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What Budget 2017 offers foreign investors

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For foreign investors, who are the main movers of Indian stocks and pumped a net of $2.9 billion into Indianshares in 2016, there is indeed something to cheer. Photo: Bloomberg

1 February marked the best budget-day gain for Indian stocks in 12 years, with the Bombay Stock Exchange's (BSE's) benchmark Sensex gaining 1.74% to close at a three-month high.

For foreign investors, who are the main movers of Indian stocks and pumped a net of $2.9 billion into Indianshares in 2016, there is indeed something to cheer.

Finance minister Arun Jaitley's fourth budget package sought to cut red tape and clear ambiguities around tax laws at a time when the markets have been concerned about possible capital outflows as US interest rates rise.

First, Jaitley proposed to keep foreign portfolio investors (FPIs), including sovereign wealth funds, pension funds and central banks, out of the ambit of indirect transfer provisions. If these provisions had been applied, then any profits made by funds with underlying assets (including equities) in India would have been taxed.

The budget offered a respite to foreign investors who had been fretting since a 21 December statement by the Central Board of Direct Taxes, or CBDT, that these provisions would cover FPIs as well. After resistance from investors who argued that this will predominantly impact India-focused funds and lead to double taxation in many cases, the board put the move on hold on 18 January. Jaitley's announcement brought much-needed clarity.

"The government has moved to provide clarity beyond doubt to investors. They could have clarified taxability of FPIs under indirect transfer norms through changes in a circular but opted to provide it in the statute to do away with any scope for misinterpretation," said Mukesh Butani, managing partner of BMR Legal.

Still, some experts say there is a lingering trace of ambiguity since the exemption has not been granted to investors such as corporate bodies, trusts, individuals and family offices.

Richie Sancheti, head of investment funds practice at Nishith Desai Associates, a law firm, said the government could have avoided the ambiguity. "The government allowed clear exemptions for the first two categories of investors and for other foreign investors said that further exemptions would be notified by way of circular. This breeds ambiguity as circulars are more often subject to interpretation as against amendments to law," said Sancheti.

Easier procedures

Secondly, the finance minister also proposed to introduce a common application form for registration, opening of bank and demat accounts, and issue of permanent account number for FPIs, doing away with the need for these investors to separately approach the capital markets regulator, the central bank and the income tax department.

The move is expected to enhance operational flexibility and ease of access to Indian capital markets. The clarity sought by FPIs on maintenance of multiple demat accounts was absent in the budget.

The Securities and Exchange Board of India (Sebi), in a 23 September board meeting, had proposed to allow FPIs to hold multiple demat accounts to address tax computation concerns. However, the proposal was shot down by the government as it was in conflict with tax provisions.

"It was expected that the government would clarify on the issue. It will make matters difficult for FPIs in the wake of the recently renegotiated tax treaties," said Sancheti of Nishith Desai Associates.

Recent changes to the treaties with Singapore and Mauritius have led to the removal of capital gains benefits. Multiple demat accounts could have addressed the issue as FPIs face challenges in allocating tax liabilities among buyers of offshore derivative instruments (ODI) who enter into these contracts at different times.

"When an ODI subscriber redeems his interest, the tax provisions provide for computation of tax liability by FIFO (first in, first out) basis. This could result in a tax liability mismatch among the ODI subscribers," added Sancheti.

Direct investment

Thirdly, for long-term investors, Jaitley also held out the promise of further liberalization of the FDI policy that could see investments into more sectors being placed under the so-called automatic route.

Cutting red tape, Jaitley proposed to do away with the Foreign Investment Promotion Board (FIPB)—the agency that grants approvals to all foreign investments that don't go through the automatic route—in 2017-18.

The role of FIPB has been gradually coming down as the government, over the past couple of years, further opened up the economy and did away with the requirement of prior government approval for investments in many sectors. Only a few sectors such as defence and retail still need to be green-lighted by FIPB. "From an investor's point of view, doing away with FIPB is cutting one level of red tape. But one needs to see how it is rolled out to call it a positive move," said Butani of BMR Legal.

The government said the approval process could shift to the ministries in charge of a specific sector or an alternative mechanism will be put into place.

"The government would need to ensure they have a mechanism for these sectors, the abolishment of FIPB and any further liberalization of the foreign investment policies would need to be done in phases," said Tejesh Chitlangi, partner, IC Legal.

Separately, Jaitley also proposed that foreign investors investing in securities including rupee-denominated bonds sold by Indian corporate entities will be subject to a lower withholding tax of 5% till June 2020. To be sure, there are certain changes in the tax regime from 2017 that will keep investors wary. Foreign investors will have to brace for the implementation of general anti avoidance rules—a measure that gives the tax department the power to invalidate transactions it deems are deliberately structured to avoid paying tax—from 1 April.

And, with the government issuing the final place of effective management (POEM) rules, investors may be subject to greater scrutiny from the tax department. Under POEM, a foreign firm can be deemed to be a resident of India if crucial management decisions are taken in India.

Introduction of two new provisions in this year's budget will also keep long-term investors wary.

The budget proposes to bring in provisions which will limit interest expenses claimed as deductions by Indian subsidiaries of multinational firms for payments made to group firms situated overseas. This was seen as an effective repatriation strategy and is expected to impact investments made through compulsorily convertible debentures and non-convertible debentures. It is expected to impact highly leveraged sectors such as infrastructure and real estate.

It also proposes to introduce the concept of secondary adjustment in transfer pricing cases where interest will be levied on any adjustment of income till such time this amount is repatriated to India. The budget also seeks to introduce the concept of notional capital gains for transactions if the amount received from sale of shares is less than the fair market value.