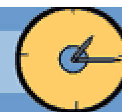

Marketing News

Publication: Economic Times Bangalore; Date: 2007 Oct 18; Section: ET Finance; Page Number 18

PN curbs to raise tax issues

Measures Could Have Adverse Tax Implications For Many Investors

Sugata Ghosh MUMBAI

THE proposed curbs on inflow through Pnotes could raise tricky tax issues for foreign investors and institutional players.

If the measures are imposed in totality, it could have adverse tax implications for many investors. The issue primarily concerns FIIs and other unregistered foreign investors located in countries, which have no tax treaty with India.

Sebi has proposed that there should be no further issuance of overseas derivative instruments (ODIs) or participatory notes by sub-accounts of FIIs. Unless the regulator issues a subsequent clarification, sub-accounts would also include proprietary sub-accounts of FIIs, formed to invest their own money. Sub-accounts are largely corporate structures or special purpose vehicles formed in tax havens by unregistered investors, with FIIs investing the money on their behalf. But many FIIs have their own sub-accounts.

For instance, an FII in Hong Kong may have a proprietary sub-account in Mauritius, which has a tax treaty with India, while Hong Kond has no such pact. If the Mauritius sub-account is barred from issuing P-notes, the only option before the FII is to issue the notes from Hong Kong. This would mean a higher tax impact. This could eventually force the FII or its affiliate in Hong Kong to stop issuing P-notes.

According to Siddharth Shah, who heads the funds practice group at the law firm Nshith Desai Associates, "There is a question mark as to whether those FIIs, which have covered their ODI exposures through sub-accounts organised in tax favourable jurisdictions will now be forced to hedge their exposures directly, and if so, if the FIIs are themselves not located in a treaty jurisdiction there could be potential adverse consequences on their exits."

Understandably, these FIIs will await the Sebi board decision and do the tax arithmetic in the next few weeks to evaluate whether it makes sense to issue P-notes to overseas clients. This assumes some significance since P-notes and more exotic offshore derivatives structures generate good fee income for the FIIs and their affiliates. For the investors, P-notes are a flexible instrument, the cost of which has gone down over the years.

According to Punit Shah, the head of the financial services tax practice of PwC, the proposed 40% cap on PNs will have tax implication for unregistered foreign investors. While such investors will buy P-notes for investment as long as it's within the 40% limit, but will have to open a sub-account with an FII for the balance investment. Once again, if such investors are located in a non-treaty jurisdiction, there could be adverse tax implications for them.

What Sebi has said is those FIIs, which have ODI exposure of less than 40% of the assets under custody in India, are allowed incremental increase of 5% of their AUC in India. This means that it may not be possible for such FIIs to straightaway raise their exposure to the extent of the headroom available; if they have to increase the ODIs they will have to increase their AUC in India through direct investment.

The existing FIIs who have an exposure in excess of 40% of the AUC in India have not been forced to cut their exposure, but they may not be able to increase their exposure except against redemption of outstanding ODIs. According to Siddharth Shah, this may put them in a slightly advantageous position vis-à-vis those FIIs, which do not have the ODI exposure of have less than 40% exposure. "Also, it seems to suggest that for new FIIs, the amount of ODI exposures that they may be able to create will be restricted to 5% of their AUC in India," he said.