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### Applicability of exemption under section 10(23FB) of Income-tax Act; section 10(23FB) and 10(35) are independent

The Mumbai Bench of the Income-tax Appellate Tribunal rendered its decision exemption under sections 10(23FB) and 10(35) of the Income-tax Act, 1961 operate in different fields and are independent of each other. Further, it has also evaluated eligibility of taxpayer Venture Capital Fund (VCF) to claim exemption in respect of income from investment made in Venture Capital Units and allowed the same based on facts.

#### Background:

- The taxpayer<sup>1</sup>, is incorporated as a Trust and registered with the Securities and Exchange Board of India (SEBI) as Venture Capital Fund (VCF) under the SEBI (Venture Capital Fund) Regulations, 1996 (VCF Regulations).
- In the return of income filed by the taxpayer for the Financial Year (FY) 2015-16, corresponding to Assessment Year (AY) 2016-17, it had:
  - Claimed exemption under section 10(23FB) of the Income Tax Act, 1961 (ITA) with respect to income earned from investments made in Venture Capital Undertakings (VCU's).  
Section 10(23FB) of the ITA provides an exemption to VCF with respect to any income from investment in VCU's.
  - Further, the taxpayer also claimed exemption under section 10(35) of the ITA with respect to dividend received from investment made in mutual funds (i.e. non-VCU investment).  
Section 10(35) of the ITA provides an exemption to any income, amongst others, in respect of the units of mutual fund.
- During the course of audit proceedings, the Assessing Officer (AO), on verification of details (including the financials of the VCUs) submitted by the taxpayer, denied certain part of the exemption under section 10(23FB) of the ITA and denied exemption under section 10(35) of the ITA on the following basis:

#### Denial of exemption under section 10(23FB) of the ITA relating to income from investment made in VCUs:

Three (out of total eleven) VCUs failed to fulfill the criteria in order to qualify as VCUs, due to the following reasons:

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<sup>1</sup> ACIT v. Aditya Birla Real Estate Fund (ITA no 7504/Mum/2019) (Mumbai ITAT)

- ABC Pvt. Ltd. (First VCU) It was not carrying out any real estate business as (amongst others) there were no financials maintained by ABC Pvt. Ltd for FY 2015-16. Thus, the said concern was not carrying out business during FY 2015-16 and did not qualify as VCU.
- LMN Pvt. Ltd. (Second VCU) The entire investment made by the taxpayer in the VCU was further lent to another company and LMN Pvt. Ltd. merely acted as a pass-through entity. The activity of borrowing and lending was in the nature of financial activity, which was in violation of the definition of VCU as per SEBI (VCF) Regulations, 1996. Thus, the said concern could not be treated as VCU.
- XYZ Pvt. Ltd. (Third VCU) The entire amount invested by the taxpayer was lent to other body corporates. However, no disallowance was made, since no income was received from XYZ Pvt. Ltd.

#### Denial of exemption under section 10(35) of the ITA on dividend received from non-VCU investment:

- Taxpayer being set-up as a VCF was eligible for deduction under specific section 10(23FB) of the ITA and therefore, it could not claim deduction under another section 10(35) of the ITA on a part of its income.
  - Post amendment<sup>2</sup> to section 10(23FB) of the ITA (w.e.f. 1 April 2008), the exemption under section 10(23FB) was available only for income received from investment in VCU and income other than the income from investment in VCUs was taxable.
  - Taxpayer being a VCF was not covered by the definition of ‘person’ as defined under section 2(31) of the ITA and the special status enjoyed was only for the specific purpose of section 10(23FB) of the ITA.
- In the course of appeal proceedings, the matter reached the Mumbai Bench of the Income-tax Appellate Tribunal (ITAT).

#### Decision of the ITAT:

##### Issue 1: Denial of exemption under section 10(23FB) of the ITA relating to income from investment in VCUs:

- The ITAT noted / observed the following:
  - The taxpayer had registration with the SEBI under the VCF regulations.
  - No case had been made by the Revenue that the taxpayer had made any default in filing with the SEBI, or that SEBI had taken adverse view on the issues raised by the Revenue.
  - The Commissioner of Income-tax Appeals [CIT(A)] had examined the conditions under section 10(23FB) of the ITA to qualify as VCF and found that the taxpayer was duly qualified.
  - No issue was made by the Revenue that the taxpayer was not qualifying as a VCF.
- Further, the ITAT noted / observed the following with respect to the investment in VCUs:

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<sup>2</sup> Currently, section 10(23FB) of the ITA, provides an exemption to VCF with respect to any income ‘from investment’ in VCU’s. Prior to 1 April 2008, exemption was available with respect to any income of a VCF ‘set-up to raise funds for investment’ in a VCU.

– ABC Pvt. Ltd. (First VCU)

The CIT(A) had made the following key observations:

- ABC Pvt. Ltd. (First VCU) was developing a project which was under construction with critical approvals in place and sale of project having commenced.
- The taxpayer had invested in November 2013, in the said concern which qualified as a VCU. Just because units had run into financial problems it could not be said that ABC Pvt. Ltd. was not engaged in the business of construction / real estate during FY 2015-16, corresponding to AY 2016-17 and hence, did not qualify as a VCU.
- Interest income accruing from the said VCU had been allocated to various investors who would have included the same in their income-tax return and paid the tax due. Taxing the said income in the hands of the taxpayer would result in double taxation.

Further, in subsequent financial year, the taxpayer had reversed the interest income from ABC Pvt. Ltd. (on the basis that the receipt was extremely doubtful). However, the taxpayer had not claimed any deduction in relation to such reversal.

– LMN Pvt. Ltd. (Second VCU)

The Revenue had not made a case that SEBI had taken any objection in respect of the fact (as claimed by the AO) that the VCU had further lent the amount invested by taxpayer, which was a financial activity in violation of the definition of VCU under the SEBI (VCF) Regulations, 1996.

The CIT(A) had made the following key observations:

- LMV Pvt. Ltd. was in the business of construction and real estate development and had undertaken a project in joint venture (with another company) through a joint venture company (JV Co).
  - LMN Pvt. Ltd. was engaged in development of the project. It had purchased and provided land for the project, obtained necessary approvals and sanctions, and had entered into development agreement with the JV Co for development and construction.
- The Mumbai ITAT in an earlier case<sup>3</sup> had held that VCU could not be denied benefit under section 10(23FB) of the ITA if the same was operating in terms of the trust deed and its certificated granted by the SEBI subsisted and there was not adverse action taken or contemplated by the SEBI for any violation of any VCF regulations.

In view of the above, the ITAT allowed the exemption under section 10(23FB) of the ITA to the taxpayer in respect of income earned from investment in VCUs ABC Pvt. Ltd. and LMN Pvt. Ltd.

Separately, since no addition was made by the AO with respect to XYZ Pvt. Ltd. no finding was given with respect to the said concern as a non-VCU either by the CIT(A) or the ITAT.

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<sup>3</sup> HDFC Property Fund v. ITO (ITA No. 7472/Mum/2015) (Mumbai ITAT)

## Issue 2: Denial of exemption under section 10(35) on dividend received from non-VCU investment:

The ITAT observed the following:

- Exemption under sections 10(23FB) and section 10(35) of the ITA operate in different fields and are independent of each other.
- Taxpayer's income from investment in VCUs was exempt under section 10(23FB) of the ITA and dividend income was exempt under section 10(35) of the ITA.

Hence, there was no infirmity in the taxpayer's claim of exemption on dividend income under section 10(35) of the ITA.

### Comment:

This ruling re-affirms the principle that VCF cannot be denied benefit of section 10(23FB) of the ITA, if it is operating in terms of trust deed; the certificate granted by SEBI is in existence and no adverse action is taken or contemplated by SEBI for violation of any of the VCF regulations.

Further, the ITAT has held that exemption under sections 10(23FB) and 10(35) of the ITA operate in different fields and are independent of each other. Thus, an VCF can claim both exemptions subject to eligibility and satisfaction of requisite conditions.

Note that, post amendment by Finance Act, 2020, dividend received from mutual funds on or after 1 April 2020 is not eligible for exemption under section 10(35) of the ITA. It is now taxable in the hands of the unit holder.

Taxpayers with similar facts may wish to evaluate the potential implications of this ruling in their specific cases.



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