a boost to onshore the fund management industry. Therefore, the fund managers should actively consider IFSC India as a favorable jurisdiction for the purpose of fund structuring.

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