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Did Tribunal get ‘carried away’ while deciding on Carried Interest?

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Background

Recently, the Bengaluru Bench of the Customs, Excise and Service Tax Appellate Tribunal (Tribunal) passed a ruling in the case of M/S. ICICI Econet Internet And Technology Fund And Others (Trusts) Versus Commissioner Of Central Tax, Bangalore North[1]. This has unnerved the entire VCF/AIF sector, inducing a sense of panic. Rippling effects of the said ruling are expected to continue and spread around on all such structures currently operating in India.

In India, the Venture Capital Funds (VCF) and Alternative Investment Fund (AIF) work under the regulations laid down by the Securities and Exchange Board of India (SEBI). As per the SEBI regulations, VCF/AIF has to be set up in the form of a Trust, Company, Limited Liability Partnership (LLP), or a body corporate. This being the case, most of the VCFs/AIFs incorporated in India are in the form of a Trust, where contributors pool in funds for investing through the Trust and returns are distributed to the contributors as they are also beneficiaries. The scheme is such that if the return crosses a particular hurdle rate set out initially, then certain contributors, who are Investment Managers (IM) or Asset Management Company (AMC), share the incremental return with other investors. This additional return is popularly referred to as ‘carried interest.’ By relying on the principle of mutuality, the industry has adopted a position that Trust is a pass-through and not an entity distinct from its beneficiaries. It is just a mechanism through which investment is made instead of each contributor directly investing.

Tribunal’s Observations

In the said ruling, the Tribunal observed that Trusts were floated to draw subscribers/investors and facilitate them to earn profits or gains out of the acquisition, holding and subsequent disposal of assets by the Trusts. The Tribunal held that the Trust retains carried interest out of income distributable to a certain class of subscribers as a charge or fee for the Trust’s asset/investment management services to the subscribers/investors. This was concluded even though the Trust does not retain such carried interest but, in fact, distributes it to IM/AMC. Tribunal seems to have been swayed by the belief that the constitution of Trust is a façade and it’s actually engaged in commercial operations. Since the Trust has utilized its discretionary powers to benefit a specific group of investors, the principles of mutuality were breached. Thus, the veil was pierced, and demand was confirmed, upholding intention to evade tax and imposing a penalty.

Be that as it may, after the above ruling, one terminology which has emerged across is ‘carried interest.’ While the term is widespread and industry players understand its meaning, it is crucial to comprehend it further and gauge its gravity with the case at hand.

Decoding Carried Interest

The term ‘carried interest’ is not specifically defined in any of the laws. In common parlance among the industry players, ‘carried interest’ is viewed as a share of profits realized by the individual fund manager(s) from the fund's investments in return for sponsoring and managing a fund, and to create an incentive to maximize the fund's returns. Furthermore, carried interest is paid only after ensuring that all the initial capital contributed by the subscribers/investors is returned, along with the agreed-upon rate of return. In other words, carried interest is issued only if the fund performs above a designated level. If a fund does not perform as planned, then there it is not payable.

There is an ongoing debate concerning the treatment of carried interest for the purpose of taxation. The IMs like to consider this akin to an entrepreneur, who organizes other investors, identifies the opportunity and gets the investment done through a vehicle in the form of a ‘Trust.’ Hence, the return is for entrepreneurship activity and, consequently, it is profit. From an income tax perspective, it is considered as profit on the sale of units/investments and hence liable to capital gains. However, the Tribunal in the above ruling considers this to be a service by the Trust to other investors and hence held to be liable to service tax.

1. 2021 (7) TMI 216 - TRIBUNAL BANGALORE

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Tax Positions Across the Globe

As the VCF/AIF industry has expanded globally, many jurisdictions have been grappling to understand the nature and determine the correct approach for taxation. It will be relevant to further analyze how some jurisdictions have been toying around the topic in terms of tax in their respective nations.

Countries such as Japan, Canada, United States, Australia, United Kingdom and Sweden have been treating carried interest as ‘profits,’ and the applicable tax rate in these countries in respect of carried interest is lower than that of business/service income. While the topic and the current tax positioning adopted by these countries have always been clouded by doubts and controversies, the industry and business have continued to survive and prosper.

In line with the above ruling, it becomes more important for Funds and investors to revisit their agreements/arrangements and review the current entitlements received from the operations/activities carried out by such Funds. To further examine the impact of this ruling, we need to understand the nature of activities being carried out by a Trust. There are implications that could have an effect not only on past transactions (or service tax period) but also on the present and future transactions in terms of applicability of GST. In fact, for GST, the issue would be more tilted in favor of tax authorities in light of the recent amendment in the definition of the scope of supply, where the principle of mutuality does not apply to GST.

Key Takeaways

There is no doubt that the topic of levying service tax/GST on carried interest will continue to be much debated, at the level of Trust as well as for IMs and its further distribution to agents, etc. It is expected to receive traction in the form of audit, investigations, and litigation on this issue. It may take several years to get concluded and the industry to gain certainty on this. Meanwhile, the industry needs to gear up and prepare for handling audits/investigations followed by years of litigation. It would be worthwhile to review the underlying documentation to evaluate risk exposure, credit eligibility, and limitation period benefit available for the past period under service tax and GST. It may also have a spillover effect on income tax as well.

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We provide integrated, digitally driven solutions encompassing Business Consulting, Business Services, and Professional Services, that help businesses navigate challenges across all stages of their life-cycle. Through our direct operations in the USA, India, and UAE, we serve a diverse range of clients, spanning multinationals, listed companies, privately-owned companies, and family-owned businesses from over 50 countries.

Our multidisciplinary teams serve a wide range of industries, with a specific focus on healthcare, food processing, and banking and financial services. Over the last decade, we have built and leveraged capabilities across key global markets to provide transnational support to numerous clients.

From inception, our founders have propagated a culture that values professional standards and personalized service. An emphasis on collaboration and ethical conduct drives us to serve our clients with integrity while delivering high quality, innovative results. We act as partners to our clients, and take a proactive stance in understanding their needs and constraints, to provide integrated solutions. Quality at Nexdigm (SKP) is of utmost importance, and we are ISO/ISE 27001 certified for information security and ISO 9001 certified for quality management.

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