CBDT Notification – Amendment to rules with respect to business connection of offshore funds

Background

The Finance Act, 2015 introduced a separate regime for an offshore fund with respect to the business connection in India. The memorandum explaining the provisions of the Finance Bill, 2015 states that under Section 9 read with Section 6 of the Income-tax Act, 1961 (the Act) the presence of a fund manager in India may create sufficient nexus of the offshore fund in India and may constitute a business connection in India even though the fund manager may be an independent person. Similarly, if the fund manager located in India undertakes fund management activity in respect of investments outside India for an offshore fund, the profits made by the fund from such investments may be liable to be taxed in India due to the location of fund manager in India and attribution of such profits to the activity of the fund manager undertaken on behalf of the offshore fund. Therefore, apart from taxation of income received by the fund manager as fees for fund management activity, income of offshore fund from investments made in countries outside India may also get taxed in India due to such fund management activity undertaken in, and from, India constituting a business connection. Further, the presence of the fund manager under certain circumstances may lead to the offshore fund being held to be resident in India on the basis of its control and management being in India.

There are a large number of fund managers who are of Indian origin and are managing the investment of offshore funds in various countries. These persons are not locating in India due to the above tax consequence in respect of income from the investments of offshore funds made in other jurisdictions.

In order to facilitate location of fund managers of offshore funds in India, a specific regime has been introduced in the Act in line with international best practices with the objective that, subject to fulfillment of certain conditions by the fund and the fund manager:

- In the case of an eligible investment fund, the fund management activity carried out through an eligible fund manager acting on behalf of such fund shall 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 situated in India.

Subsequently, Rule 10V has been introduced in the Income-tax Rules, 1962 (the Rules). It has been introduced with effect from 15 March 2016 to provide that where the investment in the fund has been made directly by an institutional entity, the number of members and participation interest in the fund shall be determined by looking through the said entity, subject to certain conditions.

1 Section 9A has been introduced by the Finance Act, 2015 with effect from 1 April 2016
CBDT Notification

Recently, the Central Board of Direct Taxes (CBDT) has issued a Notification\(^2\) amending Rule 10V of the Rules with respect to the business connection of offshore funds. The following table indicates the existing provisions and amendments made in Rule 10V of the Rules:

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<th>Existing provision</th>
<th>Amendment</th>
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<td>Rule 10V(C) of the Rules provides that where the investment in the fund has been made directly by an institutional entity, the number of members and participation interest in the fund shall be determined by looking through the said entity if it is resident of a country or specified territory with which an agreement referred to in Section 90(1) or 90A(1) has been entered into.</td>
<td>In this provision, after the words ‘has been entered into’, the words ‘or is established or incorporated or registered in a country or a specified territory notified by the Central Government in this behalf’ shall be inserted. This provision shall come into effect from the date of their publication in the Official Gazette.</td>
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Section 9A(4) of the Income-tax Act, 1961 (the Act) provides that the eligible fund manager in respect of an eligible investment fund, means a person who is engaged in the activity of fund management and fulfills the following conditions namely:- (a) the person is not an employee of the eligible fund or a connected person of the fund; (b)...... (c)...... (d)...... | For the purpose of this clause, a fund manager shall not be considered to be a connected person of the fund merely for the reason that the fund manager is undertaking fund management activity of the said fund. This provision shall be effective from 15 March 2016. |

Section 9A(4) of the Act provides that the eligible fund manager in respect of an eligible investment fund, means a person who is engaged in the activity of fund management and fulfills the following conditions namely:- (a)...... (b)...... (c)...... (d) the person along with his connected persons shall not be entitled, directly or indirectly, to more than twenty per cent of the profits accruing or arising to the eligible investment fund from the transaction carried out by the fund through the fund manager. | For the purposes of this clause, any remuneration paid to the fund manager by the fund, which is in the nature of fixed charge and not dependent on the income or profits derived by the fund from the fund management activity undertaken by the fund manager shall not be included in the profits referred to in the said clause, if the conditions specified in Section 9A(3)(m)\(^3\) of the Act are satisfied, and such fixed charge has been agreed by the fund manager in writing at the beginning of the relevant fund management activity. This provision shall be effective from 15 March 2016. |

Our comments

The CBDT Notification clarifying certain conditions of the eligible fund manager is a welcome move. The clarification will provide relaxations to meet the eligibility norms vis-à-vis fund and fund manager being an unconnected person. Further, the exclusion of fixed fees from the ambit of 20 per cent profit sharing cap will provide relaxation as generally in most funds, profit sharing ratio (i.e. ‘carry share’) is over and above the fixed management fees. Whilst the recent clarification by CBDT is a welcome move, further relaxations in the eligibility criteria shall enable the ‘Safe Harbour’ provisions to achieve the desired outcome.

\(^2\) Notification No. 106/2016, dated 21 November 2016 – Taxmann.com
\(^3\) The remuneration paid by fund to an eligible fund manager in respect of fund management activity undertaken by him on its behalf is not less than the arm’s length price of the said activity.