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Analysis



Budget 2025: The Deal Maker's Lens



Podcast - Budget 2025: The Deal Maker's Lens

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Key Takeaways

- Sovereign Wealth Funds and Pension Funds – tax exemption extended for 5 years
- LTCG income of InvITs / REITs harmonized – taxable at 12.5% and not maximum marginal rate
- Welcome clarification on tax rate applicable on transfer of securities by a Cat I or Cat II AIF
- Provision on carry forward of losses amended – is the Finance Bill, 2025 throwing the baby out with the bathwater?

Finance Minister Nirmala Sitharaman announced several important changes to the Income Tax Act, 1961 (**Act**) on February 1. Most important was the announcement on revamping and simplifying the six-decade old Act by introducing a Income Tax Bill soon. It's perhaps why the amendments proposed on February 1 are mostly limited to clarifying certain provisions, except one that comes as a challenge for corporate structuring.

SWF-PF Exemption Extended; Anomaly Fixed

Income of eligible SWFs and PFs in the nature of interest, dividend and long-term capital gains arising from specified investments are exempted from tax under the Act. The exemption was brought in 2020 to incentivize and attract patient capital in India's infrastructure sector. The sunset period for this exemption was set to end on March 31, 2025. In a welcome move, the government has proposed to extend it for another 5 years.

In another positive for SWF-PFs, an anomaly created by Finance Act, 2024 has now been fixed. Last year the Act was amended (by introduction of section 50AA) to say that any income from the transfer, redemption or maturity of unlisted debentures and bonds must now be treated as short-term capital gains, irrespective of the holding period.

This had unintended consequences for SWFs-PFs.

Since the SWF-PF exemption only applies to long term capital gains, their income from investments in unlisted debentures became disqualified for the tax benefit. (since it had to be treated as short-term capital gains (**STCG**)). The Finance Bill, 2025 (**Bill**) now proposes that "long-term capital gains (**LTCG**) (whether or not such capital gains are deemed as STCG under section 50AA) arising from an investment made by it in India, shall inter alia not be included in the total income...".

Now, STCGs on debentures fall within the SWF / PF exemption framework.

Recent InvITs did not see much interest from SWFs (and were largely domestically funded). Hopefully, the extension provides a sentiment boost to patient capital that's much needed in the infrastructure sector.

REITs / InvITs: Oversight Addressed

The Bill has made a welcome fix for InvITs and REITs. LTCG income of InvITs / REITs from sale of listed securities / MF units will now be taxed at 12.5% instead of 30% + surcharge (i.e. maximum marginal rate (**MMR**)).

This change effectively corrects an oversight in the current legislation. At present, InvITs and REITs are subject to 20% tax on STCG from listed securities / equity units and 12.5% on LTCG arising from unlisted securities / other capital assets. However, the tax provisions governing these trusts inadvertently excluded LTCG from the sale of listed shares, equity mutual fund units, and business trust units, leaving them subject to the MMR. This discrepancy created an irrational situation, as InvITs / REITs were already taxed at a 20% rate on STCG, making it inconsistent for them to face a much higher rate (i.e., MMR) on LTCG from listed securities or MF units.

For context, REITs and InvITs operate under a pass-through taxation model, meaning that income such as dividends, interest, and rent is passed through to the unitholders and taxed at their level, not at the trust level.

Welcome Clarification for AIFs

The classification of income from transfer of securities – whether taxed as business income or capital gains – has historically been a contentious issue, often leading to litigation[1].

Now, the Bill has proposed to amend section 2(14) of the Act to include *any security held by an Investment Fund specified in clause (a) of Explanation 1 to section 115UB*[2] under the definition of a 'capital asset'. Naturally, any gains from the transfer of such securities will be treated as 'capital gains.'

Historically, the Central Board of Direct Taxes (**CBDT**) has issued multiple clarifications to mitigate disputes on this issue and establish uniformity in tax assessments (explained through the table below).

Circular Number	Key Details
CBDT Circular No. 6/2016 dated 29 February, 2016	Covered all taxpayers and clarified that income from the transfer of listed shares and securities held for more than 12 months should be taxed as capital gains, unless the taxpayer wants to treat it as business income.
CBDT Instruction No. F.No. 225/12/2016/ ITA.II dated 02 May, 2016	The same tax treatment was extended to unlisted shares, regardless of the holding period, ensuring that any transfer of unlisted shares was taxed as capital gains. Also, introduced an exception that if the transfer of unlisted shares is made along with transfer of control and management of the underlying business, the assessing officer could treat it as business income. This led to uncertainty for alternate investment funds (**AIFs**) investing in start-ups or businesses where transfer of control and management is commonly involved.

[1] Devasan Investments Private Limited vs Income Tax Officer, Ward 7(1), Delhi, W.P.(C) 9970/2023 (Delhi HC); The Commissioner of Income Tax vs Gopal Purohit,228 CTR 582 (Bom); Deputy Commissioner of Income Tax vs Shri Gurumukh J. Sakhwani, Pune, ITA No. 1191/PUN/2015.

[2] "investment fund" means any fund established or incorporated in India in the form of a trust or a company or a limited liability partnership or a body corporate which has been granted a certificate of registration as a Category I or a Category II Alternative Investment Fund and is regulated under the Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012, made under the Securities and Exchange Board of India Act, 1992 or regulated under the International Financial Services Centres Authority (Fund Management) Regulations, 2022 made under the International Financial Services Centres Authority Act, 2019.

CBDT Clarification for Cat I and Cat II AIFs to Instruction No. F.No. 225/12/2016/ ITA.II dated 24 January, 2017	Clarified that the above-mentioned exception re. transfer of control and management would not apply to SEBI registered Category I & II AIFs. So, any transfer of unlisted shares (even if there is a transfer of control and management) by Category I & II AIFs would be taxed as capital gains. Essentially, CBDT recognized that Cat I and II AIFs primarily invest in unlisted shares of emerging ventures, including startups. Given the nascent stage of many such businesses, these AIFs may need to exercise a degree of control and oversight to safeguard the interests of their investors. Consequently, the transfer of control and management is commonly involved.

Post-Budget

The proposed amendment formally codifies existing circulars which stated that income from the transfer of unlisted shares by a Cat I or Cat II AIF should be classified as capital gains. Additionally, while the previous clarification re. AIFs was limited to unlisted shares, the amended provision now extends to listed shares and all other securities held by Cat I and Cat II AIFs, providing broader regulatory clarity.

Practically, the amendment solves for two things.

- Firstly, reduces any dispute regarding the tax rate applicable on transfer of securities by a Cat I or Cat II AIF, which will now clearly be taxed at 12.5% as LTCG as opposed to 30% + surcharge if the income was classified as business income (which is taxed at the MMR for funds structured as trusts)[3].

- Secondly, Cat I and II AIFs will be exempt from paying tax on the transfer of securities (essentially, avail the pass-through status) since any income other than business income is passed through and taxed at the hands of the unitholders[4].

Restriction on Carry Forward of Losses

India's tax regime has long imposed restrictions on the carry-forward of losses, particularly for closely held companies where significant changes in shareholding occur. The Bill has now proposed an even tighter restriction.

What's Changing?

Currently, business loss cannot be carried forward and set off for more than 8 years from the year it was first computed. The clock reset every time the loss-making entity underwent an amalgamation

[3] Income Tax Act, 1961: Section 115UB(4)(ii).
[4] Income Tax Act, 1961: Section 10(23FBA) read with Section 115UB.

/ business reorganisation.[5] Budget 2025 removes this reset, meaning the amalgamated entity can only carry forward losses for the remaining years from the original 8-year period – significantly reducing its tax benefit.

This change will apply to all amalgamations post-April 1, 2025, but will be effective from April 1, 2026. However, applicability of this proposed amendment on cases where mergers were initiated earlier but approved later may need further clarity.

What's Prompted The Change & Is It Really Necessary?

The proposal aims to prevent "evergreening" of losses – a practice where companies extend tax benefits by merging loss-making businesses with profit-making ones.

But there are several arguments why carry forward of losses shouldn't be as fettered and rigid as it is in the Indian context:

- Time Crunch for Recovery – Mergers often take years to stabilize. Cutting short the period for loss utilization may discourage companies from acquiring struggling firms.

- Fewer Incentives for Restructuring – Investors and acquirers may think twice before rescuing distressed companies if they can't fully offset past losses.

- More Liquidations? – Without the ability to recover past losses effectively, some struggling firms may head straight for liquidation instead of finding a buyer.

In fact, India's tax regime may be stricter compared to global regimes such as those in the U.K. and the U.S. These countries do not outright disallow loss carry-forwards due to substantial ownership changes and permit the indefinite carry-forward of losses.

With section 79[6] already restricting loss carry-forwards when shareholding changes, does India need this additional tightening? While curbing misuse is necessary, dealmakers worry that the new rule may do more harm than good – hindering mergers, slowing down revivals, and discouraging investment in distressed businesses.

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[5] Income Tax Act, 1961: Section 72A. Provisions relating to carry forward and set off of accumulated loss and unabsorbed depreciation allowance in amalgamation or demerger, etc. and Section 72AA. Carry forward and set off of accumulated loss and unabsorbed depreciation allowance in scheme of amalgamation in certain cases.
[6] Income Tax Act, 1961: Section 79. Carry forward and set off of losses in case of certain companies.

Conclusion

The Bill introduces important clarifications and fixes for SWFs / PFs, and business trust structures like REITs / InvITs. The government's willingness to address unintended consequences will be applauded by all stakeholders. The extension of SWF / PF exemption will continue to benefit India infrastructure ambitions. The clarification for Cat I and II AIFs provides much-needed consistency in the tax treatment of securities, offering clearer and more competitive conditions for investment funds. Similarly, the tax fix for InvITs / REITs ensures more consistent tax rates for long-term capital gains, addressing previous oversights.

However, the proposed restriction on carrying forward losses in amalgamations could hinder legitimate business recoveries, limiting tax efficiency for turnarounds.

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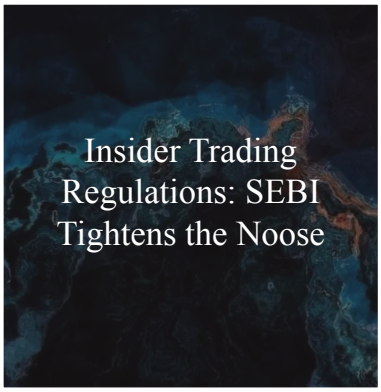
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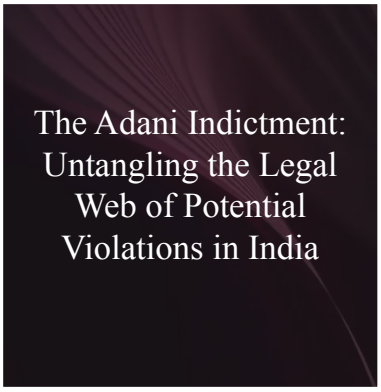
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