
AN ANALYSIS OF THE IMPLICATION OF TAX LIABILITY ON VENTURE CAPITAL FUNDS

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ABSTRACT

Venture capital is a private equity financing that is provided to start-ups and other small-to-medium enterprises (SMEs) to assist them in their growth and development through funding. In this paper, an analyzation is made on the taxation on venture capital funds. The paper begins to talk about the treatment of venture capital funds under the Income tax Act by providing the history of such tax treatment since the Finance Act, 1995 and tax liability on the investor with respect to the venture capital funds. Furthermore, the paper tends to identifies whether VCF is a specific or discretionary trust and uses the same to analyse the tax implication on VCF. Finally, the paper discusses the 2021 judgement by Customs Excise and Service Tax Appellate Tribunal, Bangalore as the same imposed service tax on venture capital funds.

INTRODUCTION

Venture capital is a private equity financing that is provided to start-ups and other small-to-medium enterprises (SMEs) to assist them in their growth and development through funding. This funding is provided based on the size, assets and stages of the start-ups and SMEs. These funds are known as venture capital funds.¹ Referring to regulation 2(m) of the Securities and Exchange Board of India (Venture Capital Funds) Regulations, 1996, venture capital is defined as “a fund established in the form of a trust or a company including a body corporate and registered under this regulation which has a dedicated pool of capital; raised in a manner specified in the regulations; and invests in accordance with the regulations”.² In general, venture capital funds (hereinafter “VCFs”) are funds aggregated from multiple investors who are interested to invest in start-ups and SMEs in order to have a stake in them. Hence, apart from financing, venture capitalists also handle the risks and failures of the company.

Venture capitalists invest in companies that has the potential to grow and develop, however, risky at the same time.³ It should be noted that these venture capitalist offers advice and are sometimes members of the board of directors of the company. Hence, the VCFs are associated with the management and functioning of the start-ups and SMEs they invest in. Further, based on the stage of the company at the time of the investment, venture capital investments are classified as seed capital, early-stage capital, or expansion-stage capital. However, irrespective of the stages of investment, their functions are the same.

INCOME TAX ACT AND VENTURE CAPITAL FUNDS

The concept of VCF was originally defined in the explanation provided under clause (a) of section 10(23F) of the Income Tax, Act⁴ (hereinafter “*IT Act or Act*”) which was introduced through the Finance Act of 1995.⁵ The essentials of VCF as per this section can be mentioned in a three-fold manner: firstly, that it should be operated through a trust deed; secondly, that the money raised by the trustees should be for the purpose of investment; and lastly, that the

¹ Dr. Rajkumar B. Salgar, *Venture Capital in India: A Birds' Eye view*, 1 INT. JRNL. OF SCI'FC RES'CH 16, 16 (2012).

² Securities and Exchange Board of India (Venture Capital Funds) Regulations, 1996, Notification, S.O. 850(E), regulation 2(m).

³ *Concept of Venture Capital*, MADHAV UNIVERSITY (May 13, 2022, 18:23 PM), <https://madhavuniversity.edu.in/venture-capital.html>.

⁴ Income Tax Act, 1961, § 10(23F), No. 43, Acts of Parliament, 1961 (India) [hereinafter “*IT Act*”].

⁵ The Finance Act, 1995, § 4, No. 22, Acts of Parliament, 1995.

investment should acquire only equity shares of venture capital undertakings (hereinafter “VCU”). However, the operation of this clause was ended by the Finance Act of 1999⁶ as it introduced section 10(23FA) of the IT Act.⁷ The definition provided under the new section was similar to section 10(23F) of the IT Act,⁸ except the scope of VCU was enlarged.

In detail, the previous definition of VCU was limited to certain industries including distribution of electricity, tele-communication, etc. However, the definition of VCU under section 10(23FA) of the Act covered business of software, information technology, production of basic drugs in the pharmaceutical sector, bio-technology, agricultural and allied sector or any other sector specified by Central Government. Consequently, section 10(23FA) was also removed and was replaced by section 10(23FB).⁹ This section enlarged the definition of VCU even more by adding more industries. However, this was subsequently amended.

TAX BENEFITS FOR VENTURE CAPITAL FUNDS

According to Section 10(23FB) of the IT Act,¹⁰ any income of a VCF established to generate capital for investment was exempt from taxes and such income was considered to have complete pass through.¹¹ Pass through status essentially means that any income that a VCF receives from the company it has invested in, is exempted from tax. Unfortunately, an amendment was carried out in 2007 to limit the scope of VCF to specific sectors such as nanotechnology, information technology relating to hardware and software development, seed research and development, bio technology, research and development of new chemical entities in the pharmaceutical sector, production of bio fuels or building and operating composite hotel cum convention centre with seating capacity of more than three thousand, or engaged in the dairy industry or poultry industry. Hence, the income of VCF was exempted from tax liability only if they have invested in companies under these specific sectors. Fortunately, such sectoral limitation was removed in the Union Budget proposed in the year 2012 and currently, any

⁶ The Finance Act, 1999, § 6, No. 27, Acts of Parliament, 1999.

⁷ IT Act, *supra* note 4, § 10(23FA).

⁸ IT Act, *supra* note 4, § 10(23F).

⁹ IT Act, *supra* note 4, § 10(23FB).

¹⁰ IT Act, *supra* note 4, § 10(23FB).

¹¹ 5.0. *Tax pass through for venture capital funds*, SECURITIES AND EXCHANGE BOARD OF INDIA (May 15, 2022, 11:23 PM),

https://www.sebi.gov.in/sebi_data/commondocs/5.0.%20TAX%20PASS%20THROUGH%20FOR%20VENTURE%20CAPITAL%20FUNDS_h.html#:~:text=Drawing%20the%20same%20analogy%2C%20a,exempt%20under%20the%20income%20tax.

income of VCF is exempted from tax.¹² It should be pointed out that, although, the tax exemption applies to “any income of a VCF received from an investment made in a VCU”, the scope of VCU is not as narrow as it was before.

INVESTOR'S INCOME FROM VCF TAXABLE

From the above explanation, it is clear that VCFs are not taxed as it enjoys a tax pass-through status. However, an income of an investor received from a VCF is taxable in his hands.¹³ According to section 115U of the IT Act, ¹⁴an investor will be taxed for an income that he has received from a VCF similar to the way an investor would be taxed if he had invested in the VCU directly. Additionally, as per section 115U, statement of income has to be prepared by the VCF through Form 64 to mention how the income is distributed.¹⁵

VCF – A SPECIFIC TRUST OR DISCRETIONARY TRUST?

Although, it is clear that VCF should be set up as a trust, there is a confusion that exist in India as to whether VCF is a specific trust or a discretionary trust. A specific trust is where the shares of the beneficiaries are fixed while discretionary trust is where the trustee can determine the shares of the beneficiaries based on his discretion. It should be pointed out that the shares of the investors with regards to the assets and revenue of the VCF is determinate.¹⁶ With that in mind, it is clear that VCF is a specific trust.

In case of this specific trust, the tax liability does not differ irrespective of whether the trust discharges the fund or the beneficiaries. This is because, the income is calculated as if it is the income of the beneficiaries. Due to this, the tax authorities can either tax the trust or the beneficiaries, however, not both as it can result in double taxation. Hence, considering the fact that VCF is a specific trust and the income of the investors from the VCF is taxable in his hands, VCF enjoys a pass-through status.

¹² Key Features of Budget 2012-2013, INDIA BUDGET (May 15, 13:21 PM), <https://www.indiabudget.gov.in/budget2012-2013/ub2012-13/bh/bh1.pdf>.

¹³ M/s Scope Private Limited v. Assistant Commissioner Income Tax, Mumbai ITAT (2010).

¹⁴ IT Act, *supra* note 4, § 115U.

¹⁵ Nijal Ajinkya, *India: Tax Tribunal Upholds Tax 'Pass Through' Status Of A Venture Capital Fund*, MONDAQ (May 15, 2022, 14:24 PM), <https://www.mondaq.com/india/tax-authorities/789830/tax-tribunal-upholds-tax-pass-through39-status-of-a-venture-capital-fund>.

¹⁶ *What is a specific trust and a discretionary trust?*, MAKAAAN (May 15, 2022, 14:54 PM), <https://www.makaan.com/iq/real-estate-faqs/trust/what-is-a-specific-trust-and-a-discretionary-trust#:~:text=A%20trust%20can%20also%20be,Act%20governs%20only%20private%20trusts.>

SERVICE TAX ON VCF?

In the year of 2021, the Customs Excise and Service Tax Appellate Tribunal (CESTAT) in Bangalore issued a judgement in the case *M/s. ICICI Econet Internet and Technology Fund v. Commissioner of Central Tax* (hereinafter “ICICI case”) which has generated concern among the trust funds.¹⁷ Further, the bench has only looked at the case from the standpoint of Service Tax Law, i.e., Chapter V of the Finance Act, 1994. The main question in the case was whether the VCF established in India as a “Trust” be regarded as delivering services to the investors.

In this regard, it should be pointed out that, trusts have pass-through status under the IT Act. However, service tax laws do not have any provisions related to them.¹⁸ Contrary to this, the bench has talked about the application of service tax on VCFs and this can be provided in a three-fold manner: firstly, that the VCF is a person who is different from the investors; secondly, that the VCF provides services to investors by managing their investments; and lastly, that the amount withheld by the VCF from the net asset value calculated of the investors to cover the expenditures incurred are effectively payments deducted for the services provided.

This ruling goes against two basic principles: one is the tax implication on specific trust; the other is the doctrine of mutuality. As mentioned earlier, in a specific trust, the trustee and the beneficiary are considered two different persons to avoid double taxation. Keeping in mind that VCF is a specific trust, the same tax implication system should be followed. However, by considering the VCF, a person different from the investors is going against this basic system.

Further, with respect to the doctrine of mutuality, it can be explained with an example, a sports club offers entertainment amenities exclusively for its members. However, these members pay for the facilities and cannot claim for the shares of profit. In this scenario, if there are any surplus, that can be utilized for the development of this club. Further, keeping in mind the doctrine of mutuality, this surplus is exempt from tax liability. This is because no differentiation can be made between the funds of the club and contribution’s fund.¹⁹ Consequently, VCF being a trust enjoys the application of this doctrine. Contrary to this, in the

¹⁷ *M/s. ICICI Econet Internet and Technology Fund v. Commissioner of Central Tax*, Customs, Excise & Service Tax Appellate Tribunal Bangalore, Service Tax Appeal No. 2900 (2012).

¹⁸ The Finance Act 1994, Chapter V, No. 32, Acts of Parliament, 1994.

¹⁹ *Sports Club of Gujarat Limited v. Commissioner of Income Tax*, 2009 TMI 77939.

ICICI case, the bench has stated that the surplus is a revenue of the VCF for the services provided.

CONCLUSION

It should be noted that our tax law is not very accurate about the tax implications on the VCF. There is no specific provision available for different types of revenue of VCF. Further, why did the 2008 amendment and the current 2013 amendment limit the pass-through to only particular categories of revenue for VCFs? Isn't it easier to give a complete pass-through for such funds' whole income? Whether the tax is paid by the fund or by investors, the ultimate tax collection will remain the same. Furthermore, what was the need for imposing service tax of VCFs. This step of imposing service tax has created a gigantic confusion on whether VCFs is calculated as per the income tax Act or the service tax laws.

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