



All expenditure of VC Funds including Carried Interest to carry GST - A major setback to the Industry

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The decision of the Hon'ble CESTAT, Bangalore in the case of ICICI Econet Internet and Technology Fund¹ ('the Appellants') where the Tribunal has unleashed an added twist to the already complicated doctrine of mutuality, has left Indian fund managers in dire straits over what awaits them next.

The decision, if not overturned, would adversely impact every Venture Capital Fund (VCF) or any other investment pooling fund set up as a trust. It confirms the demand of Service tax (on the amount withheld by the Appellant Trusts out of the gains of portfolio investments) on expenditure such as payments to AMC, Custodian, R&T agent, brokers, selling agents employed by the Trusts through their Trustees.

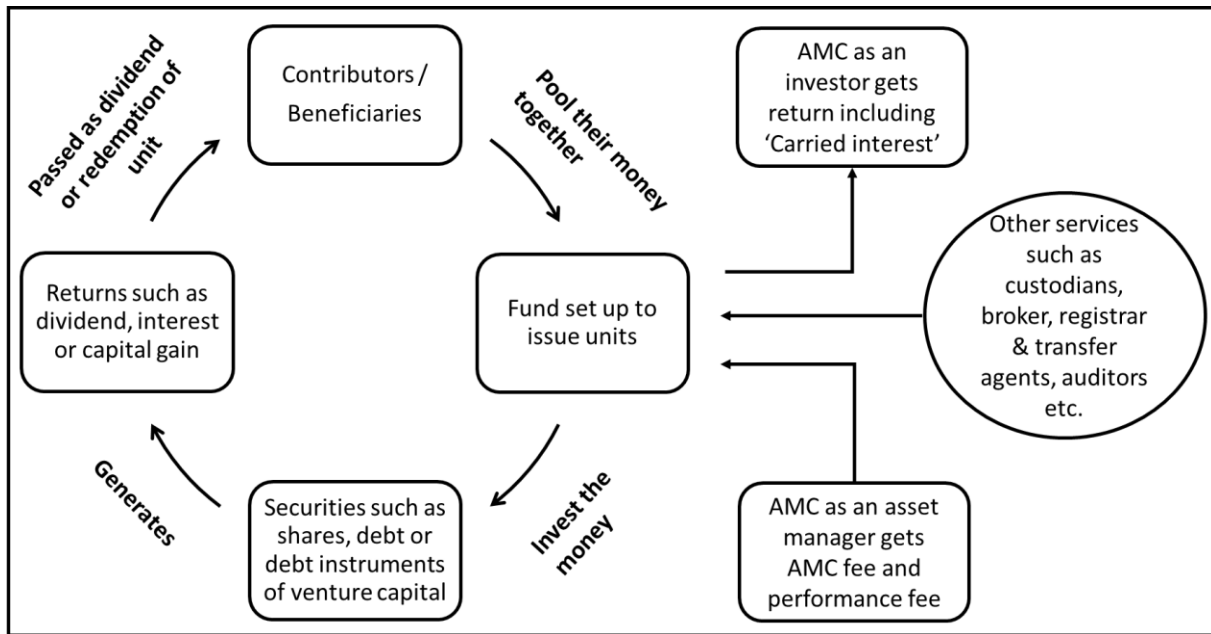
Moreover, it also treats 'Carried Interest' as a payment in nature of performance fee payable to an AMC towards rendition of services instead of return of investment. There is therefore now an enhanced liability on the Appellant Trusts to pay Service tax on the entire amount retained to meet all their expenditure including Carried Interest.

Unlike the Income tax Act, wherein explicit provisions exist to tax the income of VCF in the hands of contributors, the Service tax law has been very reticent. The primary question before the Hon'ble CESTAT was whether doctrine of mutuality can be said to exist between the Trusts and the Contributors/Beneficiaries. In this connection, the CESTAT placed heavy reliance on the decision of the Hon'ble Supreme Court in Bangalore Club Vs. CIT, wherein the following three conditions have been laid down:

- (i) There must be a complete identity between the contributors and participators;
- (ii) The actions of the participators and contributors must be in furtherance of the mandate of the association and
- (iii) There must be no scope of profiteering by the contributors from a fund made by them which could only be expended or returned to themselves.

Before elaborating further, it is important for the readers to understand a VCF model with the help of the following illustrative diagrams:

¹ 2021-TIOL-359-CESTAT-BANG



The CESTAT while examining the fulfilment of aforesaid three conditions *inter alia* held that the Trusts have violated the principles of mutuality by concerning themselves in commercial activities and by using their discretionary powers by paying huge amounts, in the form of performance fee and carried interest, to AMCs or their nominees which are neither contributors nor beneficiaries. In this connection, it captured following key findings:

- (a) The trusts are essentially mutual funds engaged in portfolio management and its essential function was of commercial concern to maximize profit.
- (b) The trust fund is managed by the trust which also distributes the dividends and other amounts payable in respect of units in accordance with Private Placement Memorandum and/or Scheme Document so created in this regard.
- (c) The trusts are registered under VCF Regulations, 1996 issued under SEBI Act, 1992.
- (d) As the trusts are treated as juridical persons for the purposes of SEBI Regulations, they should also be treated so for the purpose of taxation.
- (e) The trusts unlike clubs are initiated with a profit motive and not for common benefit of its members.
- (f) Taxation Law being a specific legislation just as the SEBI Act, 1992 should prevail over the general Trust Act and the definition given thereof.

Against this background, the Hon'ble CESTAT examined the classification of the Appellant's activities and held that the Trust carries out the activity of venture capital i.e. manage the amounts invested by contributors / beneficiaries, receive the amounts in the form of dividend / profit in their escrow account and as per their discretion, distributes the same to subscribers and entities other than subscribers. The Tribunal held that the services provided by the Trust constituted asset management services squarely classifiable under the taxable service category of Banking and Other Financial Services.

The CESTAT also held that the Circulars which provide exemption from levy of Service tax on entry and exit loads do not provide exemption on recurring expenses on account of stationery, postages, advertisements, listing on exchanges, publishing of Net Asset Value (NAV), distribution charges, custodian charges, audit fee, etc. Accordingly, CESTAT confirmed the levy under the category of Banking and Other

Financial Services. However, the CESTAT accepted the claim of the Appellant as to the CENVAT credit and Cum-duty benefit and remanded the matter for verification and re-computation.

Further, on the aspect of carried interest, it was submitted by the Appellant that carried interest is a return on investment made by a certain class of investors and not performance fee paid to AMCs. The carried interest is payable only in Funds where the AMC also makes an investment in the Fund as a contributor. In such Funds, the AMC wears two hats; as a Contributor and as a manager and the carried interest is paid to the AMC as return of investment, contingent upon investment made and units held by AMC and is computed based on a pre-agreed formula. However, the Tribunal held that the schemes are designed in a manner that AMC and / or their nominees get huge sums of money in the guise of performance fee and carried interest with the twin motive of benefitting the AMC and/or their nominees at the expense of the subscribers and avoiding the taxes. The CESTAT also consented with the Revenue's inference that, in the disguise of return of investment, carried interest is retained and distributed to AMC and its nominees and such funds eventually flows back to Settlers and its nominees.

It must be noted that generally the industry treats Carried Interest as Capital gain in nature of return on investment and accordingly, it attracts Income tax at the rate of 20% in cases of investment in domestic unlisted companies. If the instant decision is also followed by the Income tax Authorities so as to treat Carried Interest as performance fee for a service, it may require an outgo of Income tax at the rate of 30% in addition to Indirect taxes.

However, certain key points which require deeper deliberation are as under:

- A. It is held in (Para 37.7 of the decision) that Trusts have violated the principle of mutuality by using discretionary powers to benefit entities which are not investors /contributors and beyond the interests of investors / contributors. It is, however, pertinent to examine the scope and ambit of the discretion entrusted on the Trust under the placement memorandum / scheme document / subscription agreement and once the methodology has been agreed between the parties in their commercial wisdom, it is pertinent to examine whether it is open to the Department / Courts to question or undermine the same².
- B. Whether principle of mutuality of interest can be said to be absent in all kinds of mutual funds or merely in respect of funds where the Trust has wide discretionary powers to distribute dividends / profits.
- C. It is pertinent to configure as to whether Securities Exchange Board of India or Tax Authorities have the requisite powers to doubt / challenge the sanctity of the placement memorandum / subscription agreement of the Fund to the extent it outlines the manner in which the benefits are to be distributed to the investors of the Fund and the fees to be paid to investment managers or such other affairs of a venture capital fund.
- D. Merely for the reason that different class of investment may attract different rates of returns as per the agreement, whether 'Carried Interest' can be termed as consideration in the nature of performance pay against a service.

² Union of India v. Mahindra and Mahindra [1995 (76) E.L.T. 481 (S.C.)]

E. It is important to analyze whether the amounts retained by the Trust constitute pure reimbursement of costs and expenses and whether such reimbursements can be subject to Service tax prior to 01.03.2015³

Like all other cases involving the interpretation and applicability of the doctrine of mutuality, the instant issue is also likely to be ultimately resolved by the Hon'ble Apex Court.

The passing of this judgement is only a tip of the iceberg as this is likely to trigger issuance of numerous notices to funds and consequent rise in litigation. Further, in the absence of a single authority dealing with this issue, different state-wise authorities are likely to take difference views and add to the complexities. It is thereby advisable to approach CBIC, by way of a representation seeking suitable clarification or introduction of an explicit exemption.

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³ Intercontinental Consultants and Technocrats (P.) Ltd. vs. Union of India - 2012-TIOL-966-HC-DEL-ST