CBDT clarification on the tax treatment in the case of Alternative Investment Funds

4 August 2014

Recently, the Central Board of Direct Taxes (CBDT) has issued a Circular1 to provide ‘clarity’ on the taxation of Alternative Investment Funds (AIFs) that are registered with the Securities and Exchange Board of India (the SEBI) under the Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012 (AIF Regulations).

The Circular effectively 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’.

Background

With the intent to channelise capital/savings available with domestic High Net worth Individuals (HNIs) and institutions into unlisted companies and professional management of these investments, the SEBI first announced the SEBI (Venture Capital Funds) Regulations, 1996.

To allow domestic managers to further diversify into launching variety of funds (including private equity funds, debt funds, hedge funds, etc.), the SEBI revamped the said regulations and announced the SEBI (Alternative Investment Funds), 2012.

The success of these regulations can be gauged from the fact that within a short span of 2 years, more than 100 Alternative Investment Funds (AIF) with various investment themes are registered with SEBI.

To provide ease of flexibility and operations, many of these funds are structured in the form of a trust.

Taxation regime for AIFs set-up as Trusts

From year 2000 onwards, Venture Capital Funds (VCF) was governed by Section 10(23FB) read with Section 115U of the Income-tax Act, 1961 (the Act). The said sections provided for pass through taxation, whereby income from investments in Venture Capital Undertaking (VCU) was exempt in hands of VCF. Such income was directly taxed in hands of investors on proportionate basis as if investors had directly invested in the VCU.

1 CBDT Circular No. 13 of 2014, dated 28 July 2014
With the introduction of AIF regulations by SEBI in May 2012, an amendment was required to cover all AIFs under Section 10(23FB) of the Act. However, the Government in 2013 extended the regime of Section 10(23FB) only to a very specific category of AIFs (i.e., Venture Capital Fund under the sub-category of Category I AIF). The said category covered only 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 governing other form of AIFs (such as Social Venture Funds, Infrastructure Funds, SME Funds, Private Equity Funds, etc.). Consequently, such funds became governed by the generic regime of taxation provided for trusts under provisions of Section 160 to Section 167 of the Act.

Under the said provisions, taxation of trusts depends on whether the said trusts are determinate or indeterminate. In case where trusts were determinate, taxation of income of the trust would happen in the hands of the trustee in like manner and to the same extent as it would have been leviable upon the beneficiaries.

In case where the trusts were indeterminate, taxation of income of trust would happen at Maximum Marginal Rate (MMR) i.e., rate applicable to highest slab of income for individuals.

Explanation 1 to Section 164 of the Act provides that for a trust to be determinate, both the beneficiaries and their individual shares need to be expressly stated in instrument of trust and be identifiable/ascertainable on the date of instrument.

At the time of introduction of the said Explanation in 1980, Circular No. 281 dated 22 September 1980 specifically provided that intent was to prevent manipulation of arrangements in such a manner that a discretionary trust is converted into a specific trust whenever it suited tax-wise. The said Circular provided that "it is not necessary that the beneficiary in the relevant previous year should be actually named in the … instrument of trust". Further, only trusts under which discretion is given to trustee to decide allocation of income every year will be regarded as discretionary trusts.

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.

**CBDT Circular**

CBDT has now issued a Circular clarifying the tax treatment in case of AIFs where the investors name and beneficial interest are not explicitly known on the date of its creation – such information becoming available only when the Funds start accepting contributions from the investors. The CBDT Circular states that in a situation where the trust deed either does not name the investors or does not specify their beneficial interests as on the date of its creation, the provisions of Section 164 would come into play and the entire income of the AIF shall become liable to be taxed at MMR in the hands of the trustee of the AIF in its capacity as a ‘representative assessee’ of the AIF. The CBDT Circular further clarifies that in such cases, income will not be assessed again in the hands of the investor.

Finally, the Circular provides that 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.

**Our comments**

Applying Explanation 1 to Section 164 to AIFs, the following issues used to arise on a plain reading of the said Explanation:

- Whether names and shares of beneficiaries are required to be stated upfront in a trust deed?
- Whether trust deed has to be read along with contribution agreement and any future amendments for this purpose?
- What happens if beneficiaries transfer their units to another investor?
- Whether the share has to mentioned as a percentage, or formulae is sufficient for this purpose?

The Circular may have been issued with an intention to clarify the tax position for onshore funds set up as AIFs in the form of trust, however, it is likely to cause lot of practical difficulties for AIFs.

Most of the AIFs were structured based on the principle laid down by the AAR in AIG’s case, based on which only class of beneficiaries and methodology for computation of share were sufficient to make the trust determinate.

© 2014 KPMG, an Indian Registered Partnership and a member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved.
The CBDT Circular is likely to have a significant impact on AIFs who have already got investor commitments who may have to revisit their existing structure.

Going-forward, AIFs may have to consider following the process of getting in-principle approval of SEBI initially and settling the trust deed only after obtaining commitments from investors. SEBI has provided a six month window within which the trust deed needs to be registered.

Alternatively, AIFs could consider being setup in the form of Limited Liability Partnerships subject to consideration of the various intricacies involved therein.