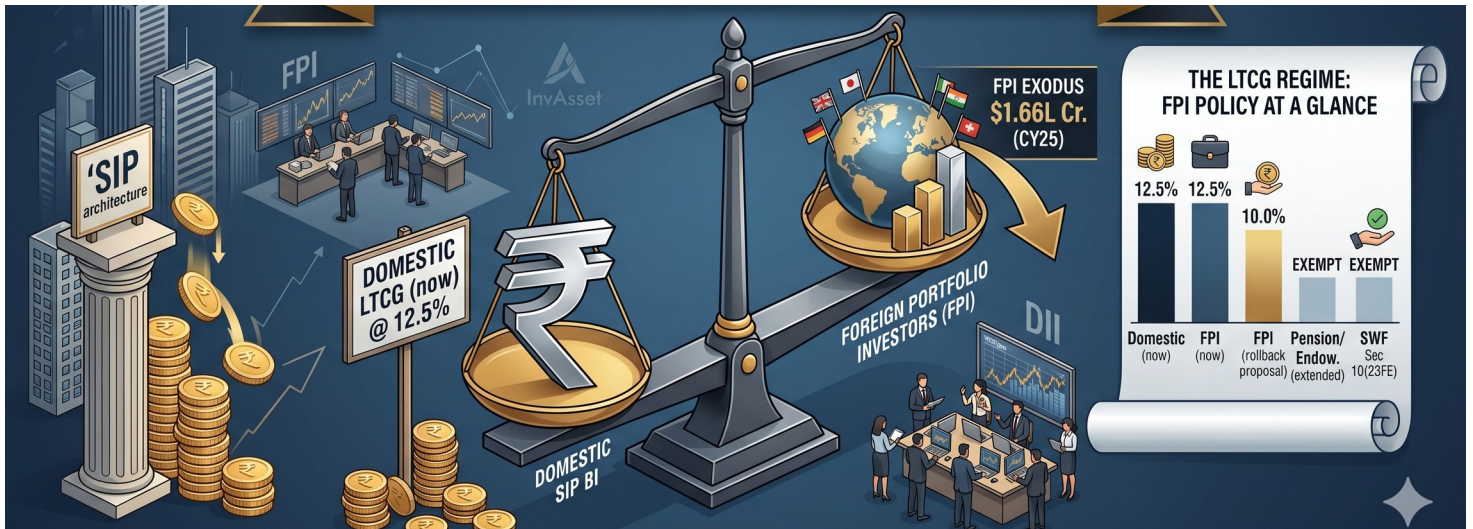


InvAsset's Voice

STRATEGIC RESEARCH · LTCG, FII vs DII



The Tax Tilt — Why the FPI LTCG Debate Decides Who Owns India Next

Why the ₹1.66 lakh crore FPI exodus, the Tiger Global verdict, and an STT-revenue hole have put the FPI LTCG rate squarely back on the table — and what the rotation looks like in each scenario.



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The 2025 FPI exodus of ₹1.66 lakh crore did two things at once: it pushed FPI ownership of NSE-listed companies toward a multi-decade low and coincided with a visible Securities Transaction Tax shortfall — the combination that has reportedly returned the FPI LTCCG rate to the Finance Ministry's policy agenda. Two specific levers are on the table: reverting the FPI LTCCG rate from 12.5% to 10% (opening a fresh 2.5-point gap against the unchanged 12.5% domestic rate), or broadening Section 10(23FE) — already used for notified sovereign and pension funds — to a wider set of pension and endowment-style foreign capital. The counter-current is the Supreme Court's 15 January 2026 Tiger Global verdict: applying substance-over-form, the Court held a Tax Residency Certificate alone is not conclusive of treaty eligibility where structure lacks commercial substance. The non-consensus reading: this is not a binary 'rollback or no rollback' trade. Partial measures (a Section 10(23FE) extension only) are the likelier path, re-pricing long-only sovereign-style capital without restoring the broader FII bid. Position into the names a returning sovereign / pension bid would absorb first — large-cap quality, financials, index heavyweights — and keep the DII trade intact. The domestic LTCCG at 12.5% has not broken the SIP architecture, and that bid is what is actually holding the market.

1. The Exodus That Forced the Debate — ₹1.66 Lakh Crore Out, and an STT Hole the Treasury Cannot Ignore

A record annual FPI outflow has pushed foreign ownership to a multi-decade low, coinciding with an STT shortfall driven mainly by weaker post-F&O-rule trading volumes — the combination that has become the political pressure point putting the LTCCG rate back in play.

Foreign portfolio investors pulled a record ₹1.66 lakh crore from Indian equities in calendar 2025 — the largest annual outflow on record — and have followed up with about ₹2.2 lakh crore of outflows in CY26 through mid-May, with roughly ₹27,000 crore leaving in May alone. For the first time, FPI ownership of NSE-listed companies has fallen to 15.8%, a 17-year low (NSE, March 2026) — now below domestic institutional ownership. DII buying, supported by record SIP flows but extending across mutual funds, insurers, EPFO and banks, has absorbed about ₹1.7 lakh crore of the CY26 outflow — close to 90% of the selling through April (against an FPI exit of roughly ₹1.92 lakh crore at that point) and roughly three-quarters of the full mid-May figure of ₹2.2 lakh crore — but absorption is not the same as a level-set: the market is being held up, not bid up.

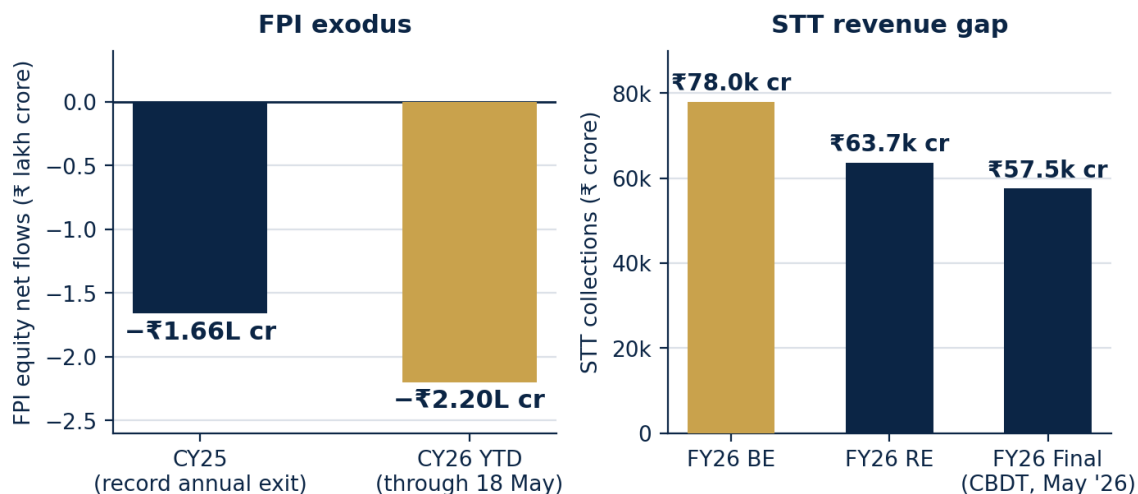


Chart 1. A record FPI exit coincides with FY26 STT collections undershooting both the Budget Estimate and the Revised Estimate.

Source: NSDL / CDSL flow data; CBDT provisional FY26 data (4 May 2026, via Business Standard and PTI). STT FY26 BE ₹78,000 cr (Budget 2025-26) cut to RE ₹63,670 cr; FY26 final ₹57,522 cr — short of BE by ₹20,478 cr and of RE by ₹6,148 cr.

Why this matters to North Block: the FPI exit coincides with a visible STT shortfall. FY26 collections came in at ₹57,522 crore (CBDT provisional, 4 May 2026) — up 7.9% year-on-year but ₹20,478 crore below the ₹78,000 crore Budget Estimate and ₹6,148 crore below the ₹63,670 crore Revised Estimate. The shortfall is driven primarily by weaker trading volumes after the F&O rule and STT changes, with FPI selling a contributor rather than the sole cause.

2. Inside the Rollback Lever — Two Specific Options on the Table

The two reported levers are sharp and narrow: revert the FPI LTCC rate from 12.5% back to 10%, or broaden the Section 10(23FE) capital-gains exemption beyond the sovereign wealth and pension funds it already covers.

In Union Budget 2024 (23 July 2024), the Finance Minister raised the LTCC rate on listed equities from 10% to 12.5%, with the basic exemption threshold raised to ₹1.25 lakh per year — applied uniformly to residents and FPIs. Budget 2025 (1 February 2025) then amended Section 115AD to align FPI LTCC at 12.5% across additional FPI security categories effective 1 April 2026, completing the 12.5% architecture on the FPI side. About eighteen months after Budget 2024, sources told Business Today (11 January 2026) the Finance Ministry was weighing two distinct revisions specifically for FPIs.

The first lever: revert the FPI LTCC rate from 12.5% to 10% — the pre-Budget-2024 rate, reverted here only for FPIs, creating a fresh 2.5-point gap against the unchanged 12.5% domestic rate. The second: broaden the Section 10(23FE) exemption — currently confined to notified sovereign and pension funds for specified infrastructure investments — to a wider set of pension and endowment-style foreign capital. One is a broad rate cut; the other is a scope expansion.

The sequencing matters as much as the substance. Section 10(23FE) operates through CBDT notifications — bringing new entities under the regime can be done administratively where they fit existing specified-person categories, though a wider endowment-fund carve-out may need legislative clarification in the Finance Bill. A rate revision, by contrast, is unambiguously a Finance Bill change tied to the Budget cycle — administratively cleaner but politically heavier, because residents will read any FPI-only LTCC cut as an asymmetric concession. That makes a Section 10(23FE) extension (where it can be notified) the more likely first move, with anything broader saved as a Budget 2027 lever if FPI flows do not turn first.

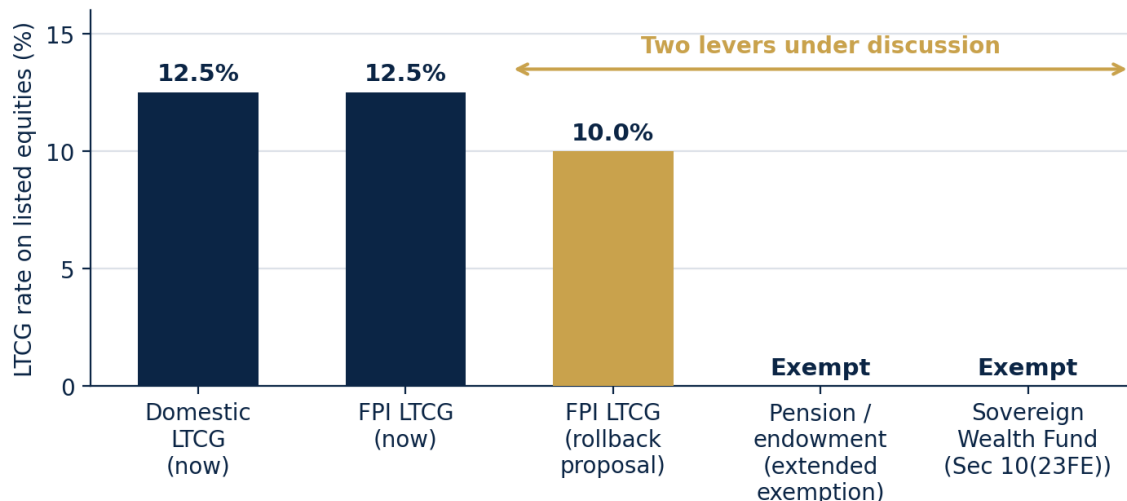


Chart 2. The two levers under discussion sit between today's 12.5% rate and the Section 10(23FE) zero-tax sovereign treatment.

Source: Income Tax Act, Section 10(23FE); Bajaj Finserv (LTCC rate); Business Today and Multibagg (rollback proposals); KPMG India Union Budget 2025-26 summary.

Counter-argument: pooled fund structures make selective FPI-only relief operationally complex, and any sustained re-rating of Indian equities ultimately requires uniform treatment, not a carve-out. The trade-off is sharp — a uniform rate cut is cleanest but costliest; a category-specific exemption is cheapest but messiest to implement.

3. The Tiger Global Verdict Is the Counter-Current — Substance-Over-Form Is Now the Operative Test

Even as the rate side is loosening, the substance side has tightened — a Tax Residency Certificate alone no longer secures treaty protection.

On 15 January 2026, the Supreme Court denied Tiger Global the India-Mauritius treaty exemption it had claimed on its 2018 Flipkart exit (₹967 crore withheld at source), holding the Mauritius entities were conduits and the transfer was indirect Indian-situs value outside the treaty. In the weeks after the verdict — with several reassessment cases time-barring on 31 March 2026 — the Income Tax Department issued notices to roughly seven foreign VC / PE firms on the same substance-over-form reasoning. The verdict is already active enforcement.

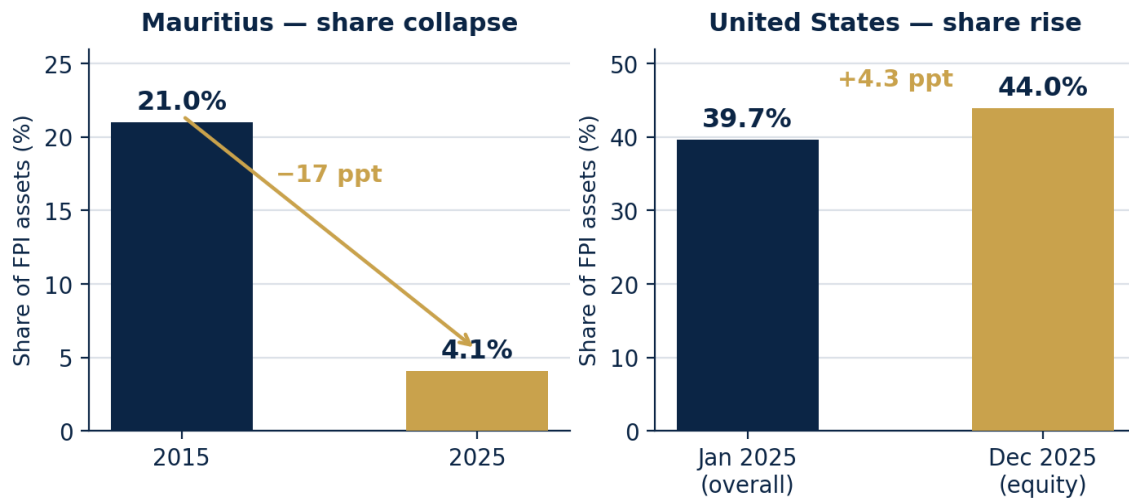


Chart 3. FPI source-jurisdiction shift — Mauritius from 21% (2015) to 4.1% (2025); US share of FPI equity at 44% (Dec 2025).
 Source: NSDL / CDSL country-wise data; Business Standard; News9live.

The substantive principle is the one that matters for everything that follows: a Tax Residency Certificate, by itself, is no longer conclusive of treaty eligibility where the structure lacks commercial and economic substance. The Court applied the existing GAAR framework (Chapter X-A) as the operative test on these facts, and the offshore investment playbook for India is being rebuilt around economic-substance tests rather than conduit-jurisdiction selection.

The shift in source jurisdictions confirms the policy is working. The Mauritius share of FPI assets has collapsed from about 21% in 2015 to 4.1% in 2025; the US share, on the other side of that move, rose from 39.7% (January 2025) to roughly 41% of overall FPI holdings by January 2026 — and to about 44% of FPI equity assets by December 2025. Treaty-route arbitrage is closing; flow is consolidating into the home jurisdictions that have nothing to gain from a TRC trick.

4. The Domestic Side Hasn't Broken — and That Is What Holds the Market

Domestic LTCG at 12.5% with a ₹1.25 lakh exemption has coexisted with record SIP inflows; the DII bid is the actual market support, with or without an FPI rollback.

On the domestic side, the same Budget 2024 LTCG hike that raised the FPI rate to 12.5% — and the parallel STT increase on derivatives — has not measurably broken retail behaviour. SIP inflows have continued to compound — ₹32,087 crore in March 2026 (all-time high) easing to ₹31,115 crore in April — with 9.72 crore contributing SIP accounts (AMFI, March 2026). DII buying, anchored by these record SIP flows but extending across mutual funds, insurers, EPFO and banks, has absorbed close to nine-tenths of the through-April FPI exit and roughly three-quarters of the mid-May figure.

The DII architecture is structurally rather than tax-sensitive: monthly SIPs are auto-debited, EPFO equity allocations are statutory, and NPS equity allocations are rule-bound. A 12.5% LTCG rate is a real cost to the long-term investor, but it has not disrupted the flow mechanism. That mechanism is what is actually holding the market, and any FPI relief that does arrive is incremental to a domestic bid that is already in place — not a rescue of a market that needs one.

Table 1. Rotation map — who is repriced as each FPI-policy outcome plays out.

Segment	Direction	Mechanism
Long-only / pension-fund-style strategies	Beneficiary	Direct beneficiary of either rollback or extended Sec 10(23FE) exemption
Index heavyweights (large-cap quality, financials)	Beneficiary	First to absorb any returning FPI bid — they sit in every benchmark
DII-supported domestic equity (PMS / SIP-fed)	Neutral / +	Domestic LTCG 12.5% has not broken the bid; rollback is incremental, not foundational
Hedge funds / short-term FPIs	Pressure	Not the target of relief; STT regime remains; horizon mismatch with LTCG benefit
Mauritius / Singapore-routed FPI structures	Pressure	Tiger Global verdict 15 Jan 2026: TRC alone no longer secures treaty protection
Pure treaty-shopping vehicles	Pressure	Substance-over-form is the operative test; GAAR scrutiny is the active counter-current

5. Three Scenarios — Sovereign-Pension Only, Full Rollback, or No Change

The base case is a partial extension of Sec 10(23FE) to pension and endowment funds; the upside is a full LTCG rollback; the downside is status quo through Budget 2027.

The most likely policy outcome is partial. A full LTCG rollback would re-open the question of whether residents should get parity — a politically expensive concession before the STT regime is netted off. A Sec 10(23FE) scope expansion, by contrast, can be drafted as a targeted notification under existing law, costs less fiscally, and targets the long-duration capital the system most wants to attract. Signposts: pre-Budget-2027 briefings (Nov-Dec), CBDT clarifications on Sec 10(23FE) scope, monthly NSDL FPI flows (two consecutive months of net inflow would flip the politics), STT receipts through Q4 FY26.

Table 2. Base / Upside / Downside — what each FPI-policy outcome does to the rotation.

Scenario	Policy outcome	FPI flow response	Portfolio read
Base case	Sec 10(23FE) notification extended to additional pension-fund categories (within existing law); any broader endowment carve-out parked for Budget 2027; FPI LTCG unchanged	Long-only sovereign-style sub-segment returns; broad FII bid muted	Hold rotation: overweight large-cap quality + financials
Upside	Full FPI LTCG rollback 12.5% → 10%	Broader FPI bid revival; STT base partially recoups	Broaden equity overweight; benefit from index repricing
Downside	No change in Budget 2027; status quo	FPI exit pace continues; DII bid must keep carrying	Stay defensive on FPI-heavy names; lean on DII-supported domestic cyclicals

Bottom line. Across all three scenarios, the rotation logic does not collapse — it shifts in degree, not in direction. The DII bid is the actual market support, and the FPI-side tax architecture is being re-priced in slow motion: a Section 10(23FE) notification widens the door incrementally; a Budget 2027 rate revision opens it wider but does not by itself reverse the substance-side tightening that Tiger Global has already locked in. The portfolio should be built for the base case (partial, notified relief) and stress-tested against the upside (broader FII bid revival) and the downside (status quo through Budget 2027) — not positioned for any one of them in isolation.

THE INVASSET READ

Stance. Position for partial relief — broadened Sec 10(23FE) — as base case. Overweight large-cap quality with sovereign-FPI exposure; avoid pure treaty-shopping structures.

Horizon. 6–9 months. The trade resolves on Budget 2027 (Feb 2027) and any interim CBDT or Finance Ministry signal.

View. The tax architecture — not the news cycle — is re-pricing the FII vs DII split. Partial FPI relief is more likely than a full rollback; Tiger Global keeps the substance side tight even if the rate side loosens.

What flips the view. A pre-Budget signal of a full FPI LTCG rollback to 10% (upside) — or an explicit Finance Ministry statement that no relief is coming (downside).

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