

Investment Funds: Monthly Digest

February 21, 2024

TAXATION OF CARRIED INTEREST - CONTROVERSY CONTINUES!

- Decision of Bangalore CESTAT overruled by Karnataka High Court
- Court holds that funds acts as a pass-through entity, wherein funds from contributors are consolidated and invested by the investment manager
- Court holds that funds do not provide any services to contributors

The Karnataka High Court ("KHC") pronounced the much-awaited decision on applicability of service tax on venture capital funds ("VCF") earlier this month and disposed-off a batch of appeals preferred by numerous funds in the matter of *Ms. India Advantage Fund III & Ors. v. The Commissioner of Central Tax & Ors.* in favour of the taxpayer.¹ The decision of the High Court comes two years after the Bangalore bench of the Custom, Excise and Service Tax Appellate Tribunal ("CESTAT") upheld the levy of service tax on carried interest distributed by the VCF, equating it to performance fee earned by the management company. Our detailed analysis of the CESTAT ruling is [here](#).

Three questions of law were addressed by the KHC as under:

A) WHETHER THE VCF CAN BE CONSIDERED TO BE A 'JURIDICAL PERSON' UNDER THE FINANCE ACT?

In this regard, the KHC held that the definition clause of each statute must be read with the object and purpose of that statute alone. It observed that while various statutes like the Goods and Services Act, 2017, the Insolvency and Bankruptcy Code, 2016 and the SEBI Act, 1992 recognize 'trusts' as juridical persons, the Finance Act does not have such a provision. Accordingly, it noted that for the levy of service tax, an entity must be recognized under the Finance Act. In absence of such recognition, the KHC held that VCF cannot be regarded as a juridical person.

Analysis

The KHC has held that trust should not be considered as a 'person' merely on basis of definition of person under the Finance Act. Interestingly, the definition of 'person' under the Central Goods and Service Tax Act, 2017 ("CGST Act") specifically includes 'trust'. Having said this, mere inclusion of trust in the definition of person should not result in levy of GST. In order for GST to be applicable, there should be a 'supply' made by the trust – in absence of supply, GST cannot be levied.

B) WHETHER THE CESTAT ERRED IN HOLDING THAT THE APPELLANT CANNOT BE TREATED AS A "TRUST" AND FAILED TO RECOGNIZE ITS PASS-THROUGH STATUS, FOR THE PURPOSES OF THE FINANCE ACT?

The KHC agreed with the taxpayer's argument that the fund does not make any profit or provide any service. The KHC held that the fund acts as a pass through, wherein funds from contributors are consolidated and invested by the investment manager.

Analysis

The finding of the KHC that the fund is a pass-through entity is welcome. On basis of an illustrative distribution waterfall, the KHC notes that ultimately all amounts are distributed to the investor by the fund.

This is in line with the principle under the Indian Trust Act, 1882 as well. A trust is merely an arrangement whereby property is held by a person (the 'trustee') for the benefit of specific people (the 'beneficiaries') or for some object permitted in law. Funds are vehicle established for the purpose pooling monies from investors. Several Contribution by investors to a fund is merely an investment in securities.² Transactions between the fund and investors represent an investor-investee relationship not of a service provider and service recipient.

C) WHETHER THE CESTAT HAS ERRED IN IGNORING THAT THE MONEYS AND FUNDS CONTRIBUTED BY THE CONTRIBUTORS, BEING THE PROPERTY OF THE APPELLANT, THE ASSET MANAGEMENT SERVICE, IF ANY RENDERED, IS BY THE APPELLANT FOR ITS OWN SELF?"

The KHC held that since the contributor's investment is held in trust by the fund and invested in furtherance of the investment manager's advice, the fund does not perform any act and there is no service to one-self. On this ground, the KHC applied the doctrine of mutuality and concluded in favour of the assessee.

Analysis

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The doctrine of mutuality states that when persons contribute to a common fund in pursuance of a scheme for their mutual benefit, having no dealings or relations with any outside body, they cannot be said to have traded or made profit from such mutual undertaking, since there is no distinction in identity between the mutual undertaking and the persons contributing to it.³ The CESTAT had held that the VCFs violated the principle of mutuality by carrying out commercial activities and using discretionary powers to benefit a certain class of investors. The CESTAT held that the VCFs made provisions to act in a manner beyond the interest of the contributors, such as the payment of huge amounts as performance fee and carry interest to the investment manager or their nominees.

The decision of KHC that principle of mutuality applies between the investors and the fund is welcome and re-iterates the pass-through nature of funds.

OVERALL COMMENTS

While the KHC order is not very detailed, the decision clarifies that there is no provision of service from the fund to its investors. Post the CESTAT decision, several funds were receiving notices from GST department asking them to take registration under the CGST Act for provision of services to investors. The decision of the KHC should put a rest to this controversy. Considering that KHC has ruled that funds do not provide a service to investors, the question of levy of service tax / GST on the funds in so far as carried interest is concerned is moot.

Having said this, the question of applicability of GST on carried interest does not get ruled out by this decision completely. Carried interest represents such portion of returns distributed by the fund to the investment manager in excess of the capital contributed by the investors and the agreed hurdle rate of return. Distribution of carried interest is dependent on performance of fund. The investment manager / sponsor receives carried interest distribution from the fund by virtue of having a continuing commitment towards the fund. The amount of carried interest is not determinable upfront.

Investment manager provides management services to the fund pursuant to investment management agreement is entered between the trustee of the fund and the investment manager. The investment manager is remunerated in form of management fees for provision of such services to the fund. The amount of management fees is clearly laid out in the investment management agreement and the fund documents. Such management fees is not dependent on the performance of the fund. Management fees earned by the investment manager is subject to GST at rate of 18%. Typically, manager passes the cost of such GST to the investors of the fund.

As per section 9 of the CGST Act, GST is levied on supply of goods or services on the value determined as per section 15 of the CGST Act at the prescribed rates. Securities have been excluded from the definition of goods. Considering that trust is a pass-through entity, one may argue that investment manager is receiving carried interest by virtue of it being an investor in the fund. Therefore, receipt of carried interest is a return on investment in 'securities' which should not be subject to GST. Typically, GST cost is passed on by the investment manager to investors. Considering this, in case where GST is levied on carried interest and such cost is passed on to the investors, it would in effect be akin to levy GST on income earned on 'securities'.

The manner in which carried interest is characterized (i.e. as service fee or return on investment) would have implications both from an income-tax and GST perspective. Carried interest will be subject to tax at applicable corporate tax rate (which may be between 25% to 30% depending upon form of the investment manager) if such income is considered as service fee earned by the investment manager. While GST will be a deductible expense from an income-tax perspective, this may increase the effective tax rate on carried interest to 43%-47% (instead of 20% in case where carried interest is considered as a return on investment). Such a high tax incidence can make Indian potentially an unfavourable jurisdiction for raising and managing of funds.

Taxation of carried interest has been an issue globally. Few jurisdictions have formulated special tax rules applicable to carried interest. Considering the size and contribution of the fund management industry to the Indian economy, it is imperative that the Indian government also provides clarity and certainty on this issue.

– Ipsita Agarwalla and Parul Jain

You can direct your queries or comments to the authors.

¹*Ms. India Advantage Fund III & Ors. v. The Commissioner of Central Tax & Ors*; The KHC dealt with 31 appeals relating to ICICI Econet Internet and Technology Fund and 10 other funds ("Appellants") and regarding tax demands covering the period from 2005-2006 to 2011-2012

²Units of an alternative investment fund has been included in the definition of security under the SCRA

³Reliance in this regard was placed on several cases like *State of West Bengal Vs Calcutta Club Limited & Chief Commissioner of Central Excise and Service Vs Ranchi Club Ltd* 2019-VIL-34-SC-ST; *JCTO, Harbour Division, Il- Madras v The Young Men's Indian Association, Madras and Others* MANU/SC/0472/1970; *Saturday Club Limited v Assistant Commissioner of Service Tax 2005 (180) ELT 437 (Cal)*; *CST v Delhi Gynkhana Club Limited (2009) 18 STT 227 (New Delhi Tribunal)*

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