PRESS MONITOR

Economic Times , Delhi
Saturday, 10th July 2021; Page: 5
Width: 25.20 cms; Height: 23.83 cms; a3r; ID: 27.2021-07-10.43

Tax Sword Hangs Over PE, VC Funds After Tribunal Ruling

Making carried interest taxable could more than double outgo if courts uphold decision

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Mumbai: A tax sword hangs precariously over all private equity (PE) houses and venture capital funds (VCFs) in India.

Money managers of these pooled investment vehicles are rattled by a tax tribunal ruling, which if upheld by higher courts, could more than double the tax on the fund manager.

A week ago, the Customs, Excise & Service Tax Appellate Tribunal, Bengaluru, has ruled that the 'carried interest' — or 'carry' in trade parlance, which is a fund's share of profits from managing investors' money — is a 'performance fee' that would attract service tax.

The ruling, which went against the appellant ICICI Econet Internet and Technology Fund, a VCF registered with Sebi, would impact the entire industry.

Funds treat carry as 'capital gains', which attract a tax of 20% as VCFs primarily invest in unlisted companies. But, if it's treated as a 'performance fee' for a 'service' provided by the manager, it would mean an outgo of 18% GST, and full income tax of over 30% on the balance amount — taking the overall tax on the manager to more than 40%.

A fund manager receives a 'management fee' — a fixed percentage irrespective of how the fund performs. It also receives a 'carried interest' which may be 20% of the share of profits if the fund performs beyond a hurdle rate.

For instance, when a ₹100-crore fund trebles the value of its investments to ₹300 crore, the profit earned is ₹200 crore and the manager earns ₹40 crore (20% of ₹200 crore). While full income tax is paid on the management fee, the tax on the carry is 20% as applicable for 'capital gain'.

The ruling by the quasi-judicial authority is being closely tracked by the VCF world and fund advisors as fund managers are driven by the money earned from 'carry'.

"Indian fund managers have been structuring the carried interest as a return on investment by tagging such returns to the redeemable units of the Fund. The said practice has been questioned in the ruling terming it actually as a service fee disguised as return on investments," said Tejesh Chitlangi, senior partner, IC Universal Legal.

"Such a ruling not only would make the carried interest payouts vulnerable to a GST levy but also as a result may potentially expose the carry returns to business income tax instead of capital gains. Since alternative investment funds (AIFs) are predominantly set up in the form of Trusts, if all such expenses incurred by the Trust are susceptible to GST, the same may also lead to increased negotiations between the AIF fund managers and investors as to who would absorb such potential levy," Chitlangi added.

According to Richie Sancheti, partner, Algo Legal, the Tribunal decision would diminish the incentives to localise India focused PE fund structures as investors do not absorb such items of tax. "However, structures based in IFSC (Gift City) should not get impacted," said Sancheti.

The ruling examined how a VCF formed as a 'Trust' performed commercial operations, rendered taxable services to its investors, and concluded that any amount retained from the distributions and paid to the fund parties was, in essence, a 'fee for the services' rendered.

"We find that the appellants (ICICI fund) have devised the structure of the fund in such a manner that the asset management company (AMC) and/or their nominees would get huge sums of money in the guise of performance fee, carried Interest, with the twin motives of benefitting the AMC and/or their nominees at the expense of the subscribers and avoiding the taxes. The fact that the AMC, Settlors and Trustees are all ICICI Group concerns would further give credence to the inference," said the ruling.

The payments made by the appellant are not in the nature of entry and exit expenses (like mutual funds) but huge amounts retained and distributed to the AMCs or their nominees subject to achieving certain levels of performance, said the Tribunal. The counsel for the ICICI fund argued that carried interest is a 'return on investment' and not a 'performance fee', and the carry is only in case of those funds where the AMC also makes an investment in the fund as a contributor. "The mere fact that AMC is also a Contributor cannot be confused to equate Carry Interest to performance fee," he said. However, upholding the view of the tax department, the tribunal said there was no doubt that the Trust was managing the funds of the contributors and thereby rendering a service to the contributors.

ICICI fund officials did not comment on the ruling.