INVESTMENT COMPANY INSTITUTE

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Mr. Arbind Modi, IRS
Joint Secretary, Tax Policy & Legislative Division
Department of Revenue
Ministry of Finance
Government of India
North Block
New Delhi 110 001
India

RE: *Impact on Foreign Institutional Investors of Proposed New Direct Taxes Code*

Dear Mr. Modi:

The Investment Company Institute[1] would like to reemphasize the serious concerns raised in our October 27, 2009 letter to you regarding the taxation of foreign institutional investors ("FIIs") under the proposed Direct Taxes Code ("DTC"). The effect of these changes, despite some moderation of the more extreme proposals, will be continued uncertainty – rather than stability – regarding India's taxation of investment income.

The revised discussion paper, released on June 15, 2010, improves somewhat on the extraordinarily large increase in the tax rate on capital gains. Nevertheless, we remain concerned about any overall increase in the taxes paid by FIIs on their Indian securities. If the proposed increase becomes effective, this very substantial tax will impact negatively both the Indian companies in which FIIs invest (because of the diminished attractiveness of the companies' securities) and the FIIs themselves. FIIs harmed by the capital gains tax proposal – and troubled by the continued uncertainty regarding India's taxation of investment income – may be less willing to invest in India altogether.

[1] The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of $11.42 trillion and serve almost 90 million shareholders.

The U.S. Fund Industry

Investment companies (also known as mutual funds) are an extremely popular and important investment vehicle in the United States. These funds are held by about 50 million households and are owned by about 90 million shareholders, the majority of whom reside in the United States.

U.S. funds have invested heavily in the Indian market because of its attractiveness relative to other foreign markets. In particular, funds will invest in India when the expected investment return of securities in Indian-domiciled companies (on an after-tax basis) is higher than the expected return of securities in companies domiciled in other markets.[2]

Capital Gains Tax Regime Should Remain Unchanged

We urge that India maintain its current capital gains tax regime for both long-term and short-term capital gains. Long-term capital gains realized by FIIs on their securities investments should remain exempt from tax; the tax rate on FIIs' short-term capital gains should not be increased. If long-term capital gains become taxable going forward, significant transition guidance will be needed so that FIIs can plan their investment strategies. Moreover, by imposing a substantial tax on long-term capital gains and increasing substantially the tax rate on short-term capital gains, India will affect negatively the attractiveness of Indian securities compared to other foreign securities because of the reduced after-tax investment returns. To the extent that demand by FIIs for Indian securities affects the market price of those securities, the proposed capital gains tax rate changes also would reduce the value of the Indian stock market.

No other country comparable to India, to our knowledge, taxes the long-term capital gains of U.S. funds investing in listed securities.[3] Indeed, countries that recently have considered taxing long-term capital gains (such as Pakistan, Greece and Kuwait) ultimately have not taxed these gains. If a tax on long-term capital gains were imposed in India, the U.S. funds (and other U.S. institutional investors as well) that are currently investing in India most likely would reduce their investments in Indian securities in favor of increasing their investments in other countries that have not imposed a capital gains tax.

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[2] Citigroup reports that, as of March 2010, FIIs owned over 24 percent of the BSE 500's securities (including American Depositary Receipts ("ADRs") and Global Depositary Receipts ("GDRs")) and over 14 percent of the BSE 500's securities (excluding ADRs and GDRs).

[3] The only countries that, to our knowledge, tax the long-term capital gains of foreign investors in listed securities are Nigeria, Serbia and Peru. Certain other countries tax gains in a much more limited fashion; for example, Brazil, Chile, Columbia, Kuwait, Thailand, Kazakhstan and South Korea impose a limited capital gains tax on unlisted securities.

Treaty Override Concerns Have Been Alleviated Only in Part

We support the effort made by the June 15 revised discussion paper to alleviate some of the impact of the proposed new DTC on existing income tax treaties. As noted in the ICI's October 2009 letter to you, the treaty override provision in the original proposal would have disrupted previously-negotiated assurances provided to investors and upset settled investment expectations. While the approach announced by the June 15 revised discussion paper is a positive step, more needs to be done. Specifically, the DTC should remove the uncertainty created by the ability of Indian tax authorities, under the revised proposal, to override a treaty under the General Anti Avoidance Rule ("GAAR"). This GAAR authority, while perhaps limited to some extent by restrictions described in the revised discussion draft, nevertheless creates uncertainty that diminishes the interest of FIIs in committing capital to the Indian securities markets.

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Our members have made substantial investments in India because they view favorably India's strong economy and significant growth potential. The relative attractiveness of the Indian securities markets turns both on applicable tax rates and certainty regarding the rules that will be applied to current and future investments. The proposed tax on long-term capital gains, and the proposed tax increase on short-term capital gains, raise pressing concerns regarding the relative attractiveness of the Indian securities market. The remaining possibility of treaty overrides creates uncertainties. Any resulting reduction in FIIs' demand for Indian securities would harm the Indian market. Consequently, we urge that these proposals not be adopted.

We appreciate your consideration of this matter. We would be pleased to discuss this matter further at your convenience. You can reach me through e-mail (lawson@ici.org) or by telephone (001-202-326-5832).

Sincerely,

/s/ Keith Lawson

Keith Lawson
Senior Counsel – Tax Law