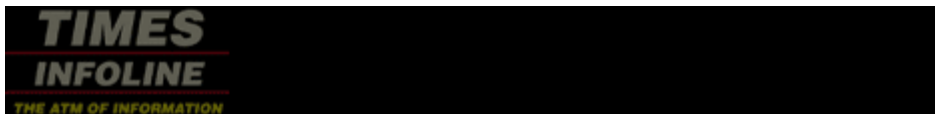


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Publication: Economic Times Mumbai; Date: 2007 Jun 18; Section: Front Page; Page Number 1



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BY CIRCULARS

FIIs, PMS investors in tax haze on share sale

Our Bureau PUNE/MUMBAI

FOREIGN institutional investors (FIIs), particularly funds operating from destinations other than Mauritius, will have to grapple with greater uncertainty surrounding the tax treatment of profits from the sale of shares. Last week's circular issued by the Central Board of Direct Taxes has also raised the tricky issue on whether local investors in portfolio management services (PMS) will have to pay a higher tax.

Significantly, even Mauritius-based FIIs, who pay no tax now on the back of a treaty that India has with the country, may find the going tough if tax authorities can prove that they have a 'permanent establishment' (PE) here. A PE does not necessarily mean an office in India. It could also mean an FII's relationship with banks and custodians in India.

Most FIIs from destinations like the US pay a 10% tax on shortterm gains — profits from sale of shares within a year of purchase. This settled position may now come into question. "The circular lays down the broad parameters to distinguish between a trader and an investor. However, it certainly does not rule out the possibility that FIIs can have business income. Such FIIs will not have to pay tax in the absence of a permanent establishment," international tax expert, Nishith Desai told ET.

If shares are held as trading assets, profits from the sale of such shares are treated as 'business income' and taxed at a maximum of 30% for individuals and 33.99% for companies. However, if the stocks are held as a capital asset, the earnings are treated as capital gains. An investor in shares does not have to pay any tax if he sells the shares after one year of holding them. Shares sold within a year of holding attracts a 10% tax.

PMS investors will have to segregate portfolios

FOREIGN institutional investors and portfolio management services investors are still in doubt over tax treatment on sale of shares. According to Punit Shah, leader — financial services of PwC, "The uncertainty over the FII tax regime could grow. Our experience is that many FIIs are filing returns as capital gains, paying a 10% tax. The circular has reproduced certain principles laid down by judicial pronouncements which seem to hint FIIs are earning business income rather than capital gains." Mr Shah also felt tax obligation of PMS investors could go up.

Currently, all PMS profits are shown as capital gains. With the circular, PMS investors, like other market players, will have to segregate their portfolio of stocks — as capital assets and trading assets — something they don't do now. The tax liability may go up since the profits from the two classes of assets will attract different taxes.

The CBDT circular allows an individual, including an FII, to have two portfolios — one for trading in shares and the other for investment. An investor pays a lower tax than a trader in shares. But taxpayers will have to produce records and evidence to prove that the stocks are held as a capital asset or a trading asset. Several traders in stocks have been camouflaging their income from shares as investment income to save on tax. The party will end now as assessing officers will be guided by three principles: whether the shares purchased were held and valued as stock-in-trade;

whether the transactions were substantial or not and the motive was to realise profits or earn dividends

Impact On FIIs

The tax treatment is, however, more complex for FIIs. This is because FIIs' tax obligations are subject to the provisions of bilateral tax treaties with India. According to such treaties, FIIs do not have to pay tax on business income earned in India if they don't have a permanent establishment. Most FIIs do not have a PE in India.

Tax authorities have always held that FIIs are investors in shares for registration. This has been contested by tax payers, particularly the US-based FIIs. So worry lines have been drawn for US-based portfolio investors, particularly pension funds, retirement trusts and university endowments which enjoy a tax-free status there. They may have to absorb an extra 10% cost on profits from sale of Indian shares, going by the circular. This is because assessing officers are bound to go by a recent ruling by a quasi judicial authority given to the US-based Fidelity group.

The authority held that income from sale of equities by offshore funds managed by this group will be treated as capital gains. But the CBDT circular is unlikely to impact FIIs based in Mauritius or Singapore significantly.

Mauritius does not tax capital gains. Mauritius-based investors are even spared of paying the 10% capital gains in India. So is the case with Singapore-based FIIs, with some riders. "If a Mauritius-based FII reports capital gains, the fear is that the assessing officer may get a fresh lease of life to examine whether the FII has a business income and if so, a permanent establishment in India," according to Sudhir Kapadia, head of tax practice of BSR&Co.

Assessing officers will look at the facts of each case to distinguish between a trader and an investor in stocks, said officials. "The circular may still not clear the uncertainty on the issue as taxpayers may have to produce evidence to determine whether shares are stock in trade or investment," according to Samir Gandhi, tax partner at Deloitte Haskins and Sells. Sources said that the revenue department wants to collect at least a 10% short-term capital gains tax from FIIs directly investing in Indian stocks. This would mean that disputes could well continue between the tax payer and revenue authorities.

PMS Investors

Official sources said that normally the gains made by a PMS investor are treated as capital gains, if the motive is capital appreciation. They said the tests to distinguish whether a person is a trader or an investor in stocks would normally prove that a PMS investor is only an investor in stocks.

However, the circular does not say anything specific about PMS investors and tax experts are of the view that the CBDT should come out with a clarification. There is no ambiguity though on the tax liability of the fund manager (or broker) of the PM. A fund manager of the PMS is a service provider. He will, therefore, have to pay income tax on the commission earned from his clients. The brokerage fees or the commission will be treated as his business income. Simply put, a PMS fund manager is neither a trader nor an investor in stocks.

