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ANALYZING THE IMPACT OF THE BUDGET ON THE FUNDS INDUSTRY: THE TIMES THEY ARE A-CHANGING!

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Following the proposals put forward by the Union Minister of Finance and Corporate Affairs in the Union Budget 2019-20 (Budget), we take a look at some of the key takeaways which have the potential to deeply impact the investment funds industry in India.

Hits!

Relaxation for eligible fund managers - a measly morsel from a possible gratuitous pie?

Fund management activities conducted by an eligible fund manager located in India, in relation to an eligible investment fund, do not constitute business connection in India, under section 9A of the (Indian) Income Tax Act 1961 (IT Act), i.e. an eligible investment fund is not deemed to be an Indian resident merely on the account of the eligible fund manager undertaking fund management activities based in India. Pursuant to a recent notification by the Central Board of Direct Taxes (CBDT), application of such safe harbour exemption was extended to mutual fund asset management companies, in addition to its extant application to portfolio managers. While this CBDT clarification had pointedly indicated towards potential relaxations with regard to the section 9A conditions (which are, presently, very stringent), the Budget failed to live up to the expectations of offshore fund managers by offering limited relief by way of two amendments.

Firstly, the Budget proposes to ease the minimum corpus requirement for an eligible fund, by revising the applicable timeline for the fund corpus to reach a minimum of INR 100 crores at the end of a period of 6 months from the end of the month of its establishment or incorporation or at the end of such previous year, whichever is later (which, earlier, was restricted only to the end of such previous year). Secondly, the minimum remuneration paid by an eligible fund to the fund manager was also revised, earlier being at the arm's length price, to now being at such price that may be prescribed by the Government, in this regard. While these amendments are in the direction of easing safe-harbour rules, amendments with more palpable impacts to such fund management activities in India were anticipated by the industry.

NRI-PIS merger with FPI- a prime candidate for the wedding of the year!

Being one of the most prized jewels of the Budget speech this year, Finance Minister’s announcement to merge the NRI (Non-resident Indian)-Portfolio Investment Scheme Route with the Foreign Portfolio Investment Route was quite a head-turner amongst the non-resident investors. Promising to be a "seamless access" conduit for NRIs looking to invest in the Indian capital markets, this union was wholeheartedly blessed by the industry. Being adopted from the HR Khan Committee recommendations on SEBI (Foreign Portfolio Investors) Regulations 2014 (HR Khan Committee), this move will catalyse streamlining of foreign investment in India. Earlier, NRI-PIS investment was governed by the Reserve Bank of India (RBI), while foreign portfolio investor (FPI) investment is regulated by the Securities and Exchange Board of India (SEBI). Now, with the unification of these investment routes, many impediments with respect to FPIs raising funds from NRIs/Overseas Citizens of India (OCIs) would be alleviated.

KYC norms tempered for FPIs, again

HR Khan Committee, being the harbinger for rationalising the know you client (KYC) norms for FPIs, was acknowledged in the Budget speech. The Finance Minister announced that integration and streaming of KYC norms for FPIs, to render the Indian investment regime more attractive and hassle-free would be one of the bounties that FPIs could look out for. Simplification of the KYC certification process and related documentation for FPIs should significantly fillip FPI investment, simultaneously ensuring that the integrity of foreign exchange inflow in India is preserved.

Resuscitating the Indian debt market for IDF-NBFC, REIT and InVIT debt

Another incentive that was offered to FPIs under the Budget was in relation to permitting investments made by FPIs in debt securities that are issued by Infrastructure Debt Fund – Non-Bank Finance Companies (IDF-NBFCs) to be transferred/sold to any domestic investor within specified lock-in period. It is expected that allowing FPIs to invest in debt securities issued by NBFCs will provide the much-needed capital to NBFCs, thereby leading to growth of the NBFC segment. Further, to bolster growth of the twin investment vehicles- Real Estate Investment Trusts (REITs) and Infrastructure Investment Trusts (InvITs); FPIs may now invest in debt issued by the former.

Passing through the losses for Category I and Category II AIFs: a breather for the funds-folks!

Earlier, pass-through treatment for income (other than business income) was not available for unabsorbed losses of an AIF. However, the Budget has, quite to the jubilation of fund managers, rectified such treatment of losses in the hands of investors, by proposing the following changes for Category I and Category II AIFs, in such regard:

- business loss of the AIF is allowed to be carried forward and may be set-off by it and cannot be passed onto an investor;

- loss (other than business loss), which has not been held by an investor for a minimum period of 12 months will also be ignored for the purposes of pass through to investors;

- loss (other than business loss), accumulated at the level of AIF as on 31 March 2019, *shall be deemed to be the loss of an investor* who held the unit on 31 March 2019 in respect of the investments made by him in the AIF and allowed to be carried forward by him for the remaining period calculated from the year in which the loss had occurred for the first time taking that year as the first year and it shall be set-off by him; and

- loss so deemed in the hands of investors shall not be available to the AIF.

Promotion of REITs and InVITs: Watch the Space!

The Finance Minister acknowledged REITs and InvITs as important investment products being part of the brownfield asset modernization strategy for augmenting infrastructure investment. It was further proposed that reform measures would be undertaken to promote the rental housing model; with the government acknowledging the need to revisit archaic rental housing laws. With nearly 40 countries having adopted the U.S.-based REIT approach to real estate investment, the listed real estate market is growing exponentially and is increasingly becoming global. We can expect a renewed thrust towards this sector by the government in light of the Budget. With modernized tenancy laws and the ambitious goal of the government aiming at "housing for all", such proposals could be the magic ingredient propelling the REIT take-off in India!

Conforming congruity between FPI and FDI

The much-welcomed increase in the extant statutory limit for FPI investment in a company from 24% to sectoral foreign investment, as may be applicable, has been another green signal to augment FPI investment in India. By bringing the investment limit for FPIs for Indian companies, at par with the applicable foreign direct investment (FDI) sectoral limit, the Finance Minister indicated that such revision in limit shall be subject to the concerned corporates having the flexibility to limit FPI investment in companies to a lower threshold. This move shall be specifically beneficial to foreign investors using both the FPI and FDI routes for different portfolios in India by levelling the investment limits applicable under both these routes. Further, this is expected to increase the share of Indian securities in the global indices, resulting in the possibility of increased allocation in India.

It's raining Gifts in the International Financial Services Centre (IFSC)

In an enthused effort towards promoting the development of world class financial infrastructure in India, the Finance Minister proposed to introduce the following additional benefits to IFSCs:

- It is proposed to extend exemptions on transfers of certain specified instruments (such as global depository receipts (GDRs), rupee denominated bonds, derivatives or securities, as notified) held by Category III alternative investment funds (AIFs) (in which all the investors are non-residents) through recognized stock exchanges set up in IFSC.

- Previously, an IFSC unit was allowed a deduction of 100% of profits for the first 5 consecutive years, and 50% for the next five consecutive years from the year of commencement. The Budget introduces a tax holiday of 100% available to IFSC units for a period of 10 consecutive years out of 15 years from approval.

- A proposed tax exemption on interest payable to a non-resident by a unit located in IFSC on monies borrowed on or after 1 September 2019 was announced. This will facilitate external borrowings by IFSC units.

- Capital gains arising on sale of specified securities traded on a recognised stock exchange in IFSC by Category III AIFs (only having only non-residents investors) shall be exempt from tax, as long as their income is earned in solely in convertible foreign currency.

- Dividend Distribution Tax (DDT) would be exempt on distribution made by a unit in IFSC from accumulated profits derived from operations in IFSC.

- Currently, the income distribution by mutual funds is subject to an additional levy in the hands of the mutual fund under section 115R of the IT Act. The Budget proposed a DDT exemption on distribution made by mutual funds in IFSC of which, all unit holders are non-residents and such mutual fund derives its income solely in convertible foreign currency.

The exemptions for Category III AIFs effectively blur the lines between investments by non-residents in the abovementioned securities on recognized stock exchanges in IFSCs and direct investments in such securities.

While the new amendments do increase the value proposition of IFSC theoretically from a tax perspective, it remains to be seen whether fund managers will opt to set up shops in the IFSC regime. Loopholes surrounding the regulatory framework of IFSCs will still need to be plugged in, however, these incentives will go a long way towards ensuring that Indian IFSCs are considered a desired funds destination domestically, as well as internationally.

More FDI measures in retail

In order to make India an attractive FDI destination, the Finance Minister has proposed the following measures:

- Considering further opening up of FDI in aviation, media (animation, AVGC) and insurance sectors in consultation with all stakeholders.
- 100% FDI will be permitted for insurance intermediaries.
- Local sourcing norms will be eased for FDI in single brand retail sector.
- FPIs will be permitted to subscribe to listed debt securities issued by REITs and InvITs.

Benevolence of "angel" tax extended to Category II AIFs!

While issuance of shares of venture capital undertaking to a venture capital fund was exempt from angel tax payable on excess premium received by such companies, this benefit has now been extended to issuance of such shares to Category II AIFs. With majority of PE funds structured as Category II AIFs, this budgetary boon will certainly fortify investment in venture capital companies by Category II AIFs, thus being a dream come true for numerous fund managers targeting early start-up and venture capital portfolio companies.

Faceless tax assessment for weeding out the bias: a step towards fairer scrutiny?

There have been numerous instances in the past in relation to unwarranted bias seeping in tax assessments for many investment fund related tax disputes. With the NDA's mission to eradicate corruption in the country, this proposed electronic "faceless" tax assessment will surely help to mitigate instances of personal interaction and the consequent partiality that may be present in the present tax assessment, ensuring a more accurate and objective treatment of tax disputes, going ahead.

A much-needed comfort for the distressed asset space

Per section 79 of the IT Act, the benefit of setting off carry-forward losses is given only if the shareholding of the company does not change by more than 49%. The Budget proposes extending the aforesaid benefit to companies, its subsidiaries and even to its step down subsidiaries where the National Company Law Tribunal (NCLT) has suspended the board of directors and appointed new directors on a recommendation by the Centre Government in case of a resolution plan under the Insolvency and Bankruptcy Code (IBC). Therefore even in case of a change in the voting power or shareholding of a company, losses can be carried forward and set off. Further, for the purposes of computation of Minimum Alternate Tax (MAT) liability of such companies, the aggregate of brought forward losses and unabsorbed depreciation shall also be allowed as deduction. This is a welcome move in the resolution of distressed companies and will benefit the industry especially in the wake of the infamous IL&FS fiasco.

Changing the exchanges: retail investment in G-secs and social stock exchange

With the aim of initiating development in the investment risk appetite of retail investors, it was proposed that facilitation of inter-operability of RBI depositories and SEBI depositories would be imperative to encourage retail investment in treasury bills and government securities. Further, creation of a 'social stock exchange' under SEBI that will list enterprises and voluntary organizations engaging in social welfare will promote such entities to raise capital and therefore, contribute to national development.

Some Misses?

Increased surcharge for non-corporates- a blow in disguise?

FPIs structured as non-corporate entities (i.e. AOPs, trusts, etc.) shall be subject to inflated surcharge applicable to HNIs, on the account of their classification as "individuals" for the purposes of the IT Act. Further, considering that most Category III AIFs are structured as trusts, the brunt of this steep surcharge for HNIs shall be borne by Category III AIFs as well. Possibility of the increased taxation burden has led to a frenzy amongst the FPI and Category III AIF players, who are contemplating to restructure their existing entities to a corporate entity, to beat the tax heat. However, such restructuring cannot be carried out at a drop of one's hat, and may be subject to significant hindrances, *inter alia*, rehauling the constitutive documentation, alignment of existing structures, possible GAAR scrutiny in light of alleged tax avoidance, and taxation on transfer of assets that may be a result of such restructuring.

Waters still muddy for Category III AIFs-Step-motherly treatment?

Perhaps one of the most eagerly awaited clarity that was sought by the fund industry in India was clarity around taxation for Category III AIFs. This was especially in the light of numerous tax assessment orders and observations received by Category III AIFs in light of the above-issues, that it became pertinent for the Budget to address some of these tax related ambiguities. It is notable that Category III AIFs are the leading asset class amongst the AIFs, and many industry players still remain wary of exploring the reaches for Category III AIFs, on account of such taxation woes.

GST on management fee for fund managers not addressed

Another issue that was prominent on the fund manager wish list, was reduction of the goods and service tax that is applicable to GST is payable on the advisory and management fee. However, with the Budget not addressing this concern, it may be hoped that some respite in such regard is introduced, soon, by the government.

Is the budget a half-baked cake from the HR Khan Committee recipe?

While some of the recommendations from the HR Khan Committee in relation to FPIs found place in the Finance Minister's maiden budget speech, the industry was all ears for a more favourable tune for FPIs for 2019-2020. For instance, pension funds were expected to be categorized as a Category I FPI in light of the social development tenor of the government. Further, removal of restriction on opaque structures and PCC/MCV declaration requirement was also anticipated, in the light of the global trend of ring fencing and segregated portfolio structures. Further, Category III FPIs continue to remain subject to onerous compliance and declaration requirements, despite being an active class of FPI investment in India. It was also expected that such entities that have owners satisfying Category I and Category II FPI eligibility criteria would also, like Category II FPIs, have the benefit of concurrently being eligible for registration as an FPI, under the same category as that of its owner. Many clarifications and rationalisation in the broad-based eligibility criteria for Category II FPIs was also an important ask from the HR Khan Committee report. Further, with the hope of destressing the mounting distressed assets in India, investment limit separate from the corporate debt ceiling for securitisation receipts was also sought from the Budget. While there has been an alignment for the sectoral limits for FPI and FDI route, operating guidelines for migration from FPI regime to FDI regime was also on the to-do list of the HR Khan Committee Report. With the Budget bidding a half-meant promise to the FPI industry, it may be hoped that more recommendations from the HR Khan Committee are implemented, in addition to the ones proposed to be enacted.

Conclusion

While the impetus given by the Budget to investment funds is proving to be flattering for the industry, painting a somewhat rosy picture for the future of India as an emerging investment destination-the practical implications of the changes introduced by the Budget are still to be seen. To the extent that the Budget has mirrored the HR Khan Committee recommendations, adequately addressed the asks of stakeholders, and aligned discrepancies in taxation treatment for comparable fund products, it seems that the Indian investment funds space is in for a smooth sojourn. However, while these proposals being perceived as "life-savers" for India Inc., efficient implementation and smooth transition in the wake of these changes will prove to be the key tools for realising the NDA 2.0 dream to reality.

- *Siddharth Shah (Partner), Anindya Roy (Associate), and Ishita Khare (Associate)*

For any queries please contact: editors@khaitanco.com

Mumbai
One Indiabulls Centre, 13th Floor
Tower 1 841, Senapati Bapat Marg
Mumbai 400 013, India

T: +91 22 6636 5000
E: mumbai@khaitanco.com

New Delhi
Ashoka Estate, 12th Floor
24 Barakhamba Road
New Delhi 110 001, India

T: +91 11 4151 5454
E: delhi@khaitanco.com

Bengaluru
Simal, 2nd Floor
7/1, Ulsoor Road
Bengaluru 560 042, India

T: +91 80 4339 7000
E: bengaluru@khaitanco.com

Kolkata
Emerald House
1 B Old Post Office Street
Kolkata 700 001, India

T: +91 33 2248 7000
E: kolkata@khaitanco.com