

# AIFs stare at higher tax outgo

Uncertainty on performance fee treatment can dissuade global players from setting up funds here

ASHLEY COUTINHO  
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A recent ruling by an indirect tax tribunal pertaining to alternative investment funds (AIFs) has put the industry on tenterhooks, as its interpretation of the performance fee paid to fund managers, if accepted more broadly, could result in higher tax outgo for such funds. The Customs, Excise and Service Tax Appellate Tribunal, Bengaluru, in the matter of ICICI Econet Internet and Technology Fund, 'ICICI Funds' versus Commissioner of Central Tax, has ruled that 'carried interest' or performance fee – a share of the profits on an investment paid to the investment manager if the fund's returns meet a certain threshold or hurdle rate – ought to attract service tax in the form of goods and services tax (GST) at 18 per cent.

Suppose a fund has a hurdle rate of 10 per cent and charges a carried interest of 20 per cent. If it returns 25 per cent on a corpus of ₹100 crore, it will take away ₹3 crore as carried interest (20 per cent of ₹15 crore).

Structuring the carried interest as a return on investment is a common practice in India and across the globe.

Legal and tax experts fear that if the ruling is upheld, such interest may also be reclassified as 'business income' by direct tax authorities, leading to a further tax outgo of 35-40 per cent for the fund. At present, carried interest is treated as capital gains and is taxed at 20 per cent.

The uncertainty around taxation and the significant tax outgo could potentially dissuade global general partners (GPs) from setting up such funds in India, and even prompt Indian GPs to relocate abroad. Several industry bodies, including the Indian Venture and Alternate Capital Association, are in the process of making representations to the government seeking clarity



ILLUSTRATION: BINAY SINHA

## KEY ASPECTS OF BENGALURU TRIBUNAL'S VERDICT

- Funds paying huge amounts as performance fee and carried interest to AMCs or their nominees
- Carried interest appears to be additional income to special unitholders other than pro rata income.
- Trusts are floated for drawing contributors and to help them earn profits
- Any amount retained is nothing but charge or fee for services rendered – it is gross consideration in service tax parlance
- Carried interest is neither interest nor return on investment and is a portion of consideration retained by funds for services rendered
- Fund devised structure such that AMCs and/or their nominees would get huge sums in guise of performance fee, carried interest, with motives of benefitting AMC and/or nominees at the expense of subscribers and avoiding taxes

in this regard, said people in the know.

"The ruling may undo a lot of good done by policymakers over the past few years for AIFs if it is not addressed comprehensively by the government," said Siddharth Shah, partner, Khaitan & Co. "You could take away a significant portion of carried interest in taxes which would misalign the interest of the GPs with the LPs and dissuade global GPs from setting up such funds in India."

Instead of seeing these funds as passive, pooled investment vehicles, the tribunal is seeing them as entities rendering services to investors under the GST law, added Shah.

### Different treatment

"Sebi treats these funds as pooled invest-

ment vehicles, direct tax authorities and indirect tax authorities want to treat it as entities rendering services. You cannot treat these funds differently under different laws," he said.

While the tribunal has questioned the taxability of carried interest for service tax purposes under this ruling, direct tax authorities could start treating it as business income instead of capital gains, which could add 35-40 per cent as taxes on carried interest, said experts.

Globally, carried interest is taxed as capital gains because of the risk involved, the amount of investment and the strategic value it brings.

"In case the carried interest is classified as taxable services by the service

tax or GST authorities, it will be interesting to see whether this also creates corresponding exposure under the Income Tax Act. Consequently, such carried interest may be characterised as income under the head 'profits and gains of business or profession' instead of 'capital gains', increasing the importance of structuring the carried interest suitably based on the underlying commercial necessities," said Hardik Mehta, deputy manager, Deloitte Haskins & Sells.

According to him, it will be important for the AIFs to reconsider their position of whether or not to discharge GST on carried interest until the matter is taken before the courts or some clarification is provided by the tax authorities.