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Fears around P-notes return to dampen D-Street mood

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The ghost of participatory notes (PNs) has started haunting India's stock markets. The fear that the income-tax (I-T) authorities would go after PN investments in equities, as General Anti-Avoidance Rules (GAAR) is implemented from April 1, saw the benchmark stock indices take a beating on Monday.

GAAR, announced in Budget 2012-2013, intends to crack down on tax evasion. Under GAAR, merely a tax residency certificate (TRC) may not be enough for foreign institutional investors (FIIs) to avoid paying taxes on capital gains in India.

"Such a thought has already spread a 'reign of terror' among foreign institutional investors," said Nishith Desai, founder of Mumbai-based Nishith Desai Associates.

GAAR puts the onus on companies to prove they are using a specific structure for commercial purpose and not to avoid tax. Taxmen can question claims of companies and FIIs. This was not the case till now if a TRC was presented.

In an interview with *Business Standard*, Rama Sithenan, the former vice-prime minister of Mauritius, said: "It is too early to comment on the introduction of GAAR, as we are not aware of many factors. We are awaiting clear guidelines. However, I read in the paper that the CBDT (Central Board of Direct Taxes) circular of 2000 in regard to the TRC will be respected, as stated by an official of the finance ministry."

According to the CBDT circular, a TRC by Mauritius was reason enough for not taxing an FII in India.

Revenue Department officials, however, clarified that GAAR was not aimed at any particular class of investment or investors.

"Any complicated deal structured just to avoid taxes will attract GAAR provisions. Also, one of the criteria of GAAR is to assess whether a deal is structured in a way that it lacks commercial substance. These provisions, they said, were already there under various existing tax clauses. The only new thing is that they are being brought under GAAR now.

GAAR will come into effect from assessment year April 1, 2013. And, the rules will be framed after the Finance Bill is passed," the official said.

In February, investments through PNs stood at 16.4 per cent of the total of Rs 11.15-lakh-crore assets under the custody of FIIs in the stock market. A majority of these PN positions are routed via Mauritius, which has a double tax avoidance treaty with India.

PNs have often been criticised by tax authorities for providing a perfect smoke screen for investors operating in a clandestine manner. Thus, introduction of GAAR may give taxmen a much-needed arm for further investigations.

Investments through Mauritius will be in focus, as government figures had suggested that roughly 43 per cent of the country's foreign direct investment is routed through the island nation.

"The newly-drafted GAAR provisions and the proposed amendments to Section 9 are very widely worded. Institutions that have bought ODIs (offshore derivative instruments, or PNs) with synthetic exposure are concerned about the potential Indian taxation," said Sameer Gupta, partner, Ernst & Young, in Mumbai.

After the high-voltage drama over the recent Vodafone case, FIIs are worried that rules are being changed with retrospective effect. FIIs have been using PNs to take exposure to Indian markets for nearly a decade now.

"The high amount of subjectivity in GAAR has spread panic in board rooms. Although PNs are perfectly legitimate instruments, these may first come under pressure as tax authorities may go after those," said Desai.

Image: A man walks past the Bombay Stock Exchange building. | Image: Danish Siddiqui/Reuters

Palak Shah in Mumbai

Source: Business Standard