Corpsec Hotline

January 19, 2013

QUALIFIED FOREIGN INVESTORS: CLEARING THE AIR ON TAX

The Ministry of Finance had previously issued a press release dated May 29, 2012 ("**Press Release**") providing various measures to remove the bottlenecks and to stimulate foreign investments via the Qualified Foreign Investor ("**QFI**") route. The ministry had under the Press Release also requested the Central Board of Direct Taxes ("**CBDT**") to issue relevant clarifications pertaining to the tax related issues, plaguing the players in the QFIs regime, especially on the withholding obligations. The CBDT has accordingly come out with clarifications by way of FAQs for QFIs dated December 24, 2012.

The FAQs significantly clarify the obligations imposed on a Qualified Depository Participants ("**QDPs**") who act as depository agents on behalf of the QFI. The CBDT FAQs states that the QDP would be responsible for withholding tax on income generated by QFI flowing through a QDP (such as in cases of distribution of profits or sale of securities). Prior to detailing the substantive clarifications arising from the FAQs, it should be noted that the FAQs come with a specific disclaimer stating that the FAQs may not be used in a court of law to interpret any circular, rules, regulations, statutes etc., one way or the other. Therefore, it should be noted that the FAQs may not be binding or for that matter even persuasive on tax authorities.

BACKGROUND

The QFI regime was introduced[1] primarily to encourage foreign inflow of funds over and above the existing inbound investment regimes. QFIs can directly participate on the trading platform to access listed Indian securities, without any need to get registered with the Securities and Exchange Board of India ("**SEBI**") or the Reserve Bank of India ("RBI"), thus deepening the Indian capital market.

However, the regime never fully took off so far owing to several operational clarifications and ambiguities on tax related aspects concerning QFIs the prominent amongst which has been the ambiguity relating to the withholding mechanism and the availability of benefits under double taxation avoidance agreements ("**DTAAs**").

QFI Route Mechanism

In effect, the QFI route allows eligible investors (i.e. investors falling within the definition of QFIs as described in Circular CIR/ IMD/ FII&C/18/ 2012 dated July 20, 2012[2]) to invest in India as a QFI either directly (through a demat account) or in case of Mutual Funds ("MF"), holding MF units via Unit Confirmation Receipts ("**UCR**").

Investment Route

In the case of a QFI investing through the direct route, the QFI may open only one demat account with any one registered QDP and shall subscribe and redeem exclusively only through that QDP[3]. Investment/ purchase of securities is carried out by placing a purchase/ subscription order mentioning the name of the scheme/MF/Securities issuer with its QDP and remitting foreign inward remittances through normal banking channel in any permitted currency (freely convertible). The QDP in turn forwards the purchase order to the concerned Issuer and remits the money to the Issuer's account on the same day as the receipt of funds from the QFI. For more on procedure and operation details regarding the QFI route, please refer to our previous hotline on this labeled "QFI: THE NEW INVESTMENT ROUTE OF CHOICE".

Tax implications of redemption/ distribution of profits

It is in context of the payment of profits by the issuer of the securities (purchased by the QFI), either when the QFI seeks redemption of security or when profit is distributed on the security (as dividends for example) that the question of withholding arises. In such a scenario, there has been some ambiguity on whether the issuer of the security must directly withhold taxes and if required to withhold, then in whose name the taxes ought to be withheld the QDP or the QFI. Further, the presence of intermediary could also raise concern on the availability of DTAA benefits to income generated by QFIs in India. Lastly, some ambiguity exists as to the extent of setting off losses by QFI on income generated through securities.

SUMMARY OF THE FAQS

The clarifications supplied by CBDT through the FAQs have been broadly classified under the following heads:

- **Withholding obligation on QDPs**
  - To avail of any beneficial rate under the Income Tax Act, 1961 ("ITA") or applicable DTAA, a QFI will be required to hold a Permanent Account Number ("PAN") with the revenue authorities in India. Failing to obtain

Research Papers

Mergers & Acquisitions
July 11, 2025

New Age of Franchising
June 20, 2025

Life Sciences 2025
June 11, 2025

Research Articles

2025 Watchlist: Life Sciences Sector India
April 04, 2025

Re-Evaluating Press Note 3 Of 2020: Should India's Land Borders Still Define Foreign Investment Boundaries?
February 04, 2025

INDIA 2025: The Emerging Powerhouse for Private Equity and M&A Deals
January 15, 2025

Audio

CCI's Deal Value Test
February 22, 2025

Securities Market Regulator's Continued Quest Against "Unfiltered" Financial Advice
December 18, 2024

Digital Lending - Part 1 - What's New with NBFC P2Ps
November 19, 2024

NDA Connect

Connect with us at events, conferences and seminars.

NDA Hotline

Click here to view Hotline archives.

Video

Reimagining CSR: From Grant Giving to Blended Finance & Outcome Based Funding
June 16, 2025

Courts vs Bankruptcy code: The

the same would result in either the highest possible slab of tax applicable to the income in question, levied at the time of payment or atleast 20% of the income being withheld whichever is higher[4].

- The QDP will be responsible for withholding tax in India before making a remittance to the QFI and for this purpose the QDP would be treated as a representative assessee/agent of the QFI. However, no reference to section 204 of the ITA concerning persons responsible for paying has been made. The QDPs may withhold taxes on a settlement basis and deposit the same with the revenue authorities before the seventh day succeeding the end of each month, as opposed to withholding taxes on a transactional basis.
- QDPs would be liable for any short deduction or non-deduction of tax even after the QFI ceases to be the client of the QDP. This may discourage many QDPs from taking on such an extraordinary liability.
- In keeping with the existing rule in relation to withholding, the QDP is not mandatorily required to obtain an Income Tax Order under Section 195(2) of the ITA for determining taxable income, but in complex cases, the FAQs has advised the QDP to obtain such orders.
- In case of consideration received under an open offer or buy back of shares, if the payment is made to the QDP who then subsequently remits the money to the QFI, then the QDP is required to withhold the applicable taxes. However, if the purchaser of such security directly makes the payment to the QFI, the purchaser is required to withhold the relevant amount in such cases.

- **Setting of Losses and Filing returns by QFIs**
  - QFI may claim refund in cases where surplus tax has been paid by filing its return of income as provided under the ITA.
  - QFI will be allowed to carry forward losses as permitted to taxpayers under the ITA provided the relevant annual returns have been filed by QFI within the applicable time limit.
  - Any loss of current year available at such time of deducting tax would be eligible to be set off against the sum payable based on which tax may be withheld on a net basis. However, once withheld, the QDP cannot further reduce the amount even if there is loss in subsequent transaction in the given year. These losses may be adjusted against profits earned from other securities in a given year as well.

    Illustration: *If a QFI makes three settlements in a given year, the first settlement on August 1 results in a profit of INR 200, the second settlement on September 1 resulting in a loss of INR 250 and the third settlement on October 1 being a profit of INR 100. Deductions or reduction of taxes to be withheld in relation the first settlement would not be allowed for the first settlement on August 1, however, for a settlement made after the second settlement, the loss resulting from the second settlement could be used to set off against such later (third) settlement.*
  - Losses in prior financial years may not be set off whilst withholding taxes by QDPs. However, the QFIs may claim previous year losses by filing annual returns as prescribed under the ITA. This imposes procedural burden on the QFI especially in instances where a QFI carry forward losses from one financial year to the next.
- **DTAA Benefits**
  - QFIs qualify under section 90(2) of the ITA to be able to elect to the more beneficial tax treatment between the ITA and the DTAA.
  - In keeping with the existing test for granting DTAA benefits, Tax Residency Certificates (compliant with the format prescribed in Rule 21AB of the Income Tax Rules, 1962 (or "**TRCs**") would be treated as a prima facie (or at first glance) proof of the QFI's residency status (but not conclusive evidence of the eligibility) and eligibility to avail DTAA benefits.

ANALYSIS

Tax specific ambiguities continue to remain. QFIs based out of jurisdictions with which India does not have a DTAA, have not yet been brought at par with FIIs. Section 115AD of the ITA provides for concessional tax treatment in respect of long-term capital gains and short-term capital gains arising to FIIs from transfer of listed shares and securities.

If indeed, the intent is to encourage and develop the QFI route as a viable path for foreign investors to enter India, piece meal clarifications in the form of FAQs (especially FAQs which explicitly are of not persuasive or authoritative value before judicial authorities) may not provide the necessary incentive to investors. Relevant statutory amendments would have to be made to the ITA and other ancillary statutes to achieve intended purpose. A larger concern looms in case of QFIs from DTAA jurisdictions.

The FAQs stipulate a procedural requirement on QFIs claiming the benefits of a DTAA only if they produce a Tax Residency Certificate ("TRC") obtained from the Government of the resident. What makes it a more onerous amendment is that such a TRC is not considered to be conclusive evidence of a QFI's residence in the country or territory issuing it. The clarification originates from the Explanatory Memorandum to the Finance Bill, 2012. This may cause issues in jurisdictions such as Cyprus where previously structures have been questioned despite producing valid TRC. This could further discourage QFIs who may be deterred by the lack of certainty in receiving tax treaty benefits. Further, from a QDP perspective, this introduces uncertainty for on the quantum of tax that should be withheld since merely reliance on the tax treaty provisions and its established rules of interpretation may no longer suffice. This could cause more uncertainty to QDPs on their ability to mitigate the risk of denial of tax treaty.

The QFI regime was introduced in August 2010 to bring about disintermediation of the capital markets and to provide direct access to foreign investors. The regime is however yet to pick up steam. The reasons for the continuing failure are not too hard to see.

The FAQs firmly establish the QDPs as the most important cog in wheel for the QFI regime to roll. The FAQs place onerous responsibilities on the QDPs in respect of withholding tax in India before making remittance to QFIs to the extent of being treated as a representative assessee/agent of the QFI. This coupled with the uncertainty as to the position of tax for QFIs vis-Г-vis treaty entitlement, could discourage QDPs from accepting investors under the QFI regime.

Prasad Subramanyan & Richie Sancheti
You can direct your queries or comments to the authors

[1] Securities Exchange Board of India ("SEBI") pursuant to its Circular No. CIR/ IMD /DF / 14 /2011 dated August 9, 2011.

[2] Circular dated July 20, 2012 is available at http://www.sebi.gov.in/cms/sebi_data/attachdocs/1342784172262.pdf (last visited on January 2, 2013)

[3] The requirements for registering as a QDP with SEBI, a depositary participant has to fulfill the following conditions:

1. Minimum paid up capital of INR 50 crores or more;
2. the applicant shall be either a clearing bank of clearing member of any of the clearing corporation;
3. the application shall appropriate arrangements for receipt and remittance of money with a designated Authorised Dealer (AD) Category - I bank;
4. the Applicant should have requisite systems and procedures to comply with applicable FATF Standards, PMLA and SEBI circulars;
5. subject to taking prior approval from SEBI before commencing the activities relating to accepting MF subscriptions by QFIs.

[4] In line with Section 206AA of the ITA.