

## Parity on CAT III AIF With Respect to Tax Carve Outs

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### Pranay Bhatia

Partner at BDO India LLP



### Nidhi Goyal

Assistant Manager, BDO India LLP

The Alternative Investment Fund ('AIF') has witnessed the sharpest growth as an avenue of investment in the recent years. AIFs have been an attractive option for sophisticated investors including high net worth individuals ('HNI') looking for diversification by participating in private markets and increasing their returns.

The tax treatment of AIFs and the income received by investors from their investments in AIFs is an important factor that goes into the decision-making process before an investment is made in an AIF. Hence, it is important to highlight the tax implications of investments in the AIF and the challenges that need to be addressed for investments in AIF considering that Budget 2023 is round the corner.

### Extension of pass-through status to Category III AIFs

The Finance Act, 2015 introduced a special taxation regime by granting a pass-through status to Category I and Category II AIFs. As a result of which, the obligation to pay tax on the income earned by AIFs (other than business income) lies in the hands of the investors of the AIF directly. In other words, the tax obligation gets passed through to the investors of AIF who are required to pay tax on the income of the AIF as if such income had accrued from investments made directly by the investors. The AIF itself is exempt from any tax obligation on its investment income.

However, despite many deliberations, such pass-through taxation regime has not been extended to Category III AIFs under the Income-tax law till date. On account of such disparity, income earned by Category III AIF is subject to taxation at the AIF level itself. Therefore, taxation of Category III AIF depends on the structure of incorporation of the AIF i.e. whether it has been set up as a Trust, Limited Liability Partnership ('LLP') or a Company. Greater clarity is desired pertaining to taxation of Category III AIF.

It has been a long-standing expectation by the industry to extend the pass through regime to Category III AIFs as well. The Finance Act, 2021 had granted the tax pass-through status to Category III AIFs incorporated in the IFSC. In order to bring in tax parity amongst the three classes of AIFs, it is now expected that Budget 2023 extends the pass through status to all Category III AIFs. It will also lead to a fair tax treatment for the investors of Category III AIF as different surcharge rates may be applicable to each investor whereas in case of taxation at the Fund level, entire income could be taxed at the highest applicable rate of surcharge.

## **Clarification on classification of income for Category III AIF**

Category III AIFs which are involved in trading activities may face the challenge of classification of income under the head business income or capital gains. There are CBDT circulars which provide certain principles which can assist in determining the classification of income under capital gains vis-à-vis business income.

However, a specific clarification is expected to be provided for Category III AIFs regarding characterisation of income earned by these funds. This will bring in uniformity in the tax treatment opted by the funds across the industry and result in simplification.

## **Exemption from indirect transfer provisions**

Another challenge pertaining to Category III AIF is applicability of indirect transfer provisions under Section 9 of the Income-tax Act, 1961 ('ITA'). As per the indirect transfer provisions, transfer of shares or interest in an offshore entity which derives its value, whether directly or indirectly, substantially from assets located in India will be treated as indirect transfer and subjected to capital gains tax in India.

Income arising to Non-resident investors on account of redemption or buyback of its share or interest held indirectly, through upstream entities incorporated outside India, in Category I and Category II AIFs have been granted exemption from the provisions of indirect transfer by way of a clarification. Similar clarification is required in case of Category III AIF as well. If an investor in Category III AIF is a feeder fund, then the investor in that feeder fund could be exposed to tax as a result of indirect transfer provisions. Accordingly, to bring in parity, Category III AIF should also be kept outside the purview of indirect transfer.

## **Tax on Debt investments**

Under the current provisions of ITA, FPI investors are granted concessional rate of tax on interest income arising from certain specified debt instruments such as government securities and corporate bonds. Also, interest income arising to foreign lenders on external commercial borrowing (ECB) loans and rupee-denominated bonds is subject to a lower tax rate.

Category III AIFs investing in foreign debt instruments have not been brought within the ambit of such concessional taxation regime. It is expected that such lower tax rate benefit is extended in relation to interest income arising to Category III AIFs from foreign debt investment. This could bring in parity in taxation of interest income earned from foreign capital by investors investing through Category III AIFs instead of the FPI route.

## **Requirement for filing income-tax return for non-resident investors of Category III AIFs based in GIFT IFSC**

Non-resident investors investing in Category I and Category II AIF located in GIFT IFSC have been exempted from the requirement of obtaining PAN and filing income-tax return in India if they do not have any other income in India apart from income from the AIF and specified conditions are met.

While the exemption pertaining to non-obtaining of PAN is also applicable for non-resident investors of Category III AIF, no such clarity is provided in relation to their return filing requirement. In order to bring in parity even non-resident investors in Category-III AIF should be granted specific exemption from filing the income-tax return if they do have any other India sourced income.

Budget 2023 is expected to provide these clarifications and relaxations to keep up the interest in AIFs and the pace of inflows in AIFs as compared to alternative asset classes viz. Mutual Funds and PMS.

*\* Views expressed above are personal & may not reflect that of the organisation.*