Tax Hotline

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INCOME ON PARTICIPATORY NOTES UNDER THE LENS OF INDIAN TAX AUTHORITIES: THE VODAFONE SAGA CONTINUES……….

The Indian income tax authorities have once again hit the news by issuing notices to Foreign Institutional Investors ("**FIIs**") claiming that the income on Participatory Notes ("**P-Notes**") is taxable in India since the income arises due to the sale of the underlying Indian security which has its situs in India.

In the Indian context, P-Notes are offshore derivative instruments ("**ODIs**") issued by FIIs to overseas investors who have no direct access to the Indian stock markets to facilitate trading in Indian securities. The Securities and Exchange Board of India ("**SEBI**") has restricted the issuance of P-Notes within certain limits to regulated entities, i.e. regulated by authorities such as a central bank, stock exchanges, securities regulator with effect from October 25, 2007.

Many of the FIIs which have made investments in India and have issued P-Notes are situated in Mauritius and hence gains arising to them on the transfer of the underlying Indian security is not subjected to tax in India, in the absence of a permanent establishment in India. The tax authorities have issued notices to the FIIs stating that they should withhold Indian tax while passing on the gains to P-Note holders, since the gains arise in India. The tax authorities seem to justify their demand on the basis that the income has a nexus with India under the Indian tax laws.

VODAFONE CONTROVERSY:

The genesis of imposing tax liability on the FIIs for issuance of P-Notes appears to stem from the recent Vodafone case filed by Vodafone B.V. (registered in Netherlands) against the tax authorities in India. In the said case the tax authorities have attempted to tax profits made outside India on the transfer / sale of shares of a foreign company by one non-resident to another on the basis that the underlying asset is the interest in the Indian Company. Accordingly, the tax authorities have issued a show cause notice to Vodafone, treating it as an 'assessee in default' for its failure to withhold tax on the payments made to the purchaser of the shares. Vodafone has challenged the right of the tax authorities to levy capital gains tax on the transfer of the shares of a foreign company outside India, for which consideration is paid outside India, by filing a writ petition, which is pending before the Bombay High Court.

ANALYSIS

The tax authorities seem to have applied the same logic as in the Vodafone case to justify imposition of tax on the income from P-Notes which represent the underlying interest in the Indian companies. The moot question is whether the income arising on the P-Notes can be said to have a nexus with India, which would probably also depend on the terms of issuance of the P-Notes. Strictly reading the Indian tax law, it is doubtful if the income on foreign P-Notes in all cases can be deemed to accrue or arise in India. The characterization of income may also have a bearing on the taxability of income from the P-Notes. Even if the situs is said to be in India, if the P-Note holder has invested through a country with which India has a tax treaty, the question is whether the terms of the applicable tax treaty would also point at the situs of the capital gains also being in India and hence subject the same to Indian taxation, which we believe is highly unlikely.

In any case, this controversy would leave the P-Note holder and the FII in a tricky situation since as per the provisions of the Indian tax laws, the FII would be required to deduct tax at source in case the income is said to be chargeable to tax in India.

CONCLUSION

The recent initiative of the tax authorities to tax the income arising from P-Notes will have far reaching implications on the investment inflows in India as a substantial percentage of investments made by the FII's is in the form of P-Notes. On the issue of taxability of P-Notes, whether such demand stands the test and scrutiny of the courts in India, is definitely debatable.

- International Tax Team

Source: The Economic Times dated May 15, 2008

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