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Non-residents to get full income tax exemption on profits from OTC derivative contracts traded in IFSC due to this rule change

By Neelanjit Das, ET Online Last Updated: Mar 29, 2025, 10:00:00 AM IST

Synopsis
No income tax: Incomes arising out of non-resident's income on Over-the-Counter (OTC) derivatives will be fully exempt from Income Tax under Section 10 (4E) provided they are routed through overseas banking units or FPIs. Yeeshu Sehgal says: "It means Non-residents can now engage in transactions through FPIs operating in IFSCs & income earned from these derivative transactions will continue to be exempt from income tax."

Non-residents to get full income tax exemption on profits from OTC derivative contracts traded in IFSC due to this rule change in the Finance Bill 2025

In what can be termed as good news for non-residents including non-resident Indians (NRIs), the government has given a special income tax exemption under the amended Finance Bill 2025. But there is a catch– only investment in specified transactions in the IFSC region covered under Section 10 (4E) of the Income Tax Act, 1961 are covered under this special tax exemption for NRs including NRIs.

Income Tax Guide
Income Tax Slabs FY 2025-26
Income Tax Calculator 2025
New Income Tax Bill 2025

Read below to understand the finer details of transactions covered under Section 10 (4E) and how a non-resident can undertake such transactions to get Indian income tax free profits.

What are the changes made to the tax exemption under Section 10(4E) brought in by the Amendment to the Finance Bill 2025?

The Government Amendment proposes to extend the exemption under Section 10(4E) to the distribution of income on Over-the-Counter (OTC) derivatives, where such contracts are entered into by a non-residents including NRIs with either Overseas Banking Units (OBU) or Foreign Portfolio Investors (FPIs) operating in an IFSC.

"The amendment to Finance Bill 2025 has broadened the scope of income tax exemptions by including income received or accrued by a non-resident from the distribution of income on Over-the-Counter (OTC) derivatives," says Chartered Accountant Ashish Karundia.

What are the transactions that are covered under section 10 (4E) of the Income tax Act, 1961?
According to a supplementary FAQ issued by the Income Tax Department, Section 10(4E) covers the following transactions:

- Transfer of non-deliverable forward contracts, offshore derivative instruments, or over-the-counter (OTC) derivatives; and
- Distribution of income on offshore derivative instruments.

Kunal Savani, Partner, Cyril Amarchand Mangaldas, says that by extending Section 10 4(E) which specifies the incomes which will not form part of total income, to NRIs the government has made a significant and much-welcomed development.

The catch- The derivatives trade must be conducted through an FPI registered in IFSC
The income tax department said the primary factor to determine whether the income from the above instruments would qualify for Section 10 4(E) income tax exemption for NRIs is that the transactions should be conducted through an International Financial Services Centre (IFSC) registered foreign portfolio investor (FPI) or off-shore banking unit.

“Earlier, the exemption under section 10(4E) was available only for derivative transactions made by non-residents with offshore banking units. The Finance Bill, 2025 extends this benefit to transactions made by non-residents with Foreign Portfolio Investors (FPIs) that are units in an IFSC,” said the Income Tax Department in its supplementary FAQ.

Dubai based Yeeshu Sehgal, Head of Tax Markets, AKM Global explains the meaning of the tax exemption’s conditions: “It means Non-residents can now engage in transactions through FPIs operating within IFSCs and income earned from these derivative transactions will continue to be exempt from income tax under Section 10(4E).”

Finer details of what are the IFSC traded instruments which may qualify for tax exemption
Rashi Khanna, Associate Partner, DMD Advocates, explains the finer details of the IFSC traded instruments which qualify for this tax exemption under the amended Finance Bill 2025.

Participatory Notes (P-Notes) may qualify for such a tax exemption
Khanna says Participatory notes (P-notes) are financial instruments issued by registered Foreign Portfolio Investors (FPIs) to overseas investors, allowing them to invest in Indian securities without directly registering with the Securities and Exchange Board of India (SEBI).

According to Khanna, the International Financial Services Authority last year had permitted IFSCA registered non-bank entities, registered with SEBI as FPIs, to issue offshore derivative instruments with Indian securities as underlying assets, also known as P-Notes in GIFT-IFSC.

The derivatives issued by FPIs are traded exclusively on the India International Exchange located in GIFT IFSC City.

"The amendment to section 10(4E) has been brought in to provide tax exemption to investments made by non-residents through FPIs as well as to expand the scope of exemption to transactions effected even with non-bank entities," she says.

Only contracts listed in IFSC GIFT city stock exchange will qualify
Sehgal, says, "The tax exemption applies to derivatives traded in IFSCs, meaning it is likely applicable only to contracts listed in IFSC exchanges such as GIFT city and not directly on NSE/BSE."

Savani agrees with Sehgal and adds: "The exemption under Section 10(4E) of the Income Tax Act, covers income arising from transactions such as non-deliverable forward contracts, offshore derivative instruments, and over-the- counter (OTC) derivatives, as well as the distribution of income from these instruments in IFSC."

BANKNIFTY, NIFTY, SENSEX derivatives can also qualify if its structured as such by IFSC registered intermediary
Pallav Pradyumn Narang, Partner, CNK says, "This amendment means that eligible derivative transactions may include forward contracts or OTC derivatives linked to Indian stock market indices such as NIFTY, SENSEX, and BANK NIFTY."

Narang adds: "Offshore derivative instruments may also be structured to have underlying assets traded on domestic exchanges such as the National Stock Exchange (NSE) or the Bombay Stock Exchange (BSE). The key requirement for availing tax exemption remains that the transactions must be executed through an IFSC-registered OBU or FPI."

How can Non-residents including NRIs make derivative transactions with FPIs?
Sehgal says, in order to transact with FPIs, non-residents would likely need to establish trading accounts with registered FPIs in the IFSC. "It means instead of trading through OBUs, non-residents can now engage in transactions through FPIs operating within IFSCs and income earned from these derivative transactions will continue to be exempt from tax under Section 10(4E)," he says.

Rohit Jain, Managing Partner, Singhania & Co, explains the finer details of how an **NRI** can open an account with an FPI:

- There are two ways: Directly investing through an FPI (if they are qualified to set up or participate in an FPI themselves). Indirectly investing by using a domestic or foreign intermediary (such as asset management companies or brokers who manage FPIs).
- Direct method: Register with SEBI and open a custodian account.
- Indirect method: Non-residents can invest in mutual funds or hedge funds that are registered as FPIs and participate in derivative trading indirectly through these funds. Non-residents can also prefer to engage a FPI broker who is licensed and registered to trade derivatives on their behalf in IFSC.

How can Non-residents including NRIs make derivative transactions with off-shore banking units?
Jain explains that a NRI must first open an account which can either be a NRE account, NRO account, or a Foreign Currency Account, depending on the type of transaction and the resident status. "Several banks, such as ICICI Bank, HDFC Bank, State Bank of India (SBI), and others, have OBUs in IFSC," says Jain.

After this NRIs need to complete the KYC and compliance checks which involves submitting necessary identification and residency documents. This could include:
- Passport, visa, and proof of overseas address for individual non-residents.
- Company incorporation documents and business registration details for corporate non-residents.

"KYC verification can be done remotely in many cases, depending on the bank's procedures," says Jain.

Once the KYC is complete, the NRI needs to select the derivative product and link their trading account with the IFSC stock exchange.

"To execute derivative trades, non-residents need a trading account that is linked with an exchange like NSE IFSC or BSE IFSC. Banks with OBUs usually have arrangements with these exchanges for seamless trading," says Jain.

Lessons from the Grandmasters