Taxation of Alternative Investment Funds

- Clarity and certainty required

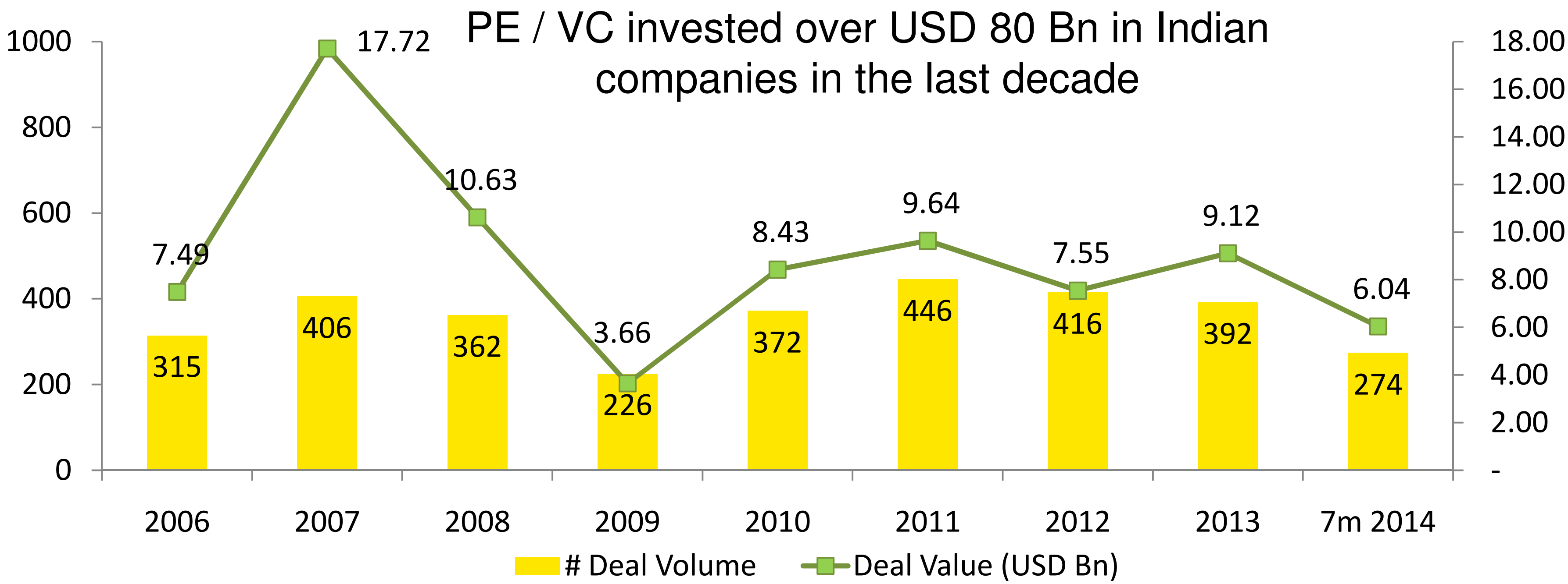
29 August 2014

Building a better working world

PE / VC is a critical source of long-term risk capital, with multi-pronged benefits

- Over USD 80 Bn investment in Indian companies by PE/VC over last 10 years
  - USD 7 - 10 Bn of yearly PE/VC investments (in 300 – 400 transactions), which is about 4x capital raised from IPO
- Over 200 active fund managers operating in India
  - Of which, about 100 are domestic fund managers
- Domestic capital pools are opening up, with over USD 1 Bn currently being raised, growing from USD 0.7 Bn in the last year
- PE / VC invests across stages – early, growth, matures stages including listed companies
  - Steady source of long-term risk capital
- With only 2.2 Mn jobs created in organized sector in last 20 years (1991-2011), PE / VC can play critical role in job-creation through start-ups and SMEs
- PE/VC aids in driving performance and corporate governance culture in corporate sector

Private equity/ venture capital investments over last 8 years



- PE/ VC has played significant role in economic development of India, creation of jobs and funding of early stage and growth companies across sectors
- Significant portion of investment are direct investment in India from offshore funds, with very limited operations in India due to uncertainty and lack of consistency in tax laws

Investment by VCFs, FVCIs & AIFs

Rs 13,465 Cr of Cumulative commitments raised by AIFs from inception (2012) till 31-Mar-14

Category	Commitments raised (Rs Cr)	%
Category I		
Infrastructure Fund	5,619	42%
Social Venture Fund	428	3%
Venture Capital Fund	264	2%
SME Fund	0	0
Category I Total	6,312	47%
Category II	6,059	45%
Category III	1,095	8%
Grand Total	**13,465**	100%

Over sector-wise investment by VCFs/ FVCIs from inception (1996) till 31-Mar-14

Sectors of Economy	VCF/ FVCI (Rs Cr)
Information Technology	5,380
Telecommunication	7,642
Pharmaceuticals	1,039
Biotechnology	327
Media/ Entertainment	1,271
Services Sector	3,867
Industrial Products	2,274
Real Estate	12,053
Others	36,201
Total	**70,054**

VCFs, FVCIs and AIFs have made / propose to make significant investments (of approx. Rs 83,500 crores) in companies at different stages across sectors

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

Progressive Regulations

1 — Tax pass-through to all PE / VC funds, under SEBI VCF Regulations 1996

3 — Finance Act 2012 revoked 9 sector restriction on tax pass-through

Prior to 2007 | 2007 | 2012 | 2013 | 2014

Ambiguous / Regressive Regulations

2 — Finance Act 2007 restricted Tax pass- through to income from 9 sectors

4 — SEBI AIF Regulations 2012 replaces VCF Regulations 1996; AIF Regulations categorizes PE / VC funds into 3 Categories

5 — Finance Act 2013) provided tax pass-through to only early-stage VC funds in AIF Category I, leaving others excluded

6 — CBDT Circular clarifications on Determinate Trusts would remove tax pass-through for all funds using the structure

Transition across regulations (VCF Regulations and AIF Regulations) not effectively harmonized and inadequate coordination among regulators (SEBI, CBDT) led to unjustified removal of tax pass-through to all other Categories of AIF, except early-stage VC Funds

EY

Uncertainty in AIF taxation

- Due to coordination gaps between SEBI & CBDT at the time of promulgating AIF Regulations and transition from VCF Regulations to AIF Regulations not being effectively harmonized, the tax ‘pass through’ status available to VCFs (being an omnibus category of funds) could not be extended to all types of AIFs. Such AIFs are hence taxable as per trust taxation framework (see Appendix)
- CBDT Circular No 13 dated 28 July 2014, creates significant tax uncertainty for AIFs setup as trust, excluding those covered by section 10(23FB) and 115U of the tax law
- The Circular directly impacts net investment returns of AIF investors i.e. domestic investors (such as insurance companies, pension funds & charitable trusts which may be taxed at a lower rate or exempt) and foreign investors (which may be eligible for exemption under DTAAs) since they will now pay tax at MMR
- Further, future investors such as provident funds, NPS, etc., may also not consider allocating funds to AIFs due to risk of taxation at MMR

Absence of clear tax pass through will result stopping of fund-flow to AIFs

AIFs seek a tax pass-through without any revenue loss

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), which was implemented*

- 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)* and all income eared by them
  - Correspondingly 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 investor thereby providing AIFs and their sponsors/ trustees much needed clarity

Once the aforesaid changes are made it will resolve the disparity in the tax laws created by the introduction of AIF Regulations

Glossary

AIF	Alternative Investment Fund
CBDT	Central Board of Direct Taxes
FVCI	Foreign Venture Capital Investor
PE	Private equity
SEBI	Securities and Exchange Board of India
VCF	Venture Capital Fund
VCU	Venture Capital Undertaking

Appendix

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

Appendix

- Authority for Advance Rulings, in the case of AIG [1997] 224 ITR 473 (AIG ruling), held that section 164 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
  - Relying on the AIG ruling, AIFs setup as trusts take a position that they are a determinate trust and do not attract the provisions of section 164 (tax at MMR)