Want to hold P-notes? Pay 7.5% tax

By *Palak Shah*, ET Bureau | Updated: Feb 14, 2017, 07.50 PM IST

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MUMBAI: Foreign institutional investors (FPIs) issuing participatory notes (P-notes) have decided to impose a 7.5 per cent tax on those who want to use these off-shore derivative instruments to bet on India's equity market.

Although, P-note holders are not subject to any domestic tax laws as they are not registered directly in India, the liability of short capital gains tax (STCG) fall on FPIs issuing these instruments.

The tax department considers registered FPI as a single entity for assessment and is not concerned with multiple P-note deals that it has cut with various un-registered clients. For FPIs, the dilemma was how to appropriately pass on the short term capital gains tax to P-note holders.

So, irrespective of whether P-note holding clients made profit or loss, FPIs will have to pay tax if there was profit recorded on their books, said lawyers and consultants who advise foreign investors. FPIs thus have decided to impose 7.5% tax on any new P-note being issued post March 31 this year to avoid hassles later.

“P-notes players may need to brace up for a tax,” said Siddharth Shah, partner, Khaitan & Co. “This may be for the first time that in over two decades, P-note issuers may end up having to collect tax at 7.5% from P-note holders. This may cover FPIs from potential tax liability arising upon them on account mismatch arising out of the first-in first-out principle that India follows to tax them."

Under the 'grandfathering' clause in the amended tax treaty, the government has allowed 7.5% tax till 2019 only to those registered FPIs, which can prove commercial substance in Singapore or Mauritius. The rest will be charged at 15%.

P-notes have equity shares or debt security as underlying, which is held in the custody of the FPI. So far, FPIs availed tax exemption if they were based out of Mauritius or Singapore. Since India amended its tax treaty with these countries, which will be applicable from April 01, FPIs will be subject to taxes on short-term capital gains.

“The 7.5% tax on P-notes may not lead to any unfair enrichment of FPIs but seems the easy way out of the tax hassles,” said Riaz Thingna, Director, Grant Thornton Advisory.
Some consultants said the lower taxes will ensure the longevity of P-notes at least over the next couple of years.

"Contrary to the popular perception that P-notes will die post March, the tax will ensure that they live-on," said Rajesh Simhan, head international taxation and partner, Nishith Desai Associates.

Those dealing in P-notes too are not complaining.

"A 7.5% tax on P-notes is better than 15% that we would have to otherwise pay for coming directly to India," said an overseas hedge fund manager. "The only thing we are demanding from P-note issuing FPIs is that they allow adjustment and carry forward of loss to next year."

