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BETTER LATE THAN NEVER! WITHDRAWAL OF ENHANCED SURCHARGE FOR INVESTORS IN THE INDIAN CAPITAL MARKETS

26 August 2019

In a much-awaited move, the Government of India (Government) vide press release dated 24 August 2019 (Press Release), announced withdrawal of the enhanced surcharge rates on income arising from the transfer of certain investments made in the Indian capital markets.

Background

The tax payable in India is to be increased by applicable rate of surcharge and the tax so increased by applicable surcharge, is to be further increased by health and education cess of 4%. Until last year (1 April 2018 – 31 March 2019), the highest rate of surcharge applicable to non-corporate taxpayers was 15%, which was increased to 25% for income greater than 2 crore but less than 5 crore, and 37% for income greater than 5 crore, by Budget 2020.

The steep hike in surcharge rates introduced by the Finance (No.2) Act, 2019 impacts all taxpayers other than companies and partnership firms (as defined under the Indian Partnership Act which does not expressly recognize foreign or limited partnerships and thus, this determination is based on features of these entities). While applicability of such enhanced surcharge on individuals was somewhat digested as a tax targeted at High Net-worth Individuals (HNIs), the impact of the same on investment vehicles structured as non-corporate entities (such as several Foreign Portfolio Investors (FPIs), Alternative Investment Funds (AIFs)) certainly soured the investor sentiment. The initial representations made to the Government to provide relief to such investment vehicles were faced with much resistance.

Announcements as per Press Release

In order to encourage investment in capital markets, the Government has now announced its decision to withdraw the enhanced surcharge on income in the following cases:

- Capital gains arising on an on-market transfer of the following securities (where applicable securities transaction tax has been paid):
  - Equity shares
  - Units of an equity-oriented fund

- Units of a Real Estate Investment Trust (REIT) or Infrastructure Investment Trust (InvIT), the units of which are required to be listed on a recognized stock exchange in India

➢ Gains arising to FPIs on transfer of derivatives

Comments

Although delayed, the withdrawal of the enhanced surcharge rates for certain investments in the Indian capital markets should definitely provide some respite to investors.

Notably, the relief has been extended only with respect to (a) gains arising on an on-market transfer of specified securities (whether the investor is a resident, non-resident or an FPI) and (b) gains arising to an FPI from sale of derivatives. Thus, higher surcharge rates would continue to apply in other cases, such as:

- Off-market transactions in such specified securities;
- Transfer of unlisted shares / securities; and
- Income from trading in derivatives by persons other than FPIs.

In case of FPIs, the benefit has been extended to income from trading in derivatives but not to gains arising on transfer of securities other than specified securities - such as listed / unlisted debentures.

With regard to the domestic fund vehicles, Category III AIFs which are set up as trusts and invest in unlisted securities and derivatives, may not have much to celebrate. In absence of an express tax pass through status of a Category III AIF (unlike in case of Category I and II AIFs except in relation to their business income) and tax consequences of a trust earning business income as well as certain practical challenges, the uncertainty of applicability of the enhanced rates of surcharge would continue to loom.

From an overall perspective, something is better than nothing and one awaits the fine print of the binding notification / amendment implementing these announcements.

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