Will 2023 Budget Spring A Midas Touch for Domestic Funds to Preserve and Enhance Wealth Creation?

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The decision of investment in an alternative investment fund ('AIF') revolves around sophisticated investors who are capable of analysing and comparing their investment with other investment options. Distinct from capital markets, investments in AIFs are illiquid, though for unconventional investors, from a long-term investment perspective, investments in AIFs offer numerous advantages. The concept of AIF was introduced a decade ago, since then, it has gained traction amongst wide group of investors managing a commitment of over INR 6,940 billion invested across sectors contribution consistently to the economic trajectory of India.

The interest of the investors in social agenda followed by optimizing returns has resulted in the AIF industry to outshine. This is backed by sovereign funds aimed to provide thrust on the capital-intensive infrastructure projects like toll roads, solar and wind power facing fund raising constraints through listed markets. Essentially, tax treatments of the AIFs also have a pivotal role while investors evaluate the decision to invest in an AIF. This article articulates broader aspects around tax considerations that require attention in the 2023 Budget that could act as a catalyst for the AIFs contributing towards the growth of Indian economy.

1. Synopsis of AIF taxability

1.1. AIFs as an alternative investment option formed as privately pooled investment vehicle invite capital from eligible domestic and foreign investors for investing with well-defined investment policies for the investors benefit. Fund raising is primary requirement to channelize progressive activities in the economy, to drive growth. AIF is a key element to infuse capital in the Indian economy through a private route. Since the end of pandemic and advent of China+1, capital raising has witnessed enhanced interest across various sectors to boost the investment activities.

1.2. The taxability of AIFs is improvised since the venture capital fund ('VCF') regime, by extending the tax 'pass-through' benefits to the VCF income arising from investment in any venture capital undertaking ('VCU'). In order to avail the tax pass-through status, AIFs are obliged to comply with the conditions prescribed under Section 10(23FB) of the Income Tax Act 1961 ('IT Act') and shall comply with the Securities and Exchange Board of India ('SEBI') Regulations with an exception that, for income of the fund treated as profits and gains from business or profession, the liability to pay tax is on the fund at maximum marginal rate ('MMR'). Presently, no tax pass-through status is offered to Category III AIF. Resultantly, income arising from the investment by these funds is taxed in the hands of AIF following the trust taxation principles. Such income accrues / arises in favour of the investors for its tax treatment.

1.3. In this context, it is worth referring the 2015 Alternative Investment Policy Advisory Committee ('AIPAC') Report headed by Infosys Ltd.'s co-founder Mr. Narayan Murthy. The report recommended that the tax pass-through status should be bestowed to Category III AIFs. This is also consistently suggested across various forums. In a pragmatic view, to address the potential bottlenecks that impedes attractiveness of domestic AIFs, the fund industry expects government to deal with tax concerns in the last comprehensive budget before the elections. This would give a fillip to the investment cycle, especially to mitigate the impact of global financial crisis and would also help to spiral the rate of wealth creation in India.

2. Tax attributes to unlock the future of AIFs in Indian economy.

2.1. While the global financial situation is grim, the Indian economy is returning back to pre-pandemic levels, fund managers consistently aim to deliver optimal returns to overcome potential crisis. The tax announcements for the fund industry in the Budget have become less of a high-profile event since most of the issues were addressed by the government throughout its tenure. The signaling of global financial recession diverged with resilient Indian economy has compelled Indian fund managers to scout for innovative ideas to optimise their post-tax returns making India an ideal destination for the investors.

2.2. In an effort to promote the AIF segment based on numerous round table discussion with the government at various forums, few tax considerations that could become a catalyst for the AIF industry towards sustainable wealth creation avenues are elucidated as under.

3. Direct taxation

3.1. Impact of unrealized gains/loss on exiting investors

3.1.1. Trust taxation principles are well enshrined under Section 160(1) read with Section 86 of the IT Act and supported by jurisprudence . Accordingly, the income of a determinate trust is taxable in the same and like manner and to the same extent as persons represented by them as per the trust deed. Resultantly, the members share of the association of person ('AOP') under Section 86 shall not be included in his total income where the association or body is **chargeable to tax on its total income** at the MMR or any higher rate under any of the provisions of the IT Act.

3.1.2. Realistically, based on section 86 of the IT Act, the exiting investors may not offer such income to tax, particularly where real income does not arise in the hands of the AIF. Due to mismatch in timing of income recognition and realisation of income, it could potentially result in distortions of taxable income. Such a situation is a potential recipe for litigation. A suitable clarification/mechanism towards such taxability is advisable to mitigate any unforeseeable litigation.

3.1.3. Alternatively, clarity under Indian accounting standards or the tax laws for interest income accruing or arising to the investors based on the financial entries and subsequently written off in the books of AIF could prevent an anomaly in the private debt AIF segment. Practically, such a case would result into timing difference for the investors if the capital losses are unadjustable and could put them at a disadvantageous position. A situation resulting into tax inefficiency for the investors needs to resolved to promote the private debt segment to avoid re-characterisation due to timing mismatch.

3.2. Avoiding the unavoidable impact of togetherness

3.2.1. An AOP is a recognised 'person' under Section 2(31) of the IT Act and is regarded a separate taxable entity. The Courts in numerous cases have held that, to constitute an AOP, persons must join in a common purpose or common action and the object of the association must be to earn income and it is not enough for the persons to receive income jointly.

3.2.2. The recent amendment to the AIF regulations permitting co-investments through a portfolio manager registration is an attractive proposition for the investors, including to the offshore investors. However, every advantage carries certain level of risk owing to lack of clarity. The Indian tax authorities, relying on the AOP provisions, may potentially claim that the control and management of an offshore investor vests with the domestic investment manager of the AIF due to co-investment and the primary investment by the AIF. This may result in a possible exposure to the offshore investor and domestic AIF to constitute an AOP and tax assessments at the AOP level than qua the beneficiaries of the onshore fund.

3.2.3. Consequently, a reasonable exception in such cases dealing with offshore investors will boost influx of capital relieving the risk of any double taxation on the same income.

3.3. Specified regime for Special Situation Fund ('SSF') and investment in Securities Receipt

('SRs')

3.3.1. SEBI notified SEBI AIF (Amendment) Regulations, 2022 to introduce the concept of investment under SSF model. This model is only for Category 1 AIF to invest in special situation assets in accordance with its investment objectives and to act as a resolution applicant under the Insolvency and Bankruptcy Code, 2016. Before the amended Regulations, AIFs were only permitted to invest in debt assets through debt securities and prohibited from accessing loans.

3.3.2. SSF can invest in distressed assets through securities of stressed companies and SRs issued by Asset Reconstruction Company. Notably, staying invested in an investee company for longer duration is paramount for turnaround of companies. In this regard, AIFs prove to be an efficient investment vehicle for resolution of the stressed assets, especially through its managerial skills they are capable to reviving an ailing business.

3.3.3. The advent of SSF could result in distortion of the tax treatment of instruments particularly when the stressed loans are acquired at a discount from the original lender. In this regard, it is worthwhile to introduce specific provisions for taxability upon acquisition of such instruments at a discount and thereafter full realization. Ideally, the taxability could have a segregated approach owing to the two being independent transactions.

3.3.4. The segregated transactions are inextricably linked with the realization proceeds being recognized as business income, taxable in the hands of the fund on realization of the SRs or its exit at full recoverable value. On the other hand, it could be treated as capital gains arising from the transfer of capital asset acquired at a discount and appreciated on exit akin to broken period interest. The clarification gets justified where the intention of an AIF is always to invest for a capital appreciation. However, due to the inherent nature of investment arising from SRs linked to the underlying loans owned by the Banks or financial institutions, it is treated as business income taxed at a higher rate than capital gains.

3.3.5. The position of higher taxation on capital assets having loans as underlying assets defeats the very purpose of investment activities of the AIFs set-up with an objective for capital appreciation. Accordingly, a clarity on the treatment of the SRs being a capital asset to be regarded under the head capital gains shall build the efficiency for the SSF model aimed to participate in the revival plans of the stressed assets industry.

3.4. Parity of capital gains taxation for listed and unlisted shares

3.4.1. Category I and II AIF investors are presently liable to pay relatively higher tax rate of 20 percent on long term capital gain ('LTCG') on their investments as compared to 10 percent LTCG tax paid by the investors in a less risky and more liquid listed stocks. This has led to an arbitrage that makes the AIF asset class less attractive option for the investors.

3.4.2. Sophisticated economies globally have tax rate parity on the capital gains arising from sale of unlisted and listed securities. A similar reform of matching the LTCG tax rates with those in public market on exit in India will to provide a level playing field to the investors of AIF Category I and II. Accordingly, bringing the tax rates at par with listed and unlisted shares for AIF investors who contribute primary investments, create jobs, and foster innovation, will deserve their due to attract more asset under management under the purview.

3.5. Tax break on management fees

3.5.1. The IT Act provides for pass-through of losses incurred by the AIF fund to the investors but, unfortunately does not provide for pass-through of the expenses incurred by the AIF. The expenses incurred by an AIF, as investment manager's fees, trusteeship fees and other administration expenses, can constitute up to 30 percent of the AIF's corpus. These expenses are a "dead loss" since neither the AIF nor their investors can offset these expenses against income / capital gains that eventually result from the AIFs investment. Further, by providing a pass through of the losses, the investors of the AIFs have to wait till there is a capital gain in their tax computation or will have to carry forward such losses till adjusted.

3.5.2. Effectively by permitting the operational expenses like management fees to be construed as a cost of investment or cost of improvement, could result in such expenses being claimed against the investors tax liability under capital gains tax computation and offer significant relief to the investors.

3.6. Pass through framework for Category III AIFs

3.6.1. Inspite of the extensive deliberation by focused and investors group at AIPAC, a "pass-through" tax regime for Category III AIFs is yet to become a reality, resulting in income / capital gains from Category III AIFs subject to taxation in the hands of the AIF itself. The AIF taxation depends on the status of entity whether established as a trust, LLP or a company. The absence of a "pass-through" status for Category III AIF has led foreign investors to register as Foreign Portfolio Investors to invest in Indian listed securities than directly investing in Category III AIF. As for the establishments the domestic fund managers are resorting to consider alternate entities to minimize their tax liabilities.

3.6.2. A determinate trust has specific shares of the beneficiaries in the trust as expressly set out in the trust deed and is identifiable and ascertainable as on the date of execution of the trust deed. The trustee of a Category III AIF set up as a determinate trust is treated as a representative assessee under Sections 160 to 162 of the IT Act who will discharge the tax liability of each beneficiary of the trusts based on their status.

Conversely, the investor does not have to pay additional tax on income / capital gains of a Category III AIF settled as an indeterminate trust and is taxed at the entity level, at MMR under the IT Act. If a Category III AIF is set-up as a limited liability partnership (LLP), such LLP is taxed and its investors level who would be as partners in the AIF and exempt from paying tax. In the unlikely event that a Category III AIF is set-up as a company, such AIF would pay tax on its profits at the applicable corporate tax rate and any dividend paid to its shareholders/investors would be taxable in the hands of such shareholders/investors.

3.6.3. SEBI registered Category III AIFs that offer the much-needed market liquidity have grown exponentially in last few years. Since AIF Category III usually invests in listed securities on a short-term basis, the income / capital gains earned by such funds is usually characterized as business income. Hence, even if such funds were granted a "pass-through status" business income earned would not benefit from the "pass-through status" except that the fund would be subject to highest level of surcharge making it tax cost inefficient. Most developed countries have a well-defined distinct tax regime for hedge funds. In India, however, lack of specific tax code for income-generated from Category III AIF investments hampers these funds, and a tax pass-through regime for category III AIFs is required.

4. Indirect taxation

4.1. GST on services by AIFs to foreign investors

4.1.1. Many countries waive or refund the GST for offshore overseas funds structures managed locally, as the ultimate investors are located offshore, and the governments intend to promote the development of a local PE / VC ecosystem. Presently, AIFs managed by India-domiciled asset managers are subject to a high rate of GST at 18 percent on the management fees paid to the fund manager causing significant cost inefficient structure deterring onshoring of funds although contributors of capital are based globally, and the fund management services qualify for export benefits.

4.1.2. It is imperative that the government shall treat fund management services to AIFs, to the extent of foreign investor contributions as 'deemed exports' under GST law and be 'zero rated'. This would enable onshoring of funds and fund managers, creating high value jobs while also being revenue accretive for the government from additional tax revenues linked to the hiring of consultants, bankers and due diligence experts onshore. The Indian government could exempt foreign investors dealing with India-registered AIFs from the GST helping anchor funds locally.

4.2. Impact of GST on management fee irrecoverable by investors

4.2.1. Since the inception of GST, the expenses incurred by the AIF are subject to GST, directly borne by the investors. Consequently, the investors have to bear a higher tax on their investment, basis the GST borne by such fund which is ultimately allocated to the investors. The issue is further aggravated where the investors are unable to claim such GST under as input credit against any service rendered.

4.2.2. The government aimed to eliminate double taxation should evaluate a mechanism to minimize the burden of higher GST particularly for foreign investors investing in a pooling vehicle domiciled in India alternatively, by exploring the introduction of remission scheme for the fund.

5. Key inferences

5.1. The introduction of AIFs has supported economic stability as existing, new and emerging entrepreneurs are assigned with right financial support for growth. AIF also offers a strong backbone for economy to remain stable and further in multiplication of GDP. The investment in AIFs are largely accommodated by high net worth individuals ('HNI') or private equity ('PE') investors possessing higher appetite for risk and return by HNI and PE investors. AIFs not only facilitate exponential returns for investors but also promote innovation in the field of technology, finance and for that matter the advanced fin-tech arena.

5.2. In light of numerous advantages of the AIFs, the government has been pro bono to devise a strategy to meet the sufficient needs of the AIFs or the investors and the relevant stakeholders. The government incentivizing AIFs could potentially result in another issue at hand that other investment platforms shall also be looking forward for the incentives. Accordingly, the revenue loss and market consequences should be have an equilibrium . Aimed to promote simplicity, a uniform AIF taxation code will likely address the ineffcienciеies in taxation models of different categories and encourage investors to dedicate funds in such AIFs.

5.3. The 2023 Budget can be a game changer for the investors to provide investment linked benefits and introducing disruptive methods to offer maximum advantage . Moreover, tax transparency and simplification will incentivise the investors to invest in a unified tax, free of any ambiguities. The rationalization of AIF taxation should further enable a fair and equitable sharing of tax revenues, curbing any evasion or avoidance. The aim to address certain finer points will not only support in furtherance of the government's objective of 'ease of doing business in India' but such clarity in the taxation structure will provide a competitive edge to the Indian AIFs for improving the prospects of an appropriate risk-return profile competing with global fund concepts.

5.4. The AIF space in India is backed by the government through frameworks that institutionalize it. Such institutionalization provides investors clarity about the structure, process, and due diligence of investments in start-ups making investing in VCF attractive. The right attributes of tax like pass-through status of AIF Category III, deduction of management fees, tax treatment of SRs and income characterization would make the AIF segment even more conducive for investor participation. An equitable and incentivized regime in the Indian venture capital business will enable AIF to flourish and facilitate the government to achieve the its objective to develop a vigorous financial market in India and contribute towards a USD 5 trillion economy in times to come.

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[1] Authority for Advance Ruling in the case of P. NO. 10 OF 1996 (224 ITR 473) [TS-5012-AAR-1996-O] and India Advantage Fund [TS-5054-HC-2017(Karnataka)-O]