Gaar may Spoil Tax Treaty Benefit for FPIs

Key benefits given to Foreign Portfolio Investors (FPIs) under amended tax treaties with Singapore, Cyprus and Mauritius may be negated by the implementation of General Anti-Avoidance Rules (Gaar).

Domestic anti-avoidance law will prevail over treaty benefits in the event of a dispute under the Singapore and Mauritius treaties. This could threaten the lower tax rate for FPIs in the two years between April 1, 2017, and March 31, 2019. Under the amended treaties, short term capital gains tax for FPIs is 15%. However, during the transition window cited above, this will be 7.5%, subsequently doubling to 15%. The tax treaties with these countries were amended last year.

Many FPIs are also worried that benefits under the amended treaties for derivatives and debt instruments may be questioned under Gaar.

Tax officials confirmed that Gaar will take effect on April 1 and that the government is not looking at issuing any additional regulations before March 31 at a meeting held recently with industry representatives, said people aware of the development. Concerned about this, many FPIs have reached out to their advisers in India. “In Singapore and Cyprus treaties, it is provided that the treaty will not prevent a country from applying its domestic anti-avoidance law,” said Sameer Gupta, tax leader, financial services, EY.

“However, one hopes the general understanding of law that a specific anti-avoidance provision (as prescribed in Limitation of Benefits article under the treaty) prevails over general provision (anti-avoidance rules) should be accepted and the government should allow FPIs to avail (themselves of) the benefits under the respective treaty.”

Limitation of Benefits or LoB refers to provisions aimed against treaty shopping. Every FPI will have to follow LoBs or risk not getting treaty benefits.

KEY BENEFITS

There are two major benefits for FPIs under the treaties. The first is the grandfathering clause, where by any investment in India before March 31, 2017, will be treated as an old one and hence not taxed in India. The other is the two-year, 7.5% window.

“While Gaar may not be invoked on each and every transaction, especially because action can be taken only after obtaining approval of the commissioner and the approving panel, as things stand as per the law, in case of a conflict between Gaar and Singapore or Mauritius or Cyprus treaties, Gaar will prevail,” said Rajesh H Gandhi, partner, Deloitte Haskins & Sells. “This could mean that the 50% tax leeway for next two years under the Singapore Mauritius treaties may not mean much.”

The government formed an expert committee in 2012 that needs to approve any Gaar adjustment made by a tax official.

LARGER QUESTION

Experts said the question isn't a simple one of whether Gaar will apply in spite of FPI coming from a treaty country. “The larger question is, can a domestic law apply to an investment in a country where an international treaty is already signed?” said a tax expert.

Additionally, investment in other instruments apart from equity may be impacted, experts said.

“The exemption for capital gains from sale of derivatives and debt instruments, which continues even under the revised treaties with Mauritius and Singapore, is not subject to any expenditure threshold under those two treaties,” said Gandhi. So it is all the more likely that Gaar could be invoked in those cases and may put a dampener to the exemption.”

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