TRILEGAL

Karnataka High Court: Service tax not leviable on performance fee and carried interest paid by venture capital funds

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The Karnataka High Court, while ruling on a batch of appeals filed by ICICI Econet Internet and Technology Fund and others, has provided clarity on the applicability of service tax to the financial services sector. The Court held that service tax is not leviable on the expenses incurred by a venture capital fund (**VCF**), organised as a trust, on the administration of the fund. This decision is likely to impact not only VCFs but all other investment pooling vehicles that are organised as trusts, such as alternative investment funds, by exempting asset management activities from the ambit of service tax.

The Karnataka High Court has set aside an order of the CESTAT and held that a venture capital fund is not liable to pay service tax on the expenses incurred by it either as performance fee paid to the asset management company or returns on investment disbursed to the asset management company, usually referred to as carried interest.

1 Background

VCFs were established under the Indian Trusts Act, 1882, and registered with the Securities and Exchange Board of India. In the current case, institutional investors/contributors had made investments in the VCF. The VCF was represented by a trustee, who in turn appointed an asset management company (**AMC**) to manage the VCF. In exchange for these services, the VCF paid a performance fee to the AMC. Additionally, the AMC and its employees/nominees were also entitled to '*carried interest*', which is a percentage of the gains earned by contributors.

Against this structural backdrop, an investigation was conducted by the Anti-Evasion Unit of the Jurisdictional Commissionerate into the activities of the VCF. It took the view that the VCF retained a portion of the income (i.e., carried interest) that would otherwise be distributed to the contributors, and it classified such portion as a service charge/fee for asset management. Consequently, a show cause notice was issued, proposing the imposition of service tax on the expenses incurred by the VCF (i.e., performance fee) and the returns paid to AMC (i.e., carried interest) by categorising them as '*banking and other financial services*' under the Finance Act, 1994 (**Finance Act**).

This tax demand was challenged before the Customs, Excise and Service Tax Appellate Tribunal (**CESTAT**), Bangalore, which held that service tax should be imposed on the expenses borne by a VCF, as they amounted to payment for asset management services. Additionally, disbursements of '*carried interest*' to the AMC and other operational expenses incurred by the VCF were also classified as service income of the trust by the CESTAT.

Accordingly, the CESTAT held that carried interest is neither interest nor return on investment, but consideration retained by VCFs for the services rendered by them to investors/contributors and passed on to AMCs or their nominees in the guise of return on investment. The CESTAT believed that the structure of the VCFs was formulated to avoid taxes and hence characterised the return on securities as a '*service fee*'.

This decision imposed additional liability on VCFs to pay service tax. Aggrieved by this decision, the VCFs appealed before the Karnataka High Court.

2 Analysis and observations of the Karnataka High Court

The High Court's analysis and decision were centered around the following key issues.

2.1 Issue 1: On whether a trust can be regarded as a juridical person for the purposes of taxation

The appellant VCF contended that a '*trust*' is not recognised as a juridical person under the Finance Act and hence, a VCF, being structured as a trust, cannot be made liable to pay service tax. Conversely, the tax department contended that since the trust is registered under the Securities and Exchange Board of India Act, 1992 (**SEBI Act**) and recognised as a juridical person within that legislation, it should similarly be recognised as such and held liable for payment of service tax.

The High Court agreed with the contention of the appellant VCFs. It held that the interpretation of definition clauses within statutes must align with the intended purpose and object of each statute, as determined by the legislature. While statutes like the SEBI Act, the Goods and Services Tax Act, 2017, and the Insolvency and Bankruptcy Code, 2016 recognise '*trust*' as a legal entity, the Finance Act does not. Since the issue at hand concerns liability for service tax, which falls under the purview of the Finance Act, the tax department's argument was deemed untenable.

2.2 Issue 2: On the pass-through status of VCFs for the purposes of taxation

The appellant VCFs contended that the VCF in the main appeal was established by the settlor, ICICI Venture Funds Management, with funds collected from institutional investors. Guided by the advice of the investment manager, the VCF invests in portfolio companies. Accordingly, in substance, the VCF does not make any profit, nor does it provide any service.

The High Court found merit in the argument made by the appellants and held that VCF functions as a '*pass-through*' entity, consolidating funds from contributors and entrusting them to the investment manager for investment purposes. In this capacity, it serves as a trustee, holding the contributors' funds to be invested according to the guidance provided by the investment manager. The Court held that the CESTAT has erred in holding that the VCF cannot be treated as a '*trust*' and failed to recognise its pass-through status for the purposes of taxation.

2.3 Issue 3: On the doctrine of mutuality

The High Court observed that the doctrine of mutuality applies when there is a shared interest between contributors and participators. Since the contributors' investments are held in trust by the VCF and managed by the investment manager, the Court concluded that the contributors and the VCF cannot be dissected into two different entities. The Court held that essentially, the VCF does not perform any independent acts, and hence, the doctrine of mutuality must apply in this case. The doctrine of mutuality states that no person can transact or make profit with himself and hence, service tax cannot be imposed on a VCF.

In light of the conclusions arrived at by the Court for each of the three issues outlined above, the Karnataka High Court set aside the order of the CESTAT.

3 Conclusion

The Karnataka High Court's decision provides much-needed relief to the venture capital funds and alternative investment funds industry. However, while it has been clarified that service tax does not apply in the context of VCFs, the judgment does not explicitly address the issue of levying Goods and Services Tax on carried interest and performance fee. Moreover, whether carried interest is taxable as capital gains or ordinary income continues to be a disputed issue. Therefore, a more thorough examination and clarifications are warranted to reduce litigation and confusion around these principles.

Although the tax department may opt to challenge the Karnataka High Court's ruling in the Supreme Court, this controversy underscores the necessity for a consistent and principled trust-based taxation system which should be immune to arbitrary changes and should only be altered with substantial justification.
