IVCA
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THE INDIAN PRIVATE EQUITY & VENTURE CAPITAL ASSOCIATION

To **5th March, 2015**

Mr Ananta Barua,
Executive Director,
The Securities and Exchange Board of India
Plot No.C4-A, 'G' Block,
Bandra Kurla Complex, Bandra (East),
Mumbai 400 051

Dear Sir,

SUB: IVCA RECOMMENDATIONS: POST BUDGET 2015-16 REPRESENTATION ON PROPOSED AMENDMENTS IMPACTING CATEGORY-I AND CATEGORY-II ALTERNATIVE INVESTMENT FUNDS

This letter refers to the special tax regime proposed under the Union Budget 2015-16, for Category-I and Category-II Alternative Investment Funds ('AIFs' or 'Investment Funds' or 'Funds') registered with the Securities and Exchange Board of India ('SEBI'). Whilst we welcome the special tax regime proposed to be introduced which provides the much needed certainty on taxation of the aforementioned categories of AIF, they contain certain provisions which are likely to impact the fund players significantly and we request you to kindly take this into account in your deliberation with the Finance Ministry.

1. NEW TAX REGIME TO BE APPLICABLE TO INVESTMENT FUNDS

A new section 10(23FBA) is proposed to be introduced under the Income-tax Act, 1961 ('the Act') for Investment Funds. As per this section, any income of an Investment Fund, other than the income chargeable under the head 'Profits and gains of business or profession', would be exempt in the hands of the Investment Fund and be taxable in the hands of the investors on a pass through basis under a new section 115UB.

It is also proposed that if in any year there is a loss at the Investment Fund level, either current loss or the loss which remained to be set-off, the loss shall not be allowed to be passed through to the investors but would be carried over at the Investment Fund level to be set-off against income of the next year in accordance with the provisions of Chapter VI of the Act.

Also, where any income, other than income which is taxable at Investment Fund level, is payable to its investors by an Investment Fund, the Investment Fund shall deduct income-tax at the rate of 10% (proposed section 194LBB).

Further as per section 10(23FBB), income in the nature of profits and gains of business or profession shall be taxable in the hands of the Investment Fund and exempt in the hands of the investors.

1.1. *Income by way of profits and gain of business at Investment Fund level*

Traditionally, the issue of characterization of exit gains (whether taxable as business income or capital gains) has been a subject matter of litigation with the tax authorities. There have been judicial pronouncements on whether gains from transactions in securities should be taxed as "business profits" or as "capital gains". However, these pronouncements, while laying down certain guiding principles have largely been driven by the facts and circumstances of each case.

The intention of the SEBI (AIF) Regulations, 2012 is to promote investments. As per the extant regulatory framework, a SEBI registered AIF is a privately pooled investment vehicle which collects funds from investors for investing it in accordance with the defined investment policy for the benefit of its investors.

The proposed change could lead to unintended litigation on characterization of income at AIF level. Given the intent of SEBI AIF Regulations is not to allow carrying on of business, there is no need to provide for taxation of business income at AIF level.

Further, any action by the tax officer to re-characterise income in the hands of AIF, effectively could result in double payment of tax by the investors and the AIF (given that investors would be widely distributed and may not be in a position to change their tax filing position to claim an exemption after the limitation period expires).

It is pertinent to note that given the activity of an AIF, it can earn only capital gains income, interest income and dividend income. Historically, Funds have been making investment in Investee Companies as an investment activity and not business activity. The primary objective of an AIF is to make investments and provide much needed capital to entrepreneurs. Therefore, income earned by an AIF from its investment activity cannot be characterised as business income.

The memorandum to the Finance Bill 2014 states that any security held by a Foreign Institutional Investors ('FII') / Foreign Portfolio Investor ('FPI') which has invested in such security in accordance with the regulations made under the Securities and Exchange Board of India Act, 1992 would be treated as capital asset only so that any income arising from transfer of such security by a FPI would be in the nature of capital gain. Subsequent amendments were carried out under the Act.

The regulatory framework of FIIs/FPIs and AIFs are similar which allow such entities to make investment in securities. Therefore, any income earned by an AIF should be characterised as capital gains.

In light of the above, we feel that the aforesaid tax provisions requiring taxation of business income at AIF level is not desired and unintended, since the AIF will never carry on business income in terms of SEBI regulations.

RECOMMENDATION – I

For the aforementioned reasons we humbly request:-

- **The proposed provisions relating to taxability of business income earned by AIF at AIF level be deleted;**
- **It should be clarified that the income earned by the AIF shall be taxable under the head 'capital gains' or 'income from other sources' and not 'business income'.**

1.2. *Loss at AIF level*

As mentioned above, it is also proposed that if in any year there is a loss at the Investment Fund level, either current loss or the loss which remained to be set-off, the loss shall not be allowed to be passed through to the investors but would be carried over at Investment Fund level to be set-off against income of the next year in accordance with the provisions of Chapter VI of the Act.

In light of the above proposal, in case of loss at AIF level with no subsequent income in future, such loss will lapse at AIF level and not be allowed to carry forward or passed through to the investors, causing undue hardship to the investors.

RECOMMENDATION - II

On account of the above discussion, it is humbly requested to allow losses at AIF level also to be passed-on to the investors.

1.3. *Withholding tax (**"WHT"**) of 10% by Investment Funds*

The Finance Bill, 2015 ('the Bill')proposes WHT obligation on the AIF at the rate of 10% on income payable to investors.

A plain reading of the aforesaid provisions of the Bill, could potentially lead to the following possibilities which are unintended:

- WHT on exempt incomes– such as dividend income (section 10(34)) and specified long term capital gains (section 10(38)) payable by the AIF to its investors.
- WHT on income to foreign investors in an AIF – where income attributable to such investors is not taxable in India on account of beneficial provisions of tax treaty, such non-taxable income could potentially suffer WHT by the AIF.
- WHT on entities which are exempt from tax – Income of certain prescribed entities are exempt under section 10 the Act eg. corporation established for welfare and economic upliftment of ex-servicemen. The proposed provision may amount to withholding of taxes of such entities.

The WHT at the rate of 10% will result in cash trap issues at the investor level, as the investors would then need to seek a refund for taxes withheld in their own income-tax returns.

RECOMMENDATION – III

In light of the aforesaid unintended outcome, it is humbly requested:-

- **to provide that the proposed WHT provisions shall not be applicable in case of exempt income payable by the AIF to its investors;**
- **to provide that the proposed WHT provisions shall be applicable in case of payment to foreign investors at the 'rates in force'; and**
- **to provide that the proposed WHT provisions shall not be applicable in case of payment to such entities whose income is exempt under the Act.**

1.4 *Fund-of-Fund Investments*

It is pertinent to note that the extant AIF regulations permit Fund-of-Fund Investments as follows:

- Category I AIF to invest into units of Category I AIFs of the same category;
- Category II AIF to invest in units of Category I and Category II AIFs.

The applicability of the above WHT tax provisions, may unintentionally result into dual withholding at the AIF level.

RECOMMENDATION – IV

As a result of this unintended outcome, it is humbly requested to provide that the proposed WHT provisions shall not apply in case of payment of income by an AIF to an AIF.

1.5 *Amendment to Section 197*

The provisions of section 197 of the Act provides an opportunity to the assessee to apply for certificate allowing deduction of income-tax at lower rates or no deduction of income-tax. However, such certificate can be applied only in case of withholding requirements prescribed under certain sections of Chapter XVII of the Act. The list of such sections mentioned as part of section 197(1) does not include the newly introduced section 194LBB.

The absence of section 194LBB as part of section 197(1) will lead to unintentional hardships to investors who could otherwise have obtained nil or lower withholding tax certificate under section 197.

RECOMMENDATION – V

Accordingly, we would humbly request to include section 194LBB as part of section 197(1) for providing an opportunity to such assessee to apply for Nil/ lower WHT certificate, where total income justifies lower or no deduction of income-tax.

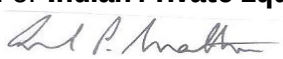
Kindly note that we are in the process of working on detailed representations for other income-tax aspects affecting the fund industry which inter alia include 'place of effective management' – residency rules, safe harbor for India based fund managers, etc., which will be sent to you in due course.

If you have any questions / need any clarifications, we would be glad to provide the same.

Thank you.

Yours sincerely,

For **Indian Private Equity & Venture Capital Association of India**



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