

Corpsec Hotline

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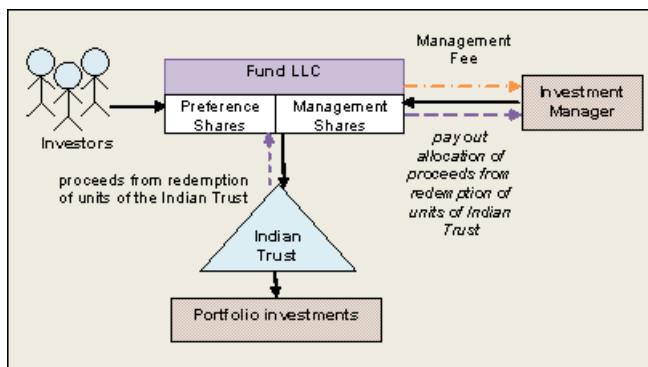
TAXATION OF CARRIED INTEREST: RECENT MAURITIUS RULING CREATES UNNECESSARY FLUTTER IN FUND INDUSTRY

The Mauritian Revenue Authority ('MRA') has recently created flutter in the venture capital and private equity industry by holding that distributions of carried interest by a Mauritius based investment fund to its Mauritius based investment manager would be subject to tax as ordinary income arising from rendition of management / advisory services by the investment manager and not as tax exempt capital gain income. Our hotline analyses this ruling in detail and seeks to shed light on what the ruling is about.

Background

The facts involve a unified structure with a Mauritius based fund ("Fund") subscribing to the units of an Indian trust ("Indian Trust"). The investment manager to the Fund ("Investment Manager") provides investment advisory services to the Fund, in lieu of which it receives fixed advisory or management fees. In addition, the Investment Manager is also entitled to receive a variable element ("Carried Interest") alongside the investors in accordance with the distribution waterfall which sets out how the proceeds from sale of investments would be allocated between the investors and the Investment Manager.

The Fund has issued only two classes of shares – 'Preference Shares' for investors committing to the Fund and 'Management Shares' for management of the Fund. The Management Shares that are issued to the Fund's Mauritius based Investment Manager for a nominal amount of US\$ 10, are disentitled from receiving dividends.



Query before the MRA

The Fund received distributions from the redemption of the units of the Indian Trust. In accordance with the distribution waterfall, the Investment Manager was entitled to receive Carried Interest on such distributions, and the question was whether allocation of the redemption proceeds of the units of the Indian Trust to the Investment Manager could be regarded as capital gain income exempt from tax in Mauritius.

The Ruling

The MRA held that since the Management Shares as such were disentitled from receiving dividends from the Fund, the income could not be held to be capital in nature and should necessarily be regarded as remuneration for advisory and management services rendered by the Investment Manager.

Analysis

In the instant case, the structuring of the carried interest entitlement had been done by way of a payout made to the Investment Manager. The fact that the Investment Manager was holding Management Shares could not change the characterization of the income paid to the Investment Manager. It may be noted that such management shares issued are typically irredeemable and do not carry any entitlement to dividend distributions of the fund entity. Accordingly, no distributions can be made on such shares and neither can such shares be redeemed for the purposes of distribution of carried interest. Since the carried interest in such a situation is distributed as performance fees paid to the investment manager, such an amount should be regarded as ordinary income of the investment manager. It may be relevant to note that a deemed foreign tax credit may be available lowering the tax rate to 3% in Mauritius on such income. Hence, in the current case, since the Investment Manager was paid a performance fee for distribution of carried interest, no capital gains tax exemption was made available to the Investment Manager.

This ruling should not have an impact on structures whereby the investment manager subscribes to a separate class of shares of the fund entity and distributions of carried interest are made by way of redemption of such shares. Many a times, the investment manager may also make a contribution to the concerned fund whereby it may be eligible to

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receive return as well as carried interest payments on account of its investment into the fund.

Conclusion

The ruling by MRA seems to be in order having regard to the particular facts of the case. However, there should be no impact of the ruling in cases where the facts or the structure is different for example when income is distributed by way of redemption of shares issued to the investment manager.

- **Richie Sancheti & Parul Jain**

You can direct your queries or comments to the authors

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