Background : Why Pass Through is essential for all AIF's

01. The existing IT Act ((Section 10(23)FB)) provides Pass Through taxation for all VCFs (irrespective of their status viz. VC/Infra/PE, etc.). VCFs are largely organised as Trusts under Indian Trust Act. Investors of such VCFs are required to pay tax on income earned from VCFs (Section 115U of IT Act) based on their individual tax bracket. It is to be noted that portion of Investors do not pay Income Tax, for example, LIC who are the significant investor in the Funds.

02. AIFs typically raise domestic money from HNIs, Family Offices and Financial Institutions. The fund raise typically happen over a period of 2 years and the funds starts investing after the first close (typically in a year) and the fund raise will continue for some time. Hence, all the beneficiaries who have invested in the trust are known only after final close of fund raise is completed.

03. The new AIF Regulations (August, 2012) replaced the erstwhile DVCF regulations. It divided AIFs into 2 categories AIF I and II and further added a third category AIF III for funds which leverage (Hedge Funds). Therefore, seeking a pass through status for AIF I and AIF II is a continuation of existing regulations for VCFs.

04. Providing a pass through status to all AIFs does not lead to any tax leakage from the revenue perspective as investors of such AIFs cannot escape payment of tax on their income from such AIFs as per applicable law. Tax liability is actually discharged by the investors. If required, AIFs can be asked to furnish details of income distributed by such AIFs to all its investors with their PAN details.

05. The new AIF regulations provide Pass Through taxation only to AIF I sub-category VCF. AIF I sub-category VCF is defined under 2(1)(z) of AIF Regulations as "which primarily investment in unlisted securities of start-ups or emerging or early stage venture capital undertakings". In India, the majority of funds invest across various stages and primarily in growth capital. All of them were covered under earlier DVCF regulations.

06. Providing a pass through status to such AIFs is a must to facilitate pooling of capital in India from both domestic & international investors and will provide such investors a certainty on the tax treatment based on their status as a tax payee. Additionally, AIFs are used as a pooling vehicle where both domestic and international investors invest substantially. The tax status of international investors, based on domicile varies from domicile to domicile.

07. Therefore, such pass through provisions are mandatory for Indian institutions such as LIC (in future PFRDA or EPF etc.) and not for foreign investors (who invest from favourable treaty jurisdictions) who do not want to commit their capital to such AIFs.

08. There is no logical argument ever offered by Tax department for seeking to tax AIFs other than stating that the same provides operational convenience to IT Department. However, in the process we are losing thousands of crores of both domestic and billions of dollars of foreign investment pooling opportunity in the country.

09. Further, there is lack of clarity among assessing officers whether the income from AIF or DVCF is in the nature of capital gain or business income. It is to be noted that in the recent budget (para 201) clarified that all income arising to Foreign Portfolio Investors (FPIs) from transaction in securities shall be considered as capital gains.

Development

01. On 28th July, 2014 unexpectedly the CBDT issued a circular stating that "all AIFs formed as Trusts whose beneficiaries are not specifically named at the time of formation of the Trust are to be taxed at the maximum marginal rate of tax". This circular apply to all AIFs other than AIF I.

02. It is quite obvious that no investors would invest in any of the AIFs other than AIF I sub-type VCF which are also now constrained after the new definition.

Solution

01. The AIF industry has grown substantially raising about Rs. 5000-6000 Crores of domestic money. In addition to domestic fund managers, typically raise about two times of this from the foreign investors. This industry is critical for both economic returns as well as job creation in the vast small and mid-market unlisted enterprises who are starved of equity capital.

02. A three part solution would make sense:

By SEBI

1.1 SEBI Chairman must re-iterate his formal position to the Minister that both AIF I and AIF II types should enjoy complete pass through taxation which was contemplated at the time of introduction of AIF Regulations and represented by SEBI in various communication to the Ministry of Finance. SEBI must take a position like FPIs, all income from AIFs should be treated as capital gains as there is no discretion of the assessing officer at the time of assessment.

1.2 As a confidence building measure, the SEBI Chairman should communicate via the press on SEBI's view of the fact that AIF I and AIF II must enjoy the pass through status and the income from both AIF 1 & II must be treated as capital gain. His statements on investment trusts before the Budget had a very positive impact on both the Industry as well as the policy makers.

1.3 The definition of AIF category I sub-type VCF is essentially a re-production of the original DVCA regulations in all manner, except for the preamble which states that "start-ups or emerging or early stage venture capital undertakings"mainly involved in new products, new services, and technology or new business model.

1.3.1 SEBI can simply make a minor alteration of the definition of VCU under Regulation 2(1)(z) **by changing one word by replacing "early" with "growth"** i.e "unlisted securities of start-ups, emerging or **growth** stage undertakings, mainly involved in new products, new services, and technology or new business model.

This captures the intention which also captures the 95% of the industry activity, as a stop-gap measure which will give immediate relief to the industry and can be done entirely by SEBI. This will go a long way to boost confidence as 100% of non-real estate and non-infrastructure funds will be captured by this definition.

By Income Tax

Clearly, the best and the long-term solution obviously, are to make the change in the definition:

2. In 10(23FB) of the Income Tax act, the definition of the Venture Capital company should be changed from "as Venture Capital Fund as a sub-category of Category I Alternative Investment Fund" to **"as Venture Capital Fund as a sub-category of Category Ior Category II Alternative Investment Fund"**

3. Similarly, taxation of the total income of Alternative Investment Funds (Category I or II or III) should follow the same principle outlined in Sec.115 AD of the Income Tax Act treating the same as "capital gain". This provision which is applicable to all foreign institutional investors, which now extended to Foreign Portfolio Investors (FPIs) in 2014 Budget.

   The clarity available in Sec.115 ADon treatment of transaction on securities as a capital gain should also be extended to VCFs/AIFs. In the absence of such a clarification many VCF/AIFs are suffering a hardship of fighting their cases with IT authorities and in the process blocking the distribution proceeds to the end investors. This again creates a negative environment for foreign and Indian investors.

   It's recommended that given the long term nature of capital commitment by the investors in AIFs they should stand ahead of FPI investors to be the beneficiary of this clarification. This will also help in creating a level playing field for domestic vs international investors.