

Investment Funds: Monthly Digest

October 13, 2021

IMPACT OF ICICI ECONET DECISION ON THE FUNDS INDUSTRY

The alternative investment funds (“AIF”) regime was introduced in India by the Securities and Exchange Board of India (“SEBI”) in 2012 under the SEBI (Alternative Investment Funds) Regulations, 2012 (“AIF Regulations”) overhauling the erstwhile SEBI (Venture Capital Funds) Regulations, 1996 (“VCF Regulations”). As per SEBI statistics as of March 31, 2021, the cumulative capital commitments raised by Indian AIFs stands at a whopping INR 4.51 lakh crores out of which INR 2 lakh crores have already been invested.¹ Over the last 15 years, PE/VC funds have added over US\$200b in Indian businesses.² The growth and development of AIF industry as globally competitive and comparable to other fund jurisdictions is the result of cumulative efforts by SEBI, tax authorities and industry players.

Having said this, there remains a lot of potential for growth of the Indian AIF industry and increasing its contribution to India’s gross domestic product, job creation and entrepreneurial environment. Since the introduction of AIF regime, a certain and competitive taxation regime has been one of the key focus areas of the Government for boosting growth of the AIF industry. Granting of a tax pass through status to Category-I and Category II AIFs, exemption from angel tax, clarity on withholding provisions, clarity on taxation of income from overseas investments have provided investors and fund managers much needed comfort on taxation in setting up AIFs in India. While the AIF industry applauds these efforts by the tax authorities, any degree of tax uncertainty in the minds of the managers or investors is likely to shake-up their confidence and could undo the tremendous efforts put in by the policy makers and the industry in promoting AIF industry.

Recently, a ruling by the Bangalore bench of the Custom, Excise and Service Tax Appellate Tribunal (“CESTAT”) has created significant uncertainty on the nature of Venture Capital Funds (“VCFs”) / AIFs set-up as trusts from a tax perspective. The Bangalore CESTAT *inter-alia* held that a VCF set-up as a trust is a separate legal entity and upheld the levy of service tax on carried interest distributed by the VCF, equating it to performance fee earned by the management company (“Ruling”).³ The Ruling 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.

The Appellants are VCFs established as a trust under the Indian Trusts Act, 1882 (“Trusts Act”) and registered with SEBI as a VCF under the VCF Regulations. The Appellants are represented and managed by a Trustee and the terms and conditions pertaining to the formation of the Appellants are contained in the Indenture of Trust (“Trust Deed”).

The Revenue Department demanded service tax, interest and penalty on the Appellants on account of:

1. Expenses incurred by the Appellants;
2. Disbursement of carried interest income to Class C unit holders of the Appellants (distribution of income earned by a specific class of unit holders was sought to be characterised as service income earned by the Appellants);
3. Provision for losses and impairment of investment debited to financials.

DECISION OF BANGALORE CESTAT

The CESTAT held that the VCFs would be treated as juridical persons distinct from its beneficiaries for the purpose of taxation. The CESTAT noted that VCFs are treated as juridical persons under the VCF Regulations. Since both the Securities and Exchange Board of India Act, 1992 (“SEBI Act”) and the Income-tax Act, 1961 (“ITA”) are specific legislation, the CESTAT held that they would prevail over the definition of a trust under the Trusts Act. It also noted a Madras High court decision which observed that a trust is a juridical person.⁴ The CESTAT further observed that the trusts in the present case were essentially mutual funds engaged in portfolio management, and that they were commercial concerns whose essential function was profit maximisation.

The CESTAT also held that the VCFs (set up as trusts) violated the principle of mutuality by carrying out commercial activities and using discretionary powers to benefit a certain class of investors. The CESTAT noted that the said trusts made provisions to act in a manner beyond the interest of the contributors, such as the payment of huge amounts as performance fee and carried interest to the Investment Manager or their nominees. Further, CESTAT observed that the said trusts had reserved powers to utilize the profits in a manner that would benefit entities other than the contributors. On this basis, the CESTAT concluded that the said trusts did not adhere to principles of mutuality of interest and failed the test laid down by the Supreme Court in *Bangalore Club v. CIT*⁵. The CESTAT observed that the Appellants were managing the funds of the contributors and were therefore rendering asset management services to the contributors, which fall under “banking and other financial services”. With respect to consideration, the

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CESTAT observed that the consideration for such services was in the form of withholding the profits that would otherwise be distributed to the contributors. Hence, on both these issues, the CESTAT held in favour of the revenue department. Basis the conclusion that the VCFs were performing commercial activities, the CESTAT further goes on to hold that the concept of trust is only a façade.

On whether service tax is leviable on carried interest, the CESTAT found in favour of the revenue department that carried interest is neither interest nor return or investment but instead a portion of consideration for services rendered by the Appellants. The CESTAT observed that the said trusts have been floated for drawing contributors and to facilitate them to earn profits. Any amount retained by the said trusts out of the income that is otherwise distributable to the contributors would constitute a fee for the services rendered. The CESTAT found that the fund structure enabled the investment manager and their nominees to receive huge amounts as performance fee and in the guise of carried interest, benefitting the recipients at the expense of the subscribers, and avoiding the taxes arising from such payment.

IMPACT OF THE RULING

The ruling by the CESTAT is one of a kind and seeks to establish views which are being considered regressive by the industry. While the Ruling pertains to the erstwhile service tax regime, it is likely to have an impact under the goods and service tax ("GST") and income-tax regime on all pooling vehicles in general.

It is most common for AIFs in India to be established as trusts and invest pooled monies for and on behalf of its beneficiaries. In order to apply indirect taxes, there should be a clear identification of the service provider, service recipient and a consideration mutually agreed between parties.

The CESTAT has failed to appreciate the well settled principle that a trust is merely an obligation annexed to ownership of fund property by the trustee. It is absurd that when the Trusts Act does not consider a trust to be a distinct legal entity, the CESTAT borrowed the definition under the General Clauses Act to consider the trust to be a distinct legal entity. Further, the objective of introduction of the VCF Regulations and subsequently the AIF Regulations was not to treat trust as separate legal entity but was to regularise and incentivise the fund management industry in India, where AIFs could even be set up as a company or a limited liability partnership and not necessarily a trust. Even under the ITA, trustees are assessed as representative assessee of the trust on behalf of the beneficiaries.

Further, merely because Appellants are engaged in profit making should not negate application of doctrine of mutuality, especially in the absence of any corresponding provisions under the service tax law during the relevant period.

While the concern around re-characterisation of carried interest as business income (against capital gains) always existed, there was no doubt on the fact that the carried interest is income in the hands of the recipient. The CESTAT has looked at the transaction from a different lens alleging that the amounts retained by the funds is consideration for management services in the hands of the fund itself. However, proceeds from exits made by the fund are distributed to investors as per the distribution waterfall which clearly provides that carried interest will be distributed to the investment manager. This is also permitted under the VCF /AIF Regulations.⁶ Having said this, the fact that carry units were issued to the investment manager closer to the exit and one of the funds had inadvertently recorded carried interest as performance fee worsened the case of the Appellants. The rules for taxation of carried interest are evolving globally.

Unlike income-tax provisions, there are no anti-abuse provisions under indirect tax laws. Nevertheless, the CESTAT has concluded that the Appellants have devised their structure with the twin objective of benefitting the investment manager and avoiding taxes. The CESTAT has also concluded that since the Appellants were performing commercial / economic operations, the concept of trust is only a façade. There are several commercial reasons for establishing pooling vehicles in the form of a trust such as ease of formation and registration, ongoing compliance, governance etc. Further, there is no tax benefit which the funds seek to obtain by setting up pooling vehicles in form of trust – the investment manager duly pays service tax on management fees received from the fund. Holding the concept of trust, which is a permissible vehicle for pooling entities, 'a façade', questions viability of the entire AIF industry in India. This may have several unintended consequences which may open a Pandora of issues for not only Indian funds but also Indian managers, investors in such pooling vehicles as well as have a knock-down effect on any structure entailing pooling of investments (such as mutual fund industry or the asset reconstruction industry).

While the private equity space is closely monitoring the developments consequent to the Ruling, it will also be essential for managers to revisit their structures and documentation. If GST on carried interest is imposed on the AIF, it is likely to become a fund expense which will be passed on the investors as an additional cost. Characterisation of carried interest as performance fees for indirect tax perspective will also increase the risk of income-tax authorities challenging the capital gains characterisation of carried interest.

Over the years, India has successfully managed to develop a robust and vibrant funds industry. Therefore, it will be interesting to see how policy makers deal with this critical issue and provide appropriate clarifications in line with global and industry best practise.

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You can direct your queries or comments to the authors

¹ <https://www.sebi.gov.in/statistics/1392982252002.html>

² Ramnath, Renuka. 2019, July 30. PE Investor and promoter need to work together. The Mint. Available at: <https://www.livemint.com/opinion/online-views/opinion-pe-investor-and-promoter-need-to-work-together-1564509759558.html>

³ Service Tax Appeal No 2900 of 2012 with others

⁴ Abraham Memorial Education Trust v C. Suresh Babu; 2012 SCC OnLine Mad 2986.

⁵ (2013) 5 SCC 509.

⁶ SEBI Circular CIR/IMD/DF/14/2014 dated June 19, 2014

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