Sebi eases norms for investment via non-FATF nations

Move to benefit investors from countries and regions like Mauritius, Cayman Islands who are eyeing Category-I licence

ASHLEY COUTINHO
Mumbai, 8 April

The Securities and Exchange Board of India (Sebi) has relaxed its guidelines for foreign portfolio investors (FPIs) seeking a Category-I licence, a move seen giving a boost to overseas investment in stocks.

Investors from countries which are not Financial Action Task Force (FATF) members can still qualify for such registrations if the countries are specified by the Indian government. The move may benefit funds and investments routed through countries, such as Mauritius and those from West Asia, and aid overseas flows coming into India, said experts.

At present, the FATF has 39 members, including Australia, Singapore, Luxembourg, South Korea, the US, the UK, and China. West Asian nations, such as Bahrain, Oman, Qatar, Kuwait, and the UAE are not its members.

Nearly 80 per cent of FPIs were put under Category-I after the reclassification of three categories into two in September last year. Being part of Category I implies lower compliance burden, simplified know-your-customer (KYC) norms and documentation requirements, and fewer investment restrictions. Such investors can subscribe and issue offshore derivative instruments and are not subject to indirect transfer provisions.

Prior to the reclassification, less than 3 per cent FPIs were part of Category-I and more than four-fifths were part of Category-II. About 13 per cent of the funds were classified as Category-III.

"The move will expand the list of countries eligible for the Category-I status beyond the FATF member countries. It will not only mean fewer KYC requirements for FPIs from such countries but also exemption from indirect share transfer regulations," said Rajesh Gandhi, partner, Deloitte India. "Along with the MSCI index rejig, this will help boost inflows into India, especially from India-focused funds."

Experts reckon non-FATF countries, such as Mauritius and those from West Asia, may now lobby to get included in the list of specified countries to be put out by the Indian government.

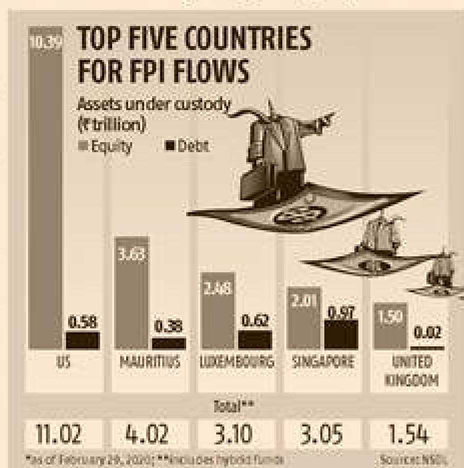
"It is a well-established fact the Category-I FPI funds enjoy larger acceptability among investors, which is why non-FATF countries and regions, such as Dubai, Cayman Islands, and Mauritius, will try to get the exemption from the Government of India," said Neha Malviya, director, Wilson Financial Services.

Most funds coming from Mauritius, Cayman Islands, Cyprus, and the British Virgin Islands are currently classified as Category-II. Despite its treaty amendment with India, Mauritius remains the second-largest source of FPI money.

"It is for the first time that, in addition to the FATF members, government-notified countries will qualify for Category I registration. Mauritius, Cayman and Indonesia figure among the prominent non-FATF member countries, which are relevant for secondary investment in Indian stock markets," said Sunil Gidwani, partner, Nangia Andersen.

According to Gidwani, qualifying for Category-I will provide FPIs with greater flexibility of operations and help them attract new investors. "Registering as Category-I FPIs makes the process of accessing the Indian markets much easier at the time of entry because of lesser due diligence and documentation. Such FPIs can issue P-notes to overseas investors and will not be required to comply with offshore transfer tax provisions," Gidwani said.

This year's Budget had clarified that Category-II FPIs would be subject to indirect transfer provisions, which were earlier applicable to unregulated funds falling under Category-III.



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FPIs stare at higher withholding tax

ASHLEY COUTINHO
Mumbai, 10 April

Foreign portfolio investors (FPIs) may have to shell out higher withholding tax on dividends received even if their final tax liability is lower, owing to existing tax treaty arrangements.

Companies may withhold tax at the rate of 20 per cent plus surcharge and cess, on the dividend paid to FPIs, even if they invest from a jurisdiction that provides for a lower rate based on India's double taxation avoidance agreement (DTAA) with that country.

The Budget had led to uncertainty regarding the quantum of tax to be withheld on dividend paid to non-residents. This was because the exact tax rate was not specified under Section 195, which covers tax deducted at source (TDS) or withholding tax for non-residents. The recently notified Finance Act 2020 has clarified that a withholding tax rate of 20 per cent, plus surcharge and cess, will be applied for dividend paid to non-residents under this section.

Further, the lower rates could be applied for residents coming from jurisdictions with which India has a DTAA.

However, there is a discrepancy. While FPIs are also classified as non-residents, the withholding tax rates for these are provided under Section 196D of the Income Tax Act. This section specifies a rate of 20 per cent (plus surcharge and cess) on dividend paid. However, it does not provide for a lower withholding rate even if the FPIs' tax liability is lower on account of an existing tax treaty.

"If an FPI's liability under the tax treaty is 5, 10 or 15 per cent, then conceptually, companies ought to withhold tax at this rate. Treaty rates are codified in Section 195, which applies to all non-residents, and which talks about withholding tax at 'rates in force'. The question is, can you read section 196D, which is specific to FPIs, along with Section 195? Or, do you just apply section 196D?" said a tax expert, on the condition of anonymity.

"There was a possibility that tax deducted for non-residents (other than FPIs) could be as high as 30-40 per cent, if they did not have a treaty arrangement. This issue has been resolved by the amendment in the Finance Act," said Sunil Gidwani, partner at Nangia Andersen.

"For FPIs, however, tax deducted at source (TDS) is at 20 per cent, under Section 196D, and this section does not allow for treaty rates, even if they are lower."

Anish Thacker, partner at EY India, points out that the effective TDS rate for non-corporate FPIs could be significantly higher if the surcharge is at the highest slab. FPIs structured as trusts, for instance, will have to pay TDS at 28.5 per cent, which includes 20 per cent tax on dividend, 37 per cent surcharge, and 4 per cent educational cess.

According to Gidwani, the excess tax collected will have to be adjusted against the FPI's aggregate annual tax on all sources of income, including capital gains and interest income. Alternatively, it will have to be claimed as a refund. Non-residents other than FPIs can pay lower withholding tax rates, as applicable under various treaties with India. They can also claim credit for the tax paid in India.

SHELLING OUT MORE

How dividends will be taxed in case of overseas investors

For FPIs

- Taxation governed by Section 196D
- Tax on dividends @20% plus surcharge, cess
- Total tax on dividends for non-corporates @28.5% after applying surcharge, cess
- Lower treaty rates not taken into account
- Excess tax can be adjusted against aggregate annual tax or claimed as refund

For other non-residents other than FPIs

- Taxation governed by Section 195
- Tax on dividends @20% plus surcharge, cess
- Lower treaty rates @5%, 10%, 15% can apply

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