

# The Pulse

# India | FPI Newsletter

September 2021 | For private circulation only

Pulse is a quick guide to the ongoing tax and regulatory developments in India that are relevant to Foreign Portfolio Investors (FPIs).

It highlights key components of changes, their impact on FPIs, and the way forward.

Our endeavour is to help you comprehend the changes easily and equip you with the requisite knowledge to assist you in staying ahead of the curve.

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# Key developments: Impact on FPIs



## **SEBI introduces T+1 equity settlement cycle from 1 January 2022**

The Indian market regulator - Securities and Exchange Board of India (SEBI) has issued a circular to introduce T+1 settlement cycle on an optional basis from 1 January 2022. It states that SEBI has been receiving requests from various stakeholders to shorten the settlement cycle (from T+2 to T+1) and the decision to allow optional shortening in settlement cycle has been taken post discussions with the stock exchanges, clearing corporations, and depositories.

In terms of the circular, a stock exchange may choose to offer T+1 settlement cycle on any of the scrips after giving advance notice of at least one month. Once a stock exchange opts for T+1 settlement cycle for a particular scrip, it will need to continue that cycle for at least six months. After the six-month period is over, if the stock exchange wishes to revert to T+2 settlement cycle, it could do so by giving advance notice of one month. Once a security is placed in T+1 settlement cycle by the stock exchange, the regular market deals as well as block deals will follow T+1 settlement cycle.

It is pertinent to note that there will be no netting of trades between the T+1 and T+2 settlement cycles. Accordingly, an investor who purchases shares in T+1 settlement cycle and sells shares in T+2 settlement cycle will need to settle both these trades separately with exchange and would not be able to net off his purchase obligation with the sale proceeds.

It appears that SEBI's primary objective in pursuing this initiative is to reduce the settlement risk in the market i.e., the risk of default in payment of money, or delivery of shares by brokers, or their clients. It is expected that shortening of the trade settlement cycle would mean higher liquidity in the hands of investors and traders. Also, it may result in higher trading volumes, thereby generating higher revenues for the entire capital market ecosystem.

However, FPIs do not seem to be in favour of reduction in the settlement cycle. Considering the time zone differences, even currently, investors in major jurisdictions such as the United States, Canada, Europe, effectively get two working days to settle their trades in India. Squeezing this timeline to one day could throw up many operational challenges for FPIs and their global as well as local custodians. The FPIs may need to pre-fund their accounts in India to execute buy transactions, which will in turn increase the cost of investing in India. In the current T+2 settlement cycle, if there are trade mismatches, the market participants get time until the first half of T+1 to resolve them. In T+1 settlement cycle, in all likelihood, trade mismatches will have to be resolved by T day itself, failing which the trades would devolve on the broker. This would, in turn, increase the risk of default given that FPI trades are generally high value and brokers may find it challenging to settle large value transactions in their books.

Press reports suggest that FPI associations and local custodians are planning to take up this matter with the Government of India (in addition to SEBI) to explain the potential challenges they would face in shortening of the settlement cycle from T+2 to T+1. At present, China is the only major market where the settlement cycle for equity trades is less than T+2 and it is understood that the United States is also considering a move to shorten the settlement cycle from T+2 to T+1 within two years (from 2021 to 2023).

Though the SEBI has been looking to shorten the settlement cycle to T+1 for some time now, the industry did not see this coming so soon. It will be interesting to watch how would the government and SEBI would react to the representations filed by the FPI stakeholders.

### **No retrospective application of indirect transfer provisions**

An amendment has been introduced to the Indian tax law whereby indirect share transfer provisions will not apply to transactions undertaken prior to 28 May 2012 (i.e., the date on which indirect transfer provisions were approved to be added in the Indian tax law). The indirect share transfer provisions apply in case of transfer of shares or interest in an entity outside India, if such entity derives its value substantially from assets located in India i.e., Indian assets account for more than 50 percent of the entity's global assets and the value of Indian assets exceed INR 100 million.

The indirect share transfer provisions were included in the Indian tax law post the famous Vodafone ruling wherein the Supreme Court of India had held that Indian tax authorities did not have the jurisdiction to tax transfer of shares of a company outside India. Post this ruling, the Indian tax law was amended (with retrospective effect from 1962) to provide for taxation of transfer of shares or interest in a foreign entity in India, if such foreign entity derives its value substantially from India.

As per media reports, Indian tax authorities had raised retrospective tax demands under the indirect share transfer provisions from around 17 companies, aggregating to INR 81 billion. A couple of the companies from whom such retrospective tax was demanded have recently won international arbitration awards against the Indian government.

In a welcome move, the Indian government has now amended the indirect share transfer provisions, whereby any transfer of shares / interest of a foreign company prior to 28 May 2012 cannot be brought-in to the Indian tax net. In addition to making the tax law prospective, the government has also provided for a mechanism to end the ongoing litigation in this matter between the tax authorities / government and the taxpayer companies. As per this mechanism, any order passed by tax authorities to raise retrospective tax demand on transfer of sharers / interest in an entity outside India prior to 28 May 2012 would be deemed to have never been passed. Also, wherever retrospective tax has been collected by tax authorities, it will be refunded back to the taxpayers without payment of interest on such refund.

The nullification of the retrospective tax demands and refund of retrospective tax collected by the tax authorities would be subject to following conditions:

- If the taxpayer has filed any appeal before any forum or Court (including any writ petition in Supreme Court or High Court) against the retrospective tax demand raised by the authorities, such appeals will need to be withdrawn or an undertaking will have to be submitted by the taxpayer to the government to withdraw such appeals.
- If the taxpayer has initiated any proceeding for arbitration, conciliation or mediation or has given any notice under any law or under an agreement for protection of investment or otherwise, such proceedings or notice would have to be withdrawn or the taxpayer would need to submit an undertaking to withdraw such proceeding or notice.

- The taxpayer shall furnish an undertaking to waive its right to seek or pursue any remedy or any claim under any law or an agreement signed between India and any other country or territory.
- Any other conditions as specified by the government.

The Central Board of Direct Taxes (CBDT) has issued draft rules to prescribe the formats of the application and undertakings to be filed by the taxpayer (along with timelines) and the certificate to be issued / order to be passed by the authorities in response to such application / undertaking.

It is interesting to note that the taxpayer is required to indemnify, defend, and hold harmless the Indian government and/ or Indian affiliate of all costs and expenses, if a separate interested party (such as shareholders, beneficial owners, officers) of the taxpayer asserts, brings, files or maintains any claim against the Republic of India or Indian affiliates, at any time after filing the undertaking. Media reports suggests that the taxpayers may find it difficult to provide third-party indemnity sought by the government under the draft rules.

### SEBI permits free of cost transfer of shares in relocation of funds from offshore jurisdictions to IFSC

In Budget 2021, the Indian tax law was amended to provide tax neutrality to offshore funds and their investors in relocating to the International Financial Services Center (IFSC) in India. With this amendment, any transfer of Indian securities from an offshore fund to a fund set up in IFSC would not be taxable in the hands of the offshore fund as well as investors of the offshore fund.

The tax neutrality was important for an investment manager to consider relocating their funds set up in offshore jurisdiction to IFSC. However, under the FPI regulatory framework, such relocation would require sale / purchase of Indian securities by offshore fund / IFSC fund on the stock exchanges and therefore, would be subject to securities transaction tax (STT), stamp duty, brokerage, and other charges. Also, sell / buy on the stock exchange would involve FX conversions.

In a recent circular, SEBI permitted a one-time off-market (free of cost) transfer of Indian securities by an offshore fund (registered in India as an FPI) to a fund set up in IFSC. This would imply that the Indian securities can be simply transferred from the offshore fund's account in depository system thereby, avoiding STT and certain other costs. The FPI would need to submit a relocation request to its Designated Depository Participant (DDP) for such off-market transfer and the relocation request would also be deemed to be a request for surrender of FPI registration by the offshore fund.

The tax neutrality and SEBI's permission for free of cost transfer of securities is likely to encourage investment managers (especially those with Indian presence) to consider relocation of their offshore funds to IFSC given the commercial, tax and regulatory incentives available in IFSC for the fund as well as the investment manager.

### Relaxations on FPI investments in Indian bonds

The Indian regulations do not permit FPIs to borrow funds in India. As an exception to this rule, the Reserve Bank of India (RBI) has allowed FPIs to borrow funds from Indian banks (Authorised Dealer Category I banks), for the purpose of placing margins with Clearing Corporation of India Limited to transact in Central as well as State Government Securities.

The FPI investment limits in Indian bonds have been revised upwards. The latest available limits and their utilisation by FPIs is depicted in the table below.

Particulars	Overall limit (in US\$ Billion)	Current Utilisation (%)
General Investment Limit	Central government bonds	48.43
	State development loans	11.38
	Corporate bonds	77.95
Voluntary Retention Route	12.28	99.99%

It is pertinent to note that the investments made by FPIs or other non-residents in following securities are reckoned under the Fully Accessible Route (FAR) and therefore, are not subject to the above limits.

Sr No	ISIN	Security Description
1	IN0020200278	05.15 GS 2025
2	IN0020180488	07.32 GS 2024
3	IN0020180454	07.26 GS 2029
4	IN0020210012	05.63 GS 2026
5	IN0020200112	05.22 GS 2025
6	IN0020200153	05.77 GS 2030
7	IN0020190362	06.45 GS 2029
8	IN0020210095	06.10 GS 2031
9	IN0020200252	06.67 GS 2050
10	IN0020200294	05.85 GS 2030
11	IN0020200070	05.79 GS 2030
12	IN0020190396	06.18 GS 2024
13	IN0020200054	07.16 GS 2050
14	IN0020190032	07.72 GS 2049

### Funds and other investment entities from Cyprus can now obtain Category I FPI license in India

The Indian government has notified the Republic of Cyprus as an eligible country from where regulated funds and other prescribed entities can register in India as Category I FPIs. Since Cyprus is not a member of the Financial Action Task Force (FATF), earlier, a fund / entity set up in Cyprus could not register as Category I FPI in India, unless the investment manager of such a fund / entity was based in a FATF member country or if such fund / entity was owned 75% or more by another entity eligible to register as Category I FPI.

As a result of the government notification, regulated funds (or unregulated funds which are managed by regulated investment managers) set up in Cyprus can now register as Category I FPIs in India. With this development, such funds from Cyprus can avail of the following benefits:

- Non-applicability of indirect share transfer pricing provisions: In view of a specific exemption available in the law, any change in shareholding / interest in a Category I FPI outside India is not exposed to capital gains tax in India;
- Issuance of / subscription to Offshore Derivative Instruments (ODIs): Category I FPIs can issue / subscribe to ODIs (such as participatory notes, total return swaps etc.) with Indian securities as the underlying;
- Higher position limits for derivative transactions: Category I FPIs qualify for higher position limits to transact in derivative transactions; and
- Lower KYC requirements: The KYC documentation requirements for Category I FPIs are lower; for instance, Category I FPIs are not required to submit Proof of Identity documents for their Ultimate Beneficial Owners.

It is pertinent to note that Cyprus is the third such non-FATF member jurisdiction to be notified by the Government of India after Mauritius and United Arab Emirates.

## SEBI allows Indian Investment Manager entities to be constituent of FPIs

Historically, the Indian regulators have not been comfortable with resident Indians making investments in funds / entities outside India which in turn invest into India. There has always been a concern on potential round tripping of funds and tax evasion. In SEBI (FPI) Regulations, 2019, resident Individuals were permitted to invest in an FPI under the Liberalised Remittance Scheme (LRS) of RBI subject to a few conditions.

Representations were made to SEBI that due to the restrictions in Regulations, India based Investment Management entities are unable to contribute seed capital in offshore funds, that could be managed by such entities in India. To address these concerns, SEBI has now permitted Investment Management entities based in India to invest in FPIs (managed by them), provided the following conditions are satisfied:

- The Investment Manager entity qualifies as an eligible fund manager of the FPI under the Income tax law; and
- The FPI qualifies as an eligible investment fund under the Income tax law, and it has obtained a specific approval from the CBDT for this purpose.

The above relaxation by the SEBI is a positive step and it supports the tax incentives extended by the Indian government to Fund Managers located in India to manage offshore funds. Having said so, it is pertinent to note that some of the eligibility conditions provided in the tax law are not easy to comply with. Further, non-compliance with any of the prescribed condition would expose the fund to tax implications and would also result in non-compliance with SEBI Regulations. Given these challenges, only a handful Investment Managers have obtained approvals from the Indian government to be eligible fund managers to offshore funds.



# Recent tax rulings



## Requirement to produce Tax Residency Certificate (TRC) ought to be relaxed, if taxpayer provides sufficient circumstantial evidence

**Vamsee Krishna Kundurthi vs. ITO (International taxation), Hyderabad [(2021) 128 taxmann.com 368 (Hyderabad-Trib)]**

An individual taxpayer, resident of Austria, was employed by an Indian company and received salary and foreign allowance from the Indian Company during Financial Year (FY) 2013-14, on which the Indian company had withheld tax. The taxpayer filed a "Nil" return of income claiming such income not to be taxable in India in accordance with Article 15(1) of the Double Taxation Avoidance Agreement (DTAA / tax treaty) between India and Austria. In terms of this Article, income arising to a resident of Austria should be taxable in Austria, unless the employment is exercised in India. In the present case, the employment was exercised in Austria.

The Indian tax law mandates every taxpayer to obtain a TRC from Revenue authorities of the relevant country to claim treaty benefits. In this case, the taxpayer could not procure the TRC and consequently, the tax authorities denied treaty benefits. The matter reached before the Income-tax Appellate Tribunal (ITAT), which ruled in favor of the taxpayer on the following basis:

- If the taxpayer provided sufficient circumstantial evidence, then the requirement under the Income Tax Act, 1961 (ITA) to procure a TRC for claiming the treaty benefits ought to be relaxed.
- Where there was a conflict between the tax treaty and the Indian tax law, the tax treaty provisions overruled the Indian tax law. By virtue of the tax treaty, the taxpayer was liable to tax in Austria for the services rendered in Austria and not in India. Therefore, although the Indian tax law mandated TRC, non-production of the same did not enable the AO to deny treaty benefits to the taxpayer.

- Based on the facts and the relevant provisions of the India-Austria tax treaty, the following conditions were required to be satisfied to claim exemption under Article 15(1):
  - the person should be a resident of Austria; and
  - salary and other remuneration should be earned in respect of employment exercised in Austria.

## Re-domiciliation of company by itself cannot lead to denial of tax treaty benefits

### ADIT vs. Asia Today Limited [ITA no. 468 and 4629/Mum/2006] (Mumbai ITAT)]

A company (taxpayer) was registered as an 'international business company' in the British Virgin Islands (BVI) in 1991. Subsequently, the taxpayer was redomiciled to Mauritius in 1998. The Mauritian Revenue authorities also issued a TRC in favour of the taxpayer. The Indian tax officer denied the India-Mauritius tax treaty benefits to the taxpayer, as it was originally a BVI company. In appellate proceedings, the matter reached before the ITAT which ruled in favor of the taxpayer and allowed treaty benefits. One of the key observations of the ITAT was that re-domiciliation of the company, by itself, could not lead to denial of treaty entitlements of the target jurisdiction. Having said so, re-domiciliation of the company could trigger detailed examination by the tax authorities to ascertain whether the company is indeed fiscally re-domiciled and whether it qualifies for treaty benefits.

## Interest earned by Singapore merchant banker from NCDs issued by Indian company taxable at 15% as per India-Singapore tax treaty

### ABC Ltd., In re [(2021) 125 taxmann.com 399 (AAR - Mumbai)]

A Singapore based merchant banker (taxpayer) invested in India as a FII and subscribed to non-convertible debentures (NCDs) of an Indian company. The taxpayer filed an advance ruling application to confirm whether the interest earned from NCDs was taxable at 10 percent in India under Article 11(2)(a) of the India-Singapore tax treaty, which provides for 10 percent tax rate on interest paid on a loan granted by a bank carrying on a bona fide banking business, or by a similar financial institution (including an insurance company). Under the Singapore law, the taxpayer was regarded as a financial institution and therefore, it contended that it should qualify for 10% tax rate on interest arising from NCDs under Article 11(2)(a) of the India-Singapore tax treaty.

However, the Authority for Advance Rulings ruled that the taxpayer could not qualify for 10 percent tax rate under Article 11(2)(a) of India-Singapore tax treaty since investing in NCDs is not akin to granting of loans. Consequently, interest arising to taxpayer from the NCDs of Indian company should be taxable at 15 percent under Article 11(2)(b) of the India-Singapore tax treaty, which covers taxability of interest income other than those covered in Article 11(2)(a).

## Dividend received on IDRs (prior to 1 April 2017) by Mauritian tax resident not taxable under India-Mauritius tax treaty

### Morgan Stanley Mauritius Co. Ltd vs. DCIT, Mumbai [(2021) 127 taxmann.com 506 (Mumbai-Trib.)]

A Mauritius company (taxpayer) held Indian Depository Receipts (IDRs) issued by Indian branch of a UK based bank. The taxpayer received dividends on such IDRs in FY 2014-15. The taxpayer was of the view that the said dividend was not taxable in India since it was received abroad in respect of a foreign company (UK Co.) and India Bank was a bare trustee (i.e. akin to a nominee) for the IDR holders. Also, the payments did not fall under the definition of 'dividends' under Article 10 of the India-Mauritius tax treaty and could be taxed only in Mauritius in accordance with Article 22 (i.e. other income) of the tax treaty.

The Tribunal ruled that it is not correct to state that the income was not received in India. The receipt of dividends from the UK based bank by the taxpayer, was an income deemed to be accruing or arising in India. The dividend declared by the Indian depository (which issued IDRs underlying the shares of UK Bank) was on the basis of the dividend declared by UK Co but, what the taxpayer was entitled to were, the benefits flowing from the UK Co shareholdings as an underlying asset of the IDRs. Therefore, dividends received on IDRs were taxable under the Indian tax law.

Under the India-Mauritius tax treaty, dividends on IDRs were not covered under Article 10. Accordingly, the taxability of dividends was to be seen in the residuary income Article 22. In terms of this Article, income arising to a Mauritian resident not covered in any of the other Articles would be taxable in the country of taxpayer's residence. Relying on Article 22 of the tax treaty, the Tribunal held that the income was not taxable in India.

## Beneficial tax treaty withholding rate to prevail over higher rate prescribed u/s 206AA of ITA

### Jyoti Ltd. vs. DCIT (International Taxation) [I.T.A. No.666/Ahd/2018 (Ahmedabad ITAT)]

During FY 2013-14, an Indian manufacturing company (taxpayer) made certain payments to a Czech Republic company (C Co.) and withheld taxes thereon at 10 percent under Article 12 of India-Czech Republic tax treaty. At the time of withholding taxes, C Co. did not furnish a Permanent Account number (PAN) i.e Indian tax ID to the taxpayer. Under the ITA, if a person fails to furnish PAN to the payer, then the payer is liable to withhold tax at higher rates, capped to a maximum of 20 percent.

During audit proceedings, the AO raised a demand on the taxpayer stating that in the absence of PAN furnished by C Co, the taxpayer had failed to withhold tax at 20 percent under the ITA. Aggrieved, an appeal was preferred before the ITAT, which ruled in favour of the taxpayer on the following basis:

- As per a circular<sup>1</sup> issued by the CBDT, specific provisions of the tax treaty shall prevail over general provisions contained in the ITA;
- Section 90(2) of the ITA provides that the tax treaty provision would override the provisions of the ITA, in case where the tax treaty provisions are more beneficial to the taxpayer;
- Basis recommendations, the tax law had been relaxed with effect from 1 June 2016 to provide that if the non-resident payee furnished certain prescribed information and documents to the deductor in lieu of PAN (e.g. tax identification number in its resident country / unique number on the basis of which the person is identified by the government of its country), the same shall suffice.
- The Supreme Court of India, in a landmark ruling, had held that the provision of the tax treaty would prevail over the general provision contained in the ITA, to the extent they are beneficial to the taxpayer.

Based on the above, the provisions of the ITA could not be invoked by the tax authorities to insist tax deduction at 20 percent, having regard to the overriding nature of the provision of section 90(2) of the ITA.

## Doctrine of impossibility applicable to withholding tax obligations arising due to retrospective amendments

### DCIT, Circle 4(3)(2), Mumbai vs. WNS Capital Investments Ltd [TS-320-ITAT-2021(Mum)]

A Mauritius company (taxpayer) was held by another Mauritius company (M Co 2), which in turn was held by an ultimate holding company situated in Jersey. On 11 July 2008, the taxpayer purchased 100 percent equity shares of a Singapore company (S Co) which held two subsidiaries in India and one subsidiary in Sri Lanka. The shares of S Co were purchased from a UK company (UK Co) and no tax was withheld on sale consideration paid by the taxpayer to UK co.

During audit proceedings, the tax officer held that the predominant purpose of the taxpayer purchasing shares of S Co was the underlying assets (i.e. two Indian subsidiaries). Accordingly, the provisions of indirect transfer tax under the ITA will be applicable to the seller i.e UK Co. Further, due to retrospective amendment in the ITA, a non-resident was required to withhold taxes from any payments made to another non-resident, when the said income was taxable in India. Accordingly, the tax officer held that the taxpayer had defaulted in not withholding taxes from payments made to UK Co. Aggrieved, the taxpayer filed an appeal with Commissioner of Income-tax (Appeals) wherein an order was passed in favour of the taxpayer (i.e. no tax withholding was needed based on retrospective amendment in the indirect transfer provisions). However, the Revenue authorities appealed to the ITAT which noted the following:

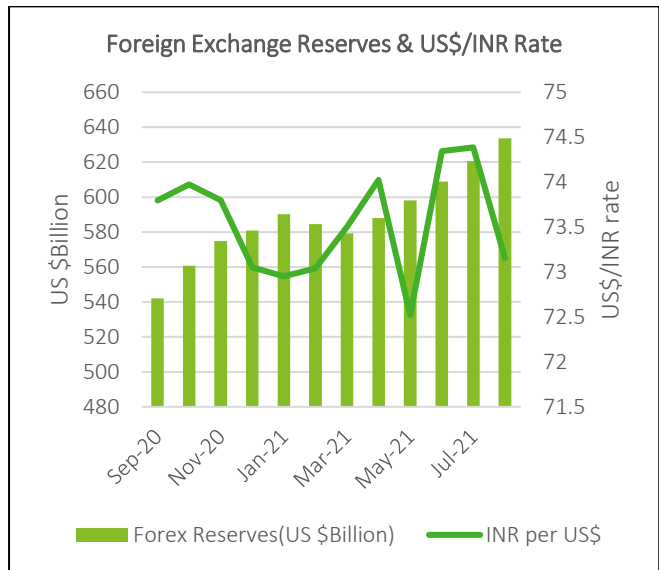
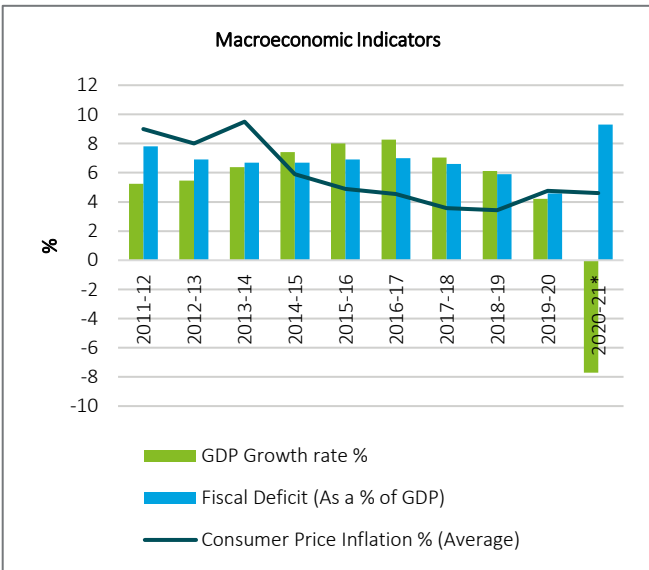
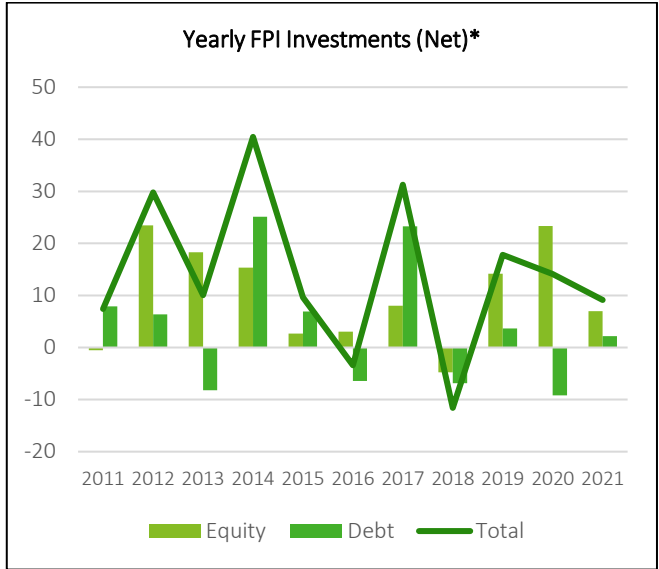
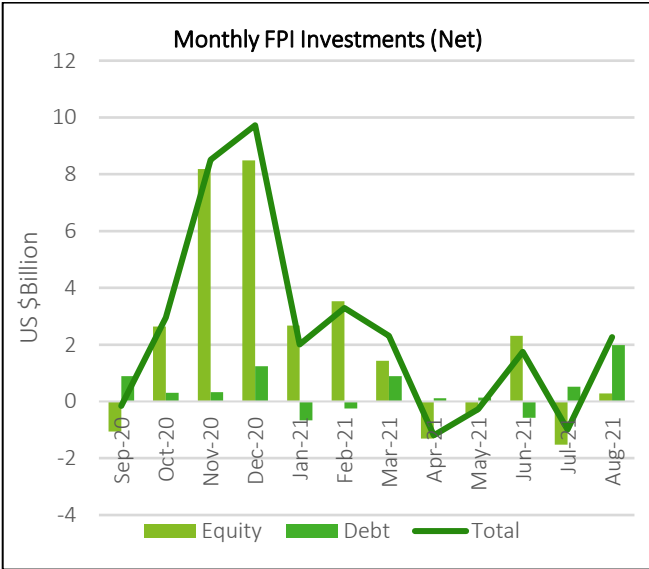
- It is a settled law that the legislature could impose tax retrospectively, though it could not be arbitrary and unreasonable.
- Relying on the decision of the Supreme Court of India in an earlier case<sup>2</sup>, it was held that for a person to perform the tax withholding obligations on the basis of an amendment in law which was enacted on a date, later than the date on which tax withholding obligations were required to be performed, was expecting that person to do the impossible.
- Persons responsible for deducting tax at source could not be expected to act basis an Explanation inserted in the statute when such an “explanation was not actually and factually in the statute”.

In view of the above, the ITAT held that the taxpayer could not be faulted for not deducting tax at source from payments made to UK Co. There were no lapses on part of the taxpayer as the related legal provisions were not even in existence at the point of time when the sale of shares took place i.e. on 11 July 2008.

<sup>1</sup>Circular no. 333 (dated 2 April 1982)

<sup>2</sup>Engineering Analysis Centre of Excellence Vs CIT [(2021) 125 taxmann.com 42 (SC)]

# Key trends at a glance



\*Upto August 31, 2021



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