THE ECONOMIC TIMES

Sebi goes slow on licence to funds from Mauritius

7 Jun 2010, 0000 hrs IST,Sugata Ghosh & Reena Zachariah,ET Bureau

MUMBAI: Capital market regulator Securities & Exchange Board of India (Sebi) is going slow on giving licences to foreign funds' investment vehicles, better known as sub-accounts, based out of Mauritius. Sebi has not spelt out the reason, but some think it may be part of a larger strategy to put subtle pressure on the tax haven to rework its 28-year-old treaty with India.

In its present form, the tax treaty allows investors from Mauritius to avoid tax on capital gains they make on investments in India. Today, local investors pay 15% short-term capital gains tax if they sell a security in less than a year before buying it, but foreign investors coming from Mauritius pay no tax. Local investors are taxed even on the long-term gains if a security is sold outside the stock exchange. But for investors from Mauritius, there is no tax on profits, either short term or long term, from such off-market deals.

Over the years, this tax advantage paved the way for rampant treaty-shopping by foreign funds, which emanated from various jurisdictions but set up paper companies in Mauritius to enter India. To bring down such tax avoidance, New Delhi wants to tweak the tax treaty to ensure investment vehicles in Mauritius are not merely shell companies.

Under the circumstances, Sebi's present stance may well be a signal to Mauritius. "In the last one month, new applicants as well those who have applied to renew their licences are experiencing delay. It's possibly because of a policy-level position, and may be part of a concerted effort to put pressure on Mauritius for renegotiating the tax treaty," feels Siddharth Shah, who heads the corporate and securities practice group at law firm Nishith Desai Associates, which is an advisor to several offshore funds.

Licences to foreign institutional investors (FIIs) and sub-accounts are renewed every three years. The renewal process for the registration takes a week to 10 days, but this time it's taking longer. However, the compulsion to change the treaty with Mauritius cannot be the official reason to delay renewals. "Granting registration by Sebi to FIIs and sub-accounts is an independent issue based on specific parameters as laid down by Sebi regulations. Also, this may not be consistent with international commitments made by India to facilitate free flow of investment between countries," said Punit Shah, financial services tax leader, KPMG.

But a senior official involved with the FII registration process said the reason for Sebi going slow on sub-account applications from Mauritius could be in light of the direct tax code being introduced and the Indian government's eagerness to amend the tax treaty. Also, officials in intermediaries dealing with Sebi confirmed that the regulator is taking unusually long in processing applications from Mauritius. Significantly, some of the funds from non-treaty destinations have been able to renew their licences.

All this is happening at a time when the Indian government is coming out with a new direct tax code that intends to overhaul the country's tax regime and change some of the antiquated provisions. The code proposes a 30% tax on short- as well as long-term capital gains. But tax experts feel that since any move by the government to dramatically change the tax provision in the treaty would be challenged in court, it is nudging Mauritius for an amendment.

A possible change in the treaty could be in the form of new conditions that funds from Mauritius will have to fulfil to be eligible for tax benefits. One such condition could be a minimum expenditure, something that is applicable for funds setting up vehicles in Singapore to invest in India. In Singapore, a fund has to spent at least S$ 200,000 for the first year and another S$200,000 in the second year to avoid capital gains tax in India. But in Mauritius, an offshore fund will need just $5,000-7,000 to set up a firm for playing the Indian stock markets. Recently, Sebi held back the entry of "multi-class share entities", which have distinct pools of investments, amid suspicion of round-tripping. But since the regulator has already clarified its stand on the matter and laid down the rules, the present delay cannot be linked to scrutiny of multi-class structures, said a source.