



Tax alert: Category III AIF not taxed at MMR, disclosing investors in original trust deed not necessary

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The Delhi High Court (HC) has held that non-disclosure of investor names in the original trust deed did not render a trust indeterminate for tax purposes; the taxpayer (a Category III AIF) was a determinate trust as the identity of investors and their income share was determined in accordance with the contribution agreements executed post the Trust Deed.

In a nutshell



No AIF can accept any commitment or investment from any investor or beneficiary unless and until it is first registered (in terms of Regulation 4(c) of the SEBI Regulations) under the provisions of Registration Act, 1908 and thereafter be granted certificate of registration under Regulation 6 of the SEBI Regulations.



The CBDT Circular no. 13/2014 clarifies that the circular 'would not be operative in the area falling in the jurisdiction of a High Court which has taken or takes a contrary decision on the issue.' This is contrary to well settled judicial principles of law. An issue of law, settled by a Constitutional Court, neither challenged nor set aside by a higher Constitutional Court, would be binding upon the Revenue authorities all over the country and cannot be implemented state-specific or area-specific.



On one hand, Explanation 1 to section 164 of the ITA and Circular no.13/2014, mandates necessary mentioning of the names of the investors or their beneficial interests in the original Trust Deed; on the other, the SEBI Act and Regulations prohibit the same. This would be an impossible situation for Category III AIF (like taxpayer) to comply with. No entity under any enactment can be perceived or compelled to perform the impossible.



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Background:

- The taxpayer¹ is engaged in the business of rendering Portfolio Management Services (PMS) in accordance with the relevant guidelines/regulations issued by Securities and Exchange Board of India (SEBI).
- SEBI issued Alternative Investment Fund (AIF) Regulations, vide notification dated 21 May 2012 classifying AIF in three categories, i.e. Category I, II, III.

The taxpayer was floated as a Category III AIF by its settlor. The object of the taxpayer as stated in the Trust Deed, was to act as an AIF Category III in terms of SEBI(AIFs) Regulations, 2012 (SEBI Regulations).

- The taxpayer launched a single open-ended scheme, **XYZ India Fund**, which was registered with SEBI for investment in listed equity shares. Pursuant to its launch, contribution agreements were executed with various investors, and units were issued.

The taxpayer claimed that the identity of investors and their income share was determined in accordance with the contribution agreements executed post the Trust Deed. The XYZ India Fund commenced operations during Financial Year (FY) 2017-18, corresponding to Assessment Year (AY) 2018-19. As per the taxpayer, since the fund is treated as a separate taxable entity, XYZ India Fund filed its separate returns of income since its very inception i.e. AY 2018-19.

- To seek clarity on the taxability, the taxpayer filed an application seeking an advance ruling on various issues before the Authority for Advance Ruling (AAR).

During the pendency of the application before the AAR, the Assessing Officer (AO) completed the audit proceedings of XYZ India Fund for AY 2018-19 holding that the taxpayer was a determinate trust and accepted the loss claimed in the taxpayer's return of income.

- During FY 2021-22, the Finance Act, 2021 abolished the institution of AAR and replaced the same with the Board of Advance Rulings (BAR). The taxpayer's application was transferred from AAR to the jurisdiction of BAR.

The BAR rejected the taxpayer's application for withdrawal (of application for advance ruling) by holding that if the names of the beneficiaries were not set out in the original Trust Deed then, such Trust would be treated as an indeterminate and resultantly be subject to Maximum Marginal Rate (MMR) under the provisions of section 164 of the ITA.

- Aggrieved, the taxpayer filed a writ petition before the Delhi High Court (HC).

Relevant provisions in brief:

Extract of Section 164 of the Income-tax Act, 1961 (ITA):

(1) "Subject to the provisions of sub-sections (2) and (3), where any income in respect of which the persons mentioned in clauses (iii) and (iv) of sub-section (1) of section 160 are liable as representative assesses or any part thereof is not specifically receivable on behalf or for the benefit of any one person **or where the individual shares of the persons on whose behalf or for whose benefit such income or such part thereof is receivable are indeterminate or unknown** (such income, such part of the income and such persons being hereafter in this section referred to as "relevant income", "part of relevant income" and "beneficiaries", respectively), tax shall be charged on the relevant income or part of relevant income at the **maximum marginal rate**....."

Extract of Section 12 of the Securities and Exchange Board of India, 1992 (SEBI Act):

Registration of stock brokers, sub-brokers, share transfer agents, etc.

¹ Equity Intelligence AIF Trust v. Central Board of Direct Taxes [2025] 176 Taxmann.com 903 (Delhi-HC)

“12. Registration of stock-brokers, sub-brokers, share transfer agents, etc.—

(1) No stock-broker, sub-broker, share transfer agent, banker to an issue, trustee of trust deed, registrar to an issue, merchant banker, underwriter, portfolio manager, investment adviser and such other intermediary who may be associated with securities market shall buy, sell or deal in securities except under, and in accordance with, the conditions of a certificate of registration obtained from the Board in accordance with the [regulations] made under this Act.....

.....

(1C) No person shall sponsor or cause to be sponsored or carry on or cause to be carried on the activity of an alternative investment fund or a business trust as defined in clause (13A) of section 2 of the Income-tax Act, 1961, (43 of 1961) unless a certificate of registration is granted by the Board in accordance with the regulations made under this Act.”

Decision of the HC:

The HC noted/observed the following:

Registration of AIF trust under Registration Act and SEBI Regulations

- A holistic, harmonious and conjunctive reading of all the SEBI Regulations and section 12 of the SEBI Act would bring to fore that Category III AIFs (like taxpayer) are strictly regulated and controlled in their functioning.

As per the same, unless and until a Trust registers the original Trust Deed, firstly under the provisions of Registration Act, 1908 and secondly, obtains the certificate of registration under the provisions of SEBI Act and Regulations, it cannot accept any funds or investment from a beneficiary.

- Regulation 6(5) of the SEBI Regulations - “*Procedure for grant of Certificate*” clearly specifies that if an AIF has been granted in-principle approval under Regulation 6(4), it may accept commitments from investors but shall not accept any money till it is granted registration Regulation 6(2).

This indicates that no AIF can accept any commitment or investment from any investor or beneficiary unless and until it is first registered {in terms of Regulation 4(c) of the SEBI Regulations} under the provisions of Registration Act, 1908 and thereafter be granted certificate of registration under Regulation 6 of the SEBI Regulations.

- If this were to be the manner and procedure stipulated under the SEBI Act and the Regulations framed thereunder, it cannot be determined as to how and in what manner would a Category III AIF entity (like taxpayer) specify or mention the names of the investors or beneficiaries in the original Trust Deed at the time of registration.

CBDT Circular No. 13/2014

- The Central Board of Direct Taxes (CBDT) Circular no. 13/2014² pertains to the clarification issued in respect of section 164 of the ITA as to how the charge of tax, when the share of beneficiaries is unknown, is to be ascertained and determined.
 - The CBDT Circular clarified that where the Trust Deed either does not name the investors or does not specify their beneficial interests, provisions of section 164(1) of the ITA would be applicable and the entire income of the fund would be liable to be taxed at MMR of income tax in the hands of the trustees of such AIFs in their capacity as ‘*Representative Assessee*’.
 - The Circular also noted that the said clarification ‘*would not be operative in the area falling in the*

² CBDT Circular No. 13/2014 [F.NO.225/78/2014-ITA.II]

jurisdiction of a High Court which has taken or takes a contrary decision on the issue.’ This was contrary to well settled judicial principles of law and appeared to have been deliberately inserted in view of the earlier HC rulings³. An issue of law, settled by a Constitutional Court, neither challenged nor set aside by a higher Constitutional Court, would be binding upon the Revenue authorities all over the country and cannot be implemented State specific or area specific.

- On one hand, the Explanation 1 to section 164 of the ITA and the Circular no.13/2014 mandate s necessary mentioning of the names of the investors or their beneficial interests in the original Trust Deed, and on the other, the SEBI Act and Regulations would prohibit the same. This would be an impossible situation for Category III AIF (like taxpayer) to comply with.

No entity under any enactment can be perceived or compelled to perform the impossible. In the case under consideration, the facts seemed to be leading to such an impossibility. The maxim *‘lex non cogit ad impossibilia’* would apply to the facts of the taxpayer.

- The Karnataka HC in an earlier ruling⁴, was interpreting the provisions of section 164 of the ITA and considering whether shares were determinable even when or even after the trust was formed or would be in future, when the Trust was in existence.

On the facts of that case, the HC had concluded that once the benefits were to be shared in the proportion to the investments made, any person with reasonable prudence would infer that the shares were determinable. Consequently, the HC had concluded that once the shares were determinable, it would meet the requirement of law to come out of the applicability of section 164 of the ITA.

- The BAR had not only overlooked the law settled by the aforesaid HC rulings⁵ but also did not consider that para 6 of the CBDT Circular no.13/2014 was contrary to well settled principles of law. Hence, the HC allowed the writ petition and BAR’s order was directed to be read down to conform to the above analysis and conclusion.

Comments:

Most AIFs in India are set up as a trust which is one of commonly used investment instrument for investors. Category III AIFs are not pass through (unlike Category 1 and Category II AIFs) and income is taxed at the AIF level. Hence, the taxability in the hands of the AIF becomes imperative. These AIFs may be regulated by regulatory bodies such as SEBI, which may prohibit name of investors or beneficiaries in the AIF trust original trust deed which should not form the basis for being termed as an indeterminate trust for the purpose of taxation.

In a relief to AIFs, the HC in this case has addressed the taxation of Category III AIF and ruled that non-disclosure of investor names in the original trust deed does not automatically render a trust indeterminate for tax purposes, thereby preventing application of MMR under section 164 of the ITA and held as follows:

- No AIF can accept any commitment or investment from any investor or beneficiary unless and until it is first registered (in terms of Regulation 4(c) of the SEBI Regulations) under the provisions of Registration Act, 1908 and thereafter be granted certificate of registration under Regulation 6 of the SEBI Regulations.
- The CBDT Circular no. 13/2014 clarifies that the circular *‘would not be operative in the area falling in the jurisdiction of a High Court which has taken or takes a contrary decision on the issue.’* This is contrary to the well settled judicial principles of law. An issue of law, settled by a Constitutional Court, neither challenged

³ The Commissioner of Income Tax & Anr. vs. M/s India Advantage Fund - VII: 2017 SCC OnLine Kar 6857 (Kar HC) and Commissioner of Income Tax, Chennai vs. TVS Shriram Growth Fund: 2020 SCC OnLine Mad 28112 (Mad-HC)

⁴ The Commissioner of Income Tax & Anr. vs. M/s India Advantage Fund - VII: 2017 SCC OnLine Kar 6857 (Kar HC)

⁵ The Commissioner of Income Tax & Anr. vs. M/s India Advantage Fund - VII: 2017 SCC OnLine Kar 6857 (Kar HC) and Commissioner of Income Tax, Chennai vs. TVS Shriram Growth Fund: 2020 SCC OnLine Mad 28112 (Mad-HC)

nor set aside by a higher Constitutional Court, would be binding upon the Revenue authorities all over the country and cannot be implemented State specific or area specific.

- On the one hand, the Explanation 1 to section 164 of the ITA and the Circular no.13/2014 mandates necessary mentioning of the names of the investors or their beneficial interests in the original Trust Deed, and on the other, the SEBI Act and Regulations would prohibit the same. This would be an impossible situation for Category III AIF (like taxpayer) to comply with. No entity under any enactment can be perceived or compelled to perform the impossible.

Taxpayers may evaluate the impact of this ruling to the specific facts of cases.



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