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Budget '23 may take up GIFT City AIFs' Tax Snags

By Sugata Ghosh, ET Bureau   Last Updated: Dec 12, 2022, 04:10 AM IST

Synopsis
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One of the businesses where this inconsistency surfaces is when a fund set up to invest and trade in listed stocks receives money from local investors.

Such a fund, which could be open ended and focused on the public market, is called a category 3 alternative investment fund (AIF), with categories 1 and 2 being venture capital and private equity funds largely betting on unlisted stocks.

The Reserve Bank of India (RBI) allowed domestic investment in a GIFT City fund using the Liberalised Remittance Scheme (LRS), under which a resident Indian can invest up to $250,000 a year in stocks and properties abroad. But administrators of category 3 AIFs receiving such LRS money may have a tough time dealing with the taxman.

Parul Jain, head of international tax practice at law firm Nishith Desai Associates, said, “Under the provisions of the Indian Income Tax Act, a ‘specified fund' includes a GIFT City AIF category 3, which has only foreign investors.”

“Such a specified fund is then taxed only at the fund level, and subsequent distributions to investors are exempt. However, if there is investment from Indian resident investors, which is routed through the LRS route into a category 3 AIF set up in GIFT City, then the fund would no longer qualify as a specified fund and, hence, the beneficial provision of taxation at fund level — with distribution being exempted for investors — would no longer be available,” said Jain of Nishith Desai Associates. “In this case, the fund set up as a trust gets taxed at the normal provision of the Income Tax Act, as per principles of trust taxation which, in the case of category 3 AIFs, are extremely complicated and impractical.”

A GIFT City category 3 AIF, thus, may find itself at a disadvantage while competing with a fund in Singapore, which is also luring wealthy Indians to invest using the LRS window.

Unlike category 1 and 2 AIFs, which say investors would be taxed, no such 'pass through' treatment of tax is specified for category 3 AIFs, most of which are set up as trusts.

Since category 3 funds invest in listed stocks, the earnings are taxed depending on whether these are treated as 'business income' or 'capital gain.' If it's business income, the trust pays the tax, but if it is capital gain, a trust may withhold a part of the tax, with the investor being required to pay the balance.

However, the tax office can go after the fund if the investor doesn't pay the tax.

The regulator, IFSC Authority, has drawn the government's attention to the issue, industry watchers familiar with the subject told ET.

Sources said it has also been discussed whether a tweak in the law would make it easier for foreign portfolio investors setting up shop in IFSC to issue participatory notes (P-notes), which are primarily unlisted equity derivatives with Indian listed stocks as underlier.

In this context, it was suggested that the Securities Contracts (Regulation) Act should be modified to include offshore derivative instruments under the definition of 'securities,' and their issuance by funds in GIFT City. "Transfers of offshore derivative instruments in GIFT IFSC have been spared taxation. But some clarity is required on taxation of offshore derivative instruments on distribution of funds," said an industry person.

P-notes, hugely popular once, are issued by offshore funds and brokerages, and subscribed by overseas investors who are keen to directly trade in Indian stocks without getting themselves registered with the Securities & Exchange Board of India (Sebi).

Over the years, Sebi has tightened regulations and disclosure standards to minimise the misuse of P-notes by residents, promoters of companies and stock manipulators. "The intent is to bring to IFSC some of the P-note issuance happening in France, Mauritius or Singapore," said the person.

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