



## INVESTMENT MANAGEMENT ACTIVITIES UNDERTAKEN BY A VENTURE CAPITAL FUND IS NOT LEVIABLE TO SERVICE TAX

### Historical Background

- The Anti-Evasion Unit had *inter alia* conducted an investigation on ICICI Econet Internet and Technology Fund (Taxpayer) wherein it was observed that -
  - The Taxpayer had retained certain income distributable to the contributors which appeared to be in the nature of service charge/ fee for managing the assets of the Trust/ Fund.
  - Such income was leviable to service tax and was classifiable as 'banking and other financial services' as defined under Section 65(105)(zm) of the Finance Act, 1994 (Finance Act).
  - The Taxpayer had not discharged applicable service tax on such incomes.
- Considering the above, a show cause notice was issued to the Taxpayer proposing to demand service tax on the following:
  - Expenses incurred by the Taxpayer; and
  - The amounts paid to Class 'C' investors as return on investments (Carry Income).
- After considering the reply furnished by the Taxpayer, the show cause notice was confirmed *vide* the Order-in-Original (OIO). Against this, the Taxpayer filed an appeal before CESTAT which had also confirmed the OIO *vide* the Impugned Order *inter alia* holding that -
  - The Taxpayer has an independent identity and distinct personality of its own. The activities undertaken by the Taxpayer of distributing dividends and other amounts to the respective unit holders substantiate its profit motive.
  - The Taxpayer has violated the principle of mutuality by involving themselves in commercial activities and by using its discretionary powers to benefit a certain class of investors. Thus, the distribution of dividends/ profit by the Taxpayer was made in a manner detrimental to the interest of the other investors/ contributors.
  - 'Carried interest' is neither interest nor return on investment, but a portion of the consideration retained by the Taxpayer for the services rendered to the investors and passed on, in the disguise of return on investments, to Class C unit holders, i.e. the Investment Manager.
  - The Taxpayer had devised the fund structure to enable the Investment Manager and/ or their nominees to receive huge sums of money in the guise of performance fee, carried interest, with the twin motives of benefitting them at the expense of the subscribers and avoiding taxes.
- Aggrieved by the above, the Taxpayer filed an appeal before the Karnataka High Court *inter alia* raising the following questions of law:
  - Whether the CESTAT has erred in holding the Taxpayer to be a juridical person.
  - Whether the CESTAT has erred in holding that the Taxpayer cannot be treated as a 'Trust' and failed to recognise its pass-through status for the purpose of taxing statutes.
  - Whether the CESTAT has erred in ignoring that the moneys and funds contributed by the contributors, being Taxpayer's property, the asset management service rendered if any, is by the Taxpayer for its own self?

### Contentions of the Taxpayer

- The Taxpayer has not provided any service to the contributors. Instead, the Investment Manager provides the services of asset management to the contributors. The Taxpayer merely acts as a 'pass-through', wherein the funds from the contributors are consolidated and are subsequently invested by the Investment Manager.
- The expenses incurred by the Taxpayer are not leviable to service tax. Further, the reimbursement received by the Taxpayer in the course of the operation of the Fund is in its capacity as an agent and hence, exempt from the levy of service tax as per Rule 5(2) of the Service Tax (Determination of Value) Rules, 2006.
- The Taxpayer is not covered under the purview of the term 'person' defined in the Finance Act. Thus, the activity undertaken by the Taxpayer is covered under the ambit of mutuality and consequently, the Taxpayer and the Contributors cannot be dissected as two separate persons for the levy of service tax.

### Contentions of the Tax Authorities

- The present appeal is not maintainable as it involves the rate of duty and as per Section 35L of the Central Excise Act, 1944, an appeal for determination of any question with regard to the rate of duty shall lie before the Supreme Court.
- The Fund accepts money from the contributors and makes profit by re-investing the same and also retains a portion of such profit.
- The Taxpayer can be considered as a 'person' on account of the following:
  - The Taxpayer's funds are registered under the Venture Capital Fund Regulations issued under the Securities and Exchange Board of India (SEBI) Act, 1992 and hence, the Taxpayer is a separate legal entity.
  - The Taxpayer has a bank account, obtains necessary approvals, deducts TDS and has obtained registration from SEBI which only a 'person' can qualify.
- The doctrine of mutuality is not applicable to the present case because the definitions in the Contribution Agreement indicate a relationship between a buyer and seller as the phrase term used therein is 'purchase of units'. Further, the various terms of the Indenture of Trust of the Fund are contrary to the principle of mutuality.

### Observations and ruling by the High Court

- **Maintainability of the Appeal:** The issue involved in the present case pertains to the liability to pay duty and not the rate of duty. Hence, the appeal in the present case is maintainable before the High Court.
- Whether the Taxpayer is a juridical person.
  - The definition clauses of each statute must be read with the object and purpose of that statute only as intended by the legislature. Various statutes such as the SEBI Act, GST law, IBC recognise 'trust' as a person whereas the Finance Act does not.
  - The CESTAT at Para 37.4 of the Impugned Order erred in observing that since the Trust is treated as a juridical person under the SEBI Act, there is no reason why it should not be treated as a juridical person for taxation.
  - Thus, the issue in the present case is answered in favour of the Taxpayer holding that it cannot be treated as a juridical person.
- Whether the Taxpayer can be treated as a 'Trust' and whether its pass-through status can be recognised for the purpose of taxing statutes.
  - The Taxpayer acts as a 'pass-through', wherein funds from the contributors are consolidated and invested by the Investment Manager. The Taxpayer acts as a Trustee holding the money belonging to the contributors for onward investing based on the advice of the Investment Manager.
  - Further, the Fund does not make any profit nor does it provide any service and therefore, the imposition of service tax in the present case is untenable.
- Whether the funds contributed by the contributors, being Taxpayer's property, the asset management service rendered if any, is by the Taxpayer for its own self?
  - The doctrine of mutuality applies when commonality is established between the contributors and participators. In the present case, contributors and the Trust cannot be dissected as two different entities because it is an admitted fact that the contributors' investment is held in the Trust by the Fund and it is invested as per the Investment Manager's advice.
  - In essence, the Fund does not do any act and hence, there can be no service to self. Therefore, the doctrine of mutuality must apply in the present case.
- In view of the above, the Impugned Order was set aside.

*[ICICI Econet Internet and Technology Fund Vs. The Commissioner of Central Tax [TS-52-HC-2024(KAR)-ST]]*

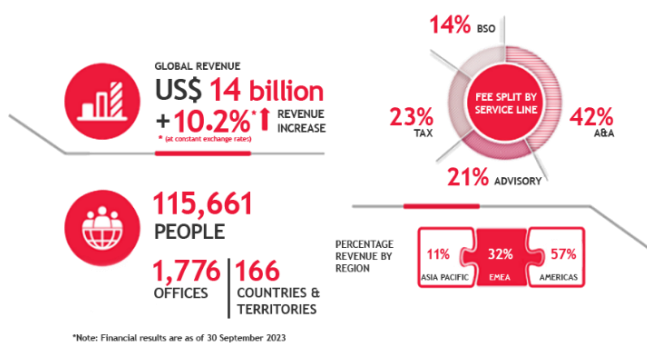
### BDO India Comments

The CESTAT Order had *inter alia* held that the expenses incurred by the Venture Capital Fund (Fund) were leviable to service tax as the fund was providing Asset Management services to the contributors.

Further, it was also held that ‘Carried interest’ paid on Class ‘C’ units held by the Investment Manager is nothing but the expense incurred by the Fund, on which, the Fund is liable to pay service tax. This had created significant uncertainty in the industry at large as the same was contrary to the position adopted by the industry since inception which was not disputed till now. The judgment of Karnataka High Court has now overturned the CESTAT judgment and the industry would hope that this judgment puts a quietus to the issue and the *status quo* on the taxability of the amounts retained by the Fund is restored.

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\*Note: Financial results are as of 30 September 2023

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