

List of issues

Sr No	Issue	Page No
1	Reduction in rate of taxation for interest income in GIFT IFSC for an investment division of an Offshore Banking Unit and Category III AIF	2 – 3
2	Exemption of dividend income for shareholders of an IFSC company and relax withholding tax requirement	4
3	Non-applicability of General Anti-Avoidance Rules provisions for units in the GIFT IFSC including global-in house units	5
4	Exemption from applicability of stamp duty for AIF in GIFT IFSC	6
5	Allowing AIF in GIFT IFSC to undertake short sale of securities	7
6	Clarification on permissibility of Category III AIF to trade securities listed on overseas exchange and its characterization	8
7	Concessional tax rate of 5% on interest income available to FPIs and foreign lenders on interest income should be extended to AIFs set-up in GIFT IFSC	9
8	Need for relief to OBUs and other units in IFSC from withholding obligation on ODI transactions	10
9	Relaxation in withholding tax requirement on payments made to GIFT IFSC unit claiming tax holiday	11
10	Exemption for investors in Category III AIF setup in GIFT IFSC from filing of return of income and lender to AIF from obtaining PAN and filing of return of income	12
11	Clarification that investors investing directly or indirectly in Category III AIF located in GIFT IFSC are exempt from indirect transfer provisions	13
12	Directions for OBUs intending to operate as an FPI	14
13	Glossary	15

Issue 1: Reduction in rate of taxation of interest income in GIFT IFSC for an investment division of an Offshore Banking Unit (OBU) and Category III AIF

Background

1. The Indian Government has been encouraging financial services players to undertake business activities from GIFT IFSC and to facilitate that, business friendly tax and regulatory environment is being offered.
2. In line with the said objective, it has also incentivized undertaking portfolio investments from GIFT IFSC, *inter-alia*, through an investment division of an OBU set-up in GIFT IFSC.

Thus, foreign banks can now, *inter alia*, undertake the portfolio investments through their OBU set-up in GIFT IFSC.

Current tax regime on interest income earned by foreign banks being an FPI outside of GIFT IFSC

3. Presently, the interest income earned on investments made by foreign banks under the portfolio investment route, in Indian debt markets, is taxable at the beneficial rate of 10%¹ under the DTAA entered into with major investing countries like USA, France, Hong Kong, Singapore, etc.

Tax regime on interest income for foreign banks through an OBU in IFSC under the Act

4. As per section 115AD of the Act, interest income earned by specified fund (which includes an investment division of an OBU making FPI investments from GIFT IFSC) is taxable at the rate of 10.92%² on a gross basis.

No tax concession on interest income earned by OBUs on investments made under FPI route

5. As can be noted from the above, section 115AD of the Act provides the rate of 10.92% on interest income for OBUs in GIFT IFSC for the FPI investments in debt securities as opposed to the present tax rate of 10% which some of these foreign banks are eligible for under the respective tax treaties where they continue to make investments from such foreign jurisdictions.

¹ For the purposes of our discussion in this note, we have not considered the concessional rate of 5% (plus applicable surcharge and cess) prescribed under section 194LD of the Act (which is available until 30 June 2023) for FPI investors on interest income on certain specified cases, being a uniform rate applicable to all investors.

² Highest applicable surcharge rate (i.e. 5%) and health and education cess (i.e. 4%) applicable to a foreign company has been considered

6. As you would appreciate from above, from a tax rate perspective, there is no incentive for foreign banks, being investment division of an OBU, to shift their portfolio investment activities from foreign jurisdiction to GIFT IFSC. In addition to above, given that most of these foreign banks have well established offices and set-up in foreign jurisdiction they would need to incur additional cost for shifting its investment operations from such foreign jurisdiction to GIFT IFSC which in absence of any tax concession or otherwise will discourage them to do so.
7. Thus, in order to encourage foreign banks to shift their portfolio investment activity especially in debt securities into GIFT IFSC, it is imperative that the tax rate on interest income is further reduced to make it more competitive when compared to the tax rate provided under some of the tax treaties. A reduced tax cost should likely result in an increased investment activity, which would effectively promote higher inflow of foreign funds in the Indian capital markets enhancing both liquidity and tax collection on account increased interest income.

Recommendation

8. In light of the above, in order to encourage foreign banks to shift their portfolio investment activity in GIFT IFSC, it is recommended that the rate of taxation of interest income under GIFT IFSC be reduced to 5% (plus applicable surcharge and cess) for investment division of OBUs as well as for other units in GIFT IFSC (such as Category III AIFs).

Issue 2: Exempt dividend income for shareholders of an IFSC company and relax withholding tax requirement

Background

1. Prior to the Finance Act, 2020, a domestic company declaring, distributing or paying dividends was subject to additional income-tax at the rate of 15% (excluding surcharge and cess) and the said dividend income was not taxable in the hands of the shareholders.
2. To provide tax incentive on dividend income distributed by the units in GIFT IFSC, section 115-O(8) was introduced by the Finance Act, 2016. The dividend declared, distributed or paid by a GIFT IFSC unit was not subject to DDT and also exempt in the hands of shareholders under the Act. The same was in line with the treatment accorded by similar International Financial Centre in Dubai, Singapore, etc.
3. The Finance Act, 2020 provided for the sunset of DDT regime and effective 1 April 2020, the dividend income is taxable in the hands of shareholders. Therefore, the Finance Act, 2020 shifted the incidence of tax from the payer of dividend to the recipient of such dividend.
4. However, due to possible oversight, no specific carve out was made for the dividend income earned by shareholders of the company, being a unit in GIFT IFSC.
5. The operations of GIFT IFSC are at a very nascent stage. At this juncture, the exemption of dividend income distributed or paid by a GIFT IFSC unit, in the hands of shareholders would be very critical.
6. The success of a GIFT IFSC depends upon it being on par with other International Financial Centres located in Dubai, Singapore, etc., where the dividend is not subject to DDT and also exempt from tax in the hands of shareholders.

Recommendation

7. In order to provide tax incentives on dividend income distributed by the units in the GIFT IFSC and to offer a level playing field comparable with offshore financial jurisdictions, the earlier exemption should be restored with respect to dividend income in the hands of shareholder of a company, being a GIFT IFSC unit.
8. Exemption should also be provided from any withholding tax on such dividend income.

Issue 3: Non applicability of General Anti-Avoidance Rules (GAAR) provisions for units in the GIFT IFSC including global-in house (GIC) units

Background

1. GIFT IFSC has been set-up mainly to bring to India all financial services transactions related to India that were till now being carried out from another countries like Singapore, Hong Kong, Dubai and London. It extends to the entire Financial Services spectrum including Banking, Capital Markets, Insurance, Asset Management and other ancillary services.
2. In their developmental role, the IFSCA has been inviting various industry participants to set up a unit in GIFT IFSC. The Act also provides various tax incentives for GIFT IFSC units such as - 10 year tax holiday for units; exemption from transfer of specified securities; concessional rate of MAT/ AMT, etc.
3. However, the Act also contains provisions relating to GAAR wherein taxpayers could be denied tax exemption/ incentives if a transaction (or a step in it) is considered to have been entered into with the main purpose to derive tax benefit.
4. It is possible that one of the main purposes of moving to GIFT IFSC may be the tax exemption (especially given the fact that some business may be moving from Mauritius / Singapore where it enjoys certain tax exemptions).
5. The provisions of GAAR are drafted in wide manner and confers wide discretionary powers on the Indian Revenue Authorities. As a result, there is an exposure that the GAAR provisions can be invoked against taxpayers who have set up a unit in GIFT IFSC and are eligible for tax incentives.

Recommendation

6. As you would appreciate from the above, an exposure to applicability of GAAR brings in uncertainty to the eligibility to tax incentives which are provided by Government to promote GIFT IFSC. To bring certainty on taxability of income of a GIFT IFSC unit, exemption should be granted from applicability of GAAR provisions while claiming the various tax exemptions/ incentives/ deductions as provided under the provisions of the Act for GIFT IFSC units and the investors in such GIFT IFSC units.

Issue 4: Exemption from applicability of stamp duty for AIF in GIFT IFSC

Background

1. As per the Indian Stamp Act, 1899 and the Amendments made to it thereafter, stamp duty is applicable on issuance or transfer of privately placed AIF units (including for an AIF in GIFT IFSC) at prescribed rates.
2. A specific exemption from stamp duty has been provided for transactions which are undertaken on the GIFT IFSC exchange and depositories established in GIFT IFSC. However, as discussed above, there is no specific exemption from stamp duty for units issued and transferred by an AIF in GIFT IFSC.
3. It is pertinent to note that similar International Financial Centre in Dubai, Hong Kong do not have stamp duty.
4. Further, as per the FAQs on the Indian Stamp Act, 1899 Amendments and Rules made thereunder, redemption of mutual fund units are not subject to stamp duty on the basis that the same is not a transfer nor an issue nor a sale. However, the FAQs are silent on non-applicability of stamp duty on redemption of AIF units.

Recommendation

5. In order to provide parity with transactions undertaken on the GIFT IFSC exchange and other foreign jurisdictions, stamp duty should not be applicable on unlisted securities, *inter alia*, privately placed AIF units upon issue or transfer or redemption in GIFT IFSC.
6. Exemption from applicability of stamp duty should also be provided on fund documentation of the AIF executed in GIFT IFSC such as contribution agreements, loan agreements, investment management agreement, etc.

Issue 5: Allowing AIF in GIFT IFSC to undertake short sale of securities

Background

1. Currently, as per the SEBI FPI Regulations, 2019 read with the Operating Guidelines, an FPI is allowed to transact in the securities in India only on the basis of taking and giving delivery of securities purchased or sold (except derivatives; SLB or any other framework specified by the SEBI).
2. Thus, FPIs are not allowed to short sell in Indian market which are otherwise permitted for domestic companies in the Indian market.
3. An AIF in GIFT IFSC would also be restricted to undertake short sale of securities in the Indian market by virtue of the FPI Regulations. This could result in impacting the volume of trading activity of such players in the Indian market.

Recommendation

4. To provide parity to the AIFs in GIFT IFSC, it should be permitted to undertake short sale of securities in the Indian market which are presently allowed to Category III AIFs registered with SEBI and domestic companies.

Necessary reporting framework should be formed for designated custodian banks to report all transactions pertaining to short sale of securities by AIF in GIFT IFSC.

Issue 6: Clarification on permissibility of Category III AIF to trade securities listed on overseas exchange and its characterization

Background

1. Regulation 22(3) of SEBI (IFSC) Guidelines, 2015 permit AIF in GIFT IFSC to invest in –
 - i) securities listed on GIFT IFSC;
 - ii) securities issued by companies incorporated in GIFT IFSC; and
 - iii) securities issued by companies belonging to foreign jurisdictions.
2. The Regulation do not expressly permit Category III AIF in GIFT IFSC to trade in securities listed on overseas exchange. The AIF in GIFT IFSC may invest in international markets as part of its investment objectives.
3. Section 2(14)(b) of the Act creates a fiction that any securities held by Foreign Institutional Investor which has invested in accordance with the regulations made under SEBI Act, 1992 shall be considered as 'capital asset'.

Recommendation

4. In order to facilitate unfettered access to securities traded on overseas exchange, clarification should be provided to permit Category III AIF to trade in international markets in addition to GIFT IFSC and Indian exchanges. This would enhance investments and capital market flows between India and other countries.
5. It should be clarified that all investments made by Category III AIF (also a SEBI registered FPI) in securities listed on the GIFT IFSC exchange, overseas exchanges and the Indian mainland exchanges should qualify as a 'capital asset' and thus, gains/ losses from the same should be clubbed being part of one integrated business conducted from an unit in GIFT IFSC i.e. set-off against each other for the purpose of determining total income from Indian income-tax perspective.

Issue 7: Concessional tax rate of 5% on interest income available to FPIs and foreign lenders on interest income should be extended to AIFs set-up in GIFT IFSC

Background

1. Under section 194LD of Act, interest income arising to FPIs from following securities is subject to a lower tax rate of 5% (plus surcharge and cess):
 - Government securities;
 - Corporate bonds where the rate of interest does not exceed 500 bps of the applicable base rate of State Bank of India
2. Under section 194LC of Act, interest income arising to foreign lenders on ECB loans and rupee denominated bonds is subject to a lower tax rate of 5% (plus surcharge and cess) provided the ECB guidelines are met.
3. Though Category III AIFs set up in GIFT IFSC have been extended tax treatment of an FPI with certain additional benefits, the 5% tax rate on interest income has not been extended to them.
4. Unlike foreign lenders, there is no concessional tax rate provided in the Act for Category I and Category II AIF to invest in Indian debt securities.

Recommendation

5. In line with benefits extended to FPIs and foreign lenders, the concessional tax rate of 5% should also be extended to interest arising to AIFs (all categories) set up in GIFT IFSC from their investments in mainland India.

Issue 8: Need for relief to OBUs and other units set up in GIFT IFSC from withholding obligation on ODI transactions

Background

1. Under section 195 of the Act, any person responsible for paying to non-resident, any interest or any other sum chargeable to tax, is required to deduct tax at source at rates in force.
2. In terms of section 5 and section 9 of the Act, the following income of non-resident is taxable under the Act:
 - Income accruing or arising in India or deemed to be accrue or arise in India;
 - Income received or deemed to be received in India
3. Where an FPI entity set up outside India enters into a ODI contract with another non-resident, there is no need for such FPI entity to withhold taxes since the income of the ODI subscriber does not accrue or arise in India and nor is it received in India. Also, such income of non-resident is also not deemed to accrue or arise or received in India.
4. If an FPI entity set up in GIFT IFSC enters into an ODI contract with a non-resident, there is a possibility of the income of non-resident being regarded as accrued or arisen in India. If that is so, the FPI entity set up in GIFT IFSC would need to withhold tax on such income under section 195 of the Act and non-withholding would render such FPI to be “assessee in default” under the Act and the tax, interest and penalties would devolve on the FPI.
5. Likewise, the ODI subscribers entering into ODI contracts with OBUs and other units set up in GIFT IFSC would be exposed to Indian tax implications.
6. Unlike foreign lenders, there is no concessional tax rate provided in the law for Category I and Category II AIF to invest in Indian debt securities.

Recommendation

7. In line with benefits extended to FPIs set up outside India in respect of ODI transactions with another non-resident, there should be no need for OBUs and other units set up in GIFT IFSC to withhold taxes on income from ODI transactions under section 195 of the Act.

Issue 9: Relaxation in withholding tax requirement on payments made to GIFT IFSC unit claiming tax holiday

Background

1. As per section 80LA of the Act, income of a unit in a GIFT IFSC from its approved business shall be entitled to a tax holiday of 100% of such income for any 10 consecutive years [at the taxpayer's option], out of 15 years, beginning from the year in which permission was obtained.
2. Even though business income is eligible for 100% deduction for the GIFT IFSC units, payment made to such GIFT IFSC unit are subject to withholding tax [e.g. where an AIF pays investment management fee to AIF manager set-up in GIFT IFSC, the AIF would be required to undertake withholding tax obligations in the absence of any specific carve out under the Act].
3. This leads to an increase in compliance burden and working capital constraints for the GIFT IFSC unit who may need to apply to the income-tax department for a nil withholding tax certificate under section 197 of the Act or claim the withholding tax as refund even though the business income is eligible for 100% deduction as explained above.

Recommendation

4. In order to avoid onerous compliance burden on the GIFT IFSC units and smooth business functioning, payment of any income to GIFT IFSC units being eligible for deduction under section 80LA should not be subject to withholding tax under the provisions of the Act.

**Issue 10: Exemption for investors in Category III AIF setup in GIFT IFSC
from filing of return of income and lender to AIF from obtaining PAN and
filing of return of income**

Background

1. Under the Act, Category III AIFs in GIFT IFSC are subject to fund level taxation. Also, as per section 10(23FBC) of the Act, any income accruing or arising to or received from the Category III AIF in GIFT IFSC or on transfer of its units is exempt from tax in the hands of investors.
2. Tax on the investors' income is already collected by way of payment of taxes by a Category III AIF in GIFT IFSC. As a result, there is no tax revenue leakage for the Indian Revenue Authorities.
3. The CBDT vide its Notifications³ has exempted non-resident investors of a Category I and II AIF located in the GIFT IFSC, from the requirement of obtaining PAN and filing return of income in India, subject to fulfilment of certain conditions.
4. Recently, the CBDT vide its Notification⁴ has granted an exemption to eligible foreign investors investing in the specified securities and non-resident investors/ unit holders of Category III AIFs located in the GIFT IFSC from the requirement of obtaining a PAN subject to satisfaction of prescribed conditions. However, the Notification does not extend the exemption to such investors from filing of return of income in India.
5. Further, non-resident entities lending to the AIF in GIFT IFSC should also be granted an exemption from the requirement of obtaining PAN and filing return of income in India since the interest income earned by such lenders would be exempt under section 10(15)(ix) of the Act.

Recommendation

6. In order to provide a level playing field and tax parity amongst the Categories of AIF, an exemption from filing of return of income should be granted to non-resident investors of Category III of AIF in GIFT IFSC who do not have any other India sourced income. Similarly, non-resident lenders to a Category III AIF in GIFT IFSC should be granted an exemption from obtaining PAN and filing return of income if such lender does not have any other India sourced income.

³ Notification no. 58/2020 dated 10 August 2020 for PAN and Notification no. 55/2019 dated 26 July 2019 for return of income.

⁴ Notification no. 42/2021 dated 4 May 2021

Issue 11: Clarification that investors investing directly or indirectly in Category III AIF located in GIFT IFSC are exempt from indirect transfer provisions

Background

1. Under the provisions of clause (i) of sub-section (1) of section 9 of the Act, transfer of shares or interest in an offshore company which derives, directly or indirectly, its value substantially from the assets located in India could be subject to indirect transfer provisions in India. This could give rise to debate on whether transfers at offshore level could be taxable in India on the basis of indirect transfer provisions.
2. Category III AIF in GIFT IFSC are subject to fund-based taxation and its investors are exempted from tax on any income accruing or arising to or received from the Category III AIF or on transfer of its units. Since, the tax is being recovered at the fund level, the same income should not be taxed again to the non-resident investors at the offshore level on the basis of indirect transfer.

Recommendation

3. As per CBDT Circular⁵, non-resident investors investing in a Category I or II AIFs in India have been exempted from indirect transfer provisions on account of redemption or buyback of its share or interest held indirectly (i.e. through upstream entities registered or incorporated outside India) in the Category I or II AIF, if such income accrues or arises from or in consequence of transfer of shares or securities held in India by Category I or II AIF and such income is chargeable to tax in India.
4. Further, the non-resident investors investing directly or indirectly in the Category I FPI are outside the purview of indirect transfer provisions.
5. In order to avoid confusion and uncertainty and to bring parity, it should also be clarified that the investments made by non-resident investors, directly or indirectly, in the Category III AIF located in the GIFT IFSC shall not be subject to the indirect transfer provisions.

⁵ CBDT circular dated 28/2017 dated 7 November 2017

Issue 12: Directions for OBUs intending to operate as an FPI

Background

1. The IFSCA has issued the International Financial Services Centres Authority (Banking) Regulations, 2020 [IFSC Banking Regulations] on 18 November 2020 laying the framework for banks to set-up units in GIFT IFSC.
2. As per para 13(7) of the IFSC Banking Regulations, a banking unit (including an investment division of an OBU) may operate as an FPI in the GIFT IFSC without a separate registration if the parent bank of the banking unit is registered with SEBI as an FPI. For this purpose, the investment division of OBU would be required to file an intimation with the IFSCA in the prescribed form and manner.
3. Further, the IFSCA vide Circular⁶ provided instructions and clarifications on circulars issued under the IFSC Banking Regulations. As per point 4(a) of the Annex to the said Circular, it has been provided that detailed directions on banking units acting as an FPI shall be issued separately. In this connection, no directions have been issued at present.
4. Until such guidelines are issued, the investment division of OBU set-up in GIFT IFSC will not be able to operate as an FPI and consequently will not be able to invest in the Indian capital markets.

Recommendation

In view of the above, we request you to kindly issue the detailed directions mentioned in the said Circular to enable an investment division of OBU set-up in GIFT IFSC to commence business as an FPI such that existing OBUs/ proposed OBUs which intend to operate as an FPI can take necessary steps and commence their operations as soon as possible.

⁶ F.No.110/IFSCA/Banking Regulation/2020-21/7 dated 24 December 2020

Glossary

Abbreviation	Full Text
Act	Income-tax Act, 1961
AMT	Alternative Minimum Tax
AIF	Alternative Investment Funds
CBDT	Central Board of Direct Taxes
DTAAs	Double Taxation Avoidance Agreements
DDT	Dividend Distribution Tax
ECB	External Commercial Borrowings
FPI	Foreign Portfolio Investor
FPI Regulations	SEBI (Foreign Portfolio Investor) Regulations, 2019
FAQ	Frequently Asked Questions
GIC	Global-in house
GAAR	General Anti-Avoidance Rules
GIFT	Gujarat International Finance Tech City
IFSC	International Financial Services Centre
IFSCA	International Financial Services Centre Authority
IFSCA Banking Regulations	International Financial Services Centres Authority (Banking) Regulations, 2020
IFSCA Act	International Financial Services Centre Authority Act, 2019
MAT	Minimum Alternate Tax
OBU	Offshore Banking Unit
ODI	Offshore derivative instrument
PAN	Permanent Account Number
Rules	Income-tax Rules, 1962
SEBI	Securities Exchange Board of India
SEBI (IFSC) Guidelines, 2015	SEBI (International Financial Services Centres) Guidelines, 2015
SEBI (AIF) Regulations, 2012	SEBI (Alternative Investment Funds) Regulations, 2012
USA	United States of America