asifma
ASIA SECURITIES INDUSTRY & FINANCIAL MARKETS ASSOCIATION

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Via Hand Delivery

April 24, 2012

The Hon. Shri Pranab Mukherjee
Finance Minister
Ministry of Finance
North Block
New Delhi 110001

Dear Finance Minister,

Re: Continued concerns related to application of the GAAR and the indirect transfer rules to cross-border portfolio investments under the proposed Finance Bill 2012

I write on behalf of the membership of the Asia Securities Industry & Financial Markets Association (ASIFMA),[1] to follow up on my letter of March 28, 2012. We thank you for the continued opportunity to convey our remaining concerns related to the adverse effects of certain tax implications for foreign investors in the Indian Capital Markets under the Finance Bill 2012 (the "Bill").

As part of foreign institutional investor ("FII") efforts to work with Government of India officials to resolve these issues, and at the request of the GAAR panel, we recently provided an outline of the industry's specific concerns and suggested solutions to the issues raised by the Bill. Nevertheless, the two main areas of concern highlighted in our earlier representations (copies of which are attached) remain unresolved, namely: the general anti-avoidance rule (GAAR) and the proposed indirect transfer rules as they each apply to cross-border portfolio investments. In particular, the GAAR provisions as written bestow tremendous discretion upon tax officials to reconstruct transactions at later dates and in unpredictable ways – this creates a strong degree of uncertainty that could provide a disincentive to FII participation in the Indian capital markets. While we understand the rationale behind the imposition of a GAAR regime, our concerns are not the creation of the regime, but our submission that the rules are so broadly drafted that it creates significant uncertainty with respect to how it will be applied. We further submit that the rules are more broadly and widely drafted than the international standards.

The international portfolio investment community continues to believe that **the only practical solution to these issues is an unequivocal exemption for cross-border portfolio investments in Indian securities from both the GAAR and the indirect transfer rules**.

We understand that these proposed tax laws were written to address certain judicial decisions and believe that the overly broad draft provisions cast a wide net that will inadvertently capture non-targeted transactions and market participants. Government leaders have the ability to avoid these unintended consequences, and the likelihood of extreme market disruption, by **applying the**

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international norm of legislating to exempt cross-border portfolio investments by FIIs from both the GAAR and the indirect transfer rules. FIIs facilitate investments in India for clients and other investors and have a responsibility to ensure that these important constituencies understand the tax implications of such investments. As of March 16, FIIs had assets under custody of more than INR 10tr (more than USD 200bn) or 17% of the capitalization of Indian securities markets, much of this provided by broad-based global funds. These investments are vital to the liquidity and efficient functioning of the Indian capital markets, which are an important source of funding and financing for the real economy.

Without the *portfolio exemption* for portfolio investors, the continued uncertainty regarding the proper taxation of these investments will render FIIs unable to articulate clearly the tax consequences of investing in Indian listed securities. **Exemption of cross-border portfolio investments would permit FIIs to continue to play their supportive role in the Indian economy uninterrupted, while also continuing to pay taxes in line with internationally accepted practice**.

We appreciate that the Government could consider alternative solutions, such as clarifying all 10 GAAR tests, but such options would have serious pitfalls and would require painstaking drafting and clarifications that -- even if successfully executed over time, which we doubt is possible -- arguably would gain ultimately little in terms of revenue for the Government and come at the cost of prolonged market disruption and uncertainty. Regardless, such solutions could not be achieved in the short term. Accordingly, we note that no major economy in the world has chosen to collect taxes from cross-border portfolio investments in the listed securities markets, and we are concerned that negative and unintended consequences will result if India puts its capital markets at risk by establishing a tax regime inconsistent with globally accepted norms.

Investors require predictability with respect to the application of tax laws. Without a reliable system of taxation, there is a significant risk that many market participants may conclude that it is far more responsible to their shareholders and investors to avoid the Indian capital markets altogether and redirect their funds and resources to other opportunities. In fact, we can already see that the markets are not handling this uncertainty well, with some financial institutions no longer making new investments and various international investors withdrawing their existing investments from the Indian markets.

To this end, since the announcement of the Finance Budget on March 16, net FII inflows have slowed dramatically. FII net inflows from the start of 2012 till March 16 were INR 437bn, while between March 17 and April 16 they stood at a mere INR 8bn, an effective daily average drop of 95%. Reduced FII participation has also had a perceptible impact on market volumes. The average daily turnover of the NSE and BSE cash segment MTD as of April 16 was down 25% compared to the first three months of the year (INR 127bn vs. INR 131bn). The impact was similar in the futures and options segment which was down 28% (INR 1195bn vs. INR 1230bn) for the same period. The data is further corroborated by feedback from local brokerage houses that are reporting sharp drop-offs in FII trading interest in general due to the uncertainty around GAAR implementation. The little activity that has taken place has mostly been to unwind positions. Accordingly if this issue is left unresolved, we reiterate our consistent concern that **there is a risk of a disorderly unwinding of significant FII holdings in the Indian capital markets**.

Turning to the second point of concern, the indirect transfer rules also cause particular confusion for international portfolio investors. Though we very much welcome your statements that participatory note (P-Note) holders would not be taxed under the GAAR provisions, multiple taxation is still possible under the indirect transfer rules. FIIs are also concerned that redemptions from the funds may be taxed under the indirect transfer rules. A straightforward reading of the draft legislation leads us to believe that double or even triple taxation of the same profits is very possible.

While the international portfolio investor community also welcomes Government assurances that disastrous and often punitive tax adjustments will somehow be avoided, these statements nevertheless have been expressed only verbally to date and in a broad manner. In reality, it will be extremely difficult to define what constitutes "adequate" commercial substance under the GAAR and, even if an FII succeeds in demonstrating "commercial substance," other provisions of the GAAR can still be used by tax officials to assert tax liability. Again, this establishes a level of uncertainty that could create a disincentive for FII participation in Indian markets.

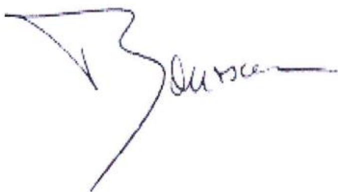
Unfortunately, given the typical size of FII portfolio investments, and FIIs' corporate and client responsibilities, these statements are insufficient to mitigate the significant risk of unforeseen tax liabilities. To this end, international portfolio investors continue to be advised by chartered accountants and legal experts that significant tax consequences remain for FIIs under the draft legislation. Furthermore, the prospect of possible years of litigation to confirm tax rules adds a further disincentive.

In light of our recent assessments, the advice from leading Indian legal and tax experts, and the pattern of precedents emanating from Indian tax authorities, it is imperative that a clear statutory basis be provided to support Government assurances in relation to the potential effects of these budget proposals on international portfolio investors.

Again, we would prefer to receive such assurances in the form of an exemption from both the GAAR and the indirect transfer rules for *cross-border portfolio transactions*, as anything else would prolong resolution of these issues and risk leading to general market instability. Therefore, we continue to urge the Indian Government to embrace a tax regime that is in line with international precedents.

The international portfolio investment community would welcome the opportunity to provide additional information or arrange for more detailed discussions of these issues with ASIFMA member representatives. Please contact Will Sage, ASIFMA Managing Director at: office: +852-2537 3895 or email – wsage@asifma.org.

Yours sincerely,



Nicholas de Boursac
CEO
Asia Securities Industry & Financial Markets Association

Attachments

CC:

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Release Date: March 28, 2012
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ASIFMA and SIFMA Urge Indian Finance Ministry to Address Unintended Tax Consequences of Finance Bill, 2012

Hong Kong, March 28, 2012—ASIFMA, joined by global alliance partner SIFMA, today sent a letter to Indian Finance Minister the Hon. Pranab Mukherjee urging him to act to preempt portions of the Finance Bill, 2012 ("Bill") that will adversely affect investment in the Indian capital markets.[1] A copy of the letter follows.

In particular, ASIFMA members believe implementation of the Bill's provisions relating to taxation of indirect transfers of assets, as well as the General Anti-Avoidance Rule ("GAAR"), are too broadly worded and could be interpreted to tax investments by Foreign Institutional Investors ("FIIs") in the Indian listed equity markets.

Nicholas de Boursac, ASIFMA CEO, also stressed, "The financial services industry is concerned that these tax proposals may inhibit the efficient operation of the Indian debt and equity markets. We believe that many of these consequences are unintended, and we urge the Finance Ministry to clarify the scope of the tax proposals and thereby avert unnecessary disruption to the Indian capital markets. Incorporating some of the recommendations of the Standing Committee on Finance would go a long way to resolving this important and urgent issue."

The relevant provisions of the Bill are expected to take effect on April 1, 2012, and it appears that market participants have already begun to reduce their positions in India. FIIs have assets under custody of more than Rs. 10 lakh crores (over US$200 billion) or 17% of the capitalization of India's equity markets. In addition, they invest substantial sums in Indian government and corporate debt.

FIIs fear that the new tax rules could subject this foreign investment to double or triple taxation. Such onerous taxation – or even the risk of such taxation – could threaten this important source of capital for India's businesses. In the meantime, FIIs are carefully evaluating these new tax risks.

In the letter to Finance Minister Mukherjee, ASIFMA and SIFMA confirmed the industry's commitment to supporting the development of the Indian economy and recognized India's potential as an important investment jurisdiction, noting that clarification of these tax provisions would help such efforts.

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[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.

The Securities Industry and Financial Markets Association (SIFMA) brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit http://www.sifma.org

28 March 2012

The Hon. Pranab Mukherjee
Finance Minister
Ministry of Finance
North Block
New Delhi 110001

Dear Finance Minister,

Re: Certain amendments proposed by the Finance Bill, 2012, (the 'Bill') to the Income-tax Act, 1961

On behalf of the membership of the Asia Securities Industry & Financial Markets Association (ASIFMA)[1] and the Securities Industry and Financial Markets Association (SIFMA)[2], we are writing to express our deep concern that certain portions of the Finance Bill 2012 ('Bill') could adversely impact investment in the Indian capital markets by the global investment community.

Specifically, the Bill's provisions relating to taxation of indirect transfers of assets as well as the General Anti-Avoidance Rule ('GAAR') are very broadly worded and could be interpreted to tax Foreign Institutional Investors ('FIIs') on their investments in the Indian listed equity markets.

FIIs are significant sources of foreign direct investment in India, with assets under custody of more than Rs. 10 lakh crores (over US$200 billion) or 17% of the capitalization of India's equity markets. They have also infused substantial sums in buying Indian Government and corporate debt and are keen to increase such investments, regulations permitting. Global investors who do not qualify as FIIs or Qualified Foreign Investors ('QFIs') rely on these institutions to invest in the Indian capital markets. FIIs fear that the new tax rules could subject this foreign investment to double or triple taxation. Such onerous taxation – or even the risk of such taxation – could threaten this important source of capital for India's businesses.

Since the budget announcement on March 16, an enormous amount of attention has been paid to these taxation issues within the investor community. FIIs are carefully evaluating these new tax risks. Some institutions have told their clients that they will not take on any new India positions. Others are hopeful that once the Indian government understands the gravity of the situation the tax rules will be clarified. However, if these tax uncertainties are not resolved quickly we fear that FIIs will decide that the tax risks are unacceptable. These investors may then proceed to liquidate their India investments and such a

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disorderly dissolution of large positions held by these overseas investors could seriously disrupt the Indian capital markets.

We believe these tax results are *unintended* consequences of the Bill and that the solutions are straightforward. The Standing Committee on Finance ('Standing Committee') has given detailed recommendations with respect to the indirect transfer and the GAAR provisions. Their recommendations would avoid market disruptions.

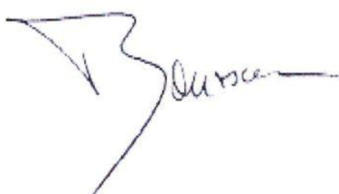
- ***Explanation 4 to Section 9((1)(i) and Explanation to Section 2(14):*** The Bill should incorporate the Standing Committee's recommendations that the indirect transfer rules should not apply to indirect ownership of "small shareholdings" of Indian companies. We understand that this recommendation was intended to ensure that the indirect transfer rule would not affect portfolio investments in listed securities.
- ***GAAR:*** The Bill should reflect the Standing Committee's recommendations that "there should be certainty on the GAAR provisions so that foreign investors do not become wary of investing in India." For this purpose, we believe that the GAAR should not apply to "small" investments in listed securities or derivatives that reference these securities or debts held by FIIs.

For both purposes, a "small" investment could be defined as an interest of 10% or less of an Indian listed company (in keeping with the 10% investment limit for each FII). For debts held by FIIs, such as government bonds and listed corporate bonds, these would be within the prescribed limits set by the Securities Exchange Board of India (SEBI). If the Bill were to incorporate these two simple suggestions, then we believe that the Indian capital markets would not be disrupted and the tax authorities would retain the right to tax transactions as intended in the Bill.

As an industry, we are committed to the Indian economy and recognize the potential of India as an investment jurisdiction. We are not averse to paying the appropriate level of Indian taxes, as long as the rules are clear so that investors can plan their affairs with a degree of certainty. Clarifying the above issues will go a long way in further making India an attractive investment jurisdiction.

We are happy to nominate people from among our memberships to work with your team to deliberate on the above issues. Please contact Will Sage, ASIFMA Managing Director at: office - +852 2537 3895; mobile - +852 9813 1519 or email – wsage@asifma.org.

Yours sincerely,



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Release Date: March 30, 2012
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ASIFMA Responds to the Indian Finance Minister's Statements on the Tax Consequences of Finance Bill, 2012

Hong Kong, March 30, 2012—The Asia Securities Industry & Financial Markets Association (ASIFMA) appreciates the Finance Minister's recent statements, reported by a number of media outlets, as an attempt to work with the industry to resolve the issues raised by the Finance Bill, 2012 (Bill).

It is helpful to know that the indirect transfer rules will not apply to participatory notes (P-Notes) holders. However, the industry would have preferred to have been consulted in advance of such a major change, before the Indian Government confirmed its plan to pursue taxation of Foreign Institutional Investors (FIIs) themselves. This type of approach would have had a less disruptive effect on capital market flows, while still resulting in a fair and equitable result.

ASIFMA CEO Nicholas de Boursac stated that "The news about P-Notes is positive. But threats of taxation directly on FIIs could seriously disrupt the Indian capital markets."

The Bill is set to take effect on Monday, April 1st and is expected to have significant impacts on FIIs.

The concerns outlined in ASIFMA's letter (www.asifma.org) Wednesday remain, namely that FIIs may be subjected to substantial levels of taxation as the new rules come into force. "We look forward to continued and constructive conversations to protect these foreign direct investment flows and will work to support the best interests of the Indian capital markets," said Mr. de Boursac.

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