

Funds Hotline

August 01, 2014

TAX PASS THROUGH FOR ALTERNATIVE INVESTMENT FUNDS: CLARIFICATION NEEDS LITTLE MORE CLARITY

- CBDT issues circular seeking to provide clarity on the tax treatment of alternative investment funds that are set up as trusts.
- In order to qualify as a 'determinate trust', the names of all investors in an AIF and their beneficial interests should be expressly stated in the trust deed on the 'date of its creation'.
- 'Date of creation' needs greater clarity as the fund formation requires multiple closings and investors get added from time to time.
- AIFs which do not fulfill the requirements laid down by the CBDT will be taxed at the maximum marginal rate in the hands of the trustee of the AIF. Ambiguity around the applicable rate of tax for capital gains
- CBDT circular to impact the availability of treaty benefits to offshore investors in an AIF and impact fund raising and fund operations of AIFs.
- Where capital is raised both offshore and onshore, co-investment structures may be preferred in comparison to unified investment structures going forward.

The Central Board of Direct Taxes ("CBDT") issued a circular¹ dated July 28, 2014 ("Circular") to provide 'clarity' on the taxation of alternative investment funds ("AIFs") that are registered under the Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012 ("AIF Regulations").

The Circular states that if 'the names of the investors' or their 'beneficial interests' are not specified in the trust deed on the 'date of its creation', the trust will be liable to be taxed at the 'maximum marginal rate'.

This poses some serious questions for the Indian fund industry that typically have multiple 'closings' where where subsequent round investors participate in the fund, may be impacted. Further, even with a single closing, owing to natural and other consequences such as termination of an investor's participation in distributions made by the fund where they default in making contributions or transfer of fund units from one investor to another, there could be revisions in the beneficial interests of investors.

BACKGROUND

A 'trust' is a vehicle of choice when setting up pooling structures in India. This is largely driven by the fact that the Indian Trust Act, 1882 allows a trust to be effectively structured as a functional equivalent of a limited partnership, as available in other jurisdictions.

The AIF Regulations provide the regulatory framework for privately placed domestic funds in India and was introduced by Securities and Exchange Board of India ("SEBI") to recognize AIFs as a distinct asset class. SEBI classifies AIFs in 3 distinct categories to tie concessions and incentives to investment restrictions.

Category I AIFs encompass AIFs with a defined investment strategy focusing on Venture Capital Funds, Small and Medium Enterprises Funds, Social Venture Funds and Infrastructure Funds, which in SEBI's view, lead to "... positive spillover effects on the economy".

Category II AIFs encompass AIFs that may not need any focused incentives. These would include private equity funds and debt funds.

Category III AIFs could be used to set up an onshore hedge fund structure with prescribed levels of leverage.

POSITION OF TAX FOR AIFS

Post the Finance Act, 2012, income is made taxable directly in the hands of investors (of Venture Capital Funds) on an accrual basis and the pooling vehicle is not to be subject to any tax.

The AIF Regulations and the Finance Act, 2013 limit the benefit of this 'pass - through' only to the Venture Capital Fund sub-category of Category I AIF. Therefore, the pass-through status is limited only to AIFs, which invest primarily in unlisted securities of start-ups, emerging or early stage ventures mainly involved in new products, new services, technology or intellectual property right based activities or a new business model. There are no explicit provisions that allow various other funds, such as Social Venture Funds, Infrastructure Funds and SME Funds, which also fall within AIF Category I to get a pass-through benefit. Further, Category II and III AIFs will also not be entitled to the tax pass-through status.

Consequently, a majority of AIFs are structured as trusts to avail of tax pass-through under general trust taxation provisions. In such a scenario, the concerned funds rely and seek to be taxed as per the general principles of taxation of trusts viz. sections 161 to 164 of the Income Tax Act, 1961 ("Tax Act") which allow for a pass-through

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As per Explanation 1 to section 164 of the Tax Act, a trust is considered to be a determinate trust if it fulfills the following two conditions:

- Beneficiaries of the income arising to the trust are identifiable on the date of the trust deed; and
- The share of income of each beneficiary is ascertainable on the date of the Indenture.

Where the trust (the fund) is determinate, i.e., the beneficiaries are identifiable with their shares being determinate, the trustee is assessed as a representative assessee and tax is levied on and recovered from them in a like manner and to the same extent as it would be leviable upon and recoverable from the person represented by them (i.e. the investors to the concerned fund). In the case of *AIG (In Re: Advance Ruling P. No. 10 of 1996)*, the Authority for Advanced Rulings ("AAR") held that it is not required that the exact names of all the beneficiaries are stated in the trust deed or the exact shares of the beneficiaries be specified for a trust to be considered a determinate trust; as long as there is no uncertainty regarding the beneficiaries and no uncertainty regarding the share of income to which they are entitled, the trust will still be treated as a determinate trust even if there is a pre-determined formula by which distributions are made and pre-determination of the class of persons who become beneficiaries of the trust. If a trust is not considered to be determinate, the income of the trust will be taxed at the maximum marginal rate in the hands of the trustee in its capacity as the representative assessee of the beneficiaries.

Several participants of the onshore funds industry have been making representation to the tax authorities seeking clarity on various issues relating to the taxation of onshore funds that are excluded from the coverage of Section 10(23FB) of the Tax Act including the requirements that need to be fulfilled to qualify as a determinate trust.

POSITION OF LAW OUTLINED IN THE CIRCULAR

What attributes 'determinate' status to an AIF and position of tax if a concerned AIF is not 'determinate': The Circular provides that in situations where the trust deed of an AIF on the date of its creation either (1) does not name the investors (i.e. the beneficiaries) or (2) does not specify the beneficial interests of such investors, the provisions of section 164(1) of the Tax Act would come into play and the entire income of the AIF shall be liable to be taxed at the maximum marginal rate in the hands of the trustee of the AIF in its capacity as 'representative assessee' of the trust.

If part or all of the income of the AIF is in the nature of business income: The Circular states that where the income of an AIF consists of, or includes, profits and gains of business, section 161(1A) of the Tax Act would take effect and the whole of the income of the AIF would be taxed in the hands of the trustee in its capacity as a 'representative assessee' of the AIF at the maximum marginal rate even where the AIF is determinate.

Tax pass – through status: Given the position under the Circular, it would appear that in respect of AIFs other than Category I AIFs (in the venture capital fund sub-category) to whom the provisions of section 10(23FB) of the Tax Act applies, a position of tax 'pass – through' can be maintained if (1) the AIF is determinate (i.e. the names of the investors and their beneficial interests are stated in the trust deed 'on the date of its creation') and (2) the income of the AIF does not consist of or include profits and gains of business.

Interestingly, it has also been provided that the clarifications contained in the Circular shall not be operative in an area falling in the jurisdiction of a High Court which has taken or takes a contrary decision on the issue.

IMPACT ON INCOME STREAMS

The Circular is likely to impact the tax treatment applicable to certain kinds of income streams of an AIF. For instance, long-term capital gains arising to an AIF on the transfer of unlisted securities is typically taxed at the rate of 20% (with indexation benefits). Similarly, long-term capital gains arising to an AIF on the transfer of listed securities on which securities transaction tax ("STT") has not been paid is taxed at the lower rate of 10% (without indexation benefits) or 20% (with indexation benefits). As a consequence of the Circular, such income may now potentially be taxed at the maximum marginal rate in the hands of the representative assessee (i.e. the trustee).

Offshore investors: Investors (including feeder funds) based out of a jurisdiction which has a favourable tax treaty with India may not be able to place reliance on the provisions of the applicable tax treaty unless the AIF meets the requirements of being 'determinate' as clarified by the Circular, failing which, the AIF will not be regarded as a tax pass-through entity. Ideally, both for computation of income and determination of tax on the computed income, the characterization of income in the hands of the trustee to the AIF should be the same as in the hands of the beneficiary (i.e. each investor to the AIF).

COMMERCIAL IMPLICATIONS FOR AIFs

The clarification provided under the Circular on the requirements to be fulfilled to qualify for 'determinate trust' status may have implications on the operation of AIFs. Some of the possible implications are discussed below.

Multiple closings

As per the Circular, an AIF that is looking to qualify as a determinate trust is required to state the names of its investors and their beneficial interests in the trust deed on the date of creation of the trust. Accordingly, such AIF may not be able to on-board new investors at a subsequent closing since this will require the trust deed to be amended and this is turn would mean that the identities of the investors and their beneficial interests will not be the same as on the date of creation of the trust.

Change in beneficial interests of investors

In an AIF, there are several circumstances in which the beneficial interests of investors could vary. For instance, part transfer of unit holding from one investor to another would alter the beneficial interests of both investors in the AIF. Further, the termination of a defaulting investor's participation in an AIF would result in a realignment of beneficial interests of the remaining investors. On June 19, 2014, SEBI issued a circular stating that where there was a material change in the placement memorandum, AIFs would be required to provide an exit option to investors who did not wish to remain invested in the fund. To the extent that any investor availed the exit option, there would be a realignment of the beneficial interests of the remaining investors.

Impact on fundraising

Since an AIF will retain its status as a determinate trust only if the names of the investors and their beneficial interests are known on the date of creation of the trust, an AIF (seeking to qualify as a determinate trust) may be restricted with

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respect to the innovations to the distribution and fee mechanisms that it can offer investors.

In particular, the use of opt-in and opt-out clauses may trigger taxation at the maximum marginal rate in the hands of the trustee. Such AIFs will need to raise its entire corpus at the initial closing so as to ensure that the names of its beneficiaries and their beneficial interests are known on the date of creation of the trust.

CONCLUSION

The Circular may have been issued with an intention to clarify the tax position for onshore funds set up as AIFs. At present, a substantial majority of AIFs have been structured as trusts and map the identities and beneficial interests of their investors, based on the principles laid down in *AIG (In Re: Advance Ruling P. No. 10 of 1996)* i.e by providing for the manner of determining the beneficiaries (such persons who sign up the contribution agreement) and for determining their beneficial interest through a formula based approach. Such AIFs may be impacted by the clarification provided by the Circular.

Globally, investment funds rely on a 'tax pass-through status' wherein the income of the investment fund is taxed directly in the hands of its investors, but not at the level of the fund itself. This provides fiscal neutrality to the funds as it eliminates tax at the pool level while maintaining taxation at the investor level.

Accordingly, what is required to be clarified now in the context of trusts is ☐ if the beneficiaries can be identified 'at any point in time' and their shares are ascertainable, the trust should be considered pass through. This would be in line with ruling laid down by the AAR in *AIG*. The requirement laid down in the Circular of explicitly stating the names of the investors of the AIF and their beneficial interests on the date of creation of the trust creates ambiguity. In fact the AIG ruling had specifically commented on each of these aspects in great detail which ought to have been replicated in the Circular in order to remove all ambiguities on the issue.

One open alternative that may still be available in a fund context is that in the event that the capital contributions of the investors in an AIF are treated as revocable, then as per the provisions of section 61 of the Tax Act, any income of the AIF is taxable directly in the hands of such investors. This could also help in making out a defensible case for treating such structures as being tax pass-through, though there are no decisions in the context of funds that are available today in this regard. It was hoped that the Circular would provide finality and remove all ambiguities on the pass through treatment for AIFs, but instead we are left with a situation where there are more questions that are being raised.

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You can direct your queries or comments to the authors

¹ Circular No. 13 / 2014 dated July 28, 2014

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