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***By Electronic Delivery***

27 November 2020

Mr. Saurabh Gupta
Under Secretary, Central Board of Direct Taxes
North Block
New Delhi – 110 001
India

**Re: Tax Issues Relating to Global Regulated Funds for Consideration in the 2021 Indian Union Budget**

Respected Sir:

ICI Global[1] thanks the Indian Government for the opportunity to submit recommendations for the Indian Government's consideration as it embarks on the preparation of the 2021 Indian Union Budget.

ICI Global appreciates and welcomes the Indian Government's receptiveness to providing tax certainty to Foreign Portfolio Investors (FPIs), thereby improving investor confidence, enhancing funds' investment experience, and promoting cross-border portfolio (i.e., non-controlling) investments in India. As it puts together the 2021 Indian Union Budget, we urge the Government to continue to take measures that foster tax certainty, and request the Government to resolve the following tax issues affecting the regulated fund industry:

1) Tax Status of Foreign Regulated Funds;
2) Reorganizations Involving Business Trusts and Debt Funds/Multi-Asset Funds
3) Off-Market Transfers of Listed Securities
4) Tax Compliance Issues re Enhanced Surcharge Tax
5) Availability of Cost Step-up Benefits for Shares Acquired in Corporate Actions

[1] ICI Global carries out the international work of the Investment Company Institute, the leading association representing regulated funds globally. ICI's membership includes regulated funds publicly offered to investors in jurisdictions worldwide, with total assets of US$31.2 trillion. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of regulated investment funds, their managers, and investors. ICI Global has offices in London, Hong Kong, and Washington, DC.

6) SPVs and Dividend Withholding Tax
7) Tax Audit Issues and Dispute Resolution
8) India-Based Fund Manager Regime

The enclosed Annexures A, B, and C provide additional information on some of these issues for which detailed analysis is necessary.

## 1. Tax Status of Foreign Regulated Funds

*The Central Board of Direct Taxes (CBDT) should clarify that regulated funds organized as business trusts but taxed as corporations in their home country have (i) the option to file as companies for Indian tax purposes and (ii) once this option is exercised by an FPI, the FPI must follow the filing position consistently in India.*

Many of the tax difficulties that foreign regulated funds experience are due to their legal form of organization as business trusts under the laws of their home country. Nearly 84% of the total mutual funds that are set-up in the US are established as trusts (e.g., Massachusetts Business Trusts or Delaware Statutory Trusts). These trusts are classified as corporations for US tax purposes. Most other countries that tax FPIs on their investments made in the source countries (e.g., South Korea, Romania, Bangladesh, Pakistan, and certain Latin American countries) are ambivalent about the legal status of FPIs, as these countries prescribe the same tax rates for all FPIs (irrespective of the legal form of the entity).

We recognize that under Indian tax law, a taxpayer is required to file its income-tax returns in India based on the taxpayer's legal form of organization in the home country. Although India prescribes the same base tax rates for all FPIs, the effective tax rates differ depending on the legal form of the entity (as summarized in **Annexure A**), because of additional surcharge and cess rates that are differently applied to the base tax rates depending on the legal form of the tax payer.

This effective tax rate differential could be resolved with the adoption of a specific rule that allows FPIs organized as business trusts to file their Indian tax returns as "companies." As explained in prior submissions,[2] section 2(17)(iv) of the Indian Income-tax Act, 1961 (Act) allows the CBDT to declare by a general or special order, any institution, association or body, whether incorporated or not and whether Indian or non-Indian to be a "company" (a foreign company). **Annexure B** includes a legal analysis of section 2(17) and explains the operation of regulated funds that are operated in the US as business trusts, and the rationale for them filing in India as companies.

## 2. Reorganizations Involving Business Trusts and Debt Funds/Multi-Asset Funds

*Enact legislation permitting all regulated funds to undergo tax neutral reorganizations with respect to all Indian securities (i.e., equity and debt).*

[2] See ICI Global letter "*Follow-up to ICI Global Meeting on Tax Issues for Global Regulated Funds*," dated 10 December 2019 by Katie Sunderland, Assistant General Counsel – Tax Law.

Foreign regulated funds organized as business trusts and classified as corporations in their home country (i.e., US regulated funds) that undergo a tax neutral reorganization are subject to capital gains tax on their Indian securities. Moreover, mergers involving regulated funds, regardless of the legal form of organization (i.e., corporates and business trusts) that result in the transfer of securities other than shares (e.g., Indian debt securities, Indian derivatives) could be taxable in India. This situation typically arises in case of foreign company mergers involving Bonds Funds, Multi-Asset Funds, etc.

The taxability of reorganizations has been a long-standing industry issue. In the past, funds organized as business trusts would owe Indian tax only on assets with short-term capital gains, to the extent such reorganizations were considered taxable. The re-introduction of the long-term capital gains tax in 2018, however, makes this an even more critical issue for the fund industry.

Under Indian tax law, only mergers involving two or more foreign *companies* are not taxable in India, provided (i) shares of an Indian company are being transferred from the predecessor foreign company to the successor foreign company, (ii) at least 25% of the shareholders of predecessor foreign company continue to remain shareholders of the successor foreign company, and (iii) such transfer does not attract tax on capital gains in the country of incorporation of the predecessor foreign company.

Unfortunately:

(i) the aforesaid Indian taxing provisions do not extend to situations wherein other assets in India are transferred as part of a foreign company merger. For example: Indian debt securities, Indian derivatives etc., are being transferred as part of a foreign company merger; and
(ii) the aforesaid Indian taxing provisions do not extend to mergers involving business trusts.

Reorganizations of Indian mutual funds, which are required to be formed as business trusts, are statutorily exempt from tax in India; this is because Indian mutual funds are exempt from tax in India on all their income (be it Indian sourced or foreign sourced).[3] Moreover, investors in Indian mutual fund schemes or plans that merge with other schemes or plans having similar attributes, as part of a consolidation scheme of the Indian mutual fund house, are not subjected to capital gains tax.[4]

In our opinion, there is no tax policy rationale for a disparate treatment under the Indian tax law that is afforded to (1) Indian mutual funds (on the one hand), and (2) foreign mutual funds (such as US regulated funds that invest in the Indian capital markets as FPIs) (on the other hand).

This problem is unique to India as it is one of the few countries that imposes capital gains taxes on foreign portfolio investors. As most other countries do not charge capital gains taxes to foreigner portfolio investors, the taxability of reorganizations is a moot issue. The few countries that do impose capital gains taxes on foreign portfolio investors, such as South Korea, Latin America, Romania, Bangladesh and Pakistan, do not treat a reorganization as a taxable event subject to capital gains tax.

[3] Section 10(23D).

[4] Section 47(xviii) and Section 47(xix).

Notably, the Bombay High Court recently issued a ruling[5] respecting the tax neutrality of a fund's reorganization and permitted the carryforward of capital losses in India, making it the law of the State of Maharashtra where a majority of the FPIs investing in India are assessed. We request that the Indian Government codifies rules that are consistent with the High Court's decision in this regard. Specifically, we urge an amendment to the Act that treats overseas reorganizations involving FPIs that are tax-free in the relevant home country as tax-free in India. Importantly, tax would still be collected when a fund ultimately disposes of its Indian securities.

**Annexure C** (in part C.1) includes, for consideration, proposed amendments to the Act, to provide tax neutral treatment for overseas fund reorganizations involving FPIs. Annexure C (in part C.2) explains in greater detail, (1) the reasons for these reorganizations, (2) the tax-free treatment of these reorganizations in the US corporate mergers, (3) the Indian tax problem faced by any such US fund that reorganizes, (4) that the problem is so severe that funds do not reorganize, and (5) that funds that reorganize, after divesting their Indian securities, sometimes do not reinvest in India.

### 3. Off-Market Transfers of Listed Securities

*Request SEBI to permit off-market transfers of Indian securities, particularly in the event of an overseas reorganization.*

Foreign funds, whether organized as business trusts or corporate entities, are not permitted to undertake an off-market transfer of Indian securities absent approval from SEBI. This is true even in the case of a fund reorganization, such as a merger, demerger or a simple name change. Funds prefer to transact off-market because of the high transaction costs incurred when buying and selling on the stock exchanges, in addition to any capital gains and securities transaction taxes (STT) that may be due.[6]

Around three years ago, SEBI no longer permitted foreign funds to perform off-market transfers.[7] SEBI's primary concern, as reported in the Indian press, is that off-market transfers may result in the non-payment of tax when foreign funds undergo a change in control. This concern is one that can be simply addressed. A disclosure requirement on taxpayers to disclose off-market transfers on their annual income tax returns should allay any concern that the CBDT has about overseas reorganizations. Importantly, the tax treatment of such reorganizations could be separately assessed by the CBDT.[8]

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[5] Aberdeen Asia Pacific Including Japan Equity Fund vs Deputy Commissioner of Income-tax (WP No 2796, 2803, and 3525 of 2019) [117 taxmann.com 185 (Bombay) (2020)].

[6] The short-term capital gain tax rate is 30% for off-market transfers of all types of Indian securities, and 15% for on-market transfers of Indian equity shares; however, the off-market transaction costs savings typically offsets the tax rate differential.

[7] See "Foreign Funds Want to Complete Mergers Off Market, Sebi say No" by Pavan Burugula, April 9, 2019, Economic Times.

[8] Reorganizations of foreign funds organized in corporate form are not taxable under the tax law. These funds, however, cannot undertake off-market transfers of Indian securities in order to save on non-tax related transaction costs (such as brokerage, funding costs, etc.) until SEBI approves the off-market transfer of securities.

This issue is increasingly important as the asset management industry consolidates, and funds undergo reorganizations as a result. Many of these funds are forced to divest their Indian holdings before they can undergo a necessary reorganization that is not taxable in their home county.

### 4. Tax Compliance Issues re Enhanced Surcharge Tax

*Rollback the application of the enhanced surcharge tax from all categories of income of FPIs.*

We are grateful to the Indian Government for the rollback and cap on the rate of the enhanced surcharge tax with respect to capital gains and dividends, respectively. Such actions removed significant tax uncertainty that was impacting our members. The rollback, however, does not apply to the following categories of income that are earned by SEBI registered FPIs and which remain subject to the enhanced surcharge tax:

i. interest income on debt securities;
ii. income from security receipts and pass-through certificates;
iii. distributions from an Indian business trust, e.g., a real estate investment trust (REIT) or an InVIT;
iv. distributions on Indian Depository Receipts; and
v. any other income (e.g., interest on income-tax refunds).

The application of the surcharge to only certain income raises income-tax compliance concerns.

Specifically:

i. the need to amend internal systems to provide for the aforesaid basis of taxation; and
ii. the aforesaid partial tax relief provided by the 2020 Act (although welcome), still requires a rather complicated basis of taxation in India in terms of the number of applicable effective tax rates that now apply to FPIs that invest in the Indian capital markets.

For example, we have provided in Annexure A the multiple tax rates that apply to FPIs that invest in Indian securities and which earn taxable income therefrom, in the form of capital gains, dividends/distributions, and interest/other income. The effective tax rates differ depending on whether an FPI is a corporate entity or a non-corporate entity (e.g., a trust) and depending on the quantum of taxable income that is earned by the FPI during a particular financial year. The number of different tax rates that apply to an FPI becomes particularly complicated for Multi-Asset Funds and Debt Funds because they can have so many different tax rates that are applicable to their cases.

### 5. Availability of Cost Step-up Benefits for Shares Acquired in Corporate Actions

*Specify that taxpayers (including FPIs) shall be eligible for a stepped-up basis on shares acquired in certain genuine transactions.*

India's re-enactment of a long-term capital gains tax, after a break of nearly 14 years, includes a cost step-up basis for equity shares acquired before February 1, 2018. Subsequently, the government

provided additional relief by identifying certain genuine transactions where the STT had not been paid but that, nonetheless, would be eligible for the cost-step-up benefit as of January 31, 2018.

As described in prior submissions,[9] the cost step-up basis provision and subsequent guidance does not seem to extend to those genuine transactions wherein equity shares may be acquired on or after February 1, 2018 by virtue of holding some other equity shares/hybrid instruments (acquired prior to February 1, 2018) that subsequently convert into new equity shares after February 1, 2018. Thus, we request that the Indian government also specifically notify the following types of genuine transactions in which taxpayers (including FPIs) shall be eligible to adopt the step-up basis:

(i) New shares received in an Indian company pursuant to a stock split or consolidation after January 31, 2018;
(ii) New shares received in an Indian company pursuant to a merger implemented after January 31, 2018;
(iii) New shares received in an Indian company pursuant to a demerger implemented after January 31, 2018; and
(iv) Equity shares received through conversion of debentures, bonds, and/or preference shares after January 31, 2018.

### 6. SPVs and dividend withholding tax

*Clarify that SPVs of business trusts do not need to withhold tax on dividends distributed to business trusts.*

Business trusts receiving dividends from SPVs are exempt from tax on such dividends. The SPVs, however, have not been provided with a corresponding dispensation from withholding tax from dividends paid to business trusts. This results in an avoidable tax outflow which the business trust will need to recoup through its tax return.

### 7. Tax Audit Issues and Dispute Resolution

*Implement a viable tax settlement mechanism that avoids consuming tax litigation for taxpayers.*

The processing by the Central Processing Centre (CPC) results in too many errors, for which unnecessary rectification applications need to be filed. In addition, funds and asset managers have faced challenges with the dispute resolution panels to resolve disputes between the taxpayers and the Indian government, particularly those relating to transfer pricing matters.

We urge the government to implement measures that promote a viable tax settlement mechanism and avoids consuming tax litigation. A reasonable time limit of rectifications and a tracking number to monitor resolutions in a timely matter should also be considered. Further, we support a more balanced approach in adjudicating matters by providing incentives to dispute resolution panel members who do quality reviews that are just and fair.

[9] See letter to Mr. Sushil Chandra, Chairperson, CBDT, re "Genuine Transactions under section 112A as inserted by Finance Act, 2018" by Keith Lawson, Deputy General Counsel – Tax Law, ICI Global, dated April 30, 2018.

### 8. India-Based Fund Manager Regime

*Simplify the IBFM regime conditions such that regulated funds may be managed by Indian-based fund managers. Issue additional guidance that IBFMs that are based in GIFT City and who manage foreign regulated funds will not create a PE risk or a POEM risk for the foreign regulated funds that they manage, if the individual fund managers of the India-based fund managers are physically located elsewhere in India.*

We welcome the steps taken by the Indian Government to simplify the India-based fund manager (IBFM) regime. There are, however, still certain conditions provided in section 9A of the Act and associated income-tax rules that are too onerous to comply with and are not in accordance with international standards.

For example, one of the conditions prescribed under section 9A is that the aggregate participation or investment in the fund directly or indirectly, by persons resident in India should not exceed five per cent of the corpus of the fund. FPIs would struggle to comply with the aforesaid condition since (a) the distribution of the fund is done by a foreign distributor through omnibus accounts who do not reveal to the FPI the identity of the investors, and (b) there could be change in tax residency of shareholders that have originally made investments in the fund as non-residents.

Further, restricting the fund to neither engage in any activity which constitutes a business connection in India nor have any person acting on its behalf whose activities constitute a business connection in India other than the activities undertaken by the eligible fund manager on its behalf could also pose a challenge for several FPIs that outsource a part of their back office/support function (such as fund administration, fund accounting etc.) and which also want to appoint an IBFM in India. Even the condition of IBFM not being a "connected person" of the fund or the offshore fund manager is a non-starter for the IBFM tax regime. Similarly, the condition that the IBFM should earn its fees from the overseas fund manager of the eligible investment fund and not directly from the eligible investment fund creates concerns, because most well-regulated investment fund jurisdictions require that a fund set-up in that country also has its investment manager located in that country.

Separately, we request guidance that advisers operating from Gujarat International Finance Tec (GIFT) City, Gujarat will be deemed to satisfy the IBFM conditions (i.e., Section 9A of the Act). While we support a safe harbor that will satisfy the IBFM conditions, we believe this program will <u>not</u> be practical if it requires fund managers to physically relocate to Gujarat to manage offshore investment funds. Even so, some global asset managers may agree to arrangements—if a safe harbor is clearly provided—wherein they set-up a legal entity in the GIFT City, to meet the aforesaid tests, so long as they have the flexibility to operate outside of the GIFT City by way of a branch office of that entity that might be set-up anywhere else in India (e.g.. in Mumbai, New Delhi, Bangalore, etc.).

* * *

Thank you again for the Indian Government's proactive response to policy situations. If we can provide you with any additional information, please do not hesitate to contact me or Russell Gaitonde, our Indian tax advisor, at your convenience.

With kind regard on behalf of the regulated funds industry,

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Mr. Russell Gaitonde, Partner, Deloitte Haskins & Sells, Mumbai

**Indian Tax rates applicable to non-corporate FPIs (i.e., Trusts)**

| Capital Gains | | | |
|---|---|---|---|
| **Particulars** | **Income up to INR 5 million (No surcharge)** | **Income exceeding INR 5 million up to INR 10 million (surcharge at 10%)** | **Income exceeding INR 10 million (surcharge at 15%)** |
| Long term capital gains (LTCG) on STT and Non-STT paid transactions | 10.40% | 11.44% | 11.96% |
| Short term capital gains (STCG) on STT paid Transactions | 15.60% | 17.16% | 17.94% |
| Short term capital gains (STCG) on Non-STT paid transactions | 31.20% | 34.32% | 35.88% |
| LTCG / STCG on buy-back transactions where public announcement is made on or after July 5, 2019 | Exempt | Exempt | Exempt |

| Income other than Capital Gains | | | | | |
|---|---|---|---|---|---|
| **Particulars** | **Income up to INR 5 million (No surcharge)** | **Income exceeding INR 5 million up to INR 10 million (surcharge at 10%)** | **Income exceeding INR 10 million up to INR 20 million (surcharge at 15%)** | **Income exceeding INR 20 million but up to INR 50 million (surcharge at 25%)** | **Income exceeding INR 50 million (surcharge at 37%)** |
| Interest income – From (a) Government and Rupee Denominated bonds covered under Section 194LD, and (b) distributions of interest by Indian business trusts | 5.20% | 5.72% | 5.98% | 6.50% | 7.124% |
| Other income from securities (including interest not covered under Section 194LD) | 20.80% | 22.88% | 23.92% | 26.00% | 28.496% |
| Other income (non-securities related) | 31.20% | 34.32% | 35.88% | 39.00% | 42.744% |
| Dividend received from investments in Indian companies | 20.80% | 22.88% | 23.92% | 23.92% | 23.92% |

## Annexure A – ICI Global Letter

*Corporates: Tax rates on various streams of income earned by FPIs*

**Indian Tax rates applicable to Corporate FPIs**

| Capital Gains | | | |
|---|---|---|---|
| **Particulars** | **Income up to INR 10 million (No surcharge)** | **Income exceeding INR 10 million up to INR 100 million (surcharge at 2%)** | **Income exceeding INR 100 million (surcharge at 5%)** |
| Long term capital gains (LTCG) on STT and Non-STT paid transactions | 10.40% | 10.608% | 10.92% |
| Short term capital gains (STCG) on STT paid Transactions | 15.60% | 15.912% | 16.38% |
| Short term capital gains (STCG) on Non-STT paid transactions | 31.20% | 31.824% | 32.76% |
| LTCG / STCG on buy-back transactions where public announcement is made on or after July 5, 2019 | Exempt | Exempt | Exempt |

| Income other than Capital Gains | | | |
|---|---|---|---|
| **Particulars** | **Income up to INR 10 million (No surcharge)** | **Income exceeding INR 10 million up to INR 100 million (surcharge at 2%)** | **Income exceeding INR 100 million (surcharge at 5%)** |
| Interest income – From (a) Government and Rupee Denominated bonds covered under Section 194LD, and (b) distributions of interest by Indian business trusts | 5.20% | 5.304% | 5.46% |
| Other income from securities (including interest not covered under Section 194LD) | 20.80% | 21.216% | 21.84% |
| Other income (non-securities related) | 41.60% | 42.432% | 43.68% |
| Dividend received from investments in Indian companies | 20.80% | 21.216% | 21.84% |

**Notes:**

1. All the above tax rates are inclusive of Health and Education Cess of 4% applicable on the base tax and surcharge amount
2. The above rates do not take into account tax treaty relief, if any, that may be available to an FPI

**Issue: Tax Status of US Regulated Investment Funds in India**

## 1. Operation of US Regulated Funds

Regulated investment funds may be organized as different types of entities in their home country. For example, in the US, investment funds may be organized under state law as either corporations or business trusts. The fund complex launching an investment fund decides upfront on the state forum and the legal structure to be used for setting-up a new fund, after weighing the pros and cons associated with various state laws for each type of legal form. One key consideration today is the relative flexibility to respond to changing circumstances and market conditions. Convenience factors, such as online registration systems, also can influence organizational structuring choices. Many fund complexes prefer the same state law and legal form for all of their funds; this consistency, which helps simplify legal processes and compliance procedures, can be the determinative factor.

The differences between state laws and legal forms today are relatively minor, though important. One benefit of a statutory framework for fund organizations (compared to the common law framework under which US funds first were organized) is the legal certainty that comes from complying with a well-defined statute; this benefit arises whether the statute provides for a corporate or trust form of organization.

The differences between the corporate and trust forms of organization likewise are relatively minor, though important. Depending on the state law, certain fund transactions (such as mergers, certain reorganizations, and liquidations) may be undertaken without a shareholder vote under either form of organization. The annual shareholder meeting requirement was one factor that initially caused funds organized as Massachusetts business trusts to consider other forms of organization. Certainty that an investor's liability is limited to his or her amount invested (which is the standard rule for corporations) is one factor favoring a corporate or statutory trust model compared with the common law business trust model (where this limitation is not explicit).

<u>How is a Massachusetts Business Trust ('MBT') established?</u>

The MBT is an unincorporated business created by a legal document (a declaration of trust) and used in place of a corporation or a partnership for the transaction of various kinds of business with limited liability. An MBT is not necessarily one that is operated in the state of Massachusetts.

An MBT gives its trustees the legal title to the trust property to administer it for the advantage of its beneficiaries who hold equitable title to the trust's property. A written declaration of trust specifying the terms of the trust, its duration, the powers and duties of the trustee, and the interests of the beneficiaries is essential for the creation of the business trust. The beneficiaries receive certificates of beneficial interest as evidence of their interest in the trust; these certificates are freely transferable. An MBT is provided with the right to contract and to obtain legislatively constructed business

organization advantages without attaining permission to enter into a business activity. The property of the business trust is managed and controlled by trustees who have a fiduciary duty to act in the best interest of the trust beneficiaries. Profits and losses resulting from the use and investment of the trust property are shared proportionally by the beneficiaries according to their interests in the trust.

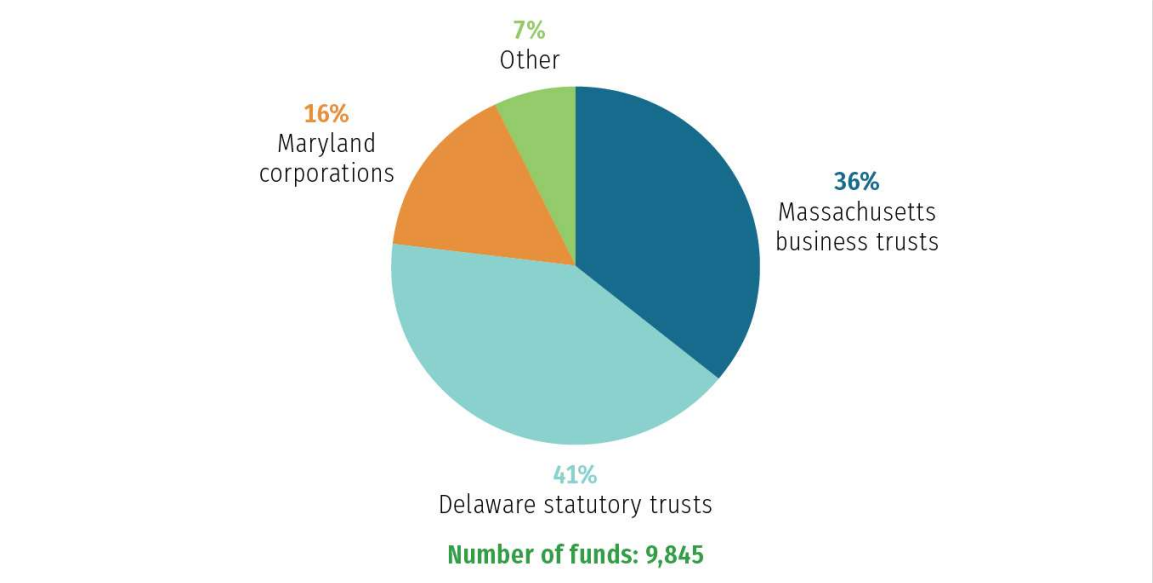
History of the MBT

The business trust made its debut in the State of Massachusetts in 1827. As a result, a US business trust today is often colloquially referred to as an MBT in legal circles. The method of transacting business in commercial enterprises originated in Massachusetts as a result of negative laws prohibiting certain business-related activities without a special act of the legislative or in other words, without "permission" of the state. So, the business trust was created under the common law right to contract to obtain legislatively constructed business organizations advantages but without having to gain "permission" to enter into a business activity and suffer under the burdens and restrictions that are placed on "statutorily constructed organizations."

How are mutual funds set up in the US?

In the US, a mutual fund typically is organized under state law either as a corporation or a business trust. The three most popular forms of organization are the MBT, the Maryland Corporation, and the Delaware Statutory Trust ('DST'). A few mutual funds are set up as other forms of organizations and with other domiciles. (Refer Fig A1)

Most popular forms of US Mutual Funds




*Source: Percentage of funds, year-ended 2019 as is depicted in the ICI Fact book, Figure A1.*

MBTs have historically been the most popular of these trusts. The very first mutual fund was formed as an MBT, which was a popular form of organization at the time for pools that invested in real estate and public utilities. The fund, the Massachusetts Investors Trust, provided a model for other funds to follow, leading to widespread use of the MBT throughout much of the industry's early history. Developments in the late 1980s gave asset management companies other attractive choices. In 1987, Maryland amended its corporate statute to align with interpretations of the Investment Company Act of 1940 concerning when funds are required to hold annual meetings, thereby making Maryland corporations more competitive with the MBT as a form of organization for mutual funds. In 1988, Delaware – already a popular domicile for US corporations – adopted new statutory provisions devoted specifically to business trusts (since renamed statutory trusts). As a result of these developments, many mutual funds created in the last 25 years have been organized as Maryland Corporations or DSTs.

Mutual funds have officers and directors (if the fund is a corporation) or trustees (if the fund is a business trust). The fund's board or trustees play a pivotal role as regards the oversight and accountability of the fund. Unlike other companies, a mutual fund typically is externally managed, it is not an operating company, and it has no employees in the traditional sense. Instead, a fund relies on third parties or service providers – either affiliated organizations or independent contractors – to invest the fund's assets and carry out other business activities. These service providers include: Sponsors, Board of Directors/Trustees, Investment Managers, Administrators, Principal Underwriters, Transfer Agents, Custodians, Auditors etc.

How are US mutual funds taxed in the US?

US mutual funds whether organized as MBTs, DSTs, or corporations, are all treated as corporations for US tax purposes and are subject to special tax rules set forth in subchapter M of the Internal Revenue Code (IRC). Unlike most corporations, mutual funds generally can eliminate the tax due on their income or capital gains at the entity level, provided they meet certain gross income and asset requirements and distribute all of their income to their investors.

Subchapter M of the IRC applies to investment companies that meet certain requirements to be treated as Regulated Investment Companies (RICs). To qualify as a RIC under Subchapter M, at least 90 percent of a mutual fund's gross income must be derived from certain sources, including dividends, interest, payments with respect to securities loans, and gains from sale or other dispositions of stocks, securities or foreign currencies. In addition, at the close of each quarter of the fund's taxable year, at least 50 percent of the value of the fund's total net assets must consist of cash, cash items, government securities, securities of other funds, and investments in other securities which, with respect to any one issuer, represent neither more than 5 percent of the assets of the fund nor more than 10 percent of the voting securities of the issuer. Further, no more than 25 percent of the fund's assets may be invested in

the securities of any one issuer (other than government securities or the securities of other funds), the securities (other than the securities of the other funds) of two or more issuers which the fund controls and are engaged in similar trades or businesses, or the securities of one or more qualified publicly traded partnerships.

If a mutual fund satisfies the gross income and asset tests to qualify as a RIC and distributes at least 90 percent of its income (other than net capital gains) so that it qualifies for Subchapter M treatment, the fund is taxed only on the income and capital gains that it retains; these amounts are taxed at the regular corporate tax rate of 21 percent. Therefore, mutual funds typically distribute each year all of their income and capital gains to eliminate a tax that would reduce investor returns.

The IRC also imposes an excise tax unless a fund distributes by December 31st at least 98 percent of its ordinary income earned during the calendar year, and 98.2 percent of its net capital gains earned during the 12-month period ending on October 31st. Mutual funds typically seek to avoid this charge – imposed at a 4 percent rate on the "undistributed" amount – by electing to distribute their income currently.

**Business Trusts are treated as corporations for US federal tax purposes. There are no US tax differences between investment funds that are organized as corporations, MBTs or DSTs.**

How are investors in US mutual funds taxed in the US?

Investors in US mutual funds are ultimately responsible for paying tax on a fund's earnings, whether they receive the distributions in cash or reinvest them in additional fund shares/interests. Tax will not be due currently, however, if the fund shares are held through tax-deferred retirement accounts or variable annuities. In addition, the income earned by funds from investing in the bonds of state and local governments is exempt from tax at the federal level (although generally taxable at the state level unless the bonds are issued by the investor's own state government).

Eligibility of All US Funds – including Business Trusts – for tax treaty benefits

All US funds – including those organized as statutory or business trusts – that meet the RIC requirements qualify for treaty benefits as persons, residents, and the beneficial owners of their income. Business Trusts also are formally recognized in the India-US tax treaty and are treated as beneficial owners under the treaty.

1. *Person*

   Paragraph 1(e) of Article 3 (General definitions) of the India-US tax treaty defines a "person" to include *"an individual, an estate, a trust, a partnership, a company, any other body of persons, or other taxable entity."* A fund organized as a business trust is regarded as a "person," as defined in Article 3 of the India-US tax treaty, because it is a trust, it is treated as a company, and it is a taxable entity.

2. *Resident*

Paragraph 1 of Article 4 (Residence) of the India-US tax treaty defines a "resident" to mean *"any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, citizenship, place of management, place of incorporation, or any other criterion of a similar nature, provided however that:*

*(a) This term does not include any person who is liable to tax in that State in respect only of income from sources in that State; and*
*(b) In case of income derived or paid by a partnership, estate or trust, this term applies only to the extent that the income derived by such partnership, estate or trust is subject to tax in that State as income of a resident, either in its hands or in the hands of its partners or beneficiaries."*

Since the income earned by the Business Trust is liable to tax at the trust level – and is taxed, upon distribution, to the trust's investors, the trust is regarded as tax resident in the US

3. *Beneficial Ownership*

The Treasury Department's Technical Explanation of the Convention, in discussing the *"beneficial ownership"* requirement of Article 10 (Dividends) or Article 11 (Interest) provides that *"The term 'beneficial owner' is not defined in the Convention; it is, instead, defined by domestic law of the Contracting States. A nominee or agent which is a resident of a Contracting State may not claim the benefits of this Article if the dividend is received on behalf of a person who is not a resident of that Contracting State. However, dividends received by a nominee for the benefit of a resident would qualify for the benefits of this Article."*

Unfortunately, the term *"beneficial owner"* is not defined in the IT Act. Hence, from an Indian context, one has to rely on general taxing principles while interpreting this term. Business Trusts, as discussed above, retain full control over their income and are not transparent. This is because while the value of a Business Trust's units includes the value of any income (such as dividend, interest, or capital gain) earned by the Business Trust, a unit holder has no right of receipt of that income until a dividend with respect to that income is declared. If an investor sells his units before the dividend is declared, the investor is not entitled to the dividend. Conversely, if an investor buys units after the income is earned but before the dividend is declared, the investor is entitled to the dividend. Moreover, the US tax and securities laws prevent items of income or tax benefit from being allocated specially to individual unit holders. All unit holders in a Business Trust are entitled to an equal share of any tax treaty benefit received by the Business Trust. In addition, a Business Trust

does not act as an agent for its investors. Thus, Business Trusts are the beneficial owners of their income.

*4. Recognition of Business Trusts in Article 10 (Dividends) of the India-US tax treaty*

Paragraph 2 of Article 10 (Dividends) of the India-US tax treaty provides as follows:

*"2. However, such dividends may also be taxed in the Contracting State of which the company paying the dividends is a resident, and according to the laws of that State, but if the beneficial owner of the dividends is a resident of the other Contracting State, the tax so charged shall not exceed:*

*(a) 15 percent of the gross amount of the dividends if the beneficial owner is a company, which owns at least 10 percent of the voting stock of the company paying the dividends;*
*(b) 25 percent of the gross amount of the dividends in all other cases.*

*Sub-paragraph (b) and not sub-paragraph (a) shall apply in the case of dividends paid by a United States person which is a Regulated Investment Company. Sub-paragraph (a) shall not apply to dividends paid by a United States person which is a Real Estate Investment Trust, and sub-paragraph (b) shall only apply if the dividend is beneficially owned by an individual holding a less than 10 percent interest in the Real Estate Investment Trust. This paragraph shall not affect the taxation of the company in respect of the profits out of which the dividends are paid."*

The Treasury Department's Technical Explanation of the Convention, clarifies that *"the second and third sentences of paragraph 2 relax the limitations on source country taxation for dividends paid by US Regulated Investment Companies and Real Estate Investment Trusts. Dividends paid by Regulated Investment Companies are denied the 15 percent dividend rate and subjected to the 25 percent portfolio dividend rate regardless of the percentage of voting shares held by the recipient of the dividend. Generally, the reduction of the dividend rate to 15 percent is intended to relieve multiple levels of corporate taxation in cases where the recipient of the dividend holds a substantial interest in the payer. Because Regulated Investment Companies and Real Estate Investment Trusts do not themselves generally pay corporate tax with respect to amounts distributed, the rate reduction from 25 percent to 15 percent cannot be justified by the 'relief from multiple levels of corporate taxation' rationale. Further, although amounts received by a Regulated Investment Company may have been subject to US corporate tax (e.g., dividends paid by a publicly traded US company to a Regulated Investment Company), it is unlikely that a 10 percent shareholding in a Regulated Investment Company by an Indian resident will correspond to a 10 percent shareholding in the entity that has paid US corporate tax (e.g., the publicly*

*traded US company). Thus, in the case of dividends received by a Regulated Investment Company and paid out to its shareholders the requirement of a substantial shareholding in the entity paying the corporate tax is generally lacking."*

Given the above, if a Business Trust (which is recognized as a Regulated Investment Company for US tax and regulatory purposes) were to distribute dividends to its unit holders who are Indian tax residents, as per Article 10 (Dividends) of the India-US tax treaty, the Business Trust would need to withhold tax in the US at the rate of 25 percent on such dividends declared to its unit holders who are Indian tax residents.

Since, a Business Trust (which is recognized as a Regulated Investment Company for US tax and regulatory purposes) is treated like a corporation, under US Federal tax law as well as for the purposes of Article 10 (Dividends) of the India-US. tax treaty, then India should allow such a Business Trust also to be treated as a corporation for all Indian income-tax purposes.

**2. The Variation with the Indian Tax Law**

The Indian tax law requires every person to determine its tax status based on its legal status. This determination needs to be done up front at the very beginning (i.e., at the time of seeking a tax registration: PAN from the Indian Revenue authorities), as well as throughout the life of the taxpayer (i.e., at the time of filing its tax return in India). For example:

- While paying advance tax, every taxpayer has to disclose its legal status (*i.e.*, corporate or non-corporate) and discharge its tax liability accordingly;
- While withholding tax, every payer needs to determine the legal status of the payee (*i.e.*, whether corporate or non-corporate) and deduct tax at source at the applicable tax rates;
- While filing a tax return in India, every taxpayer needs to complete its own tax return by using the proper tax return form (*i.e.*, whether for corporate or non-corporate filers) and have the said return submitted within the stipulated deadlines (which could be different for corporate and non-corporate tax payers).

Some of the key reasons for the above determination emanate from the fact that the Indian tax law provides different bases of taxation for different types of taxpayers. For example:

- Even though FPIs are subject to tax in India, irrespective of their legal form, at the same base tax rates, when you tack on surcharge and cess to the base tax rates, non-corporate tax payers are subject to slightly higher tax rates vis-à-vis corporate tax payers. This is because the Indian

Government has prescribed higher surcharge rates for non-corporate taxpayers as compared to corporate taxpayers.

- The due date for filing corporate tax returns is different from that for non-corporate taxpayers. The forms for completing the income-tax returns are also different.
- Sometimes fiscal benefits are afforded to only certain types of taxpayers.

Confusion has arisen for US mutual funds that are established in the US as state law trusts, and which file their tax returns in their home country (i.e., the US) as corporations, regarding (i) the tax return that the investment fund should file in India and the timing of the filing; and (ii) the tax rate that the fund should pay in India (i.e., the rate applicable to corporate taxpayers or the rate applicable to non-corporate taxpayers). Are the funds corporate or non-corporate entities? They file corporate tax returns in the US but might be required to adopt a contrary position in India and file as non-corporate entities.

Hence, the question whether such investment funds are to be treated as corporations or trusts for Indian tax purposes has arisen repeatedly.

Certainty regarding the tax rate and filing status of investment funds, for reasons noted above, is crucial for investment funds and their investors. Conclusive guidance that is adhered to by all tax officials regarding such administrative issues will make the investment environment in India more attractive.

### 3. The Indian Mutual Fund Experience

Currently, the Securities and Exchange Board of India (SEBI) mandates every domestic mutual fund that is set-up in India, to be established as a trust under the Indian Trust Act, 1882. The legal form of an Indian mutual fund is similar to that of a US mutual fund that is organized under state law as a trust. However, unlike US mutual funds that have the option of being established as corporate entities in the US, Indian mutual funds do not have the option of being set up as corporate entities.

The Indian tax law exempts all income earned by mutual funds in India from tax in the hands of the mutual fund[1]. Depending on the nature of the Indian mutual fund scheme and the status of the investor in the Indian mutual fund scheme, an Indian mutual fund is required to pay an additional income-tax on distributed income at the rates tabulated below[2]:

| Nature of the Indian mutual fund scheme | Type of investor in the Indian mutual fund scheme | |
|---|---|---|
| | Individuals and HUFs | Others |

[1] Section 10(23D)
[2] Chapter XII-E

| | | |
|---|---|---|
| Equity Oriented Fund ('EOF') | 10% | 10% |
| Non-EOF | 25% | 30% |

The distribution income that is received by investors in Indian mutual fund schemes is exempt from tax in the hands of the investors[3].

An investor who sells mutual fund units usually incurs a capital gain/loss in the year of transfer; an exchange of shares/interests between funds in the same fund family also results in a capital gain/loss. Any capital losses can be offset against other capital gains that may be earned by the investor from his investments in other mutual fund shares/interest, or stocks, bonds or other securities. Depending on the investment focus of the mutual fund, the investors in such mutual fund could be subject to varying tax rates on their capital gains income. For example: investors in EOFs are required to pay a *de minimis* Securities Transaction Tax ('STT') at the time of redemption of their mutual fund units, and the resultant LTCG and STCGs that they realize are taxed in their hand at a flat rates of 10 percent and 15 percent respectively. Investors in Non-EOFs do <u>not</u> pay any STT, but are required to pay tax at the rates of 20 percent on their LTCGs realized and pay tax at their residuary tax rate on their STCGs realized.

<u>Principle of reciprocity</u>

The US does not tax a foreign investment fund that conducts only portfolio investments in the US capital markets as a US taxpayer with tax filing requirements. The only US taxes that are imposed on a foreign investment fund are the withholding taxes that apply to dividends paid by US companies to non-US investors. The statutory withholding rate on these payments is at most 30 percent. No US tax generally is imposed on interest payments or gains from the sale of securities.

India is one of the few countries that taxes foreign portfolio investors on their Indian-sourced capital gains income and mandates that such investors file annual tax returns in India. We are not asking the Indian Government to stop taxing foreign portfolio investors or stop requiring them to file annual tax returns in India thereby reporting their Indian-sourced income. All we are seeking is a level playing field for investment funds that are constituted as business trusts (be they MBTs or DSTs, etc.) and which are treated as corporations in their home country, for l income-tax purposes, to continue with this position for Indian income-tax purposes.

[3] Section 10(35)

## 4. Restructuring is Not a Solution

It is sometimes suggested that regulated funds should simply reorganize into corporate form to avoid disparate tax treatment in India. A corporate reorganization, however, is not always feasible. For example, some funds are precluded by their domestic law from restructuring (i.e., requirements that a fund be organized as a trust, similar to India). There also may be adverse consequences in other countries where the funds make investments. Specifically, a reorganization undertaken solely for tax purposes is highly scrutinized and risks being treated as taxable; thus, triggering capital gains tax in each country the fund invests.

## 5. Suggestions

We recommend that the Central Board of Direct Taxes (CBDT) confirm that all regulated funds should file tax returns in India based on their home country tax status. This would resolve many of the issues that US regulated funds that are organized as business trusts experience when investing in India.

This solution is preferable to formal restructuring, for several reasons. First, the relief can be provided quickly; legislation is not needed. Second, this relief resolves the issue for those funds that are precluded by their domestic law from restructuring. Third, for those funds for which restructuring is legally available, this solution prevents the funds—and, therefore, their moderate-income investors—from incurring any costs or adverse consequences in other countries where the funds may invest. Finally, this Indian-driven solution does not create potential legal considerations in the fund's domicile.

The CBDT has the authority to carry out this guidance pursuant to a provision in the IT Act, *i.e.*, section 2(17)(iv), which allows the CBDT to notify *"any institution, association or body, whether incorporated or not and whether Indian or non-Indian, which is declared by general or special order of the CBDT to be a company."*

The analysis below reproduces section 2(17), describes the notification procedure and explains why any institution, association, or body (which is headquartered outside India) that is declared a "company" under section 2(17)(iv) would then be regarded as a "foreign company."

A. Section 2(17) of the Income Tax Act, 1961 ( the Act), as amended by the Finance (No. 2) Act, 1971, grants CBDT powers to declare any institution, association, or body, whether incorporated or not, to be a company, by general or special order. Section 2(17) of the Act is reproduced below:

> *"company" means—*
>
> *(i) any Indian company, or*
> *(ii) any body corporate incorporated by or under the laws of a country outside India, or*

*(iii) any institution, association or body which is or was assessable or was assessed as a company for any assessment year under the Indian Income-tax Act, 1922 (11 of 1922) or which is or was assessable or was assessed under this Act as a company for any assessment year commencing on or before the 1st day of April, 1970, or*

*(iv) any institution, association or body, whether incorporated or not and whether Indian or non-Indian, which is declared by general or special order of the Board to be a company :*

***Provided** that such institution, association or body shall be deemed to be a company only for such assessment year or assessment years (whether commencing before the 1st day of April, 1971 or on or after that date) as may be specified in the declaration;*

The statutory powers under section 2(17)(iv) have been earlier used by CBDT (as stated in the Explanatory Memorandum extracted below), to confer the status of company on entities ('bodies') even though they do not possess the ordinary characteristics of a company limited by shares. The history of this provision and the powers granted to CBDT under this provision as stated in the Explanatory Memorandum to the Finance Bill of 1971 when section 2(17) was amended is reproduced below:

***"70. Definition of "company"** - For the purposes of Income-tax Act, the term "company" is defined to mean: (i) any Indian company; or (ii) association, whether incorporated or not and whether Indian or non-Indian which is declared by a general or special order of the Central Board of Direct Taxes to be a "company" for the tax purposes of the Act. This power to declare any association to be a "company" for tax purposes has been made use of for several years past with a view to conferring the status of a "company" on foreign companies as also on entities which are not otherwise within the scope of that concept. Such declaration is given by the Board, ordinarily, in the case of any entity which possesses the ordinary characteristics of a company limited by shares and which is a legal person according to the laws of the country in which it is incorporated. Besides declaring companies registered in foreign countries to be "companies" for purposes of taxation in India, statutory corporations established by a Central, Provincial or State enactment, such as road transport corporations, air transport corporations, etc., have been declared to be companies. Foreign corporations in which the capital is held wholly or partly by a foreign Government have also been declared as "companies" for the purposes of income-tax, where such corporations are legal entities separate from the Government and are capable of holding property independently and of suing and being sued according to the laws of that country. The provision has also been used, on a few occasions, to confer the status of company on bodies such as chambers of commerce, clubs, etc., even though these bodies do not possess the ordinary characteristics of a company limited by shares. The declaration under this provision has been given in some cases with retrospective effect to cover past years as well.*

> ***71.*** *The requirement that a foreign company could be treated as a company for purposes of the Income-tax Act only if it has been declared as a company by the Board generates unnecessary work. Further, giving retrospective effect to declarations made in the case of foreign companies or other non-corporate entities may not be said to be strictly in accordance with the provisions of the law. In order to place the existing practice, that has been followed over the last many years, on a statutory footing and to reduce the number of cases in which declaration as a company has to be given by the Board, it is proposed to amend the definition of "company" for the purposes of the Income-tax Act. Under the proposed definition, the term "company" will include, besides any Indian company, any body corporate incorporated by or under the laws of any country outside India. The term will also include any institution, association or body which is or was assessable or was assessed, under the 1922 Act or the 1961 Act, as a company for any assessment year up to and including the assessment year 1970-71. Further, as under the earlier definition, the Central Board of Direct Taxes will have the power to declare, by general or special order, that any institution, association or body, whether incorporated or not and whether Indian or non-Indian, will be treated as a "company" for purposes of the Income-tax Act. This power of the Board is now being specifically made exercisable even in relation to past assessment years (whether commencing before, or on, or after 1-4-1971) and the declaration will have effect for any assessment year or years specified therein."*

B. Therefore, the power to notify entities (whether possessing the ordinary characteristics of companies or not) as companies has been retained with the CBDT under the amended provisions of section 2(17).

C. A regulated fund <u>not</u> set up as a company or a firm, e.g. set-up as a trust, (i.e. an institution, association or body) that is declared a **"company"** under section 2(17)(iv) the Act, would be regarded as a **"foreign company"** under section 2(23A) of the Act. This will bring it on par with all FPIs that are regulated funds and which are set-up as companies which invest in the Indian capital markets. This is because such a regulated fund will <u>not</u> be an **"Indian company"** under section 2(26)(ib) of the Act, as it will <u>not</u> have its registered office or principal office in India [and would therefore be covered by the exclusion stated in the proviso to section 2(26) of the Act]. Consequently, it will <u>not</u> be regarded as a **"domestic company"** under section 2(22A) of the Act, because it does <u>not</u> fulfil the conditions of that section that either it is an an Indian company <u>or that</u> makes the prescribed arrangements for the declaration and payment of dividend within India. Consequently, it will be a **"foreign company"**, as defined in section 2(23A) of the Act to mean a company which is <u>not</u> a domestic company.

D. The relevant provisions of the Act are reproduced below:

(i) Section 2(26) of the Act, as amended by the Finance (No. 2) Act, 1971, deems any institution, association, or body which is declared by the CBDT to be a company, under section 2(17), to be an Indian company. Section 2(26) of the Act is reproduced below:

*"Indian company" means a company formed and registered under the Companies Act, 1956[4] (1 of 1956), and includes —*

*(i) a company formed and registered under any law relating to companies formerly in force in any part of India (other than the State of Jammu and Kashmir [and the Union territories specified in sub-clause (iii) of this clause];*

*[(ia) a corporation established by or under a Central, State or Provincial Act;*

*(ib) any institution, association or body which is declared by the Board to be a company under clause (17);]*

*(ii) in case of the State of Jammu and Kashmir, a company formed and registered under any law for the time being in force in that State;*

*[(iii) in the case of any of the Union territories of Dadra and Nagar Haveli, Goa, Daman and Diu, and Pondicherry, a company formed and registered under any law for the time being in force in that Union territory:]*

**Provided** that the [registered or, as the case may be, principal office of the company, corporation, institution, association or body] in all cases is in India;

(ii) The Memorandum explaining the provisions of the Finance (No. 2) Bill, 1971 also explains the rationale for amending the definition of **"Indian company"** so as to confer benefits of those corporations that are established by or under a Central, State or Provincial Act, or those institutions, associations or bodies that are declared by the CBDT to be a company under section 2(17) of the Act.

The relevant extract of the Memorandum is reproduced below:

***"72. Definition of "Indian company"*** *– The definition of the term "Indian company" in the relevant provision of the Income-tax Act presently covers only those companies which are formed and registered under the Companies Act, 1956 or the law relating to companies formerly in force in any part of India including, Jammu & Kashmir or in the union Territories of Dadra and Nagar Haveli, Goa, Daman and Diu and Pondicherry. It does not cover statutory*

[4] Now Companies Act, 2013

*corporations which, as stated in paragraph 70 have to seek a declaration to be a company for purposes of taxation. Such a declaration does not, however, confer the status of "Indian company" on such statutory corporations. Even under the provisions now proposed to be made in the Income-tax Act as discussed in paragraphs 70 and 71, a statutory corporation established in India will not come within the definition of "Indian company". Apart from this, statutory corporations by their very nature do not often have a share capital as such and hence such a corporation is not in a position to qualify for being treated as a 'domestic company' i.e. an Indian company or a company which has made the prescribed arrangements for the declaration and payment of dividends within India. This position sometimes results in unintended difficulties both as regards the rates of tax applicable to the company's income and also its eligibility to some of the tax concessions, such as the export market development allowance, which are available only to domestic companies. It is accordingly proposed to amend the definition of 'Indian company' so as to cover statutory corporations established in India as also any institution, association or body which is declared by the Board to be a company and which has its principal office in India."*

(iii) Section 2(22A) of the Act, which defines the term **"domestic company"**, is reproduced below:

*"domestic company" means an Indian company, or any other company which, in respect of its income liable to tax under this Act, has made the prescribed arrangements for the declaration and payment, within India, of the dividends (including dividends on preference shares) payable out of such income;*

(iv) Section 2(23A) of the Act, which defines the term **"foreign company"**, is reproduced below:

*"foreign company" means a company which is not a domestic company;*

**Proposed amendments to the Income-tax Act, 1961 (Act) to provide tax neutral treatment for overseas fund reorganizations involving Foreign Portfolio Investors (FPIs)**

- First, the Act should be amended to exempt reorganizations of investment funds from capital gains tax if the reorganizations are treated as "tax neutral" in the home country. Comparable exemptions already exist in the Act for numerous types of reorganizations; but these exemptions do not currently apply to trust structures.
- Second, in case of a reorganization that is treated as "tax neutral" in the home country, the Act should allow a successor fund to take into consideration: (i) the cost of acquisition of the shares acquired by it from the predecessor fund; and (ii) the period of holding of the shares of the predecessor fund, while computing the successor fund's capital gains tax liability. Similar provisions exist in the Act in case of mergers and demergers of Indian companies, conversions etc.[1]
- Third, the Act should be amended to allow capital losses incurred by a predecessor fund to carry over to a successor fund that acquires the predecessor fund's assets in a reorganization that is "tax neutral" in its home country. Notably, the Bombay High Court recently issued a ruling[2] respecting the tax neutrality of a fund's reorganization and permitted the carryforward of capital losses in India, making it the law of the State of Maharashtra where a majority of the FPIs investing in India are assessed. We request that the Indian Government codifies rules that are consistent with the High Court's decision in this regard.
- Fourth, the provisions of the Act[3] that allow a successor entity that earns "business income" to address tax filings and other obligations of its predecessor entity should be extended to investment funds and tax filings associated with capital gains of a predecessor fund.

A draft amendment to the Act implementing these changes is provided below:

Firstly, introduce in new clause in section 47 of the Act, for granting tax neutral treatment to the overseas re-organization

"(___) any transfer in a reorganization, of a capital asset being a security held by an amalgamating Foreign Institutional Investor to an amalgamated Foreign Institutional Investor, if such transfer does not attract tax on capital gains in the country in which the amalgamating Foreign Institutional Investor is set-up."

Explanation – For the purposes of this clause –

[1] Sections 2(42A) and 49 of the Act.
[2] Aberdeen Asia Pacific Including Japan Equity Fund vs Deputy Commissioner of Income-tax (WP No 2796, 2803, and 3525 of 2019)
[3] Section 170 of the Act.

(a) the expression "Foreign Institutional Investor" shall have the meaning assigned to it in clause (a) of the Explanation to section 115AD;

(b) the expression "security" shall have the meaning assigned to it in clause (h) of section 2 of the Securities Contracts (Regulation) Act, 1956 (42 of 1956

Secondly, establish a suitable connection in section 49 of the Act that links to the aforesaid clause to be introduced in section 47 of the Act, for allowing the amalgamated Foreign Institutional Investor to carry over the original cost of acquisition of the amalgamating Foreign Institutional Investor

"(1) Where the capital asset became the property of the assesse –

.....

(iii) (e) under any such transfer as is referred to in clause (___) of section 47

.....

the cost of acquisition of the asset shall be deemed to be the cost for which the previous owner of the property acquired it, as increased by the cost of any improvement of the assets incurred or borne by the previous owner or the assesssee, as the case may be....."

Thirdly, introduce a section in Chapter VI of the Act, which deals with "Aggregation of Income and Set-off or Carry Forward of Loss", for allowing the amalgamated Foreign Institutional Investor to carry over the capital losses incurred by the amalgamating Foreign Institutional Investor. This will be consistent with international norms:

"(1) Notwithstanding anything contained in any other provision of this Act, where there is a reorganization involving two or more Foreign Institutional Investors, the accumulated loss of the amalgamating Foreign Institutional Investor for the previous year in which the reorganization was effected, shall be deemed to be the loss of the amalgamated Foreign Institutional Investor for the previous year in which the reorganization was effected, and other provisions of this Act relating to set off and carry forward of loss shall apply accordingly

Explanation – For the purposes of this clause the expression "Foreign Institutional Investor" shall have the meaning assigned to it in clause (a) of the Explanation to section 115AD"

Fourthly, introduce a section in Chapter XV of the Act, which deals with "Liability in Special Cases", for allowing the amalgamated Foreign Institutional Investor to address tax filings and other obligations of the amalgamating Foreign Institutional Investor. This will help resolve administrative issues that are currently faced by Foreign Institutional Investors in India when they reorganize overseas:

"(1) Where there is a reorganization involving two or more Foreign Institutional Investors –

(a) the amalgamating Foreign Institutional Investor shall be assessed in respect of the income of the previous year in which the reorganization took place up to the date of the reorganization;

(b) the amalgamated Foreign Institutional Investor shall be assessed in respect of the income of the previous year after the date of the reorganization.

(2) Notwithstanding anything contained in sub-section (1), when the amalgamating Foreign Institutional Investor cannot be found, the assessment of income of the previous year in which the reorganization took place to the date of the reorganization and of the previous year preceding that year shall be made on the amalgamated Foreign Institutional Investor in a like manner and to the same extent as it would have been made on the amalgamating Foreign Institutional Investor, and all the provisions of this Act shall, so far as may be, apply accordingly.

(3) When any sum payable under this section in respect of the income of such amalgamating Foreign Institutional Investor for the previous year in which the reorganization took place up to the date of the reorganization or for the previous year preceding that year, assessed on the amalgamating Foreign Institutional Investor, cannot be recovered from it, the Assessing Officer shall record a finding to that effect and the sum payable by the amalgamating Foreign Institutional Investor shall thereafter be payable by and recoverable from the amalgamated Foreign Institutional Investor and the amalgamated Foreign Institutional Investor shall be entitled to recover from the amalgamating Foreign Institutional Investor any sum so paid.

Explanation – For the purposes of this clause the expression "Foreign Institutional Investor" shall have the meaning assigned to it in clause (a) of the Explanation to section 115AD"

**Issue: Reorganizations Involving Business Trusts and Debt Funds/Multi-Asset Funds**

## 1. The Genesis of the Issue

Fund reorganizations occur for many different business and regulatory reasons. Under US law, for example, a fund reorganization may involve multiple funds or a single fund. When two funds are merged, the assets of the funds (which have comparable investment objectives) are combined; the investors in the remaining (successor) fund have a proportionate interest in each asset that previously was held by each of the predecessor funds. When a single fund is reorganized, there is no change in the assets, ultimate investors, fund manager or in some instances the directors/trustees of the predecessor fund and the successor fund. All such reorganizations, whether involving one or multiple funds, are treated as "tax neutral" in the US provided they meet specified requirements.

We are not aware of any other country that imposes capital gains taxes when a foreign fund undergoes a tax-free reorganization in its home country, as most countries do not tax foreign portfolio investors on capital gains. The few countries where foreign portfolio investors are subject to capital gains taxes (e.g., South Korea, Romania, Bangladesh, Pakistan, and certain Latin American countries), do not treat a reorganization as a taxable event.

The tax issue for funds seeking to reorganize involves the potential tax consequences if Indian securities are held in any of the affected portfolios. Specifically, the possibility of Indian tax, to the extent the portfolio consists of Indian securities, can prevent a transaction from occurring or cause the Indian securities to be sold before the transaction and perhaps not reacquired after the transaction occurs. The re-introduction of long-term capital gains tax in India, in 2018, makes this an even more critical issue for the fund industry.

## 2. Why Do Funds Merge?

Fund managers merge funds to increase economies of scale and enhance investor returns. Mergers may occur after one fund manager acquires another or when a single fund manager determines that investors would benefit from the merger of two of its funds. Following the acquisition of one fund manager by another, the fund offerings will be reviewed and comparable funds will be merged. Typically, when a single fund manager merges two of its own funds, the fund with a narrow investment objective, that has not generated sufficient investor interest, will be merged into a fund with a comparable, but broader, investment objective.

## 3. Why Do US Investment Funds Reorganize Themselves from a Corporate Structure to a Trust Structure?

Reorganizations in the US of a single fund may occur either to effect a change in form (such as from corporate to trust form), a change of jurisdiction (such as from Maryland to Delaware), or to change the

trust under which the fund is constituted, or a combination of these. These single-fund reorganizations typically occur because of state law innovations that improve fund governance and make a particular form or jurisdiction more attractive than it previously had been.

Some states in the US, such as Delaware, have codified the common law principles regarding the existence and structure of statutory trusts. Once created, the statutory trust is recognized as a separate legal entity. Hence, a Delaware Statutory Trust (DST) is a statutory legal entity that is created by the execution of a governing instrument and the filing of a Certificate of Trust with the Delaware Secretary of State. The governing instrument is an agreement entered into between one or more trustees and one or more persons who are to own equity interests in the DST. Only one trustee is required in order to create a statutory trust. The trustee (or, if there is more than one trustee, at least one of the trustees) must be either: (i) a natural person who is a resident of Delaware; or (ii) an entity that has Delaware trust powers. There are a number of banks in Delaware that can provide the requisite Delaware trustee services.

A DST is similar to a corporation in that the beneficial owners of the trust have no greater liability than that of a stockholder in a corporation. That is, if the governing instrument does not provide to the contrary and if the beneficial owners comply with the formalities of the governing instruments, with few exceptions, their liability is limited to the amount of their required investment. The law of a DST is drafted into the trust instrument, and provides full flexibility to eliminate governance procedures that are obligated under the corporate form; this has been one of the great attractions of the trust form. For example, the trust instrument can be drafted to dispense with routine shareholder meetings. Similar to a corporation, the law provides that, once formed, a DST has perpetual existence and is not terminated by the death, incapacity, dissolution, termination or bankruptcy of a beneficial owner, or the transfer of a beneficial interest. However, all of the foregoing may be altered by the terms of the governing instrument.

**4. Why do Investment Funds Shift the Place of Their Trust Domicile?**

US mutual funds, as described in greater detail in Annexure B,2, initially were formed as Massachusetts business trusts. Over the years, a number of developments led funds to consider other forms of organization. In addition to the developments discussed, there was some uncertainty, particularly in states other than the one in which a fund was organized, regarding the legal rights and responsibilities of a fund's investors vis-à-vis the fund and its trustees.

Statutory business trust statutes address certain potential difficulties with operating a fund as an MBT. In addition, these statutes can eliminate many of the uncertainties associated with common law trusts. The Delaware Statutory Trust Act ('Delaware Act'), which was enacted in 1988, provides, among other things, that the business trust is a separate legal entity and that the personal liability of the beneficial owners are limited to the same extent as stockholders in a Delaware Corporation. Under the Delaware

Act, the rights, obligations, and liabilities of the trustees and the beneficial owners of the trust can be varied to suit investors' needs. The Delaware Act contains specific provisions that make it attractive for use by RICs, including the authorization of separate portfolios.

Given the above, some investment funds that initially were organized as MBTs, for example, reorganized themselves into DSTs. This would essentially entail migrating the investment fund from its existing state to the State of Delaware and to be set up as a DST under the Delaware Statutory Trust Act. In each of these instances there is no change in the assets, ultimate investors, fund manager or in some instances the directors/trustees of the predecessor fund and the successor fund. Such reorganizations are treated as "tax neutral" in the US, and in most other jurisdictions as these countries either do not tax foreign portfolio investors on capital gains or respect the tax-free nature of the reorganization.

**5. How are such Reorganization Treated in the US?**

The policy rationale for tax-free reorganizations in the US, and many other countries, is that the transaction represents a "mere change in form" of the shareholders interest in the company. The shareholders have not "cashed out" their investment but instead have substituted one investment in the company for a similar investment in the same or related company. Importantly, a tax-free reorganization does not mean the company escapes taxation indefinitely. Rather, tax is deferred until the company sells, transfers or otherwise disposes of its assets.

The different types of reorganizations are defined in the Internal Revenue Code (IRC or Code) under section 368(a)(1) with a list of specific types of transactions defined in subparagraphs (A) through (G). Each type of reorganization is generally referred to by its relevant subparagraph (i.e., a Type A reorganization is defined in section 381(a)(1)**(A)**, and so on). A reorganization can be taxable or tax-free. To qualify as tax-free, the reorganization must satisfy strict requirements, including continuity of shareholder interest and continuity of business enterprise principles that generally ensure there is no meaningful change in ownership control or the underlying assets.

A brief description of the different types of reorganizations in the US is provided below:

- Acquisitions and Mergers – Type A, B, C, and some D Reorganizations.
    - Type A: a statutory merger or consolidation. As a result of a merger or consolidation, (1) all the assets and liabilities of the merged entity or entities become the assets and liabilities of the surviving entity; (2) the surviving entity issues stock to the shareholders of the merged entity or entities; (3) the stock in the merged entity or entities get cancelled by operation of law and the merged entity or entities cease to have a separate legal existence. This form of reorganization is less common for US regulated funds.

  - Type B: a "stock for stock" acquisition in which the acquiring or purchasing corporation uses solely voting stock to acquire a controlling interest in the stock of another corporation. Not used for US regulated fund reorganizations.
  - Type C: a "stock for assets" acquisition in which (1) one corporation uses voting stock to acquire substantially all the assets of another but smaller corporation (typically liabilities are assumed as well); (2) the surviving entity issues stock to the merged entity, which the merged entity onward distributes to its shareholders as part of the liquidation of the merged entity thereby making the shareholders of the merged entity shareholders in the surviving entity. This is perhaps the most common reorganization undertaken by merging US regulated funds.
  - Type D (acquisitive): a "stock for assets" acquisition in which (1) one corporation uses voting stock to acquire substantially all the assets of another but larger corporation (typically liabilities are assumed as well); (2) the surviving entity issues stock to the merged entity, which the merged entity onward distributes to its shareholders as part of the liquidation of the merged entity thereby making the shareholders of the merged entity shareholders in the surviving entity.
- Spin-offs and Divisions
  - Spinoffs and Type D (divisive): a divisive reorganization in which one corporation is divided into two or more corporations in a corporate division transaction, such that the first corporation divides itself by placing some of its assets into a new (or two or more) corporations and transfers ownership of the newly formed corporation to all of the first corporation's shareholders (a "spin-off") or to some of its shareholders (a "split up" or "split off"). US tax rules generally do not allow an investment company to divide itself tax-free, so, as a result, US regulated funds generally are not able to satisfy the conditions for a tax-free spinoff or other divisive reorganization, Type D (divisive) or otherwise. Thus, tax-free US fund divisions are not currently undertaken.
- Internal Restructuring – Type E, F, and G Reorganizations
  - Type E: a recapitalization in which the bondholders or shareholders of one corporation exchange their bond or stock interests for a different kind of equity interest in the same corporate enterprise.
  - Type F: involves a "mere change in identity, form, or place of organization of one corporation." **This type of reorganization is very common for US regulated funds and is sometimes referred to as a mere "name change."** In this type of reorganisation, (1) the old fund transfers all its assets and liabilities to a newly-formed empty fund (usually called a "shell fund"); (2) in exchange for which the new fund issues shares to the old fund, which the old fund then immediately distributes to its shareholders on liquidation of the old fund, thereby making the shareholders of the old fund shareholders of the new fund.
  - Type G: covers certain internal reorganization of one corporation in the bankruptcy setting.

US regulated investment funds typically undergo either Type A, C, or F reorganisations.

Under US tax law, a fund organized as a trust (be it an MBT or a DST) is treated as a regulated investment company (RIC) and taxed (as discussed in Annexure B.2) as a corporation for all US tax purposes under the IRC subchapter M rules. Hence, any fund reorganization that involves a trust is treated as tax neutral in the US (so long as it meets the requirements under the IRC for a tax-free reorganization), as it enjoys the same tax neutrality that is afforded to all corporations.

## 6. The Variation with the Indian Tax Law

The Indian tax law grants tax neutral treatment, in section 47(via) of the Indian Income-tax Act, 1961, to mergers involving two or more foreign companies.[4] The tax neutrality of the Indian tax provisions would extend to Type A and Type F reorganisations involving US companies / corporations.

The Indian tax law, however, does not extend the tax neutral treatment to reorganisations involving business trusts (e.g., MBTs or DSTs), and which qualify for the aforesaid tax neutral treatment in the US, on the basis that they are regarded as corporations for US tax purposes. Consequently, there are significant tax implications for overseas fund re-organizations that do not qualify for a tax neutral treatment in India:

- First, India treats the reorganization as a taxable transfer of all Indian assets from the predecessor fund to the successor fund. This results in unnecessary capital gains tax leakage for the predecessor fund.
    - Notably, the reintroduction of a long-terms capital gains tax in 2018 significantly increases the amount of leakage.
    - Further, the off-market transfer short-term capital gain tax rate is 30% compared to the regular 15% short term capital gain tax rate.
- Second, securities that are held by the predecessor fund for more than one year lose their status as long-term capital assets. This loss of status will result in short-term capital gains being triggered in the hands of the successor fund should the successor fund decide to sell any part of its portfolio within one year of the reorganization taking effect.
- Third, any accumulated capital losses on Indian securities held by the predecessor fund are "lost" upon the reorganization and cannot be used by the successor fund.
- Fourth, under the Income-tax Act, 1961 (Act) (i) the successor fund cannot file tax returns on behalf of the predecessor fund; and (ii) practical challenges arise in having the predecessor fund file its tax return in India and represent its case before the Indian Revenue authorities after the fund has shut down, as there is no one available to sign the last tax return of the predecessor fund or

[4] This assumes that SEBI permits the "off-market" transfer of securities for a fund undergoing a reorganization.

represent the predecessor fund's case, as and when it comes up for hearing before the Indian Revenue authorities.

**7. The Indian Mutual Fund Experience**

In India, all SEBI registered mutual funds operate under a trust structure as is mandated under the SEBI (Mutual Fund) Regulations, 1996. Unlike in the US, mutual funds in India do not have the option of being organized as corporate entities. Hence, the foregoing issue of reorganizations of mutual funds in India from one legal form to another, wherein the fund adopts a trust structure does not exist in an Indian context, as the Indian regulations do not allow for it.

Having said that, it is pertinent to note that mutual funds in India nevertheless can reorganize. Their reorganizations, however, typically are of the following kinds:

- Mergers of two or more mutual fund schemes when one mutual fund house is acquired by another mutual fund house.
- Consolidation of two or more mutual fund schemes that have similar attributes, as has been stipulated by SEBI.
- Consolidation of two or more plans within a mutual fund scheme, as has been stipulated by SEBI.

In all these instances, the mutual fund houses combine their schemes (which are managed by a trust set up in India) by transferring the assets and liabilities of the predecessor fund to the successor fund; the unit holders in the predecessor fund are given units in the successor fund in exchange for their units in the predecessor fund. Such combinations or mergers involving Indian mutual fund schemes that use the trust structure do not trigger any Indian income-tax implications for the mutual fund schemes because, under the Act, any income of a SEBI registered mutual fund is exempt from tax in India as per section 10(23D) of the Act. The unit holders in the predecessor funds, schemes, or plans, do <u>not</u> suffer tax on the consolidation / merger, as the Act provides them with a tax neutral treatment in sections 47(xviii) and 47(xix) respectively.

Hence, our request is for a level playing field to be provided for US mutual funds that undergo reorganizations under the home country, based on the home country law, and which are treated as tax neutral in the US and other countries worldwide. Our request is based on the tenet that even when Indian mutual funds undergo mergers in India, they do not suffer any Indian tax consequences.

<u>Principle of reciprocity</u>

As we have pointed out in Annexure B.2, the US does not tax a foreign investment fund that conducts only portfolio investments in the US capital markets as a US taxpayer. Because the foreign fund is not treated as having a permanent establishment in the US, its only US tax liability, like that of any other non-US portfolio investor in US securities, is the withholding tax on dividends paid by US companies.

A non-US fund making portfolio investments is not required to file a US tax return. Consequently, were an Indian mutual fund to reorganize its operations in India, such a reorganization would not trigger US tax implications. No tax would be due even if, as part of the reorganization, US securities held by one fund were transferred to another fund.

India is one of the few countries that taxes foreign portfolio investors on their Indian-sourced income and mandates that such investors file annual tax returns in India. We are not asking the Indian Government to stop taxing foreign portfolio investors. All we are seeking is a level playing field for US funds that are organized as trusts, treated as RICs, and therefore taxed as corporations, or that wish to reorganize themselves as trusts, to be exempted from their Indian tax liability arising on account of such one-off reorganizations. This same treatment is provided when an Indian mutual fund reorganizes itself in India; it neither triggers income-tax implications for itself in India (because all of its income is exempt from tax in India under section 10(23D) of the Act), nor does it trigger income-tax implications for itself in the US as the US does not tax Indian mutual funds on the gains from their U.S portfolio investments.

## 8. Tax Neutrality Afforded Under the Act

We wish to submit that the Act does contain certain provisions that treat as "tax neutral" mergers involving two or more entities, subject to certain conditions. Comparable exemptions that already exist in the Act include mergers between Indian companies,[5] mergers between foreign companies wherein shares of an Indian company are transferred,[6] demergers of Indian companies,[7] demergers of foreign companies wherein shares of an Indian company are transferred,[8] conversions of sole proprietorship concerns or firms into companies,[9] and conversions of companies into LLPs.[10]

**The Act should be amended to exempt reorganizations of investment funds from capital gains tax if the reorganizations are treated as "tax neutral" in the home country.** The exemption should be agnostic to the legal form of the investment fund. For example, if a US investment fund were to reorganize itself from one corporate form to another, it could claim exemption under the current provisions of section 47(via) of the IT Act. However, if the US investment fund uses a trust structure, it will not be able to claim exemption under the IT Act, simply because it is not a corporation; hence, our request for a change to be brought about in the Indian domestic tax law to set right this anomaly, which causes such unintended consequences.

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[5] Sections 47(vi) and 47(vii) of the IT Act.
[6] Section 47(via) of the IT Act.
[7] Sections 47(vib) and 47(vid) of the IT Act.
[8] Section 47(vic) of the IT Act.
[9] Sections 47(xiii) and 47(xiv) of the IT Act.
[10] Section 47(xiiib) of the IT Act.

**9. Hardship That is Followed by the US Investment Funds**

US investment funds that are organized as trusts, treated as RICs, and taxed as corporations, and that hold Indian securities have three options in regards to reorganization.

- Option 1 (Which is the least preferred): Funds can reorganize while holding Indian securities. This potentially creates a tax liability for the fund, including short-term capital gain implications for the reorganized fund in its first year of operation. Also, capital loss carry forwards, if any, will not be available to the reorganized fund. There also are costly and complicated reporting and filing requirements.

- Option 2 (Which is undesirable for the funds): Funds choose not to reorganize due to the undue hardship to the funds and, consequently, to their shareholders.

- Option 3 (Which also is undesirable for the funds and harms the Indian capital markets): Funds sell all of their Indian holdings prior to reorganization. After reorganization, funds determine if India still is an appropriate investment. Some funds will invest their proceeds from the liquidation of their Indian holdings in other countries or will not reinvest fully in India for reasons such as tax uncertainty or overvaluation of the Indian markets.

Hence, we need a solution that is workable and addresses the funds' concerns. If such a solution were to be provided, through tax neutral treatment to investment funds that reorganize themselves, more reorganizations would take place with no loss of fresh investment into the Indian capital markets.