

Tax Hotline

October 05, 2005

INDIAN GOVERNMENT TO RE-EXAMINE TAX IMPACT ON FII'S INVESTMENT INCOME IN INDIA

The Indian government is set to take a fresh look into the existing tax treatment of the income of foreign institutional investors ("**FIs**") operating through sub-accounts. The review will be conducted by an internal sub-group set up by the Central Board of Direct Taxes ("**CBDT**").

This review has been proposed in light of a number of FIIs having approached the Authority for Advance Ruling ("**AAR**"), following the ruling in the case of a US based fund, namely, Fidelity Advisor Series VIII, wherein the AAR held that the trading income of Fidelity Advisor Series VIII from Indian securities would be classified as "business income" and not as "capital gains" thereby not being subject to tax in India in the absence of a permanent establishment ("**PE**") in India. The new advance ruling applications are filed by several FIIs to determine the tax treatment of their income from investments in securities, in the hope to get exemption from short-term capital gains tax. Currently, short-term capital gains from sale of listed securities are taxed at 10%.

Fidelity Advisor Series VIII had approached the AAR to specifically determine whether gains accruing from trading in Indian securities would be treated as "business income or capital gains". The AAR, took into consideration various factors including the frequency and magnitude of purchase and sale of securities, and held that the gains on sale of securities were in the nature of "business income" which would not be subject to tax in India in the absence of a PE in India.

The internal sub-group set up by the CBDT will examine if there is a case for treating income accruing to FIIs operating through sub-accounts as "business income". The business income of an FII can be taxed in India only if it has a PE in India. It is interesting to note that the Comptroller and Auditor General of India had earlier this year recommended to the Indian government that the income of FIIs from trading in Indian securities should be treated as business income. It has also asked the CBDT to clarify whether sub account arrangements would constitute PE in India.

However, a policy change, if at all, to the existing tax treatment will have to wait till the above proposal has been approved by the Parliament and if it does undergo a change, then capital flows could surge from destinations other than Mauritius or Singapore.

-Bijal Ajinkya & Khushboo Baxi

Source: The Economic Times dated October 5, 2005

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