UnFair Tax Treatment Hurts Foreign Investor Sentiments!!

Non-residents entities who have invested in Indian projects through local resident entities find themselves in a relentless debate with the Indian tax authorities. The issue at the heart of this debate is whether Fair Market Value ('FMV') norms apply to investments made at premium by a non-resident through a resident entity in India. These are essentially the cases where a large number of overseas investors pool in their resources to optimise risk exposure and invest into a corporate entity in India that acts as a channel for downstream investments into project specific SPVs, typically in infrastructure projects. As per section 56(2)(viib) of the Indian Income Tax Act, 1961, when such investment is received at the level of Indian corporate entity, there is no problem as the investment is received directly from non-residents. However, when as per the investment objective, the said Indian corporate entity merely acts as a pass-through vehicle for the non-resident investors and makes a downstream investment in the equity of a SPV, and such investment is made at a premium, the tax authorities are questioning the premium and proposing to add the amount of share premium to the income of such SPV. It is ironic that this issue would not emerge if the same investor invests the same funds directly in the state level companies. Merely because the investment is routed through an Indian Holding company/ pass-through entity, it is technically regarded as investment by a resident and the FMV gets questioned. This is an unwarranted anomaly that ought to be removed in interest of the industry, FDI sentiments and in the interest of the policy objective of the Government.

The tax payers have argued that absence of specific treatment for pass-through investment mechanism places the entire investment in jeopardy as the funds provided by the non-resident investors are at the risk of not being fully available for the SPV. The pooling of resources by non-resident investors into an Indian corporate entity is done for the sake of convenience of investment and effective control over use of the funds for the desired objective. This is a legitimate investment mechanism. Since the intent of law is to exclude non-resident investments from the purview of section 56(2)(viib), a clarification or amendment must be looked into to recognize pass-through investment vehicles at par with direct investment channel.

There are other fundamental cases deserving of exclusion from the purview of 56(2)(viib). A classic case is where holding company invests into its subsidiary at premium. This is done merely to enhance the capital base of the subsidiary and the provisions of this section should not come into play. The section was introduced in 2012 as a measure to prevent generation and circulation of unaccounted money i.e. conversion of unaccounted money to accounted funds by routing it through other entities at high premiums so that the real investor retains control of the investee company. A holding subsidiary relationship is sacrosanct and thus any premium charged should not be subjected to the rigors of this section.

Recent proceedings against infrastructure companies is causing serious concerns to investors. Facing an imminent risk of substantial tax on investment, the investee companies are finding it hard to convince the tax officers who believe that the section confers on them a legitimate right to tax share premium. With somewhat limited understanding of share valuation aspects, the tax officers are leaving no stone unturned in challenging the valuation reports prepared by experts. Besides key economic factors such as inflation rate, residual value and discounting methodology in a typical Discounted Cash Flow (DCF) valuation, proprietary business factors such as the revenue projections and growth rate are being looked into, and rejected too, all based on individual opinions. While it is certain that the investee companies will challenge such unwarranted treatment vis-à-vis investment channel and FMV valuation aspects, this is surely causing an immediate impediment to the genuine investments made into Indian assets and acting as deterrent to inflow of serious FDI in India.

Sunil Arora
Partner - Taxation
Email: sunil.arora@asa.in