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DISAMBIGUATION OF TAXABILITY OF ALTERNATIVE INVESTMENT FUNDS: ACTUATING A CLEAN SLATE PERSPECTIVE- Nooransh Grover¹**ABSTRACT**

Diversification of models of investment is a direct corollary of economic prosperity. Development and prosperity, demands opening up of multiple avenues for investment as well as streamlining the process for investment. This in turn shall not only attract domestic investment but also act as a catalyst in attracting foreign investments, both in the form of Foreign Direct Investment as well as Foreign Portfolio Investments. Investment is fuel for the economic engine which shall drive India to the path of economic prosperity.

Investors, both domestic as well as international, take a highly conscious and calculated decision while investing funds through whatever channels into an economy. The primary motive of any investment is profit and in order to achieve so, they undertake a careful study of the entire business and economic setup to ensure that they maximize profits and gains. One such important aspect, is the taxation policy of any country. The taxation regime of a country must be unambiguous and it must facilitate ease of doing business and investments. The taxation policy of alternative investments funds has undergone major changes which have short-term and long-term impact on the economy. The purpose of this research is to analyze the taxation regime with regards to alternative investment funds and propose certain changes as well to the same.

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OBJECTIVES

1. Examine the taxation policy of alternative investment funds
2. To analyze the impact of changes in tax with regards to AIF's
3. Recommend changes in the tax treatment of AIF's
4. Highlight the importance of favorable tax treatment to AIFs for the economy as well as tax collections.

HYPOTHESIS

Favorable tax treatment of Alternative Investment Funds shall lead to increase in investments resulting in increasing tax collections.

INTRODUCTION

There are several complex factors that must be taken into account while making a certain investment choice. An investor demonstrates awareness that a careless strategy has the potential to rapidly deplete their money. These factors may include government policies, the global landscape, a nation's internal situation, government organization, regulatory frameworks, financial infrastructure, and the tax system. Investors are required to carefully analyze all relevant factors from a detailed perspective and make informed decisions based on calculations.

In addition to formulating laws, rules, and regulations, the government must also consider the viewpoint of investors while crafting these policies, while also taking into account domestic factors. In order to effectively attract both domestic and international investment, it is essential for the government to develop laws and regulations that are conducive to the interests and preferences of potential investors. The tax system has a crucial role in influencing an investor's decision-making process. Investing in an alternative investment fund may exhibit lower levels of liquidity compared to investments made in equities markets.

In the context of an alternative investment fund, investors have the opportunity to allocate their investments towards various types of funds, including social venture funds, infrastructure funds, and angel funds, among others. Specifically, investors who choose to invest in Category I Fund are exposed to a diverse range of sectors, such as toll plazas, infrastructure projects, and startups. This exposure is distinct from the investment options available in traditional stock markets.

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Investors in Alternative Investment Funds (AIFs) are required to make a single, initial financial commitment towards their investment, which may be paid in installments rather than as a lump sum.

The research focuses on the concerns surrounding the tax treatment of investors who invest in Alternative Investment Funds (AIFs). Currently, there are ambiguities regarding the varying tax rates based on the category of AIF and the timing of tax deductions. This study aims to address these concerns and propose legislative and regulatory changes to ensure a more favorable tax treatment for AIF investors.

ALTERNATIVE INVESTMENT FUNDS: Meaning

Regulation 2 (1)(b) of Securities and Exchange Board of India (Alternative Investment Fund) Regulations, 2012 defines Alternative Investment Fund as,

“Alternative Investment Fund” means any fund established or incorporated in India in the form of a trust or a company or a limited liability partnership or a body corporate which,

(i) is a privately pooled investment vehicle which collects funds from investors, whether Indian or foreign, for investing it in accordance with a defined investment policy for the benefit of its investors; and

(ii) is not covered under the Securities and Exchange Board of India (Mutual Funds) Regulations, 1996, Securities and Exchange Board of India (Collective Investment Schemes) Regulations, 1999 or any other regulations of the Board to regulate fund management activities”

ALTERNATIVE INVESTMENT FUND: Categorization

Regulation 3 (4) of the SEBI (Alternative Investment Fund) Regulations, 2012 provides for the categories under which an alternative investment fund can register itself. The tax treatment of each category is different as specified under the applicable laws and rules which shall be discussed further.

The categories of AIF's are:

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Category I Alternative Investment Fund:

These Alternative Investment Funds invest in new age companies, startups, social ventures and companies which the market regulator and the government feel are beneficial for the society and economy.

Example – Social Venture Funds, Infrastructure Funds, Angel Funds, SME Funds.

Category II Alternative Investment Fund

These funds do not fall under Category I AIF and the government provides very less investment for such funds.

Examples – Real Estate Fund, Private Equity Funds etc.

Category III Alternative Investment Fund

AIFs that engage in a variety of or a complicated level of trading techniques and may use leverage, including investments in listed or unlisted derivatives, might be considered to fall under this category.

Examples – Hedge Funds, PIPE Funds etc. may be registered as Category III AIF's²

TAX DEDUCTED AT SOURCE IN LIGHT OF ALTERNATIVE INVESTMENT FUNDS

Under the Income Tax Act, 1961 (“Act”), Section 194LBB lays down the entire TDS mechanism of income from units of an alternative investment fund. Units, as specified under the Explanation clause of Section 115UB, defines it as a “beneficial interest of an investor in the investment fund or a scheme of the investment fund and shall include shares or partnership interests”.

Section 194LBB confers a statutory duty upon the person making such payment to a unit holder to deduct income tax in respect of the unit holder's investment in an investment fund. Section 194LBB further provides that tax shall be deducted at a rate of 10% if the payee is a resident and in case of a non-resident unit holder or a foreign company, tax shall be deducted as per the rates provided for in the relevant financial year considering Double Taxation Avoidance Treaty

²“SEBI, <https://www.sebi.gov.in/legal/regulations/jan-2023/securities-and-exchange-board-of-india-alternative-investment-funds-regulations-2012-last-amended-on-january-9-2023-67273.html> (last visited Oct. 15, 2023).”

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between India and the resident state of such non-resident. It is further clarified that tax shall be deducted on accrual basis rather than on receipt basis.³

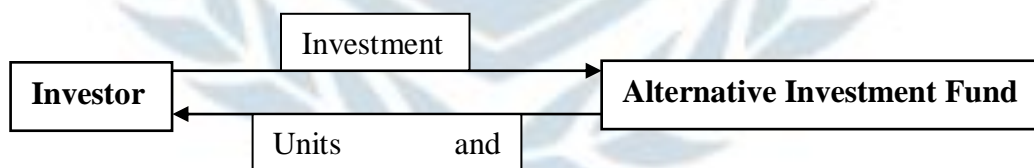
This clause also provides for an exception in cases where the income is of similar nature as provided under Section 10 (23FBB) of the Act. Section 10 (23FBB) states that an income received by virtue from investment in an investment fund as per Section 115UB shall be computed in the total income of an assessee under the head 'Profits and Gains from Business and Profession'⁴

Analysis of Taxation Regime in case of an Investment Fund

The entire taxation regime in case of income pertaining to an investment fund rests upon tax liabilities of the investment fund and the unit holders. By virtue of Section 10(23FBA), all income of an investment fund except PGBP income shall not be included in its total income and hence shall not be liable to tax.⁵

A detailed analysis of Section 115UB indicated that all income arising, accruing or received by a unitholder by virtue of his/her investment in an investment fund shall be liable to tax except PGBP income.

Section 115UB starts with a blanket provision of treating income accrued, arisen or received by virtue of being a unitholder in an investment fund as income chargeable to income tax. Such income shall be treated as if the investment had been made by the unitholder himself.⁶



³“The Income-Tax Act, 1961, § 194LBB, No. 43, Acts of Parliament, 1961 (India).”

⁴“The Income-Tax Act, 1961, § 10 (23FBB), No. 43, Acts of Parliament, 1961 (India).”

⁵“The Income-Tax Act, 1961, §10 (23FBA), No. 43, Acts of Parliament, 1961 (India).”

⁶“The Income-Tax Act, 1961, § 115UB, No. 43, Acts of Parliament, 1961 (India).”

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CONCEPT OF PASS THROUGH IN AN ALTERNATIVE INVESTMENT FUND

The Indian tax legislation bestows a distinctive tax pass-through status upon Category-I and Category-II Alternative Investment Funds (AIFs). In essence, this confers upon AIFs a unique position where they are essentially disregarded as distinct entities in the realm of taxation concerning income derived from investments. Under this arrangement, there exists a legal presumption that investors directly engage in these investments. Consequently, any income received by the AIF is taxed in the hands of the investor, subject to the specific tax provisions applicable to said investor.

However, it is crucial to note that even though, from a legal standpoint, the investment is made by the AIF entity and the resultant income is received by the AIF, the law mandates that the AIF must withhold an appropriate amount of tax from the income credited or distributed to the investor. This withholding is done at rates applicable to the investors.

It is imperative to highlight that this pass-through status does not extend to the 'business income' of the AIF. In cases involving business income, the AIF itself is liable for the applicable taxation. Consequently, when such income is distributed by the AIF to the investor, there is no withholding tax applicable. This distinctive tax pass-through mechanism represents a sophisticated approach in Indian tax law, ensuring clarity and accountability in ⁷the realm of investments and income taxation.

As per the Indian Taxation Regime, only Category I and Category II Alternative Investment Funds enjoy the pass-through status, meaning thereby the income generated out of the investment in an AIF is taxed at the Investor Level except PGBP income.

The Bone of Contention: Need for upsetting the apple cart

There is absolutely no reasonable explanation of not extending the pass-through status to Category III Alternative Investment Funds.⁸ From the available statistics released by the Securities and Exchange Board of India, it is sufficiently clear that one of the most fund-generating category of AIF after Category I AIF, is the Category III AIF's. It is also important to

⁷“PKC, <https://pkcindia.com/pass-through-income-and-all-you-need-to-know-about-it/> (last visited Oct. 15, 2023).”

⁸“Tata Capital, <https://www.tatacapital.com/blog/wealth-services/taxation-rules-for-aif-in-india/> (last visited Oct. 15, 2023).”

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note that this category of AIF along with Category II Alternative Investment Fund are big funds which bring in huge capital and it is pivotal for the economic interests of India that these funds are adequately incentivized.

When there is an absence of a pass-through status, the investment fund has to be aware about the tax status of its beneficiaries. Most Category III Alternative Investment Trusts are registered as 'Determinable Trusts' as per Section 160-Section 162 of the Income Tax Act, 1961. As per this concept, it becomes essential for the trustee of these trusts to pay off the tax liabilities of these beneficiaries. This poses a significant problem with respect to overburdening the AIF with additional responsibilities. The AIF is required to pay off its own tax liabilities as well as be aware of the tax liabilities of its beneficiaries. This burden comes along with additional obligations pertaining to regulatory compliances and overall function of the AIF itself.

There is also an argument that this situation can lead to a situation of double taxation. I do not conform with this argument as the tax is levied on different heads of income namely PGBP income of the AIF and all income other than PGBP income of the investor arising/ accruing/received out of the investment made in the AIF.

By enabling a pass-through status for Category III AIF's, the determination of the tax liability of the assessee shall become easy and less cumbersome. The investor shall be taxed individually according to their tax bracket under the applicable rates of taxation for capital gains for the relevant previous year. The present tax regime provides for tax benefits for foreign portfolio investors under Section 115AD⁹. This has enabled a large number of investors to invest less through the AIF route and rather adopt the FPI route.

Thus, in the interest of investments into the India economy, it is essential that the taxation regime is conducive and facilitatory rather than obstructionist.

TAX LIABILITY OF NON-RESIDENT INVESTORS INCOME BY VIRTUE OF OFF-SHORE INVESTMENTS

⁹"The Income-Tax Act, 1961, § 115AD, No. 43, Acts of Parliament, 1961 (India)."

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The entire tax regime of India cannot be understood in its entirety unless there is clarity about the concept of a resident and a non-resident and its repercussion thereto. It is important to understand that Section 6 of the Income Tax Act is the base for understanding this concept upon which the entire direct tax system of India subsets.¹⁰

On 3rd July 2019, the Central Board of Direct Taxes issued a circular (Circular No.14/2019) by virtue of which the CBDT clarified about the tax liability of non-resident investors by virtue of income earned by off-shore investment in an AIF. In Para 5 of the said circular, the CBDT stated that “As section 115UB (1) of the Act provides that the investments made by Category I or Category II AIFs are deemed to have been made by the investor directly, it is hereby clarified that any income in the hands of the non-resident investor from off-shore investments routed through the Category I or Category II AIF, being a deemed direct investment outside India by the non-resident investor. is not taxable in India under section 5(2) of the Act.”

Such an argument, I believe is not agreeable in its totality. The CBDT, by virtue of this circular, purports an argument that only the off-shore investment made by a non-resident in Category I and Category II AIFs shall not come under the purview of Section 5(2) and hence shall not be taxable in the hands of the investor. This argument is based on the underlying concept of ‘pass-through’ which is available only for Category I and Category II AIF’s.¹¹

A non-resident who makes an off-shore investment in a Category III AIF shall be liable to tax and shall come under the purview of Section 5(2)¹². The CBDT sought assistance from Section 115 UB stating that as per Section 115UB, the investments made by Category I and Category II AIF’s, shall be deemed to made by the investor himself and based on this assumption, the CBDT analyzed the tax liability of the non-resident investor.

The underlying concept of pass-through plays an important role in this entire discussion. Just because Category III AIFs do not enjoy a pass-through status, a non-resident investor shall be

¹⁰“The Income-Tax Act, 1961, § 6, No. 43, Acts of Parliament, 1961 (India).”

¹¹“Income Tax India, https://incometaxindia.gov.in/communications/circular/circular_no_14_2019.pdf (last visited Oct. 15, 2023).”

¹²“The Income-Tax Act, 1961, § 5(2), No. 43, Acts of Parliament, 1961 (India).”

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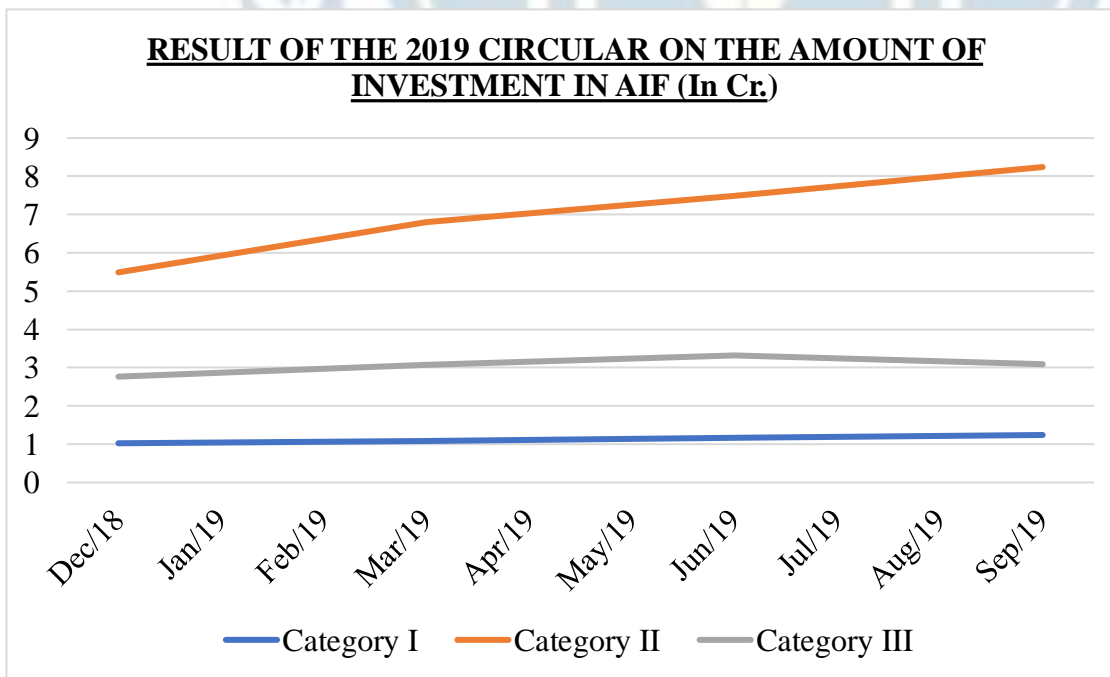
taxed for his investment in a Category III AIF. This is in complete violation of Section 115UB (1) and thereby Section 5(2) of the Income Tax Act.

Nowhere in Section 115UB (1), the Act distinguishes between a Category I/Category II AIF and Category III AIF and simply states about the investments made in an investment fund shall be treated to be made by the investor himself and not the fund

It is necessary that the CBDT and the government takes note of this and make necessary amendments. It is necessary that the government brings about an amendment and provides a pass-through status to Category III AIF's as well. It is agreed that Category I AIFs are socially and economically necessary, but the importance of Category III AIF's can also not be negated and disregarded.

STATISTICAL ANALYSIS

The Circular of 2019 as stated above came on 3rd July 2019, the statistical analysis shall prove the detrimental effect of such a measure on the level of investments made in the relevant periods.



As is evidently clear from the graph, the level of investment in Category I and Category II AIFs are on a steady rise. But this was not so with the investments in Category III

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AIFs as is relevant in the data. The investments in Category III AIFs went down in September 2019 which is undoubtedly a testament of the fact that investors had reacted negatively to the circular issues by the CBDT and had withdrawn their investments from Category III AIF's.

Another important aspect of the results of the graph is the importance of Category III AIFs. It is evident that the level of capital and investment that is pumped into the economy by Category III AIFs is huge and it is pivotal for the economic well-being of India that such capital bringing funds are also incentivized.

It is a settled principle of business and investment transactions that investors, whether domestic or international, make informed and well-researched decisions taking into consideration a variety of static and fluid factors especially those factors which shall affect their investment and returns. Thus, in India's pursuit of becoming a favored investment destination, it is essential that India formulates its domestic policy in a favorable manner.¹³

CONCLUSION

Extensive evidence supports the assertion that the rationale for denying Category III AIFs the designation as pass-through businesses is an invalid methodology. The implementation of a policy approach with significant ramifications should be avoided due to the potential for bad results. One aspect to consider is the operational burden placed on Alternative Investment Funds (AIFs) in terms of calculating the tax liabilities of their investors. Conversely, there is a diminished appeal in investing in AIFs due to unfavorable government policies. Consequently, investors are compelled to explore alternative options that offer more favorable conditions.

Taxes are applicable to off-shore investments made by non-resident investors in Category III Alternative Investment Funds (AIFs), but investments made by investors in Category I or Category II AIFs are free from taxes. This disparity represents a notable distinction between the two investment categories. The lack of differentiation based on the type of Investment Fund in Section 115UB, and the uniform treatment of all categories in terms of the investor's perceived investment, renders the rationale behind Circular 14/2019 similarly unreasonable and illogical.

¹³“SEBI, <https://www.sebi.gov.in/statistics/1392982252002.html> (last visited Oct. 15, 2023).”

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The study's results provide sufficient evidence to support the extension of pass-through status, now accorded to AIFs in Categories I and II, to AIFs in Category III as well. The rationale for such discriminatory attitudes cannot be substantiated by any equitable reasoning or legal framework. The study effectively presents a comprehensive overview of the Alternative Investment Fund and its relationship with the tax system in India.

The importance of the taxation system cannot be disregarded due to its role in incentivizing investment and serving as a catalyst for economic growth and development. Therefore, it is essential to emphasize the need of establishing a robust taxation system in India in order to enhance its efficiency and efficacy.



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