

23 October 2012

Attn: Chairman and Members of the Expert Committee on GAAR:

Dr. Parthasarathi Shome - Chairman

Shri N. Rangachary, former Chairman, IRDA - Member

Dr. Ajay Shah, Professor, NIPFP - Member

Shri Sunil Gupta, Joint Secretary, Tax Policy & Legislation, Department of Revenue - Member

By Hand: Expert Committee on GAAR
15th Floor, Hindustan Times Building,
Kasturba Gandhi Marg, New Delhi - 110 001

By Email: partho.shome@icrier.res.in

By Fax: +91 11-24620180

Dear Chairman and Members of the Expert Committee on GAAR,

RE: Application of indirect transfer taxation rules to portfolio investments

On behalf of the membership of the Asia Securities Industry & Financial Markets Association (ASIFMA)¹ and the Capital Markets Tax Committee of Asia (CMTC)², we wish to thank you and the other members of the Expert Committee (“the Committee”) on the General Anti-Avoidance Rule (“GAAR”) for giving us the opportunity to provide our suggestions/ feedback in connection to with the matters relating to GAAR and the applicability of the indirect transfer rules, in the context of portfolio investments made by Foreign Institutional Investors (FIIs).

¹ The Asia Securities Industry & Financial Markets Association (ASIFMA) is an independent association that promotes the development of liquid, efficient and transparent capital markets in Asia and facilitates their orderly integration into the global financial system. ASIFMA priorities are driven by over 40 member companies involved in Asian capital markets, including global and regional banks, securities dealers, brokers, asset managers, credit rating agencies, law firms, trading and analytic platforms, and clearance and settlement providers. ASIFMA is located in Hong Kong and works closely with global alliance partners: the Global Financial Markets Association (GFMA), the Securities Industry and Financial Markets Association (SIFMA) and the Association for Financial Markets in Europe (AFME). More information about ASIFMA can be found at: www.asifma.org.

² The Capital Markets Tax Committee of Asia (“CMTC”) is a financial services industry body consisting of a number of banks, investment banks, securities firms and other diversified financial services institutions operating in Asia who are represented through their regional tax directors. The main objects of the CMTC, according to its Constitution, are “to provide a forum for discussion by corporate tax managers responsible for the tax affairs of investment banks, securities firms, banks and other diversified financial services institutions of topical taxation issues in Asia affecting their capital and securities markets and similar activities; ... to keep members informed of up to date information on taxation matters affecting capital and securities markets, and to exchange views on the technical analysis thereof; [and] to represent the interests of its members through acting as the respected voice of investment banks, securities firms, banks and other diversified financial services institutions, and to participate in liaison or advocacy activities on tax matters either directly or indirectly through representation with other groups or societies concerned with or by fiscal matters.”

At the outset, please accept our compliments for the efforts put in by the members of the Committee for releasing the Draft Report on the recommendations to the Government on the Retrospective Amendments to the indirect transfer rules as introduced in the Income-tax Act, 1961 (IT Act) vide the Finance Act, 2012 (“the Draft Report”).

Like the report on GAAR, the Committee has yet again provided an objective, reasoned and a path breaking report on the retrospective amendments relating to indirect transfer rules, with its recommendations being aligned with norms of certainty, predictability and stability of the tax laws.

We truly welcome the Committee’s recommendation that such amendments should apply on a prospective basis and that any retrospective changes to law should be made in ‘the rarest of rare cases’. The Draft Report also sets forth a cogent analysis of the appropriate parameters of an indirect transfer tax.

Some of the recommendations by the Committee are particularly salutary and highly welcomed, such as defining ‘substantial’ as 50%, confining taxation to proportional value of assets, calculation of the ‘value’ to mean net assets (net of liabilities), non-applicability of withholding tax provisions on the payer and taxability in the hands of the payee (taxpayer) who has derived the capital gains from the transaction, enlisting exemptions from purview of indirect transfers, and non-taxability of dividend paid by foreign companies.

Given the tight time line available with the Committee, it is indeed commendable that the Committee gave due opportunity to diverse stakeholders to share their views on the subject. The views and sentiments of the taxpayers are well reflected in the Draft Report and the illustrations dealt with are reasonably wide, which should also help in mitigating the use of discretionary power.

In furtherance of the objective of finalization of the Draft Report in line with the recommendations made by the Committee, we have in the **Annexure** provided our additional suggestions for the Committee’s consideration, to the extent they have a bearing on FIIs.

We are pleased to forward our suggestions for consideration of the Committee. We trust that our concerns shall receive due consideration of the Committee. We greatly appreciate your efforts and the attention given to this serious matter.

Please feel free to contact Will Sage, ASIFMA Managing Director at office: +852 2537 3895 or email at wsage@asifma.org.

Yours sincerely,



Mark Austen
Chief Executive Officer
ASIFMA



Jocelyn Lam
Chairperson
Capital Markets Tax Committee of Asia

1. **FII that are subject to tax in India**

With a view to allaying apprehensions and provide greater clarity on the taxation of portfolio investments made by FIIs, the Committee has recommended in para 4.9 of the Draft Report that *"In view of the above, it may be clarified through a circular that the investments made by a Foreign Institutional Investor (FII) as per regulation of the SEBI are subject to tax, in India in the hands of the FII. Taxation of non-resident investors investing, directly or indirectly, in the FII may lead to double or multiple taxation....."*.

The words 'subject to tax' are liable to be interpreted in a manner that tax ought to have actually been paid by the FII for the investors of FIIs to be immune from indirect transfer rules. To address this concern, it should be explicitly provided that *"In view of the above, it may be clarified through a circular that on income from investments made by a Foreign Institutional Investor (FII) as per regulation of the SEBI, tax may either (i) have been paid or is payable in India or (ii) exempted from tax in India under a treaty or applicable domestic law provisions.It is therefore clarified that....."*.

2. **Non-residents investors who have invested directly or indirectly in the FII**

Para 4.9 also states that non-resident investors making investments in FIIs should not be taxable where:

- (i) a non-resident investor has made any investment, directly or indirectly, in an FII; or
- (ii) the investment made by an FII in India represents, directly or indirectly, the underlying assets of investment by a non-resident.

In examining this issue, the Committee has taken cognizance of the typical investment structures of FIIs - which could be multi-layered direct investment structures or synthetic investment structures and also considered the fact that investors may exist at subsequent levels/ upper levels and may not be direct investors in the FII.

The Draft Report states that given the nature of the multi-layered direct investment and synthetic structures, unless the non-resident investors at various levels in the structures are legally excluded, the same may be taxable in India within the ambit of the indirect transfer rules. This may lead to multiple taxation of the same income, particularly where the frequency of transfers is likely to be high at all levels in both investment structures.

Additionally, with the objective of clarifying the meaning of the term 'share or interest in a company or entity' and the unintended consequences that may arise from the interpretation of the said term (such as its coverage relating to any contractual arrangements), the Committee in para 4.2 of the Draft Report has recommended that it should be specified that the phrase "the share or interest in a company or entity

registered or incorporated outside India” in Explanation 5 to section 9(1)(i) of the IT Act should mean and include only such share or interest which results in participation in ownership, capital, control or management and thus, all other types including mere economic interest should not be contemplated within the ambit.

Both the recommendations in paras 4.2 and 4.9 of the Draft Report are a welcome move on the part of the Committee and highly appreciated by all industry participants. The above recommendations on the part of the Committee remove the uncertainty in respect of non-resident investors in a multi-layered investment structure.

Specifically in the context of synthetic investment structures, given the global nature of the business, we wish to point out that there are various parties involved in addition to the investors (being the P-note holder) such as the shareholder of the FII, the affiliate entity that may issue the P-note, etc.

While a harmonious reading of the recommendations in paras 4.2 and 4.9 have certainly gone a long way in removing doubts on the interpretation and impact of the indirect transfer rules for synthetic investment structures as well, **in order to ensure complete clarity and dispense with all concerns, it should be clarified that in a synthetic investment structure, the indirect transfer rules would also not apply to affiliates of the FII (including the affiliates that issue the offshore derivative instruments in a synthetic investment structure to foreign investors), lenders to the FII or other parties that enter into contractual arrangements with FIIs as well as persons investing in such offshore derivatives instruments.**