Foreign Institutional Investor (FIIs) plays a dominant role in flourishing of the Indian Capital Market. For the first 25 days of October 2010 FII's have invested $6.11 billion in Indian capital market and the net invested reached a record of $24.48 billion in the whole year of 2010, which is the magic figure of above Rs.1-trillion mark ($22 billion) by overcoming the 2007 peak of $17 billion. This is due to the Government’s assurance to continue with the liberalization of foreign investment policy. In this juncture the Government of India is planning to replace its 50 years old Income Tax Act with Direct Tax Code (DTC) which will to be implemented by 2012. The DTC has proposed to tax the income of FIIs from the sale and purchase of securities as capital gains. This paper explains the existing status of taxation of FIIs in Indian capital market and the effects of proposed DTC on the important issues of investments like taxation, capital gains, country of residence, and General anti-avoidance rule (GAAP), etc.

JEL Classification: G23, F30

Key Words: Direct Tax Code, Foreign Institutional Investors, General anti-avoidance rules (GAAAP), Double Taxation Avoidance Agreements (DTAAAs)
Is the Proposed Direct Tax Code a Boon or a Burst to FII’s in India?

1. Introduction

India is one of the most accepted destinations for overseas portfolio investors to park their fund in the Asian region for 2010. It may be an indicator of increasing confidence in the Indian growth story, when the rest of the world is struggling to fight the recession. According to analysts, the upward revision of economic growth from 5.8 per cent to 6.1 per cent, better-than-expected performance of companies in the quarter ended June 30, 2010 and the trade policy with an ambitious target of US$ 200 billion exports for 2010-11 have all revived the confidence of FIIs investing in India.

Government of India is planning to replace its 50 years old Income Tax Act with Direct Tax Code (DTC) which will be implemented by 2012. The DTC has proposed to tax the income of FIIs from the sale and purchase of securities as capital gains. DTC released in August 2009 had threatened to bring all foreign investors under the tax net by overruling bilateral tax treaties signed with other countries.

1A. FIIs Role in the Indian Economy

Foreign institutional investors have gained a significant role in Indian capital markets. Availability of foreign capital depends on many firm specific factors other than economic development of the country. In this age of transnational capitalism, significant amounts of capital are flowing from developed world to emerging economies. Positive fundamentals combined with fast growing markets have made India an attractive destination for foreign institutional investors (FIIs). Portfolio investments brought in by FIIs have been the most dynamic source of capital to emerging markets in 1990s. At the same time there is unease over the volatility in foreign institutional investment flows and its impact on the stock market and the Indian economy.

1B. Growth in FII investments in Indian capital Market

Apart from its impact on the market, their holdings will influence firm performance. For instance, when foreign institutional investors reduced their holdings in Dr. Reddy’s Lab by 7% to less than 18%, the company’s share dropped from a high of around US$30 to the current level of below US$15. This 50% drop is apparently because of concerns about shrinking profit margins and financial performance. These instances made analysts to generally claim that foreign portfolio investment has a short-term investment horizon. Growth is the only inclination for their investment. Their strategy is — ‘Why take risk when you are not in profit-exit’. According to the industry experts, hedge funds played a very active role in Indian stock market since 2003 by entering both Indian cash and derivative market. The upward trend in the domestic market is due to hedge funds and regular long-term FIIs. Thus the foreign portfolio investments are found to be very volatile in nature.

Despite these observations, countries and firms are interested in attracting foreign capital because it helps to create liquidity for both the firms stock and the stock market in general.
This leads to lower cost of capital for the firm and allows firm to compete more effectively in the global market place. This directly benefits the economy and the country. Availability of foreign capital depends on many firm specific factors other than economic development of the country.

### TABLE 1: TRENDS IN FII INVESTMENT FROM 1992-93 TO 2009-10*

| Year   | Gross Purchases (Rs.Crore) | Gross Sales (Rs.Crore) | Net Investment (a-b) | % Increase  
|--------|-----------------------------|------------------------|----------------------|----------------
| 1992-93| 17                          | 4                      | 13                   | 39338.46154   
| 1993-94| 5593                        | 466                    | 5127                 | -6.456017164 
| 1994-95| 7631                        | 2835                   | 4796                 | 44.74562135  
| 1995-96| 9694                        | 2752                   | 6942                 | 23.52348027  
| 1996-97| 15554                       | 6979                   | 8575                 | -30.51895044 
| 1997-98| 18695                       | 12737                  | 5958                 | -126.5861027 
| 1998-99| 16115                       | 17699                  | -1584                | 739.0151515  
| 1999-00| 56850                       | 46734                  | 10122                | -1.847460976 
| 2000-01| 74051                       | 64116                  | 9935                 | -11.87720181 
| 2001-02| 49920                       | 41165                  | 8755                 | -69.29754426 
| 2002-03| 47061                       | 44373                  | 2688                 | 1602.529762  
| 2003-04| 144858                      | 99094                  | 45764                | 0.25565947   
| 2004-05| 216953                      | 171072                 | 45881                | -9.622719644 
| 2005-06| 346978                      | 305512                 | 41466                | -25.62340231 
| 2006-07| 520508                      | 489667                 | 30841                | -                

*Source: www.equitymaster.com*

2. Literature Review on FIIs impact

As the Indian equity market is growing, the trend and future prospects in foreign institutional investments has become a topic of great concern. A recent research survey by Japan Bank for international operation (JBIC), shows that in the next 3 years, India will be the third most favored investment destination for Japanese investors. A Smith Barney (a CITI group Division) study says estimated market value of foreign institutional investment in the top 200 companies in India (including ADRs and GRDs) at current market prices is US$43 billion. This is 18% of the market capitalization of BSE 200.

It is established in literature that block shareholders influence the firm performance (Cho & Padmanabhan, 2001). Governance of listed companies plays an important role in foreign institutional investment decisions. Further more management of businesses run by family groups plays a distinctive role. When governments become block shareholder their objective will be quite different from those of private investors.

Douma, Pallathiattra and Kabir (2006) investigated the impact of foreign institutional investment on the performance of emerging market firms and found that there is positive effect of foreign ownership on firm performance. They also found impact of foreign
investment on the business group affiliation of firms. Aggarwal, Klapper and Wysocki (2005) observed that foreign investors preferred the companies with better corporate governance. Investor protection is poor in case of firms with controlling shareholders who have ability to expropriate assets. The block shareholders affect the value of the firm and influence the private benefits they receive from the firm. Companies with such shareholders will find it expensive to raise external funds. Yin-Hua and Woidtke (2005) found that when members who are affiliated to the controlling family dominate company boards, investor protection will be relatively weak and it is difficult to determine the degree of separation of management from ownership. They also observed that firm value is negatively related to board affiliation in family controlled firms. Li (2005) observed that in case of poor corporate governance the foreign investors choose foreign direct investment (FDI) rather than indirect portfolio investment. It is generally believed that FDI could be better protected by private means.

Dahlquist et al. (2003) analyzed foreign ownership and firm characteristics for the Swedish market. They found that foreigners have greater presence in large firms, firms paying low dividends and in firms with large cash holdings. They explained that firm size is driven by liquidity. They measured international presence by foreign listings and export sales. They reiterated that foreigners tend to underweight the firms with a dominant owner.

Covirg et al. (2007) concluded that foreign fund managers have less information about the domestic stocks than the domestic fund managers. They found that ownership by foreign funds is related to size of foreign sales, index memberships and stocks with foreign listing.

Li and Jeong-Bon (2004) found that foreign investors tend to avoid stocks with high cross corporate holdings. They suggested that FII are likely to be efficient processors of public information and are attracted to Japanese firms with low information asymmetry. Morin (2000) explored the influence of French model of shareholding and management on FII. They commented that France has undergone rapid change from a financial network economy to a financial market economy. The new pattern has broken the traditional system of cross holding and facilitated the arrival of FII who bring with them new techniques and demands efficient corporate management. What could be firm level factors that influence foreign capital from an economic standpoint is the question yet to be answered. Outside investors will lower the price they pay if they fear consumption of private benefits of control family. Choe, Kho, Stulz (2005) found that US (United States) investors do indeed hold fewer shares in firms with ownership structures that are more conducive to expropriation by controlling insiders. In companies where insiders are dominating information access and availability to the shareholders will be limited. With less information, foreign investors face an adverse selection problem. So they under invest in such stocks.

Leuz, Nanda and Wysocki (2003) further asserted that the information problems cause foreigners to hold fewer assets in firms. Firm level characteristics can be expected to contribute to the information asymmetry problems. Concentrated family control makes it more likely that information is communicated via private channels. Informative insiders have incentives to hide the benefits from outside investors by providing opaque financial statements and managing earnings. Haw, Hu, Hwang and Wu, (2004) also found that firm level factors cause information asymmetry problems to FII. Their paper found evidence that
US investment is lower in firms where managers do not have effective control. Foreign investment in firms that appear to engage in more earnings management is weak in countries with poor information framework.

There is a growing literature on the determinants of global investment flows and allocations. Most of these studies have analyzed global and country level factors that influence investment allocations. This paper investigated empirically the different specific variables like taxation, capital gains and GAAP that influence the investment decision of foreign investors.

3. Direct Taxes Code

The draft Direct Taxes Code (DTC) along with a Discussion Paper was released on 12 August 2009 for public comments to simplify the direct tax legislation in India. Subsequently, comments were solicited from the public and examined by the Government. A Revised Discussion Paper was issued on 15 June 2010 to respond to the major concerns and comments of stakeholders. On 30 August 2010, the DTC Bill 2010 was presented in the lower house of the Indian Parliament. Presently, the Income-tax Act, 1961 (the Act) governs the taxation of income earned in or from or with India. The Direct Tax Code, 2010 is proposed to replace the Income-tax Act, 1961. It is proposed to come into force from the financial year beginning 1 April, 2012.

The revised paper of the DTC has retained the clause directing foreign institutional investors to classify income from investments as capital gains and pay tax on it. “The majority of FIIs are reporting their income from such investments as capital gains. However, some of them are characterizing such income as business income and consequently claim total exemption from taxation in the absence of a Permanent Establishment in India. It is, therefore, the revised discussion paper state that the income arising on purchase and sale of securities by an FII shall be deemed to be income chargeable under the head capital gains.

This would simplify the system of taxation, bring certainty, eliminate litigation and is easy to administer, the paper said. The capital gains arising to foreign institutional investors will not be subjected to TDS and they will be required to pay tax by way of advance tax on such gains. But the draft code has created confusion among FIIs in the following aspects and some of them are:

3A. Impact of DTC on FII’s– Taxation

While the draft DTC released in August 2009 had threatened to bring all foreign investors under the tax net by overruling bilateral tax treaties signed with other countries, the Discussion Paper recognizes that this is not feasible. Clarifications have also been issued on a number of ambiguous aspects such as determining if income was capital gains or business income, test of residence, and so on.
3B. Double Taxation Avoidance Agreements (DTAA)

The initial draft had proposed that neither the tax code nor double taxation avoidance agreements (DTAAs) shall have preferential status if litigation arose. It had further provided that the one that is later in point of time shall prevail. This had led to fears that bilateral treaties could be overruled and large number of FIIs which were not paying any tax in India, as they were purported to be paying tax in their country of incorporation, could now be brought into the tax net.

This proposal was not feasible since no country could unilaterally negate a treaty that was entered into by two countries bilaterally. The Discussion Paper therefore proposes that in case of litigation, the law that is more beneficial to the taxpayer — between domestic law and DTAA — shall prevail.

India has bilateral tax treaties for double taxation avoidance with more than 60 countries and a significant chunk of the FII funds flowing into the stock market are estimated to be routed through tax havens, such as Mauritius, that are covered by the DTAA.

3C. FII’s Covered by DTAA

According to the Discussion Paper, foreign investors utilizing the double taxation avoidance rule to avoid paying capital gains tax in India can now continue to enjoy this benefit. They would neither have to pay short-term nor long-term capital gains tax under the revised proposal as the tax rate on capital gains in countries of their incorporation is almost zero.

However, the tax authorities have the power to invoke GAAR (general anti-avoidance rule) where they think that the DTAA provisions are being misused. In such instances, the Discussion Paper states that domestic laws will prevail over DTAA and the FII can be made to pay taxes it was avoiding.

Since SEBI is already attempting to plug the inflow of money from unwanted sources into the Indian stock market, through various measures such as asking for greater compliance with disclosure norms in participatory notes and banning FIIs with multi-layered opaque structures, it would not be surprising if the tax authorities also follow suit and invoke GAAR where the source of funds is not apparent.

3D. FIIs not covered by DTAA

Foreign investors not covered by any DTAA will face higher capital gains tax outgo if the proposals in the revised DTC are implemented. They are now only paying short-term capital gains tax at the rate of 15 per cent and no long-term capital gains tax. According to the changes proposed, short-term capital gain will be added to the income of the taxpayer and taxed accordingly. Capital gains on assets held for more than one year from the end of the financial year in which the investment is made, will now be added to the income and taxed albeit after deducting a specified percentage of the capital gains that will vary according to the
taxpayer's tax slab. This can have the negative effect of removing the incentive to hold stocks for longer periods, maybe resulting in greater churn in FII portfolios. Some external investors who are contemplating booking profit on investments held over many years might now rush to do so prior to implementation of the DTC on April 1, 2011. This factor could contribute to volatility in the first quarter of next year.

3E. Business Income or Capital Gain

The Code has now clarified that income that FIIs make from buying or selling shares will be treated as capital gains and not business income. While majority of foreign investors prefer to pay short-term capital gains tax at 15 per cent, there are some who claim that it is business income and avoid paying tax in the absence of a permanent establishment in India. This has led to long-drawn litigations with tax authorities for proving the place of residence. Taxing all FIIs' income from stocks has simplified the issue. The exchequer is not losing any money by asking all FIIs to declare their income as capital gains, as short-term capital gains is anyway taxed as part of income. Thus FIIs who are predominantly trading in cash or derivatives will anyway pay tax at a higher rate. The need to distinguish between trading and investment gains of FIIs is no more relevant.

3F. Test of Residence

The revised DTC has also made the determination of the residence of a company that is incorporated outside India easier. It proposes that a company will now be considered resident in India for taxation purpose if its board of directors or executive directors make or approve decisions in India. This means that irrespective of where the executive board meets or the number of times they meet, the place out of which they function would now be considered the country of residence.

3G. Controlled Foreign Company (CFC) Rules:

As indicated in the revised discussion draft, CFC rules have been incorporated to provide for the taxation of income attributable to a CFC to be taxed in the hands of the resident. A foreign company would be considered as a CFC which

- For the purposes of tax is a resident of a country or territory with a lower rate of tax
- The shares of the company are not traded on any stock exchange
- One or more persons individually or collectively exercise control over the company
- It is not engaged in any active trade or business
- The specified incomes exceed INR 2.5 million.

Rules pertaining to the computation of the income attributable to the CFC that would be required to be added to the income of the resident have been provided.
3H. General anti-avoidance rule (GAAP)

In addition to clarifying on test of residence, the modified GAAR lays down that income-tax officers can determine the tax consequence to assesses by disregarding the arrangement (such as DTAA) where the transaction lacks “commercial substance or is carried on in a manner not normally employed for bona fide business purpose.” This means that tax authorities can now invoke GAAR with respect to the shell companies formed for routing money from tax havens into Indian equities and make them pay capital gains tax as per Indian laws. Such companies would have to prove that they had commercial substance. It might not be possible for such offshore companies to take refuge under the tax treaties as the revised code lays down that domestic law will take precedence over bi-lateral tax treaties when GAAR is invoked.

4. Conclusion

The stock market is booming. The discriminating observer will know that this is attributable to heavy influx of funds into the stock market by foreign institutional investors (FIIs). They find the Indian market attractive on many counts, one being the liberal tax regime in operation. It has always been a matter of controversy whether stock market gains should be taxed as capital gains or business profits. Tax law makes a distinction between investment asset and business asset. Gains on investment assets are taxed as capital assets. The government should keep in view of the role played by FIIs in Indian economy and compare the tax laws applicable in different other competitive countries before imposing any tax on the FIIs.
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