Taxpayers' dilemma: Conflicts between tax laws and Fema

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As a resident taxpayer, one not only has to comply with domestic tax laws, but also exchange control regulations under the Foreign Exchange Management Act (Fema). The provisions of both laws are often conflicting on certain transactions. One such situation is where you need to help a non-resident friend or relative who is going through a financial crisis. But what are the rules that you need to know before sending a loan or a gift?

Under the Liberalised Remittance Scheme (LRS) of Fema, within the $250,000 annual limit, you can give a foreign currency loan only to a relative as defined under the Companies Act. This definition only covers immediate relatives, i.e. parents, grandparents, and siblings, children, grandchildren and their spouses. Therefore, you can't give such a loan to an uncle or aunt, or to a cousin or close friend. Under Fema, assistance in such manner is completely ruled out.

Can you instead give them a gift? Under LRS, you are permitted to give a gift to any non-resident. So, is that the solution? Unfortunately, this is where the tax laws complicate the issue. From 2019 onwards, any gift received by a non-resident from a resident is deemed to accrue or arise in India, and is therefore considered as part of the non-resident's taxable income in India.

The gift received by the non-resident is taxable in India, unless it falls under the exemption available for gifts to relatives. Here, the definition of relatives creates a problem. Friends and cousins are not relatives as per this definition. Even an uncle and aunt are not a relative of the person making the gift, though the nephew is a relative of the uncle or aunt. This is truly baffling! How can the relationship be only one way and not the other?

So, the recipient of the gift (uncle/aunt/cousin or friend) would be liable to pay tax in India on the gift amount. You might think that tax is their problem – let me just give the gift and be done with it! Unfortunately, you cannot get away so easily. Under the law, you are required to deduct tax at source on such gift at 30% plus surcharge and cess and pay it to the government.

This tax largely defeats the whole purpose of assisting that person—to help him out with $10,000, for instance. To ensure that the entire amount reaches him net of tax, you would need to gross it up considering $10,000 as the post-tax amount, pay about $5,000 by way of tax, and then remit the balance $10,000.

Of course, if the recipient of the gift is able to procure a Tax Residency Certificate from the tax authorities of his country of residence, the benefits of the double taxation avoidance agreement (tax treaty) of that country with India may provide exemption for such an income in India.

Take another instance, which involves overseas tax. You wish to acquire foreign securities, but are advised to set up a company in a tax haven, and acquire the securities in the name of the company, to ensure that your heirs do not end up paying inheritance tax in the country where the securities are held. Easier said than done! While foreign exchange laws permit you to acquire securities abroad as portfolio investment, you cannot set up a foreign company to carry out this activity. You may therefore have to risk an exposure to inheritance tax in the foreign jurisdiction by acquiring the securities in your own name.

A similar situation arises in relation to acquisition of overseas real estate, wherein Fema provisions—prohibiting setting up of companies to hold real estate—work counter to the interests of its residents, who may end up paying inheritance tax to a foreign country.

One wonders whether such confusion can be avoided, with the law framed such that genuine transactions are facilitated by harmonization of the provisions of tax and Fema. Unfortunately, each regulator looks at the law from its own perspective and frames provisions accordingly. A consolidated relook at some of the foreign exchange provisions and income tax provisions applicable to individuals may be the need of the hour.

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