By Electronic Delivery

28 February 2023

Honorable Prime Minister Mr. Narendra Modi
The Prime Minister's Office
South Block
New Delhi – 110 001
India

Re: *Indian Union Budget 2023: Impacting the competitiveness of the Indian debt markets globally. Urgent request to make permanent the 5% concessional income-tax rate on interest income earned by Foreign Portfolio Investors (FPIs).*

Respected Prime Minister Mr. Modi:

The undersigned fund industry associations, on behalf of their regulated fund members, strongly urge the Indian Government to make permanent the concessional income-tax rate regime introduced by the Finance Act, 2013 for FPIs by virtue of amendments brought about to section 115AD read with section 194LD of the (Indian) Income-tax Act, 1961, which lowered the statutory income-tax rate from 20% to 5% on interest payments on Indian Rupee denominated bonds and government securities.[1]

Since the 2013 enactment of the concessional rate, (gross) FPI inflows into the Indian debt markets have been INR 27.415 trillion (i.e., approx. US$ 334.329 billion), with (gross) inflows of INR 3 trillion or more (i.e., approx. US$ 36.59 billion or more) in each of FY 2016-17, 2017-18, 2018-19 , and 2019-20 and (b) net incremental FPI inflows into Indian debt securities over the same period have been INR 973.76 billion (i.e. approx. US$ 11.88 billion) on a net basis.[2] Long-term US regulated funds and European UCITS held approximately US$18.6 billion in Indian debt securities as of September 30, 2022.[3]

The current income-tax regime provided to FPIs investing in Indian debt securities has over the years (i) encouraged greater subscription by FPIs in Indian debt securities, (ii) encouraged the development of the Indian debt markets, and (iii) accelerated the growth of the Indian economy. At a minimum, we strongly recommend that the concessional income-tax rate be extended for another three years, as was previously done in 2017 and 2020. Maintaining the concessional rate is necessary to ensure the competitiveness of the Indian debt

[1] In 2020, the Indian Government extended, vide Finance Act, 2020, the concessional 5% income-tax rate to interest received on FPI investments in Indian municipal debt securities.

[2] The FPI inflows data has been sourced from data published by Central Depository Services (India) Limited for the period FY 2013-14 to FY 2022-23 (up to January 2023).

[3] Sourced from Morningstar.

markets globally, deepen the Indian bond market, and to provide FPIs with a stable and predictable tax regime in India.

Regulated funds and Indian borrowers will be severely negatively impacted.

The expiration of the concessional 5% income-tax rate will significantly decrease investors' after-tax returns – a full 15% for FPIs without access to a lower treaty rate – and, consequently, reduce the attractiveness of Indian debt securities. Tax treaties may only cap the income-tax rate in India to 10% (e.g., most of India's tax treaties with EU member states) or 15% (e.g., US-India treaty), and many funds cannot claim foreign tax credits (FTC) or have shareholders that cannot benefit from them. For example, US tax law allows certain funds to elect to treat all shareholders as effectively incurring the foreign tax directly, permitting the fund's shareholders to claim an FTC. Investors in retirement accounts, however, cannot benefit from FTCs and thus their after-tax return is decreased by any increase in foreign taxes paid. More than half of all assets in long-term mutual funds are owned by retirement account holders who cannot avail themselves of FTCs in their home country.[4]

FPIs and their investors have been absorbing the cost of the current concessional 5% income-tax rate. However, once this income-tax rate increases to a tax treaty level rate (e.g. 10% or 15%), or even the 20% income-tax rate (in the case of FPIs that cannot access tax treaty benefits), one could expect FPIs to closely re-evaluate whether investing in Indian debt securities makes good financial sense for them on an after-tax returns basis. This is particularly important for FPIs investing foreign currency into INR denominated Indian paper, as the FPIs also incur the costs of hedging currency risk.

Elimination of the concessional rate will also harm corporate India, who often borrow monies on the international debt markets from foreign lenders. Such lending arrangements are done on a tax-protected basis, consistent with international debt markets. Consequently, the cost of this borrowing (i.e., the interest, which will be grossed-up for Indian taxes), will be borne by Indian corporate borrowers.

Global withholding tax rates are either zero or low on interest income.

India's concessional rate on interest income is more consistent with international tax norms. Regulated funds typically invest in publicly offered debt and most countries do <u>not</u> impose withholding tax on interest paid on these types of securities. Few impose withholding tax on interest income,[5] and even fewer tax interest paid on government or corporate debt and may only apply withholding tax to "other interest income" or "private debt." Most G-20 countries do <u>not</u> tax regulated funds on their source country interest income.

We urgently request the Indian Government to make the 5% concessional income-tax rate for interest on rupee denominated bonds, government securities, and municipal debt securities received by FPIs, permanent. At a

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[4] See 2022 Investment Company Institute Factbook, Figure 7.10.

[5] Notable examples of countries imposing income-tax rates, including withholding tax rates, on interest paid to regulated funds and collective investment trust include: South Korea- 0% rate on government debt and approximately 14% on interest from corporate debt and "other interest,"; Indonesia – 10% rate on all interest income; Italy – 10% on "other interest" under applicable treaties and all other interest payments at 0% statutory rate; New Zealand – 0% on government debt and 10% on all other categories of interest income.

minimum, we recommend that the Government extend the concessional income-tax rate for at least three more years, as has been done twice in the past. The aforesaid will help retain existing FPI investments in Indian debt securities and has the potential to attract fresh FPI investment in Indian debt securities. This, in turn, could support the Indian economy further and aid in its continued growth.

With kind regards on behalf of the undersigned fund industry associations,

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