Foreign portfolio investment in India

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India continues to be the fastest-growing major economy in the world with a GDP growth rate well above 7 percent. In its latest publication, “World Economic Outlook” (October 2018), the IMF\(^1\) states that it expects India’s growth rate to be 7.3 percent in 2018 and 7.4 percent in 2019. In the medium term, the IMF predicts that India’s growth rate will remain strong at 7.75 percent as the country benefits from ongoing structural reforms by the government such as the GST, the inflation-targeting monetary policy framework, the Insolvency and Bankruptcy Code (IBC), the liberalization of foreign investment norms and the steps taken to improve the business environment. It is noteworthy that India’s position in the World Bank’s “Ease of Doing Business” ranking has improved dramatically from 130 in 2016 to 77 in 2018. \(\triangleright\)

\(^{1}\) International Monetary Fund
Though the country has experienced a significant outflow of funds in recent times (in line with other emerging markets) coupled with falling stock market indices and a weakening currency, these adversities appear to have been triggered primarily by external factors such as rising US yields and soaring crude oil prices. Given its strong fundamentals and growth forecasts, India is expected to remain an attractive destination for foreign investors in the medium to long term.

**Inbound investment routes**

Indian regulations currently allow global investors to invest in India via a number of different routes depending on the nature and purpose of the investment. These include FDI, FVCI, FPI, ECB, NRI-PIS and the AIF route, which may be summarized as follows:

- **Foreign Direct Investment (FDI)**—primarily used for private equity and strategic investments
- **Foreign Venture Capital Investment (FVCI)**—venture capital investments in ten specified sectors
- **Foreign Portfolio Investment (FPI)**—portfolio investments in listed equities and other securities
- **External Commercial Borrowing (ECB)**—offshore foreign currency and rupee lending to Indian corporates
- **Non-Resident Indians—Portfolio Investment Scheme (NRI-PIS)**—portfolio investments by non-resident Indians
- **Alternative Investment Fund (AIF)**—domestic pooling vehicle with a liberalized investment and tax regime

In addition to the above, foreign investors can also acquire exposure to Indian securities by using indirect access products such as participatory notes, swaps, offshore foreign currency notes, and ADRs/GDRs.

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**FPI framework**

As briefly discussed above, foreign investors can make onshore investments in listed equities and other securities via the FPI route. For this purpose, they need to obtain an FPI registration (i.e., license) in India in accordance with the SEBI² (FPI) Regulations, 2014. The FPI license is granted by a local custodian in its capacity as a DDP³ on behalf of the SEBI. To obtain an FPI license, the investor needs to make an application in a prescribed format and complete the necessary documentation. Based on the investor's risk profile, it can obtain one of the following three categories of registration:

<table>
<thead>
<tr>
<th>FPI Category</th>
<th>Type of entity</th>
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<tbody>
<tr>
<td><strong>Category I</strong></td>
<td><strong>(Sovereign &amp; international entities)</strong></td>
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<tr>
<td></td>
<td>Government and government agencies, sovereign wealth funds, central banks,</td>
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<tr>
<td></td>
<td>international or multilateral organizations/agencies</td>
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<tr>
<td><strong>Category II</strong></td>
<td><strong>(Regulated entities)</strong></td>
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<tr>
<td></td>
<td>Broad-based⁴ investment funds, asset managers, broker dealers, swap dealers,</td>
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<tr>
<td></td>
<td>portfolio managers, pension funds, banks, insurance companies, university</td>
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<td></td>
<td>funds</td>
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<tr>
<td><strong>Category III</strong></td>
<td><strong>(Unregulated entities)</strong></td>
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<tr>
<td></td>
<td>Non-broad-based funds, hedge funds, corporates, family offices, individuals,</td>
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<tr>
<td></td>
<td>and all other investors not covered in Categories I &amp; II</td>
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2. Securities and Exchange Board of India
3. Designated Depository Participant
4. Having at least 20 investors investing in the fund directly or on a look-through basis
India is a segregated market and the FPI regulations do not permit omnibus structures. As a result, the investing entity (e.g., fund, sub-account) needs to obtain an FPI license as well as open accounts (depository and bank) in its own name. This requires the investing entity to submit an FPI application form and various other documents. Importantly, every Category II and III FPI needs to identify natural person(s) as the beneficial owner(s) (BO) of the FPI and provide personal information of such BO to the local custodian in India. FPIs are permitted to invest in most transferable securities (including equities, bonds, derivatives, units of mutual funds & AIFs, and securitized debt instruments) on the Indian capital markets, subject to certain restrictions. In respect of equity investments, FPIs can only invest in listed equities or equities that are to be listed. Also, investments made by a single FPI or all related FPIs5 taken together should account for less than 10 percent of the paid-up capital of the Indian company. If the Indian company is a private sector bank, the 10 percent limit is reduced to 5 percent. FPI investments in debt securities are primarily regulated by the RBI. In April 2018, the RBI introduced additional restrictions on FPI investments in debt securities, which have adversely affected debt investments in the last six months.

FPIs need to open an INR account with an authorized bank (typically the custodian bank) through which all the investments and disinvestments are to be routed. Any remittance of sale/income proceeds out of India can be made only after the necessary taxes have been discharged. FPIs are not permitted to borrow funds in India. Also, they are not permitted to earn interest on the balance in the bank account maintained in India.

Upcoming regulatory changes
Simplification of FPI norms: the SEBI has set up a high powered working group (of which Deloitte is a member) under the chairmanship of Mr. H.R. Khan (ex-Deputy Governor of the RBI) to further simplify the FPI regulations and rationalize the entry process. Based on interim recommendations submitted by the working group, the SEBI has already amended the KYC framework that applies to FPIs. The working group is expected to submit its final recommendations in the next few months, after which the SEBI board will take them up for implementation.

Voluntary Retention Route (VRR): the RBI recently issued a white paper for public comments in which it proposed a new route for FPIs to invest in government securities and corporate bonds. Under this framework, an FPI would commit to investing a specified amount in Indian bonds for a minimum retention period of three years or more, as specified by the RBI. Also, the FPI would need to ensure that at least 67 percent of the committed amount remained invested at all times during the retention period.

5. Related FPIs are defined as two or more FPIs that share more than 50 percent of their beneficial ownership.
**Taxation framework**

As a first step in the taxation process, FPIs are required to obtain a Permanent Account Number or PAN (tax ID) from the Indian tax authorities. A PAN card is also a mandatory KYC document and the PAN must be quoted in the FPI’s depository account opened with the custodian. Also, the PAN is quoted in all tax filings as well as tax payments.

Income characterization: gains made by FPIs from the transfer of shares and other securities are characterized as capital gains under Indian tax law, which provides certainty as to the classification of income received by FPIs (this is not the case for other investors). Other than capital gains, FPIs earn income from securities in the form of dividends and interest.

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**Tax rates**

**Domestic tax rates**

| Type of income                                      | Tax rate  
|-----------------------------------------------------|----------
| **Capital gains on sales** of listed shares/redeemption of equity-oriented mutual funds (where securities transaction tax is paid) | Long-term: 10 percent  
|                                                     | Short-term: 15 percent  
| **Capital gains on transfers of other securities** (e.g., bonds, derivatives) | Long-term: 10 percent  
|                                                     | Short-term: 30 percent  
| **Interest on securities**                          | 5 percent / 20 percent  
| **Dividend**                                        | Exempt  

India has signed comprehensive tax treaties with over 90 countries, some of which (e.g., those with Cyprus, Ireland, Japan, Mauritius, Singapore, and Switzerland) allow for an exemption from capital gains tax on sales of securities other than shares, whereas others (e.g., those with Denmark, France, Netherlands, and Korea) also allow for an exemption from capital gains tax arising on sales of shares. Where a treaty applies, the FPI automatically enjoys the benefits arising therefrom if these are more favorable than domestic law.

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6. The tax rate is exclusive of surcharges and cesses, which vary depending upon the investor’s legal form.
7. Five percent (plus surcharges and cesses) is applicable on interest payable up to 30 June 2020 on government bonds and those corporate bonds whose coupon rate does not exceed 500 bps of the base rate of the State bank of India on the date of issuance of bonds. Interest from other corporate bonds is taxable at 20 percent.
8. The Indian company is required to pay dividend distribution tax of 20.56 percent on the dividend.
**Key tax updates**

**Long-term capital gains tax**
On 1 April 2018, India introduced a 10 percent tax on long-term capital gains on transfers of shares and equity-oriented mutual fund units. Before this change took effect, such gains were exempt from tax provided that the transaction was subject to securities transaction tax. To avoid retrospective levying of this tax, gains already accrued on 31 January 2018 have been grandfathered. The grandfathering provision is enabled by providing a step-up in the actual cost of acquisition on the basis of the fair market value of the shares on 31 January 2018, capped at the sale price.

**Amendment of India’s tax treaties with Mauritius and Singapore**
In a historic development, India amended its tax treaty with Mauritius (effective 1 April 2017) and introduced source-based taxation on sales of shares. This essentially means that gains on sales of shares of Indian companies by a Mauritian tax resident are now taxable in India at Indian domestic tax rates. Investments made prior to 1 April 2017 were grandfathered and a Mauritian investor can also enjoy a 50 percent reduction in the tax rate for purchases and sales made during the period from 1 April 2017 to 31 March 2019 provided that the investor satisfies the Limitation of Benefit (LOB) clause in the treaty. In line with the change in the treaty with Mauritius, India also amended its tax treaty with Singapore effective 1 April 2017 with similar effect except for a modified LOB clause. It is important to note that the revised Mauritius and Singapore treaties continue to provide exemption from capital gains tax on securities other than shares. Furthermore, the revised Mauritius treaty provides for a 7.5 percent tax on interest income, which is the lowest tax rate on interest income agreed by India with any country.

**Ongoing tax compliance procedures**
FPIs appoint a tax consultant in India to compute capital gains and other taxes payable and the tax consultant is required to issue letters/certificates to the custodian banks for the remittance of any income outside India. The tax agent also helps the FPI to file its PAN application, file annual income tax returns, respond to notices from tax authorities, and attend tax audit hearings.

While the tax framework for FPIs is fairly straightforward, the selection of jurisdiction for registering the investment entity has become more complex since the introduction of the GAAR. Also, frequent changes to the regulatory provisions including KYC and debt investment conditions have irked investors, although the government and the SEBI have made some efforts to simplify the regulations.

To the point:
- Any foreign investor can access Indian capital markets by obtaining a FPI license. The license is issued by the local sub-custodian on behalf of the regulator.
- FPIs are permitted to invest in almost all types of listed securities including equities, bonds, derivatives, domestic mutual funds, alternative investment funds etc. The investments are subject to certain restrictions and caps.
- Gains from sale of securities attracts Indian capital gains tax which is required to be paid before remitting funds out of India.
- Each FPI needs to obtain a tax ID and file an annual income tax return.
- Recent tax changes include introduction of long term capital gains tax and partial removal of capital gains tax exemption under India’s tax treaties with Singapore and Mauritius.

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