Influence of GAAR and tax treaties on FPIs

Why in news?

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The government has finally brought in changes to DTAAs, to ensure that foreign investors using double tax avoidance agreements (DTAAs) with Mauritius and Singapore do not get away without paying capital gains tax on their investments.

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Tax treaty tweak:

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- The DTAAs with these countries were amended this fiscal to the effect that capital gains that arise from shares purchased after April 1 by foreign investors based in these countries can be taxed in India.
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- There is, however, a 50 per cent concession on the tax rate from April 1, 2017 to March 31, 2019, if the investors are able to show that they have a substantial presence in these countries.
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- Else, the full rate will apply. From 2019-20, these investors will be taxed at the full domestic capital gains tax rate.
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- Capital gains tax of at least 7.5 per cent can be charged on short-term gains from equity of investors from Mauritius and Singapore over the next two years and 15 per cent thereafter.
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- There will be no capital gains tax on investments held for more than a year, in line with domestic regulations.
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- The second impact is through the General Anti Avoidance Rules (GAAR) that will be applicable on income earned in 2017-18, relating to tax assessment year 2018-19. While investments prior to March 31, 2017, are protected from GAAR, any tax benefit that arises from this April due to innovative tax arrangements can be scrutinised and questioned by the taxman.
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Will it affect flows?

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- While these changes are pretty significant, they might not impact flows materially.
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- FPIs have had sufficient time to realign their investment routes. In 2016, FPIs’ investment in Indian equity, at 20,568 crore, was among the lowest in recent years.
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- While it could be partly due to the lacklustre returns of Indian equity markets last year, the rule changes could also have influenced flows.
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- In 2016, equity investments of FPIs from Mauritius declined 5.95 per cent to 3,90,323 crore from 4,15,001 crore towards the end of 2015.
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- On the other hand, investments of FPIs from the US increased 5.49 per cent and those from Luxembourg saw a significant jump of 9.35 per cent, implying that alternate routes are already becoming popular.
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What are the implications of the changes?

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- These regulatory changes do not appear to have impacted the investment strategies of FPIs, which mostly moved in tandem with sectoral returns.
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- According to NSDL, foreign investor stakes in the metals and mining sector increased 86 per cent in 2016 as prices of these stocks surged last year.
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- Hindustan Zinc saw the FPI stake rising from 1.51 per cent to 3.03 per cent between September 2015 and end-2016. Hindalco Industries, NALCO and Vedanta are the other metal stocks that recorded a rise.
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- However investments in software services dropped 9.82 per cent in 2016 as the sector struggled with growing competition. Consumer durables, healthcare and textiles are other sectors where FPIs reduced their holdings.
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Conclusion:

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Foreign investors using the Mauritius and Singapore routes will have to pay capital gains tax on fresh investments, albeit at a reduced rate for some time. Tax authorities will also have more power to question investments through shell companies set up in tax havens.

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