

# Taxation of Alternative Investment Funds

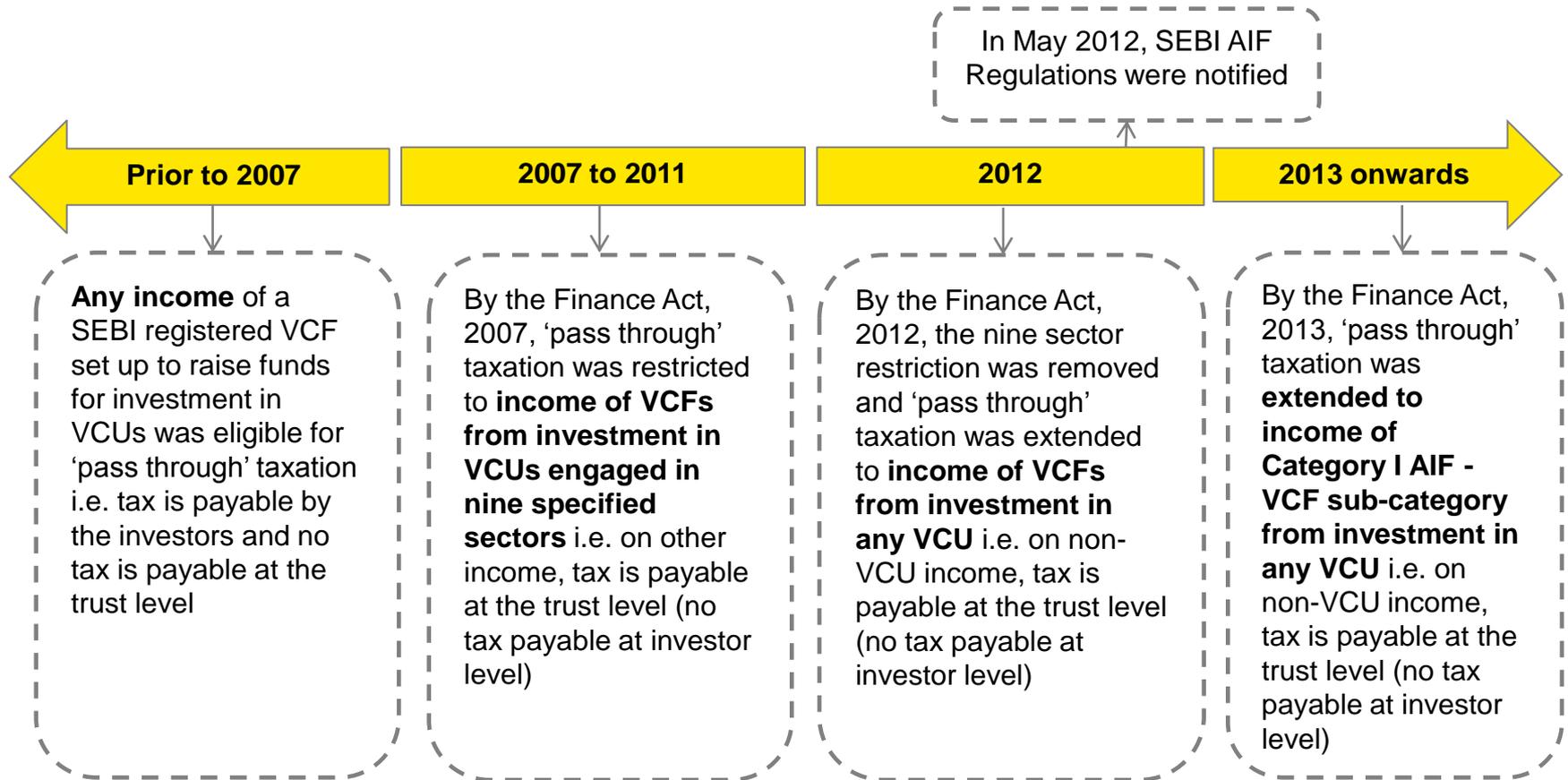
- Clarity and certainty required

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# Tax 'pass through' – section 10(23FB)/ 115U



Presently, in the absence of a 'pass through' provision, other AIFs i.e. Category I (other than VCF), II & III setup as a trust are taxable as per the framework for trust taxation in the tax law. The framework also applies to income of AIFs/VCFs from non-VCU income.

# Trust taxation framework

## - Relevant provisions

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- ▶ **Section 160** - Trustee appointed under a trust instrument is a representative assessee. Representative assessee deemed to be an assessee under the tax law
- ▶ **Section 161** - Trustee liable to assessment in his own name in respect of the trust's income. Tax payable to be determined in "*like manner and to the same extent*" as it would be recoverable from the trust's beneficiaries
  - ▶ If trust's income consists of, or includes, business profits, the whole income is taxable at maximum marginal rate (MMR) – section 161(1A)
- ▶ **Section 164** - Trust's income, which is not specifically receivable on behalf of/ for the benefit of any one person/ where the individual shares of the persons on whose behalf/for whose benefit such income is receivable are indeterminate or unknown, tax shall be charged on such income at MMR
  - ▶ The provisions shall not apply if the beneficiary name(s) and their individual share(s) is expressly stated in the trust deed on the date of such deed

The Authority for Advance Rulings, in the case of *AIG [1997] 224 ITR 473 (AIG ruling)*, held that this provision shall not come into operation provided the trust deed sets out expressly the manner in which beneficiaries are to be ascertained and also the shares to which each of the beneficiaries would be entitled without ambiguity and without leaving these to be decided upon at a future date on a discretionary basis

- ▶ **Section 166** - Direct assessment/ recovery of tax from the trust's beneficiary is permitted

**Conceptually, the provisions envisage a single level taxation of trust's income i.e. taxation either in the hands of the trustee or in the hands of the beneficiary but not both**

# CBDT Circular No.13 dated 28 July 2014

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- ▶ CBDT has responded to clarification sought on tax treatment of AIF (being non charitable trusts) where the investors name and beneficial interest are not explicitly known on the date of its creation (such information becoming available only when the funds start accepting investor contributions)
- ▶ CBDT has clarified as follows:
  - ▶ Where the trust deed does not name the investors or does not specify their beneficial interest, the trust will be regarded as an indeterminate (or discretionary trust) – resultantly, under the provisions of section 164 the entire income of the funds shall be taxed at MMR in the hands of the AIF's trustee. Provisions for direct taxation of investors contained in section 166 shall not be invoked as income has already been taxed in the hands of the trustee.
  - ▶ Where the trust deed names the investors and their beneficial interest and the trust's income consists of or includes business profits, the whole of the AIF's income would be subject to tax at MMR in the hands of the trustee as per section 161(1A).
  - ▶ It has also been stated that the Circular shall not be operative in the area falling in a High Court jurisdiction that takes or has taken a contrary decision on the issue

**The Circular creates significant tax uncertainty for AIFs setup as trust excluding those that are covered by the provisions of section 10(23FB) and 115U of the tax law**

# AIF tax position

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- ▶ Under SEBI (AIF) Regulations 2012, AIFs raise funds from investors whether Indian, foreign or non-resident Indians by way of issue of units
  - ▶ Unit is defined as the beneficial interest of the investors in the AIF
- ▶ The AIF Regulations require all the key information as may be necessary for the investor to take an informed investment decision to be disclosed in the AIF's placement memorandum
  - ▶ All the key legal aspects of the placement memorandum are reflected in the AIF's trust deed and associated documentation
- ▶ The AIF's trustee and its investment manager are bound by the above covenants and any departure requires SEBI approval and/or majority investor consent
- ▶ Given the manner in which AIF's raise investor commitments, in a majority of the cases, the investor names and shares are not known on the date of the trust deed
  - ▶ However, the trust deed and associated legally binding documentation will always set out expressly the manner in which beneficiaries are to be ascertained and also the shares to which each of the beneficiaries would be entitled (without any discretion)

**Relying on inter alia the AIG ruling and the above factors, AIFs setup as trusts have taken a position that they are a determinate trust and do not attract the provisions of section 164 (tax at MMR)**

# AIF tax position (contd.)

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- ▶ Predominantly, all Category I and II AIFs invest with the objective of long term capital appreciation and/or for earning dividends and interest. These AIFs are by Regulation not permitted to borrow with respect to their investment activities

**Based on these factors, relying on CBDT circular/instructions and judicial precedents, the AIFs take a view that the gains realised are in the nature of “capital gains”**

- ▶ Tax is paid on the AIFs income at either the trust level or the investors level (where tax is paid at the investors level, appropriate documentation supporting payment of taxes by the investor is maintained by the AIF's trustee)
- ▶ However, AIFs, inter alia, face the following challenges before the tax administration:
  - ▶ Classification of the trust as a determinate trust (to mitigate the trigger of section 164)
  - ▶ Characterisation of income as business income [to mitigate the trigger of section 161(1A)]
  - ▶ Taxation of income at the AIF level despite tax having been paid by the investor on the AIF's income (and vice versa)
  - ▶ Claiming credit for taxes paid by the AIF in the investors' tax returns
  - ▶ Dual points of taxation of income for AIFs/VCFs covered by section 10(23FB)/115U (for VCU and non VCU income)

# Request for clarification/ tax law amendment

**Ashok Lahiri chaired Advisory Committee on Venture Capital and K.B. Chandrasekhar Committee on Venture Capital have supported a tax pass through status for funds (*i.e. once registered with SEBI, the fund should be entitled to automatic tax pass through at the pool level while maintaining taxation at the investor level without any other requirement under the tax law*)**

- ▶ Amend the Income-tax Act 1961 to grant tax 'pass through' status to all AIFs
  - ▶ Amend section 10(23FB) to provide a tax pass through status to all Categories of AIFs (*at least all Category I and II AIFs*)
  - ▶ Amend section 10(23FB) to extend the tax treatment to any income (for inclusion of non-VCU income) – this will mitigate the present dual point of taxation faced currently by VCFs/ Category I AIF(VCF)
  - ▶ Amend section 115U to impose the tax liability on the AIFs income on its investors, based on the details provided by the AIF (in Form no 64)
  - ▶ Exempt from tax withholding provisions any interest payments to AIFs (this will mitigate the AIFs need to file a tax return solely for the purposes of claiming a tax refund)

**The aforesaid provisions should not cause any revenue loss. As such, they will effectively shift the point of taxation to the investor thereby providing AIFs and their sponsors/ trustees much needed clarity**

# Request for clarification/ tax law amendment

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- ▶ As an interim measure, pending the tax law amendment, clarify the following by way of a CBDT circular:
  - ▶ Clarify that the provisions of section 164 will not be attracted so long as the trust deed sets out expressly the manner in which beneficiaries are to be ascertained and also the shares to which each of the beneficiaries would be entitled without ambiguity and without leaving these to be decided upon at a future date on a discretionary basis
  - ▶ Trustees to consequently discharge taxes in a *“like manner and to the same extent”* as it would be recoverable from the AIF’s beneficiaries
  - ▶ Provide a mechanism for the AIF (similar to that contained in Rule 37BA of the Income tax Rules, 1962) to pass over credit of tax paid by the AIF (including tax withheld in its name) to the beneficiary including reflecting such tax payments in the investors’ Form 26AS
  - ▶ Instruct assessing officers explicitly that where reasonable evidence of tax paid by the AIF investors is produced by the AIF, no tax shall be recovered from the AIF on its income. Likewise, where reasonable evidence of tax paid by the AIF is produced by the investors, no tax shall be recovered from the investors on income earned from AIFs

# Request for clarification/ tax law amendment

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- ▶ Gains from investment by AIFs (at least all Category I and II AIFs) in listed or unlisted securities should be characterized as 'capital gains'
  - ▶ The Finance Bill 2014 proposes to amend the definition of capital asset under section 2(14) to include securities held by Foreign Institutional Investors. Resultantly, notwithstanding their individual trading patterns/ investment strategy, FII gains from securities transactions shall be characterised as capital gains and be entitled to concessional rates of tax provided in the tax law
  - ▶ Based on historical CBDT circulars and judicial precedents on the subject, gains derived by AIFs (Category I and II AIFs) should be regarded as 'capital gains'
  - ▶ For the above reason and to eliminate an apparent disparity between foreign investors and comparable domestic investors, the benefit of the deeming provision in the tax law should also be extended to securities held by SEBI registered AIFs

**The aforesaid provisions should not cause any revenue loss given that the clarification will be consistent with the current practice. The amendment will however provide much needed clarity and mitigate avoidable litigation for the AIFs and their sponsors, trustees and investors**

# Glossary

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AIF	Alternative Investment Fund
CBDT	Central Board of Direct Taxes
SEBI	Securities and Exchange Board of India
VCF	Venture Capital Fund
VCU	Venture Capital Undertaking