

# Investment Funds: Monthly Digest

February 27, 2021

## AIFS UNITS ARE NOW SECURITIES: WHAT ARE ITS LEGAL AND TAX IMPLICATIONS?

The Government of India, through the Finance Bill, 2021, has proposed to amend the definition of 'securities' in the Securities Contracts (Regulation) Act, 1956 ("SCRA"), to include the units of Alternative Investment Funds ("AIFs") within the ambit of the said term ("the Proposed Amendment").<sup>1</sup> This Hotline decodes the far-reaching consequences of this move on the AIF industry and its interface with other regulatory and tax legislations in place.

### BACKGROUND

The AIF industry in India has been evolving at a rapid pace and has invested over ₹1.8 lakh crores across ventures as of December 31, 2020.<sup>2</sup> While introducing the regulatory regime for AIFs in India, the Securities and Exchange Board of India ("SEBI") allowed AIFs to act as private pools of the capital of institutional and/or sophisticated investors and recognised it as a distinct asset class apart from Mutual Funds ("MF") or Collective Investment Scheme ("CIS").<sup>3</sup> Accordingly, the SEBI (Alternative Investment Funds) Regulations, 2012 ("AIF Regulations") have also been drafted keeping this in mind as well as considering the global norms around such vehicles, which has resulted in a steady rise in the number of AIFs in India and encouraged global and Indian investors participation.

Earlier, units of an AIF were kept outside the purview of stamp duty levy in cognizance of the nature of the unit of an AIF as representative of a beneficial interest, and hence were considered to be outside the scope of an "instrument" within the meaning of the term under the Indian Stamp Act, 1899 ("Stamp Act"). The statement of units, typically issued by the AIFs to its unit holders, was also not considered as 'instrument' for levy of stamp duty. However, the SEBI Circular dated June 30, 2020 ("SEBI Circular"),<sup>4</sup> which was issued in light of the amendments to Section 8A of the Stamp Act, had the effect of levying stamp duty on issue, transfer and sale of units of AIFs. The SEBI Circular was not taken well by the industry since imposing stamp duty on unlisted and privately placed units of investment funds is a feature unique to India, without any global precedents.

Another ground for criticism of the SEBI Circular was that for units of AIF to be subject to stamp duty under Article 56A of Schedule I of the Stamp Act, they must be covered within the definition of the term 'securities' under the Stamp Act and consequently under the definition of the term under the SCRA.<sup>5</sup> However, the term 'units of AIF' was not included in the definition of 'securities' either under the Stamp Act or the SCRA, and hence the levy of stamp duty *vide* the SEBI Circular came under scrutiny. The Proposed Amendment aims to fix this significant anomaly, thereby providing a legal rationale for the levy of stamp duty on issue and transfer of units of AIF. However, the consequences of such a move may well exceed the underlying intention of the legislature behind introducing the Proposed Amendment.

### THE PROPOSED AMENDMENT

The Proposed Amendment seeks to amend the definition of 'securities' under Section 2(h) of the SCRA as follows:

(h) "securities" include---

(i) shares, scrips, stocks, bonds, debentures, debenture stock or other marketable securities of a like nature in or of any incorporated company or **a pooled investment vehicle or other body corporate;**

...

(ida) **units or any other instrument issued by any pooled investment vehicle;**

...

Further, the definition of 'pooled investment vehicle' has been inserted in the SCRA. The term has been defined as a fund established in India in the form of a trust or otherwise, such as MF, AIF, CIS or a business trust as defined in Section 2(13A) of the Income-tax Act, 1961 ("ITA") and registered with SEBI, or such other fund, which raises or collects monies from investors and invests such funds per SEBI regulations.<sup>6</sup> Further, business trust have been defined to mean a trust registered as an Infrastructure Investment Trust or a Real Estate Investment Trust under the relevant SEBI regulations.<sup>7</sup>

Therefore, the Proposed Amendment has included the units of AIF in the definition of 'securities' under the SCRA which is set to affect the AIF industry in the legal context under the Stamp Act and the ITA, and even otherwise.

### EFFECT OF THE PROPOSED AMENDMENT

In addition to strengthening the rationale for levying stamp duty on the issue and transfer of units of AIF (as discussed above), the Proposed Amendment will have an impact on the direct taxation scenario of the AIF industry.

- Taxation under Section 56(2)(x) of the ITA: Once the units of an AIF fall within the scope of the defined term 'securities' under the SCRA, Section 56(2)(x) of the ITA becomes a concern in case such units are transferred

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below the fair market value (“FMV”).<sup>8</sup> Section 56(2)(x) of the ITA provides that, where any person receives, in any previous year, any property, other than immovable property, for a consideration which is less than the aggregate FMV of the property by an amount exceeding ₹50,000, the aggregate FMV of such property as exceeds such consideration, shall be chargeable to income-tax under the head “Income from other sources”

Provisions relating to taxation of AIFs and its investors provide a legal fiction for taxation of investors in the same manner as if the investment made by the AIF were made by such investors directly. Specifically, section 115UB, provides for disregarding of the act of subscription into units of an investment fund by maintaining an identity between the unit-holder and the investment fund for all streams of income (other than income which is chargeable to tax under the head ‘profits and gains of business or profession’). Thus, any transaction between the unit holder and the investment fund in respect of subscription to units of the investment fund should only be subject to the rigors of Section 115UB and the provisions of section 56(2)(x) should not have an application, considering that section 115UB provides for a ‘*non obstante*’ clause.

Basis the above, while it may be argued that section 56(2)(x) should not be applicable at the time of issue of units by AIFs during any subsequent closing, nevertheless considering the qualification of AIF units as “securities”, tax authorities could argue that the provisions of Section 56(2)(x) are triggered where such issuance is below the fair market value.<sup>9</sup> In other words, if the units are subscribed to or purchased by the transferee below FMV (which is an industry practice), then the recipient of the units could be subject to tax under Section 56(2)(x). In such a scenario, there could be another level of tax (absence availability of tax step up) at the time that actual income is received by the investor on such units from the AIF . Hence, as a direct consequence of the Proposed Amendment, the AIF industry may have to rethink the standard practice of issuing the units of AIF at par, to avoid double taxation. This would also entail further burdens on manager to determine the value of the units of AIFs on each closing.<sup>10</sup>

- Contradiction with AIF Regulations: As per the AIF Regulations, all AIFs are mandated to raise funds “through private placement by issue of information memorandum or placement memorandum, by whatever name called.” As per the definition of an AIF as a “privately pooled investment vehicle”, these private placement memorandums (PPMs) that have been approved by SEBI also have restrictions on any transferability of said units. Hence, the units of AIF set up using a trust structure should not be regarded at par with other marketable securities.

## CONCLUSION

The Government of India has been proactive in incentivising the AIF industry by way of introducing various changes in the legal framework concerning AIFs in India from time to time. However, the Proposed Amendment seems to be a move against the tide, considering its potential impact on the industry and lack of global precedents. Any legal, regulatory or tax deviation in India from global norms, especially on the private equity investment side suggests India’s lack of readiness to accept sophisticated foreign inflow of funds. Hence, the Proposed Amendment seems to do more unintended harm than good.

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You can direct your queries or comments to the authors

<sup>1</sup> Section 139, The Finance Bill, 2021

<sup>2</sup> Data relating to activities of Alternative Investment Funds (AIFs), SEBI; available at: <https://www.sebi.gov.in/statistics/1392982252002.html>

<sup>3</sup> [to be added]

<sup>4</sup> SEBI/HO/IMD/DF6/CIR/P/2020/113

<sup>5</sup> Section 2(23A)(a) of the Indian Stamp Act, 1899 defines ‘securities’ to include securities as defined in Section 2(h) of the Securities Contracts (Regulation) Act, 1956 (“SCRA”)

<sup>6</sup> Proposed Section 2(da), SCRA

<sup>7</sup> Section 2(13A), Income Tax Act, 1961 (“ITA”)

<sup>8</sup> Section 56(2)(x) of the ITA provides that, where any person receives, in any previous year, any property, other than immovable property, for a consideration which is less than the aggregate FMV of the property by an amount exceeding ₹50,000, the aggregate FMV of such property as exceeds such consideration, shall be chargeable to income-tax under the head “Income from other sources”

<sup>9</sup> The Mumbai Tribunal in case of *Sudhir Menon HUF v. Assistant Commissioner of Income-tax* [2014] 148 ITD 260 (Mumbai – Trib), held that disproportionate allotment of shares to existing shareholders at less than FMV are taxable under section 56(2)(vii) (erstwhile for of Section 56(2)(x))

<sup>10</sup> Regulation 23 of the SEBI (Alternative Investment Funds) Regulations, 2012 provides that:

(1) The Alternative Investment Fund shall provide to its investors, a description of its valuation procedure and of the methodology for valuing assets.

(2) Category I and Category II Alternative Investment Funds shall undertake valuation of their investments, atleast once in every six months, by an independent valuer appointed by the Alternative Investment Fund: Provided that such period may be enhanced to one year on approval of atleast seventy-five percent of the investors by value of their investment in the Alternative Investment Fund.

(3) Category III Alternative Investment Funds shall ensure that calculation of the net asset value (NAV) is independent from the fund management function of the Alternative Investment Fund and such NAV shall be disclosed to the investors at intervals not longer than a quarter for close ended Funds and at intervals not longer than a month for open ended funds.

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