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Category III AIFs may turn to GIFT to move past surcharge hurdle

Category III AIFs registered as FPIs in GIFT will still have to pay tax at 30 per cent on derivatives gains

Ashley Coutinho | Mumbai Last Updated at August 29, 2019 22:18 IST

A section of alternative investment funds (AIFs) that primarily target foreign investors may toy with the idea of registering anew in Gujarat's tax-friendly zone to avoid paying higher surcharge.

Category III funds, specifically long-short funds that do derivatives trades and earn income under the head 'business income', remain impacted by the higher surcharge introduced in the Union Budget. Such funds will see an increase in tax rate to 42.7 per cent, from 35.9 per cent, if income earned exceeds Rs 5 crore.

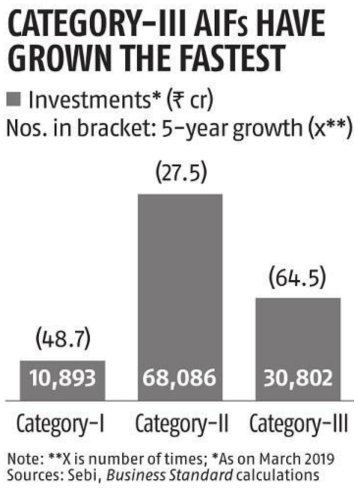
"The current tax regime makes it unattractive to run long-short AIF strategies in the onshore market, as these funds are liable to pay higher surcharge. One alternative available to those raising foreign money in long-short funds will be to set up Category III AIFs at GIFT (Gujarat International Finance Tec-City) rather than onshore," said Subramaniam Krishnan, partner, private equity & financial services, EY India.

Long-short funds comprise 65-70 per cent of the funds that make up Category III, and employ derivatives strategies that involve buying equities expected to increase in value and shorting equities that may see a decline.

Experts believe it is not possible to re-register an onshore fund in the GIFT City directly. Instead, a new fund will first have to be set up at GIFT under the AIF regime and then registered separately as a foreign portfolio investor (FPI). This fund can then raise fresh money from foreign investors or ask existing investors in the onshore AIF to redeem and reinvest via the fund set up at GIFT.

"AIFs registered as FPIs and coming through GIFT will be subject to the same tax treatment as FPIs. The big incentive for setting up in GIFT is that the fund manager can potentially claim 100 per cent tax holiday on its profits for 10 years, subject to meeting substance and general anti-avoidance rules," said Krishnan.

On the flip side, Category III AIFs registered as FPIs in GIFT will still have to pay tax at 30 per cent on derivatives gains. Gains from derivatives are treated as capital gains, and not business income, as is the case with Category III onshore AIFs.



"Category III AIFs can register as FPIs at GIFT to avoid the surcharge hike, but investors will need to get separate permanent account numbers and file returns individually. This is because while the Category III fund is an offshore entity from the Securities and Exchange Board of India's perspective, it will still be treated as an onshore one from an income-tax (I-T) point of view," said Rajesh Gandhi, partner, Deloitte India.

GIFT AIFs will continue to be relatively unattractive, compared to offshore funds investing directly into India from jurisdictions like Mauritius or Singapore. According to India's treaties with these countries, there is no tax to be paid on capital gains on derivatives or fixed income securities.

According to Richie Sancheti, head-investment funds at Nishith Desai Associates, existing norms for AIFs operating out of GIFT need to be liberalised to EASE shorting of securities. "The regime governing GIFT City-based AIFs are coming up very well and the regulators seem to be open to recommendations. To encourage long-short strategies, AIFs set up in GIFT could be permitted to operate in liberalised exposure and netting norms, compared to the 2x net asset value leverage on netted basis regulating onshore AIFs. GIFT could emerge as a regulatory sandbox for regulators to monitor before applying changes onshore," said Sancheti.

Category III AIFs have seen their investments rise by over 60x over the past five years to Rs 30,801.8 crore as of March 2019. This makes it the fastest-growing of the three categories of AIFs.

Another alternative to AIF fund managers to sidestep the surcharge hike would be to consider setting up funds offshore and manage those funds from India by availing the fund management safe harbour rules in Section 9A of the I-T Act. Despite recent relaxations, however, meeting the requirements for availing safe harbour regime remain onerous, and not many funds have got the permission to operate under this regime as yet.