

CBDT Circular: Blow for AIFs

The Central Board of Direct Taxes (CBDT) has issued a circular on July 28, 2014 providing clarity on taxation of Alternate Investment Funds (AIFs) that are set up as trusts. Currently, only Venture Capital Funds, sub-category of Category I AIF, were entitled to avail the benefits of ‘pass-through’ and other funds which fall under Category I AIF (like Social Venture Funds, Infrastructure Funds and SME Funds), Category II AIF and Category III AIFs are not entitled to the tax pass-through status. Consequently, majority of AIFs are presently structured as trusts and map their identities and beneficial interests of their investors based on the principles laid down in AIG case¹ to avail the tax pass-through benefits.

Clarifications Outlined in the Circular

- a) **What attributes ‘determinate’ status to an AIF:** The trust deed on the ‘date of its creation’ should expressly mentioned the (1) name of investors (i.e. the beneficiaries); *and* (2) beneficial interest of such investors.
- b) **Position of Tax if AIF is not ‘determinate’:** If an AIF is set up as a trust and is not able to meet with the attributes of ‘determinate’ trust as mentioned above, then the *entire income* shall be liable to be taxed at the maximum marginal rate (i.e. 30%) in the hands of trustee of AIF in its capacity as ‘representative assessee’ of trust.
- c) **If part of income of AIF is in the nature of business income:** If all or part of the income of AIF consist of profits and gains of business, then 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.
- d) **Tax Pass-Through Status:** Other than Venture Capital Funds, AIF set up as a trust can maintain pass-through status if (1) AIF is able to meet with the attributes of ‘determinate’ trust as mentioned above and (2) the income of the AIF does not consist of profits and gains of business.
- e) **Applicability:** The Circular expressly states that it 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 of Circular

- a) **Income from transfer of securities:** If an AIF is not considered as pass-through structure, then income from transfer of securities which are typically taxed at 10% to 20%², may now potentially be taxed at the maximum marginal rate in the hands of the representative assessee (i.e. the trustee).

¹ In Re: Advance Ruling P. No. 10 of 1996. The Authority for Advance Ruling (AAR) held that it is not required that the exact names or shares of all the beneficiaries are stated in the trust deed for a trust to be considered as determinate trust. 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.

² Typically, long term capital gains arising out of the transfer of unlisted securities is taxed at the rate of 20% (with indexation benefits). Similarly, long term capital gains arising 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).

- b) Reliance on DTAA by Offshore Investors: Offshore Investors (including feeder funds) may not be able to place reliance on the provisions of the applicable Double Taxation Avoidance Agreement (DTAA) 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.
- c) Multiple Closings: AIFs may not be able to on-board new investors at a subsequent closing, if they are looking to qualify themselves as ‘determinate trust’, since it will require an amendment to the trust deed and in turn the identities of the investors and their beneficial interests will change from the date of creation of the trust.
- d) Change in Beneficial Interests of Investors: In a fund lifetime, there are several circumstances in which the beneficial interest of the investors could vary. For instance, part transfer of units to another investor, termination of defaulting investors’ participation, availing of exit option by investors due to material change in the placement memorandum. In such situations, there would be a realignment of the beneficial interests of the investors from the date of creation of the trust and subsequently, such AIFs may not be able to classify themselves as ‘determinate trust’.
- e) Impact on Fundraising: In order to retain their status as ‘determinate trust’, AIF may be restricted with respect to innovations to the distributions and fee mechanisms that it can offer to investors.

ARA LAW View

- The trustees/sponsors may have to assess how they would safeguard themselves against residual liabilities should there be any demand that arises on account of interpretation as set out in the Circular.
- AIF may need to consider and evaluate other structures or having multiple AIFs instead of multiple closing keeping in mind the administrative cost and other factors.

The Circular is certainly a blow for the AIF industry. Given the significance of the AIF industry to the economy as a whole and in order to provide a regime that gives a boost to the AIF Industry, the above Circular definitely needs a re-consideration.

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