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By Electronic Delivery

27 February 2020

Mr. Pramod Chandra Mody
Chairman, Central Board of Direct Taxes
North Block
New Delhi – 110 001
India

Re: *India Union Budget 2020 –*
ICI Global Recommendations

Respected Sir:

ICI Global[1] and our members support the Government of India's proposal to abolish the Dividend Distribution Tax (DDT) mechanism in the recently released Indian Union Budget 2020. This proposal — to tax investors directly on dividends received rather than impose a distribution tax on the dividend-paying Indian company — is consistent with international norms. Importantly, this change would enable foreign portfolio investors (FPIs), including collective investment vehicles (CIVs), to receive treaty-provided tax reductions and claim foreign tax credits against home country tax liabilities.

We urge the following changes to the Union Budget to address issues, perhaps unintended, that could impact CIVs' investment decisions.

1. First, dividends received by FPIs should be exempted from the enhanced surcharge tax.

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[1] ICI Global carries out the international work of the Investment Company Institute, the leading association representing regulated funds globally. ICI's membership includes regulated funds publicly offered to investors in jurisdictions worldwide, with total assets of US$32.2 trillion. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of regulated investment funds, their managers, and investors. ICI Global has offices in London, Hong Kong, and Washington, DC.

2. Second, treaty-provided withholding tax rate reductions should be applied when a dividend is paid, rather than only after an FPI has filed a tax return claiming the treaty relief. This will require the following amendments to be made to the Indian domestic tax laws:

    a. Section 196D(1) of the Income-tax Act, 1961 ('IT Act'), which deal with the Income of Foreign Institutional Investors from securities, needs to be amended so as to provide that any person responsible for paying to an FPI income in respect of securities should withhold tax at the *"rates in force"* as is defined in section 2(37A) of the IT Act.
    b. Section 2(37A)(iii) of the IT Act, needs to be amended so as to draw reference to section 196D of the IT Act.
    c. The First Schedule – Part II of the Finance Bill, 2020 needs to be amended so as to insert the withholding tax rate of 20 percent on dividends paid to an FPI.

    The aforesaid amendments will allow tax to be withheld at 20 percent under the Indian domestic tax law on dividends paid to an FPI, but at the same time allow the withholding to take place at tax treaty rates, where applicable.

3. Third, the indirect transfer provision needs to be streamlined with the SEBI (FPI) Regulations, 2019, to ensure that all FPIs other than *"corporate bodies"* and *"family offices"*, as is referred to in the definition of Qualified Institutional Buyer under the SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2018, are exempted from the applicability of the indirect transfer provisions.

Dividends Should be Exempt from Enhanced Surcharge Tax

The enhanced surcharge tax that was introduced in the Finance (No. 2) Act, 2019 was unexpected and had profound negative effects on the Indian financial markets. We are grateful for the Indian Government's proactive response that restored investor confidence and stabilized the tax regime by withdrawing the enhanced surcharge tax on capital gains of all securities held by FPIs, through the introduction Taxation Laws (Amendment) Ordinance, 2019 followed by the enactment of the Taxation Laws (Amendment) Act, 2019.

Unfortunately, the 2020 Indian Union Budget would reverse this positive result in part by applying the enhanced surcharge tax instead to dividends. The significant tax uncertainty that arose last year when the enhanced surcharge tax was proposed for all incomes including capital gains earned by non-corporate and non-firm FPIs would return unless dividend income is also exempted.

We recommend a complete repeal of the enhanced surcharge tax insofar as it presently applies to non-corporate and non-firm FPIs. A full withdrawal would resolve the remaining surcharge tax issues raised in ICI Global's letter dated December 10, 2019.[2] Among other things, imposing the surcharge tax on only certain categories of income raises significant income tax compliance concerns.

Alternatively, the Indian Government could resolve the enhanced surcharge tax issue, and many other tax issues, by treating a CIV's organizational form for Indian tax purposes consistent with how the CIV is classified for tax purposes in its home country.[3] As we have described in previous submissions, many of the tax difficulties that foreign CIVs experience in India are due to India effectively ignoring how non-Indian CIVs are organized and taxed at home. In the United States, all CIVs are taxed as corporations regardless of their organizational form. Consequently, because almost 85 percent of all US mutual fund assets are held in funds organized as Massachusetts Business Trusts or Delaware Statutory Trusts, almost the entire US industry is adversely impacted by any Indian rule that imposes different treatment on trusts versus corporations. We submit that there is no sound tax policy reason for the surcharge tax to be levied on investors in funds organized in non-corporate form when comparable funds organized as corporates are exempt.

Treaty Relief Should be Provided At Source and by Reclaim

By proposing to abolish the DDT, as noted above, India's financial markets will become more attractive to FPIs as investors claim treaty-provided withholding tax rate reductions. The proposal is deficient, however, in that companies would be required to withhold taxes on dividends paid to FPIs at a base rate of 20%, plus applicable surcharge and cess,[4] rather than at the generally-lower treaty rate.

We strongly urge the Indian Government to permit Indian companies to withhold at an FPI's applicable treaty rate ("at source" treaty relief). At-source treaty relief generally is much simpler and less expensive than the process of filing tax refund claims. At-source treaty relief is common in jurisdictions with significant foreign capital investment. In many markets, FPIs utilize global and local custodians to certify investor treaty eligibility to the companies in which they invest. Typically, the custodian will collect from the FPI a certificate of tax residency from the FPI's home government and attestations of treaty entitlement (*i.e.*, the FPI is the beneficial owner of the income and does not have a permanent establishment in the source country).

A few countries have "preclearance" procedures that allow FPIs to apply to the source-country tax authority for a withholding tax certificate that verifies treaty entitlement. While this "preclearance" mechanism would introduce additional costs on investors, the mechanism would provide tax certainty to the FPIs, to dividend payors, and to the Indian Government.

[2] *See* ICI Global letter "*Follow up to ICI Global Meetings on Tax Issues for Global Regulated Funds*" from Katie Sunderland, Assistant General Counsel to Mr. Pramod Chandra Mody, Chairman, Central Board of Direct Taxes, dated December 10, 2019.

[3] Specifically, the CBDT, under section 2(17)(iv) of the Income Tax Act, can declare by a general or special order, any institution, association or body, whether incorporated or not and whether Indian or non-Indian to be a "company" (specifically, a foreign company in this case).

[4] The applicable tax rate on dividends as a result of the enhanced surcharge and cess can range from 21.84% for CIVs organized in corporate form to 28.5% for CIVs organized in non-corporate form.

Of course, should treaty relief not be provided at source, an FPI must retain the ability to obtain the treaty-provided relief by filing a tax return. A separate tax refund claim mechanism should be avoided as recovery can be very expensive and take many years. Reclaim-only markets typically are not viewed as investor-friendly and cause significant uncertainty.

Indirect Transfer Provision Should Not Apply to Portfolio Investors

The indirect transfer provision should be applied, if at all, only to abusive situations in which a controlling interest in a non-Indian intermediary company is transferred to avoid Indian tax. Applying the provision to tax portfolio investors holding modest interests[5] in non-Indian CIVs that make portfolio (non-controlling) investments in Indian companies would have significant negative implications for the Indian markets. Applying the provision to portfolio investors would discourage CIVs from making substantial Indian investments because of the negative consequences for CIV investors of the 50% underlying Indian securities investment threshold being reached. The associated recordkeeping costs and related administrative burdens likely would extinguish any benefit of investing in India rather than elsewhere.

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If we can provide you with any additional information, please do not hesitate to contact me or Russell Gaitonde, our Indian tax advisor, at your convenience.

With kind regard on behalf of the regulated funds industry,

Katie Sunderland

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[5] An individual who held an extraordinarily-large investment (totaling 1 percent) in a non-Indian CIV—that held no more than 5 percent of the shares of any single Indian company (and that investment totaled no more than 5 percent of the CIV's assets)—would own (through the CIV), at most, only 0.0025 percent of the shares of any Indian company.