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## TAX CODE

## FIIs to benefit, may hurt local investors

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Foreign institutional investors, or FIIs, the key drivers of Indian equity markets, will benefit from the new draft direct tax code that eliminates the threat of a "treaty override" and allow them to continue enjoying the so-called double-taxation avoidance benefit.

Domestic investors, however, will be hit by the proposal to impose tax on long term capital gains. Currently, capital gains on investments beyond a year are not subjected to any tax.

A majority of FIIs are registered in tax havens such as Mauritius and Singapore.

These countries have signed a double taxation avoidance agreement, or DTAA, with India and the entities registered there enjoy tax exemption.

The earlier draft, released in August, had said its provisions would override these tax treaties. But this overriding clause has been removed in the new version, clearing the cloud over taxing FII income.

FIIs have so far bought \$5.04 billion (around Rs23,537 crore) worth of Indian equities net of sales this year. Since 1993 when India opened the doors for this group of investors, FIIs have pumped in \$72.86 billion.

The draft code has proposed that between the domestic law and the relevant DTAA, the one which is more beneficial to the taxpayer shall apply.

Siddharth Shah, partner, Nishith Desai Associates, a Mumbai-based law firm said the ref-



erence to a treaty override, which was part of the original draft, has been done away with. "That will be beneficial to FIIs. As long as the double-taxation avoidance treaty itself is not changed, the FIIs can continue to avail tax exemption."

Also, for FIIs, capital gains shall not be subjected to tax deducted at source, or TDS, and they will only be required to pay tax by way of advance tax on such gains.

Ashvin Parekh, national leader, audit and consulting firm Ernst and Young, said the move will benefit foreign investors as they won't need to get into lengthy refund procedures. "The move is progressive. Earlier, tax was deducted upfront for all FIIs and they had to claim refunds, if they were not liable to be taxed."

The code has also clarified

## FRESH PROPOSALS

## THE NEWS

The draft code has proposed that between the domestic law and the relevant tax treaty, the one that is more beneficial to the taxpayer shall apply. Long term capital gains will be taxed in the hands of domestic investors

## THE BACKGROUND

After the first draft was submitted in August 2009, there was widespread expectation that long term capital gains would not be taxed.

## THE IMPLICATION

FIIs coming through tax havens will continue to enjoy tax exemption, while local investors will be required to pay tax for assets held beyond one year.

PHOTO BY ARVIND YADAV/HT; GRAPHIC BY YOGESH KUMAR/MINT

that all income of FIIs arising out of transactions in Indian securities will be considered for taxation under a single head as capital gains and that accordingly, capital gains, tax will be levied on this.

Even though most of the FIIs have been classifying their income from such investments as capital gains, some of them show them as business income and claim total exemption from taxation in the absence of a permanent establishment in India.

"In terms of characterization of income of FIIs as capital gains, it's a confirmatory position. This is beneficial to the foreign investors as they can claim the double taxation avoidance treaty benefit," Shah of Nishith Desai Associates said.

U.R. Bhat of Dalton Strategic Partnership Llp, an FII, said

that it's status quo for foreign investors.

Bhat said the code's purpose would be defeated if the taxation rates are not declared in advance. "The purpose of the direct tax code was to have a long-term fiscal policy and allow people to plan for (the) long term."

The new code has proposed to remove the current distinction between short-term investments and long-term investments on the basis of the length of holding of the assets. At present, assets held beyond a year are classified as long-term investments, and appreciation on such investments are not taxed under capital gains.

This will not go down well with domestic investors.

V.K. Sharma, business head, private broking and wealth management, HDFC Securities Ltd, described the draft code proposals as "backward looking and retrograde".

"From an investor's point of view, there is no incentive to stay long term. This is bad, considering that the government is planning to bring so many public issues," he said.

"Since the distinction between long-term and short-term capital gains has been removed, any gain that is made in the stock market is liable to be taxed. On the other hand, FIIs are exempt from this as they take the Mauritius route," Shah said.

Parekh of Ernst and Young said despite this, the overall market sentiment will be positive as large chunk of funds come only from the FIIs.

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