Budget 2024 | AIFs' key priority is the support to navigate the tax and regulatory waters

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Category III AIFs with long-short strategies suffer from the risk of having their entire income categorised as business income rather than capital gains, subjecting them to higher tax rates due to the frequency of their trading, writes Khaitan & Co's Siddharth Shah and Rohan Priyadarshi.

India stands on the brink of unprecedented economic expansion, partially driven by the pivotal role of Alternative Investment Funds (AIFs) in channelling both domestic and international risk capital. As the Union Budget 2024 approaches, stakeholders in the funds industry eagerly anticipate clarifications that could catalyse further growth in this sector.

Top GainersTop LosersMost Active Price ShockersVolume Shockers

Company	Value	Change	%Change
Titan Company	3,466.85	₹212.40	6.53

Company	Value	Change	%Change
ITC	492.20	₹25.65	5.50
TATA Cons. Prod	1,256.90	₹52.10	4.32
Adani Ports	1,507.35	₹40.00	2.73
NTPC	382.45	₹8.95	2.40

Clarity on Taxation of Category III AIFs

AIFs operate as privately pooled investment vehicles, which raise funds from a mix of domestic and international investors. These funds are deployed according to predefined investment policies aimed at generating profits. The tax treatment of AIFs depends on their legal structure (viz., trust, LLP, or company) and their category (viz., category I, category II and category III).

While Category I and II AIFs benefit from a 'pass-through' status, the same benefit has not been extended to Category III AIFs. These are funds employing complex trading strategies, with an investment focus of both listed and unlisted securities and include hedge funds and long-short funds. Without pass-through status, Category III AIFs face taxation at the entity level, often at the highest marginal rate with surcharges, significantly burdening investors who may not individually fall into such high tax brackets.

Moreover, Category III AIFs with long-short strategies suffer from the risk of having their entire income categorised as business income rather than capital gains, subjecting them to higher tax rates due to the frequency of their trading. The industry seeks a framework for single-layer taxation or clear principles for distinguishing between short-term trading and long-term investments for tax purposes.

Rationalising Taxation on Listed and Unlisted Instruments

Presently, capital gains from listed instruments are taxed at a lower rate (10%) than those from unlisted instruments (20%). This tax disparity discourages investments in the unlisted sector, particularly in startups, hindering efforts to foster a culture of entrepreneurship and innovation. To remedy this, stakeholders urge the government to consider reducing the tax burden on unlisted investments or aligning the tax rates with those applicable to listed instruments.

Clarity on Taxation of Carried Interest

Carried interest represents the share of profits distributed to fund managers based on the fund's performance, often treated as capital gains for tax purposes. This treatment benefits from a lower rate of direct tax compared to business income tax rates. However, the absence of legislative backing for this practice leaves this approach vulnerable to potential reclassification as business income by tax authorities. Uncertainty also looms

large over the applicability of indirect taxes (i.e GST) on carried interest earned by AIFs and several funds are receiving notice from income tax authorities raising further questions on this subject. The industry pleas that legislative framework akin to the European Union (where only fee-based services such as management fee are charged service tax) or UK (where only a fraction of carried interest is subject to service tax).

Enhancement of Overseas Investment Limits

AIFs can currently invest in venture capital undertakings outside India up to a total industry-wide limit of USD 1.5 billion, subject to SEBI's approval for each investment. In contrast, international jurisdictions often allow funds to invest across borders without similar constraints. Stakeholders advocate for reforms to remove these limitations, encouraging more asset managers to establish global funds in India, thereby facilitating greater inflow of international capital in the economy.

Co-Investment Rules

Co-investment, in fund parlance, is where an AIF's manager offers investments to other entities related to the fund. This activity was until very recently, unregulated in India. To bring such activities within its regulatory purview, SEBI recently introduced regulations defining the scope of co-investments and mandating a separate registration requirement. While these regulations aim to legitimise co-investment activities, stakeholders highlight the need for a holistic review of the regime, including the need to obtain a separate licence and prescriptive restrictions on the terms on which co-investments may be offered and made that may deter global funds from operating in India.

Conclusion

The government's support for the funds industry remains crucial for fostering a conducive economic environment for long-term growth. The government, through institutions such as Small Industries Development Bank of India and National Investment and Infrastructure Fund has facilitated significant capital injection into the ecosystem. The time is ripe for strategic reforms to streamline regulatory frameworks, enhancing ease of doing business, and reinforcing India's position as an attractive destination for global investment.

The Union Budget 2024 holds immense potential to address these strategic demands of the AIF sector, ensuring it continues to drive India's economic growth trajectory in the years ahead.

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