

Handling start-up funding with care

Rationalise taxation of AIF's for greater flows and remove discriminatory policies



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THE funding of start-up enterprises and unlisted companies in India largely takes place through SEBI-registered Alternative Investment Funds (AIFs) and direct investments. The AIFs provide the much required long-term and high-risk capital to start-up and growth oriented enterprises. AIFs had received over ₹70,000 crore of capital commitment from its investors and have raised over ₹33,000 crore from them, till the end of December 2016. In the listed segment, the investments take place through Initial Public Offerings, Mutual Funds (MF), Portfolio Management Schemes (PMS) and directly by investors. But the tax regime for AIFs and MFs is different and discriminatory against AIFs. The finance minister in his Budget 2017 has not addressed the concerns of the AIF industry.

MFs are exempt from payment of income tax on any income earned by them. However, non-equity oriented MF schemes in India are required to pay Dividend Distribution Tax (DDT). Equity oriented schemes are liable to pay Securities Transaction Tax (STT) and not DDT. Dividends received by investors from all MF schemes in India are tax-free.

MF investors are not subject to a pass-through taxation on income earned by the MFs. Instead, they are only required to pay income tax on capital gains arising from the redemption/transfer of their MF units. The rate of capital gains tax differ based on the type of schemes (equity or debt) and the period of holding (short-term or long-term). Expenses incurred by the MFs are subsumed in the computation of the Net Asset Value (NAV) of the MF schemes resulting in lower taxation to the investor to that extent.

Under the present income tax regime, Category I and II AIFs (defined as “investment fund” under the Income tax Act) are exempt from payment of income tax on any income earned by them other than business income. As a corollary, investors in Investment Funds are tax exempt on business income earned by such funds and are subject to pass-through taxation on interest, dividends and capital gains earned by them, on an

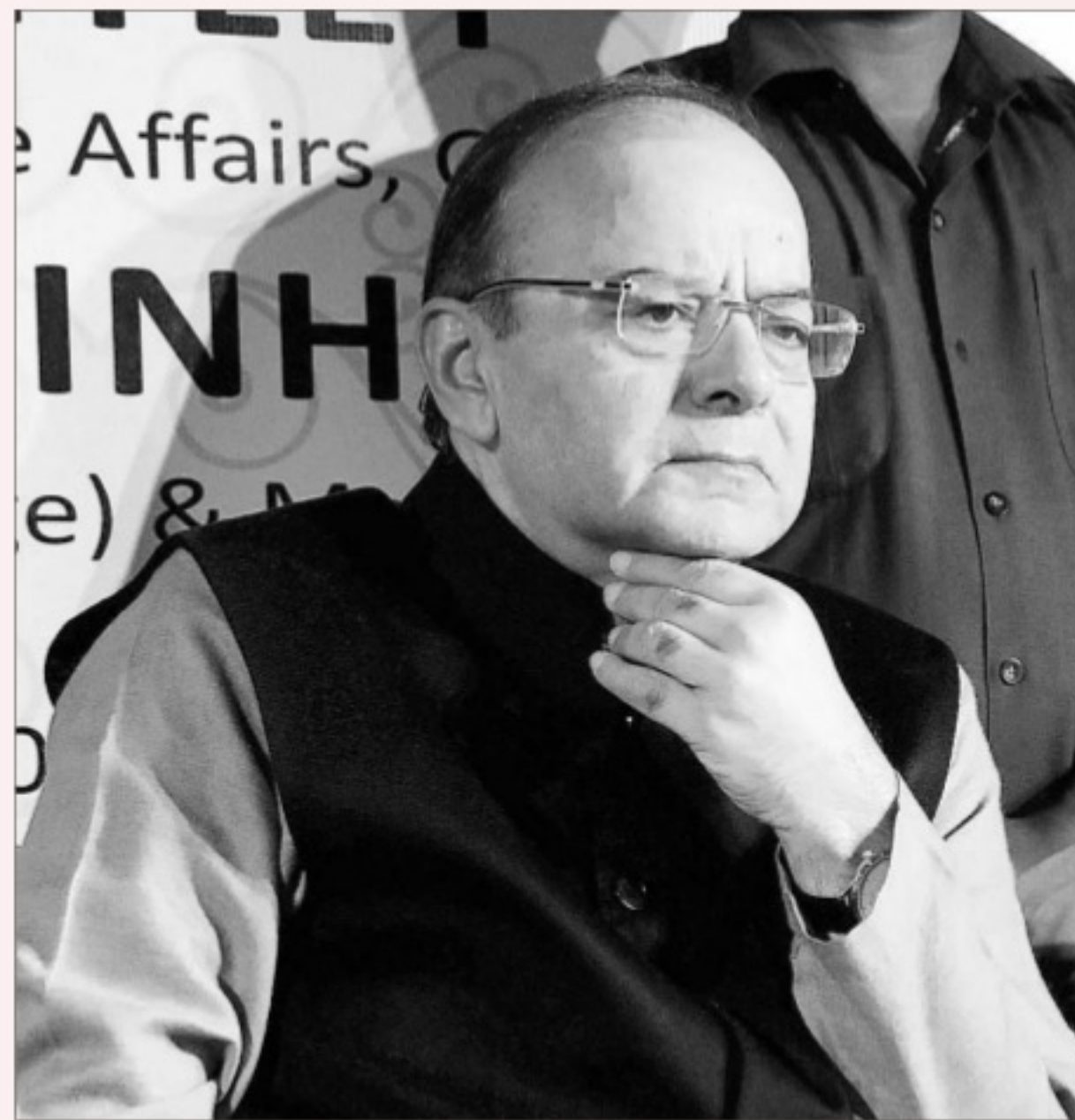
accrual basis. This concept of partial pass-through taxation is unique to India. It is baseless to expect investment funds to earn business income.

Category III AIFs are the ones that employ diverse or complex trading strategies and leverage, including through investment in listed or unlisted derivatives. They include funds such as hedge funds, PIPE Funds, etc. Category III AIFs are not included in the definition of an “investment fund”, and are consequently not granted pass-through taxation. In its absence, majority of these funds, organised as trusts, are taxed at the maximum marginal tax rate of 30%, since they fail to qualify as a determinate trust. Most such funds are, thus, domicile overseas.

Investment Funds (Category I and II AIFs) are required to withhold income tax at 10% on non-business income payable to domestic investors. The tax regulations do not indicate if the withholding tax is applicable on gross income of the fund or on income after netting off expenses incurred by it. Shareholders earning dividend income from domestic companies are tax exempt up to ₹10 lakh per annum. Long term capital gains arising from sale/transfer/redemption of listed equity shares or equity oriented MF schemes are also tax exempt. Thus, any requirement to withhold tax on such exempt income would make it suffer taxes without cause. It is absurd to expect an investment fund to withhold income tax on exempt income, which is against the cardinal principle of taxation. This will lead to needless harassment of investment funds resulting in litigation.

The biggest challenge for investment funds, and its investors, is the categorisation of income. Generally, income earned from the conduct of a trade or business is considered as “active” or “business” income and investment activities generating interest, dividend, rental income and capital gains are considered as “passive income”. Investment activities are considered passive since the investor does not actively participate in the day-to-day operations of the business. The distinction between active and passive income is important as capital gains is subject to a concessional rate of taxation in India compared to business income.

The entire income of all categories of AIFs (including Category III) can only be considered as passive income in view of the intent, activities, functioning and the definition of AIFs as per SEBI (Alternative Investment Funds) Regulations, 2012 and the Income tax Act, 1961. By providing that business income of investment funds will be taxable at the fund level, the tax regulation provides ample scope to the assessing officers



The FM should stop the inefficient litigation prone pass-through taxation regime applicable to Category I and II AIFs, which could lead to tax terrorism by tax authorities. There would be equity in taxation if all categories of AIFs (including Category III) are completely exempt from taxation

(AOs) to characterise income earned by an investment fund as business income. The I-T authorities have not issued any specific guidelines on how to determine business income of an AIF.

What is considered to be passive income by an AIF could be characterised as business income by the tax authorities during an assessment and taxed accordingly. This causes uncertainty in income characterisation for an AIF and its investors, and thereby its taxation. As tax assessments happen with a lag, this exposes investors to uncertain liabilities.

It is a global practice that venture capital (VC) funds and private equity (PE) funds (both are AIFs by definition) generally assist the management of an investee company in addition to providing capital. They also have a seat on the board of the investee company to mentor the management team, closely monitor the growth of the company and participate in various strategy and decision making process. The I-T authorities in

India could view these activities as the carrying on of a trade or business by that fund, and consequently categorise the income generated by the fund on the sale of its shares as business income instead of capital gains. The CBDT, superseding its earlier order, recently advised its officers that transfer of unlisted shares along with ‘control and management of the underlying business’ by investment funds should be treated as capital gains. The need for issuing such an order clearly indicates the approach taken by the tax authorities in this regard.

In the United States, a VC or a PE Fund is usually organised as a limited liability partnership (LLP) which is a tax pass-through entity. A US partnership that elects an “investment partnership” status in its income tax filing, is not considered to be engaged in trade or business merely because of buying and selling of its investments and providing some ancillary management services in the formation, capitalisation, or of-

fering of interests in a corporation. This safe harbour prevents the income of an investment partnership from being categorised as business income. Similar guidelines have not been issued by the I-T authorities in India, thereby exposing investment funds to the risk of being categorised as a business entity rather than an investment entity.

The nature of income determined by the investment fund would pass-through to its investors. If the fund determines its income to be capital gains, it is tax exempt on such capital gains (other than its obligation to withholding tax). Instead, the fund investors would pay income tax on their share of capital gains income. If the income tax authorities during an assessment procedure reclassify the capital gains income as business income, it would result in double taxation—as business income for the fund and as capital gains for its investors. This uncertainty in income characterisation would remain till the proper classification of income is resolved under a judicial process, which is an unduly time consuming process.

In the case of dividend income earned by a fund which was passed through to its investors, the income tax authorities contended that the dividend income was taxable under “Income from Other Sources” in the hands of the investor since DDT tax was not paid by the fund while distributing the dividend. The Delhi ITAT opined that AO and CIT(A) had taken a wrong view by holding that the assessee cannot claim exemption unless additional tax was paid. This case relates to FY06 and FY07, and the order was pronounced on January 29, 2016, a decade later. The time taken to resolve this issue, caused uncertainty to AIFs and its investors.

There is no clarity on the deduction of expenses incurred as well. Investment funds incur annual expenditure in the form of management fees paid to fund managers, office rent, legal, accounting and other operational expenses. Over the life of the fund, these expenses could be about 18-20% of the capital commitment of the investors. The income generation of Investment Funds is back-ended as majority of the income is earned as capital gains on exit of its investments. It generally takes more than five years to generate capital gains. During this investment period, funds earn tax-exempt dividend income or low amount of taxable income which is inadequate to offset the annual expenditure, resulting in losses. The tax regulations do not clearly indicate if the investors are entitled to a pass-through expense deduction. The amount of annual pass-through taxable income in the initial years is lower than the corresponding

expenditure incurred, resulting in a high quantum of unclaimed expenses.

Foreign portfolio investors or foreign institutional investors (FIIs) are subject to only capital gains taxation in India since any securities held by a FPI/FII, which has invested in such securities in accordance with Sebi regulations, qualify as capital asset.

In summary, all gains made from investments in financial instruments by investors in public markets in India are taxed under the head “capital gains” for domestic investors and FPIs/FIIs.

The Alternative Investment Policy Advisory Committee (AIPAC), set up by Sebi under the chairmanship of NR Narayana Murthy to advise on various issues related to the alternative investment industry and development of the start-up ecosystem has rightly suggested in its report that investments in PE and VC funds are risky, commonly illiquid, and relatively longer term in nature. Accordingly, PE and VC funds should, at the very least, have a tax regime that is on par with that applicable to investors in public markets. Investment gains of AIFs should be deemed to be ‘capital gains’ in nature, is another recommendation of AIPAC Report.

The FM should stop the inefficient litigation prone pass-through taxation regime applicable to Category I and II AIFs, which could lead to tax terrorism by tax authorities. There would be equity in taxation if all categories of AIFs (including Category III) are completely exempt from taxation similar to MFs, and investors in AIFs are subject to capital gains taxation similar to investors in MFs. The tax authorities should impose STT on all categories of AIFs at the time of their investments and divestments. This tax regime would ensure that there is no loss of tax revenue as investors would be liable to payment of capital gains tax on sale/maturity of AIF units and the AIFs would be subject to payment of STT on investment and divestment of its investments. This will ensure that the risk of mis-categorisation of capital gains as business income vanishes and expense deduction is subsumed in the NAV computation. This tax regime will bring in uniformity in taxation of all financial risk bearing instruments in India, regardless of whether the investment is in a MF or an AIF. In the absence of a pass-through mechanism, there would be no requirement to withhold tax on tax-exempt income paid by AIFs to its investors, resolving some of the challenges currently faced by AIF investors.

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