To, **August 29, 2014**

Mr Arvind Mayaram
Finance Secretary, Department of Economic Affairs
Ministry of Finance, New Delhi, India

Subject - Alternative Investment Funds urgently seek tax clarity and certainty

Dear Sir,

Securities and Exchange Board of India (SEBI) registered Venture Capital Funds (VCFs)/Alternative Investment Funds (AIFs) and Foreign Venture Capital Investors (FVCIs) have contributed Rs 83,000 crores as Private Equity - Venture Capital (PE-VC) investments to a large number of Indian companies at different stages of evolution, averaging approximately INR 9,000 crores annually.

Unlike many other sources of capital, such as Foreign Portfolio Investment or Capital Markets, PE-VC (administered through VCF/AIF / FVCI) is a stable source of long term (generally 5-7 years) capital for businesses in India. Domestic capital pools are also opening up, with over INR 6,000 Cr currently being raised, growing from Rs 4,200 Cr last year.

In 2012,the erstwhile VCF regulations were substituted with the SEBI AIF Regulations, 2012 (AIF Regulations).Due to possible coordination gaps between SEBI and CBDT at the time of the promulgation of AIF regulations and the transition from VCF Regulations to AIF Regulations not being effectively harmonized, the ‘pass through’ status of the erstwhile VCFs was not appropriatelycarried over to the AIF regulations. A 'pass through' regime has the feature that taxation applicable to specific investors, continues to be applicable when they invest in a pooled fund vehicle. For example, different taxation applies to foreign investors (e.g. from nations with tax treaties), domestic individual investors and domestic institutions (e.g. institutions such as the Life Insurance Corporation have special tax status).

The ‘pass through’ status was limited only to one sub-type of the six identified fund-types under AIF Regulations. The sub-type that has been given ‘pass through’ status under AIF Regulations is “Venture Capital Funds” under Category I *(the definition of “Venture Capital Funds” under AIF regulations is limited only to early-stage funds, as against the generic wider definition of the same term under the erstwhile VCF regulations not restricted to early stage funds only),*and not

to others i.e. AIFs registered as Category I (other than VCF), II and III were not granted a 'pass through' status under the the Income-tax Act, 1961 ('the Act').

The restriction of pass-through status only to early-stage funds under the Act, means that effectively, less than 2% of the PE-VC capital pool have the 'pass through' status, as against all funds getting the status under the erstwhile VCF regulations.

A 'pass through' under section 10 (23 FB) read with 115 U of the Income-tax Act, 1961 (the Act) to AIFs does not result in any tax leakage, or revenue loss, to the exchequer and therefore, it is not a concession. Further, AIFs can be asked to provide details of their income and beneficiaries, and the beneficiaries of AIFs income are liable to pay tax on income received based on their tax status.

In the absence of a 'pass through' status for all AIFs, various AIFs adopted a determinate trust structure to ensure pass through nature of AIFs. However, a recent CBDT Circular No 13 dated 28 July 2014 issued by the CBDT, in the context of AIFs , has issued clarifications, whereby, all existing AIFs, not having the names and beneficial interest of all the contributors upfront at the time of the formation of the AIF, may lose their pass through status. In the absence of a 'pass through' status, AIFs will not be feasible in the future.

In order to prevent the cessation of fund-raising by AIFs and the decline of the industry, we request that tax 'pass through' status is made applicable to all SEBI-registered AIFs and thereby encourage the formation of domestic pools of stable, long-term capital.

The size of capital of AIF's will rise manifold if a pass through status under section 10 (23FB), read with section 115 U of the Income tax Act, 1961 is made applicable to all AIFs and the recent clarification issued to Foreign Portfolio Investments (relating to characterisation as capital gains) is extended to AIFs.

In connection with the above, we have enclosed the following annexures –

- **Annexure 1** - Relevance of PE-VC investments [specifically in the context of VCF/ AIFs / FVCIs] in the Indian economic scenario and background on AIF Regulations
- **Annexure 2**-Background on taxation of AIFs and key issues
- **Annexure 3** - Immediate action that is required from a long term perspective, to resolve the tax issues faced by AIFs
- **Annexure 4** - Interim measures required to resolve the tax issues faced by AIFs

We look forward to an expeditious and favourable action to save AIFs/VCFs which not only provide stable, long-term capital but contribute significantly to improve corporate governance,

create lacs of jobs and generate increased tax revenues for the exchequer through direct and indirect tax contribution by their portfolio companies and AIF Fund managers.

Thank you.

Respectfully,

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President
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Annexure 1 - Relevance of PE-VC investments in the Indian economic scenario and background on AIF Regulations

1. The PE-VC industry has rapidly evolved during the last 10 years. From an annual investment volume of less than USD 0.25 billion in 2001, the Indian PE-VC industry has grown significantly to annual investment volume of USD 8-10 billion across 300-350 investment deals, thereby reaching out to a vast majority of the Indian industry. The AIF Regulations have also provided a good framework for domestic capital to flow into the industry.

2. PE investments have been a part of India's emerging story for years, during which time we have seen a multitude of events shaping the investment climate in India. PE has been a significant source of long-term risk capital for the Indian industry, especially in the last decade.It is reported that PE funds (foreign and domestic) have invested a total of US$71.13 billion[1] from 2006 to July 2013. The PE-VC industry has accounted for an estimated USD 93 billion of sticky, long term foreign capital flows into the country's economy during the last 13 years. The impact of the PE sector on economic development in India is amplified by the scarcity of capital available with the entrepreneurial class and the challenges in accessing the IPO route for raising capital.

3. As exemplified by the investment data, while PE funds have invested in start-up/ early stage investments, a significant portion of PE investments have been made in the expansion/ growth stage of Indian companies. This trend would be reflected both in investment by foreign funds and by domestic VCFs/ AIFs.

4. Further, the investments in the small and mid-size companies have also remarkably increased in last few years. A significant proportion of PE-VC capital has been invested in unlisted, SME companies which have very few avenues of raising equity capital from the markets. With the increase in the number of entrepreneurs looking to raise funds, angel and seed stage funding are also expected to increase in the coming years.

5. The domestic PE/VC sector in India is a relatively new means of raising capital for Indian entrepreneurs. SEBI issued the VCF Regulations in 1996. However, investment through this route only gained momentum in 2006. As per SEBI data, domestic VCFs have cumulatively investedINR 35,987 crores and foreign investors under the FVCI route have cumulatively invested INR 45,262 crores, as on 31 March 2014[2]. A majority of these investments, consistent with the above statistics, would be expansion/ growth capital investments made by PE funds that have been raised under the VCF Regulations.

[1] Ernst & Young research
[2] Source: SEBI

A sector-wise break-up of investments (in INR, crores) by VCFs and FVCIs from inception till 31 March 2014 is provided in table below-

SECTORS OF ECONOMY	VCF/ FVCI
Information Technology	5380
Telecommunication	7642
Pharmaceuticals	1039
Biotechnology	327
Media / Entertainment	1271
Services Sector	3867
Industrial Products	2274
Real Estate	12053
Others	36201
TOTAL	**70054**

6. On the regulatory front, SEBI introduced a comprehensive legal framework in the form of AIF Regulations in May 2012 repealing the VCF Regulations and grandfathering funds that have already been raised under the VCF Regulations. AIF Regulations were introduced acknowledging the sector's demand to allow fund managers the flexibility to design fund products to cater to wider investor demand/ risk profiles, to provide targeted concessions to certain funds, as well as to bring within the ambit of regulation all types of domestic pooling vehicles. Due to possible coordination gaps between SEBI and CBDT and the transition from VCF Regulations to AIF Regulations not being effectively harmonized, at the time of promulgating AIF Regulations, the 'Pass through' status of erstwhile VCFs was not appropriately carried over to the AIF Regulations. The 'Pass through' status was limited only to one sub-type of the six identified fund-types under AIF regulations. The sub-type that has been given 'Pass through' status under AIF regulations is "Venture Capital Funds" under Category I *(the definition of "Venture Capital Funds" under AIF Regulations is limited only to early-stage funds, as against the generic wider definition of the same term under erstwhile VCF Regulations not restricted to early stage funds only),*and not to others i.e. AIFs registered as Category I (other than VCF), II and III were not granted a 'Pass through' status under the Act.

7. Under the AIF Regulations, domestic funds are required to register as AIFs under three broad categories depending on their investment strategy –

   - Category I - Funds that invest in startup or early-stage ventures or social ventures or SMEs or infrastructure or other sectors or areas that the government or regulators consider as socially or economically desirable. This includes VCFs, SME funds, social venture funds and infrastructure funds.

- Category II - Funds that do not fall in Category I and III AIF and that do not undertake leverage or borrowing other than to meet the permitted day-to-day operational requirement. This includes private equity and debt funds.

- Category III - Funds that employ diverse or complex trading strategies and may employ leverage, including through investment in listed or unlisted derivatives. This includes hedge funds.

8. With the AIF Regulations now making a clear distinction between VCFs and PE funds, fund managers raising capital primarily for growth capital investments are registering as Category II AIFs. Based on the data available from SEBI, under the AIF Regulations, 106funds have been registered till 31 May 2014. Out of these AIFs, about 85% are non-Category I -VCFs (i.e. registered under other categories/ sub-categories).In the terms of value of the share of these AIFs, nearly 98% of the total capital commitments raised by these AIFs do not represent VCFs i.e. out of a total commitment of INR 13,465 crores, only INR 264 crores is from AIF category I - VCFs. Effectively, less than 2% of the PE-VC capital pool has been given the 'Pass through' status, as against the total 100% getting the status under the erstwhile VCF Regulations. A category wise break-up of commitments/funds raised and investments made (in INR, crores), as on 31 March 2014 is provided intable below -

Category	Commitments raised	% of TotalCommitments raised	Investments made	% of Total Investments made
Category I				
Infrastructure Fund	5619.25	41.73%	170.25	5.08%
Social Venture Fund	428.29	3.18%	38.91	1.16%
Venture Capital Fund	264.09	1.96%	14.68	0.44%
SME Fund	0	0.00%	0	0.00%
Category I Total	6311.63	46.87%	223.84	6.69%
Category II	6059.08	45.00%	2479.63	74.06%
Category III	1094.63	8.13%	644.82	19.26%
Grand Total	13465.34	100.00%	3348.29	100.00%

Note : The above report is compiled on the basis of quarterly/monthly information submitted to SEBI by registered AIFs.

Annexure 2 - Background on taxation of AIFs and key issues

1. Section 10(23FB) of the Act, inserted in the Act by the Finance Act 2000, encapsulates the current provisions for taxation of VCFs registered with SEBI[3]. Section 10(23FB) of the Act, until its amendment by the Finance Act 2007, provided an exemption on *any* income earned by SEBI registered VCFs. At this stage, VCFs were exempt from tax on any income earned irrespective of whether the income is derived from investment in a venture capital undertaking (VCU)[4](albeit section 115U of the Act provides for the discharge of taxes by the investors on the income earned by the VCF). This provision was amended by the Finance Act 2007 to introduce limitations to the aforesaid exemption to only income from investment in specified sectors[5]. Subsequently, based on industry representations on the hardships faced by VCFs, section 10(23FB) of the Act was again amended by the Finance Act 2012 to remove the sector restrictions and once again exempt income earned by VCFs. The distinction however was that in the 2012 amendment, the exemption was restricted to only income from investments in VCUs (as defined in the VCF Regulations) leaving the residual income (from treasury investments and investments in entities that do not qualify as a VCU) to be taxed at the VCF level.

2. As discussed above, in May 2012, the VCF Regulations were repealed and the AIF Regulations were notified by SEBI. With a new regulatory framework, there was a need for the Act to provide a basis for taxation of AIFs. Consequently, the Finance Act 2013 amended section 10(23FB) of the Act to extend the tax treatment for VCFs to only the VCF sub-category of Category I AIFs. Therefore, this amendment left outside the purview of section 10(23FB) a majority of the AIFs who presently do not have a specific code in the Act for their taxation.

3. Pertinently, section 115U of the Act which is a corresponding provision in the tax law that deals with taxation of income earned by investors in VCFs (and now AIFs) provides a direct charge of tax on the investors for such income (to the extent it is exempt at the VCF/AIF level) in the same manner as it would have been taxed had the investor made the investment directly.*In essence therefore the provisions of sections 10(23FB) and 115U of the Act provide a single level levy of tax on specified income from investments in venture capital funds.* This is similar to the manner in which determinate trusts formed and registered in India are taxed. The sections merely clarify the party that will be liable under the Act to pay the tax.

[3]Before the introduction of section 10(23FB), taxation of VCFs was governed by section 10(23F) and subsequently by section 10(23FA) of the Act

[4]The SEBI (VCF) Regulations, 1996 have historically permitted registered VCFs to invest in any sector (subject to a negative list). The investment conditions permit VCFs to invest (upto a specified extent) in companies other than those that qualify as a VCU under the VCF Regulations

[5]The Act specified a list of nine sectors for this purpose by defining the term VCU in a more restrictive manner

4. The present tax provisions creates the following disparities:

- Sections 10(23FB) and 115U of the Act apply only to VCF sub-category of Category I AIFs. The AIF Regulations recognise Category I AIFs as AIFs that *"are generally perceived to have positive spillover effects on economy and for which the Board or Government of India or other regulators in India might consider providing incentives or concessions"*. However, the tax provisions have only been extended to VCF sub-category of Category I AIFs thereby creating a disparity inter se in the tax treatment of different types of Category 1 AIF funds (other subcategories include SME funds, social venture funds, infrastructure funds).

- *Category II (which comprise of private equity and debt funds also have a positive spillover effect on the economy) and Category III funds are not entitled to tax pass through status.*

Finally, VCFs/AIFs are permitted by the SEBI regulations to make investments in entities that do not qualify as VCUs to a specified extent. The present tax pass through treatment, where available, only extends to income from investment in VCU. This creates dual points of tax compliance ie income from VCU investments is taxed at the investor level and income from non-VCU investments at the trust level, which adds to the complexity for investors, fund managers and the tax administration.

Issues with trust taxation

5. The majority of domestic VCFs/AIFs are constituted in the form of trusts. Where a codified tax provision for taxation of VCFs/AIFs (including for a portion of their income) is not available, one would need to fall back on the provisions of the Act as relevant to taxation of trusts generally. The provisions for taxation of trusts contained in section 160 to 166 of the Act had been designed prior to the evolution of the funds industry - mutual funds, private equity, AIFs etc.

Determinate vs indeterminate

The provisions of section 161(1) of the Act impose the tax liability in respect of a trust's income on its trustee in a representative capacity, the trustee in turn is required to determine the tax liability *"in a like manner and to the same extent"* had the tax been recoverable from the beneficiaries directly. This section applies where the individual shares of the beneficiaries are determinate and known. Explanation 1 to section 164 is a special provision that sets out the circumstances in which the individual shares of a beneficiary are indeterminate and unknown. The Explanation casts some doubt on whether the individual shares of the beneficiaries of a VCFs/ AIFs, who may join the fund

at various stages, are "determinate and known" for the purposes of taxation[6]. Briefly, a trust is regarded as a determinate trust, if the name of the beneficiaries and their individual shares are expressly stated in the instrument of trust and are identifiable on the date of instrument. The individual share of the persons for whose benefit such income is receivable is not ascertainable on the date of the instrument, the trust is regarded as an indeterminate trust. In such a case, the income of the trust is taxable in the hands of the trustee at maximum marginal rate (MMR).

Circular No. 281 dated September 22, 1980, which explained the amendments to the Act by the Finance (No 2) Act, 1980, specifically stated that "it is not necessary that the beneficiary in the relevant previous year should be actually named in the … instrument of trust, all that is necessary is that the beneficiary should be identifiable with reference to the … instrument of trust on the date of such … deed". Further, the Circular clarifies that trusts under which discretion is given to the trustee to decide allocation of income every year or where a right is given to the beneficiary to exercise the option to receive the income or not each year will be regarded as discretionary trusts.

Given the manner in which AIF's raise investor commitments, it is practically not feasible to know the names of the beneficiaries at the time of formation of trust as the raising of money typically happens subsequent to the formation of trust/ registration with SEBI. Thus, in a majority of the cases, the investor names and shares are not known on the date of the trust deed. However, since the trust deed and associated legally binding documentation expressly set out the manner in which beneficiaries are to be ascertained and also the shares to which each of the beneficiaries would be entitled a position is adopted that the trust is a determinate trust. In this regard, reliance is placed on the decision of the Authority for Advance Rulings, in the case of AIG [1997] 224 ITR 473.

Capital gains vs business profits

Section 161(1A) of the Act provides that where the income of a trust consists of or includes profits and gains of business, tax shall be charged on the whole of the income of the trust at the maximum marginal rate.

CBDT Circular No. 13 dated 28 July 2014 (CBDT Circular)

6. In response to the clarifications sought on tax treatment of AIFs (not covered under section 10(23FB) of the Act), the CBDT Circular provides the following clarification -

[6]Conceptually, a VCF/AIF will always be determinate given that at any given point of time, the income/assets of the trust belong to a determinate set of investors for a certain share

- 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 of the Act, the entire income of the fund shall be taxed at MMR in the hands of the AIF's trustee. Provisions for direct taxation of investors contained in section 166 of the Act 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) of the Act.

- The circular also states that it 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 instead of clarifying and simplifying the taxation of AIFs (not covered under section 10(23FB) of the Act), has created significant tax uncertainty.

We have summarised below the key tax issues faced by AIFs -

- As on 31 May 2014, 106 funds have been registered under the AIF Regulations. Out of these, about 90 AIFs are Category I (other than VCF)/ Category II/ Category III, with majority being Category II AIFs i.e. funds which invest in companies/ sectors which have a high growth potential. Under the Act, AIFs registered as Category I (Other than VCF), II & III do not have a specific tax 'Pass through', since section 10(23FB) of the Act, is applicable only to Category I - VCFs.

- Characterization of income from investments in securities has always been a vexed issue with no objective criteria and only guiding principles to distinguish a capital asset and stock in trade. The CBDT Circular provides that if the income of a determinate trust consists of or includes business profits, it will be subject to taxation at MMR. While this is already provided under the Act, now there is greater probability of tax authorities characterising the gains from investments by AIFs as 'business profits' so as to tax the entire income at MMR. In view of the subjective nature of this determination, given that Category I and II AIF's typically have a medium to long term view on their investments a clarification that their income would be deemed to be capital gains would help in achieving certainty on this aspect as well.

- Section 10 (23FB) of the Act does not provide tax pass through treatment to non-VCU income of VCFs and AIF Category I - VCF. Taxation of non-VCU income at trust level, creates dual points of tax compliance ie income from VCU investments is taxed at the

investor level and income from non-VCU investments is taxed at the trust level. This adds to the complexity for investors, fund managers and the tax administration.

Annexure 3 - Immediate action that is required from a long term perspective, to resolve the tax issues faced by AIFs

Provide tax pass through to all Categories of AIFs

A. Action required

- Amend section 10(23FB) of the Act to provide a tax pass through status to all Categories of AIFs (at least all Category I and II AIFs) and all income earned by them.
- Correspondingly amend section 115U of the Actto impose the tax liability on the AIFs income on its investors, based on the details provided by the AIF.
- 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).

B. Rationale

- Several committees[7] have greatly emphasized the importance of providing fiscal neutrality to VCFs, as income is taxed in the hands of the final recipient and the intermediary body is considered a pass-through entity. A pass-through tax status granted to SEBI-registered AIFs would put India at par with other countries, where the tax pass-through is automatically available to collective investment vehicles.
- A tax pass-through system ensures that tax collected on the fund's income is no more than the tax that would have been payable had the investor invested funds directly in the investee company/asset. This is fundamentally the basis on which Indian determinate trusts are taxed under the provisions of the Act. Accordingly, where the tax pass-through is extended to AIFs, there should not be any loss to the revenue, on an as is basis. Further, there is also no deferral of tax since the investors will be liable to pay tax as and when income is accrued to the AIFs.
- On the contrary, clarity of tax pass through should bring additional flows into the AIFs, which as they accrue capital appreciation should result in additional tax receipts to the Government. Further, growth of the AIFs in India would directly contribute to growth in

[7] The K.B. Chandrasekhar Committee Report dated 8 January 2000, The Advisory Committee on Venture Capital set up under the Chairmanship of Dr. Ashok Lahiri in its report issued in the year 2003

fees for managers of AIFs, which again will directly correspond to growth in corporate and individual income-tax and service tax collections[8].

Deemed characterisation of investment gains of VCFs/ FVCIs/ AIFs as capital gains

A. Action required

- Amend the definition of capital asset under section 2(14) of the Act to include securities held by VCFs/ FVCIs/ AIFs.

B. Rationale

- The Finance Act, 2014 has amended the definition of capital asset under section 2(14) to include securities held by FIIs.Resultantly, notwithstanding their individual trading patterns/ investment strategy, FII gains from securities transactions shall be characterized as capital gains and be entitled to concessional rates of tax provided in the tax law. This results in an apparent disparity between FIIs on the one side and AIFs/ VCFs/ FVCIs on the other.

- Given the long term nature of investments under AIF/ VCF/ FVCI route, these investors should stand ahead of FII investors to be the beneficiary of this clarification. This will also help in creating a level playing field for all the investors.

- The amendment should not cause any revenue loss given that the clarification will be consistent with the current practice. It will however provide much needed clarity and mitigate avoidable litigation with the tax authorities.

[8] Illustratively, for every Rs 1,000 crores growth in assets under management (AUM), the approximate service tax collected will be Rs 2.5 crores (assuming an average fee of 2% of AUM) and corporate and individual income-tax will be Rs 4.5 crores (assuming that 75% of gross income would be subject to income-tax allowing for 25% of expense deduction other than salaries). It is estimated that tax certainty can contribute to at least a 50% growth in inflows in PE funds which would have a significant multiplier effect on the Indian economy.

Annexure 4 - Interim measures required to resolve the tax issues faced by AIFs

Withdraw Circular No 13 dated 28 July 2014 and issue a new circular clarifying following -

1. Income of AIFs [other than the AIFs covered under section 10(23FB) read with section 115U of the Act] would be liable to tax in the hands of its trustee(s) in the capacity of a 'representative assessee' as defined u/s 160(1)(iv) of the Act. As provided in section 161(1) of the Act, the tax liability of the trustee in respect of the income of the AIF shall be determined in a like manner and to the same extent as it would be leviable upon and recoverable from the beneficiaries of the AIFs. **A clarification is sought that where the tax is discharged on the AIF's income using the Permanent Account Number of the AIF's investors (to enable the investors in the AIF trust to take credit for the tax paid by the AIF in their individual tax returns while offering their individual share of the AIF trust's income/ gains), no action under section 161 of the Act to recover the tax from the trustee will be initiated where evidence of tax payment by the AIF's trustee from the AIF's property is provided.**

2. In relation to provisions of section 164(1) of the Act, it has been provided in Explanation 1 to section 164 that for the purpose of the said section, the persons and their individual shares on whose behalf or for whose benefit the income is receivable shall be deemed to be unknown unless the persons and their individual shares are expressly stated in the instrument of trust and are identifiable/ascertainable as such on the date of the instrument. In view of the Securities and Exchange Board of India (AIF) Regulations, 2012, which specifically provide the manner in which AIFs raise funds (by way of issue of units, being the beneficial interest of the investors in the AIF) and the judicial interpretation of the aforesaid provisions, **a clarification is sought that the provisions of section 164 of the Act should not be attracted where the instrument of trust 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. The clarification sought is consistent with the judicial interpretation of Explanation 1 to section 164 of the Act and the rationale for its introduction by the Finance (No 2) Act, 1980 explained in Circular No. 281 dated September 22, 1980.**

3. Circular No. 281 dated September 22, 1980, which explained the amendments to the Act by the Finance (No 2) Act, 1980, specifically stated that *"it is not necessary that the beneficiary in the relevant previous year should be actually named in the … instrument of trust, all that is necessary is that the beneficiary should be identifiable with reference to the … instrument of trust on the date of such … deed"*. Further, the Circular clarifies that trusts under which discretion is given to the trustee to decide allocation of income every

year or where a right is given to the beneficiary to exercise the option to receive the income or not each year will be regarded as discretionary trusts.

4. In connection with the characterisation of an AIF's investment gains as "capital gains" vis-a-vis "profits and gains of business", the Central Board of Direct Taxes has issued Instruction No.1827 dated August 31, 1989 which was supplemented by Circular No 4/2007, dated June 15, 2007 on the issue of distinction between a capital asset and a trading asset. While maintaining that no single principle would be decisive and the total effect of all the principles should be considered to determine whether in a given case the investment is held as a trading asset or as a capital asset, we seek **clarification that the following indicators should be determinative of the AIF's investments being capital assets:**

   i. **The investments are made for long term appreciation and/or for earning dividends and interest.**
   ii. **The investments are made out of the AIF's own funds and not out of any borrowings.**
   iii. **Medium to long-term holding period of the investments before they are sold. An average holding period of the portfolio in excess of two years may serve as a useful benchmark in this regard.**
   iv. **Low magnitude of purchases and sales and ratio between purchases and sales and the holding.**

5. It should further be clarified that generally, AIFs are setup for long-term investment and assessing officers should not hold in routine manner that income is in nature of profits and gains of business. Where the AIF's investment gains are characterised as "capital gains", the application of section 161(1A) of the Act should not arise