Date: 12/07/2019

To

Smt. Nirmala Sitharaman
Union Finance Minister
Ministry of Finance
134, North Block
New Delhi - 110001

Dear Smt. Sitharaman,

Greetings from Indian Association of Alternative Investment Funds (IAAIF)!

In reference to the proposal in the recent budget to increase the surcharge for AIF Cat III funds that are incorporated as Trusts, we take this opportunity to present our views:

Background

India's capital market regulator, the Securities and Exchange Board of India (SEBI), notified the Alternative Investment Funds (AIF) Regulations, 2012 (AIF Regulations) in May 2012. The regulatory philosophy for the AIF structure was[1]:

- Creating a structure where a regulatory framework is available for all shades of private pool of capital or investment vehicles so that such funds are channelized in the desired space in a regulated manner without posing systemic risk.

- Provide a framework to deter from fraud, unfair trade practices and minimize conflicts of interest.

AIFs contribution to the economy:

Category III AIF's are a stepping stone in India for providing globally renowned innovative investment products for investors. Also, **for fulfilling Government of India's vision of boosting exports of services, the category III AIF industry will need the domestic performance track record to effectively sell the products abroad.**

Lastly we have highlighted the contribution of Category III AIF's to the economy as follows:

- **Aiding Governments disinvestment programme with one of the largest subscribers to CPSE and Bharat 22 ETF's**

[1] SEBI concept paper on proposed AIF Regulations for public comments

- Bringing world class products and innovation to investors
- Aiding capital formation by attracting money to equities
- Instrumental in increasing market liquidity, for longer term investors to participate.
- **Sizeable Jobs creation**
- **Beginning to attract foreign capital, using 9A approvals under Income Tax Act**.
- **Great potential for export of services**

Global Pension funds, sovereign wealth funds and large institutional investors allocate sizeable money to these funds. The only requisite is a reasonable long track record of performance

Most of the AIFs are set-up as trust in India as compared to a Limited Liability Partnership or a Company. In a Trust structure, the assets are owned by the Trust on behalf of the beneficial owners and the Trustees have the responsibility to carry out the objectives of the Trusts.

Reasons why trust structure are used and merits

The trust structure offers certain key advantages as compared to a corporate or partnership structure. Some of these key advantages are listed below:

- Operational & organizational flexibility: The Trust structure is much more cost efficient than a corporate structure. Upon entry / exit of funds, a trust structure allows the fund to issue / redeem units in a relatively seamless manner. In a corporate / partnership structure, it is much more complex to update registers, issue / cancel shares etc. upon entry / exit of shareholders. Also, the regulatory filings in corporate structures are significantly more cumbersome than trust structure.

- Multiple schemes: Under a trust structure, it is possible to launch multiple schemes to cater to different investment strategies and returns for different set of investors. Since the AIF registration is required only at the launch of 1st scheme, there is a huge saving in time and cost in case of follow-on schemes.

- Solvency rules: The trust structures typically do not have solvency rules as applicable to corporate structures.

- Number of shares. Shareholder meeting and other corporate compliances: Unlike a company where maximum number of shares issued is required to be documented in the company's Articles of Association, the number of units allotted to investors in trust structure is typically unlimited. There is no need to convene shareholder meetings in a trust structure whereas it is a mandatory requirement in corporate structures. The same applies to other compliances relating to the corporate structure.

- Major policy decisions: In a corporate structure, there is typically a need to obtain certain percentage of shareholder approval before major policy decisions can be taken whereas in a trust structure, the trustees are generally empowered to take such decisions on their own.

Proposal[2] in the Finance Bill, 2019:

On 5 July 2019, the Finance Minister presented the 1st Budget of the newly formed government for financial year (FY) 2019-20. One of the key proposals in the budget was increase in the surcharge rates for non-corporate investors (other than firm or co-operative society) as follows:

Income range	Existing Surcharge	Proposed surcharge
Above INR 50 lacs but upto INR 1 crore	10%	10%
Above INR 1 crore but upto INR 2 crores	15%	15%
Above INR 2 crores but upto INR 5 crores	15%	25%
Above INR 5 crores	15%	37%

As a result, Category III AIFs set-up as trusts may be required to pay the proposed increase in surcharge based on the total taxable income from financial year 2019-20. **If the above tax rates are put in effect it will just kill the industry and shut the possibility of making a long track record onshore.**

It would also lead to sizeable jobs losses directly and indirectly, wherein the support functions which are outsourced would also bear the brunt of no work. The total AUM as per SEBI in category III AIF's is about Rs 42000 crores.

In this regard, we wish to submit as follows:

1. **Unfavorable tax treatment as compared to Category I and II AIFs and Portfolio Manager**

   Issue and Rationale

   - AIFs are vehicles set-up to pool investments from various investors and to invest across different asset classes using different investment strategies.

   - Really speaking, the income that is sought to be taxed is the income of the investors. The taxation of an income, or the taxpayer itself, should not change, merely because an investor decides to use a professional asset manager to make investment decisions for him vis-à-vis directly making those investment decisions. Further, the manner of taxation should not also change, where an investor invests in an AIF instead of investing in his own name using a SEBI registered portfolio manager.

[2] The Proposal becomes effective once it receives approval of both houses of Parliament and assent of the President of India.

- The basis of pass-through or no pass-through seems to be derived based on the type of investment strategy and the underlying activity of the AIF. If at all, although it is debatable, the investment strategy should be used to decide on the characterization of income but not the pass-through status.

- In any case, it is clear that irrespective of the investment strategy, the policy of the Government is to have one-level tax in terms of the income arising from/ to the AIF – i.e., either the AIF will be taxed or the investor, but not both (on the basis that usually the AIF is a trust).

- In absence of specific pass-through under the Act and to avoid litigation associated with the Trust taxation, many Category III AIFs have opted to pay tax in its own Permanent Account Number (PAN). Where the total annual income of these AIFs exceeds INR 5 crores, they have to discharge tax at applicable rate (based on nature of income) plus surcharge of 37% and cess of 4%. In such scenarios, though the annual income of investor may not exceed INR 5 crores, a surcharge of 37% has been levied. This results in unnecessary higher tax leakage and reduced investment returns to the investors.

<u>Recommendation</u>

- Similar to Category I and II AIFs, extend tax pass-through to Category III AIFs so that the taxability is determined in the hands of investors. There will be no revenue loss to the Government since the surcharge will be collected from investors even if a pass through is given.

- Exempt Category III AIF from applicability of increased surcharge of 25% or 37% (whichever is applicable) based on the income-slab.

2. Tax credit

<u>Issue and Rationale</u>

- Even in a scenario where a Category III AIF pays surcharge at 37%, the investor should ideally be able to obtain tax credit of the same. Since the AIF uses its own PAN to discharge tax liability, there is no mechanism at present to pass on the tax credit to the investor.

- This results in excess tax payment on the income of the investor and acts as a dis-incentive for the investor to make investments through AIF.

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Recommendation

- Introduce a mechanism to allow tax credit of at least the surcharge portion of the total tax paid by the AIF. This will result in accurate tax payment for the investor without creating any loss of revenue for the government.

Yours Faithfully,

For Indian Association of Alternative Investment Funds (IAAIF)

Aditya Gadge
Principal Advisor