INDIRECT TAX UPDATE

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CESTAT HOLDS VENTURE CAPITAL FUNDS LIABLE TO PAY SERVICE TAX ON EXPENDITURE INCURRED IN ADMINISTRATION OF FUND AND CARRIED INTEREST: ITS IMPACT ON THE PE FUND MANAGEMENT INDUSTRY

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The Customs Excise and Service Tax Appellate Tribunal ("Tribunal"), Bangalore bench vide order dated 1 July 2021 in ICICI Econet and Internet Technology Fund v Commissioner of Central Tax [Service Tax Appeal No 2900 of 2012] confirmed service tax liability on expenses incurred by a venture capital fund ("VCF") incorporated as a trust, as consideration received towards asset management services. Disbursement of "carried interest" to the Asset Management Company ("AMC") and other expenses incurred by the VCF in the course of its operations, have also been characterized as service income of the trust.

FACTS

VCF is a fund in form of a trust set up as per Securities and Exchange Board of India (Venture Capital Funds) Regulations 1996 ("SEBI Regulations"). The VCF is a vehicle established to undertake sizeable investments in portfolio companies based on contributions received from various investors. The VCF is managed by a trustee for the benefit of its contributors/subscribers. The trustee typically appoints an AMC to manage pooled investments and take investment / divestment decisions. The fund incurs certain expenses like fees paid to the AMC, trusteeship fees etc.

In the present case, ICICI Econet and Internet Technology Fund ("Appellant") was a VCF set up under the SEBI Regulations. Against the contributions received from investors, the Appellant had allotted various classes of units, each with its own set of rights and privileges. While Class A units were ordinary units, Class B/C units carried special privileges and were issued to the AMC, which in this case was ICICI Venture Limited, and its nominees belonging to the ICICI group. The process of Disbursement of dividend/profits earned from the Appellant investments was governed by its Private Placement Memorandum ("PPM") and related documents. Firstly, disbursement of an amount equal to the capital and a promised rate of return was made to Class A unit holders. These amounts were also paid to Class B/C unitholders of the fund. However, Class B/C unitholders were additionally entitled to receive a share from the surplus profits generated by management of fund, known as Carried Interest ("CI").

The tax department conducted an investigation, which culminated in an Order confirming taxability of services allegedly rendered by the Appellant, under the entry Banking and Other Financial Services" ("BoFS") as per Section 65(12) of the Finance Act, 1994. The Appellant as a VCF was held to be responsible for capital appreciation of the contributors' investments and providing other financial assistance. The amounts retained by the Appellant for incurring its own expenses and the CI paid to Class B/C unitholders were together held to represent consideration towards the aforesaid services. In particular, the CI paid to Class B/C unitholders (which included the AMC and its nominees) was deemed to be a "Performance Fee" and not a return on investment. The Order was challenged in appeal before the Tribunal.

The primary issue before the Tribunal was whether expenses incurred by the Appellant in the course of its operations, together with the CI paid to Class B/C unitholders represented consideration towards services provided by it to contributors. The Tribunal, in its decision, upheld the Order of the tax department and in doing so, decided appeals pertaining to 11 funds belonging to the ICICI group.

CONTENTIONS

Appellant's contentions regarding the fund structure:

(a) Provisions of service tax did not recognize the arrangement between the Appellant (trust) and its contributors/beneficiaries to be a relationship between a service provider and a service recipient.

(b) Liability under the category of BoFS arises when services are rendered by a bank, non-banking financial company, body corporate or any other commercial concern.

(c) The Appellant (trust) not having general legal identity, was formed for limited objective to benefit its contributors and purely as a pass-through entity. Hence, it

did not qualify to be a commercial concern.

(d) No service provider-recipient relationship arises when a fund is formed out of amounts invested by the contributors/subscribers.

(e) There was mutuality of interest between the Appellant and its contributors inasmuch as each contributor is a beneficiary.

(f) There was no distinction between the trust fund the amounts invested by the contributors. In such a situation, liability of service tax could not arise on account of doctrine of mutuality.

Appellant's contentions regarding taxability of expenses and CI:

AMC had already discharged service tax liability on fees charged by it for rendering fund management services.

(a) CI paid to Class B/C unit holders was a return on investment and taxed as "Capital Gains" under income tax provisions. CI should not be confused with performance fee. Wherever a performance fee was paid, service tax liability had duly been discharged by the service provider (AMC).

(b) Service tax liability arises pursuant to an express contract for provisioning of services. As per Section 67(a) of the Finance Act, 1994 consideration means an amount payable for provision of services. Expenses incurred for administration of the fund and distribution of CI did not represent consideration for any activity performed by the Appellant for its contributors.

Tax department's contention on doctrine of mutuality:

(a) Pooled investments were deployed for the purpose of profit maximization. Contributions were used to advance loans to portfolio companies or buy financial instruments. These activities indicated that the trust funds were put into commercial activities.

(b) The fact that registrations were obtained by the Appellant (in its own name) under SEBI and Service Tax laws, indicated existence of an identity distinct from its contributors.

(c) Engagement with third parties (portfolio companies) for commercial operations and earning profits therefrom, was against the doctrine of mutuality.

(d) There was a disparity in returns distributed to Class A and Class B/C unit holders, evidencing the non-existence of mutuality between the Appellant and its contributors.

Tax department's contention on taxability of expenses and CI:

(a) Charges incurred in form of custodian fees, brokerage charges etc. were debited as expenses and disbursements to unit holders were net of such charges.

(b) CI was not a return on investment for special unit holders. It was a performance fee payable to the AMC, which was retained until a specific target was achieved in terms of return on fund's capital deployed.

(c) The Appellant offered services to its contributors by exercising discretion over distribution of dividends/profits to ensure objectives of the Appellant are met.

(d) Service tax was applicable on the value of consideration involved in rendering of services. Hence, even the CI (which was held to be a performance fee, and thus an expense of the Appellant) was includible in the taxable value / consideration for services.

VERDICT

Based on the above contentions and observations, the Tribunal held that the Appellant could not be treated as a "trust" for the purposes of service tax law, since it was involved in commercial activity pertaining to investment and capital appreciation, thereby vitiating doctrine of mutuality. The Tribunal termed the concept of a trust in the present case, as merely a façade.

The Appellant disbursed profits/dividends upon redemption to Class A unit holders, net of expenses incurred while managing the fund. These expenses formed a consideration for services rendered by the Appellant. The Appellant, on the other hand, disbursed an additional amount to Class B/C unitholders (i.e. the AMC and its nominees) as CI even without redemption.

Distribution of an amount by terming it as CI was not a return on investment for the AMC, but an extra amount received based on realizations made by exiting portfolio investments. Resultantly, the Tribunal termed CI to be a Performance Fee and included it in the taxable value (consideration) for determination of value of taxable services. Based on disproportionate amounts paid to Class B/C unit holders, the Tribunal concluded that such amounts could not be termed as return on their investments.

Finally, observing that the settlors of the funds, trustees and AMCs were all ICICI group entities, the Tribunal also held that the structure of the fund was devised to enable the AMC and its nominees to earn huge sums in the nature of Performance Fee, but disguised as CI. The Tribunal thus rejected the appeal of the Appellant and upheld the Order passed by the tax department. The matters were remanded to the adjudicating authority for quantification of demand based on factors such as admissibility of CENVAT credit, cum-duty benefit and exclusion of notional expenses.

COMMENTS

The decision of the Tribunal represents the first ruling on taxability of activities carried out by VCFs under the service tax regime. The controversy, however, is expected to settle only at the level of the Apex Court, since the subject matter of the decision questions the core structure of investment funds.

The decision and its reasoning could also spill over on other similar investigations underway.

CI, previously considered to be a fund-based return, has now been termed as a fee-based return and made liable to tax. Such a recognition could adversely affect taxpayers under the GST regime (since provisions have largely been carried forward) as well. The decision could be used as a precedent to disallow the pass-through status of investment funds as adopted by the industry.

The decision of the Tribunal requires a relook in light of several factors, namely (i) whether the classification, rights and privileges of units are open to scrutiny by tax authorities, particularly when all terms are fully disclosed in the PPM and investments made by contributors is subject to such terms; (ii) the pass-through nature of investment fund vehicles and taxability of such vehicles and of CI under income tax laws; (iii) investment in portfolio companies was not for commercial purposes of the trust, but for commercial purposes of portfolio companies; and (iv) disproportionate returns would not *per se* vitiate the doctrine of mutuality since equality of treatment of beneficiaries is not a sine qua non of a trust.

The decision is likely to be appealed against. In the meanwhile, existing similar structures should expect scrutiny by the tax authorities and explore if a distinction on facts could be drawn. Since the ruling is likely to affect other pooling structures equally and impacts the very fundamentals of an investment fund, an industry-level representation to the Central Board of Indirect Taxes and Customs could be an option worth seriously considering.

IMPACT ON THE PRIVATE EQUITY FUND MANAGEMENT INDUSTRY

The above decision of the Tribunal is being closely watched by the Indian private equity industry. Based on how this finally settles with the SC, this could potentially have a far reaching impact on the future growth of this asset class in the country.

The PE industry, after having faced a long drawn tax uncertainty around its tax-passthrough status for nearly a decade under the direct tax regime had started gaining the confidence of both the GPs and the LPs after the policy makers addressed the issue by offering tax pass-through status to Cat I and Cat II AIFs as well as VCFs in and around 2015-16. In fact, this tax certainty combined with the relevant changes to FEMA provisions proved to the bedrock of the '**Manage in India**' campaign rolled out by the government to encourage domestic and international fund managers to manage

the funds sitting right here without triggering any adverse tax consequences for them and their investors. However, this ruling itself, combined with its retrospective effect, may start making GPs and LPs wonder if a long term tax uncertainty in India is illusional and may start putting doubts in their minds which will not help in encouraging fund managers to manage funds out of India.

Lastly, besides the arguments surrounding the 'principles' in this case which will surely be examined on merits by the supreme court, we believe that the policy makers will need to examine the issue with a much wider lens. CI structured as return on investment is a very established structure globally for the PE industry. Besides creating incentive for the GP, it aligns the interests of the stakeholders and hence it also carries an element of risk of investment that GP makes alongside the LPs. This aspect obviously seems to have been ignored by the tribunal which is understandable as their examination was limited to the existing facts. Even the most developed countries with relatively less dependence on this form of long-term value creating capital have consciously refrained from disturbing the 'equilibrium' on the issue as it has merits to be treated as fund based incentive, does India need to apply a different lens to this form of GP participation resulting in a significant disincentive for the 'arranger and manager' from bringing this form of value creating capital onshore.

One will keenly watch the space as to how the arguments around the legal principles evolve in this case and how the policy makers rise to the occasion to deal with this critical issue from a fund management industry perspective. Speaking purely from an industry perspective, a strong rebuttal combined with a comprehensive solution addressing the characterisation issue would be needed to thwart the fear in the mind of GPs and LPs and to avoid triggering of the 'brain-drain' which the industry had faced during the past tax uncertainties.

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