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# *Investing in India: The new normal asset management perspective*

*September 19, 2016*

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## ***In brief***

India, one of the largest democracies in the world, today is also the seventh largest economy by nominal Gross Domestic Product (GDP) and the third largest by purchasing power parity (PPP). It is a developing economy with a GDP growth rate of about or over 7% over the last few years. India, as an emerging market, has also been looking to attract more inbound foreign investments through liberalized foreign investment rules and measures to ease conducting business. This publication provides insights on Indian tax policy, recent measures and our expectations regarding the Indian tax and regulatory environment with respect to foreign investments, from an asset management perspective.

India has a robust regulatory regime governing foreign investments in private businesses (generally under the Foreign Direct Investment (FDI) policy) and in listed securities (under the Foreign Portfolio Investors (FPI) regulations). Both FDI and FPI investments infuse much needed capital for Indian economic development and foreign exchange reserves, and the government has been taking policy measures to attract them. These measures include liberalization of foreign exchange control policies, changes in the capital markets and sectoral regulations, initiatives such as Make in India, Digital India, the Start-up India, International Financial Services Centers, etc. The changes have begun to open up new avenues for investments into India. In the past two years, India has seen more than a 25% growth in FDI investments as compared to the previous year.

Besides the regulatory and business initiatives, the India government has brought about changes to Indian tax laws and treaties as well. These recent changes are with respect to the taxation of capital gains from Indian shares, and generally fall into two baskets.

One basket of changes provides relief regarding the level of tax payable in India on capital gains. Notable provisions include a reduction of long-term capital gains tax (CGT) rate on gains from the disposal of shares of private companies from 20% to 10%, and a reduction of the holding period from 36 months to 24 months for unlisted shares to qualify for the concessional long-term CGT rate. This is in addition to the CGT exemption on long-term public equities which has been a part of the legislation for some time now.

The other basket of changes aims to give India the right to tax capital gains arising from the direct or indirect disposition of Indian investments. These changes include introducing anti-abuse provisions, taxing gains on indirect transfer of Indian assets, and renegotiating tax treaties to curtail CGT exemptions, for example, the recent signing of the protocol to the India-Mauritius tax treaty to withdraw the CGT exemption on shares (the Protocol) and renegotiation of certain other Indian treaties with CGT exemptions.

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## **In detail**

### **Recent treaty renegotiation developments**

#### **India-Mauritius tax treaty amendments**

Mauritius has been a popular jurisdiction for making investments into India. To date, it has been one of the largest sources of both public and private investment into India.

The India-Mauritius tax treaty that came into force in 1983, provided that capital gains earned by a Mauritius resident upon disposal of assets in India, including shares of an Indian company, should not be taxable in India. The India-Mauritius tax treaty has been subject to discussions as far back as 1996, when India first indicated its intention to revisit the terms of the treaty. The countries set up a joint working group in 2006 to put in place safeguards to prevent misuse of the treaty. The negotiations intensified in recent years, with India proposing amendments to the tax treaty in 2011. It was widely reported that Mauritius had suggested a Limitation of Benefits (LOB) clause as well as a tax information exchange agreement to address India's concerns. Following a series of meetings of the joint working group in 2015-16, the Protocol was signed on May 10, 2016.

The Protocol's key changes to the India-Mauritius tax treaty with respect to CGT are:

#### **Removal of CGT exemption on sale of shares**

Capital gains from the disposal of shares of an Indian resident company should now be taxable in India if the shares were acquired on or after April 1, 2017. Gains from disposal of shares acquired prior to April 1, 2017, should continue to be exempt from tax in India regardless of when the shares are disposed of insofar as the Mauritius resident is eligible to India-Mauritius tax treaty benefits. Thus, existing shares, or shares acquired by March 31, 2017, are grandfathered, which is a positive outcome for existing investors/investments.

The Protocol further provides a transition period of two years under which gains from shares acquired *and* sold between April 1, 2017 and March 31, 2019, should be taxable in India at 50% of the applicable tax rates, subject to fulfilment of the newly introduced LOB conditions. Generally speaking, this benefit should be limited for shares held for a short term (listed shares held for 12 months or less, and unlisted shares held for 24 months or less), or for listed shares held for more than 12 months sold off the stock market. For other scenarios, the benefit may not be relevant e.g. (i) gains from sale of listed shares held for more than 12 months on the stock exchange should anyway be exempt under the Indian domestic tax law, (ii) there will be no disposal of "long-term" unlisted shares acquired on or after April 1, 2017 since to qualify as a long-term capital asset the shares would need to be sold after March 31, 2019 which would be after the end of the transition period.

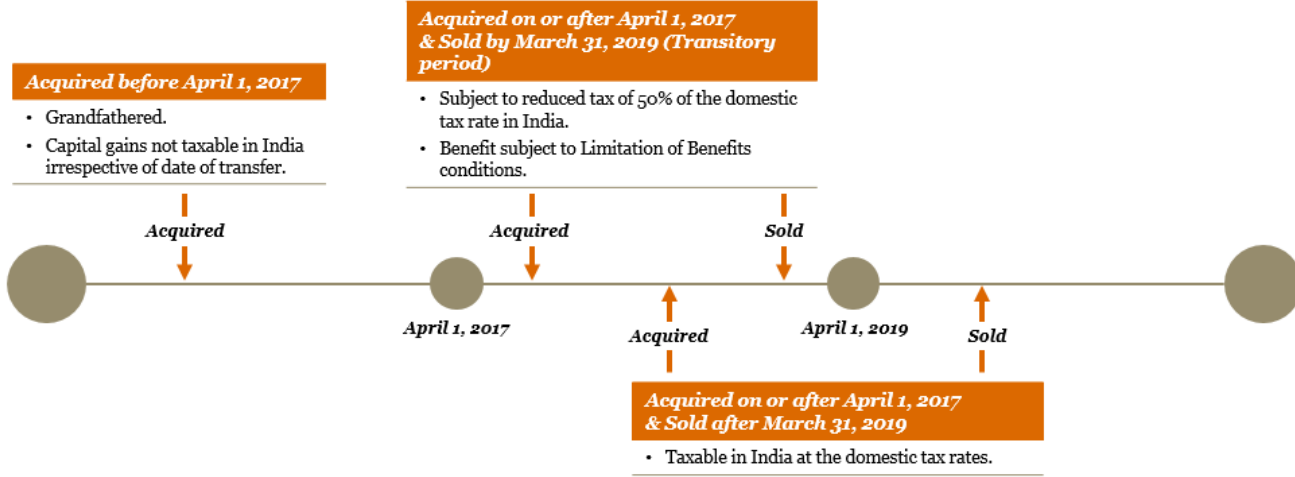
#### **LOB conditions for applying reduced tax rate from April 1, 2017, to March 31, 2019**

The LOB Article contained in the Protocol requires fulfilment of two tests for the seller (i.e. a Mauritius tax resident in this case) to benefit from the lower CGT rate-

- a) Primary purpose test: If the affairs of the Mauritius tax resident are arranged with the primary purpose of taking advantage of the benefit of the lower rate, the Mauritius tax resident shall not be entitled to the benefits of lower tax rate during the transition period.
- b) Bona fide business activity test: A shell/conduit company that claims it is a resident of Mauritius shall not be entitled to the benefits of lower rate of tax during the transition period. A shell/conduit company has been described in the Protocol as any legal entity falling within the definition of resident provided in the India-Mauritius tax treaty, with negligible or nil business operations or with no real and continuous business activities carried out in Mauritius.

A Mauritius resident company shall be deemed not to be a shell/conduit company if it is listed on a recognized stock exchange in Mauritius, or its expenditure on operations in Mauritius is at least Mauritius Rupees 1.5 million (approx. USD 43,000) during the 12 months preceding the date on which the gains arise.

**Grandfathering rule**



**CGT exemption on securities other than shares of an Indian resident company**

The CGT exemption for gains on securities other than shares of an Indian resident company, such as, debt instruments, derivatives, and shares of foreign companies should continue under the India-Mauritius tax treaty.

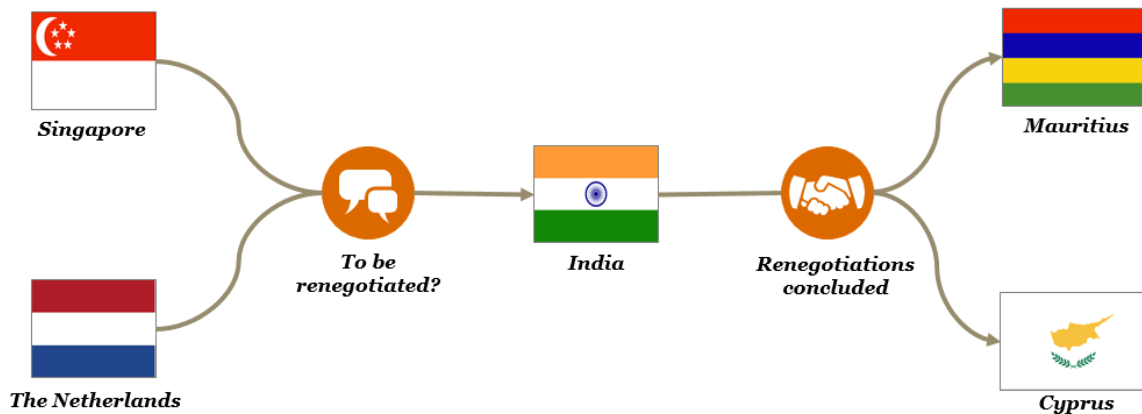
**Interest**

The Protocol caps the interest withholding rate at 7.5%, which is very favorable and amongst the lowest in India’s tax treaties. Currently, the withholding on interest is governed as per the domestic tax law of the payor and therefore, could be taxed at a rate as high as 40% in certain cases. The reduction in interest withholding rate could provide a broader access to debt for Indian companies from Mauritius.

**Other changes**

The Protocol also includes other changes, such as giving taxing rights for fees for technical services and other income to the source country.

**Impact on other jurisdictions**



The change in India-Mauritius tax treaty is just first of its kind. There are treaties with other jurisdictions that currently provide CGT exemption, which get impacted with renegotiation of the India-Mauritius tax treaty, the most significant one being Singapore.

It is our understanding that the changes to the India-Mauritius tax treaty could be followed by changes to treaties with other jurisdictions that currently provide a CGT exemption as well, most significantly the treaty with Singapore.

### Singapore

The CGT exemption in the India-Singapore tax treaty is linked to the CGT exemption under the India-Mauritius tax treaty. Thus, with the elimination of the CGT exemption on shares under the India-Mauritius tax treaty, gains arising from the disposal of assets, including shares of an Indian resident company by a Singapore tax resident, may become taxable in India. Soon after the Protocol was signed, Indian government officials indicated that they would look to renegotiate the treaty with Singapore. Given the investment and political relationships between the two nations, this was not unexpected.

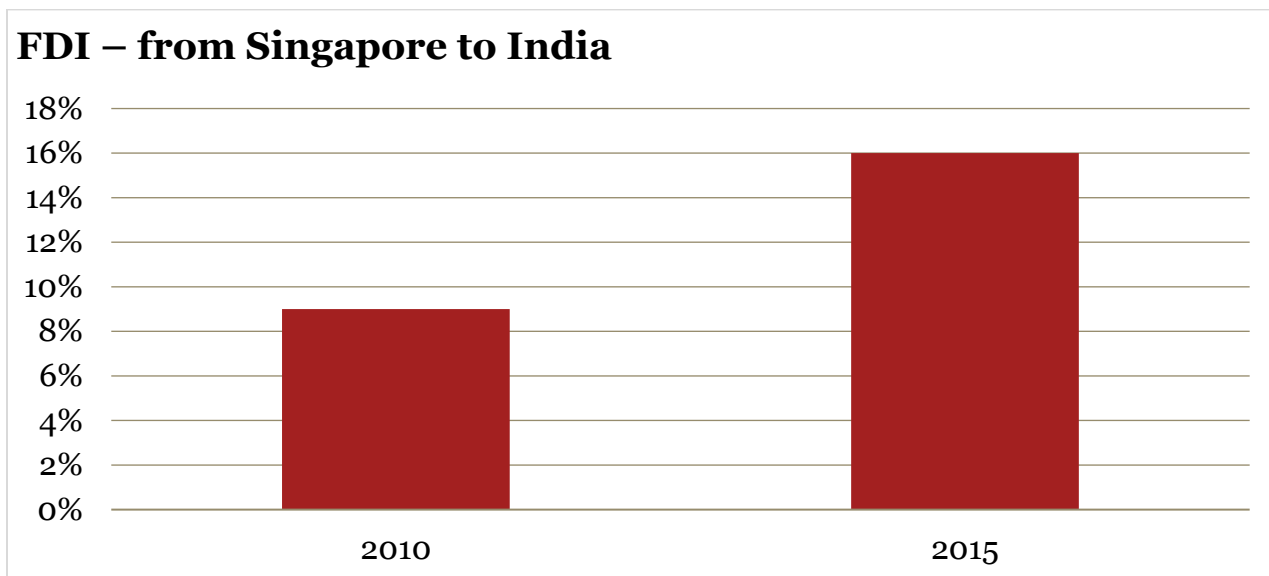
The peculiarity of linkage of the India-Singapore tax treaty with the India-Mauritius tax treaty dates back to 2005 when India and Singapore concluded the Comprehensive Economic Cooperation Agreement (the CECA) to promote business and investment relations between the two countries. The CECA has four key components: a free trade agreement (FTA) for goods; an arrangement for boosting trade in services, including financial services; a package to promote investment flows and provide mutual investment protection; and a new agreement for avoiding double taxation.

One of the objectives of the CECA was to establish a transparent and facilitative investment regime. As part of this larger plan of facilitating investments between India and Singapore, changes to the India-Singapore tax treaty were brought about through a protocol signed in 2005. The main change to the tax treaty was the CGT exemption with respect to investments. This exemption was added along with other measures to ensure that the CGT exemption is not unfairly used by foreign investors. These measures included a robust LOB provision and a framework for information exchange (later updated by a 2011 protocol). However, the exemption exists only as long as the CGT exemption regarding shares of Indian resident companies under the India-Mauritius tax treaty does as well.

The Indian government is aware of the immediate impact on the Singapore treaty due to its linkage with the Mauritius treaty and is therefore renegotiating the tax treaty with Singapore.

There are several reasons why India may want to consider measures to promote investments from Singapore.

- The CECA measures facilitated increased FDI into India from Singapore. Cumulative FDI from Singapore into India increased from 9% in 2010 to 16% in 2015. Major sectors into which Singapore investors have made investments in India include real estate, infrastructure and technology, and India continues to need investments in these sectors.



- Singapore offers a vibrant ecosystem for sourcing capital, making deals and hiring talent. 81% of total private equity assets under management from Singapore was sourced elsewhere. Of this, 54% was sourced from the Asia-Pacific

region, 19% from Europe and 18% from North America. Singapore is also a part of the ASEAN Fund Passport regime and is in the process of rolling out the Open Ended Investment Company (OEIC) Framework to boost Singapore's fund management industry.

- Global institutional investors favour investing from Singapore, given its strategic location and developed capital markets. Singapore also acts as a regional headquarters for their investments in Asia.
- Under Singapore's regulations, financial institutions operating in Singapore must put in place robust controls to detect and deter the flow of illicit funds through Singapore's financial system. Such controls include the need for financial institutions to identify and know their customers (including beneficial owners), to conduct regular account reviews, and to monitor and report suspicious transactions. Thus, Singapore seems equipped to address one of India's main concerns in providing CGT exemption — money laundering.

Given the large amount of investments made from Singapore, coupled with Singapore's focus on anti-money-laundering and exchange-of-information efforts, which are the core areas of concern for the Indian government, there seems to be a good case to renegotiate the India-Singapore tax treaty to make it investor-friendly. However, whether the economic and political factors combined with Indian relationships with Singapore, will influence the Indian government to retain the CGT exemption in the India-Singapore tax treaty and provide Singapore with more favourable treatment, remains to be seen. In the past few weeks, the Indian and Singapore governments have held discussions with the industry and other stakeholders, and have heard their views on what the industry wants out of the renegotiation. Both governments are expected to work towards a speedy renegotiation.

#### Other countries

Media reports in India also suggest that India intends to renegotiate other treaties that provide a CGT exemption on the disposal of shares.

The India-Cyprus tax treaty has already been renegotiated to withdraw the CGT exemption on gains from the disposal of shares acquired after April 1, 2017, similar to the India-Mauritius tax treaty under the Protocol. Investments from Cyprus into India had decreased after the Indian government blacklisted Cyprus in 2013, and the Indian government had been keen on renegotiating the treaty with Cyprus since. This renegotiation is now concluded and India is considering withdrawal of the blacklisting with retrospective effect.

There also is news suggesting that India will attempt to renegotiate the India-Netherlands tax treaty to remove its CGT exemption. The India-Netherlands tax treaty currently provides for CGT exemption on shares to the extent that the interest held in the Indian company is less than 10%, or the sale of shares is to a non-Indian-resident buyer.

In general, the Indian government's belief in the inherent strength of the Indian economy has led it to make a series of changes to Indian tax laws and treaties to tending towards source-based taxation for shares.

It will be interesting to see if the government renegotiates treaties with other countries which provide partial or full CGT exemption in India, such as Spain, France, South Korea, etc.

#### ***Aligning tax protection under treaties and domestic General Anti Avoidance Rule***

As noted above, the Protocol, while withdrawing the CGT exemption, grandfathers gains on shares acquired by March 31, 2017. It is expected that other treaties that get renegotiated to remove the CGT exemption will provide similar grandfathering. This is a positive move to provide tax certainty to investors on current investments and allows investors to plan their structures for investments to be made on or after April 1, 2017.

The new Indian General Anti Avoidance Rule (GAAR) is scheduled to take effect from April 1, 2017. Broadly, GAAR empowers the tax authorities to treat an arrangement as an impermissible avoidance arrangement if its main purpose is to obtain a tax benefit and the arrangement fulfills certain other criteria, such as lacking commercial substance, not being conducted at arm's length, etc.

If GAAR is invoked, based on the provisions of the current law, the tax authorities could disregard or recharacterize arrangements, structures and income, and deny treaty benefits. The tax authorities have not yet issued rules and guidance

on the implementation of GAAR, but the Finance Minister's 2016 Budget speech reinforced that the government will implement GAAR as per the currently scheduled date. Thus, we expect the rules and guidance on implementation to be provided during the current tax year.

Note that the GAAR rules were recently amended to grandfather investments made up to March 31, 2017. Thus, gains from investments made up to March 31, 2017 that are protected from Indian taxation under the treaties, now should also be protected from taxation through invocation of GAAR.

### ***What investors may need to consider in relation to investments into India***

These developments lead to the question whether there is likely any benefit for investors to use a treaty platform for India. The answer to this depends on the structure and type of investment contemplated. In general, securities other than shares in Indian companies (including shares/investment in non-Indian resident intermediary holding companies) should continue to benefit from the CGT exemption under certain treaties. Certain treaties also provide a concessional interest withholding rate.

India is witnessing large transactions as well as majority control buy-out deals. This is an indicator of industry maturity, with asset managers becoming more comfortable doing business through professional management, contrary to the former trend of letting Indian promoters carry out the local business. The instruments being considered for buy-outs include debt as well as equity securities.

Notably, India has been making policy changes to open up investments in non-equity instruments through various routes. Until recently, for privately held investments, Indian foreign exchange control policies generally allowed investments in equity shares, compulsorily convertible instruments, or listed non-convertible debentures (NCDs) of Indian companies. There were limited avenues to hold other instruments, such as an optionally convertible debt under the Foreign Venture Capital Investor (FVCI) regime, under which investments could be made in limited sectors. With the country's growing investment needs, the Indian government has been more amenable to opening up more investment avenues and has enacted a series of related changes to the Indian regulatory framework.

The recent liberalization of External Commercial Borrowings (ECB) conditions, introduction of INR-denominated Corporate (i.e. Masala) Bonds and relaxation of regulations for NCDs have opened up new opportunities for foreign investment in India. The government's stance is to provide Indian borrowers with additional funding resources while simultaneously insulating them from currency rate fluctuations. Further, foreign investors also may capitalize on the Reserve Bank of India's directive to clean Indian banks' balance sheets of toxic non-performing assets. The offloading of bad loans via the securitization route, coupled with relaxation of foreign investment norms in securitization and asset reconstruction companies, can be an additional investment avenue for foreign investors.

Another important change is allowing foreign investments in an Indian domestic fund set up as an Alternative Investment Fund (AIF). The policies not only allow foreign investments into AIFs, but also state that the investments should be considered domestic (and therefore not subject to FDI norms) if the manager of the AIF is more than 50% owned and controlled by Indian residents. Another example is liberalizing investments into limited liability partnerships (LLPs) in India. While foreign investment into an LLP formerly needed regulatory approval, this now can be done freely as long as there are no performance-linked conditions for the sector in which the LLP operates. We understand the government is working on an announcement to include hybrid instruments in the basket of FDI-compliant instruments.

Overall, given the liberalization of the investment types that can be made in India, the use of treaty platforms for investment into India should not lose its attractiveness, even though gains from investment in Indian company shares should remain taxable under Indian tax laws.

### ***Foreign tax credits will be a consideration***

The asset management sector still might continue with its treaty platforms even though some of the investments might become taxable in India. In these circumstances, one would need to analyze whether CGT paid in India by the treaty platforms in which US persons hold an interest can be used to offset the US tax liability of such persons.

This should be analyzed in light of the structure for making the investments (i.e., whether the intermediary entities are flow-through from a US tax perspective), US domestic tax rules on claiming foreign tax credits and sourcing capital gains

income and the provisions of the India-US tax treaty. Given that taxes paid in India could affect post-tax internal rates of return (IRRs), the ability of US persons to take credits for taxes paid in India would be an important consideration. This, however, may only be possible for investors that are taxable in the United States. For tax-exempt investors, the taxes paid are a sunk cost. A similar evaluation should be done for investors from other jurisdictions.

### **Outlook**

According to the World Bank's recent report, India reached a 10-year low in infrastructure investment. This concern was recently reiterated by the Finance Minister, Arun Jaitley, who stated that India needs more than USD 1.5 trillion over the next decade to close the infrastructure gap. Further, government initiatives like Make in India, Digital India, Skill India, Start-up India, Smart City and GIFT-City require investments as well. Therefore, India is in need of capital investments.

The Indian government believes in the inherent strength of the economy and its ability to attract foreign investment, while cognizant that ease of doing business and tax certainty are two key elements that need to be embedded in its policies to keep foreign investors interested. Thus, the government is making policy changes to give impetus to more foreign investments, such as bringing in tax certainty, expanding the types of instruments that can be used to invest in India, introducing REIT and InvIT regimes for investment in real estate and infrastructure sectors, allowing foreign investments in AIFs and easing or removing sectoral caps in a number of sectors.

The government, however, wants to adopt a balanced approach and wants to ensure that there is no undue advantage taken of the treaties India has with other countries. A move towards adopting source-based taxation is one example of this. Further, the grandfathering of existing investments does give tax certainty to investors.

Also note that while the Indian government is making efforts to move to source-based taxation, it also has been introducing measures to ease the CGT on foreign residents under the domestic tax law. As noted above, the recent round of amendments included a reduction in the tax rate on privately held shares on a long-term basis to 10% from 20% and a reduction in the holding period from 36 months to 24 months to classify unlisted shares as long-term capital assets.

Adopting source-based taxation, but providing relief and certainty under the domestic tax law, seems to be the current approach. One would need to watch out whether the government will provide further relief in tax rates or incentives for specific classes of investors, such as Sovereign Wealth Funds and pension funds that in many cases do not have to pay taxes in their home countries. Other items to watch for will be whether the government provides tax relief to investors in sector where India needs funding, such as infrastructure and whether the government provides specific exemption in the case of intra-group or related-party transfers and reorganizations.

The return on investment (ROI) for foreign investors is amongst others, affected by three factors: (i) the gross returns earned on investment in the local country; (ii) the tax outflow on such return in the local country; and (iii) the strength of the local currency. The last five years have seen the INR depreciate annually. This coupled with a withdrawal of CGT exemption could dampen the ROIs from India and at this point may be counterintuitive to the government's effort of attracting new investments into India.

Global investors with diversified portfolios generally have pre-determined percentage allocations for emerging markets. The jurisdictions in this segment compete for the maximum share of this allocated capital. While adopting source-based taxation, the Indian government may need to consider whether the shift could make investments into other emerging markets more attractive on a post-tax basis. Some comparable jurisdictions, such as China, Russia and South Africa, impose a lower CGT rate or provide exemptions for trading in listed shares (including on short-term gains), which could lead to a reconsideration, at least for liquid trading.

Country	Capital Gains Tax	Unlisted shares (not land-rich)	Listed Shares
China	Domestic law	10%	10% OR NIL (for gains derived by qualified foreign institutional investors from transactions through the China or Shanghai-Hong Kong Stock Connect as of November 17, 2014)
	Singapore Income tax treaty	Nil (if ownership interest is less than 25% in 12 months preceding the transfer)	Nil (if ownership interest is less than 25% in 12 months preceding the transfer)
Mexico	Domestic law	25% (gross) or 35% (net)	10% or 25%/35% in certain cases
	Singapore Income tax treaty	Nil (if ownership interest is less than 25% in 12 months preceding the transfer)	Nil (if ownership interest is less than 25% in 12 months preceding the transfer)
Philippines	Domestic law	5% (first ~ US\$2,000 gains) / 10% (gains in excess of ~ US\$2,000)	Nil, subject to conditions; else 5% or 10%
	Singapore Income tax treaty	Nil	Nil
Russia	Domestic law	Nil, subject to conditions	Nil, subject to conditions
	Singapore Income tax treaty	Nil	Nil
South Africa	Domestic law	Nil	Nil
	Singapore Income tax treaty	No relief under treaty, but domestic tax rate is Nil	No relief under treaty, but domestic tax rate is Nil

India has been an active supporter of the OECD’s BEPS recommendations. It has been one of the first countries to make legislative changes to adopt BEPS measures and will continue to focus on it. The Indian government has already introduced country-by-country reporting and an equalization levy on online advertising revenue in line with the BEPS recommendations. Further, GAAR is scheduled to take effect in India on April 1, 2017, which would address concerns regarding abuse of treaty provisions and form-over-substance.

India also has been eager to add LOB and exchange-of-information provisions to treaties it has been negotiating or renegotiating in the past few years. It has put into place several measures to counter treaty abuse and promote information sharing, in light of which source-based taxation, which could affect the volume of investments into India, may not be absolutely necessary.

### The takeaway

In light of India’s position on source-based taxation, investment structures and IRRs would need to be vetted in line with the new normal. Given India’s need for capital, there is constant effort to open up numerous other avenues for investments into India. While these developments may change how investments are made, given the potential of the Indian economy, India should remain an attractive investment destination.

## ***Let's talk***

For a deeper discussion of how this might affect your business, please contact:

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