Budget 2014: FIIs not paying tax in capital gains net

A handful of UK and US-based foreign institutional investors (FIIs) who aggressively interpret the law to escape tax in India will now feel the pinch. These funds pay neither the shortterm capital gains tax nor the higher income tax with the help of tax structuring and classification of earnings.

They declare their profits from stock trades in cash and derivatives market as "business income" to avoid paying 15% tax on short-term capital gains.

Simultaneously, they avert 40% tax (as applicable to foreign companies in India) on the income on the grounds that they have no "permanent establishment" in India. The net result: they pay no tax in India even though they do not route their investments through Mauritius or Singapore.

Under India's treaties with the US and the UK, while FIIs are exempt from paying business tax in India, they have to pay capital gains tax. Since the Budget has spelt out their gains will now be treated as capital gains, these funds would have to fork out 15% tax.

"Characterisation of FII tax in the Budget will negatively impact institutions which took business profit positions with respect to derivatives," said Sameer Gupta, senior partner with accounting firm Ernst & Young.

Equity derivatives are classified as security which attracts capital gains tax.

According to Siddhart Shah, senior partner at law firm Khaitan & Co, "The Budget announcement may have sent out a conflicting message to FIIs. Post the 2010-11 GAAR (General Anti-Avoidance Rules) controversy, many FIIs were investing directly in India rather than routing their funds through Mauritius or Singapore. But now they would be pushed to choose to either move back to countries with which India has complete tax avoidance treaty or even some may take positions in the offshore market." Moreover, the reaffirmation that GAAR would be applicable from April 2015 has generated concern among market participants. The provision empowers Indian revenue authorities to deny tax benefits on trades routed through paper or shell companies floated in tax havens (particularly Mauritius).

After the then finance ministry Pranab Mukherjee first said that GAAR would be implemented, many FIIs moved their bases from Mauritius to Singapore because the India-Singapore treaty clearly lays down the conditions that entities setting up base there have to fulfill to avoid capital gains tax in India. Some of them have also started investing directly from their home countries.

Shah says that most FIIs believed that government wanted them to invest directly in India and also give them a comfort of characterisation.

But including derivative income under capital gains tax (together with GAAR) may rattle these funds.

While most market participants welcomed the FM's move to spell out that FIIs' trade profits in India would be classified as capital gains (and not business income) - thus, doing away with an anomaly - the proposal would hurt some funds who went on categorising their stock earnings as "business income" despite negative rulings by tax authorities.

"However, the announcement will resolve the issue over permanent establishment," Vineet Bhatnagar, managing director, Phillip Capital.

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