

Funds

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INDIA BASED MANAGERS NOT TO LEAD TO TAX EXPOSURE FOR OFFSHORE FUNDS: A PROPOSAL

In a bid to encourage fund managers to operate from India, the Indian Government has now sought to clarify that activities undertaken and services provided by fund managers to offshore funds would not constitute a 'business connection' or result in a 'permanent establishment' of an offshore fund (or its investors) being constituted in India.

The proposed safe harbor from domestic taxation for offshore funds would follow the precedents in UK and other jurisdictions. UK allows *investment manager exemptions* to offshore funds from having a taxable presence in respect of certain types of investment transactions which may otherwise be considered to constitute trading in the UK through an investment manager.

A circular is expected to be issued by the Central Board of Direct Taxes ("CBDT") based on the recommendations by the Finance Minister to this effect. Such a clarification would be extremely welcome for the fund management industry and could help to establish India as a centre for fund management.

BACKGROUND

What constitutes permanent establishment. Management teams for India focused offshore funds are typically based outside India as an onshore fund manager enhances the risk of the fund being perceived as having a permanent establishment ("PE") in India. Although tax treaties provide for the concept of a PE in Article 5 (as derived from the Organisation for Economic Co-operation and Development ("OECD") and United Nations ("UN") Model Convention), the expression has not been exhaustively defined anywhere. The Andhra Pradesh High Court, in *CIT v. Visakhapatnam Port Trust* (144 ITR 146), held that:

"The words "permanent establishment" postulate the existence of a substantial element of an enduring or permanent nature of a foreign enterprise in another country which can be attributed to a fixed place of business in that country. It should be of such a nature that it would amount to a virtual projection of the foreign enterprise of one country into the soil of another country."

The presence of the manager in India could be construed as a place of management of the offshore fund and thus the manager could be held to constitute a permanent establishment. Consequently, the profits of the offshore fund to the extent attributable to the permanent establishment, may be subject to additional tax in India.

What tantamount to business connection in the context of an offshore fund? 'Business connection' is the Indian domestic tax law equivalent of the concept of PE under a tax treaty scenario. The term business connection, however, is much wider. The term has been provided as an inclusive definition per Explanation 2 to Section 9(1)(i) of the Income tax Act, 1961 ("ITA"), whereby a 'business connection' shall be constituted if any business activity is carried out through a person who (acting on behalf of the non-resident) has and habitually exercises in India and has the authority to conclude contracts on behalf of the non-resident. Thus, the legislative intent suggests that (in absence of a tax treaty between India and the jurisdiction in which the offshore fund has been set up) under the business connection rule, an India based fund manager may be identified as a 'business connection' for the concerned offshore fund.

It is important to note that the phrase 'business connection' is incapable of exhaustive enumeration, given that the ITA provides an explanatory meaning of the term which has been defined inclusively. A close financial association between a resident and a non-resident entity may result in a business connection for the latter in India.¹ The terms of mandate and the nature of activities of a fund manager are such that they can be construed as being connected with the business activity of the offshore fund in India.

Accordingly, offshore funds did not typically retain fund managers based in India when a very real possibility existed that the fund manager could be perceived as a PE or a business connection for the fund in India. Instead, many fund managers that manage India focused offshore funds, tend to be based outside India and only have an advisory relationship in India that provide recommendatory services.

ANALYSIS

It is anticipated that CBDT will issue a clarification that activities undertaken and services provided by fund managers do not constitute a business connection between the fund manager and the offshore fund or the investors in such fund, nor create a PE of such fund or its investors in India.

Globally, fund investors ('LPs') prefer management teams that are closer to the asset for both investment identification and preservation of value. The above CBDT clarification should provide much needed relief in addressing such structuring concerns.

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Fund management requires management of assets and risks. From a transfer pricing perspective, a higher income allocation may be sought by the tax authority in respect of the Indian entity carrying out management activities.

Another concern arises from the perspective of the general anti-avoidance regulations ("GAAR") which comes into effect on April 1, 2016. These provisions empower the tax authorities to declare any arrangement as an "impermissible avoidance arrangement" provided the arrangement has been entered into with the main purpose being that of obtaining a tax benefit and involve arrangements that lack or are deemed to lack commercial substance. The tax authorities may deny tax benefits even if conferred under a tax treaty, in case of an impermissible avoidance arrangement.

The presence of the management team in a particular jurisdiction, adds to the justification of why the fund was set up in such jurisdiction from a commercial substance perspective. This contention may not be available if the fund manager is based in India.

CONCLUSION

The CBDT clarification as and when issued, shall be a paradigm shift for the Indian fund management industry and would encourage high-value-ended fund management activities being carried out from India. It is relevant to note that India will follow in the footsteps of other countries who have already adopted a similar regime such as the United Kingdom, Singapore, Hong Kong, United States and New Zealand. The exemptions typically provide a 'safe-harbour' to prevent offshore funds from having a taxable presence (in the nature of either PE or business connection) in respect of certain identified types of investment transactions.²

In the Indian context, certain issues however remain. We will need to wait and watch for the actual text of the circular and see if issues relating to GAAR / entitlement to treaty benefits are addressed. Further, while the offshore fund may be insulated as a result of the proposed circular, issues relating to transfer pricing and management fees may still need to be addressed.

Until the tax and regulatory regimes are aligned to make India an attractive jurisdiction for pooling capital, management teams for India focused offshore funds may continue to operate from abroad.

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You can direct your queries or comments to the authors

¹ *CIT v. Bombay Trust Corpn*, 4 ITC 442.

² See Review of an Investment Manager Regime as it relates to foreign managed funds, Board of Taxation - Australian Government, available at http://www.taxboard.gov.au/content/Content.aspx?doc=reviews_and_consultations/collective_investment_vehicles/report/html/Appendix_B_and_C.htm (last visited on September 14, 2013).

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