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Is the tax system neutral in India: An analysis of tax treatment of select funds

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Abstract

One of the fundamental principles of taxation is neutrality. In finance this assumes significance since decision to invest must not depend on tax. It is also true that any departure from neutrality must be grounded in sound economic purpose. Neutrality is desirable for well-functioning financial markets. Investment funds[1] form an integral part of financial markets.These can operate through different structures and invest in different asset classes. Some of these funds can channel resources to sectors that are considered key for growth and development. Selecting AIF, REIT, InviTs and Securitisation trusts in India the tax system is compared for these and evaluated. It is found that the existing structure is not neutral and paper presents scope for policy change.

1 Introduction

The decision to invest in an instrument is primarily based on expected returns. Return, an income, is taxed according to the prevailing tax law. As a result taxation, a wedge between the returns earned and received, can potentially assume a significant role in the decision to invest in a market or an instrument. Tax applicable is not only the headline or statutory rate but is

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[1]In this paper the term fund includes the selected investment vehicles including securitisation trusts. This should not be confused with the nomenclature used in Income Tax Act, 1961

also based on interpretation of the law. Judicial interpretation can alter the prevailing statutory rates. For example, the dis-allowance of a deductible expense can increase the effective tax rate. Further, in the case of cross border incomes, tax treatment of investment returns depends on the treaty provisions and specified withholding rates.

In every law, a specific kind of tax treatment is prescribed to incomes accruing to capital.These incomes may be characterised as profits,capital gains, interest, rental and dividend. Each of these incomes can be taxed similarly or otherwise. Further, incomes accruing to different kinds of capital owners, foreign and domestic, or financial products may also be treated differently.

The principles of taxation suggest that the ideal tax system is one that is simple, offers certainty to taxpayers, is fair, flexible and neutral. Among these principles, neutrality, can be thought of as central to finance. Abstracting from Jason Furman's testimony before the US Senate committee-"Although the proper level of capital taxation is highly controversial, there is little or no justification for the widely varying rates on different forms of capital income. Establishing more uniform rates would improve the allocation of investment and finance, reduce wasteful tax avoidance expenditures, and ultimately enhance the productivity and stability of the economy" and that "deviations from a neutral tax system reflect the goals of policymakers." [2]. Thus tax policy must be clear on economic goals that influence its design.

Design of taxation in different countries illustrates that neutrality seldom tenable. Firstly, incomes arising from various sources or to different kinds of investors receive disparate treatment. This could in part be because of variety of economic goals or an attempt to restore partial parity between substitute instruments. Such digression from neutrality must be identified and contextualised. The aim of this paper is to detail the structure of taxation of financial markets so as to comment on the prevalent scale of non-neutrality in India's financial market. This useful to identify the scope for policy change.

Investment in Indian equity is either made by individuals directly through the stock market or by purchasing units of investment funds that further invest in assets including shares of corporations. Further, there are listed and unlisted securities that individuals can invest through different kinds of fund structures. There are many focal areas for economic work plan but a few assume importance in the present context. First among these is need for increased investment, these could be in infrastructure and housing. Both have

[2] https://www.brookings.edu/wp-content/uploads/2016/06/0415_tax-_neutrality_furman-1.pdf

remained an area of concern. Economic Survey is 2018-19 suggested that India at present needs to spend 7-8 per cent of its GDP in infrastructure. However, the current shortfall necessitates diversion of private capital[3]. On the other hand, the Indian banking system is under stress. In 2018, India had among the highest ratios non-performing loans to total loans. At 9.46 per cent this was more than that reported in other countries, such as Spain (3.69), Italy (8.39), Argentina(3.11) and Colombia(4.4)[4]. In order to tackle the mounting bad loans while maintaining the flow of capital to fresh ventures, there is yet again need for private participation. There exist collective investment vehicles that are designed to tackle each of these issues. Infrastructure and investment in real estate can be facilitated through real estate investment trusts (REIT), infrastructure investment trusts(INviT), alternative investment fund (AIF).While higher investment in stressed assets is possible through AIFs and asset reconstruction companies(ARC). These are regulated by SEBI under separate regulations.

If the nature of activity of these funds are related to the stated economic objectives then it is worth examining if the tax treatment is neutral for these funds. Any non-neutrality among these can potentially give precedence to an economic objective. Therefore in this paper the taxation of incomes distributed to investors in select funds as well as the income of funds is detailed. Note that differences in tax treatment can arise from the general or overall design of the tax structure. That is,for example debt may receive a separate treatment from equity. However, separate kinds of investment funds may also receive a different tax treatment. Therefore, tax treatment of select funds is compared.

The first part of the paper introduces the concept of an investment fund and summarises the regulatory landscape under which each of the selected funds operate in India. The second part details the concept of neutrality and its relevance in assessing the taxation of financial markets. The last section pieces together the taxation of different kinds of funds and compares these to assess if there is indeed such difference and whether an shift is discernible in the pattern of investment.

[3]Page 210, Economic Survey

[4]The statistics are compiled from Financial Soundness Indicators, IMF

2 What are investment funds

2.1 Brief history of investment funds

Investment funds are collective investment vehicles that are created to invest in different kinds of instruments.Investment funds are not a new concept. In 1744 a Dutch merchant and broker Adrian van Ketwich founded what is now formally acknowledged as among the earliest examples of modern day investment trust (Rouwenhorst , 2004). *Endrangt Makt Mang*, named after the maxim of the Dutch Republic which translates to "unity is strength", was established in response the crisis of 1772-73[5]. The trust primarily invested the capital in foreign bonds among other instruments. The articles of the prospectus mandated diversification of investment portfolio. The payment to investors of this fund was based on a complex lottery. A part of the interest received on the bonds was paid as dividend from the fund and the rest was used to purchase back share at a premium of 20 per cent[6].

The opportunity for greater risk spreading at lower cost as well as reduce the costs associated with information processing such as stock selection and risk management[7] remain the rationale for the modern day investment funds .

2.2 General structure of an investment fund

Investment funds can be set up as a company, a trust or a limited partnership, depending on the regulation and choice of sponsors. Further, the kind of investment strategy can vary by fund. That is, it can invest in equity shares, debt instruments, real estate or even distressed assets. While these funds can be uniquely characterised as per their operations a general structure can be used to describe the flow of incomes. Figure 1 provides an illustration of a general structure.

To begin with there are investors[8] who wish to put their money in a particular portfolio of asset class(es). These investors can then pool their resources in a fund set up by the management company and managed by a fund manager. The form that the fund takes can vary. For example, in India other than the entity type, the fund must be registered under separate regulations of Securities Exchange Board of India(SEBI) depending on the investment

[5] Page 1, Rouwenhorst, 2004

[6] See details of scheme on Page 8, Rouwenhorst , 2004

[7] Chapter 2, Viitala(2005)

[8] Where the fund takes the form of a limited partnership, the investors are limited partners(LP) and the fund manager is the General Partner(GP)

strategy. A fund can be registered under and regulated by Mutual Fund regulation, Collective Investment Vehicles(CIV) regulation, Foreign Portfolio Investors regulation or Alternative Investment Fund regulation, Real Estate Investment Trust regulation and Infrastructure Investment Trust regulation. In contrast, Asset Reconstruction Companies (ARCs) and the trusts are regulated by RBI by the SARFAESI Act. To each of these separate rules apply for investment limit, compliance processes, capital contributions, lock in period of investment, lifespan of a fund and avenues of investment.

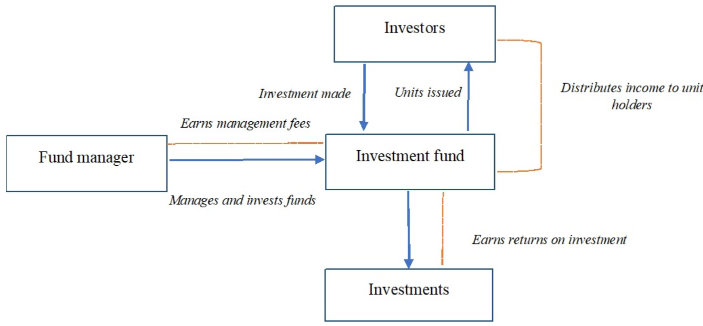
A general structure of an investment fund is presented in Figure 1. First, a fund is set up with capital contribution from investors. In lieu of such contribution a unit is issued to the investor. The funds received are then invested by the fund manager in portfolio of investment, as permitted by the regulation applicable to the fund. For this the manager is paid a fee comprising of a fixed percentage of net asset value and a variable component based on returns(or capital gains). From the income earned on the investment, the fund distributes to the unit holders. Different kinds of funds prescribe varying terms of distribution[9].

To begin with the fund can be set up within the jurisdiction where the investment is made i.e. *onshore* or outside the jurisdiction i.e. *offshore*. Even where the fund is onshore, that is it is located in the jurisdiction where the investment is made, the investors participating in the fund and can be domestic and foreign. Investors may also be individual or institutional. Where the latter may comprise of pension funds, sovereign wealth funds, endowment plans and family offices[10]. The foreign investors can invest in the fund either directly, through a offshore fund or as individuals, alongside domestic investors or they could invest in a domestic fund comprising of offshore and onshore investors that makes further investment. Thus a fund could be purely offshore, a unified investment or co-investment structure. Therefore the structure presented in Figure 1 can be further complicated if domicile of each of the participants in the funds market is different. As a result the tax implications for the investors, manager and the fund will vary.

[9] For example, real investment trusts are mandated to distribute 90 per cent of the earnings to the unit holders

[10] https://www2.deloitte.com/content/dam/Deloitte/us/Documents/Tax/us-tax-2017-annual-wealth-guide-tax-implications-of-fund-investing.pdf

Figure 1: Structure of investment fund



A periodic return on the investment paid out to unit holders or investors may be characterised as dividends, rental or interest. This can depend on the nature of the assets invested in. Further, on sale of asset held by the fund or on sale of units held in the fund capital gain may arise. A part of this income earned by the fund accrues to the investor, depending on the regulatory requirement to distribute. In some cases, the fund will make profit or loss. Characterisation of the distributions may often be more complex. It will be shown in the subsequent sections, the nature of investments particularly in the case of a securitisation trust established by an ARC may be more complex resulting in problems of characterisation. This can result in uncertainty of tax treatment.
The fund manager receives a fixed fees as a percentage of the asset under management and a variable share of the profits. As has already been mentioned, each of these incomes may arise in the jurisdiction where the investor and manager are resident or in a foreign source jurisdiction. Depending on whether the source and the residence jurisdiction is the same or not the relevant provisions of domestic tax law and that of treaties apply.

2.3 Principles of taxation:Neutrality in the context of funds

An ideal system of taxation must be such that the payments are proportional to one's ability (*Ability principle*), the payments should be certain and not arbitrary(*Certainty*), these should have some equivalence with the benefit derived (*Benefit principle*) and most importantly it should not distort economic decision making (*Neutrality*). Among the principles of taxa-

tion, particularly neutrality, have been discussed widely in relation to investment vehicles. For example discussions in 1962 International Fiscal Association's(IFA) annual congress recommended that the participants in investment funds be treated similarly irrespective of their legal form and that taxes withheld must be reclaimed with the use of national legislation and double tax avoidance agreements[11]. Neutrality in the application taxation to collective investment vehicles is often acknowledged as key. It follows then that a reform must not be pursued if it makes tax the main or principal determinant of an investment decision. Instead, the decision to invest must rely on the fundamental determinants of portfolio choice-risk, return and liquidity[12]. Note that while IFA's reference to neutrality is with regard to fund level taxation. As has already been mentioned the concept of neutrality can extended to investor. An investor can choose to invest in different instruments. The instruments can be taxed similarly or otherwise. Neutrality at the fund level, can be maintained if distribution to investors is treated the same as if it were paid directly. Treatment of investment funds as transparent entities for tax purposes can help fulfil such neutrality.
While for cross border investment the concept of neutrality extends to *capital export neutrality* and *capital import neutrality*. To establish whether a tax system is export or import neutral would require a comparison of tax rates across jurisdictions. This is beyond the scope of this paper since the analysis limited to comparing the tax treatment of returns from select investment funds within India.

3 Types of investment funds: Regulations and structure in India

In India different kinds of funds operate in the financial market. These funds can invest in instruments that are listed in the market or in unlisted securities. The Securities Exchange Board of India(SEBI) regulates the registration and operation of funds, usually classified as per the asset class that it invests in. Broadly, a fund can be a Mutual fund (MF), Index Fund,Exchange Traded Fund, AIF[13], REIT and InvIT.
The primary aim of a fund is to aggregate investments to provide the benefits of diversification, expertise and economies of scale to investors in a particular asset class.

[11] Page 19, P. Brown in The Tax Treatment of CIV and REIT IBFD
[12] page 325,Tomi Viitala (2004), IBFD
[13] earlier referred to as Venture Capital Funds

As mentioned earlier, considering the present economic goals each of the select fund type can play a vital role in economic revival. For example, start-ups and unlisted can with technological innovation sustain and bolster growth. AIFs or more specifically VCF may be instrumental in providing the necessary investment to these start-ups. Thus AIFs are perceived to have positive spillovers in the economy[14]. Then there are ARC trusts or securitisation trusts that can provide capital necessary to revitalise banking credit. Lastly, REITs or InvITs can be helpful in meeting the funding gaps in infrastructure development.

In the previous section a general structure of investment fund was described. However, more complex or peculiar structures may be adopted by different kinds of funds. This may in part be driven by investment objective as well as investor profile of the fund. These have been presented alongwith an overall regulatory landscape governing each of the fund/CIV category.

1. **AIF**: In 2012, SEBI introduced the AIF regulation in place of the existing Venture Capital Fund regulation. AIF regulation lays down the eligibility criteria for registration and the investment conditions. There are three categories of AIF I, II and III. The first category comprises of a company, trust or limited liability partnership established to collect funds from investor and to invest these in either a start-up, social venture[15], SME fund[16], infrastructure fund[17]. The category of funds investing in venture capital undertakings includes angel funds[18]. AIF category II are all funds that are not covered under categories I and III. These include private equity, debt funds, distressed asset fund[19] and real estate funds[20]. These are funds to which no specific incentives have been given by the government[21]. AIF category III are funds that employ diverse or complex trading strategies.

[14] Regulation 4(a) of SEBI(AIF) Regulation, 2012

[15] Regulation 2(u) of SEBI(AIF) Regulation 2012 describes what is a social venture. SVF must invest in the units of a venture that fulfil the social performance norms laid down by the fund

[16] Fund which invests primarily in unlisted securities of investee companies which are SMEs or securities of those SMEs which are listed or proposed to be listed on a SME exchange or SME segment of an exchange

[17] A fund that invests in the units of a company/trust/SPV that operates, develops or hold infrastructure projects

[18] They are a sub-category of AIF-I defined in Chapter III of the SEBI(AIF) Regulation 2012

[19] In 2018 Category II and III AIFs were permitted to invest in Security Receipts issued by ARCs, provided that the fund did not invest in the ARC itself

[20] https://www.indiainfoline.com/article/general-blog-nri-services/what-is-aif-can-nri-pio-oci-invest-in-aif-118100400385_1.html

[21] Para 4(c) of AIF regulation

These include hedge funds, open ended funds with no incentives and funds that trade to make profits. For each of these categories there are specific threshold requirements for individual contribution by investors,borrowing restrictions, total corpus of the fund and asset class in which the fund may invest. Indian or foreign investors can freely invest in AIFs. 100 per cent Foreign investment in AIFs is approved through automatic route. This in in fact made investment in debt more attractive through AIFs since these are considered onshore funds and therefore the limits on investment in debt that are otherwise applicable to foreign investors are not applicable. The minimum corpus for *all* AIFs is INR 20 crore and the minimum investment by each investor is 1 crore(unless employees or director). Among the three categories category III has no restrictions on investment in listed securities including derivatives whereas for categories I and II, there are restrictions to investment in listed securities.That is in the case of AIF I two-third of the investable funds are to be invested in unlisted equity shares or equity linked instruments of a venture capital undertaking or in companies listed or to be listed SME exchange. Any investment made by category I and II AIF in shares of entities may be listed on institutional trading platform[22]. AIFs can also invest in units of other AIFs. Further, the units of close ended AIF may be listed in minimum tradable lots of INR 10 million, provided that it is not an angel investment fund[23]. AIFs registered in IFSC can invest in securities listed in the stock exchange at the IFSC[24]. The AIF's income may comprise of capital gains through sale of assets, interest and/or dividend. The unit holder receives such income from the fund in proportion to his/her holding.Further, the unit holders can trade the units itself. Which means that there can be capital gains from the sale of units. In 2019, the investment received by AIFs INR 1097.8 billion. The highest segment to receive this investment were funds in category II. The investments received were close to 40 per cent of the commitments made, although for category II these are close to 70 per cent.

2. **REIT and InvIT**: A real estate investment trust and an infrastructure investment trust are entities that pool funds to own, operate or finance income generating real estate and infrastructure respectively. REIT can in-

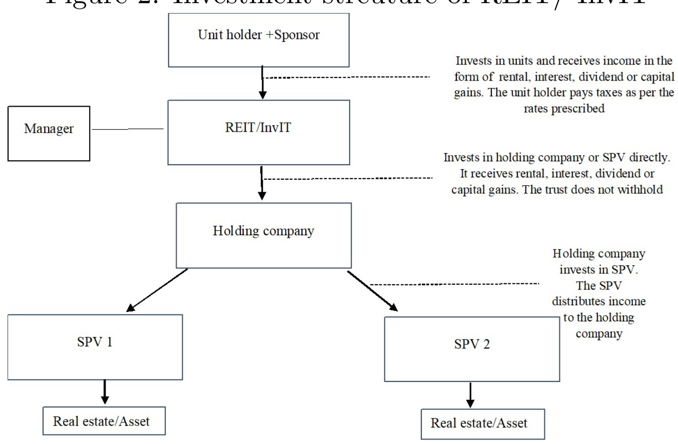
[22]This a platform for start-ups and growing companies

[23] SEBI(AIF) regulation 14(1) and 19(H)

[24]https://www.sebi.gov.in/legal/circulars/may-2017/securities-and-exchange-board-of-india-international-financial-services-centres-guidelines-2015-permis 34951.html

vest, directly or through hold co, in real estate or property[25]. These include hotels, hospitals, convention centres, whether rent generating or income generating[26]. An InviT can invest in infrastructure projects that includes subsectors such as energy, transport, water and sanitation, communication and social and commercial infrastructure[27]. As has already been mentioned, the investment can be made directly or through a holding company structure or through SPVs. Where the investment in real estate is through a hold co it is mandated that the controlling interest of the trust must exist in this company. The units of an InvIT are to be listed through private placement or public offer.Figure 2 shows the hold co structure.

Figure 2: Investment strcuture of REIT/ InvIT



Further, the units of the REIT and InvIT must be listed, subject to criterion that InvIT/REIT assets(including the interest in hold co and SPV) exceed INR 5 billion. The minimum offer size must be INR 2.5 billion. Until April 2019, the listed REIT and InvIT had to offer units in minimum lots of 200,000 and INR 1,000,000 respectively. These were reduced to 50,000 and 100,000. REIT and InvITs must invest at least 80 per cent in completed and revenue generating projects. The investors permitted to invest in the units of REIT and InvIT include scheduled commercial banks, RBI, multilateral/ domestic financial institutions, systemically important NBFC registered with RBI, infrastructure finance company registered with RBI

[25]Defined as land or permanently attached improvements by SEBI(REIT)regulation 2014

[26]Regulation 2(zi) of SEBI(REIT)regulation 2014

[27]referred to in notification of Ministry of Finance dated October 07, 2013 available at dea.gov.in/sites/default/files/HarmonisedMasterList_Infrastructure_0.pdf

and foreign portfolio investors[28].
In 2019, the asset under management of 4 listed InviTs was INR 400,000 million[29]. Whereas until recently there was only one REIT-Embassy Office Parks Private Limited, raised investment of INR 47500 million. Though there has been an increase in investment in these trusts,these are still modest in comparison to the listed markets.
3.**ARC Trusts/Securitisation trusts**: The ARCs may acquire banking assets through the process of auctions or bilateral negotiations[30]. After the acquisition of the asset the securitisation company or reconstruction company may offer security receipts to qualified buyers[31] or raise funds by formulating schemes, where for each such scheme separate and distinct accounts will have to be maintained [32]. These SRs can be held by the bank or issued to other qualified investors[33]. ARCs may set up trusts that acquire and sell these assets.An ARC can carry out securitisation functions if its net owned funds are in excess of INR 2 crore or 15 per cent of total financial assets acquired or to be acquired, as specified by RBI[34] . Note that RBI mandates that ARCs and SCs invest a minimum of 15 per cent of SRs[35](See Figure 3 for illustration). Over the years, the banks consisted of large fraction of the SR market, owning more than 90 per cent of these receipts. Among the buyers that are qualified to purchase SRs are financial institutions, insurance company, bank, state financial corporation, state industrial development corporation, asset management company making investment on behalf of mutual fund or pension fund or foreign institutional investors. As is mentioned earlier category II and III AIFs are now permitted, as per RBI notification[36], to invest in security receipts issued an ARC subject to certain conditions[37]

[28] Chapter I, 2(ztb) of REIT regulation and Chapter 1 2(zza) of InvIT regulation

[29] https://economictimes.indiatimes.com/markets/stocks/news/invit-aum-may-grow-5-fold-in-2-years-crisil/articleshow/70367012.cms?from=mdr

[30] Check FAQs provided by https://www.rarcl.com/faqs.html

[31] Section 7(1), SARFAESI Act 2002

[32] Section 7(2), SARFAESI Act 2002

[33] Section 2(u) of SARFAESI Act 2002

[34] Chapter II, 3(1)(b) of SARFAESI Act 2002

[35] RBI notification no. RBI/2014-2015/164

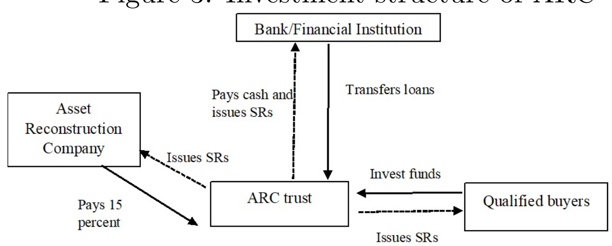
[36] http://www.egazette.nic.in/WriteReadData/2018/187058.pdf

[37] a. The AIF which has invested in an asset reconstruction company (ARC) shall not invest in the security receipts issued by that ARC;b. The AIF shall not invest in the security receipts issued on the underlying loans of any of its associate or group company;c. The AIF shall not invest in the security receipts backed by non-performing assets of banks which hold equity of more than 10 per cent in that AIF.

In recent times higher provisioning norms stipulated for banks holding SRs has led to an increase in cash component for financial year 2019[38] . This trend has been accompanied by an increase in interest from institutional buyers such as pension funds, foreign banks, PE and hedge funds that now account for 60 per cent of SRs[39]

The trust is a pass through entity that may exist as a SPV. The ARC earns management fees[40], interest, any profit from sale (20 per cent[41]). The ARC can undertake resolution plan using different approaches. For each type of resolution plan the tax treatment of the income of the investor will be different.

Figure 3: Investment structure of ARC



In 2018, SRs worth INR 1203 billion were issued of which INR 5 billion were subscribed by FPI[42]. Figure 1 is a general representation of a fund structure. However from the discussion in this section it is clear that for more specialised funds such as REIT, InvIT or the ARC trust these structures may be distinct. A common identifiable feature for the selected fund types is that the investors may be required to make large investments in comparison to direct investment in stock market or even when compared to that in mutual funds units. Further, there is cross holding among investor types making these complementary- as in the case of AIFs that invest in ARCs- or substitutes-the case of real estate where there are real estate AIFs

[38]CRISIL's 2019 report *Bolstering ARCs estimates these at 91 per cent*

[39]https://www.crisil.com/content/dam/crisil/our-analysis/reports/Ratings/documents/2019/august/bolstering-arcs.pdf

[40] RBI notification no.RBI/2014-2015/164 specified that management fees should be calculated or charged as a percentage of NAV at the lower end of the range of NAV specified by Credit Rating Agency,provided that the same is not more than the acquisition value of the underlying asset. However, management fees are to be reckoned as a percentage of the actual outstanding value of SRs, before availability of NAV of SRs

[41]rest is passed on to other SR holders

[42]Page 65, Report on Trends and Progress of Banking 2017-18

and REITs. It is desirable that tax treatment across the various kinds of funds, irrespective of whether they are substitutes or complements. The next section details the tax treatment across fund types.

4 Tax treatment of investment income

There are different agents that form part of the fund structure. There are the sponsor, investors, fund manager and the fund itself. Each of these agents are taxed on incomes they receive from their respective contribution. For the purpose of this paper the analysis will be restricted to the taxation of incomes of the funds and its investors.

Neutrality in taxation may be evaluated through a two-fold approach. One, that the fund itself must retain the character the income, as when paid directly. Tax transparency of fund allows for incomes paid to investors to be treated on par with when paid by the fund. On the other hand, distributions to investors should be taxed similarly. The latter is relatively hard to maintain. The classic example of such dissimilarity , also an unsettled matter of debate, is the deductibility of return on debt which is theoretically weighed against the non-deductibility of returns paid to equity for tax purposes. Such differences may be further amplified by special treatment of incomes from certain instruments. Therefore is is possible that units issued by a specific fund gets preferential treatment. In this section the taxation of incomes and those in case of units of select funds in India is detailed.

4.1 Taxation of incomes in India

Income to unit holder may be a regular payment in the form of interest, dividend or rental and capital gains may accrue on the transfer of such units/underlying assets owned by the fund. The taxation of each of these incomes is specified in the Income Tax Act 1961. For incomes paid to non-residents the relevant tax treatment and the withholding rates applicable are specified in the Act and DTAAs respectively. The general tax treatment of incomes to all types of investors is detailed first and is then contrasted with the taxation of incomes paid out by different funds.

4.1.1 Pass through status in the Income Tax Act

Investment funds may be set up as a company, trust or LLP, depending on the regulatory requirement and the preference of the sponsors. SEBI regulations mandate that Mutual funds, REITs and InviTS in India are set up as trusts whereas the AIFs may set up as company, trust or partnership. In the Income Tax Act a reference is made to the SEBI regulation for tax applying to each of these.
Chapter XII of the Income Tax Act 1961 specifies the*determination of tax in certain special cases* and Chapter III of the Act lists the *incomes which do not form a part of the total income.* These together specify the incomes that may be taxed for various fund types.
Income of a mutual fund[43],Income of Securitisation Trust from securitisation activities[44], dividends and long term capital gains of a venture capital fund or venture capital company[45], any income of investment fund which means AIF in category I and II(excluding profits and gains from business)[46], real estate investment trust[47], dividend and interest from SPV paid to a business trust are not to be included in the computation of total income which is subject to tax. Until 2019, the pass through status to AIF was only applicable in case of profits, however this has been amended to allow for pass through of losses[48]. Therefore, among the primary means to achieve neutrality, which is transparency of the funds or trusts, has been extended to all funds selected for analysis in this paper, with exception of AIF category III. It can be said that the first level of neutrality- that is at the fund level- is largely maintained.

4.1.2 Taxation of dividends

When funds are pass through the character of the income is retained and the said income is taxed in the manner specified. First among the kind of incomes that paid to unit holders is dividend. In India profits distributed are taxed at the level of company and are exempt in the hands of the investor. This unique levy was introduced with the purpose to ease compliance. The distributed profits are taxed at the rate of fifteen percent. In calculating the dividend subject to tax, total dividend shall be reduced by dividend paid

[43]Section 10(23D)Income Tax Act(ITA) 1961
[44]Section 10(23DA), ITA 1961
[45]Section 10(23F), ITA 1961
[46]Section 10(23FBA), ITA 1961
[47]Section 10(23FCA), ITA 1961
[48]Sub-section 2A is inserted in Section 115UB, ITA 1961

by subsidiary[49] to the domestic company, provided that tax is paid on the distribution by the subsidiary. This has particular significance in the case of funds, where fund of funds may be taxed heavily. Further, with effect from October 2014, the amount so determined as taxable as dividends must be grossed up. Such reduction in the amount taxable as dividends for taxes already paid by subsidiary is available once. Exceptions to this tax are made for companies located in IFSC that are not subject to dividend distribution tax[50] and no tax is payable on profits distributed to a business trust[51][52].
Although the headline rate of dividend distribution tax is 15 per cent different rates have been specified for profits distributed to unit holders of different kinds of collective vehicles. For example, profits distributed by money market mutual funds/liquid funds are taxed 25 per cent if distributed to a person being an individual or HUF and otherwise at 30 per cent[53]. Distributions of equity oriented funds are taxed at 10 per cent[54]. For the REITs and InvITS, an exemption was made on DDT in the budget for 2016-17, the dividend paid to REIT directly by a SPV is exempt from DDT, provided that the REIT has controlling interest(100 per cent)in SPV[55]. Where the dividend is paid by the hold co, the exemption may not apply and DDT of 15 is payable as tax on the distributions. As for the AIFs, the dividend paid to investors is taxed at the level of investment company not at the level of the AIF. The dividend paid by AIF will be subject to withholding at the rate of 10 per cent.
In 2018, an additional dividend distribution tax was levied on a resident individual, HUF or firm that received dividend in excess of INR 10,00,000 from a domestic company[56].
DDT is therefore payable irrespective of whether the recipient is a resident or non-resident. Since the dividend income is exempt in the hands of the investor the withholding rates, as specified in the DTAAs, are not applicable or relevant. A flipside of such treatment of dividends is that despite a tax having been levied on distributions the non-resident investor may not be

[49] Explanation to Section 115 O of ITA 1961, a company is considered a subsidiary if the another company owns more than half of the equity share capital of the of the subsidiary company

[50] sub-section 8 of Section 1150, ITA 1961

[51] Sub-section 7 of Section 115 O, ITA 1961

[52] A business trust is defined in Section 2(13A) ITA 1961 as an InVIT and REIT, the units of which are to be listed on a recognised stock exchange

[53] Section 115 R

[54] Section 115 R

[55] Section 10(23FC),Section 10(23FCA) and Section 115O of ITA 1961

[56] Section 115BBDA of ITA 1961

able to claim credit against such tax paid.

4.1.3 Taxation of capital gains

In India capital gains are levied at separate rates on gains classified as long term and those classified as short term. The period of holding is specified in the act to classify these as short term and long term and these vary as per the asset class. Therefore there are two elements of taxation of capital gains one the holding period and the other is the rate specified. For capital assets in the category of equity/preference share, other listed securities, units UTI, units of equity oriented funds and zero coupon bonds the holding period prescribed for short term capital gains is less than 12 months, for unlisted shares it is less than 24 months and for all others is less than 36 months[57]. The sale of short term capital asset which includes equity share or unit of an equity oriented fund or business trust, where securities transaction tax has been paid on such transaction, shall be taxable at the rate of 15 per cent[58]. From 2016, this is applicable to income arising from transfer of units of business trust acquired by assessee in lieu of share of SPV. For all other cases, the rate applicable are the "rates in force" as per part I of the first schedule of the relevant year's Finance Act. That is, the slab rate applicable to incomes. The tax rate applicable in case of short term capital gains earned by foreign institutional investors (FII)[59] for categories of assets other than equity share or unit of an equity oriented fund or business trust, where STT has been paid, the gains are taxable at the rate of 30 per cent[60]. In the case of long term capital gains tax, transfer of listed equity share or unit of an equity oriented fund[61] is chargeable to tax at the rate of 10 per cent on gains in excess of INR 100,000[62]. The Income Tax Act further specifies the treatment of capital gains arising to non-residents and FII. In the case of other assets such as listed securities, units or zero coupon bonds the tax applicable is lower of the two- 20 per cent after taking the benefit of indexation or 10 per cent without taking such benefit. In case of non-residents

[57] Definition of capital asset in Direct Taxes Manual Volume 3

[58] Section 111A, ITA 1961

[59] These are now regulated by the FPI regulation

[60] Proviso to sub section (b) clause (ii) Section 115AD, ITA 1961

[61] Is a mutual fund whose 65 per cent of the total proceeds are invested in equity and 90 per cent of the proceeds are invested in units of a fund with 65 per cent invested in equity

[62] Section 112A, ITA 1961

any long term capital gains on assets other than unlisted securities[63] is taxable at the rate of 20 per cent and 10 per cent in all other cases. Note that for transactions undertaken in the IFSC, the capital gains, long term[64] or short term[65], are not subject to tax.

Long term capital gains earned from sale of different instruments is subject to withholding at the rate of 10 per cent whereas that for short term capital gains is 15 per cent. Further, the DTAAs allocate the right to tax. Given these articles are negotiated bilaterally it is expected that the capital gains articles may not be similar across treaties. Taking for example, the jurisdictions that are important source of foreign investment in India, it is observed that in the case of UK and USA each contracting state may tax capital gains in accordance with their domestic law. In contrast, treaties with Mauritius [66] and UAE treaties make gains from equity shares taxable in source jurisdiction[67].

4.1.4 Interest

Interest received from investment in debt instruments is taxable at the rate applicable to total income with the exception of bonds and government securities on which interest is exempt. Tax deducted on interest payments made on securities[68]. In case of income distributed by business trusts in the form of interest received from SPV or income received from renting or leasing or letting out any real estate asset owned directly by it the tax deducted for residents is 10 per cent whereas that for non-residents is 5 per cent[69]. Similarly, for rupee denominated bonds issued by Indian Companies or Government securities to a Foreign Institutional Investor or a Qualified Foreign Investor[70] and,payment of interest on infrastructure debt fund[71] the rate of withholding is 5 per cent. The Income Tax Treaties also specify the withholding rates for interest, these range between 10 to 15 per cent except for Mauritius for which the rate is 7.5 per cent.

[63] Clause (f) of Section 115C, ITA 1961

[64] Sub-section(3) of Section 112A, ITA 1961

[65] Second Proviso to Section 111A

[66] This takes into account the amending protocol signed in 2018

[67] In Mauritius treaty the tax rate shall not exceed 50 per cent of the tax rate applicable on such gains in the State of Residence of the company whose shares are being alienated

[68] Section 193, ITA 1961

[69] Section 194LBA, ITA 1961

[70] Section 194LD, ITA 1961

[71] Section 194LB, ITA 1961

4.2 Taxation of collective investment vehicles

4.2.1 Tax treatment of AIFs

In 2015, to streamline the taxation of alternative investment funds[72] pass through treatment of incomes earned by venture capital funds (Section 10(23FB)ITA, ITA 1961) was extended to all funds registered under category I and II of the SEBI(AIF)2012 regulation[73]. Therefore any distributions made to unit holders of a fund are chargeable to tax as if it were the income accruing or arising to, received by, such person had the investment made by the investment fund made directly by him. Note that for distributions made by an investment fund, implying AIF I and II, the distributions made are not taxable as specified in the case of mutual funds, money market liquid funds or DDT applicable to companies. Instead, the AIF is to withhold tax on the incomes paid to the unit holders at the rate of 10 per cent for resident taxpayers and the rate prescribed for non-resident[74]. The loss made by the fund could be carried forward but until July 2019 pass through was applicable only to profits.

4.2.2 Tax treatment of REIT and InvIT

REITs and InvITs are treated slightly differently from AIFs for tax purposes in India. As has been shown earlier the trust can choose to hold assets directly or through SPVs. where the holding company structure is adopted the tax applicable therefore is at four levels; At the level of REIT, holding company, SPV unit holder.

For the SPV and hold co any income derived from the asset is taxed as business income. Further, any gain from sale of the underlying asset is taxable as capital gains for SPV and hold co. Dividend paid by a SPV or Hold co that owns 100 per cent of equity capital of trust is exempt at the SPV level. In other cases 15 per cent applies at the level of trust. However, if the tax is paid at the SPV level then it is exempt at the REIT.For the REIT interest, income from assets and dividends are exempt provided that the tax has been paid by SPV or where the 100 per cent of equity of SPV/hold co is held by the trust. However for income from assets directly held by the REIT[75] or interest received from SPV by REIT/InvIT tax is withheld at the

[72] Budget Speech 2015

[73] Section 115UB Income Tax Act

[74] Section 195 ITA and treaty rates

[75] maximum marginal rate applies in case of an InvIT

rate of 10 per cent for residents and 5 per cent for non-residents. Any sale of asset by SPV or shares of SPVs by the trust is subject to capital gains. As for the unit holders distributions such as interest and rental income(in the case of REIT) are taxed at rates in force. For non-residents 5 per cent withholding on interest and 40 per cent on rental income is applicable. As for rental income it is exempt from tax for REIT/InviT as well as the unit holder.

4.2.3 Tax treatment of ARC trusts

Similar to the AIF, in 2016 ARC trusts were given pass through status and the income distributed is taxable in the hands of the investors. Until 2016, the distributions by ARC trusts were subject to tax at the rate of 25 per cent in the case of individuals and HUF and 30 per cent for all others[76]. While the income was not subject to tax in the hand of the investors[77]. In June 2016, the regime the distribution tax was done away with[78] while making the income taxable in the hands of the individual[79]. The securitisation trust, including reconstruction companies and securitisation companies, must withhold tax on incomes paid at the rate of 25 per cent in case of HUF or individuals, 30 per cent of others and foreign company or non-resident(not company) at "rates in force"[80]. This was a major change from the earlier regime where income of securitisation trusts were subject to gross tax at the level of trust, making it difficult to claim credit. The ARC trust must withhold the tax on behalf of the SR holders.

Beyond the basic tax treatment spelt out in the Act, the taxation may vary as per the nature of resolution plan adopted by the ARC. Broadly, the income received by the SPV may be of repayment of principle, dividends for equity issued, interest on underlying loan, capital gains on issue or redemption of SRs. Each of these incomes will be taxed as per the treatment prescribed Income Tax Act and discussed earlier. There has been discussion of characterisation issues. For example, in the case of securitisation trustees the interest income received may be classified as *profits from gains and business* or *income from other sources*, this can impact loss offsets as well as rate applicable to non-residents[81]. Even in the case of non-resident

[76] Section 115TA, ITA 1961
[77] Section 10(35A), ITA 1961
[78] 5th Proviso to Section 115 TA
[79] Section 115TCA, ITA 1961
[80] Section 194LBC, ITA 1961
[81] Page 61, Report on Housing Finance Securitisation, RBI, 2019

investors, the rate applicable to FPI on income from securities is 20 per cent whereas the tax applicable on business profits is 40 per cent

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5 Is the system tax neutral?

Tax policy tends to move in tandem with the shifts in the economy. It is observed that the engines of growth receive fiscal give-aways as tax breaks.This is common place during nascent stages of development. As the economy transitions to a relatively developed state attempts are made to streamline the tax system by removing such non-neutralities. Simultaneously, the tax law also adapts though amendments to keep pace with innovations in finance and accounting practices.This is true for the Indian economy as much it is for any other. The previous section detailed the tax treatment across incomes and vehicles of investment. With the introduction of new forms of financial instruments and structures of pooling vehicles separate sections were introduced in law. Through successive amendments and the last in 2016, as has been shown,the first fold of neutrality has been achieved by allowing the select funds and trusts pass through status, except for the case of AIF category III[82].

The second form of neutrality could exist where the incomes from each the selected funds is taxed uniformly. Given that there are largely similar class of investors that operate in this market any difference in tax treatment could potentially distort investment decisions. The differences arise both in terms of the treatment of various categories of income. For example, the distinction between listed and unlisted securities for capital gains as well as debt and equity creates a wedge in taxation of incomes. Further, the difference in tax treatment of distributions to investors of particular funds draws a further wedge between asset classes.

Dividends distributed by AIF I and II to residents, tax is to be withheld at the rate of 10 per cent whereas in the case non-resident investor no tax is to be withheld. The latter is similar for REIT/InvITs unit holders of which are exempt from any tax on dividend, except for the case where such dividend is paid through the hold co. Similarly, for securitisation trusts the dividend is exempt in the hands of the investors. Further, the foreign investor cannot claim any credit for DDT in their country of residence.

Capital gains may arise both when the underlying asset of the fund/trust is

[82] Although in certain cases where the trust is determinate trusts that may achieve a pass through status

transferred or when the units are transferred. First, in the case the transfer of underlying assets there is a wide ranging tax treatment among the select funds. Capital gains, like the dividend, are exempt for REIT and InviT, when directly paid to the investor, whereas for AIF I and II the unit holder and the unit holder is taxed at the rate applicable depending on the nature of the asset. As for securitisation trust, it has been observed that the nature of taxation is complicated by characterisation. The tax is withheld for resident individuals at 25 per cent and 30 per cent in other cases. As for non-residents including FPI the tax applicable on the long term capital gains is 10 per cent, short term capital gains at the rate of 15 per cent for listed securities and 30 per cent of unlisted securities. Therefore, any capital gains that are characterised as said, the income from SRs are treated case by case basis as is true for AIFs I and II. But the withholding in the case of the said AIFs is uniform. Therefore, REIT/InviTS enjoy a special advantage in the form of capital gains exemption whereas AIFs have less usurious and more uniform withholding.

When we examine the sale of units or SRs, the observed differences in holding period and rates, mentioned earlier, play out. For example, unit of a business trust and equity would be treated on par such that the minimum holding period for the gains on transfer to qualify are long term gains is 12 months. Whereas for the non-equity and unlisted securities and the period would be 36 months and the tax rates applicable would also be different. To listed securities would be 10 per cent without indexation and 20 per cent with indexation. Whereas for the unlisted the rate of 20 would be applicable. Therefore REIT and InviTs are treated on par with equity and are relatively advantaged, since shorter holding period of units may lend more liquidity.

Lastly, if we take the case of interest rates, in the case of REITs and InviTs, the non-resident investors are offered a lower rate of withholding at the rate of 5 per cent whereas for interest paid to residents by these two kinds of business trusts as well as in the case of AIFs the rate is 10 per cent. Yet again in the case of interest payments on security receipts is subject to the distribution tax as specified earlier and for non-resident a withholding of 20 per cent, as the case may be.

Further, for investment funds and companies located in the IFSC exemptions have been extended on account of capital gains and dividend. This adds one more layer of incentives and complexity.

It is therefore evident that the tax treatment is not uniform and for similar class of investors a wide variation in taxation may arise based on the fund they choose to invest. REITs and InviTs are particularly advantaged whereas the securitisation trusts or companies have higher withholding rates as well as uncertainty in tax treatment. If each of these funds can facilitate in achieving a particular economic goal, there is merit in re-examining the specific treatment and bringing about parity in taxation of the said instruments. Possible ways to do that is bring on par withholding rates/TDS, introduce uniformity to holding period in the case of capital gains and by making dividends creditable. It may also be useful to evaluate incentives,such as beneficial withholding rates/TDS to particular investor type such as in the case of REITs and InviTs and the incentives to offshore centres. Evidently, these have not fructified into higher investment.A possible explanation is the interplay of regulations, that is limits on investment and participants that can counteract any incentive regime. Even so, it may be worth looking into the efficacy and usefulness of tax incentives.

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