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Litigation Alert

Date: July 13, 2021

Venture capital funds operating as trust are liable to service tax

M/s. ICICI Econet Internet and Technology Fund and Others v Commissioner of Central Tax, Bangalore North.[1]

The division bench of the Customs, Excise and Service Tax Appellate Tribunal ('CESTAT') Bangalore, in the said appeal came to examine the applicability of services tax on trusts that engage in commercial activities.

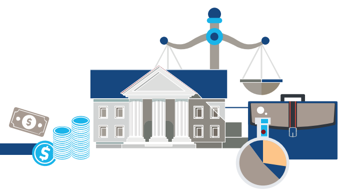
Facts of the case:

- M/s. ICICI Econet Internet and Technology Fund and others ("the Appellants") are venture capital funds ("VC funds") established as a trust under the Indian Trusts Act, 1882, ("Trusts Act") and registered with the Securities and Exchange Board of India ("SEBI") as a VC fund.
- The tax department alleged that the following items are subject to service tax under the taxable category of 'Banking and other financial services' as contained in Sec. 65 (12) of the Finance Act, 1994 ('the Act'):
  - Expenses incurred by the trust
  - Disbursement of carried income and carried interest
  - Provisions for losses and impairment of investments

Arguments advanced by the Appellants:

- The Appellants submitted that as a trust they are not a legal entity or "juridical person", and so the Act does not confer any service tax liability on the trust. Given this, service tax was not recoverable from the Appellants. Furthermore, it was submitted that the inclusion of trusts as a person/juridical person under the Act was incorporated in the legislation long after the periods under dispute in this case.
- It was argued that expenses incurred as interest cannot be categorized as income in the hands of the trust. It was further submitted that the disbursement of carried interest was actually a pay-out by the trust to its investors as return on their investment and hence is not in the nature of performance fee as alleged by the tax department
- The Appellants further submitted that when applying the principle of mutuality of interest between the Appellants (the trust) and the contributors (its members), the fundamental condition of existence of a service provider and service receiver is not met.

[1] 2021-VIL-278-CESTAT- BANG - ST



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- With respect to consideration, the Appellants submitted that in the instant case neither the Appellants nor its members have any intention to treat the expenses as "consideration" from the members to the Appellants; therefore, there is no link between the alleged provision of services and the consideration received.
- The appellant further submitted that if the services considered to be taxable, they would also be entitled to CENVAT credit that would be equivalent to ninety-eight per cent of the service tax demand raised on them and so the demand is revenue neutral to that extent.

Arguments advanced by the Tax Department:

- The tax department argued that, the trust is 'providing facilities' to persons, i.e., investors, to participate in the income, profits and gains arising out of the acquisition, holding or disposal of portfolio investments, property or rights or any other benefits under the schemes floated by VC funds. In furtherance of these activities, the VC fund incurs several costs and expenses, such as management fees, performance fees and fund expenses, and meets them by retaining a portion of the proceeds before making over the balance of proceeds to the investors; such retention of the proceeds is the consideration for the services rendered by the VC fund to the investors. It was argued that the VC funds deduct a significant portion of the investors' distribution funds and pays it to its affiliates in an alternate form in such a manner that no party in the chain i.e., the VC fund/trust/AMC has to pay taxes. Large returns are made to the AMC (for fairly small investments) as income from investments. The VC fund in turn retains these sums from the investors' distribution fund in order to make payment to the AMC. Given this, the demand raised on expenses incurred and carried interest is appropriate.
- The tax department relied on the definition of "VC Funds" under the Venture Capital Funds Regulations, 1996 ('Regulations') issued under the SEBI Act, 1992, which states that a 'VC Funds' means a fund established in the form of a trust or a company including a body corporate and registered under the Regulations, in order to establish that no distinction is made between the three entities specified therein and that the Appellants are juridical persons who ought not to be regarded as distinct for tax purposes. The Regulations regard them as legal entities; hence, it would not be correct to say that a VC Funds is an amorphous entity. Furthermore, it was submitted that as no VC Funds can function without registration under the Regulations, the Regulations should prevail over the general trust laws applicable in India.
- The Appellants engage in a systematic process, for long-term maintenance of the assets or property of the investors in the fund. Based on documents provided, it was clearly demonstrated that the services provided by the Appellants is akin to the service provided by a banking company or a financial institution to its customers.
- Based on the clauses of the trust deed it was established that there is no mutuality between the appellant and its members. Refence was also made to the decision of the Supreme Court in the case of *M/s Bangalore Club Vs. Commissioner of Income Tax*[2]**,** to distinguish a club from a VC and to establish that the three conditions for applicability of principle of mutuality as laid down by the Supreme Court are not met by the Appellants in the instant case. Both sides also made submissions on valuation, limitation, interest and penalty.

Judgement of the CESTAT:

After considering the submissions, the division bench decided as follows:

- The trust registered under the Regulations is a juridical person for the purposes of SEBI Regulations and should be treated as the same for tax purposes.

[2] MANU/SC/0030/2013

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- It was held that *Trusts have violated the principles of mutuality by concerning themselves in commercial activities and by using the discretionary powers to benefit a certain class of investors or nominees or employees or subsidiaries.* For this reason, they can no longer be treated as trusts for the purposes of taxation statutes.

- It was observed that Taxation Law, being a specific legislation just like the SEBI Act, 1992, would prevail over the general trust laws applicable in India.

- After considering detailed submissions on "Mutuality of Interest" and various cases cited to draw an analogy that clubs are similar to VC funds to apply principles of "Mutuality of Interest", it was found that there is basic difference between VC funds and clubs. The trusts, as seen above, have been initiated with a profit motive, and the activities are akin to those of a bank or financial institution, whereas clubs have no or minimal commercial interest and basically are formed to share facilities which would normally be inaccessible or unaffordable at an individual level. The bench agreed with the department that VC funds bear no comparison to members of a club, which, by its very incorporation, is a grouping of individuals who have chosen to be members of a particular institution or club for fulfilment of certain human needs (social, sporting, recreational etc) that cannot be fulfilled except in such organized collectives.

- Pertinently, it was held that the VC funds are named as trusts but by not adhering to the principle of mutuality of interest and by carrying out commercial activities they have failed the test laid down by the hon'ble Supreme Court in *Bangalore Club* [Supra]. The bench remarked that in the instant case, as the trust have engaged in commercial activity, being a trust is a facade.

- The bench upheld that the appellant is managing the money invested by its members, which constitutes rendition of services to its members and squarely falls under asset management services which is covered under "Banking and Other Financial Services". With respect to the consideration for service, the consideration is not charged to the members but is retained from the amounts that are duly distributable to members. Thus, the Appellants arguments that three distinct elements (Service Provider, Service Recipient and Consideration) are absent have no standing.

- It was held that besides the definition, the Appellants are understood to be VC funds and based on various cases cited have been held to be juridical persons as far as taxation is concerned. For this reason, it is legal and logical to hold that the trust exists and function as juridical persons as far as they are rendering services exigible to tax as per the provisions of the Finance Act, 1994 notwithstanding the treatment meted out to them under different statutes. Hence, they are liable to service tax in the instant case.

Dhruva Comments:

In our view the findings of the hon'ble CESTAT in categorizing all the expenses and pay-outs in the books of the trust/VC Funds as income earned by such trust/VC Funds on the basis that such retentions by the trust/ VC Funds are towards facilitation provided by the trust to the investor does not take into consideration the concept of waterfall distribution and the true functions and role performed by the trust. The waterfall arrangement contained in the Trust Deed, has been considered to be a retention in the hands of the Trust. In a traditional VC fund structure, there is no retention of any service fee or income by the trust as it merely distributes the distributable surplus among various classes of investors, as per waterfall clause agreed between the investors after deducting expenses that were incurred by or on behalf of the Trust. In such distributions, no discretion in exercised by the Trust.

The chief premise of the judgment is that the VC Funds as a trust cannot engage in commercial activities for the benefit of selective investors/nominees. Oblivious to a globally accepted practice, the judgment concludes that since significant returns (in the form of carried interest) is received by Investment Managers (holding Class C Units) without making any substantial contributions, the entire transaction has been structured to avoid tax on

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fee for services, which otherwise gets booked as returns on investment. The concept of trusts operating as a pass-through (for the benefit of its investors) has been rejected, and instead it has been held that for such transactions the principle of mutuality would not apply, as such trusts are operating as independent juridical persons (i.e., separate from their investors) and are recognized as such by SEBI. On this basis, it has been concluded that the function of incurring expenses and undertaking pay-outs (managed by the Trustee) are services and should be subjected to service tax. The aspect that the trust is only a pooling vehicle and therefore is merely a pass-through entity and not a service provider in its own capacity has not been given due consideration. In the broader scheme of things, the services if any are provided by the Investment Managers, as is also evident from the trust deed, whereby the trustee's role is more fiduciary in nature and it is the Investment Manager who is appointed to manage the VC Funds. Hence, it is only the Investment Manager who is providing services, for which the Investment Manager is recovering service charges for management of the Funds and charging service tax.

Also, the finding that no one in the chain pays any service tax not does take into consideration that service tax is being discharged by the Investment Manager on the management fee as well as on the various third-party expenses that are incurred by the VC fund/the investment manager. Hence, in effect, most of the expenses incurred by the trust are service tax paid.

Also, if the arrangement is looked at in its entirety, it is nothing but the distribution of proceeds from investment activity, distributed by the trustee (in a fiduciary capacity) amongst various classes of investors by way of waterfall distribution. Service tax cannot be made applicable to such distributions arising from profit on investments.

The aforesaid decision could lead to demand notices on trusts both under service tax and the GST Laws (it is to be noted that there is a specific inclusion of "Trust" as 'persons' under the GST regime unlike in the case of service tax).

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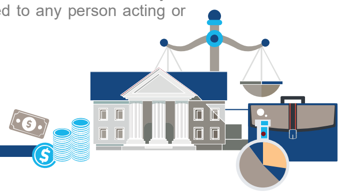

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