Funds Hotline

May 29, 2020

REMUNERATION RECEIVED BY SECTION 9A FUND MANAGERS NOTIFIED!

- With effect from April 01, 2019, CBDT removes the assumptions on arms' length applicable on transactions between the eligible fund and eligible fund manager under section 9A of the ITA.
- CBDT re-defines the minimum remuneration to be paid by the eligible fund to the eligible fund manager to qualify for safe harbour provisions under section 9Aof the ITA, including remuneration linked to hurdle rateif the only incentive for such manager is to receive remuneration of this nature.
- Provisions introduced for multiple eligible fund managers being appointed by the eligible fund, extending benefits of section 9A to funds with segregated portfolios/ classes.
- The amendments are expected to reduce litigation and provide certainty to eligible investment funds in relation to safe harbour provisions under section 9A.

The Central Board of Direct Taxes ("**CBDT**") amends Rule 10V of the Income-tax Rules, 1962 ("**IT Rules**") to prescribe the manner of calculation of the minimum amount of remuneration to be paid by the eligible fund to the eligible fund manager(s) to qualify for safe harbour provisions under section 9A of the Income-tax Act, 1961 ("**ITA**").[1]

Finance Act, 2015 introduced section 9A in the ITA to encourage fund management activity from India and provide safe harbour in respect of offshore funds.

Section 9A provides that in the case of an eligible investment fund, the fund management activity carried out through an eligible fund manager located in India and acting on behalf of such fund shall by itself not constitute business connection in India of the said fund.

Further, an eligible investment fund shall not be said to be resident in India merely because the eligible fund manager undertaking fund management activities on its behalf is located in India. The benefit under section 9A is available subject to fulfilment of certain conditions provided in the said section.

The Finance Act, 2019 amended one of the conditions for availing safe harbour under section 9A by removing the requirement for the eligible fund manager to receive an arm's length remuneration for performing the fund management activity and replacing it with a minimum fee to be prescribed by the CBDT.On December 5, 2019 CBDT released draft notification[2] to amend Rule 10V of the IT Rules for public comments and inputs.

In this regard, CBDT has now notified the amendment to Rule 10V through the Income-tax (10th Amendment) Rules, 2020 ("**Notification**").

AMENDMENT TO RULE 10V

The Notification discontinues certain existing sub-rules of Rule 10V regarding remuneration of eligible fund managers on or after April 01, 2019.

Correspondingly, the Notification introduces new rules on remuneration for fund managers to qualify for safe harbour under section 9A of the ITA as explained below.

In case where the eligible investment fund is a registered Category I Foreign Portfolio Investor ("**FPI**") which has obtained such registration due to its status as an endowment fund, a sovereign wealth fund, a Government, a university, an appropriately regulated entity*(banks, insurers, managers, advisers etc.)*under the relevant provisions as described in the Notification, the amount of remuneration for the eligible fund manager shall be at least 0.10% of assets under management ("**AUM**").

In other cases (i.e. other than for Category I FPIs of the kind explained above), the amount of remuneration for the eligible fund manager is required tobeat least:

1. 0.30% of AUM; or
2. 10% of profits derived by the fund in excess of the specified hurdle rate, where the fund manager is entitled only to remuneration linked to the income or profits derived by the fund; or
3. 50% of management fee, where the fee is shared with another fund manager reduced by operational expenses.

The Notification also allows for the CBDT to approve a lower remuneration to be charged if the eligible investment fund is able to satisfy CBDT.

Every eligible fund manager is required to obtain a report in Form 3CEJA (format also notified) from an accountant in

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respect of activity undertaken for the eligible investment fund. This report will be in addition to any report to be furnished by the eligible fund manager under transfer pricing provisions, to the extent applicable.

ANALYSIS

The fund management industry has not been able to take advantage of the safe harbour provisions in section 9A due to the requirements being too onerous or impractical for investment funds generally, as discussed below. The amendment to Rule 10V is one more welcome step towards moving more fund managers to take advantage ofthe safe harbour provisions under section 9A, which are currently grossly underutilised.

Typically, venture capital / private equity fund manager(s) charge up to 2% of the assets under management as management fees. From this perspective, the minimum amount of remuneration prescribed under the Notification seems feasible.

The Notification also covers fund structures where the fund manager is entitled only to remuneration linked to the income or profits derived by the fund. It is unlikely for fund managers to link their fee payment to profits derived by the fund, as management fee is a service fee charged by such managers for their investment management service; whereas, their share in any profits of the fund could be a return on the investment made by the fund manager in the fund. It is not clear whether such return will also fall within the ambit of this Notification.

The Notification also provides for fund structures where two fund managers are appointed by the eligible fund. It is common for funds to have multiple managers with segregated portfolio where each manager is managing a different set of portfolio or class for the fund.

The eligible fund has also been given the option to apply to CBDT in case the actual amount of remuneration is lower than the thresholds provided under the Notification.Replacement of the transfer pricing requirements under Rule 10V with the prescribed remuneration thresholds will also go a long way in reducing tax litigation and providing certainty to eligible funds in relation to the safe harbour provisions. Under the earlier regime remuneration to the eligible fund manager had to adhere to arms' length price, and given the lack of industry benchmark on manager remuneration being stipulated in the IT Rules, the tax authorities could challenge the arms' length price leading to disqualification of safe harbour status of the eligible fund in certain situations. The Notification alongwith the relaxations proposed to section 9A under the Union Budget 2020 should boost the utilisation of the safe harbour provisions under section 9A.[3]

While, the Notification is welcome and comes as a relief to the fund management industry, the government may also consider extending safe harbour provisions for all fund managers/ advisors of new offshore funds who are not taking treaty benefits, and are thus paying tax in India.This is more so considering the amendments made to India's tax treaties with Mauritius, Singapore and Cyprus as well as to taxation of gains made from sale of listed equity shares, whereby capital gains income earned by offshore funds on exit from India portfolio companies would be taxable in India irrespective of whether the offshore fund has a business connection in India or not. Extending the safe harbour provisions under section 9A to offshore funds which are not taking any treaty benefits and paying tax in India, may further boost section 9A safe harbour provisions.

Further, section 9A requires the eligible fund to fulfil conditions *inter-alia*with respect to having at least 25 members who are, directly or indirectly, not connected persons, limits the maximum participation interest of members in the eligible investment fund etc.It is not market standard for pooling vehicles to have a minimum of 25 investors. An investment vehicle is expected to engage in pooling and investing activity, where 'pooling' is not quantifiable as a thumb rule for different types of fund strategies).Pertinent to note that even under the Securities and Exchange Board of India (FPIs) Regulations, 2019 ("**SEBI FPI Regulations**") the requirement for funds to achieve broad-based status has been done away with and SEBI is now focusing on the source of funds and investor KYC.

Having noted the change in the SEBI FPI Regulations, the government may also consider removing conditions with respect to minimum number of investors, limits on their participation interest etc. in the offshore fund as long as the offshore funds are complying with the SEBI FPI Regulations. This will not only make the safe harbour provisions under section 9A more realistic and remove onerous conditions but will also align the provisions of ITA with the SEBI FPI Regulations.

Section 9A also requires any fund investor, along with its connected persons to not have a participation interest exceeding 10% in the fund and the aggregate participation of ten or less people along with their connected persons to be less than 50%. Similar to the requirement of minimum number of investors as stated above, a condition of this nature limits the type of funds which can take advantage of the safe harbour provisions under section 9A. It is common for the sponsor or manager to have a skin-in-the-game in the form of sponsor/ investor commitment, which in itself couldadd up to breach the restrictions.

Similarly, the condition of a fund presumed to be controlling or managing a business carried out by any entity, if the fund holds share capital or a voting power or an interest exceeding twenty six per cent of the total share capital of, or as the case may be, total voting power or total interest in, the entity, which disqualifies the fund for the safe harbour exemption seems onerous. This condition suggests that the Section 9A safe harbour does not intend to cover private equity funds within its the purview.

Overall, the prescription and finalisation of the minimum remuneration to the Indian fund manager is a welcome move, and the fund industry looks forward to some more changes which may result in a broader utilisation of the safe harbour provision.

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You can direct your queries or comments to the authors

1 Notification No G.S.R. 315(E) dated May 27, 2020.
2 CBDT Press Release [F.NO.142/15/2015-TPL], DATED December 5, 2019.
3 *Our hotline containing a detailed analysis of relaxations proposed under the Union Budget 2020 can be found here.*

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