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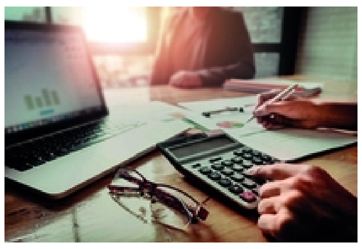
VC, PE, hedge funds to see additional taxes on certain transactions following change in definition of securities

Synopsis
Transactions between investors, drawdown in AIFs will now face fair market value test by taxman



Industry trackers have reached out to the government and even sought clarity around the same.

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Mumbai: A spectre of additional **tax** hangs over several funds and their India portfolio investments as the government changed the definition of **securities** to include alternate investment funds.

The government in the finance bill 2021 has proposed to amend the definition of securities to include AIFs.

Tax experts say that this would mean that any investment in the AIF, or transaction between two **investors** within AIFs would now attract **taxes** under the "anti-abuse" provision of the income tax.

This provision looks at the value at which a transaction takes place and taxes any investment that doesn't happen at fair market value.

Not just that taxman would also check if the transaction is done at a "fair market value" and not doing so would attract taxes.

This would mean that any "fund" or "trust" that falls under the definition of AIF would come under the taxman's lens.

"The change would impact venture capital, private equity and **hedge funds** that operate in India and there could be a tax implication every time there is a transfer," said Prashant Prakhar, leader, global capital market listing, Nishith Desai Associates, a law firm.

Around Rs 1.8 lakh crore have been invested in AIFs that includes vehicles that invest in equity as well as debt in India.

Up until now there was no tax on such transactions.

Following a separate change in regulation in 2020 all investment funds now operate through three AIF categories in the country. The regulation will only cover AIFs registered in India.

Tax experts say that often investors within an AIF undertake transactions, and this will now be scrutinised whether they were done at a fair market value or not.

"The proposed inclusion of AIFs within the definition of securities has created uncertainty on applicability of deemed income provisions where the AIF issues units below the fair market value. This could impact all three categories of AIFs," said Rajesh H Gandhi, partner, Deloitte India. The tax rate could be as high as 30% under the income tax regulations.

The regulation may also impact the way fund managers raise money as a difference of valuations or price of the AIF unit between commitment and drawdown may result in taxes too, say experts.

“In case of an AIF, the manager accepts commitments from investors at multiple closings and units are allotted to investors at par on draw downs,” said Yashesh Ashar, partner, Bhuta Shah & Co LLP.

In most cases, funds start making investments after they close the first round of raising money. Now, if the valuations or value of per unit increases in the subsequent rounds, this could result in taxes. The tax department can question the fair market value and levy taxes on the difference.

Additionally, investors make commitments first but drawdown happens only when the fund manager calls for it.

Tax experts say that the units are issued / allotted to the investors only after the money is drawn down by the fund manager. If there is a price difference between these two it could attract taxes too, say tax experts.

Tax experts say that the way the amendment is made; it could cover past transactions as well. Many funds could explore legal routes if this tax is levied retrospectively, say industry trackers. “There is still no clarity as to whether this would apply to earlier transactions or only those happening after April would be covered, but if earlier transactions aren’t grandfathered then it could lead to potential litigation,” said Prakhar.

Industry trackers have reached out to the government and even sought clarity around the same. They say that ambiguity around the tax impact could also impact some of the larger transactions where one VC or PE fund buys out a portfolio or part of the other fund.

“Inclusion of units of AIFs as ‘securities’ could, on the basis of certain judicial precedents, result in tax in the hands of the investors on allotment at par. Considering the anti-abuse objective of the relevant provisions, it is recommended that such unintended consequence is clarified,” said Ashar.
