Taxation of IFSC Funds and its Investors

 

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1 SYNOPSIS

1.1 The International Financial Services Centre ("IFSC") in the Gujarat International Finance-Tec City ("GIFT") set up by the Government of India is a response and an elegant alternative to investors, family offices and financial services entity looking for managing their wealth and monies closer home, and an alternative to typical financial jurisdictions. The rapid proliferation of financial services sector activities in IFSCs has piqued overwhelming interest from numerous market players in both India and abroad. The IFSC regulations have been framed and are continuously monitored and amended (as required) in an endeavour to ensure these are at par or as attractive as the regulations in jurisdictions outside India.

1.2 Needless to mention, tax is indeed an integral measure in ensuring the success of IFSC as a result of which the Government of India has introduced or amended the provisions of tax laws to provide adequate comfort on the tax positions while setting up a particular structure in IFSC. Having said that, there are different tax regimes applicable depending on the fund structure, residential status of investors, nature of investments, etc. which needs to be analysed carefully at the structuring stage itself to have certainty over the tax position for the funds as well as the investors.

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1.3 In this article, we have captured some of the key income tax considerations relevant to certain fund structures in IFSC, in particular the following:

(a) Category I, II and III AIF;

(b) Family Investment Fund ("FIF"); and

(c) Offshore banking unit.

2 AIF IN GIFT IFSC

2.1 AIFs: Common structures

(a) Under the International Financial Services Centres Authority (Fund Management) Regulations, 2022, ("IFSCA Regulations"), venture capital schemes that invest primarily in unlisted securities of startups or early-stage venture capital undertakings, or technology or intellectual property rights-based activities, etc are to be filed with the IFSC Authority as a Category I AIF. Similarly, fund management entities ("FMEs") launching Restricted Schemes (Non-Retail) which invest in startups or early-stage ventures or social ventures, infrastructure sectors, etc. are to be filed with the IFSC Authority as a Category I AIF.

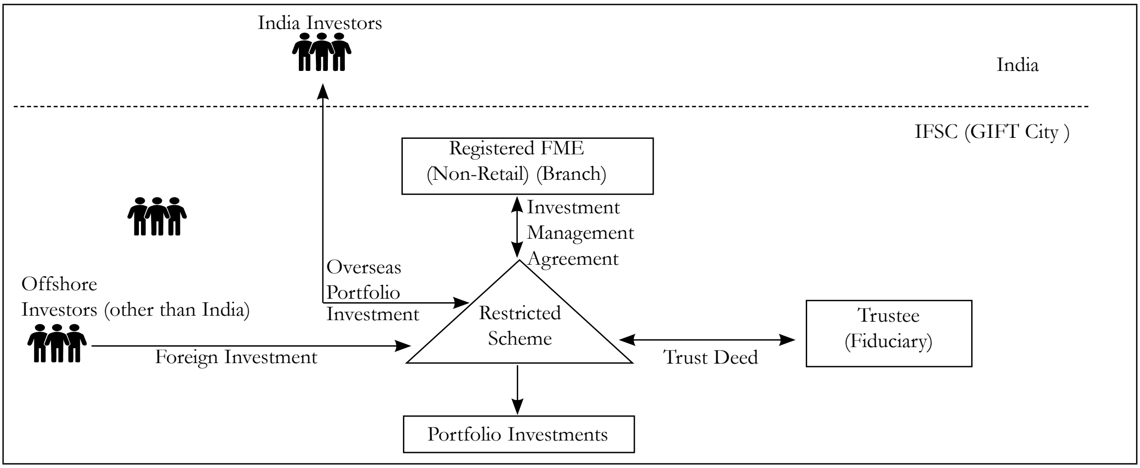
(b) On the other hand, FMEs launching Restricted Schemes (Non-Retail) for undertaking diverse or complex trading strategies including investment in listed or unlisted derivatives are to be filed as a Category III AIF.

(c) Restricted Schemes (Non-Retail) which do not fall either under (a) or (b) above shall be filed as a Category II AIF.

(d) The aforesaid schemes / AIFs can be set up as a trust, limited liability partnership ("LLP"), or a company in India. While each form of entity has its benefits and limitations, a trust structure is among the most popular choices and prevalent for setting up an AIF.

(e) A trust structure involves a settlor and a trustee getting the trust initiated, with the contributors / investors playing the role of beneficiaries of the trust contributing capital to the AIF under a contribution agreement. The AIF in turn enters into an agreement with an Investment Manager who is responsible for managing the AIF's investment activities. The investments are made and held by the AIF, with the beneficiaries entitled to their respective shares. The trust has no separate legal existence from its beneficiaries and hence, all the investments and income are held by the trustee in a fiduciary capacity for the beneficiaries.

(f) A diagrammatic representation of a typical fund structure is set out below:



2.2 Category I and II AIF

Tax pass through

(a) Under the provisions of section 115UB read with section 10(23FBA) of the IT Act, any income earned by AIF from its investments (other than profits and gains of business or profession, hereinafter referred to as "Business Income" or "PGBP") is exempt from tax for the AIF but taxable directly in the hands of the investors on a pass-through basis. The taxability in the hands of the investors is determined in the like and same manner as if such investment was made directly by the investors. Accordingly, the nature of income for investors is determined qua the nature of income earned by the AIF. For example, if AIF earns capital gain from sale of shares held in an Indian company, the investors are liable to tax under the head 'capital gains' at the rates applicable to respective investors.

(b) The Business Income is however taxable at AIF level at the rate specified in the Finance Act for AIF being a company or a limited liability partnership or at maximum marginal rate ("MMR") if the AIF is set up as a trust. Interestingly, the provisions of Section 80LA of the IT Act provides a tax holiday on 100% of the Business Income for a period of 10 assessment years (out of a block of 15 years) to a unit of IFSC which has been approved for undertaking such business in IFSC in a Special Economic Zone. The block of 15 years commences from the year in which the permission or registration is obtained under International Financial Services Centres Authority Act, 2019. Therefore, where the AIF qualifies to be a 'unit" within the provisions of Section 80LA, it could claim a tax holiday on its Business Income for any 10 years within the 15 years block. The AIF would however continue to be liable to minimum alternate tax under Section 115JB of the IT Act (where it is set up as a company that does not opt for concessional tax regime under

Section 115BAA of the IT Act) or alternate minimum tax under Section 115JC of the IT Act (for AIF set up as a trust or limited liability partnership). The Business Income which is taxed in the hands of the AIF is exempt from tax for the investors under Section 10(23FBB) of the IT Act.

Tax losses

(c) The tax treatment of losses incurred by the AIF is similar to the income related provisions discussed above. The unabsorbed loss under the head PGBP can be carried forward and set off by an AIF against its income under the head PGBP for the following 8 financial years (other than loss from speculation business which is allowed to be carried forward and set off against income from speculation business for 4 financial years).

(d) However, the losses other than under the head PGBP, shall be allowed to be carried forward and set-off in the hands of the investors of an AIF provided the units in respect of which the loss has arisen have been held by the investors for a period of at least 12 months.

Business Income vs Capital Gains

(e) As no tax pass through is available for Business Income, it is critical to assess whether the income arising from sale of shares and securities could be classified as Business Income or Capital Gains. Traditionally, the issue of characterisation of exit gains (whether taxable as Business Income or Capital Gains) has been a subject matter of litigation. There have been judicial pronouncements on whether gains from transactions in securities should be taxed as "Business Income" or as "Capital Gains". However, these pronouncements, while laying down certain guiding principles have largely been driven by the facts and circumstances of each case.

(f) Also, the Central Board of Direct Taxes ("CBDT") has provided guidance, vide its Instruction: No. 1827, dated 31 August 1989 and Circular No. 4/2007, dated 15 June 2007, in respect of characterisation of gains as either capital gains or business income. Following are the key illustrative factors indicative of capital gains characterisation (not Business Income):

(i) Intention at the time of acquisition – capital appreciation;

(ii) Low transaction frequency;

(iii) Long period of holding;

(iv) Shown as investments in books of accounts (not stock in trade);

(v) Use of owned funds (as opposed to loan) for acquisition;

(vi) Main object in constitution document is to make investments; and

(vii) Higher level of control over the portfolio vehicle.

Further, the CBDT had issued various circulars clarifying the position on income arising transfer of listed and unlisted shares and securities.

Accordingly, the characterisation of income as Business Income or Capital Gain needs to be assessed and determined based on the facts and circumstances of each case considering the principles set out in judicial precedents and various instructions and circulars issued by the CBDT.

Withholding tax obligation

(g) Given the pass-through status, it has been clarified (refer section 197A(1F) of the IT Act read with Notification no. 51 of 2015) that no tax shall be withheld by payor while making payment of any income (other than Business Income) to the AIF.

(h) However, the AIF is required to deduct tax at source at 10% in case of Indian resident investors and at the rates in force for the non-resident investors (which include rates prescribed under the applicable Tax Treaty), at the time of credit of income to the account of investors or payment, whichever is earlier (refer section 194LBB of the IT Act).

2.3 Investors in Category I and II AIF

(a) As mentioned above, Investors are liable to tax on income earned by AIF (other than Business Income). The tax liability is determined as if the investment by AIF was made directly by the investors and hence, the nature of income for the investors shall be the same as the income earned by AIF. Typically, an AIF could earn dividend income, interest income and capital gain on sale of shares and securities. An overview of the tax rates (excluding surcharge and cess) applicable to Indian resident and non-resident investors on different streams of income is set out in the table below:

Sr No.	Income stream	Indian resident investor	Non-resident investor[1]
1.	Dividend Income	Ordinary applicable rate (maximum being 30%)	20%
2.	Interest Income	Ordinary applicable rate (maximum being 30%)	40% (for foreign company) / 30% (for others)
3.	Long term capital gain on sale of listed shares which is subject to securities transaction tax ("STT")	Gain exceeding INR 100,000, taxable at 10%	Gain exceeding INR 100,000, taxable at 10%
4.	Long term capital gain on sale of listed shares (where STT is not levied)	10% (without indexation) or 20% (with indexation), whichever is lower	10%
5.	Long term capital gain on sale of listed securities (other than shares)	10% (without indexation) or 20% (with indexation), whichever is lower	10%

Sr No.	Income stream	Indian resident investor	Non-resident investor[1]
6.	Long term capital gain on sale of unlisted shares and securities	20%	10%
7.	Short term capital gain on sale of shares which is subject to STT	15%	15%
8.	Short term capital gain on sale of other shares and securities	Ordinary applicable rate (maximum being 30%)	40% (for foreign company) / 30% (for others)
9.	Gain on market linked debentures and specified mutual fund[2], deemed as short term capital gain in all cases (refer Section 50AA)	Ordinary applicable rate (maximum being 30%)	40% (for foreign company) / 30% (for others)

1 Re non-resident investors, no tax should be payable on income arising on or from investment by AIF in entities outside India.

2 Market Linked Debenture has been defined to mean a security by whatever name called, which has an underlying principal component in the form of a debt security and where the returns are linked to market returns on other underlying securities or indices and include any security classified or regulated as a market linked debenture by the Securities and Exchange Board of India ("SEBI"). Further, specified mutual fund has been defined to means a Mutual Fund by whatever name called, where not more than 35% of its total proceeds is invested in the equity shares of domestic companies. The definition of specified mutual fund is not limited to SEBI registered mutual funds and hence, there is an ambiguity on applicability of this deeming provision (section 50AA) on gain arising from units of other funds (such as an offshore fund, an AIF with debt investments, etc).

Further, section 90(2) of the ITA provides that the provisions of the IT Act would apply to the extent they are more beneficial than the provisions of the Double Taxation Avoidance Agreement ("Tax Treaty") between India and the country of residence of the non-resident investor, subject to satisfaction of relevant conditions. Eligibility to Tax Treaty benefit is a mixed question of law and fact and needs to be assessed based on various aspects (including investors tax residential status (as evidenced by a tax residency certificate), legal and beneficial ownership, control and management, substance and commercial rationale of a particular structure).

Indirect Transfer Tax

(b) Often the investment in AIFs is made by non-residents through a pooling vehicle / feeder fund situated outside India. While the investing entity is taxed on the income earned from AIF, the non-resident investors in such vehicle may also be liable to tax in India on income arising at the time of redemption or transfer of their shares / interest in such entity if it derives substantial value (directly or indirectly) from assets located in India ("Indirect Transfer Tax"), subject to any relief under applicable Tax Treaty. The 'substantial value' test is met where the value of Indian assets (held by investing entity, directly or indirectly) (i) exceeds INR 100 million; and (ii) represents at least 50% of the value of the offshore entity. However, there are certain exceptions available to this Indirect Transfer Tax as set out below:

(i) Small shareholder exemption: The non-resident shareholders (along with its associated enterprises) do not hold (a) the right of control or management in the offshore entity; and (b) the voting power or share capital or interest exceeding 5% in such offshore entity, at any time during 12 months preceding the date of transfer.

(ii) FPI exemption: The offshore entity is registered as Category I Foreign Portfolio Investor ("FPI") and the investment by the offshore entity is made in an AIF under the FPI route.

(iii) AIF specific exemption: The redemption or buyback of share or interest held in the offshore entity is in consequence of transfer of shares or securities held in India by an AIF which is chargeable to tax in India (subject to certain conditions).

2.4 Category III AIF (only non-resident investors, except for sponsor / manager)

(a) As a unique approach, a special tax regime has been introduced for Category III AIF which has only non-resident investors (except for the sponsor or manager). Under this regime, the investors are completely exempt from tax on the income earned from investment in a Category III AIF as per Section 10(23FBC) of the IT Act.

(b) While AIF is liable to tax on dividend income, interest income and capital gain on sale of shares in an Indian company, following income streams are exempt from tax (refer Section 10(4D) of the IT Act):

   (i) Capital gain on transfer of bonds, global depository receipts, rupee denominated bonds and derivatives, on a recognised stock exchange located in any IFSC and where the consideration for such transaction is paid or payable in convertible foreign exchange.

   (ii) Income from transfer of securities (other than shares of an Indian resident company).

   (iii) Income from securities issued by a non-resident (not being a permanent establishment of a non-resident in India) and where such income otherwise does not accrue or arise in India.

   (iv) Income from securitisation trust subject to certain conditions.

(c) Tax on dividend income and interest from securities is taxable at the rate of 10% (with no surcharge and cess being applicable). Long term capital gain on sale of equity shares held in an Indian company is taxable at 10% (plus surcharge and cess) whereas short term capital gain is taxable at 30% / (15% on sale of equity shares which is subject to STT), plus applicable surcharge and cess (refer section 115AD of the IT Act).

(d) The aforesaid tax treatment is limited to the income of AIF which is attributable to non-resident unitholders (not having a permanent establishment in India). While this regime is indeed attractive from India standpoint, the non-resident investors may have to assess availability of credit for taxes paid by AIF in India against the tax liability in their home jurisdiction and resultant impact on the net cash position.

2.5 Category III AIF (mix of Indian resident and/or non-resident investors)

(a) For Category III AIF which is set up as a trust and has Indian resident investors or a mix of Indian resident and non-resident investors, the general trust taxation principles would apply (refer section 160 to 163 of the IT Act). Typically, these trusts are irrevocable and determinate in nature and hence, the trustee is liable to tax as representative assessee of the investors, in the like and same manner as the investors.

(b) Once the income is taxed in the hands of the trustee (as a representative assessee), there should not be any further tax implications on subsequent distribution of the said income by the trustee in the hands of the investors. Having said that, the tax authorities have an option to assess the tax in the hands of the investor or in the hands of the trustee. Where the tax authorities assess to tax AIFs income in the hands of the investor directly, based on certain jurisprudence, the tax, if any, paid by the trustee in its capacity as a representative assessee should be available as credit against the tax liability, if any, of the investors.

2.6 Other key considerations

(a) Tax neutral relocation of offshore fund

Offshore funds established in countries having a Tax Treaty with India, may also seek benefit of tax neutral transition, and may migrate to IFSC by transferring its assets to an IFSC based fund on or before 31 March 2025, for a consideration that is discharged in the form of shares/units of resultant IFSC based fund. Relocation of such offshore fund to an IFSC based fund is tax neutral for the offshore fund, IFSC based fund and its investors, subject to prescribed conditions (refer section 47(viiac) and 47(viiad) of the IT Act).

(b) Deemed income on investment in shares / securities

In terms of Section 56(2)(x) of the IT Act, if shares / securities (including units of AIF) are received for a consideration which is lower than its fair market value of the shares / securities (computed as per prescribed rules) ("Tax FMV"), the difference between such Tax FMV and the purchase price is deemed as ordinary income of the recipient.

Thus, if an investor acquires units of the AIF or if the AIF acquires shares or securities of the investee companies at a price below its Tax FMV, the difference between such Tax FMV and the price paid would be taxed as ordinary income under the IT Act.

Separately, on sale of shares other than "quoted shares", its Tax FMV is deemed to be the minimum sale consideration for computing the capital gains tax. "Quoted share" is defined as the share *quoted on any recognised stock exchange with regularity from time to time, where the quotation of such share is based on current transaction made in the ordinary course of business."*

(c) Tax collection at source ("TCS") on remittance under Liberalised Remittance Scheme ("LRS")

An authorised dealer, who receives an amount, for remittance outside India from a buyer, being a person remitting such amount under LRS is required to collect tax at source at the rate of 5%. The Finance Act, 2023, has deleted the words 'outside India' from the provisions and increased the TCS rate from 5% to 20% for all LRS payments (with effect from 1 October 2023) and hence, TCS could apply on Indian residents investing in IFSC based AIF under LRS (refer section 206C(1H) and circular 10 of 2023). The Indian resident individuals can claim credit of TCS paid against their tax liability in India or claim a refund in the tax return.

(d) Exemption from Permanent Account Number and return of income

Non-resident investors in an AIF set up in IFSC have been exempted from obtaining Permanent Account Number and filing income tax return in India provided the only income earned by such investors during the relevant financial year is from the IFSC based AIF, on which applicable taxes have been deducted at source and subject to certain other prescribed conditions (refer Rule 114AAB of the Income Tax Rules, 1962 and notification No. 55 of 2019).

3 FAMILY INVESTMENT FUNDS IN IFSC

3.1 FIF structure

(a) The IFSC Regulations define FIF as a self-managed fund pooling capital only from a single family. The term 'single family' has been defined to "mean a group of individuals who are the lineal descendants of a common ancestor and includes their spouses, children, entities such as sole proprietorship firm, partnership firm, company, limited liability partnership, trust or a body corporate, in which an individual or a group of individuals of a single-family exercises control and directly or indirectly hold substantial economic interest.

(b) FIF is gaining prominence given the flexibility for Indian residents to invest overseas and in due course, has the potential to replace jurisdictions such as Singapore for setting up family offices (at least by Indian based families). A FIF can be set up by an individual or an entity in India by settling a contributory determinate trust or by setting up an LLP or a company in IFSC.

3.2 Taxation of FIF

(a) Unlike AIFs, the IT Act does not provide for pass through status to FIFs.

Consequently, any income earned by FIF would be taxed at FIF level. Tax rates would depend on the form of entity set up as FIF. If FIF is set up as a trust, taxation would be same as discussed in paragraph 2.5 above. If FIF is set up as a company or LLP, its investment would be taxed at the rates (excluding applicable surcharge and cess) set out as under:

Sr No.	Income stream	Company	LLP
1.	Dividend Income	Ordinary applicable rate (ranges from 22% to 30%)	30%
2.	Interest Income		
3.	Long term capital gain on sale of listed shares or sale of shares under offer for sale, which is subject to STT	Gain exceeding INR 100,000, taxable at 10%	
4.	Long term capital gain on sale of listed shares outside the exchange	10% (without indexation) or 20% (with indexation), whichever is lower	
5.	Long term capital gain on sale of listed securities (other than shares)	10% (without indexation) or 20% (with indexation), whichever is lower	
6.	Long term capital gain on sale of unlisted shares and securities	20%	
7.	Short term capital gain on sale of shares which is subject to STT	15%	
8.	Short term capital gain on sale of other shares and securities	Ordinary applicable rate (ranges from 22% to 30%)	30%
9.	Gain on market linked debentures and specified mutual fund2, deemed as short term capital gain in all cases	Ordinary applicable rate (ranges from 22% to 30%)	30%

Any subsequent distribution of profits by FIF (being a company) as dividend would be taxable for shareholders at ordinary rate (maximum being 30%, plus surcharge and cess). On the other hand, profit distribution by LLP to its partners is tax exempt.

4 OFFSHORE BANKING UNITS IN GIFT IFSC

4.1 Introduction

As widely noted, various non-resident investors take exposure to Indian securities through offshore derivative instruments ("ODIs") issued by foreign banks registered as an FPI. In an endeavour to provide direct access, the banking units set up in IFSC are now allowed to issue ODIs to the non-resident investors. Consequentially, the taxation is sought to be brought at par with taxability on issuance of ODIs by an offshore banking unit set up outside India.

4.2 Taxation

(a) An investment division of an offshore banking unit (set by a non-resident in IFSC), which is registered as a Category I FPI and has commenced its operations on or before 31 March 2024, is exempt from tax (refer section 10(4D)) on income arising from:

- (i) transfer of bonds, global depository receipts, rupee denominated bonds of an Indian company and derivatives, on a recognised stock exchange located in any International Financial Services Centre and where the consideration for such transaction is paid or payable in convertible foreign exchange.

- (ii) transfer of securities (other than shares of an Indian company).

- (iii) securities issued by a non-resident (not being a permanent establishment of a non-resident in India) and where such income otherwise does not accrue or arise in India.

- (iv) a securitisation trust subject to certain conditions.

(b) Accordingly, the investment division of an offshore banking unit is liable to pay tax only on following income streams (refer section 115AD):

- (i) Interest and dividend income earned from India: Taxable at 10% with no surcharge and cess being applicable.

- (ii) Capital gain on sale of shares in an Indian company: Long term capital gain is taxable at 10% (plus surcharge and cess) and short term capital gain is taxable at 30% (plus surcharge and cess); or 15% plus surcharge and cess (for gain on sale of shares which is subject to STT).

(c) Further, any income earned by a non-resident as a result of transfer of non-deliverable forward contracts or ODIs entered into with an offshore banking unit is exempt from tax. This tax exemption has been extended to income distributed by offshore bank unit on ODIs. As a result, distribution of interest, dividend income and capital gain on sale of shares in Indian company (which is taxable for offshore banking unit), shall be exempt from tax for the non-residents who have entered into ODIs with the offshore banking unit in IFSC (refer section 10(4E)).

(d) Further, any business income derived from an offshore banking unit set up in IFSC is eligible for tax holiday of 100% for 10 consecutive assessment years out of 15 years, beginning with the year in which permission referred to in Section 23(1)(a) of the Banking Regulation Act was obtained.

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