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Investing in Foreign Stocks through IFSC – Tax and Regulatory Implications

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Background

In October 2020, the International Financial Services Centre ('IFSC') Authority prescribed[1] the regulatory framework for listing of Depository Receipts ('DRs') in an IFSC. In furtherance of the said framework, in August 2021 NSE's wholly owned subsidiary, NSE International Exchange ('NSE IFSC') announced its intention of facilitating trading in select US companies' stocks through its platform in IFSC. This was followed by BSE-owned India INX announcing its proposal to offer stocks from US and other countries, covering about 80% of the investing universe.

NSE IFSC has announced that the investment product will be in the form of unsponsored DRs of select US stocks. India INX has gone a step further and stated that it will add international stocks to trading and under the first phase, access will be provided to over 130 exchanges across 31 countries.

Despite COVID-19, stock markets over the world have rallied significantly in the past one year, and by and large, the Indian stock market has shot up even more; this has further heightened the need for geographical and currency diversification, and, in that context, these announcements will facilitate broadening of the investment spectrum for Indian investors.

Overseas investment options thus far

Until now, an Indian investor could have invested in overseas stocks directly or indirectly.

Direct investments could have been made through Indian brokers with a tie-up with foreign brokers or through foreign brokers and trading platforms that enable Indian investors to trade in US stocks and mutual funds. On the other hand, one could invest indirectly in foreign stocks through Indian mutual funds that are focused on investing in international markets. This is like investment in foreign debt or equity, but without remitting money abroad, and still invested in dollar terms. Yet another option for indirect investments in foreign stocks is investment in foreign mutual funds through Indian brokers partnered with foreign brokers or through foreign brokers.

Implications under Foreign Exchange regulations

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Direct investments in foreign stocks or in foreign mutual funds would require remittance of funds overseas. Para A.1. of Master Direction - Liberalised Remittance Scheme ('LRS')[2] allows remittances by resident individuals upto USD 250,000 in every financial year for any permitted current and capital account transactions. As per Para A.6. of the same Master Direction, capital account transactions permissible to an individual under the LRS include, *inter alia*, acquisition and holding shares of both listed and unlisted overseas company and debt instruments, as well as investment in units of mutual funds.

In terms of process, the remittance can also be made to an overseas bank account and subsequently, utilised for purchasing stocks or mutual funds (through an Indian or foreign broker).

As contrasted with direct investments, if an investment is made indirectly through an Indian mutual fund focusing on overseas stocks, funds are not remitted outside India, Foreign Exchange regulations are not applicable and hence, there are no limits on the investment; however, the returns would indirectly reflect in foreign currency terms.

Implications under Income-tax law

In case of direct investments, at the time of remittance, such remittances made under LRS (if more than INR 7 lakhs) shall be subject to TCS (tax collected at source) @ 5% under section 206C(1G) of the Income-tax Act, 1961 ('ITA').

Capital gains upon transfer of foreign stocks or units in foreign mutual funds, if held for more than 24 months, shall be taxable in India as long term capital gains @ 20% (plus surcharge and cess) under section 112 of the ITA (after indexation benefit). If the gains are short-term (i.e. if the stocks/ units were transferred within 24 months), the same shall be taxable at the applicable slab rates.

Since the gains would accrue or arise to the individuals in foreign currency, the conversion mechanism prescribed under Rule 115 of the Income-tax Rules, 1962 ('Rules') would be applicable i.e. the capital gains income in foreign currency shall be converted into Indian rupees using the telegraphic transfer buying rate of the relevant foreign currency as on the last day of the month preceding the month in which the stocks/ units were transferred.

Lastly, the investment will have to be disclosed as foreign assets by Indian investors who are tax resident in India, in their tax returns under Schedule FA.

In case of indirect investments through Indian mutual funds investing in foreign stocks, the capital gains shall be characterised as long term if the mutual fund units are held for more than 12 months (if listed on Indian stock exchange) and shall be subject to tax @ 10% (plus surcharge and cess, surcharge restricted to 15%) under section 112A of the ITA. Short term capital gains arising from sale of listed mutual fund units shall be subject to tax @ 15% (plus surcharge and cess) under section 111A of the ITA.

New investment option

With NSE IFSC and India INX entering the foreign investment scene, Indian investors will now have a new avenue to invest in foreign stocks. The initial product that NSE IFSC is likely to offer are DRs which will be based on underlying shares of US companies traded in US markets. Investors can also trade in fractional quantities or values, thus making US stocks affordable to Indian retail investors.

Implications under Foreign Exchange regulations

While these DRs will be traded on exchanges in IFSC, since entities in IFSC are considered as "persons resident outside India" from a FEMA perspective, the investment in such DRs should still be subject to the LRS limits of USD 250,000 as discussed above, even though technically no funds will be remitted outside India.

Implications under Income-tax law

DRs would usually be considered as 'capital assets' and therefore, transfer of such DRs should be subject to capital gains tax in India.

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Since the exchanges in IFSC have been recognised as stock exchange by SEBI and also, since IFSCs are geographically situated in India, the DRs listed thereon should be considered as listed securities on recognised stock exchanges in India (even though under the Foreign Exchange regulations, the stock exchange would be treated as a person resident outside India). Therefore, the DRs should be considered as short-term capital assets if held for 12 months or less. To avoid any unwarranted confusion, CBDT should clarify that the stock exchanges in IFSC shall be considered as "recognised stock exchange in India" for income-tax purposes.

If the DRs are sold after being held for more than 12 months, the gains thereon should be long term capital gains and should attract tax @ 10% (plus surcharge and cess) without indexation benefit (or 20% with indexation) under section 112 of the ITA. If the gains are short term, the tax rate would be the applicable slab rate.

Similar to direct investments in foreign stocks, since the gains would be in foreign currency, they will have to be converted into rupees as per Rule 115 of Rules using a specified rate of exchange (telegraphic transfer buying rate) on the last day of the month preceding the month in which the DRs are transferred.

In terms of disclosure in tax returns, Indian residents have to disclose their foreign assets in a Schedule FA which is a part of the tax return.

Tabulated below is a comparison of the various options that would be available to Indian resident investors for investment in foreign stocks:

Parameters	**Directly in foreign stocks/ foreign funds**	**Indirectly through Indian mutual funds investing in foreign stocks**	**Through DRs trading on recognised stock exchanges in IFSC**
Forex conversion costs	High	Not applicable	Expected to be much lower
FEMA restrictions	LRS limit of USD 250,000	Not applicable	LRS limit of USD 250,000
Taxability of dividend income	Slab rate (Tax credit for TDS in foreign country should be available)	Slab rate (if dividend option)	Slab rate (if dividend is declared on DRs)
Short Term characterisation	If held for 24 months or less (since not listed on Indian stock exchange)	If held for 12 months or less (if units listed on Indian stock exchange)	If held for 12 months or less
Tax rate of capital gains (at highest surcharge rate)	Long Term: 28.5% Short Term: 42.74% (See Note below)	Long Term: 11.96% Short Term: 17.94%	Long Term: 14.25% Short Term: 42.74% (See Note below)
Disclosure as foreign assets in tax return	Yes, required	Not applicable since Indian asset	Yes, required

Note: Source country in which the foreign stocks/ funds are domiciled could levy a source-based taxation, in which case, the source country (i.e. foreign country) could charge capital gains tax on capital gains and credit for such taxes paid in the foreign country should be available in India.

The tax implications discussed above are on the basis of the information available currently and are likely to evolve once the operational and functional details are announced. There is also a possibility that such DRs and shares of foreign companies to be traded on stock exchanges in IFSC may get a specific tax regime under the ITA (similar to Global Depository Receipts issued by Indian companies).

Summing up

With a rapid growth in the ecosystem of banks, exchanges, capital market intermediaries in the IFSC in GIFT City, it is emerging as a facilitative portal for financial investments in India as well as globally.

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Trading of foreign stocks and its derivative products on Indian exchanges could go a long way to facilitate foreign investments by Indian investors.

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[1] Circular No. 87 dated 28 October 2020

[2] FED Master Direction No. 7/2015-16

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