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PN holder's income & underlying tax questions

Govt Thinks It Is Legitimate To Levy Tax On PN Holders' Income In Tax Havens When Gains Arise From Sale Of Indian Equities

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WITH the growing integration of the Indian economy with the global economy, the Indian tax authorities like their counterparts elsewhere are increasingly focussing on offshore transactions in which the underlying assets are basically Indian. The well known case is that of Vodafone which is battling a case after the income tax department served a notice to the firm for payment of capital gains after it acquired Hong Kong-based Hutchison's stake in the Indian telecom major Hutch-Essar.

Much in keeping with this pattern, the revenue department has also issued notices to some prominent foreign institutional investors who had issued participatory notes (PNs) to overseas investors. These set of investors are now awaiting the next move by the department considering the tax implications on their income arising from sale of shares of Indian firms. For a while now, the department has been assessing the implications of taxing the capital gains of foreign portfolio investors.

For long, the government's hands had been tied since most portfolio investors route their investments into the Indian stock markets through Mauritius. The Indo-Mauritius tax treaty provides legitimacy for capital gains tax exemption on sale of shares in the secondary market. At a time when capital inflows were needed, the treaty was useful but now the government is trying to re-negotiate the tax treaty to curb treaty shopping, a practice where the residents of a third country claim tax benefits of this treaty. The attempt is to boost tax revenues for the country.

However, the renegotiation efforts are proving to be tough. So Indian tax authorities are now attempting to lift the corporate veil and look at the past transactions of foreign portfolio investors with PN holders, mainly hedge funds. PNs are in the form of off-shore derivative instruments where the underlying shares are of Indian companies. FIIs have agreements with PN holders on passing on the gains from the sale of shares, after retaining their commission. Tax authorities have sought details of such agreements made in the past to assess if there is a strong case to levy tax on the capital gains which flow to PN holders. The rationale for this is that the income which accrues to a PN holder is from the sale of an underlying security that has its 'situs' in India.

Past agreements are obviously under scrutiny as PNs have accounted for a large chunk of trading volumes in India in mid-2000. Until last year, they accounted for well over one-third of the total transactions. That trend is set to change, with market regulator Sebi restricting the issuance of PNs to regulated entities since December last year.

Tax officials are not clear whether these PNs were issued in Mauritius or in the country of residence of hedge funds. The issue under consideration is whether the benefit of the Indo-Mauritius tax treaty will be available on such transactions as the income is effectively earned by hedge funds and the underlying assets are in India.

Tax experts see a clear link between the notices sent to FIIs with the one sent to Vodafone on its \$11-billion acquisition of Hong Kong-based Hutchison's stake in Indian telecom major Hutch-Essar. In the Vodafone deal, the income-tax department thought it reasonable to claim tax though the transaction was outside India and between two overseas parties. The government's contention is that although the deal may not have been made in India, tax is payable because the deal-making involves an Indian asset, which is part of the valuation of the transaction. The issue is before the Bombay High Court.

The government has already opened the doors for taxing many other cross border deals through a legislative amendment which says that the onus of paying capital gains tax on an acquisition in India will rest with the buyer. He is expected to deduct tax at source and failure to do so will make him liable to pay the tax.

There are indications now that foreign portfolio investors may also be asked to withhold tax at source before passing on gains to PN holders (hedge funds) in tax havens.

But some tax consultants aren't so sure. "It is doubtful if the income on PNs in all cases can be

deemed to accrue or arise in India. The characterisation of income may also have a bearing on the taxability of income from PNs," says Nishith Desai Associates international taxes head Shefali Goradia.

This means if the PN holder has invested through, say, Mauritius, he may not be liable to pay tax in India. But if the investor is from a country that does not have a tax treaty with India, he could come under the tax net.

According to Shefali, the tax department's move will have far-reaching implications for the investment inflows into India.

Tax officials, though, are clear that there are provisions in the existing law to levy a tax on the income of PN holders in tax havens as such gains arise from sale of Indian equities.

But this will be done on a 'case by case' basis, after examining the fine print of the agreements between the FII and PN holder. The view which the tax department takes after vetting the agreements will be crucial not just for foreign portfolio investors but also the local financial markets.

