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Service tax not leviable on recovery of expenses by a venture capital fund from contributors - Karnataka HC

22 February 2024

Summary

The Karnataka High Court (HC), while setting aside the Customs, Excise and Services Tax Appellate Tribunal (CESTAT) order, has held that the contributors and the trust cannot be treated as separate entities. The HC noted that the relevant statute in the present case is the Finance Act, which does not recognise trusts as persons for taxation purposes. Furthermore, the HC emphasised that the trust does not make any profit, nor does it provide any service to its contributors, and therefore, the imposition of service tax is not sustainable. The trusts only act as a trustee that holds money belonging to contributors to be invested as per the advice of the investment manager.

Facts of the case

- M/s. India Advantage Fund II (the appellant) is a venture capital trust. Investors contribute money to the trust fund and the same is managed by an investment manager. Pursuant to an investigation by the anti-evasion unit, it was alleged that the appellant had retained portion of the income that was meant to be distributed to the contributors, which would constitute as a service charge for the asset management. Therefore, service tax was to be levied under the category of banking and other financial services.
- A show cause notice (SCN) was issued demanding service tax on the expenses incurred by the appellant and amount paid to Class 'C' investors as return on investment.
- Later, the demand was confirmed by the commissioner.
- Aggrieved by the above, the appellant filed an appeal before the Tribunal.
- The Tribunal also upheld the demand.
- Aggrieved by the order mentioned above, the appellant filed the present writ petition before the HC.

CESTAT's observations

- The trust is managing the funds of the contributors and, thereby, is rendering a service to the contributors.
- The said service squarely falls under asset management, as applicable under banking and other financial services.
- The trust has violated the principles of mutuality.
- The remuneration is retained from the amounts that are duly distributable to the contributors.

Appellant's contentions

- The appellant contented that they were not covered under the purview of person under the Finance Act.
- They are not providing services to the contributors, and not receiving consideration from the contributors.
- The service tax is levied on the amount charged for taxable services and the same has been clarified.
- The reimbursement received by the appellant during the operation of the trust is in the capacity of an agent and the same is exempt from service tax.

Department's contentions

- Firstly, the department contended that the appeal is not maintainable before the HC, as the issue involved in the present case is of determining the rate of duty, which is appealable only before the Supreme Court.
- Also, the department contended that the appellant accepts money from the investors, makes profit by re-investing, distributes the profits to investors and retains some portion of the same to its benefit.
- The trusts are registered under the VCF regulation issued under the SEBI Act, 1992, and accordingly, the appellant is a separate legal entity.
- The doctrine of mutuality does not apply since the definition in the contribution agreements indicate a relationship between a buyer and seller, as the term used is 'Purchase of units.'

Karnataka HC's observations and judgement [C.E.A No. 20/2021, order dated 8 February 2024]

- **Settled position under law that the present appeal is maintainable before the HC:** The HC placed reliance on the decision in the case of Shriram Refrigeration Industries, wherein it was held that except an appeal involving the rate of duty, all other appeals are maintainable before the HC. Further, the HC noted that in the present case, the assessee has denied the liability to pay the service tax and there is no dispute regarding the rate of duty. Therefore, the appeal is valid.
- **Trusts are not recognised as judicial persons:** The department contended that the trust is registered under the SEBI Act, and therefore, it should be treated as a judicial person. The HC emphasised that the definition clauses of each statute must be read with the object and purpose of that statute only. Therefore, the HC noted that the relevant statute in the present case is the Finance Act, which does not recognise trusts as persons for taxation purposes.
- **Trust acts as a pass-through entity that consolidates funds from the contributors:** The HC noted that the trust do not make any profit nor does it provide any service, therefore, the imposition of service tax is not sustainable. The trust only acts as a trustee that holds money belonging to contributors to be invested as per the advice of the investment manager.
- **Doctrine of mutuality applies between the contributors and the trust:** The HC held that the contributors and the trust cannot be treated as separate entities due to the nature of the arrangement where contributors' investment is held in the trust by the fund, and it is invested as per the advice of the investment manager. Since the trust does not perform any act, hence there can be no service to itself. Therefore, the HC concluded that the doctrine of mutuality applies in the present case, as there is a commonality established between the contributors and the trust. The doctrine of mutuality means no person can transact with himself. There can be no sale or supply to self, i.e., to say that a man cannot trade with himself, or no one can make profit out of himself. Therefore, the CESTAT's order was set aside.

Our comments

Earlier, the CESTAT had held that the appellant (VCF in the form of a trust) had violated the principles of mutuality by engaging in commercial activities and were rendering service in the nature of portfolio management to the contributors. The consideration for such services was in the form of withholding the profits distributable to the contributors. Therefore, it was held that service tax is leviable on performance fee, carried interest and other expenses under the head ‘banking and other financial services’ (BOFS) defined u/s 65(105)(zm) of the Finance Act, 1994.

The present ruling is a significant and welcome ruling and provides much needed relief to the financial services industry. Even though the ruling addresses only VCF issue, it is likely to have impact on other investment collaboration arrangements.

The ruling may have widespread ramifications under GST too since similar provisions exist and the classification of carried interest had been disputed by the authorities.

It would also be interesting to watch out if the Revenue challenges the said ruling before the apex court.

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