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Analysing developments impacting business

ANALYSING THE IMPACT OF BUDGET 2020 ON INVESTMENT FUNDS: IS ENOUGH AS GOOD AS A FEAST?

6 February 2020

The first full union budget of the re-elected Narendra Modi Government presented on 1 February 2020 (Budget 2020) was a highly anticipated one from the perspective of the Indian fund management industry, with the industry expecting several tax and regulatory announcements to give a fillip to the industry. While Budget 2020 did deliver on several counts from the industry's perspective, certain long-standing demands continue to remain unfulfilled. In this newsflash, we take a closer look at some of the key policy announcements and their expected impact on the Indian fund management industry, and of course some of the misses which did not find a place in the Budget 2020.

[Infrastructure and Real Estate: In for a penny, in for a pound](#)

➤ **Tax exemption for 'Sovereign Wealth Funds' investing in the infrastructure sector**

Sovereign Wealth Funds (SWFs) and any wholly owned subsidiary of the Abu Dhabi Investment Authority have been granted a complete tax exemption from dividend, interest and long-term capital gains on infrastructure investments made before 31 March 2024 and held for a period of at least 3 years, subject to the following eligibility criteria:

- SWF is wholly owned and controlled, directly or indirectly, by the Government of a foreign country and regulated under the laws of the said country;
- no portion of the earnings from such SWF benefits private person;
- it does not undertake any commercial activity whether within or outside India; and
- it is specified by the Central Government, by notification in the Official Gazette, for this purpose.

The amendment is proposed to become effective from 1 April 2021 and shall apply from the assessment period 2021-2022 and onwards.

KCO Insights: *The Indian infrastructure sector, that has been facing an acute shortage of capital, would benefit from augmented investment from a stable long-term source of capital like SWFs and should help the Government achieve its very ambitious targets for infrastructure in the future. The Finance Bill 2020 (Finance Bill) also provides the Government with the flexibility to extend the scope of such exemption for SWFs to other sectors which may also benefit from stable long-term capital source.*

Having said that, in our view, the proposal could have punched a little higher by extending the same benefit to Government managed pension funds as several countries do not have SWFs and instead, primarily rely on Government managed pension funds for making investments. These investors, like SWFs, are also long-term investors with the capability to provide long term and stable source of capital.

➤ **Tax pass-through status for privately placed unlisted InvITs**

Private unlisted infrastructure investment trusts were introduced by the Securities and Exchange Board of India (SEBI) in 2019. However, the pass-through status for interest and rent income was available only to Infrastructure Investment Trusts (InvITs) and Real Estate Investment Trusts (REITs) whose units were listed on a recognised stock exchange. InvITs which did not list its units would then have to comply with the general principles of trust taxation where trustee pays tax for and behalf of each investor. This posed a host of practical difficulties such as payment of tax by the trustee under trustee's PAN or each investor's PAN, availability of credit of taxes paid by the trustee to the investors, risk of applicability of maximal marginal rate to the total income of the trust if it includes 'business income', making such unlisted InvITs less viable due to tax and administrative complexities.

The Finance Bill has now addressed the disparity in taxation between privately placed, listed and unlisted InvITs, by amending the definition of 'business trust' to remove the requirement of units of the InvITs to be listed, resulting in the benefits of pass through status being extended to unlisted InvITs as well. The income generated by the InvITs (whether listed or unlisted) shall be taxed in the hands of the investors only.

The amendment is proposed to become effective from 1 April 2021.

KCO Insights: *The benefit of being a tax transparent vehicle may stimulate a surge in the number of players opting for private unlisted InvITs, with steepened interest particularly from certain select investor groups seeking to enter into mutual arrangements with Indian promoters for infrastructure assets. Further, this should also in the longer run help create a pipeline for publicly offered listed InvITs offering an attractive investment asset class for yield investors like insurance companies and pension funds as well as retain investors.*

➤ **Tax on dividends in the hands of unitholders of a business trust**

The dividend received by a business trust from special purpose vehicles (SPV), which was earlier tax exempt subject to the business trust meeting the prescribed conditions, has now been exempted in the hands of the business trust unconditionally. The dividend shall now be directly taxed in the hands of the unitholders of the business trust at the applicable tax rates under the Income Tax Act 1961 (IT Act) for resident unitholder and / or the relevant tax treaty in case of non-resident unitholders, depending on the tax residency of the non-resident unitholder.

KCO Insights: *With the exemption on dividend at the business trust level becoming unconditional but the same being charged on a pass-through basis in the hands of the unitholders of the business trust, there may be an impact on the overall net returns in the hands of the investors.*

Further, while the dividend is to be taxed in the hands of the unitholders, business trusts would still be required to deduct 10% tax at source for residents and at the applicable rate for non-residents, while distributing dividend income to its unitholders. In addition to the withholding at the business trust level, in the absence of a corresponding amendment exempting the SPVs from deducting tax at source while making dividend distributions to the business trust, they may end up deducting tax at SPV level as well which would translate to tax deduction at source at two levels instead of one. This

appears to be unintended, but necessary clarification / exemption with respect to the withholding at the SPV level will need to be included.

➤ **Extension of time period for approval / sanctions for Affordable Residential Housing**

Given the liquidity crunch and increasing pressure on the real estate sector due to reduced demand, lack of funding sources, developers' defaults, etc., in an attempt, albeit a feeble one, to salvage the sector, the Finance Bill:

- Extends the period of obtaining the approval for affordable housing projects from the competent authority from 31 March 2020 to 31 March 2021. Such approval from the competent authority is a prerequisite for claiming a deduction of the profits and gains derived from the business of developing and building affordable housing projects; and
- Extends the period for procuring sanctions of loans by financial institutions from 31 March 2020 to 31 March 2021, which is a prerequisite for claiming deductions on the interest on the loans taken for acquisition of an affordable residential house property.

KCO Insights: *With the extension of the period for meeting the conditions for claiming deductions under the IT Act with respect to affordable housing projects, combined with extension of tax holiday for the developers of affordable houses, the Finance Bill has created an incentive for the real estate funds to invest in such affordable housing projects leading to stimulated channelization of their investments into such projects.*

➤ **Increase in safe harbour limit**

The IT Act provides that the sale consideration of property shall be the circle rate (i.e., the stamp duty value of the property) in cases where the actual sale consideration for such property is less than such circle rate. However, the buyer and seller for such property are not taxed, when the variance in the circle rate and actual consideration is not more than 5%. This exemption variance is proposed to be increased from 5% to 10% by the Finance Bill, thereby easing the way for property transactions where such difference in consideration and circle rate is enlarged in view of market fluctuations.

KCO Insights: *The proposed revision of safe harbour rule on the applicability of the deeming provision in relation to real estate transaction would ensure that the homebuyers are not taxed in this sluggish market and could improve the number of transactions being undertaken in the sector. Further, this should also facilitate asset acquisition transactions by larger real estate platforms or REITs without incurring adverse tax consequences when the negotiated price is lower than the circle rate.*

FPIs: Hope Springs Eternal

➤ **Lower withholding rate for FPIs on interest income set to continue for now**

Under the Finance Bill, the concessional withholding tax rate of 5% on the interest income earned by Foreign Portfolio Investors (FPIs) from their investments in Rupee Denominated Bonds¹ and Government Securities, which was available till 1 July 2020, has been extended till 30 June 2023. Further, since FPIs have now been permitted to invest in Municipal Debt Securities, the concessional tax rate of 5% shall also extend to interest earned by FPIs on Municipal Debt Securities.

¹ The exemption that has been granted covers only those Rupee Denominated Bonds where the rate of interest does not exceed 500 basis points over the Base Rate of the State Bank of India i) on the date of the issue of the bond, where the bond has been issued after 1 July 2010; ii) on 1 July 2010 where the bond has been issued before 1 July 2010.

The amendment is proposed to become effective from 1 April 2020.

KCO Insight: *FPIs who are looking to hold their investments in these debt securities beyond 1 July 2020 will benefit from the concessional withholding rate of 5%. This may also ensure a steady flow of foreign funds being diverted towards Rupee Denominated Bonds, Government Securities and Municipal Debt Securities.*

➤ **Increase the corporate bond limits for FPIs**

The Budget 2020 has enhanced the limit for FPI investments in corporate bonds from the existing 9% to 15% of the bond market. The increased limit shall be applicable upon notification by the Reserve Bank of India.

KCO Insight: *In a bid to deepen the Indian bond market, the Central Government has opened it further for foreign investors. Given that FPIs did not exhaust the existing limit, it is to be seen whether the increased supply of corporate bonds for FPIs does, in fact, have an impact on the market.*

➤ **Indirect transfer tax exemption restricted to Category I FPIs**

Under the IT Act, income earned from shares / interest held in entities outside India is to be taxed in India, if such share / interest derives its value substantially from assets located in India (i.e., if the value of such assets exceeds INR 10 crores, or represents at least 50% of the value of all the assets owned by such entity). However, the text of the IT Act currently exempts Category I and Category II FPIs from such indirect tax (Indirect Transfer Tax Exemption). Owing to the overhaul in the FPI regime and re-categorization of FPIs into 2 categories under the SEBI (FPI) Regulations, 2019 (FPI Regulations 2019), there was ambiguity in the applicability of the Indirect Transfer Tax Exemption and the industry had been seeking clarity about whether the Indirect Transfer Tax Exemption would apply to both Categories of FPIs, or if the tax law was just pending amendment. The Finance Bill has now clarified that the Indirect Transfer Tax Exemption will be made available only to Category I FPIs under the FPI Regulations 2019. Further, the Finance Bill has also clarified that the exemption available to the erstwhile Category I and Category II FPIs under the earlier regime will continue to extend to investments made before the notification of the FPI Regulations 2019.

The amendment is proposed to become effective from 1 April 2020 and shall apply from the assessment period 2020-2021 and onwards. In other words, post the introduction of the FPI Regulations 2019, which took effect on 23 September 2019, the Indirect Transfer Tax Exemption will be available to: (i) investors that fall under the new Category I FPI, and (ii) the erstwhile Category I and Category II FPIs in respect of their investments made prior to 23 September 2019.

KCO Insight: *This may have a significant bearing on funds established in Mauritius and Cayman Islands, which will now have to carefully evaluate their structure, distribution rights and redemption options to ensure that investor exits do not get hit by such indirect transfer tax provisions.*

Fund Managers: Some respites and benefits

➤ **Smaller NBFCs to become attractive opportunities for fund managers**

The Budget 2020 proposed that NBFCs with a lower asset size of INR 100 crore (as opposed to INR 500 crores under the current regime) or a lower loan size of INR 50 lakhs (as opposed to INR 1 crore under the current regime) should be made eligible for debt recovery under the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act 2002 (SARFAESI Act). The proposed amendment shall come into effect once it is notified by the Central Government.

KCO Insight: *The proposed change would improve the cash flows of smaller NBFCs as they would be permitted to invoke the beneficial provisions of the SARFAESI Act to recover their dues, thereby making them an attractive portfolio investment for fund managers.*

➤ **Additional benefits to funds claiming Section 9A benefits**

Under Section 9A of the IT Act which created a safe harbour for eligible funds appointing Indian managers from constituting a business connection, the limit on aggregate participation of persons resident in India in such eligible funds was limited to only 5% of the corpus of the fund. The same has now been relaxed to provide that for the purposes of calculation of participation limit, contributions by Indian resident eligible fund managers, during first 3 years up to INR 25 crores shall not be accounted for. However, post the completion of this 3-year period from commencement of operation of the fund, the resident Indian participation limit of 5% would continue to apply to the eligible fund managers as well. The present position was doubly disadvantageous to managers as it prevented them from both building a track record for offshore funds, as well as from demonstrating 'skin in the game' in such offshore funds, in tandem with today's global market standards.

Further, the requirement for eligible funds to maintain a minimum monthly average of the corpus at INR 100 crores at the end of 6 months from the last day of the month of its establishment or incorporation, or at the end of such previous year, whichever is later, has now been streamlined to provide that if the fund has been established or incorporated in the previous year, the condition of minimum monthly average of the corpus of the fund must be fulfilled within 12 months from the last day of the month of its establishment or incorporation.

The amendment is proposed to become effective from 1 April 2020 and shall apply from the assessment period 2020-2021 and onwards.

KCO Insight: *Global investors always insist on the 'skin in the game' of fund managers looking to raise capital. Further, hedge funds typically have sponsor/manager contribution as their first source of capital to establish a track record for investors. The erstwhile restrictions on participation of Indian resident participation in offshore funds under 9A prevented such managers/sponsors to effectively establish track record for global funds managed by them. However, this proposed amendment in section 9A will definitely help resident managers managing offshore funds to better showcase track record for such funds.*

Miscellaneous

➤ **2020 gifts for the GIFT City**

The Budget 2020 announced the setting up of an International Bullion exchange(s) as an additional option for trading by global market participants in the Gujarat International Finance Tec-City GIFT City (GIFT City), the only International Finance Services Center (IFSC) in India. This will mark the maturation of Indian exchange, create jobs, and lead to better price discovery of gold.

The Finance Bill has also proposed that Indian companies, REITs or InvITs raising rupee denominated bonds or long term bonds which are listed on IFSC stock exchanges and issued to persons resident outside India, on or after 1 April 2020 but before 1 July 2023, shall be subject to reduced tax deduction of 4% (as against 5% for non-IFSC listed bonds), *provided* the interest paid on such bonds does not exceed the prescribed thresholds.

In addition to the above, the Finance Bill proposes to provide certain stamp duty relief to IFSC, wherein no stamp duty shall be chargeable in respect of the instruments of transaction in stock exchanges and depositories established in the IFSC.

The amendment is proposed to become effective from 1 April 2020.

KCO Insight: *In-sync with the overall theme of Budget 2020 to encourage foreign investments, the Government has proposed a host of changes. The proposed relaxations for GIFT-IFSC are welcomed and should further the Government's efforts to make the GIF-IFSC attractive for resident and non-resident players.*

➤ **Certain categories of Government Securities to be made fully available to non-resident investors**

The Finance Minister has proposed that certain categories of Government Securities be made 'fully open' to non-resident investors.

KCO Insight: *While the category of such Government Securities has not yet been announced, providing foreign investors greater access to Government Securities has the potential to allow foreign investors to improve risk management within their portfolios.*

➤ **Credit Default Swap legislation coming soon**

The Finance Minister has announced that a new legislation will be placed before the house to expand the scope of credit default swaps by laying down a mechanism for netting of financial contracts.

KCO Insight: *While the fine print of the legislation remains to be seen, a robust framework for the mechanism and enforcement of credit default swaps will heighten interest from foreign investors that are looking to protect themselves against counterparty default risk.*

➤ **Another Government Debt-ETF coming your way**

After the success of its previous Exchange Traded Fund ("ETF") that consisted of corporate bonds, the Finance Minister has announced that the Government will float a new debt ETF consisting primarily of government securities.

KCO Insight: *The repeated use of ETFs by the Central Government is expected to go a long way in deepening the public's confidence in the Indian investment funds industry. The liquidity concerns of long-term investors are also expected to be addressed by these ETFs. Additionally, such ETFs may also further enhance the opportunity for FPIs to take exposure to government securities.*

Some misses?

The overarching theme of the Budget 2020 has been to incentivize the flow of foreign investments. However, certain demands of the domestic funds industry may have slipped through the cracks.

The industry has been unwaveringly seeking clarity on the taxation of Category III AIFs including a tax-pass through in line with other categories of AIF. However, Finance Bill has remained silent on this aspect which means that the ambiguity around the tax characterisation as well as level at which such tax should be collected continues. Further, no exemption or relaxation from the applicability of increase surcharge on the 'super-rich' to such pooled structures has been made, making these structures potentially inefficient for investors. Also, a legitimate demand for offset of management

fee from the overall income for Category I and Category II AIFs and the GST offset on management fees with significant offshore pool of capital has remained unaddressed.

One of the highlights of the Budget 2020 was the abolition of the dividend distribution tax. However, taxation of dividends in the hands of the domestic investors could be as high as 47% (including the additional surcharge now applicable on the income of the super-rich), significantly reducing net returns to the investors particularly on the dividend source of income from investee companies. The impact of this on the uptake by the domestic market is to be seen and this may encourage entities to either explore alternate ways of distributing profits such as buyback or may even motivate entities to rather reinvest profits to create better capital growth for the investors.

CONCLUSION

Over time the industry had been making concerted efforts with the regulators as well as the ministry for their demands. While the Budget 2020 has addressed some of the issues raised by the funds industry, some of the larger issues, particularly around Category III AIF taxation, remain untouched or unaddressed perhaps making the industry feel that their legitimate asks have not been heeded to. However, one must not lose hope since the policy makers have in the past handed out significant tax bonanzas to the industry during the year in the form of amendments, clarifications or circulars. In the meantime, the industry should take the Budget 2020 in its stride and start to look ahead at the newer opportunities that are likely to emerge out of the current proposals in sectors like infrastructure, real estate, credit, start-up or even the public market space.

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