

VCF eligible for tax exemption on income from temporary investments in mutual funds: Mumbai ITAT

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Summary

The Income tax Act, 1961 (Act) provides¹ for exemption of income earned by a Venture Capital Fund (VCF) from investments made in a Venture Capital Undertaking subject to the VCF fulfilling the prescribed conditions² under the Act.

There has been debate on the tax exemption allowed to a VCF on income earned from temporary investments, pending deployment of funds towards the VCF's main objectives. The Mumbai bench of Income-tax Appellate Tribunal (ITAT) has, in a recent decision,³ held that temporary deployment of funds by way of investment in units of mutual funds and in debenture application money were within the ambit of the Trust Deed and VCF Regulations. Accordingly, the VCF was held to be eligible for exemption under the provisions of the Act.

Facts of the case

- The taxpayer is a trust established under the Indian Trust Act, 1882 and is registered as a VCF with the Securities and Exchange Board of India (SEBI) under the VCF Regulations.
- During Assessment Year (AY) 2014-15 the taxpayer had temporarily invested its unutilised funds in units of mutual funds and towards application money for optionally convertible debentures.

¹ Section 10(23FB) which provides exemption to any income of a venture capital company/ fund from investment in a venture capital undertaking

² Provided under Explanation (b)(A)(I) to section 10(23FB) of the Act: ie the VCF (i) operates under a trust deed, duly registered; (ii) has been granted a certificate of registration as a VCF; and (iii) is regulated by SEBI (Venture Capital Fund) Regulations, 1996 ('VCF Regulations')

³ M/s HDFC Property Fund vs ITO [ITA No. 7472/ Mum/2017]

- The tax officer denied the tax exemption on the ground that investment in units of mutual funds and in debenture application money does not qualify to be investment in VCU and is also in violation of VCF Regulations.
- The first appellate authority ruled in favour of the department. Hence, the taxpayer filed an appeal before the ITAT.

Taxpayer's contentions

- It has fulfilled all the conditions required to qualify as a VCF which is eligible for claiming exemption under the Act.
- The taxpayer relied on the decision of the Hon'ble Supreme Court⁴ to submit that it is not open for the tax officer to assume violation of VCF Regulations as long as the certificate of registration granted by SEBI is not withdrawn.
- The taxpayer submitted that it has not committed any violation of the Trust Deed, as the said Trust Deed permits temporary deployment of funds in mutual funds and in convertible debenture application money, until deployment of funds in targeted VCUs.
- Further, reference was drawn to a SEBI (Informal Guidance) Scheme 2003 in connection with the VCF Regulations which permitted SEBI registered VCFs to invest any un-invested portion of their investable funds in liquid mutual funds or in bank deposits or in such similar liquid assets till deployment as per objectives of the VCF.
- It was also highlighted that it is an industry and trade practice amongst the VCFs to make temporary investments, pending regular investments in VCUs for certain purposes, such as disbursement of expenses, distribution to unit-holders, etc.

ITAT's observation and decision

- On the perusal of the Trust Deed, it was observed that investment in units of mutual funds and in debenture application money were permissible temporary investments, pending regular investment for the stated purpose.
- The ITAT also took cognisance of the SEBI (Informal Guidance) Scheme, 2003 wherein a SEBI-registered VCF was permitted to make temporary investments in liquid funds.
- The ITAT noted that the certificate of registration issued by SEBI continued to subsist and there was no adverse action taken by the SEBI against the taxpayer for violation

⁴ Gestetner Duplicators P. Ltd vs. CIT 117 ITR 1 (SC)

of any VCF regulations. Therefore, the tax officer's opinion regarding violation of VCF Regulations was not acceptable.

- The Tribunal also found merit in taxpayer's argument that there is an industry and trade practice whereby VCFs retain certain amounts, pending regular investments in VCUs. Also, investments in the debenture application money of convertible debentures can be construed as investment in equity linked instruments, given that the debentures would ultimately be converted into equity shares and would thereby fall within the prescribed limits given under the VCF Regulations.
- In view of the above, the ITAT held that the temporary investment made by the taxpayer was permitted by its Trust Deed and was within the purview of the VCF Regulations. The taxpayer was therefore entitled to claim exemption envisaged under the Act.

Our comments

It is a welcome ruling wherein the Tribunal has examined the issue in light of the relevant provisions under the Act, applicable SEBI regulations, informal guidance issued by the SEBI, and the industry practice. This ruling should help strengthen the position adopted by VCFs during the course of their ongoing tax litigations and also help reduce future litigations on this aspect.

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