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Investors fear retrospective taxation on American depository receipts

By ET Bureau | 10 Mar, 2015, 01:53AM IST

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MUMBAI: As unsponsored American depository receipts (ADRs) gain momentum, depositories, custodian banks and investors are seeking expert advice regarding concerns about retrospective taxation.

The finance ministry's Department of Economic Affairs issued the Receipts Scheme notification last year, following which JPMorgan and Bank of New York Mellon applied to the US Securities and Exchange Commission for approval to issue ADRs against shares of Indian companies.

The fear is that the tax authorities may come up with regulations that impact past investments. "There are some stakeholders who want to market this (ADRs) as a product in the US to their clients, but there is no clarity on the tax part in India," said Rajesh H Gandhi, partner — tax, Deloitte Haskins & Sells LLP. "We hope the guidelines around this are announced soon, otherwise this could impact the appeal of this instrument."

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Experts said the unsponsored ADR route could create a parallel platform for trading in Indian company shares abroad. They said new entrants may find this easier than registering as foreign portfolio investors (FPIs) in India and meeting regulatory and tax norms.

To be sure, the [Indian government](#) has been at pains to allay fears of investors about retrospective taxation as it looks to boost growth. It's looking to encourage offshore fund managers to set up shop in India, apart from setting up financial special economic zones for stemming the exodus of rupee and [Nifty](#) trading.

Some experts said FPIs may use the notification as a loophole to avoid short-term gains tax in the absence of clear rules. "An FPI that bought shares of company six months back can now go to a depository and convert the shares to ADRs and sell it on the American stock exchange," one of them said. "By doing so, the FPI can now bypass the short-term capital gain tax that it would have paid had it sold the shares on the Indian stock exchange by arguing that the conversion of the shares to ADRs is a non-taxable event."

It is expected that the government may issue rules regarding the matter in the coming months. Clarity is needed on how ADRs with Indian unlisted securities as an underlying asset trading on another country's platform would be taxed in India, said Pranay Bhatia, partner, [direct tax](#) and business advisory at BDO India. "Going ahead, foreign investors could prefer investing in ADRs, as it not only reduces the [forex](#) risk but also could potentially mitigate adverse taxation issues, including applicability of MAT (minimum alternate tax) to foreign companies."

Apart from the loophole mentioned above, it's not clear whether capital gains tax can be levied on the conversion of ADRs to shares and the methodology for computing this on the sale of such stock on Indian stock exchanges, Gandhi said. While the earlier FCCB (Foreign Currency Convertible Bond) Scheme of 1993 provided for a method to determine the cost of acquisition on conversion of ADRs to shares, the new 2014 scheme is silent on tax. This adds to the uncertainty, Gandhi said.

If the sale of shares for conversion to ADRs takes place either through bilateral transactions or by tendering through a public platform, this could have tax leakage implications for the seller since these would typically be off-market transactions.

Interestingly, the MS Sahoo Committee while issuing its recommendations for unsponsored ADRs had suggested that the sale of shares through public tender should be given the same beneficial tax treatment as that which takes place on the stock market. However, none of the recommendations on tax treatment has found a place in the 2014 Depository Receipt Scheme. The government may want to provide for the tax treatment of ADRs/GDRs by making changes in the Income-Tax Act rather than through the scheme, experts said.

Some analysts said the government may just refer to the earlier rules on GDRs for taxation (Section 115AC of the Income-Tax Act). The recent Budget stipulated that only listed companies can be traded as ADRs/GDRs on exchanges outside India, making things clearer.

"As per the 2014 scheme, ADRs/GDRs can be issued against underlying securities which can be debt instruments, shares, units, etc. and the issuing company can be listed, unlisted or private or public companies," said Jeenendra Bhandari, partner — MGB and Co, a tax firm.

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"The Budget restricted concessional tax treatment to ADRs/GDRs, where the underlying shares are listed on a stock exchange." This is more logical since the concessional capital gains tax regime is normally only available to listed securities on which securities transaction tax has been paid and not to unlisted companies, he said.



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