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Bye, bye to tax credit under treaties

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Foreign direct investments (FDIs) continue to play a very important role in the Indian economy. FDI inflows touched $3.6bn during the year '02-03. FDIs necessitate application of tax treaties.

Mauritius, in fact, continued to be a major investor, and 34.5% of FDI investments for the period from January '91 to March '04 were routed through Mauritius. Direct investments from the US contributed just 16.7% to the total inflows.

The proposal to introduce a transaction tax of 0.15% on the value of all transactions of purchases of securities, has resulted in a million dollar question. Will the foreign investor be entitled to a tax credit for such taxes in its home country? The answer, at least for now, from international tax experts, seems to be a resounding 'No!'

Points out Shefali Goradia, head international taxes, at Nishith Desai Associates, "Tax treaties apply only to taxes that are covered in the treaty. These are generally in the nature of income tax." "It can be said that the FM has converted a direct tax levy (capital gains tax) into an indirect tax levy. Thus, a tax credit in the home country of the foreign investor is unlikely," says Dinesh Kanabar, partner RSM & Co.

Sudhir Kapadia, partner, Bharat S Raut & Co, says, "The provisions for such a transaction tax are contained within the I-T Act. So, from an economic point of view, perhaps an argument could be built in favour of a tax credit. But in practical terms, this being a tax on the value of a transaction, in practice it would be next to impossible to claim a tax credit." This is not the only story. The end result may be a double whammy.

So far, if a foreign investor came via Mauritius, and on sale of Indian securities, made capital gains, whether long or short-term, the Indo-Mauritius treaty provided that India would not tax such gains.

It would be taxed only in the country of residence (Mauritius). We all know, that Mauritius currently does not impose capital gains tax. "With transaction tax now in the picture, this benefit is lost," explains Ms Goradia.

However, Mauritius will still be useful for those foreign investors that are short-term investors. Long-term capital gains arising out of securities sold on stock exchanges (read listed securities), are now tax free. Short-term capital gains for investors, including FIIs, will be charged at 10%. By using Mauritius, the tax on short-term capital gains can be avoided in toto, adds Ms Goradia.

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