TAX TREATMENT OF ALTERNATIVE INVESTMENT FUNDS AND THEIR INVESTORS

- AN ANALYSIS

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The decision to invest in an alternative investment fund ("**AIF**") is, like any other investment decision, driven entirely by financial considerations. Investors weigh the pros and cons of the proposed investment and compare it with other investment options available to them. Investments in AIFs are undoubtedly less liquid than investments in listed securities. However, for many investors with a long-term investment horizon, such investments provide various advantages. For example, investors in a category 1 infrastructure fund can get exposure to infrastructure projects such as toll roads, solar and wind power projects, which cannot be easily achieved by investing in listed securities. Investors with a social agenda can invest in social venture funds. Investors in AIFs do not have to pay their proposed investment amount upfront. They only have to make a capital commitment and pay such commitment amount in instalments as and when a drawdown notice is issued.

The tax treatment of AIFs and that of the income received by investors from their investments in AIFs is a very important factor that goes into the decision-making process that precedes an investment in an AIF. This paper seeks to analyse the provisions of the Income-tax Act, 1961 ("**IT Act**") which are relevant for AIFs and their investors.

1. TDS on Income from AIF Units

Section 194LBB was inserted in the IT Act with effect from June 1, 2015, to provide that where any income, other than that proportion of income which is of the same nature as income derived from profits and gains from business or profession, is payable to a unit holder in respect of units of an investment fund specified in clause (a) of the Explanation 1 to section 115UB of the IT Act, the person responsible for making the payment shall, at the time of credit of such income to the account of such unitholder or at the time of payment thereof in cash or by issue of a cheque or draft or by any other mode, whichever is earlier, deduct income-tax thereon.

In the case of resident unit holders, AIF is required to deduct tax under section 194LBB of the Act at the rate of 10% (ten percent) of such income derived.

For a non-resident unit holder or a foreign company, the deduction is required to be done at the rates in force prevalent during the relevant financial year or the rates specified in the applicable the Double Taxation Avoidance Agreement ("**DTAA**") entered between India and the country of residence of such non-resident. TDS must be deducted at the time of payment to the unitholder or credit of the income to their account, whichever is earlier. In other words, tax is payable on accrued income, even if such income is not actually received by the investor.

What happens to exits proceeds accruing to Sponsors with respect to the minimum sponsor commitment?

Regulation 10(1)(d) of the Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012 ("**AIF Regulations**") prescribe a minimum sponsor commitment of Rs. 5,00,00,000 (Rupees five crore) or 2.5% (two-point five percent) of the aggregate capital contributions received by category I and category II AIFs and a minimum sponsor commitment of Rs. 10,00,00,000 (Rupees ten crore) or 5% (five percent) of the aggregate capital contributions received by category III AIF is required to be maintained by the sponsor of an AIF during the tenure of the AIF.

Sponsors of AIFs make a capital commitment for a value not less than the minimum required capital contribution and subscribe to units of the AIF as and when drawdown notices are issued to them. However, since sponsors are required to maintain this minimum capital contribution till the expiry of the AIF, the units held by them cannot be redeemed until the expiry of the AIF, even if units held by other investors are redeemed periodically, as and when exit proceeds are received by the AIF. Even though, the units held by a sponsor in respect of the sponsor's minimum commitment cannot be redeemed, the redemption proceeds in respect of such minimum

commitment may be deposited in a special account by the trustee of the AIF. The AIF's PPM may also specifically state that redemption proceeds relating to such units may be invested in liquid investments or even fixed deposits and the interest income or other income arising from such investment may be paid to the sponsor In any event, since income has become payable to the sponsor in respect of the units constituting the sponsor's minimum commitment for the purpose of Section 194LBB, TDS has to be deducted from such income and the sponsor would be liable to pay income tax in respect of such income to the extent TDS has not been deducted.

Unlike investments in AIFs, investments in mutual funds or any other funds which deal with listed securities are not subject to income tax collection/deduction at source. Profits and gains made from the transfer of listed securities whether or not held through a fund is chargeable to tax at the hands of the investors as long-term or short-term capital gains.

2. Differential Tax Rates for Capital Gains Arising Out of Listed and Unlisted Securities

Definition of capital assets

Section 2(14) of the IT Act defines a "**capital asset**" to include:

"*(a) property of any kind held by an assessee, whether or not connected with his business or profession;*

(b) any securities held by a Foreign Institutional Investor which has invested in such securities in accordance with the regulations made under the Securities and Exchange Board of India Act, 1992 (15 of 1992) ……"

Section 2(14) also includes a list of items which are excluded from the definition of a 'capital asset', such as, any stock-in-trade other than the securities referred to in sub-clause (b), consumable stores or raw materials held for the purposes of his business or profession.

Securities of an Indian company which are not expressly classified as stock in trade, may be regarded as "**property**" under Section 2(14) (a) of the IT Act and consequently treated as a capital asset.

Classification of capital assets

The capital gains arising from the transfer short-term capital assets ("**Short-Term Capital Assets**") are charged at a higher tax rate as compared to capital gains arising from the transfer of long-term capital assets ("**Long-Term Capital Assets**").

Section 2(42A) of the IT Act defines a Short-Term Capital Asset as a capital asset held by an assessee for not more than 36 (thirty-six) months immediately preceding the date of its transfer. Long Term Capital Assets as defined under Section 2 (29AA) of the IT Act are those capital assets which are not short-term capital assets and hence any capital asset which is held for more than a period of 36 (thirty-six) months immediately preceding the date of their transfer.

However, Section 2 (42A) of the IT Act provides that unlisted shares of an Indian company would be treated as a short-term capital asset only if it has been held for less than 24 (twenty-four) months. Section 2 (42A) of the IT Act applies only to equity shares and unlisted securities other than shares (such as debentures) need to be held for more than 36 (thirty-six) months to qualify as a long-term capital asset. In the case of listed securities, as per the second proviso to Section 2 (42A) of the IT Act, it is sufficient to hold them for a period exceeding 12 (twelve) months for such securities to qualify as long-term capital asset. Therefore, shares of Indian companies which are listed on any recognised stock exchange in India, units of equity oriented mutual funds, listed

securities like debentures and Government securities, Units of UTI and Zero-Coupon Bonds qualify as a long-term capital asset if held for a period exceeding 12 (twelve) months.

Differential Tax Rates for listed and unlisted securities

At present, there is a disparity in the tax rates applicable to capital gains arising from the sale of listed securities vis-à-vis sale of unlisted securities.

Rate of tax for long term capital gains:

Long-term capital gains are charged to tax at the rate of 20% (twenty percent) (plus surcharge and cess as applicable) for unlisted securities.

However, as per Section 112A of the IT Act, capital gains arising from the transfer of a long-term capital asset being a listed equity share in a company or a unit of an equity-oriented fund or a unit of a business trust shall be taxed at the rate of 10% (ten percent) (plus surcharge and cess as applicable) of such capital gains exceeding Rs. 1,00,000.

Thus, not only should unlisted securities be held for a longer period than listed securities (24 months instead of 12 months) to qualify as a long-term capital asset, but they are also taxed at a higher rate (20% instead of 10%).

Rate of tax for short term capital gains:

Short term capital gains arising out of the transfer of unlisted securities are charged to tax at the slab rate applicable to the relevant investor. The income tax slabs vary from 5% (five percent) to 30% (thirty percent) plus surcharges and applicable cess.

As per Section 111A of the IT Act, capital gains arising from the transfer of a short-term capital asset, being a listed equity share in a company or a unit of an equity-oriented fund or a unit of a business trust, shall be taxed at the rate of 15% (fifteen percent) (plus surcharge and cess as applicable)

As shown below in detail, Category I and Category II AIFs usually invest in unlisted securities, whilst Category III AIFs usually invest in listed securities. Therefore, for reasons mentioned above, Category III AIFs have a huge tax advantage vis-à-vis Category I and Category II AIFs.

The relevant[1] investment parameters of Category I AIFs, Category II AIFs and Category III AIFs, as provided for in the AIF Regulations are detailed below:

Category I AIF: Permitted Investments

In the case of venture capital funds ("**VCF**"), a sub-category of Category I AIFs, at least two-thirds of the investable funds of the VCF must be invested in unlisted equity shares or equity linked instruments of a venture capital undertaking or in companies listed or proposed to be listed on a SME exchange or SME segment of an exchange. Not more than one-third of the investable funds of the VCF can be invested in: (i) subscription to initial public offer of a venture capital undertaking whose shares are proposed to be listed; (ii) preferential allotment, including through qualified institutional placement, of equity shares or equity linked instruments of a listed company subject to lock in period of one year; (iii) the equity shares or equity linked instruments of a financially weak company or a sick industrial company whose shares are listed.

[1] These are not exhaustive and are merely meant to show how Category I and Category II AIFs usually invest in unlisted securities, whilst Category III AIFs usually invest in listed securities.

In the case of SME Funds, also a sub-category of Category I AIFs, at least seventy five percent of the investable funds shall be invested in unlisted securities or partnership interest of venture capital undertakings or investee companies which are SMEs or in companies listed or proposed to be listed on SME exchange or SME segment of an exchange. Listing on the SME segment of any recognized exchange is sufficient to qualify the investment for the purpose of long-term capital gains.

In the case of social venture funds, which is also a sub-category of Category I AIFs, at least seventy five percent of the investable funds shall be invested in unlisted securities or partnership interest of social ventures.

Category II AIF: Permitted Investments

AIFs that do not fall under category I and III and do not undertake borrowing or leverage other than to meet the day-to-day operational requirements and are permitted in the AIF Regulations are classified as category II AIF. This includes debt funds or private equity funds, which receive no specific incentives or concessions from the government or any other regulator. A few examples of a category II AIF are, private equity funds, real estate funds, debt funds, funds for distressed assets, etc.

Category II AIFs should 'primarily' invest in unlisted investee companies or in units of other AIFs. SEBI has clarified, vide an informal guidance dated February 28, 2014 issued to India Realty Excellence Fund II LLP, that the requirement to 'primarily' invest in unlisted investee companies or in units of other AIFs means that a majority of the investments of the Category II AIF should be in unlisted securities.

Private equity funds, real estate funds, debt funds, funds for distressed assets, etc. are examples of Category II AIFs.

Category III AIFs: Permitted Investments

Category III AIFs face very little restrictions and are allowed to make all of their investments listed securities, if they so wish.

> Regulation 18(a) of the AIF Regulations states as follows: *Category III Alternative Investment Funds may invest in securities of listed or unlisted investee companies, derivatives, units of other Alternative Investment Funds or complex or structured products;*

3. Pass-Through Status for AIF

Pass-Through Status for CAT I and CAT II AIF

The Finance Act of 2015 amended the IT Act to grant a pass-through status to Category I and Category II AIFs, as a result of which, the obligation to pay tax on the AIF's income (other than on the AIF's business income), rests with the fund's investors, rather than on the AIF entity. In other words, the tax obligation gets "passed through" to the investors in the AIF and the investors will have to pay tax on the income / capital gains of the AIF, as though such income / capital gains had accrued from investments made directly by the investor. The AIF itself is exempt from any tax obligation on its investment income / capital gains. Grant of the pass-through status brings AIF legislations on par with their global counterparts. The relevant Sections of the IT Act relevant to the above discussion have been reproduced below,

> ***"Section 10.*** *In computing the total income of a previous year of any person, any income falling within any of the following clauses shall not be included—*
> *(23FBA) any income of an investment fund other than the income chargeable under the head "Profits and gains of business or profession";"*

"***Section 115UB.*** *(1) Notwithstanding anything contained in any other provisions of this Act and subject to the provisions of this Chapter, any income accruing or arising to, or received by, a person, being a unit holder of an investment fund, out of investments made in the investment fund, shall be chargeable to income-tax in the same manner as if it were the income accruing or arising to, or received by, such person had the investments made by the investment fund been made directly by him.*
(4) The total income of the investment fund shall be charged to tax—
(i) at the rate or rates as specified in the Finance Act of the relevant year, where such fund is a company or a firm; or
(ii) at maximum marginal rate in any other case.
Explanation 1. — For the purposes of this Chapter, —
(a) "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 has been granted a certificate of registration as a Category I or a Category II Alternative Investment Fund and is regulated under the Securities and Exchange Board of India (Alternative Investment Fund) Regulations, 2012, made under the Securities and Exchange Board of India Act, 1992 (15 of 1992) 9[or under the International Financial Services Centre Authority Act, 2019 (50 of 2019)];. "

Pass-through of Losses

Initially, after introduction of the pass-through status, only the profits of the AIF could be passed on to its investors. In practice, an AIF usually disposes off its profitable investments first, and then, seeks to sell the relatively lesser performing investments, towards the end of its life. As a result of which, when Category I and Category II AIFs incurred net losses on investments closer to their maturity date, or had unabsorbed losses, which could not be utilized by the AIF, such losses would lapse. This also led to the investor paying tax on the gross profits, as opposed to the actual income received by the investors from their investment in the AIF.

This disparity was rectified to an extent by the amendment of Section 115UB of the IT Act by the Finance Bill of 2019, which paved the way for the pass-through of losses accrued in the AIF to the investors, as well. Now, the investors may pay taxes on the capital gains of the AIF after deducting the losses incurred by the AIF. The relevant amendment to Section 115UB of the IT Act is reproduced below,

*"**Section 115UB**. (2) Where in any previous year, the net result of computation of total income of the investment fund [without giving effect to the provisions of clause (23FBA) of section 10] is a loss under any head of income and such loss cannot be or is not wholly set off against income under any other head of income of the said previous year, then,—*
6[(i) out of such loss, the loss arising to the investment fund as a result of the computation under the head "Profits and gains of business or profession", if any, shall be, —
(a) allowed to be carried forward and it shall be set off by the investment fund in accordance with the provisions of Chapter VI; and
(b) ignored for the purposes of sub-section (1);
(ii) the loss other than the loss referred to in clause (i), if any, shall also be ignored for the purposes of sub-section (1) if such loss has arisen in respect of a unit which has not been held by the unit holder for a period of at least twelve months.]
7[(2A) The loss other than the loss under the head "Profits and gains of business or profession", if any, accumulated at the level of investment fund as on the 31st day of March, 2019, shall be, —

> *(i) deemed to be the loss of a unit holder who held the unit on the 31st day of March, 2019 in respect of the investments made by him in the investment fund, in the same manner as provided in sub-section (1); and*
> *(ii) allowed to be carried forward by such unit holder for the remaining period calculated from the year in which the loss had occurred for the first time taking that year as the first year and shall be set off by him in accordance with the provisions of Chapter VI:*
> *Provided that the loss so deemed under this sub-section shall not be available to the investment fund on or after the 1st day of April, 2019.]"*

Investors who have held Category I and Category II AIF units for a period of more than 12 (twelve) months are eligible to benefit from a 'pass-through' status of losses (other than losses under the head of 'profits and gains of business or profession') incurred by such AIFs

Tax treatment of non-resident investors' income relating to off-shore investments

In July, 2019, the Central Board of Direct Taxes ("**CBDT**")[2] issued a circular which clarified that income received by non-resident investors from their investments in Category I and Category II AIFs, which relate to from off-shore investments of such AIFs, would not be taxed at the hands of such non-resident investors since such off-shore investments would be deemed to be a direct investment outside India by the non-resident investor on account of the pass-through status conferred by Section 115UB. However, the Circular also further clarified that any loss arising from the off-shore investment by an AIF, being an exempt loss, cannot be carried-forward and set off against the income of the Category I or Category II AIF.

Mirror obligations

The tax liability of an investor in a Category I or Category II AIF takes the nature of the liability that would have been incident on the AIF, if pass-through status weren't available for the investors of such AIFs. Consider the following example. All investors in an AIF make aggregate capital contributions of Rs. 10,00,00,000 (Rupees Ten Crores Only) in April 2015, pursuant to a drawdown notice, all of which is invested in Company A by the AIF. In February 2016, the AIF sells of its investment in Company A at a profit of Rs. 2,00,00,000 (Rupees Two Crores Only). The capital gains of Rs. 2,00,00,000 (Rupees Two Crores Only) are distributed to its investors and the principal amount of Rs. 10,00,00,000 (Rupees Ten Crores Only) is reinvested in Company B. The investors would be liable to pay tax on the short-term capital gains received by the AIF. Later in March 2020, the AIF sells off its investment in Company B for Rs. 13,00,00,000 (Rupees Thirteen Crores Only) at a profit of Rs. 3,00,00,000 (Rupees Three Crores Only). The principal and capital gains of Rs. 13,00,00,000 (Rupees Thirteen Crores Only) are distributed to its investors who would be liable to pay tax on the long-term capital gains. Usually, AIFs do not reinvest the principal amount since it has the effect of enlarging the initial capital commitment made by investors. Assuming, in this example, the AIF in February 2016 reinvests in Company B, both the principal and capitals gains of Rs. 12,00,00,000 (Rupees Twelve Crores Only) from the sale of the investment in Company A, investors in the AIF would still be liable to pay short-term capital gains on account of the exit from Company A, for the financial year ending in March 2016. It would not be possible for the investors in the AIF to argue that the units of the AIF issued to them in April 2015 and redeemed by the AIF only in March 2020 and hence the capital gains of Rs.2,00,00,000 (Rupees Two Crores Only) from the investment in Company A should be treated as long term capital gains.

No Pass-through of Expenses

Although the IT Act now provides for the pass-through of losses incurred by the relevant AIF fund to the investors, it does not yet provide for pass-through of the expenses incurred by the AIF.

[2] Circular No 14/2019 dated 3 July, 2019, available at https://www.incometaxindia.gov.in/communications/circular/circular_no_14_2019.pdf .

Expenses incurred by an AIF, in the form of its investment manager's fees, trusteeship fees and other administration expenses, can constitute up to 30% (thirty 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.

Tax liabilities of CAT III AIFs

Despite much deliberation by focus groups and anticipation by the public, a "pass-through" tax regime has not been extended to Category 3 ("**CAT III**") AIFs, as a result of which, the income / capital gains from CAT III AIFs is subject to taxation in the hands of the AIF itself. Therefore, the taxation of the AIF entity will depend on whether it has been set up as a trust, LLP or a company. The absence of a "pass-through" status for CAT III AIF has led some foreign investors to register as Foreign Portfolio Investors ("**FPI**") and invest in Indian listed securities rather than investing through a CAT III AIF.

Most CAT III AIFs are set up as determinate trusts. A trust will be considered to be a 'determinate trust' if the specific shares of the beneficiaries of the trust are expressly set out in the trust deed and are identifiable and ascertainable as on the date of execution of the trust deed. The trustee of a CAT III AIF set up as a determinate trust will be treated as a representative assessee as per Sections 160 to 162 of the IT Act and such trustee shall discharge the tax liability of each beneficiary of the trusts. This would require the trustee to be aware of the tax status of the investor/beneficiary (who may be an individual or a company or other legal entity) and pay the appropriate tax. Subsequently, the investor/beneficiary would not have to pay any further tax income / capital gains of a CAT III AIF set up as an indeterminate trust shall be taxed at the entity level, at the maximum marginal rate as specified in the Finance Act of the relevant year.

If a CAT III AIF is set-up as an LLP, such LLP would be taxed and its investors, who would be partners in the AIF, would be exempt from paying tax. In the unlikely event that a CAT III AIF is set-up as a company, the CAT III AIF would pay tax on its profits at the applicable corporate tax rate and any dividend paid to its shareholders/investors would also be subject to tax at the hands of such shareholders/investors.

As detailed above in Section 2 of this paper, under the AIF Regulations CAT III AIFs face much fewer investment restrictions than CAT I AIFs and CAT II AIFs. Since CAT III AIFs usually invest in listed securities on a short-term basis, the income / capital gains earned by CAT III AIFs usually take the form of business income. Even if CAT III AIFs were to be given a "pass-through status" such business income would not benefit from the "pass-through status".

4. Universities and Public Trusts Cannot Invest in AIFs

In India, private universities are set up as either a society registered under the Societies Registration Act, 1860 or as a public trust registered under the public trusts act of the relevant state or as a company under section 8 of the Companies Act of 2013. Section 11(1)(a) of the IT Act exempts from taxation the income derived from property held under trust wholly for charitable or religious purposes, to the extent to which such income is applied to such charitable or religious purposes in India.

Further, Section 11(1) provides that if any such charitable or religious income is accumulated or set apart for application to such charitable or religious purposes in India, to the extent to which the income so accumulated or set apart is not in excess of 15% (fifteen per cent) of the income from such property, such income shall also be exempt from income tax. Section 11(2) of the IT Act provides that the balance 85% (eighty five per cent) of the income from such property shall also not be subject to income tax, even if it is not applied, or is not deemed to have been applied, to charitable or religious purposes in India during the previous year provided certain procedural conditions are complied with and the money so accumulated or set apart is invested or deposited in the forms or modes specified in sub-section (5) of Section 11 of the IT Act.

Rule 17C of the Income Tax Rules, 1962 ("**IT Rules**") prescribe the forms or modes of investment or deposits that can be made by a charitable or religious trust or institution, for the purpose of availing of the exemption mentioned in Section 11(5), one of which is investments in units issued under any scheme of mutual fund registered with the Securities and Exchange Board of India.

Hence, universities that are set up as public charitable trusts can invest their surplus funds in units issued under any scheme of the mutual funds as specified under the act and the relevant rules. However, Rule 17C of the IT Rules does not cover investments in AIFs and so universities are disincentivised from investing in AIFs since the capital gains from such investments would be subject to taxation.

5. POEM and PE FOR AIFs

Place of Effective Management (POEM)

Section 6(3) of the IT Act prescribes the requirements for a body corporate to qualify as a resident of India.

> *A company is said to be a resident in India in any previous year, if—*
> *(i) it is an Indian company; or*
> *(ii) its place of effective management, in that year, is in India.*
> *Explanation. — For the purposes of this clause "place of effective management" means a place where key management and commercial decisions that are necessary for the conduct of business of an entity as a whole are, in substance made.*

The CBDT vide Circular No. 06 of 2017 dated January 24, 2017 has clarified that a company would be considered to have 'POEM' outside India only if it does not have active business outside India. A company shall be said to be engaged in "active business outside India" if the passive income is not more than 50% (fifty percent) of its total income; and all of the following conditions are met: (i) less than 50% (fifty percent) of its total assets are situated in India; and (ii) less than 50% (fifty percent) of total number of employees are situated in India or are resident in India; and (iii) the payroll expenses incurred on such employees is less than 50% (fifty percent) of its total payroll expenditure. In cases of companies other than those that are engaged in active business outside India, the determination of POEM would be a two-stage process, namely: **-** (i) First stage would be identification or ascertaining the person or persons who actually make the key management and commercial decision for conduct of the company's business as a whole. (ii) Second stage would be determination of place where these decisions are in fact being made.

CBDT has further clarified vide Circular No. 25/2017 dated October 23, 2017 that place of effective management guidelines shall not apply to Companies whose turnover is Rs 50,00,00,000 (Rupees Fifty crore) or less during a Financial Year.

An AIF regulated by SEBI, whether it be a trust or an LLP or a company, is required to be established or incorporated in India. Therefore, every AIF would be an Indian resident. However, many AIFs receive investments from overseas investors through feeder funds, which are set up outside India by the investment manager of the AIF, usually in tax friendly jurisdictions like Mauritius or Singapore or the Cayman Islands. It is possible that some or most of the critical management decisions pertaining to such feeder funds are made in India by the investment manager of the AIF. If an overseas incorporated feeder fund is held by the income tax department to have its place of effective management in India for any financial year, it would be tax as a resident for such year. Consequently, such feeder fund's total income will be subject to Indian income tax in accordance with Section 5 of the IT Act.

Permanent Establishment (PE)

Even if an AIF's overseas feeder fund is not treated as an Indian resident, if such fund meets the threshold prescribed under Section 9(i), it would be deemed to have a permanent establishment in India and all income accruing or arising, whether directly or indirectly, through or from **any business connection** in India, or through or from any property in India, or through or from any asset or source of income in India, or through the transfer of a capital asset situate in India would be subject to Indian income tax.

Safe Harbour from POEM and PE

Section 9A of the IT Act, which was introduced by the Finance Act, 2015 in order to create a safe harbour for India-based managers of offshore funds ("eligible investment fund") from income tax obligations under Section 6(3) and Section 9 of the IT Act. In order to be eligible for the safe Harbour created by Section 9A, the eligible investment fund should not carry on or control and manage, directly or indirectly, any business in India or from India. It should also not be engaged in any activity which constitutes a business connection in India, either directly or through any person acting on its behalf. In addition to the aforesaid conditions, the eligible investment fund should also fulfil the following conditions:

- India should have a DTAA with the country in which such eligible investment fund is incorporated;
- the aggregate investment in the fund, directly or indirectly, by Indian residents, should not exceed five per cent of the corpus of the fund;
- the fund should have a minimum of twenty-five shareholders or investors, who are, directly or indirectly, not connected persons;
- No shareholder or investor of the fund (along with any connected person) shall hold more than ten per cent of the fund's corpus;
- the aggregate participation interest, directly or indirectly, of ten or less investors of the fund, along with their connected persons in the fund, shall be less than fifty per cent;
- the fund shall not invest more than twenty per cent of its corpus in any entity;
- the monthly average of the corpus of the fund shall not be less than one hundred crore rupees;

If the conditions mentioned above are met, the eligible investment fund shall not be said to be resident in India for the purpose of Section 6 of the IT Act merely because its fund manager, undertaking fund management activities on its behalf, is situated in India. Further, notwithstanding anything in section 9 of the IT Act, any fund management activity carried out on behalf of such fund shall not constitute business connection in India of the said fund, provided the manager of such eligible investment fund fulfils the following conditions:

- the person is not an employee of the eligible investment fund or a connected person of the eligible investment fund;
- the person is registered as a fund manager or an investment advisor in accordance with regulations applicable to such eligible investment fund;
- the person is acting in the ordinary course of his business as a fund manager;
- the fund manager along with his connected persons shall not be entitled, directly or indirectly, to more than twenty per cent of the profits accruing or arising to the eligible investment fund from the transactions carried out by the fund through the fund manager.

If an investment manager who is resident in India manages an off-shore fund which does not invest in India, Section 9A would keep such investment manager safe from the incidence of Indian income tax, provided the various conditions specified in Section 9A are met. However, if the off-shore fund invests in Indian securities or in Indian AIF, Section 9A would not protect such investment manager.

Double-Tax Avoidance Agreements

Section 90 of the IT Act authorises the Central Government to enter DTAAs with foreign countries.

> Section 90(2) of the IT Act provides that *Where the Central Government has entered into an agreement with the Government of any country outside India or specified territory outside India, as the case may be, under sub-section (1) for granting relief of tax, or as the case may be, avoidance of double taxation, then, in relation to the assessee to whom such agreement applies, the provisions of this Act shall apply to the extent they are more beneficial to that assessee.*

Therefore, if any foreign feeder fund which invests into an Indian AIF is established in a jurisdiction (such as Mauritius or Singapore) with which India has entered a DTAA, such feeder fund may avail of the tax rates provided in the relevant DTAA if such rates are more beneficial than the rates applicable under the IT Act.

6. Changes to the Tax Regime for the Private Equity and Venture Capital Industry Proposed by the Budget 2022

The union budget for the financial year 2022-2023 ("**Budget**") noted that venture capital and private equity investments worth over 55,00,00,00,00,000 (Rupees five lac fifty thousand crore) have facilitated India's start-up and growth ecosystem. As part of her budget speech on February 1, 2022, the Hon. Finance Minister announced that an expert committee would be set up to examine the regulatory and other frictions faced by the PE & VC industry. The following other key announcements were also made in relation to the PE & VC industry:

(a) Thematic Funds under a blended finance model: Under a blended finance model, the government would promote thematic funds that would invest in important sunrise sectors such as climate action, deep-tech, digital economy, pharmaceuticals and agri-tech. These thematic funds would be managed by private fund managers and the government's stake in such funds shall not exceed 20% (twenty percent).

(b) Extension of the eligibility criterion for start-up companies: start-up companies established before March 31, 2022 had been provided a tax incentive, namely the right to claim a tax holiday, for 3 (three) consecutive years out of 10 (ten) years from their incorporation. [3] The period of incorporation required for start-up companies to be eligible for this incentive has been extended by an additional year, and so start-up companies established before March 31, 2023 may now claim this incentive.

(c) Harmonisation of surcharges on long term capital gains derived from listed and unlisted assets: Currently long-term capital gains on listed equity shares, units etc. are liable to a maximum surcharge of 15% (fifteen percent), while other long term capital gains are subject to a graded surcharge which goes up to 37% (thirty seven percent). It was announced that the surcharge on long term capital gains arising on transfer of any type of assets would be capped at 15% (fifteen percent).

As mentioned above, there is a huge disparity in taxation between listed and unlisted long-term capital gains. Though this disparity remains, the surcharge on long-term capital gains arising out of transfers of unlisted securities has been capped at 15% (fifteen percent), as a first step towards achieving parity between taxation of listed and unlisted long-term capital gains. Further, it is expected that this new cap will encourage investments by AIFs in unlisted manufacturing companies and start-up companies since there will be lesser tax liability at the time of exiting from such investments.

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