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Draconian regs

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The latest regulatory initiative by the Indian government looks set to add to the burden already facing foreign institutional investors in the country. An overhaul of India's capital gains tax regime is expected to have serious implications for FIIs – and for the country's equity markets, in which they play a crucial role. **Manju Dalal** reports.

Proposals by the Indian government to modify tax regulations could prove a debilitating blow to foreign institutional investors active in the country. In particular, there could be a serious knock-on impact on India's equity markets.

The proposed Direct Tax Code, on which the Indian government is seeking comments by June 30, will be tabled before the country's Parliament in July.

At the heart of the issue is a plan to classify stock market income earned by FIIs as capital gains rather than business income, leading to a hike in FII tax obligations. Tax relating to business income is payable in the FII's home country, but capital gains tax must be paid in India unless there is a treaty exemption.

As a result, some market observers fret that FIIs from the US and the UK could be hardest hit by the reclassification because these countries' Double Taxation Avoidance Treaties provide no relief from capital gains tax. Others counter that the effect could be mitigated for many such FIIs if they are already managing their Indian operations from tax-friendly jurisdictions like Mauritius and Singapore.

But even this mitigation could turn out to be limited. The Singapore-India tax treaty is comprehensive, but has restrictions on benefit clauses. To qualify for capital gains exemption, for instance, the Singapore operation of an FII must conform to certain minimum investment requirements in Singapore.

And that's not all. FIIs, especially those investing in equities or equity mutual funds would now face the burden of "long-term" capital gains tax. At present, capital gains in India are classified as short-term if the relevant investment is held for less than one year, and it is only FII's short-term capital gains that are taxable. Typically such taxes fall within a 15%–30% range, depending on the investment and the relevant treaty.

But the new code would also introduce long-term capital gains for FIIs, with the burden likely to be in the range of 10%–30%. That is likely to have a significant impact on holdings in listed equity.

Some reckon that such changes will prompt many FIIs to route their investments through participatory notes, which are issued to overseas investors by registered FIIs and are not taxed in India. But the authorities have clamped down on such investments in recent years: as of February, just 13% of FII investment in India was routed through P-notes, compared to a peak of 55.7% in June 2007. Sebi, the Indian market regulator, has on several occasions banned large foreign banks from issuing new P-notes, citing failures to comply with stringent disclosure requirements.

Cost of business

The tax code has made an attempt to give some relief to FIIs by not requiring the payment of the capital gains tax as soon as the income is generated, but market participants reckon this relief will not be enough. FIIs will also continue to be liable for the 1.25% securities transaction tax for all listed securities trades.

“There have been a lot of regulatory changes in the FII regime in India lately. The proposed changes to the DTC will add to the uncertain and ever-changing environment in India which increases the risk and cost of doing business in India, and I am not sure how the FIIs will look at India now,” said Parul Jain, head of international tax practice at Nishith Desai Associates, a law and taxation firm in India.

According to Jain, it is unclear if derivative instruments will also fall within the scope of the new DTC, although there have been some recent rulings where the income from derivatives has been classified as business income.

“The new DTC’s premise of classifying FII income as capital gains goes against the fundamental principles of income taxation. When FIIs happen to be foreign mutual funds or pension funds and indulge in billions of dollars of trades in shares, bonds and derivatives globally, it would be completely irrational to describe their income as capital gains,” she added.

Furthermore, adjustments for exchange rate fluctuations are also not available to FIIs. “Clearly this matter must be reconsidered by the government” she added.

The new tax code also proposes to introduce for the first time a tax regime where the undistributed passive income earned by foreign companies directly or indirectly controlled by Indian residents will get taxed in India. Tax experts reckon that the recent acquisition of Zain Africa by Bharti Airtel and the acquisitions of Corus and JLR by Tata Motors could be caught by the new rules, which include “controlled foreign corporation” (CFC) provisions.

“Indian companies have just begun to learn their first lessons in globalisation and it seems that [the new rules] will add significant burden on India Inc at this point in time,” said Jain. “Relief in respect of foreign losses of foreign subsidiaries is the need of the hour.”