

CBDT clarification on characterisation of income on transfer of unlisted shares by Category I and Category II AIFs registered with the SEBI

Taxation regime for Alternative Investment Funds

Under the provisions of the Income-tax Act, 1961 an investment fund established or incorporated in India and registered with the Securities and Exchange Board of India (SEBI) as a Category I or a Category II Alternative Investment Fund (AIF) is accorded tax pass through status, i.e., income of the AIF shall be chargeable to tax directly in the hands of its investors. However, where the income of the investment fund is characterised as income under the head “Profits and gains of business or profession”, the investment fund would be taxable in respect of such income at the maximum marginal rate of tax.

Characterisation of income

There have been a host of judicial pronouncements on whether gains on transfer of securities should be taxed as “business profits” or as “capital gains”. However, these pronouncements, while laying down certain guiding principles, have largely been driven by the facts and circumstances of each case. The Central Board of Direct Taxes (CBDT) had provided guidance (*vide* its Instruction: No. 1827, dated 31 August, 1989 and Circular No. 4/2007, dated 15 June, 2007) in respect of characterisation of gains as either capital gains or business income. Subsequently, with respect to the characterisation of gains arising on transfer of unlisted shares, the CBDT had issued an instruction dated 02 May, 2016 providing that income from transfer of unlisted shares, would be considered under the head “capital gains”, irrespective of the period of holding. The CBDT, however, carved out the following three exceptions for the Tax Officer to take an appropriate view on the characterisation of income, if:

1. the genuineness of transactions in unlisted shares itself is questionable; or
2. the transfer of unlisted shares is related to an issue pertaining to lifting of corporate veil; or
3. the transfer of unlisted shares is made along with the control and management of underlying business.

CBDT clarification

The CBDT has noted that Category I and II AIFs registered with the SEBI invest in unlisted shares of companies, being new set-ups or start-ups, and to safeguard the interest of its investors, such AIFs may exercise some form of control and management in the underlying business of the start-ups. Hence, based on representations received in this regard, the CBDT has clarified that the exception relating to transfer of unlisted shares along with the control and management of the underlying business as mentioned in the CBDT instruction dated 02 May 2016, would not be applicable to SEBI registered Category I and II AIFs only. Accordingly, gains earned by the SEBI registered Category I and II AIFs on transfer of unlisted shares, even where the transfer is made along with the control and management of the underlying business would be characterised as capital gains.

This is a welcome clarification, and will provide certainty on the taxability and pass through nature of the income earned by Category I and II AIFs on transfer of unlisted shares, thereby reducing litigation exposure for such AIFs.

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