asifma

Growing Asia's Markets

30 September 2019

By Electronic Delivery

Attention:
Mr. Jithesh John
Department of Economic Affairs
Ministry of Finance
57, North Block
New Delhi, India 110001

Re: India Tax Regime Streamlining and Rationalisation

Dear Mr. John,

At the outset, Asia Securities Industry & Financial Markets Association ("ASIFMA")[1] commends the Government for introducing landmark tax reforms through the Taxation Laws (Amendment) Ordinance, 2019 by reducing Corporate Tax rate to 25% for existing companies and to 17% for new manufacturing companies. This historic measure to introduce globally competitive tax rates should help India attract stable long-term foreign investments and innovate solutions, which would augur well for the broader economy.

ASIFMA would like to thank you for the opportunity to provide feedback on taxation in the India capital markets and suggestions to streamline and rationalise the current regime in India. ASIFMA has made regular submissions on specific tax issues with the MOF over a number of years; however these have been very detailed and technical. We are now delighted to provide some high-level suggestions for streamlining the tax regime affecting the India capital markets. It should be noted that streamlining and rationalization of the tax regime in itself is not sufficient to promote foreign portfolio investment and must be coupled with the streamlining of the foreign portfolio regime including the reduction or removal of limits on investments and further market capital development which would among other things promote Indian bond inclusion into global benchmark indices.

The Government should encourage product innovation and foreign portfolio investor ("FPI") access by prescribing relevant and globally competitive tax rates for products traded in the Indian capital markets. Our specific suggestions on streamlining the Indian tax regime to make it more market-friendly are summarized below:

[1] ASIFMA is an independent, regional trade association with over 120 member firms comprising a diverse range of leading financial institutions from both the buy and sell side, including banks, asset managers, law firms and market infrastructure service providers. Together, we harness the shared interests of the financial industry to promote the development of liquid, deep and broad capital markets in Asia. ASIFMA advocates stable, innovative, competitive and efficient Asian capital markets that are necessary to support the region's economic growth. We drive consensus, advocate solutions and effect change around key issues through the collective strength and clarity of one industry voice. Our many initiatives include consultations with regulators and exchanges, development of uniform industry standards, advocacy for enhanced markets through policy papers, and lowering the cost of doing business in the region. Through the GFMA alliance with SIFMA in the United States and AFME in Europe, ASIFMA also provides insights on global best practices and standards to benefit the region.

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I. Promote a Stable Tax Regime in India
II. Removal of Capital Gains Tax on Equities
III. Removal of Complexity and Harmonisation of Tax Treatment
IV. Provide Consistent Tax Rates for Debt and other Capital Market Products
V. Grandfathering of Certain Provisions
VI. Uniform Tax Rate on Similar Capital Markets Activities

In the subsequent sections, we have set-out the rationale for our suggestions. We remain supportive of India's development and will be happy to coordinate our efforts to promote sustainable growth. Please let us know if further meetings with you and/or relevant representatives are needed in order to offer our feedback and ideas in a constructive and collaborative way. We would be glad to discuss any aspect of this feedback further with the Ministry of Finance.

If you have any follow up comments or questions, please feel free to contact Mark Austen (Chief Executive Officer, ASIFMA) at mausten@asifma.org or +852 2531 6510.

Yours sincerely,

Mark Austen
Chief Executive Officer, ASIFMA

Annexure

I. Stability of the Tax Regime

In order to promote confidence of foreign investors in the Indian capital markets, we recommend that India adopt as a policy maintaining stability in the regulatory regime, particularly in relation to tax.

One of the recurring issues that affects investors into the India market is the unpredictability and frequency of changes in the regulatory and tax regime, with little/no prior consultation. This does not create an atmosphere that is conducive to confidence in the Indian markets, as foreign investors can find themselves at the mercy of changing regulatory winds, interpretations in laws, costs in transitioning or developing infrastructure, which can be especially daunting when some regulations (in particular tax) may be retrospective in scope.

We advocate for increased transparency on the policy agenda and industry-wide consultations, including foreign investors, ahead of making regulatory changes or prescribing tax rates for capital markets products, being accessed by a wide range of investors.

II. Removal of Capital Gains Tax ("CGT") on Equities

We suggest **not** to charge any capital gain tax on investors from overseas in Indian equities to the extent the investment holdings fall within the permitted limits allocated to Foreign Portfolio Investors (FPI's) to bring India in line with the vast majority of countries worldwide. Very few countries (e.g. Pakistan, Bangladesh, India) have a combination of transaction taxes and capital gains taxes. Ignoring real estate, there is currently no income (including capital gain) taxation imposed on portfolio investments by corporate non-residents in the Americas (the USA, Canada and Mexico), in Europe (the UK, Germany, the Netherlands), and throughout Asia (Australia, China, Hong Kong, Indonesia, Japan, Korea, Malaysia, New Zealand and Singapore) excepting Pakistan, Bangladesh and India.

As the focus is on streamlining and rationalising the current regime, we suggest examining the CGT framework with a view to determining if there is a better method of taxation that can encourage long-term capital inflow, whilst at the same time meeting India's fiscal needs. In our view, CGT is a complex tax regime and the current method of collecting this tax is inefficient, administratively difficult and costly to foreign investors (especially since the introduction of long term CGT in 2018). We therefore recommend to have zero tax on overseas investors' capital gains on equities for the following reasons:

(i) Overseas Capital, unlike domestic capital, is not trapped capital and has various investment destinations to choose from where such taxes do not exist.

(ii) Overseas investments bring in essential capital into the domestic country, which helps in fuelling India's growth especially at a time where domestic banks are under pressure.

(iii) Transaction Taxes are easier to monitor, implement and collect where taxation is warranted for fiscal reasons.

(iv) US, UK, Canada, other most developed economies in Europe and developed/EM in Asia do not charge capital gains taxes as stated above so that puts India in a competitive disadvantage.

(v) It will help in growing India's domestic securities market at the expense of offshore trading destinations which seems to be a goal of the Indian government.

CGT particularly affects indexed investors, as CGT is not a tax which can be replicated in an index form (since it depends on timing of inflows and outflows) as it creates calculation complexity which raises concerns regarding tracking errors and has generated concerns and scrutiny by some major index sponsors.

Recently, Hon'ble Prime Minister Narendra Modi has specifically mentioned modifications to taxation of Indian equities on par with global equities tax regime in his speech at Bloomberg Global Business Forum held in New York on 25 September 2019 that. To quote, the Hon'ble Prime Minister said "*We will make necessary modifications on a regular basis on tax related laws and to bring tax on equity investments on a par with global tax regime.*"[2]

If removing CGT altogether is not possible, then removal (or at least reduction) of the Long-Term Capital Gains Tax ("LTCGT") on Equities may help in this regard. We recommend at minimum reverting to the old law – i.e. LTCGT on transfer of equity shares to be exempt under the Income-tax Act, 1961 (the "Act"). It should be acknowledged though that the existence of LTCGT rate of 10% can itself act as a discouraging factor for long-term investment into India by many investors. Attracting long-term foreign investments, by exempting LTCGT should result in the appreciation of the rupee amongst other fiscal benefits.

III. Removal of Complexity and Harmonisation of Tax Treatment

We suggest removing complexity of taxing different products within asset classes at multitudes of different rates. We recognize that incentives may be given to specific types of securities from time to time and we recommend that these incentives and the broader tax rates should be reviewed and streamlined on a regular basis. However, some areas could be harmonized now with respect to capital gains if these taxes are to be kept:

(i) **Harmonisation of Capital Gains**: Tax rate on capital gains arising on sale of equity and any other securities (including derivatives) in the hands of all taxpayers should be harmonised.

(ii) **Rationalisation of Debt and other products:** The tax rate for capital gains for debt securities and equity securities should also be identical. The period of holding to classify a security as "long term" is different between equity securities which has a period of 12 months and debt securities which has a period of 36 months. We suggest to streamline the holding period for all asset classes to avoid complexity of tax computation.

(iii) **Preferential / Differential Tax Rates:** Different rates for some foreign jurisdictions with respect to capital gains should be removed to encourage a level playing field and discourage tax jurisdiction shopping. Amend Section 10(38) of the Act to provide for exemption of tax on capital gains (long term and short term) from any capital gains tax on payment of Securities Transaction Tax (STT) as mentioned at point II above. Alternatively, we suggest to provide a most favored nation capital gain clause in all treaties in order to provide a level playing field to all market participants and remove any arbitrage between FPI's investing from different jurisdictions.

[2] https://www.livemint.com/news/india/wooing-investors-pm-modi-says-more-reforms-soon-1569433013056.html

(iv) **Bonus Share Issuances:**

- Bonus share issuances are a common occurrence in India. Whilst they should theoretically be roughly tax neutral (since the "gain" in newly issued shares is offset by the "loss" in the original shares – in the same way as a stock split is treated), this is not the case in many instances. Indian companies generally have to go for a bonus issue rather than stock splits due to the restrictions on par value which have to be adjusted for stock splits.

- The current tax treatment of bonus issues is skewed against long term holders as losses recognised on the original stock purchase which will be long term (holding more than 12 months) may not match or compensate for the gain realised on sale of the bonus issue which may be short term (holding less than 12 months), which creates a tax disadvantage for long-term holders.

- This negative effect is magnified for grandfathered stocks that are held in tax-treaty countries (such as Mauritius) since they are subject to a 0% CGT, but the newly-issued bonus shares are liable for the full 15% CGT.

- We advocate for closing this inconsistency, as it appears to be more of an unintended consequence than an actual objective of the Indian tax authorities, and merely acts to harm long-term investors.

IV. Provide Consistent Tax Rates for Debt and Other Capital Market Products:

Debt and other capital market products rely on interest rates for their effective pricing. Taxation of interest and other flows affects the pricing of debt products. In this light, taxation of debt and other similar products should be predictable and consistent over the long-term.

(i) **Fixed Income Products**:

- Treatment of withholding tax (WHT) for bonds/debentures[3]:

  - Commercial debt investments returns are measured on net interest margin i.e., interest earned less funding and other expenses. A high WHT on interest received without any allowance for deductions of expenses reduces and could even make the return negative. This lessens the appetite of such lenders for these debt issuances by India.

  - The Government of India has reduced the withholding tax (WHT) on interest on borrowings made in foreign currency by such companies from a source outside India and on long term infrastructure bonds from the 20% to 5% before 1st July 2020 under Section 194LC of the Act.

  - The government has reduced the WHT from 20% to 5% before 1st July 2020 under Section 194LD of the Act on interest paid to FPI on rupee borrowings made through Government securities, Treasury bills and qualifying corporate bonds.

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[3] NB: The term bonds/debentures are interchangeably used in the context of investments by Foreign Portfolio Investors in debt instruments issued by Indian companies

- Voluntary Retention Route has been introduced for FPIs since March 2019, which specifies a minimum retention period of three years. For FPIs to invest with certainty over this period, the WHT rate should be made known upfront.

- For the aforesaid reasons, we request the government to consider extending the lower WHT regime (and the tax holiday for Masala bonds) for another 5 years before 1st day of July 2025. This would ensure stability of the tax regime so investors can make informed, long term decisions with respect to India.

- Additionally, FPIs were allowed to invest in securitized debt instruments in 2016. However, by not including securitized debt in the list of instruments eligible for the concessional withholding tax rate of 5%, these instruments have become very unattractive for any FPI to invest in compared to other debt instruments. We request an amendment to Section 194LD of the Act to include securitized debt instruments as well.

- There are **several conditions which are imposed while providing the lower WHT** rate such as limit on the interest rates approvals from government and payee type being FPI which should be removed. We believe that in situations like credit quality of Indian borrower being low, and resultant interest rate being higher, the issuer of the bonds may not be able to take advantage of the reduced 5% WHT regime due to the conditions specified under the proviso to Section 194LD(2) and Item (ii) of Section 194LC(2) of the Act. This would substantially further increase the cost of borrowing for the issuer:

  - Amend Section 194LC and Section 194LD of the Act to extend the sun set dates till 1st July 2025 (as noted in (iv) above) from the current 1st day of July 2020.

  - Amend the aforesaid sections to remove restrictions as to rates of interest, payee type and approval from government.

- Provide clarity on taxation of **Separate Trading of Registered Interest and Principal of Securities** (STRIPS).

- **Zero-coupon bonds (ZCB)** that are held to maturity should be deemed as capital gains instead of interest income.

(ii) **For FX Products**: We suggest consistency in tax treatment for FX hedging transactions is required. Align India to other financial centres such as Singapore, Hong Kong and London, i.e., by levelling no tax on FX transactions for non-residents.

(iii) **For Equity Products:** For a local entity, currently there is some ambiguity around ability to **offset gains/losses from stock trading against losses/gains on derivatives**, as the former is classified as speculative and the latter is non-speculative. This seems inconsistent for a broking entity which is into the business of trading in stocks and derivatives. The two should be treated the same for tax purposes. This will help foreign investors set up trading businesses onshore.

V. Grandfathering of Certain Provisions:

(i) **Investments Made prior to April 2020 from Anti-Avoidance Rules under Tax Treaty:** Any positions created prior to 1 April 2020 should be grandfathered from the purview of treaty-based anti-avoidance provisions (specifically, Principal Purpose Test arising from OECD BEPS Action Plan 6) irrespective of when these positions are sold. This would prevent for those positions (e.g. stocks) sold after 1 April 2020 from being adversely taxed. Where the tax office is able to invoke anti-avoidance rules in respect of investments made prior to such rules coming into effect, it would amount to a form of retrospective taxation. This specific provision (grandfathering) already exists for the Indian GAAR Rules which came into effect on 1 April 2017. In that case, it was specified that positions pre 1 April 2017 will not be subject to GAAR even if they are sold post that date. The recommendation is to provide a similar grandfathering to treaty based anti-avoidance rules.

Further, the multilateral BEPS regime is being developed and is expected to be operational from April 2020. It would greatly benefit market participants and global investors if the tax authorities publish a white paper on their approaches to implementation of BEPS anti-avoidance rules in India. Such transparency would help foster greater confidence for capital market intermediaries and would encourage growth in volumes traded on the Indian markets.

(ii) **Tax Neutral Platform for Reorganising Mauritius Investments:** As it is one of India government's objective to reduce investments in India being routed through Mauritius, we recommend allowing the transfer of grandfathered assets in Mauritius with no negative tax implications:

- Currently, in order to move Indian assets from being held via Mauritius, FPIs would have to sell the assets held via Mauritius on market buy them back in India.
- This would mean losing the grandfathered CGT status of those securities, and crystallising taxes such as the STT on transfer as these transactions must be done on-market, which is not in the best interests of the FPIs & their investors.
- We advocate for a one-off allowance to enable the transfer of assets from Mauritius whilst still retaining the grandfathered 0% CGT status of the original assets, and not having to crystallise any tax liability, as a mean to incentivise a simple shift to direct investment by FPIs from their home countries.

VI. Uniform Tax Rate on Similar Capital Markets Activity:

Taxpayers should be treated the same for tax purposes for the same activity: for example, the tax surcharge rate should be the same for corporates, partnerships, trusts, etc. for the same activity. While we welcome the rollbacks on 23 August and 20 September of higher surcharge of all kinds of capital gains arising to FPIs including debt securities, we note that the highest effective rate for FPIs still varies for the same activity depending on the legal structure (e.g. Corporates, partnerships, trusts) which adds to the complexity of the regime thereby creating uncertainty and opportunities for arbitrage by different types of investors.

If capital gains taxes are to continue to be applied to foreign investors, these types of discrepancies should be streamlined and rationalized. FPIs should be treated the same by adopting a common tax rate which is consistent with a fundamental principle of tax law, to treat the same activity in the same manner, in order

to not prefer one structure over another and treated different entities differently for no obvious reason which creates arbitrage opportunities.

The increased surcharge rate has been clarified (by Press Release and Tax Amendment Ordinance) not to be applicable to capital gains, but it is still applicable to other types of income such as interest income. This is the first time India has introduced multiple surcharge rates on a taxpayer. Compliance for local tax agents, FPIs, and the tax authority will be challenging. We would like to seek additional clarity to figure out how to calculate tax correctly (or preferably abolish the increased surcharge on income for FPIs). Please refer to the **Appendix** for a summary of applicable tax rates to FPIs.

To give another example, pension funds (usually exempted from tax in most large economies) are subject to capital gains when registered as FPIs in India while mutual funds in India are treated as pass-through structures and have a different tax treatment. These should be rationalised.

VII. Other Recommendations

(i) **Off-Market Free of Cost Transfers & Intra Group Reorganizations:** These types of transfers should be allowed to be made free of tax. Examples include: (a) In line with other jurisdictions, we suggest SEBI permits off-market free of cost transfers for restructuring of funds (e.g. mergers, consolidation, re-organisation or re-domiciliation requiring a new PAN) that have exposure to India stocks. Requiring such restructurings to be done through the stock exchange would trigger various taxes as well as market volatility; (b) Reorganizations of FPIs are taxable in India if one of the entities is a non-corporate (i.e. trust), but is non-taxable if both entities are corporations. Intra-group reorganizations should be non-taxable in India if they are non-taxable in their home country; and (c) A change in location will result in tax implications. For example, a fund relocating from one state in the US to another will require a PAN and legal entity change although the investors remain unchanged. This change results in a transfer of assets in India with tax applicability.

(ii) **Tax Scrutiny:** We recommend that cases be selected for scrutiny only on certain criteria and to have a speedy disposal mechanism of long-standing disputes on the same issue over multiple years.

(iii) **Tax Certification & Other Procedural Matters:**

- *One-Time Certification*: To allow for a one-time certification or at least a low renewal frequency (e.g. maximum on a yearly basis) of an investor's non-resident status under applicable tax treaties for interest on debt securities rather than on a per payment certification basis as is the case now.

- *Notarising Documents*: No local notarisation of documents should be required, and allow intermediaries to centralise the original certificates and maintain the originals for record keeping purposes.

- *Principle Date for Withholding Tax:* Only withholding tax based on the principal date should be taken into consideration if tax is required. As taxation on capital gain is complex and it is costly to compute, the tax should not be calculated based on the holding period;

- *Enabling Onshore Management of Offshore Funds:* The replacement of the requirement to receive an arm's length remuneration (having regard to the transfer pricing provision) with a method to be prescribed by the CBDT is a positive step in assuring eligible investment funds that

the safe harbor obtained under Section 9A of the Act would not be rendered null and void pursuant to an adverse transfer pricing scrutiny assessment. Having said the above, we also wish to reiterate that some of the more stringent conditions like (i) monitoring and tracking of the indirect ownership of Indian residents and (ii) requirement of eligible investment fund and Indian fund manager not to be connected persons, remains unaddressed. These conditions have proved to be a significant barrier for the offshore funds to avail themselves to the benefit of the tax safe harbor under Section 9A of the Act. The amendments to the aforementioned stringent eligibility conditions would provide a much-needed fillip to the offshore funds in availing themselves to the benefit of tax safe harbor and thereby act as a catalyst in achieving the Government's stated intent of developing the onshore fund management industry.

- *Central Stamp Charges Replacing State Levy:* We suggest the Ministry of Finance to confirm and announce the implementation date regarding the Central Stamp Act replacing the state levy as soon as possible. According to The Finance Act 2019 issued by The Gazette of India dated 21 Feb 2019, "Amendment to The Indian Stamp Act, 1899" was announced in Chapter IV. It is noted under Paragraph 15 Item 9A (3) that the stamp act shall replace the state levy from the date of commencement. However, the implementation date has yet to be announced.

(iv) **Onshore Tax Matters:**

- *Foreign Bank Corporate Tax Rate should be Rationalized*: Foreign Banks are subjected to tax on profits at 43%, on par with Indian companies, considering DDT is applicable to such Indian companies on distribution of dividends. However, with the reduction of the Corporate tax rate for Indian companies (including Indian banks), the rate of tax applicable to foreign banks operating in India should be rationalized and brought on par with Indian companies, as was the case prior to the amendment under The Taxation Laws (Amendment) Ordinance 2019.

- *IFSC Taxation*: Characterization of income from derivative trading by a unit in IFSC needs clarification: It should be clarified that such income will be characterized as "business income" (and not as capital gains) and therefore, will be eligible for an exemption.

- *Exempt Primary Dealers from Thin Capitalization Rules:* Primary dealers are engaged in market-making activity and are funded through an appropriate mix of capital & borrowings. Given the nature of Primary Dealers business, **Interest disallowance under thin capitalization rules**, should be made not applicable to Primary Dealers as well as Non-Banking Financial Companies (NBFCs) or at a minimum drafting errors in the prescribed calculation method should be rectified such that it produces the intended results.

Appendix

The current effective tax rates applicable to FPIs

Highest effective tax rate for different types of FPIs					
		Base tax rate	Effective tax rate for Corporates	Effective tax rate for Partnerships	Effective tax rate for all other FPIs (including trusts, individuals, family offices etc.)
Capital gains on transfer of listed equity shares/units of equity mutual fund / units of business trust (STT is paid)	Long Term	10%	10.92%	11.648%	11.96%
	Short Term	15%	16.38%	17.472%	17.94%
Capital gains on transfer of debt securities (including debt MFs)	Long Term	10%	10.92%	11.648%	11.96%
	Short Term	30%	32.76%	34.944%	35.88%
Capital gains on listed derivatives	Short Term	30%	32.76%	34.944%	35.88%
Interest from government bonds and those corporate bonds where coupon is within 500 bps of base rate of State Bank of India		5%	5.46%	5.824%	7.124%
Interest from other bonds		20%	21.84%	23.296%	28.496%