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India needs to remove tax friction for more FDI

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Synopsis
India is looking to boost foreign investment by reforming its tax system. Recent proposals aim to simplify taxes on foreign holdings. The country faces challenges with its current tax structure, which is seen as complex and frequently changing. Reforms are needed to make India competitive and predictable for global investors. This will help attract more capital and support economic growth.

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The Union Cabinet on Wednesday reportedly approved of doing away with **capital gains tax** on **FPI holdings in government securities**. This would be a welcome move to attract greater overseas investments.

India's net FDI fell from $45 bn in FY21 to $0.35 bn in FY25, driven by higher repatriation of profits and lack of commensurate increase in inflows. China Plus One near-shoring, impact of the US war on Iran, opportunities in the US and East Asia, and the negative impact of AI on Indian IT services partly explain this dip. But India's underlying structural frictions that now stand exposed are also a problem.

One such friction is the tax system. India has made genuine progress: simplification of direct tax code, expansion of advance pricing agreements (APA), abolition of angel tax and progressive digitisation are real gains. Indian taxation is largely in line with peers at the point of entry of long-term capital, much higher and more complex than others through the holding period, and frequently changing at exit. Finally, India lacks a fast and reliable **tax dispute redressal mechanism**.

Taxation at entry: Most countries minimally tax capital at arrival. India's stamp duty of 0.005% on share issuance and 0.015% on transfers is broadly in line with China's, though lower than Britain's.

Holding period: This phase is where gaps relative to peers are substantial, and targeted reforms would deliver the greatest impact.

Dividends: India applies a 20% **withholding tax** on non-residents, treaty-reducible to 5-15% at the higher end of the peer range. China and Vietnam apply 10% and 0% respectively, while Singapore and Britain apply 0% under their exemption frameworks.

Royalties & technical service fees: Finance Act 2023's doubling of withholding from 10% to 20% pushed companies out of a simple withholding relationship into treaty claims to reduce rates to 7.5-15%, triggering annual filing obligations, assessment exposure and refund cycles.

China holds royalty withholding at 10% with a single administrative filing regardless of treaty status; Vietnam applies a final 10% contractor tax discharged at source with no further obligation. India is now outlier on both rate and process.

Debt: Sections 194LC and 194LD provided a 5% concessional withholding rate on interest paid to non-residents on foreign currency borrowings for a decade. Finance Act 2023 allowed this regime to lapse without renewal. India should continue with flat 5% concession across mechanisms, providing stability.

Taxation on exit India's exit tax framework - LTCG on listed equity at 12.5% along with surcharge - is on the higher end of peers. Developed markets like the US, Britain and Singapore entirely exempt non-resident investors from capital gains. But more pressing is the frequency of change. India's equity exit framework has been revised more than 4 times in three decades, with 3 different regimes for buyback taxation since 2013 alone.

Architectural predictability that global institutional investors require to model long-term equity returns does not exist. In contrast, the US capital gains regime has held structural shape for decades. China's 10% withholding on non-resident equity gains has been stable since 2008. Restoring India's LTCG on listed equity to 10% (at par with China's, and with the rate in India between 2018 and 2024) can signal a competitive and stable framework.

Investors also find India to be an outlier with STT and LTCG, unlike most countries that favour one or the other. With substantial digital tracking of investors today, India should abolish distortionary STT, at the very least on cash equity.

Finance Act 2015 introduced Section 115UB, establishing pass-through taxation for Category I and II AIFs. Extending pass-through status to **Category III AIFs** by statute would not forgo revenue, but would eliminate the punitive fund-level rate that makes India-domiciled Category III structures uncompetitive against Singapore and US equivalents.

Cutting across the three phases is fragmented and uncertain compliance. India has opted out of mandatory binding international tax arbitration - unlike the US, Britain and the EU - leaving investors with limited recourse when domestic proceedings go against them. Supreme Court rulings in Tiger

Global (2024) and Nestle (2023) retroactively narrowed treaty benefits, reviving the ghost of retrospective taxation.

India should adopt a single-window filing architecture for non-resident compliance - a low flat 10% withholding rate applicable without requiring treaty access, a unified digital portal with defined processing timelines, dedicated fast-track dispute resolution, and enforcement with statutory time limits. India should ratify relevant provisions of the multilateral instrument for dispute resolution, signalling commitment to durable and enforceable treaty provisions.

Making India's **international taxation** system attractive to investors doesn't require India to become a tax haven, or to compromise its revenue base. It requires it to be in line with global norms, be consistent, predictable and operationally frictionless.