Budget brings tax worries for foreign portfolio investments

Portfolio investors based out of the US and other countries with which India does not have favourable tax treaties will have to pay a 15 per cent tax on their derivative transactions, after the Budget decided to classify income from all foreign portfolio investment as capital gains.

Many foreign portfolio investors earlier described such trades as business income and paid no tax on these.

The US is the largest source of portfolio investment into India, at Rs 5.56 lakh crore, or nearly a third of the total foreign holdings in Indian equity, according to depository data. The proportion of institutional investors that will be affected depends on how many of them were treating portfolio transactions as business income for tax purposes.

Bijal Ajinkya, partner at law firm Khaitan & Co, said derivative trading was earlier generally characterised as business income, which was taxable only if the foreign institution had a business connection or a permanent establishment in india. "Because the fund manager was located abroad, no permanent establishment was established. This meant derivative trading was almost tax-free," she said.

This will change with the Budget announcement. "Derivatives will be taxed as short-term capital gains. Derivative trading will now attract a tax rate of 15 per cent, compared with zero earlier, unless, of course, a favourable tax treaty is relied upon," said Bijal.

Three of the top-five sources for portfolio investments do not have a favourable treaty with India on capital gains. Countries other than the US in this list are the UK and Luxembourg. Institutions based in Singapore and Mauritius, the other two countries in the top five, will not have to pay tax on derivative trades because of their treaties with India that exempt tax on capital gains.

The Budget sought to bring certainty to the taxation of such income. There has been much litigation on the issue between portfolio investors and the tax department.

"It is more attractive to be based out of jurisdictions where the treaty exempts taxes," said Pranay Bhatia, partner of BDO India LLP. "Investors could also explore setting up a proper commercial presence in countries with which India has a favourable tax treaty," said Suresh V Swamy, executive director, tax & regulatory services, PricewaterhouseCoopers.

The General Anti Avoidance Rules (GAAR), under which the revenue department has the power to look into arrangements entered into only to save tax, though, could stall such migration. Institutional investors might be unwilling to have a token presence in treaty jurisdictions for tax purposes if they can later be subject to review under GAAR, if and when the government decides to implement it.

The Budget also said offshore fund managers could locate themselves in India. “While it may impact the taxability of derivative transactions of certain treaty-based investors negatively, it also opens up the possibility of fund managers setting up a base in India and managing funds from India. Due to this change, there could be increased economic activity resulting in an overall positive impact on flows,” said Swamy.

Foreign portfolio investors have net-bought Rs 68,596 crore of Indian equities so far in 2014.

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