FPIs hope Budget to dilute tax rule on indirect transfer

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MUMBAI: Large foreign portfolio investors (FPIs), mainly India focused exchange traded and hedge funds, are pinning their hopes on the Budget for a possible change in the law that tax gains on indirect transfer of shares.

“The clarification issued by India’s tax department on December 21 about the law relating to indirect transfer provisions has instilled fear of God among most fund managers,” said the chief of a Singapore-based hedge fund. “Budget is the only hope where we see the finance minister ring-fencing FPIs from the law as tax officials are turning a deaf ear to our arguments.”

The Central Board of Direct Taxes (CBDT) on December 21 clarified that even FPIs and others including private equity (PE) and venture capital (VC) funds would fall under the ambit of indirect transfer provisions. The law contained in Section 9 (1Xi) of the Income Tax Act says all income arising from asset or source of income in India or through the transfer of a capital asset situated in India, shall be deemed to accrue or arise in India and taxed here.

As per this, overseas investors putting money into large offshore funds would have to forego a slice of their gains while selling or redeeming the units they hold.

The department has said if shares of an Indian company held by a fund constitute over 50% of its total assets and value of the holding exceeded Rs 10 crore, the transaction would be taxed in under the indirect transfer rules.

“The ghost of Vodafone is here to haunt even FPIs, PE and VC funds now,” said Siddharth Shah, partner, Khaitan & Co. “Tax department’s clarification with regard to the law shows a complete lack of sensitivity towards foreign investment in equity markets. If FPIs and PE, VCs are not ring-fenced in the budget from this law, it would lead to a bigger disaster than MAT (Minimum alternate tax). No expert can deny that indirect transfer provisions on FPIs amount to double taxation.”

Currently, FPIs are already subject to securities transaction tax (STT) in addition to short term capital gains tax at 15%. The treaty benefits they enjoyed for over a decade (on equity investments) no longer exists with India revising the Mauritius treaty.

Why double taxation?
The answer lies in investment structure of multi-billion dollar global funds. Usually, large pension and endowment funds allocate their capital to step-down offshore investment vehicles that may include a feeder fund or an emerging market (EM) fund, which further invests in a Singapore or Mauritius based India focused funds which then deploy the money in Indian securities.

The units of these India funds, feeder funds and EM funds are listed on foreign exchanges where these can be bought and sold like the mutual fund units on Indian bourses.

Even though overseas investors or the ultimate beneficiaries buying fund units are not directly under the jurisdiction of the Indian tax office, their gains, arising out of underlying assets in India, would be taxed. For instance, if an individual offshore investor or fund X registered in Cayman Island sells NAV of India focused fund on the US exchange, then there would be tax on profits earned on the transaction. The India focused fund that sells the underlying stocks would anyway have to pay securities transaction tax and short term tax (if applicable) on gains.

Shah says it amounts to taxes being implemented on various layers and may become challenging for global investors to allocate investment capital towards India. “Why would funds not investing directly in India file their tax returns here?,” said Shah.
"Also, as per the clarification there is no limit to number of times tax can be levied on each layer,"` said RajeshSimhan, Partner, Nishith Desai Associates. "Hope the budget brings an end to such application of law. Else, it may lead to a plethora of litigations."

