

Nangia Andersen LLP

CESTAT- VCF trust is a service provider to its contributors, confirms service tax demand





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Category - Service tax

Outcome - In favour of the Revenue

Background

The Customs, Excise and Service Tax Appellate Tribunal, Bangalore (CESTAT) in the case of ICICI Econet Internet and Technology Fund (the VCF/ the assessee) held that the VCF established as a Trust was managing the money of the investors/ contributors/ subscribers like a banking/ financial institution, which qualifies to be a taxable service. Accordingly, the levy of service tax was confirmed on the amounts retained by VCF towards expenses, and carried interest distributed to a specified class of investors. The matter has been remanded back to the adjudicating authorities for determination of gross value of taxable services, considering the availability of CENVAT credit.

Brief facts and contentions

- The assessee is a VCF established as a trust under the Indian Trusts Act, 1882 and is registered with the Securities and Exchange Board of India (SEBI). It was represented and managed by Trustees.
- To ensure that the assessee receives relevant professional and experienced advice, the Trustee appointed an Investment Manager/ Asset Management Company (IM/ AMC) to manage the assets of the VCF that charged a fee for its services. The Trustee received trusteeship fee from the VCF for its functions.
- The VCF distributed the returns on investment to various classes of contributors, after meeting operational expenses.
- The service tax authorities contended that the VCF was managing the money of the contributors/ investors/ beneficiaries, which was squarely covered under Banking and Other Financial Services. Further, the deductions in terms of various expenses, carried interest paid to class C unit holders were consideration for providing investment management services to investors, and hence, there was a liability to pay service tax.
- The assessee claimed that VCFs function as a pooling vehicle, such that several investors combine their investment into one large corpus that invests in many companies. The contributors and VCF are one and the same and that the question of VCF rendering a service to its own contributors does not arise at all, since no person can render service to self. The fact that the contributor is also the beneficiary of VCF proves 'mutuality of interest'.

CESTAT's Ruling

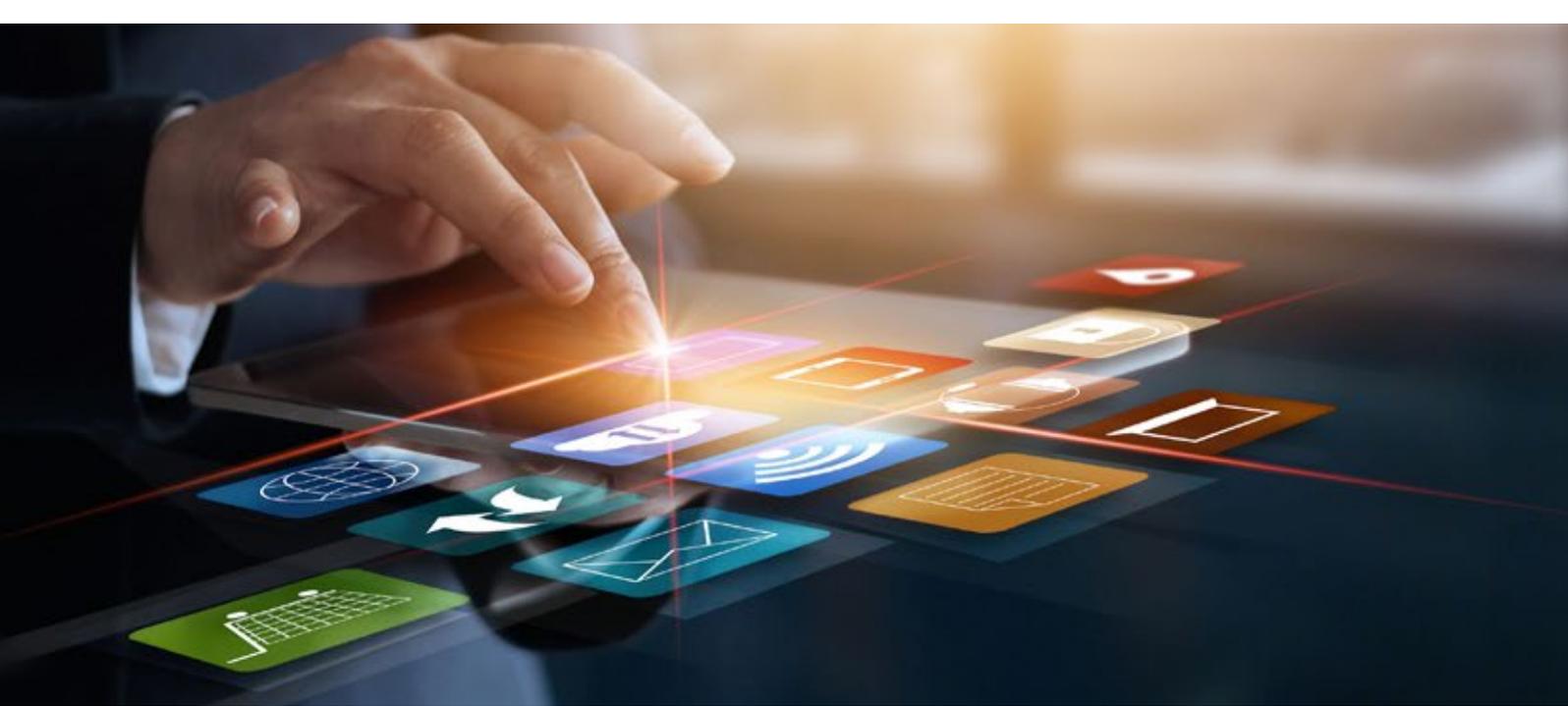
Ruling against the assessee, the CESTAT confirmed the levy of service tax. Key observations are as follows:

- The VCF had independent identity and distinct personality of its own and acted as a commercial concern. It undertook the KYC process for their contributors, thereby, indicating that they were independent of their investors.

- The Private Placement Memorandum and other scheme documents enabled the VCF to distribute dividends and other amounts to the respective unit holders. The profit motive of the fund was thus evident.
- The VCF had violated the principle of mutuality by concerning themselves in commercial activities and by using discretionary powers to benefit a certain class of investors/ nominees/employees/ subsidiaries. They can no longer be treated as trusts for the purposes of taxation statutes at least.
- The funds had been paying huge amounts to the AMCs in the form of Performance Fee and carry interest to the AMC or their nominees. Thus, as far as the distribution of dividends/ profit is concerned, the Trusts made provisions to act in a manner which is beyond the interest of the Subscribers/ Investors/ Contributors.
- The carried interest is neither interest nor return on investment, as claimed by the Appellants, but a portion of the consideration retained by the VCFs for the services they rendered to the investors and passed on, in the disguise of return on investments, to class C unit holders, i.e. the IM/ AMC
- The assessee devised the structure of the fund in such a manner that the AMC and/ or their nominees would receive huge sums of money in the guise of performance fee, carried interest, with the twin motives of benefitting the IM and/ or their nominees at the expense of the subscribers and avoiding taxes.
- Hence, the service tax demand was confirmed and the matter was remanded back to the adjudicating authorities for recalculation of gross value of taxable services, availability of CENVAT credit and cum duty benefit.

Nangia Andersen LLP's Take

The judgement may have the effect of unsettling the position that a VCF is a pooling vehicle, which does not carry out any activity. It may have a bearing on similar pooling structures as well. Additionally, the Tribunal's comments on the nature of carry interest could spark fresh litigation and may warrant documentation and review of tax position. Interestingly, in Budget 2021, a new provision has been added in the GST Act, with effect from July 1, 2017, to do away with the principle of mutuality, and to enhance the scope of 'supply'.

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