BOMBAY CHAMBER
Bombay Chamber
of Commerce & Industry

SUGGESTED AMENDMENTS TO SECTION 9A OF THE INCOME-TAX ACT, 1961 (ACT)

Section 9A of the Act provides a safe harbor from the risk of creation of business connection/ place of effective management (POEM) of the offshore fund in India, where the fund manager of the said offshore fund is located in India.

In this regard, we wish to highlight the challenge in one of the key conditions in section 9A of the Act read with Rule 10V of the Income-tax Rules, 1962 (Rules) which we believe may limit fund managers from undertaking this activity in India. We have provided below a brief background of Section 9A of the Act and suggested amendments to the aforesaid rule for your consideration.

Background

- The Finance Act 2015 introduced section 9A into the Act to mitigate potential adverse tax consequences for an offshore fund that was managed by Indian fund manager. The tax safe harbor under section 9A of the Act is subject to the conditions prescribed therein.

- The objective of the conditions seems to be to regulate the offshore funds that are sought to be managed from India in terms of the jurisdictions that they belong to, their ownership pattern, and how the fund manager is being remunerated.

- That said, the provisions of Section 9A of the Act with the amendments thereto have been completely inadequate for fund managers in India to be able to manage foreign funds. In particular, one key condition which has been most challenging for the Fund to comply is clause (c) of Section 9A(3) of the Act, which states as under:

  "the aggregate participation or investment in the fund, directly ***or indirectly,*** *by persons resident in India does not exceed five per cent of the corpus of the fund.*

  Provided that for the purposes of calculation of the said aggregate participation or investment in the fund, any contribution made by the eligible fund manager during the first three years of operation of the fund, not exceeding twenty-five crore rupees, shall not be taken into account."

Practical challenges faced in meeting with this condition

- The purpose of this condition is to ostensibly check round tripping of Indian monies via global funds. While the Fund is able to validate the participation of direct investors (being natural persons in the Fund), in the context of the global fund industry, a significant set of investors in such Funds includes institutional investors or reputed discretionary wealth managers who allocate a portion of the wealth managed by them on behalf of their clients to specified asset managers. In such cases, the eligible investment managers have no access to the investors in those funds or the clients of the wealth managers.

Established 1836.
Admin Off.: The Ruby, 4th Floor NW, 29 Senapati Bapat Marg, (Tulsi Pipe Road), Dadar (W), Mumbai - 400 028. India. Tel. : +91-22 6120 0200 Fax: +91-22 6120 0213
E-mail : bcci@bombaychamber.com URL : www.bombaychamber.com
Regd. Off.: Mackinnon Mackenzie Building, 4, Shoorji Vallabhdas Marg, Ballard Estate, Mumbai 400 001. India. O : +91-22 4910 0200
CIN : U74999MH1924NPL001128

- In order to alleviate the above challenge, Rule 10V(2) of the Income-tax Rule, 1962 (Rules) was introduced to provide that where the direct investor is the Government / Central bank / sovereign fund / appropriately regulated investor, the fund should obtain a written declaration from the direct investor regarding the participation, if any, of Indian residents in that fund.

- Additionally, where the direct investor in the fund is an unregulated fund, the fund is required to undertake *'appropriate due diligence'* to ascertain the indirect Indian participation and the extent thereof. There is currently no clarity on what would be deemed to be appropriate due diligence but in approval that has been granted by the CBDT to the Fund, it has been intimated that they '*should be in a position to provide information of ultimate beneficial owners being Indian residents, when called for, in case their investment in the Applicant exceeds 5%'.*

- Practically, obtaining such declarations from institutional investors is extremely difficult since:

  - It is practically impossible to verify participation by Indian residents on an ongoing basis in cases where the eligible investment fund is an open-ended fund or listed on overseas stock exchanges.
  - Given the broad-based nature of these funds, obtaining declarations for each investor (solely to validate Indian tax residence) is not practically possible.
  - Despite several efforts by fund administrators, most sovereign investment funds and government / state pension funds have practically refused to provide such declarations on account of the amount of diligence that would need to be done to provide such a declaration. Furthermore, the India allocation of the corpus may also be a small portion of the global fund.
  - The shares of public retail funds are often sold through intermediaries and distribution partners that are themselves regulated and conduct their own Know Your Customer (KYC) and Anti-money laundering (AML) checks on the investors of these funds. Fund managers of these funds often do not have visibility (certainly not on a daily basis) over the identity of the investors of these funds as they may change frequently (due to subscriptions and redemptions) and are, in effect, customers or clients of the intermediaries rather than the fund managers.
  - In many cases, the institutional investors may themselves have institutional investors and getting such declaration up the chain is not practically possible.
  - There is no real incentive to go through all the documentation effort and monitor such participation as there is no tax benefit provided to the fund manager upon obtaining an approval under section 9A and the fund could very well continue to operate without any such requirement by simply moving/keeping the fund manager outside India.

Amendment sought to amend first proviso to section 9A(3) of the Act

"….
(c) the aggregate participation or investment in the fund, directly or indirectly, by persons resident in India does not exceed five per cent of the corpus of the fund.
(m) …
Provided that the conditions specified in clauses ***(c)****, (e), (f) and (g) shall not apply in case of an investment fund set up by the Government or the Central Bank of a foreign State or a sovereign fund, or such other fund as the Central Government may subject to conditions, if any, by notification* in the Official Gazette, specify in this behalf."*

*CBDT to issue notification (similar to Notification no. 41/ 2020) as under:

In exercise of the powers conferred by the proviso to sub-section (3) of section 9A of the Income-tax Act, 1961(43 of 1961), the Central Government hereby notifies that the conditions specified in clause (c) of the said sub-section shall not apply in case of an investment fund set up by a Category-I foreign portfolio investor registered under the Securities and Exchange Board of India (Foreign Portfolio Investors) Regulations, 2019, made under the Securities and Exchange Board of India Act, 1992 (15 of 1992)

Rationale for the amendment sought

- In the FPI context, SEBI has already prescribed KYC/ AML regulations which have been designed to identify natural investors/ track money laundering/round tripping. SEBI follows UBO concept for tracking the quality of investors from a KYC perspective.

- In accordance with the changes in Prevention of Money Laundering Rules, 2005 (PML Rules), beneficial ownership thresholds for FPIs has been lowered to 10% from the existing 25%. Accordingly, FPIs are required to identify and report the information with respect to the beneficial owners considering the lowered threshold of 10%.

- SEBI has released a circular (Circular 'SEBI/ HO/ AFD/ AFD – PoD – 2/ CIR/ P/ 2023/ 148' dated 24 August 2023), which outlines a framework for mandating additional granular disclosures for FPIs fulfilling certain criteria.

- Separately, participation or investment by Indian residents in an FPI is appropriately regulated by SEBI. As per the extant SEBI (Foreign Portfolio Investors) Regulations, 2019, the aggregate contribution of NRIs, OCIs and resident Indians shall be below 50% of the total contribution in the corpus of the FPI with a single resident shall be below 25% of the corpus. Further, SEBI has approved the aggregate participation by OCI/ resident Indians/ NRIs upto 100% in an FPI established in IFSC.

- Given that SEBI already prescribes guidelines in this regard, which are well understood and followed by market participants, there should not be any additional requirement under section 9A of the Act with respect to the participation of Indian residents.

- Considering the above, we wish to humbly submit that the Act is neither an appropriate statute for governing and regulating this aspect nor will it be able to keep pace with the updates/ amendments made by the relevant Regulator from time-to-time resulting into compliance with such onerous requirement on an ongoing basis.

  The UK and Australia, which have similar fund incentive schemes to promote domestic fund management, do not impose such rigorous conditions and have seen their regimes flourish over the years.

- A progressive regime enabling the management of offshore funds from India will help create an ecosystem for fund management, employment, talent, investment flows and nurturing of global best practices in the market. In particular, it would also help create employment opportunities in the fund management industry and encourage talent to remain in the country and contribute to the economic growth. A booming fund management industry helps to develop several ancillary services such as trusteeship services, custodial services and fund administrators.

Established 1836.
Admin Off.: The Ruby, 4th Floor NW, 29 Senapati Bapat Marg, (Tulsi Pipe Road), Dadar (W), Mumbai - 400 028. India. Tel. : +91-22 6120 0200 Fax: +91-22 6120 0213
E-mail : bcci@bombaychamber.com URL : www.bombaychamber.com
Regd. Off.: Mackinnon Mackenzie Building, 4, Shoorji Vallabhdas Marg, Ballard Estate, Mumbai 400 001. India. O : +91-22 4910 0200
CIN : U74999MH1924NPL001128

- We also wish to emphasize that:

  - Section 9A of the Act is not an incentive scheme but merely confers a protection to offshore funds from any potential adverse Indian tax consequences;

  - The offshore funds will continue to discharge appropriate taxes on their gains from investment in Indian capital markets (irrespective of the location of the fund manager);
  - FPIs and Indian fund managers are registered with and regulated by SEBI; and

  - SEBI monitors compliance with KYC and anti-money laundering norms by FPIs on an ongoing basis.

  - The presence of clause (c) in section 9A(3) of the Act, does not by itself prevent the participation of resident Indians in the FPI. It will have the result of preventing Indian fund managers and their employees from having the ability to manage offshore funds. Offshore funds will continue to invest in India by locating the manager outside India.

Exemptions to Fund Manager in Gujarat International Finance Tec-City (GIFT) International Finance Service Centre (IFSC)

- IFSC is conceptualized to be a world class financial centre on par with global financial centres. The Government has done a remarkable job developing IFSC towards this vision.

- As stated above, the issue of creating a Business Connection / Permanent Establishment/ POEM of the foreign fund / investing entity in India is equally applicable where the Fund manager is located in IFSC, because the fund manager is a resident of India and the challenges of meeting the conditions of section 9A of the Act also equally apply.

- In line with the intent of the Government of India to make IFSC a world-class financial centre, and to incentivize the fund managers to locate in IFSC, a specific dispensation should be provided to Fund managers under section 9A of the Act.

- As discussed earlier, the UK, Singapore, Hong Kong and Australia, which have similar fund incentive schemes to promote domestic fund management, do not impose such onerous conditions and have seen their regimes flourish over the years.

Proposed changes in the Income Tax Act

- Section 9 of the Act should be amended to include a proviso which states that any offshore Fund, being managed by a Fund Manager located in IFSC shall not constitute business connection or permanent establishment in India due to the Fund management functions being performed from IFSC. The intention can be attained by inserting a proviso in section 9(1) of the Act before Explanation 1 as under:

  "Provided that nothing contained in this section will apply to an offshore Fund/ non-resident entity being managed by a Fund Manager in IFSC. "