Economic Times , Delhi
Thursday, 22nd July 2021; Page: 11
Width: 23.11 cms; Height: 22.69 cms; a3r; ID: 29.2021-07-22.83

PEs, VCs Mull Recast to Get Around GST on Carry Fee

Plan non-banking buffer entity to absorb charge before passing it on to main firm; experts say tax on carry fee could lead to transfer pricing issues

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Mumbai: Top private equity (PE) and venture capital (VC) funds are a worried lot. PE and VC funds – looking to resolve the issue of indirect tax on the carry fee earned by managers – are trying to create a step-down entity that will act as a buffer to absorb the charge before passing it on to the main firm.

Carry fee is essentially a share of profit or investment that fund managers make.

Fund managers tend to earn millions in carry fees when they invest the money of PE or VC funds and also when they exit such investments.

A quick resolution of this issue is needed, tax experts say, since it could also lead to transfer pricing complications.

ET was the first to report on July 6 that a tax tribunal had held that indirect taxes were applicable on expenses incurred by VC, PE and mutual fund firms, even if they were structured as trusts. Essentially, it means expenses such as carry fees, legal fees and salaries incurred by a fund held as a trust could attract indirect tax.

The tax tribunal order was in relation to service tax under the erstwhile tax regime, but experts say the same principles apply to Goods and Services Tax (GST).

If PE and VC funds operate through an entity registered outside India, the problem becomes bigger, say tax experts.

Typically, PE and VC funds work on a "cost plus" structure in India.

This means the Indian arm charges the actual cost plus a margin.

If the tax authorities demand GST on the costs, the tax returns calculation would go haywire, experts say. This could attract transfer pricing, a tax framework that determines how costs are charged in transactions involving group entities.

Tax Trouble

Currently, no indirect tax is applicable on carry fees of PE/VC firms

Carry fee is a share of profit or investment that fund managers make

Many fear that following a recent tax ruling, taxman may demand GST on carry fees

Many firms that operate on "cost plus" models may even see transfer pricing adjustments, say tax experts

GST may become pure cost for PE/VC firms

BUFFER FIRM

So, many PE and VC firms are thinking of setting up a non-banking buffer entity.

"Banking companies receiving the services will have to reverse the credit of 50%, whereas if a non-banking company receives the same service, then there may not be any reversal when such a company renders only taxable supplies," said Abhishek Rastogi, Partner at Khaitan & Co.

If they create a non-banking step-down entity, then the GST cost could be parked there. This means they can even claim tax credit – 50% GST cost can be passed on to the investee company or limited partners, in some cases.

"The (tax tribunal) ruling has mentioned that the carried interest paid to specified class of investors would be in the nature of a performance fee, subject to the erstwhile service tax. This has the potential to trigger similar issues in the current GST regime and, hence, VC funds are evaluating the options…," said MS Mani, partner, Deloitte India.

Top fund managers have in the past earned hundreds of crores in carry fees.

If the tax ruling is applicable, not only will some of them have to cough up service tax on past transactions, they may also end up paying GST on all transactions going forward. The far-reaching implications of the ruling have made fund managers scurry to tax advisors to study its granular impact on their carry fees and fund returns, experts say.

"The global teams are really worried about creating a step-down entity, or even rocking the boat in a way that transfer pricing is triggered. Indirect tax is a domestic matter, but transfer pricing is an international tax concern for most PE and VC funds," a person who is aware of the developments said.