NEWS

Rich investors stare at a possible higher tax outgo after Sebi tweaks AIF rules

Tax experts are hoping for some reprieve from the tax department.

Synopsis

Such funds have been given two alternatives by the regulator: one, they could sell the illiquid investments to a new scheme within the same AIF; two, they could do what is called in-specie distribution where the fund transfers shares or securities to each investor based on their unitholding.

By Pavan Burugula, ET Bureau

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New Delhi: Rich **investors** whose money is stuck in loss-making Alternative Investment **Funds** (AIFs) are staring at a likelihood of an additional **tax** burden on account of a decision by the capital market regulator on Wednesday. The Securities and Exchange Board of India (**Sebi**) cleared a new framework for **AIFs**, which are stuck with illiquid investments even after the maturity of fund tenure.

Such funds have been given two alternatives by the regulator: one, they could sell the illiquid investments to a new scheme within the same AIF; two, they could do what is called in-specie distribution where the fund transfers shares or securities to each investor based on their unitholding.

Both the methods could have tax implications on the investors, say experts. When an AIF moves illiquid investments from a maturing scheme to a new one, the transfer could lead to loss of holding period benefit for investors. Unlisted shares owned for more than two years qualify for long-term capital gains tax. These AIFs mostly own shares of unlisted companies that become illiquid in tough market conditions.

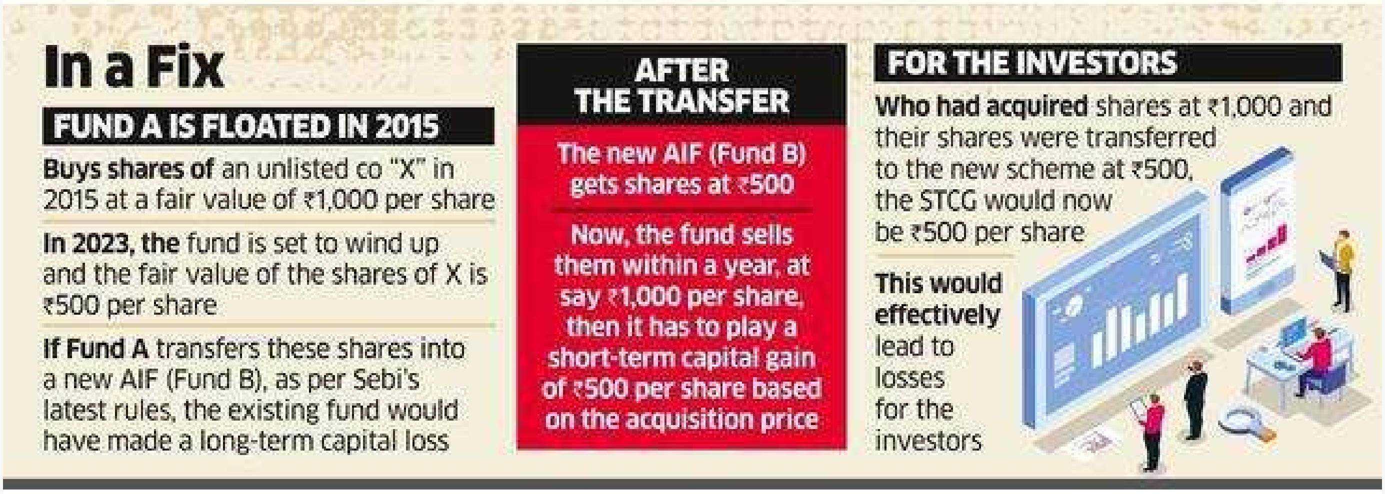
Moreover, such transfers could lead to a scenario where investors end up with long-term capital loss in the old fund and short term capital gains in the new one, said tax experts.

"On a plain reading of the approvals in the press release, it seems that some of the industry's substantive recommendations around liquidation scheme could not make their way to SEBI," said Nandini Pathak, leader, investment funds at Nishith Desai Associates. "The request was to allow the existing scheme to repurpose itself as a liquidation scheme (as one of the alternatives to deal with unliquidated portfolio) to avoid inefficiencies from a regulatory and tax perspective."

Sebi had floated a discussion paper on the same in February. Market participants said the industry had given its feedback to provide a framework that would be more tax friendly.

An email sent to Sebi remained unanswered.

This is how such transfers could lead to a higher tax outgo.



For instance, an AIF was floated in 2015 and it purchased shares of an unlisted company say 'X' in 2015 at a fair value of ₹1,000 per share.

In 2023, the fund is set to wind up and the fair value of the shares of X is only ₹500 per share. If the AIF transfers these shares into a new AIF as per Sebi's latest rules, the existing fund would have made a long-term capital loss. The new fund would acquire the X shares at ₹500. Assuming that the market conditions improve and the fund sells them at say ₹1,000 per share, it would mean that the new fund made a short-term capital gain (STCG) of ₹500 per share based on the acquisition price (cost at which transfer to the new fund happened). So, for investors who had acquired shares at ₹1,000 and their shares were transferred to the new scheme at ₹500, the STCG would be ₹500 per share. This would effectively lead to losses to the investors.

Tax experts are hoping for some reprieve from the tax department.

"From an income tax perspective, the announcement has created a grey area and therefore one expects clarification from the CBDT by way of a circular or notification according a tax neutral status to unliquidated investments transferred to new scheme or in-specie distribution," said Riaz Thingna, partner, Tax, Grant Thornton Bharat.

"Further, CBDT may also clarify that upon eventual sale of such investments by new scheme or investors, the original cost of acquisition and original holding period of the erstwhile scheme may be deemed to be the cost of acquisition and holding period of the new scheme or investors."

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