FPIs on the edge as investments via P-notes may face more tax

By *Sachin Dave*, ET Bureau | Updated: Dec 28, 2016, 01.42 AM IST

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MUMBAI: A recent clarification from the government regarding indirect transfer of shares has created a scare that might deliver a death blow to investment in the domestic capital market through participatory notes (P-notes), still recovering from a daze from a 33-month low in November.

Many foreign portfolio investors (FPIs) who have P-note holders as ultimate beneficiaries fear revenue officials will start slapping taxes on them next year onwards. Many FPIs and their custodians have been in touch with their tax advisers seeking clarifications.

“The taxability applies to situations of transfer of any interest exceeding 5% in the overseas entity and the FAQs (government clarification) issued by the CBDT reiterate this proposition.

However, the applicability of these provisions to the overseas transfer of any such interest by a P-note holder would need to be examined on a case to case basis, depending on the structure established by the FPIs for making investment in India,” said Punit Shah, partner, Dhruva Advisors.

While the government clarifications don’t speak of P-notes specifically, the original regulation read along with some part of clarifications issued recently could eventually mean more taxes, say industry experts.

Neither the FPIs, custodians nor their tax consultants want to ask the government for a specific clarification on P-notes due to fear that a fresh clarification may worsen the situation.

The government last Wednesday issued a clarification around indirect transfer of shares framework by answering some 19 situations.

As per the clarification, if shares of an Indian company held by a fund constitute more than 50% of its total assets and the value of the holding exceeds Rs 10 crore, the transaction would be taxed in India.

The clarification also says if an investor holds less than 5% of assets in India, then he won’t be taxed in India. Yet in most cases P-note investors could see tax on their returns. In a typical structure, P-Note holders invest in a foreign investment company — say in UK — that invests in an FPI— eg Singapore.

The FPI then invests in Indian capital market. Even if the P-note investor doesn’t hold 5% (threshold for attracting indirect transfer) in the UK investment vehicle there could be tax on the returns as the vehicle holds more than 5% in the Singapore FPI investing in India.

So the P-note holder may see tax when the interest or gains from India are redeemed from the Singapore FPI to the investment vehicle in UK, say experts.

“While no specific clarification is given regarding the P-notes, there is a view that indirect transfer always applied and investors could face tax. The revenue department may go ahead and tax the structures and the PNote investors,” said Amit Maheshwari, partner, Ashok Maheshwary & Associates LLP.

This comes at a time when P-notes are losing its earlier gleam. In November, investments through P-notes fell to Rs 1.8 lakh crore, the lowest in last 33 months.

“P-notes are no longer a preferred route for investing in India and going forward, more and more investors could opt for investing through the FPI route. This is happening due to the regulatory restrictions on the P-Note route and the removal of treaty benefits for Mauritius funds,” said Rajesh H Gandhi, partner, Deloitte Haskins and Sells.

Additionally, market regulator SEBI’s stricter KYC norm means tax officials know the ultimate beneficiary of P-notes, say experts. “It’s no longer difficult to track P-note holders after recent tightening of KYC/disclosure norms. In June this year, in response to the SIT suggestions, SEBI tightened the KYC and the disclosure rules for PNote holders,” said Maheshwari.