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High Court 'Read Down' CBDT Circular on Taxation of AIF Trust

Background

Alternative Investment Funds ("AIFs") are a popular vehicle for pooling investments in India due to certain tax benefits and are regulated by SEBI. While Category I and Category II AIFs enjoys a pass-through status for taxation purpose (with respect to all income earned other than business income), such tax benefit is, however, not extended for Category III AIFs. The taxation of Category III AIFs is determined based on the underlying trust.

Under the provisions of the Indian Income Tax Act, 1961 ("the Act") a trust can be either a determinate trust or a non-determinate trust:

- **Specific/Determinative Trusts:** In these trusts, the beneficiaries and their respective shares are known. Trustee is taxed as a representative assessee at the same tax rates that would be applicable to the beneficiaries.
- **Discretionary/Non-determinative Trusts:** In such trusts, either the beneficiaries are not defined, or their shares are not mentioned. In such instances, the Trustee will be subject to tax at the Maximum Marginal Rate¹ ("MMR").

To provide certainty with respect to taxation of AIFs, the Central Board of Direct Taxes ("CBDT") on July 28, 2014 issued *Circular No. 13/2014* clarifying that where the trust deed either does not name the investors or does not specify their beneficial interests, then, the entire income of the Fund shall become liable to tax at MMR.

Recently, in the case of *Equity Intelligence AIF Trust v. CBDT*², this circular was challenged before the Delhi High Court, primarily on the ground that that it conflicted with the SEBI regulatory framework, which prohibits the naming of investors in the trust deed prior to registration. The High Court was, thus, called upon to adjudicate the validity of the CBDT circular and its application to AIFs.

FACTS:

Equity Intelligence AIF Trust, a Category III AIF, operated an open-ended scheme which invested in listed equity shares and had been established in compliance with the SEBI (Alternative Investment Funds) Regulations, 2012 ("SEBI Regulations"). The original trust deed, however, did not name the investors or specify their beneficial interests. Pertinently, under Regulation 3(1) and Regulation 6(3) of the SEBI Regulations, as well as Section 12 of the SEBI Act, an AIF could not accept investments unless it obtained registration from SEBI and for such registration, the AIF was required to submit the trust deed to SEBI. Thus, the trust deed of AIF cannot contain the name of investors, and if it did, it would then be in violation of SEBI Regulations.

To seek clarity on taxation, the Trust filed an application before Authority for Advance Ruling ("AAR"), which was later replaced with Board of Advance Ruling ("BAR"). The BAR, however, relying upon above CBDT Circular No. 13/2014, held that the absence of investor names in the original trust deed has rendered the trust "indeterminate" under Section 164 of the Act and therefore, the Trust will be subjected to tax at the MMR.

Being aggrieved, the Trust further challenged both the BAR's order and the validity of the CBDT Circular No. 13/2014 before the Delhi High Court.

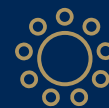
High Court's Findings:

The Delhi High Court delivered a detailed and reasoned judgment, addressing the interplay between the SEBI Regulation, the provisions of the Act and the CBDT circular. The key findings of the Court are as follows:

- **Analysis of SEBI Regulations**

¹ Maximum Marginal Rate is the highest tax rate applied on taxpayer's income, without reference to any other tax slab. The Maximum Marginal Rate is 30% (plus applicable surcharge and cess).

² W.P. (C) 9972/ 2024



Regulation 3(1) of the SEBI Regulations and section 12(1) and 12(1C) of the SEBI Act commence with a negative covenant indicating the strict application of the said provisions. Thus, 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.

- **Analysis of past judicial precedents**

The Court concurred with the judgment of Karnataka High Court (*India Advantage Fund*³) and Madras High Court (*TVS Shriram Growth Fund*⁴) wherein it was held that the key test under Section 164 of the Act is the determinability of beneficiaries' shares, and not the naming of beneficiaries in the original trust deed. Thus, if the shares of beneficiaries are ascertainable, the trust would be treated as 'determinate' for tax purposes, even if the names of beneficiaries are not specified in the original trust deed. Post registration of Trust with SEBI, the identity and share of the beneficiaries could be determined basis the contribution agreement.

- **Doctrine of impossibility would apply**

While Explanation 1 to Section 164 of the Act and the Circular no.13/2014 mandate necessary mentioning of the names of the investors or their beneficial interests in the original trust deed, the SEBI Act and Regulations prohibit the same. Thus, it would be an impossible situation for Category III AIF (like the Trust) to comply with both laws. No entity can be compelled to perform the impossible in accordance with the maxim, *lex non cogit ad impossibilia* (which means that the law does not compel the doing of impossibilities).

Conclusion

CBDT Circular Read Down

The Court instead of invalidating the CBDT Circular held that such circular, to the extent it conflicted with SEBI Regulations and established judicial precedents, must be read down and therefore, the requirement to name investors in the original trust deed was found to be legally untenable and impossible to comply with by AIFs.

Key Takeaways:

This Court ruling provides much needed respite and significant clarity for AIFs structured as trusts, ensuring that their tax treatment does not suffer adversely just because such AIFs (complying with SEBI Regulations) cannot name their beneficiaries in the original trust deed.

This judgment also underscores that the requirement to name investors in the original trust deed is not a prerequisite for a trust to be considered determinate for tax purposes, provided the shares of beneficiaries are otherwise ascertainable later (for example by way of the contribution agreement which is prepared after the trust deed). Additionally, the judgment signifies the need for a harmonious interpretation of tax and securities laws, and that the tax authorities must consider the regulatory framework governing AIFs and cannot impose requirements that are impossible to comply with due to Securities Regulations.

This judgment reinforces the principle that judicial precedent prevails over administrative circulars and a legal issue settled by Court in India is binding on all revenue authorities across India and cannot be implemented on state specific basis.

3 The Commissioner of Income Tax & Anr. vs. M/s India Advantage Fund VII: 2017 SCC Online Kar 6857

4 Commissioner of Income Tax, Chennai vs. TVS Shriram Growth Fund: 2020 SCC Online Mad 28112

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