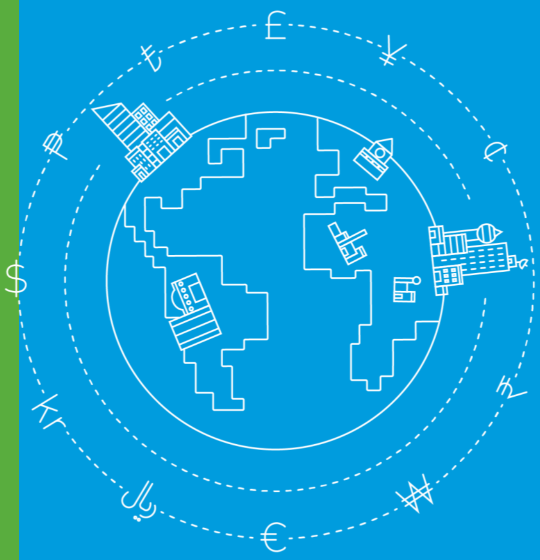
THE POWER
OF BEING
UNDERSTOOD



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NEWSFLASH - CLARIFICATIONS ON THE INDIRECT TRANSFER OF CAPITAL ASSET UNDER THE INCOME TAX ACT, 1961

- Circular no. 41 of 2016

THE POWER OF BEING UNDERSTOOD

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Background

Under the indirect transfer provisions contained in section 9(1)(i) of the Income Tax Act, 1961 ('Act'), all income accruing or arising, whether directly or indirectly, through or from any business connection in India, or through or from any property in India, or through or from any asset or source of income in India or through the transfer of a capital asset situate in India, shall be deemed to accrue or arise in India. Explanation 5 thereof clarifies that an asset or a capital asset being any share or interest in a company or entity registered or incorporated outside India shall be deemed to be and shall always be deemed to have been situated in India, if the share or interest derives, directly or indirectly, its value substantially from the assets located in India. Explanation 6 provides that the said Explanation 5 will be applicable, if on the specified date the value of such assets exceeds the amount of Rs.10 crore and represents at least 50% of the value of all the assets owned by the company/ entity. Explanation 7, however, provides a carve out from the applicability of Explanation 5 to small investors holding no right of management or control of such company / entity and holding less than 5% of the total voting power / share capital / interest of the company/ entity that directly or indirectly owns the assets situated in India. Section 285A of the Act casts a reporting obligation on the Indian concern whose shares are substantially held directly or indirectly by a company or entity registered or incorporated outside India.

FAQs

Queries have been received by the Board about the scope of the indirect transfer provisions. In this regard, CBDT had constituted a Working Group on 15 June 2016 to examine the issues raised by stakeholders. CBDT has considered the comments of the Working Group on the said issues and following clarifications are issued vide Circular no. 41 of 2016 dated 21 December 2016.

Q1 A Fund is set-up in a popular jurisdiction and registered as FPI for undertaking portfolio investment in Indian securities. It pools monies from retail/ institutional investors and invests in shares of Indian listed companies. The value of assets in India i.e. shares of Indian companies held by the Fund constitute more than 50% of its total assets and exceed Rs.10 crores. The Fund buys and sells shares on the Indian stock market and pay taxes as per section 115 AD of the Act or applicable tax treaty rates. On the ongoing basis, the Fund, on request of its unit holders/ shareholders, redeems their units/ shares. Does Explanation 5 to section 9(1)(i) of the Act apply to above redemption made by the Fund?

A1 Explanation 5 to section 9(1)(i) of the Act will be applicable in respect of investors in the Fund also, as their case falls within the ambit of clause (a) of Explanation 6 of the said section. However, the investors covered under Explanation 7(a)(i) of the Act are excluded.

Q2 Fund I and Fund II are feeder funds set-up in country X and country Y respectively. Both the feeder funds pool monies from investors and feed that into a Master Fund set-up in country X. None of the investors of the feeder funds have the right of control or management in the Master Fund or hold voting power or share capital or interest, directly or indirectly, exceeding 5% in the Master Fund. The Master Fund is registered as FPI for undertaking portfolio investment in Indian securities. The value of assets in India i.e. shares of Indian companies held by the Master Fund constitute more than 50% of its total assets and exceed Rs.10 crores. Will indirect transfer provisions apply to investors in master-feeder structures, where feeder funds are merely used to pool monies from investors, where none of the ultimate investors hold or will hold right of control or management or voting power or share capital or interest, directly or indirectly, exceeding 5% in the fund and a declaration to this effect is furnished by the feeder fund to the Fund registered as FPI.?

A2 Since conditions of Explanation 7(a)(ii) to section 9(1)(i) of the Act are, prima facie, fulfilled by the investors in the Feeder Funds I and II, income of such non-resident investors from transfer of their interests in the Feeder Funds would not be deemed to accrue or arise in India.

Q3 ABC Co. acting as nominee/ distributor is engaged in pooling of funds for the Offshore Fund registered as FPI. None of the investors investing through nominees / distributors have right of control or management in the Offshore Fund or hold voting power or share capital or interest, directly or indirectly, exceeding 5% in the Offshore Fund. ABC Co. is in India i.e. share of Indian companies held by the Offshore Fund constitute more than 50% of its total assets and exceed Rs.10 crores. Will indirect transfer provisions apply to investors in nominee-distributor type –structures, which are merely used to pool monies from investors where none of the ultimate investors hold or will hold right of control or management or voting power or share capital or interest, directly or indirectly, exceeding 5% in the fund and a declaration to this effect is furnished by the nominee or distributor to the Fund registered as FPI?

A3 Since conditions of Explanation 7(a)(ii) to section 9(1)(i) of the Act are prima facie fulfilled by the investors in the nominee / distributor company, income of such non-resident investors from transfer of their interest in the nominee / distributor would not be deemed to accrue or arise in India.

Q4 Fund X is an offshore fund set up in country A. It pools monies from investors for undertaking portfolio investments in Asia. It invests 90% of its corpus in shares of companies of country B. Fund X has allocated 10% of its corpus for India investments. For this purpose it has set-up an India focused sub-fund domiciled in a tax efficient jurisdiction for investing exclusively in Indian securities. Will indirect transfer provisions apply to Fund X using a separate Indian focused sub-fund for India investments, where none of the ultimate investors hold or will hold right of control or management or voting power or share capital or interest exceeding 5% in the offshore fund?

A4 Indirect transfer provisions u/s 9(1)(i) of the Act read with Explanation 5 thereto will be applicable in case of Fund X, since the value of shares I units held by it in the sub-fund derives its value substantially from assets located in India, irrespective of shareholding of the ultimate investors.

Q5 An offshore listed fund is registered as an FPI for undertaking portfolio investment in Indian securities. The value of Indian assets i.e. shares of Indian companies held by the offshore listed fund constitute more thcin 50% of its total assets and exceed Rs.10 crores. The investors or unit holders of the offshore listed fund keep on changing on daily basis and settlement of funds for buying and selling is done through stock exchange prescribed settlement mechanism. Will indirect transfer provisions apply on transfer of shares or units of an offshore listed entity?

A5 Explanation 5 to section 9(1)(i) of the Act will be applicable in respect of investors in the Fund also, as their case falls within the ambit of clause (a) of Explanation 6 of the said section. However, the investors covered under Explanation 7(a)(i) of the Act are excluded.

Q6 Fund P and Fund Q are formed as 'Corporate' entities in Country A. The value of assets in India i.e. shares of Indian companies held by Fund P constitute more than 50% of its total assets. On account of a scheme of amalgamation, Fund P is merged into Fund Q in Country A. The merger is tax neutral in Country A. Consequent to the merger, investors of Fund P became investors in Fund Q. Will the shareholders or investors of Fund Pliable to tax in India on account of indirect transfer provisions, though the amalgamation of Fund P and Fund Q is not regarded as 'transfer' under section 47(viab) of the Act?

A6 Under section 47(viab) of the Act, any transfer in a scheme of amalgamation of a share of an offshore company deriving its value substantially from the shares of an Indian company, held by the amalgamating foreign company to the amalgamated foreign company is not regarded as transfer, subject to the conditions specified therein. Under the existing provisions, this exemption does not extend to the shareholders / investors of the amalgamating foreign company. Hence, such shareholders/ investors will be liable to tax in India under section 9(1)(i) of the Act.

Q7 Fund X and Fund Y are 'non-corporate' entities formed in Country A. Company Z is a SPV formed in a tax efficient jurisdiction exclusively for Indian investments. Fund X holds 100% of shareholding of Company Z. On account of a scheme of amalgamation, Fund X is merged into Fund Y in Country A. The merger is tax neutral in Country A. Consequent to the merger, investors of Fund X became investors in Fund Y. Will indirect transfer provisions apply in case of offshore amalgamation or demerger of foreign 'non-corporate' entities?

A7 The provisions of section 47 of the Act apply only in respect of amalgamation of corporate entities. Consequently, the amalgamation of non-corporate entities will attract the provisions of section 9(1)(i) of the Act.

Q8 Fund X is registered as an FPI. As on last date of the preceding accounting period, the value of assets in India i.e. shares of Indian companies held by Fund X constitute more than 50% of its total assets and exceed Rs.10 crores. However, as on the date of transfer, the value of assets in India held by Fund X is only 47% of its total assets. The book value of assets as on the date of transfer does not exceed by at least 15% of the book value of assets as on the last day of accounting period preceding the date of transfer. Will indirect provisions apply even if the offshore transfer does not fulfill the substantial value test as contemplated under clause (a) to Explanation 6 of section 9(1)(i) of the Act on the date of transfer?

A8 Under Explanation 6 to section 9(1)(i) of the Act, the value of the asset of an offshore entity deriving its value substantially from assets located in India, will be computed as on the specified date as per clause (d) of the said Explanation. In the illustration, the specified date will be the date on which the accounting period of such entity ends preceding the date of transfer. The indirect provisions will apply since the offshore transfer fulfils the substantial value test as on the specified date.

Q9 Company A is an Indian public limited company listed on a recognized stock exchange in India. Many FPis [including offshore listed funds] invest in Company A under the FPI route. At the offshore level the shares or units of the FPI are bought and sold on daily basis and the investors in the FPI keep on changing frequently. How should Company A in such circumstances determine whether the value of assets in India held by an FPI investor exceed 50% of its total assets? Where FPI has invested in multiple Indian companies, there are practical challenges for Indian concerns to comply with this provision.

A9 Reporting requirement under section 285A triggers when shares of the foreign company / entity derive their value substantially from assets located in India. Since section 285A and Rule 114DB are recently introduced, their practical implementation should first be seen.

Q10 FPis are mainly portfolio investors and not strategic investors. The gains earned by FPis on sale or transfer of Indian securities is liable to tax in India in accordance with provisions of the Income-tax Act, 1961.If indirect transfer provisions are made applicable to these FPis, then there is a possibility of double taxation of the same income i.e. tax on gains earned on direct transfer of Indian securities by the FPis and tax on gains earned by investors of the FPis on redemption of units in the FPis. Hence, exemption should be provided for FPis.

A10 Carve-out is already available for smal investors in Explanation 7 to section 9(1)(i) of the Act.

Q11 The 5% threshold for exempting small shareholder should be increased. Additionally, the meaning of the term 'associated enterprise' in the context of FPis should be defined in line with what is reckoned by the Securities and Exchange Board of India for the purpose of ascertaining common beneficial ownership of FPis i.e. more than 50% common beneficial ownership.

A11 The 5% threshold is reasonable for excluding small shareholders from the ambit of the indirect transfer provisions. Alignment of the definition of 'associated enterprise' with the SEBI definition is not required as the definition of associated enterprise under the Income Tax Act is well-founded and is based on the concept of management, control and capital of an enterprise.

Q12 The monetary value of threshold of INR value of 10 crores of Indian investment for triggering applicability of indirect transfer provisions for FPis should be increased to INR 100 crores.

A12 The Rs. 10 crore threshold is reasonable.

Q13 In case of an FPI which is listed on an overseas stock exchange, frequent trading of share or units takes place on the overseas exchange every day. Hence, FPis that are regulated and listed on the recognized stock exchange should be excluded from the purview of indirect transfer provisions.

A13 The circumstances to determine taxability under the indirect transfer provisions are provided in Explation 6 and Explanation 7 of section 9(1)(i) of the Act. In view of the same, carve-out to specifiGally exclude FPis regulated and listed on overseas stock exchanges from the ambit of the indirect transfer provisions is not feasible.

Q14 The benefit of exemption provided for transactions in internal restructuring is currently restricted only to FPis classified as 'companies'. Can this benefit be extended to non-corporate FPis and to the shareholders or unit holders of all the FPis?

A14 The benefit under section 47 of the Act does not extend to shareholders / investors of the amalgamating foreign company. Hence, such shareholders/ investors will be liable to tax in India under section 9(1)(i) of the Act. Further, the provisions of section 47 of the Act apply only in respect of amalgamation of corporate entities, subject to certain conditions mentioned therein. As such, the amalgamation of non-corporate entities will attract the provisions of section 9(1)(i) of the Act.

Q15 The rules to determine the fair market value of Indian assets vis-a-vis global assets should be prescribed.

A15 Vide notification S.0.2226(E) dated 28 June 2016, Rule 11UB and Rule 11UC have been inserted in the IT Rules, 1961 to provide for method of determination of the fair market value of assets and apportionment of income for the purposes of section 9(1)(i) of the Act.

Q16 Indirect transfer provisions are to be applied if, on a specified date, the fair market value of Indian assets exceeds a specified threshold. Specified date for this purpose generally means the date on which accounting period of the company or entity ends, preceding the date of transfer of share or an interest. The specified date should be the date of transfer.

A16 Clause (d) of the Explanation 6 to section 9(1)(i) of the Act provides for two situations for the determination of the specified date, i.e. the date on which the accounting period of such entity ends preceding the date of transfer and. where the book value of the assets of the entity on the date of transfer exceeds the book value of the assets on the abovementioned accounting period end date by 15%, the date of transfer will be taken as the specified date. Taking the specified date alone as the date of transfer may result in abuse of the provision.

Q17 The rules to determine the fair market value of Indian assets vis-a-vis global assets are to be prescribed in due course. At the time of notifying these rules, it is suggested that manner of determination of cost of acquisition in the hands of the non-resident transferor (including clarity on availment of indexation benefit and benefit of foreign exchange fluctuation) should also be specifically provided to avoid any disputes.

A17 Vide notification S.0.2226(E) dated 28th June, 2016, Rule 11UB and Rule 11UC have been inserted in the IT Rules, 1961 to provide for the method for determination of the value of assets and apportionment of income for the purposes of section 9(1)(i) of the Act. The availment of indexation benefit I foreign exchange fluctuation will be as per the Act.

Q18 The indirect transfer provisions should be made operational only after a reasonable time of prescribing necessary rules by the Government.

A18 The indirect transfer law and rules have already been operationalised.

Q19 Given the uniqueness in FPI operational structure and the challenges to comply with indirect transfer tax provisions, it is suggested that FPis should be relieved from the withholding tax requirement. Alternatively, the threshold for enforcing such requirement on the FPis may be increased. Further, it should be clarified that no interest or penalty for failure to deduct taxes at source will be levied and the FPI will not be treated as an ‘assessee in default’ or the ‘representative assessee', on account of retrospective application of indirect transfer provisions.

A19 The provisions of withholding tax, interest and penalty shall apply as per law.

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This newsflash is general in nature. In this newsflash, we have summarised clarifications issued by CBDT in respect of 'Indirect transfer of capital asset under section 9 of the Income-tax Act, 1961' vide its Circular no. 41 of 2016, dated 21 December 2016. It may be noted that nothing contained in this newsflash should be regarded as our opinion and facts of each case will need to be analyzed to ascertain applicability or otherwise of the said notification and appropriate professional advice should be sought for applicability of legal provisions based on specific facts. We are not responsible for any liability arising from any statements or errors contained in this newsflash.

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