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TAX TRIBUNAL UPHOLDS TAX 'PASS THROUGH' STATUS OF A VENTURE CAPITAL FUND

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In *M/s HDFC Property Fund v Income Tax Officer*, the Mumbai bench of the Income Tax Appellate Tribunal (Tribunal) has, through an order dated 28 February 2019, ruled in favour of the taxpayer, a SEBI registered Venture Capital Fund (VCF) upholding its 'pass-through' status. The tax authorities had denied the exemption to the taxpayer on the basis that it had made investments in violation of the SEBI (Venture Capital Fund) Regulations 1996 (VCF Regulations). The Tribunal held that on fulfilment of the criteria elucidated under Section 10(23FB) of the Income Tax Act, 1961 (IT Act), and in the absence of an apparent violation of SEBI regulations, the taxpayer is eligible to the exemption provided under the IT Act.

Background

Under the IT Act, Section 10(23FB) provides an exemption for income earned by a VCF from investments in a Venture Capital Company (VCC), where such VCF: (i) operates under a trust deed, duly registered; (ii) has been granted a certificate of registration as a VCF before 21 May 2012; and (iii) is regulated by the VCF Regulations. Further, Section 115U of the IT Act provides that income arising to a person out of investments made in a VCF shall be taxed as if it were income arising to such person on account of investments made directly in the Venture Capital Undertaking (VCU). Accordingly, VCFs have been accorded a tax pass-through status in relation to investments in a VCU and the income received from such investments is taxable in the hands of the investors in the VCF.

In this case, the tax authorities challenged the tax pass-through status of *M/s HDFC Property Fund* (Assessee) being a SEBI registered VCF and taxed its income in the nature of capital gains and dividends etc. under the residuary head of income.

Facts

The Assessee is a trust established under the Indian Trusts Act, 1882, wherein Housing Development Finance Corporation Limited, in its capacity as settlor, had identified investment opportunities in high-growth sectors, including real estate. In furtherance of these investment opportunities, the Assessee was established as a VCF and was registered with the SEBI under the VCF Regulations.

For the relevant year (2013-14), the Assessee, *inter alia*, earned income from investments in VCUs and sought an exemption under Section 10(23FB) as well as Section 10(35) for dividend income from units of mutual funds.

The tax authorities were of the view that the investments made in: (a) units of mutual funds; and (b) debenture application money (towards optionally convertible debentures), did not qualify as investments in VCUs and were therefore, in violation of the trust deed as well as the VCF Regulations. Accordingly, the Assessee was considered non-compliant with conditions prescribed for a VCF and was denied exemption under Section 10(23FB).

Tribunal Ruling

The Tribunal rejected the contention of the tax authorities and held that the Assessee is eligible to exemption under Section 10(23FB) based on the following key observations:

- The Assessee fulfilled all the conditions prescribed under section 10(23FB), i.e.: (i) it operates under a registered trust deed; and (ii) it has a valid certificate of registration under the VCF Regulations.
- The Tribunal analysed the trust deed which enabled the Assessee to make 'temporary investments' which was defined to include *inter alia*, money market instruments, units of money market liquid funds and other similar debt instruments. Reference was also made to an informal guidance issued by the SEBI wherein a SEBI registered VCF was permitted to make investments in liquid funds. Accordingly, the Tribunal held that the temporary investment made by the Assessee in the units of mutual funds was within the ambit of its trust deed as well as the VCF Regulations.
- The Tribunal also noted that there is adequate industry practice wherein VCFs retain certain amounts pending investment in VCUs, to meet disbursement expenses, distribution to holders, etc. Till such time, VCFs often make temporary, short-term investments to earn monies. Moreover, the VCF Regulations do not prohibit VCFs from deploying funds in liquid mutual funds, bank deposits and other high-quality assets.
- As regards investment by way of debenture application money towards optionally convertible debentures, the Tribunal accepted Assessee's contention that the same should be treated as an equity linked investment. In any case, regulation 12(ii) of the VCF Regulations specifically permits 33.33% investment in debt instruments of a VCU in which a VCF has already made equity investment. Thus, even if the same is viewed as a debt investment, given that the Assessee had made an equity investment in the same VCU and since, the debenture application money was within the aforementioned limits, there was no violation of the VCF Regulations.

Comment

This is a welcome ruling where the Tribunal has examined the issue in light of the relevant provisions of the IT Act, applicable SEBI regulations, informal guidance issued by the SEBI as well as the industry practice.

In this case, the taxpayer was registered as a VCF and was governed by the VCF Regulations, which have now been repealed and replaced by the SEBI (Alternative Investment Funds) Regulations, 2012 (AIF Regulations). Investment funds are now registered as Alternate Investment Funds (AIF) under the AIF Regulations, which also enjoy a tax pass through status so long as they are registered as Category I or II funds. Thus, the ruling will continue to have significance for the funds industry.

The case does leave one question open vis-à-vis the jurisdiction of the tax authorities to determine compliance with other laws. The taxpayer did raise a specific objection as

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to whether it is within the domain of the tax authorities to determine infraction with other laws, however, the Tribunal has not dealt with this question.

- Bijal Ajinkya (Partner), Ritu Shaktawat (Partner) and Srishti Mukherjee (Associate)

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