



The CBDT notifies the Rules in relation to the Safe Harbour provisions for offshore funds

Background

The Finance Act, 2015 had introduced the provisions of Section 9A of the Income-tax Act, 1961 (the Act) whereby an offshore fund shall not be construed to have a business connection in India or be considered as a person resident in India solely on account of an investment manager being situated in India (hereinafter referred to as 'safe harbour provisions'). These provisions laid down certain onerous eligibility criteria for the offshore fund and the investment manager for the benefit of these safe harbour provisions to apply. Several representations were made by the industry to relax these conditions in order to be more practical.

Subsequently, a committee chaired by Mr. Narayan Murthy was constituted by the Securities and Exchange Board of India (SEBI) which recommended certain policy changes to make the safe harbour provisions more effective. However, there were no material amendments on this front in the Union Budget 2016.

In this backdrop, the Central Board of Direct Taxes (CBDT) has now issued Rule 10V of the Income-tax Rules, 1962 (the Rules) providing guidelines for application of the safe harbour provisions.

Summary of the Rules

Existing conditions under Section 9A of the Act	Clarification on Section 9A of the Act vide Rule 10V
<p><i>Eligible fund shall have minimum 25 members who are, directly or indirectly, not connected persons</i></p> <p><i>[Section 9A(3)(e)]</i></p>	<p>Where the investment in the fund has been made directly by an institutional entity, the number of members and the participation interest in the fund shall be determined on a look-through basis, subject to the following conditions:</p> <p>a. The Institutional entity is in compliance with the following conditions as under:</p> <ul style="list-style-type: none"> i. Participation by the person resident in India in the institutional entity does not exceed 5 per cent of its corpus; ii. The institutional entity has a minimum 25 un-connected members; iii. No individual investor holds more than 10 per cent in the institutional entity, and iv. 10 or less members do not hold 50 per cent or more in aggregate participation in the institutional entity. <p>b. The institutional entity has been set up solely for the purpose of pooling funds and its investment;</p> <p>c. The institutional entity is a resident of a country or a specified territory with which an agreement referred to in Section 90(1) or Section 90A(1) has been entered into for double taxation avoidance, exchange of information, etc.</p>

Existing conditions under Section 9A of the Act	Clarification on Section 9A of the Act vide Rule 10V
<p><i>Aggregate participation/investment in the fund of a person resident in India, directly or indirectly, not to exceed 5 per cent of the corpus</i></p> <p>[Section 9A(3)(c)]</p>	<p>Where the direct investor in the fund is not a natural person, appropriate due diligence is to be undertaken by the fund to ascertain such participation and the extent thereof. In the case of an investment in the fund by specified investors (like the central bank, sovereign funds or other appropriately regulated entities like pension funds, mutual funds, etc.), a declaration from such a specified investor should be obtained by the Fund regarding direct or indirect participation by person resident in India being below 5 per cent.</p>
<p><i>Eligible fund shall not carry on or control and manage, directly or indirectly, any business in India</i></p> <p>[Section 9A(3)(k)]</p>	<p>The fund shall be deemed to control or manage a business carried on by the investee entity if the fund directly or indirectly holds such rights in or in relation to the investee entity which results in the fund to hold more than 26 per cent of the voting power, share capital or interest in the investee entity.</p>
<p><i>Remuneration paid to the investment manager to be at Arm's Length Price</i></p> <p>[Section 9A(3)(m)]</p>	<p>a. Arm's length pricing is to be determined as per the existing transfer pricing provisions applicable to international transactions deeming the fund and the investment manager to be associated enterprises (and other provisions of the Act shall apply as if they are associated enterprises);</p> <p>b. Investment manager to keep and maintain transfer pricing documentation; and</p> <p>c. Investment manager to furnish an additional report from an accountant (in addition to the transfer pricing documentation mentioned in point b above) in the prescribed form.</p>
<p><i>Eligible fund to furnish a statement for fund's activities</i></p> <p>[Section 9A(5)]</p>	<p>Fund to furnish a report electronically in the prescribed form (Form 3CEK) in every financial year to the jurisdictional assessing officer</p>

No denial of the benefit of safe harbour provisions in certain cases

The benefit of safe harbour provisions will not be denied in the following cases:

- a) Non-fulfillment of the conditions relating to the (i) activities of the fund being subject to applicable investor protection, (ii) minimum number of investors or (iii) participation by person resident in India, if the said conditions cannot be complied with in the following circumstances:
 - Circumstance beyond the control of the fund for any period of 90 days;
 - Does not exceed the period of 18 months from the date of set-up or final closing of the fund, whichever is earlier (bonafide efforts made to satisfy conditions); and
 - Specified conditions cannot be complied with for the period of one year after the initiation of the winding up process of the fund.
- b) Delay in filing of Form 3CEK and such delay does not exceed 90 days; and
- c) Remuneration to the fund manager not being at arm's length (if other conditions of Section 9A of the Act are satisfied). However, the benefit shall be denied if the arm's length criteria are not complied with in:
 - A period of three successive preceding years; or
 - A period of any three out of four preceding years.

Option to offshore funds to seek CBDT approval

For the purpose of establishing certainty on the Indian tax implications, the fund has been provided an option to seek approval of the CBDT to ascertain its eligibility for the safe harbour provisions. The approval so obtained shall be valid prospectively for the succeeding years. The benefits of safe harbour provisions shall not be denied to such approved funds unless the approval so granted is withdrawn.

Our comments

While these Rules do consider some of the recommendations provided by the Narayan Murthy committee, some of the conditions still remain onerous. For example, there is no relaxation in relation to the conditions of i) investment restrictions of the eligible fund (not more than 20 per cent of its corpus in any entity) ii) eligibility criteria of the fund manager, especially the condition of the fund and the investment manager to be unconnected persons. iii) The manner in which the limit of 26 per cent is prescribed for determining control and management of the Indian investee companies, may eventually turn out to be a road block for funds acquiring controlling stake.



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