



CBDT clarifies that indirect transfer provisions shall not apply to a non-resident on account of redemption or buy-back of its share or interest held indirectly in specified funds

Background

As per the provisions of Section 9(1)(i) of the Income-tax Act, 1961 (the Act), all income accruing or arising, whether directly or indirectly, through or from, any business connection in India, or any property in India, or any asset or source of income in India or through the transfer of a capital asset situated in India, shall be deemed to accrue or arise in India. Explanations 5, 6 and 7 to Section 9(1)(i) of the Act further define the scope of the said provision.

Concerns have been expressed by investment funds, including private equity funds and venture capital funds, that on account of the extant indirect transfer provisions in the Act, non-resident investment funds investing in India, which are set up as multi-tier investment structures, suffer multiple taxation of the same income at the time of subsequent redemption or buyback. Such taxability arises firstly at the level of the fund in India on its short-term capital gain/business income and then at every upper level of investment in the fund chain on subsequent redemption or buyback. The Central Board of Direct Taxes (CBDT) has received representations to exclude investors above the level of the direct investor, who is already chargeable to tax in India on such income, from the ambit of indirect transfer provisions of the Act.

The Finance Act, 2017 amended indirect transfer provisions of the Act with effect from 1 April 2015 whereby Category I and Category II, FPIs have been exempted through the insertion of proviso to Explanation 5 to Section 9(1)(i) of the Act. However, there could be situations in multi-tiered investment structures, where the interest or share held indirectly by a non-resident in an investment fund or a venture capital company or a venture capital fund

(specified funds), is redeemed in an upstream entity outside India in consequence of transfer of shares or securities held in India by the specified funds, the income of which have been subject to tax in India.

In such cases, the application of indirect transfer provisions on redemption of share or interest in the upstream entity may lead to multiple taxation of the same income. In respect of Category I and Category II FPIs, such multiple taxation will not take place on account of the insertion of proviso to Explanation 5 to Section 9(1)(i) of the Act, vide Finance Act, 2017.

CBDT circular

Recently, CBDT has issued a circular¹ clarifying that the provisions of indirect transfer (provided under Section 9(1)(i) of the Act read with Explanation 5) shall not apply in respect of income accruing or arising to a non-resident on account of redemption or buy-back of its share or interest held indirectly (i.e. through upstream entities registered or incorporated outside India) in the specified funds² if such income accrues or arises from or in consequence of transfer of shares or securities held in India by the specified funds, and such income is chargeable to tax in India. However, such benefit shall be applicable only in those cases where the proceeds of redemption or buyback arising to the non-resident do not exceed the pro-rata share of the non-resident in the total consideration realised by the specified funds from the said transfer of shares or securities in India. It is further clarified that a non-resident investing directly in the specified funds shall continue to be taxed as per the extant provisions of the Act.

¹ CBDT Circular No. 28/2017, dated 7 November 2017

² Venture Capital Company or Venture Capital Fund

Our comments

The CBDT circular is a welcome step for the private equity and venture capital industry and is partly in line with the announcement made by the Finance Minister in his Budget 2017 speech. It provides indirect transfer exemption only for indirect/ultimate investors in specified funds (i.e., Category I AIF, Category II AIF, Venture Capital Funds and Venture Capital Company). The benefit of exemption has not been extended to indirect investors in entities other than specified funds (such as Foreign Direct Investment (FDI), Foreign Venture Capital Investor (FVCI), Category III AIF and Category III FPI entities) and accordingly, indirect transfer provisions continue to apply to investors in such entities. While the circular provides relief for certain types of foreign investment routes, the benefit should also be extended to other foreign investment routes wherein income has been charged to tax in India. Therefore, non-resident investors in specified funds need to analyse the eligibility of the circular to claim its benefit against their Indian tax liability.



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