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P - Notes: A story far from over

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Participatory Notes ("**P-Notes**") are a form of Offshore Derivative Instruments ("**ODIs**") that are issued by Foreign Institutional Investors ("**FIIs**") to entities that do not directly invest in the Indian public markets by registering themselves under the FII Regulations. The past few days have seen a frantic scramble by FIIs to understand the implications of the recent budget proposals on the P-Note business as there was an initial perception that income stream from ODIs could be doubly taxed - first in the hands of the ODI holders on account of the indirect transfer (taxation of transfer of interests of a foreign entity having underlying Indian assets) and second if anti-avoidance measures are invoked, denial of treaty benefits to issuer FII who would then pass on the liability to the ODI holder.

Though the Finance Minister has clarified to allay some concerns, a consensus view can only emerge once the budget proposals are formalized. In this hotline, we have set out the issues and implications the issues that FIIs / ODI holders could be potentially faced with under the budget proposals.

What would constitute a P-Note?

ODIs have been defined in Regulation 15A of the Securities and Exchange Board of India (Foreign Institutional Investors) Regulations, 1995 (the "**FII Regulations**"), as "*any instrument, by whatever name called, which is issued overseas by a FII against securities held by it that are listed or proposed to be listed on any recognized stock exchange in India, as its underlying*."

Therefore, to be perceived/ classified as reportable ODIs, the concerned offshore contracts would need to refer to an Indian underlying security and also be hedged onshore to whatever extent by the issuer FII. Accordingly, unless so hedged, an ODI remains a contract note, that offers its holder a return linked to the performance of a particular underlying security but need not be reported under the disclosure norms set out under the FII Regulations.

It is the issuing FII that engages in the actual purchase of the underlying Indian security as part of its underlying hedge to minimize its risks on the ODI issued. The position of the ODI holder is usually that of an unsecured counterparty to the FII (with inherent counterparty risks amongst others) and under the ODI (the contractual arrangement with the issuing FII)

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the holder of a P-Note is only entitled to the returns on the underlying security with no other rights in relation to the securities in respect of which the ODI has been issued.

Position of tax on P-Notes

The basis of charge of Indian income-tax depends upon the residential status of the taxpayer during a tax year, as well as the nature of the income earned. Notwithstanding the aforesaid, what needs to be crucially determined is whether the concerned transaction is subject to tax in India. Capital gains from the transfer or sale of shares or other securities of an Indian company held as capital assets would ordinarily be subject to tax in India (unless specifically exempted). Section 9(1)(i) of the Income Tax Act, 1961 ("**Act**"), deems all income accruing or arising through the transfer of a capital asset situated in India, as taxable.

In case of ODIs, the contractual arrangement between an ODI holder and the FII is typically such that it is not mandatory for the FII to actually hedge its underlying position (i.e. actually 'hold' the position in Indian securities). Further, even when the ODI holder redeems the ODI, there is no requirement that the FII also sell the underlying securities. Given that ODIs typically are 'unsecured' contractual obligations, even in case of any liquidation of the FII, the ODI holder is subject to counterparty risk and cannot rightfully receive the underlying shares. Therefore, considering that the ownership of the underlying securities vests with the FII, the ODI holder should generally not be taxable in India.

The 2012 Budget proposals ("**Budget**") seek to alter some of the critical understandings on how transactions are to be taxed in India. To begin with, the Budget proposes to amend the definition of "capital asset" to mean "an asset or a capital asset being any *share* or *interest* in a company or entity registered or incorporated outside India shall be deemed to be and shall always be deemed to have been situated in India, if the share of the interest *derives, directly or indirectly, its value substantially from the assets located in India"*. In case of an ODI Holder, while the value of the ODI is linked to the value of an asset located in India, the ODI is not in the nature of a 'share' or an 'interest' in any foreign entity since it is merely a contractual arrangement. This is one of the requirements that need to be satisfied for the transfer of a foreign asset being deemed to be regarded as the transfer of a capital asset in India.

The second proposal under the Budget is to determine the *substance* of a transaction by overlooking the *form* of the transaction on the ground that it represents an '*impermissible avoidance arrangement'* by way of applying the General Anti-Avoidance Rule (GAAR). The concerns under the GAAR provisions for an ODI holder arise since (a) it derives its value from an underlying Indian security, and (b) hedge is (may be) carried out by the counterparty FII residing in a jurisdiction with a favorable tax treaty with India. The concern is further

deepened considering that the Budget also introduces an explanation to clarify that the withholding tax obligations under Section 195 of the Act (liability to deduct tax in respect of payments made for purchase of capital asset) apply to all non-residents, irrespective of whether they have any presence whatsoever in India. This could technically come into play as and when an ODI holder redeems an ODI (the obligation in which case lies on the issuer FII) or sells the ODI to another non-resident (on the purchaser non-resident in this case). In case of the FII issuing the ODI, the main concern that arises is whether the GAAR provisions can be used to deny treaty benefits to the FII in respect of the underlying hedge on purchase / disposition of Indian securities.

How real are the risks of Indian taxes being imposed on P- Notes?

The Budget proposals are still in a draft form and up for consideration by the Indian legislature. However given the recent turmoil on the Indian secondary markets due to the nature of the proposals, the Finance Minster clarified that "*… entities investing in stock markets through P-Notes (participatory notes) would not be required to pay taxes in India*". While it is merely a clarification on a proposed law, it still is comforting.

However, what still stymies the comfort is his adding "*the Income-tax Department would examine the tax liability of the FIIs*". Which means that while ODI holder may not be taxed, there could be some burden imposed on the counterparty FII. The formal language of the law however remains to be seen which is expected to be confirmed by the month of May, effective however from April 1, 2012.

Impact on the industry

If the possible outcome is that ODI structures could come under tax scanner, irrespective of whether it would be the ODI holder or the issuer FII that is taxed, this could lead to several disruptive issues that could potentially sound the death knell for the industry.

The first issue would be whether GAAR would be applied in respect of such structures and the manner of such application. Whether it be applied to '**look through**' the FII structure and therefore seeks to tax the ODI holder directly or will it '**look at**' the FII structure to deny treaty benefits to the issuer FII. The tax consequences and issues that arise can be materially different in respect of the two scenarios.

Under the '*look through'* scenario, the tax authority can perceive the ODI holder as the actual owner of the hedged underlying securities and seek to tax on that basis. In such case, it

could be expected that all income, expenses, tax credits, rebates, gains and losses from the ODI transaction should be passed on to the ODI holder concerned. Some of the key questions / issues that can arise in a case where the ODI holder is being taxed directly are - would the ODI holder (a) be entitled to offset loss transactions against profit transactions; (b) be entitled to a credit in the home jurisdiction or vice versa under given the conventional source rules as applicable on international transactions; (c) what would be the characterization of income in the hands of the ODI holder and what should be the applicable tax rate on such transactions. On the issuer FII side, issues may arise on account of (a) how to treat and account for the losses that may be sitting in its books of the FII entity which actually relate to ODI trades made in the past and (b) will the FII be required to withhold taxes in relation to the ODI trades when redeeming the ODI.

On the other hand, in the 'look at' scenario, the tax authorities can seek to deny treaty benefits to the FII and tax the FII on the income made on sale of the underlying hedge (Indian securities). The first issue that could arise is what would the nature of the income sought to be taxed. In case of 'business income' the same would be taxable in India only if the FII has a permanent establishment ("**PE**") and only that component of income, which is attributable to the Indian PE. In case the treatment of the income is that of 'capital gains', the same may not be taxable in India if the FII is resident of a tax favorable jurisdiction. Further the risk of GAAR being applied to deny treaty benefits to the FII could make it difficult to obtain a certificate pursuant to Section 195 of the Act that such income (or a proportion thereof) is not income chargeable to tax.

Determination of the position on the aforesaid issues is critical as there are vast differences between the rates of taxation on the possible characterizations of the income stream. The capital gains tax will vary depending on the nature of the security and whether the gain recognized on the sale qualifies as a short-term or a long-term gain. The variation in such cases could be from 0% to 40%. Alternatively, if any of the income streams arising from the ODI structure is characterized as business income (subject to tax in India to the extent that it is attributable to a permanent establishment in India) the same is taxable at the rate of 40% on a net income basis.

Other issues that arise is how do the FIIs pass on the tax risk to the ODI holder considering there will be a mismatch between the ODI holder's income and the FII income on a trade. Further issues arise as to whether indemnities in the ODI contract note can resolve the problem and how it can actually be applied. Possible issues in case of indemnities include credit issued for the ODI holder and issues relating to interest / penalties. Another issue to be resolved is that if the FII does not 'true hedge' the ODI, how the withholding would and indemnity obligations work.

Some FIIs are actively considering moving their current Mauritius holdings to a Singapore

structure. The move has merits for groups that have ability to demonstrate substance (both in entity and in Singapore as a jurisdiction). However, key concerns arise on whether the initial transition itself to Singapore could attract GAAR and consequently, be taxable in India. Further, the eligibility criteria for claiming capital gains tax exemption under the tax treaties with India should also be carefully studied as the same may (as in case of Singapore) require some substantive conditions to be established in the jurisdiction.

Way forward: Reaction from prime brokers and other issuers of P-Notes

Most of the FIIs have constricted their ODI issuance. The stance seemed to be taken is that contractually, the risks (including that of any taxes) should lie with the P-Note holder. A combined reading of the Finance Minister's statements and the proposals under the GAAR lead to a perception (albeit not a consensus view) that that while indirect transfers/ redemptions of P-Notes may not be taxed in India, the GAAR provisions could challenge the FII structure in the ODI mechanism. Under such circumstances till the Budget is approved and clarity is obtained, most FIIs could limit the issuance of ODIs until some resolution is obtained on some of the issues set out.

Beyond doubt, jurisdictions globally are in a fight for attracting capital. Recent reports indicate that FII exposure to stock markets through P-notes stood at over US$ 36 Billion. It is required that the regulators take a pragmatic approach as any move towards taxation of ODIs would likely lead to fatal consequences as the margins for the issuer FIIs and may no longer justify the business and cost risks that would get inherent in the structure. The fundamental question that arises is whether in the hasty move to bring in GAAR, without taking into consideration any of the proposals set out by the Parliamentary Standing Committee, the Finance Minister has actually sounded a death knell for the P-Note business which will only result in a significant slowdown in inflow of foreign capital and adversely impact the capital markets. Neither of these can be afforded at this stage.

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