Structuring Funds for Investment in India: Maximizing Tax Efficiency for U.S. Investors

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Introduction

The typical private equity model seeks to return capital and profits to investors with little to no entity or investment-level taxation, leaving potential tax drag, if any, at the investor level. In practice and in line with a global tax paradigm where capital gains are generally sourced to the residency of the investor, this means that tax on the exit of a portfolio company is generally imposed exclusively by the jurisdiction in which the investor is resident and not by the jurisdiction in which the portfolio company is located. Where local tax rules do not follow this paradigm, income tax treaties may reduce or eliminate local capital gains taxes, or to provide a credit for local capital gains taxes against taxes imposed by the investor's home jurisdiction.

Investing in a manner that reduces or eliminates local taxes is crucial to enhancing returns to tax-exempt investors, as they make up a large portion of the investors that seek exposure to emerging market funds and, very generally, they are not subject to taxation in their home jurisdictions. In addition, for taxable investors reducing or eliminating local taxes may simplify tax reporting requirements in their jurisdictions of residence and limit the chance for "tax leakage" where the local tax rate exceeds the home tax rate or less than all of the local taxes are creditable.

In the case of India-focused investment platforms, fund sponsors often domicile their funds in Mauritius, where until recently they sought to avail themselves, among other potential benefits, of an exemption of Indian capital gains tax on disposition gains realized on a transfer of shares by a Mauritius resident fund under the India-Mauritius tax treaty. Effective as of April 1, 2017, subject to a transition period, the India-Mauritius tax treaty no longer provides for exemption from such Indian capital gains tax.[1]

The remainder of this article will discuss certain aspects of the current Indian tax regime that applies to capital gains, and the structuring of India-focused private equity funds in a manner that is intended to increase tax efficiency for U.S. tax-exempt and U.S. taxable investors.

Disposition Gains under the India-Mauritius Tax Treaty and Indian Domestic Law

In May 2016, India and Mauritius signed a Protocol that amended the India-Mauritius tax treaty. Under the Protocol, Indian capital gains tax generally applies to gains arising from the alienation of shares acquired on or after April 1, 2017. For this purpose, alienation generally includes any sale, exchange, buy-back or other taxable disposition of shares by a Mauritius resident fund. There is a phase-in for the imposition of the Indian capital gains tax, where gains from shares

1. In addition, effective as of the same date, a mirroring exemption that was set forth in the India-Singapore tax treaty for Singapore resident funds is equally phased out. The considerations discussed in this article with respect to Mauritius-based private equity funds also apply to Singapore-based private equity funds.

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disposed of prior to April 1, 2019 will be subject to tax at 50% of the Indian tax rate; thereafter, gains from share dispositions will be subject to full Indian tax under the domestic rules of Indian taxation.[2] Indian tax advisors should be consulted regarding the structuring of investments and the potential to claim other benefits under Indian tax treaties and/or to reduce or eliminate the amount of Indian tax due.

Absent the benefit of an income tax treaty, under Indian domestic law, the applicable capital gains tax rate for Mauritius resident funds with a long-only investment strategy is determined by reference to, among others, the holding period in such shares and the manner by which the shares are sold (over-the-counter versus on an exchange). The standard tax rate for long-term capital gains realized on unlisted shares (24-month holding period) or shares listed on an exchange (12-month holding period) is currently 10%. In the case of a sale of listed shares on an exchange with respect to which the Indian securities transaction tax (STT) was paid, long-term capital gains realized are exempt from Indian capital gains taxation. In the case of short-term capital gains realized, the tax rate is generally 40%, but a reduced rate may apply for such gains realized on listed shares with respect to which STT was paid. In addition, certain surcharges may apply.

India Investment Fund Structures from a U.S. Tax Perspective

India-focused private equity funds or feeders domiciled in Mauritius (which are referred to as "offshore" funds from an Indian point of view, since they are generally managed and controlled outside of India) are generally structured as private limited companies denominated with share capital that are "hybrid" vehicles for U.S. tax purposes. As a hybrid, the offshore fund is treated as a corporation for Mauritius and Indian tax purposes (and the tax purposes of other jurisdictions), but intended to be treated as a partnership for U.S. tax purposes.[3] The treatment of the offshore fund as a partnership for such purposes is effected by its filing an entity classification (or so-called "check the box") election on Form 8832 with the U.S. Internal Revenue Service (IRS). The hybrid structure provides U.S. taxable investors with a "pass-through" investment structure, which is generally the most tax-efficient structure for them.[4]

Sponsors of India-focused private equity funds should note that establishing a fund or feeder as a Mauritius company likely precludes their upper-tier investors from claiming any Indian tax treaty benefits that they otherwise would have been able to claim in their own right. This is because any disposition gains or other income realized by the fund will not be considered realized by such investors for purposes of determining whether a treaty claim is available (i.e., they are not the beneficial owner of such income for tax purposes). This potential detriment is of little practical relevance, however, unless the tax treaty between India and the jurisdiction of residence of the investor provides a more beneficial outcome than the treatment that applies to the offshore feeder under Indian domestic law. For instance, the India-U.S. tax treaty does not provide any benefit with respect to disposition gains realized in a standard investment fund context.

More recently, offshore funds have preferred investing through an Indian trust or partnership (the "onshore" fund), which serves as a master fund that is generally fiscally transparent from an Indian tax perspective and directly invests in Indian portfolio companies. The onshore fund, in addition to having the offshore fund as an investor, is generally structured as the investment vehicle for Indian resident investors, and as the vehicle through which affiliates of the fund sponsor receive their incentive or performance compensation (also known as "carried interest"). By structuring the performance compensation as a profits interest from an onshore Indian entity that is fiscally transparent for Indian tax purposes, rather than as a fee or through a share class in an offshore entity, fund sponsor affiliates expect to receive certain preferential tax treatment under Indian tax law. This position is generally consistent with

2. While beyond the scope of this article, since the Protocol under the India-Mauritius tax treaty only applies to shares, we note that certain equity trading strategies via swaps or other derivatives (e.g., an option or forward contract), may potentially continue to be eligible for exemption from Indian taxation under the India-Mauritius tax treaty depending on all facts and circumstances involved.
3. The Mauritius fund would need to monitor certain transfers of direct or indirect equity interests to avoid becoming subject to certain "publicly traded partnership" rules, which, very generally, may cause partnerships to be treated as corporations solely for U.S. tax purposes. So long as transfers of interests in the offshore fund are subject to market-standard restrictions, and transfers are not recognized by the fund except with sponsor consent, however, this risk should be remote.
4. A Mauritius fund generally also insulates non-Indian investors against the risk that potential Indian tax filing requirements apply as a result of underlying investments in Indian portfolio companies. Certain exceptions may apply, such as on transfer or redemption.

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the preference of non-corporate U.S. taxable investors investing in a fund structured as a partnership for U.S. tax purposes, because it avoids limitations as to deductibility that would apply if the compensation is instead structured as an incentive fee. For U.S. tax purposes, the onshore fund is generally classified as a partnership and, as a precautionary measure, it typically also files an entity classification election on IRS Form 8832 to confirm such classification.

Through this single or double layer "partnership" structure, disposition gains realized in respect of shares of Indian portfolio companies (and dividends and interest, if any, paid by such portfolio companies), will pass through the onshore and offshore funds to U.S. investors for U.S. tax purposes. At the same time, the offshore fund will serve as a "blocker" that insulates U.S. investors from certain Indian tax consequences, meaning that the offshore fund will be the person that, among others, potentially makes a claim for benefits under the India-Mauritius tax treaty, files certain tax returns with (and, if necessary, remits taxes to) the Indian tax authorities, and generally would be the subject of any Indian tax audit.

Key U.S. Tax Considerations for U.S. Investors

The considerations for U.S. investors generally fall into one of two categories: U.S. tax-exempt versus U.S. taxable investors. The key U.S. tax considerations for each of these categories of investors are described below.

U.S. Tax-Exempt Investors – UDFI Taxation

U.S. tax-exempt investors typically include university endowments, charitable foundations and pension plans. These investors are generally exempt from U.S. tax on their investment income, such as dividends, interest and capital gains. However, if investment income is earned on a leveraged basis—either through direct borrowing by the U.S. tax-exempt investor or on a pass-through basis by partnerships in which the U.S. tax-exempt investor invests—then under the U.S. "unrelated debt-financed income" or UDFI rules, the U.S. tax-exempt investor generally will be subject to U.S. corporate taxation (generally at the rate of 35%, increased with potential state and local taxes) and filing requirements on the proportion of its income that is treated as leveraged.[5] For example, if 50% of the U.S. tax-exempt investor's investment was acquired with the use of borrowed funds, then 50% of the gains on the investment would be subject to U.S. corporate taxation and the remaining 50% would continue to be exempt from U.S. tax. In addition, the CFC and PFIC rules, each described below, do not apply to U.S. tax-exempt investors unless they debt-finance their investment.

In a typical private equity investment fund structure, including in the case of India-focused private equity funds, portfolio companies are oftentimes not acquired with leverage at the fund (i.e., offshore or onshore fund) level.[6] Borrowing, if any, is generally undertaken at the portfolio company level. Portfolio companies, especially in the India market, are formed as companies under local law (and generally do not make check-the-box elections to be classified as pass-through entities for U.S. tax purposes). As a result, U.S. tax-exempt investors are not expected to recognize UDFI and are therefore not expected to be subject to U.S. tax on their profits, even if those profits were generated in part through leverage in the manner described above. That being said, U.S. tax-exempt investors will nonetheless bear the economic burden of any taxes imposed

5. U.S. tax-exempt investors are also subject to U.S. taxation on so-called "unrelated business taxable income" (UBTI) which may arise in case of an investment in a U.S. or non-U.S. operating company that is treated as fiscally transparent for U.S. tax purposes. However, in case of a fund focusing on a standard Indian equity strategy making investments in portfolio companies formed as public or private limited companies, UBTI issuesare generally not expected to arise.
6. It should also be noted that private equity funds typically take the view that certain types of short-term leverage (e.g., to finance partnership expenses or bridge capital call notices) do not give rise to UDFI.

at the level of the offshore fund or lower in the fund structure, including any Indian capital gains taxes imposed on the offshore fund and not eliminated or reduced under the India-Mauritius tax treaty. As a result, the Indian capital gains tax would constitute an additional cost of making the investment and reduce the expected return to U.S. tax-exempt investors.

U.S. Taxable Investors – Tax Rates and Credits

U.S. taxable investors in Indian private equity funds are generally individuals and taxable trusts or estates, and can from time to time include U.S. corporations such as insurance companies. U.S. individuals and taxable trusts and estates are subject to the same tax rates, which under current law are up to 43.4% for ordinary income (interest and certain nonqualified dividends and capital gains realized on shares held for one year or less (short-term capital gains)) and 23.8% on capital gains realized on shares held for more than one year (long-term capital gains) and dividends that are eligible for preferential treatment under the "qualified dividend income" rules. U.S. corporations are subject to the same rate of tax (generally 35%) on both ordinary income and capital gains (whether short-term or long-term). State or local taxes may also apply. Individual U.S. taxable investors are unable to claim foreign tax credits (FTCs) for entity-level taxes paid by a corporation in which they are invested, which would generally include any Indian portfolio companies formed as public or private limited companies (certain corporate U.S. taxable investors are eligible to claim FTCs for local taxes paid by companies from which they receive dividends). However, subject to limitations and exceptions, all U.S. taxable investors are permitted to claim an FTC against their U.S. tax liability for taxes paid to local jurisdictions, provided that such taxes are directly or indirectly incurred through a pass-through entity and are attributable to income treated as "foreign source" for U.S. tax purposes. (Very generally, under a mechanical rule the U.S. tax liability that can be offset is determined by reference to the ratio that the U.S. investor's foreign-source income has over its worldwide income). Therefore, in the case of an India-focused private equity fund, dividends and interest paid by Indian companies should constitute foreign source income and any Indian withholding tax incurred with respect to such income should generally give rise to an FTC. On the other hand, capital gains realized by such investors are considered to be from U.S. sources for this purpose (and the distinction listed versus unlisted shares, or a long or short-term holding period is irrelevant in this regard). Therefore, U.S. taxable investors are generally unable to claim an FTC with respect to the Indian capital gains taxes described above that may apply upon exit by the private equity fund, unless they also realize other income from foreign sources (which may be from sources unrelated to the private equity fund). In addition, the India-U.S. tax treaty does not provide any additional relief in this regard (i.e., it does not cause disposition gains to be resourced for purposes of determining the availability of an FTC).

U.S. Taxable Investors – CFC and PFIC Regimes

In addition, when investing outside of the United States, U.S. taxable investors may be subject to the U.S. "controlled foreign corporation" (CFC) and "passive foreign investment company" (PFIC) rules. The CFC and PFIC rules, very generally, are intended to dissuade U.S. taxpayers from moving capital offshore to non-U.S. corporations where those non-U.S. corporations make investments in passive assets (including interest- and dividend-generating financial instruments) that could be made directly from the United States.

Under the CFC rules, if one or more U.S. persons that own 10% or more of the voting power of a non-U.S. corporation together own more than 50% of the voting power or value of an entity treated as a non-U.S. corporation, then the non-U.S. corporation will be treated as a CFC with respect to such 10% U.S. shareholders. As a result, each such 10% U.S. shareholder will be required to include in income, on a current basis, for U.S. tax purposes its *pro rata* share of the CFC's "subpart F income," which includes dividends, interest and capital gains, for the year, and a portion of its long-term capital gains attributable to non-subpart F accumulated earnings and profits may be subject to ordinary income tax rates. 10% U.S. shareholders of, as well as certain other U.S. persons involved with, non-U.S. corporations are required to provide information annually regarding the corporation on IRS Form 5471, as well as to report their subpart F income on IRS Form 5471 with their annual U.S. tax filings.

Under the PFIC rules, which can apply only to investors with respect to whom the CFC rules do not apply, if a non-U.S. corporation has 75% or more passive income (for example, interest, dividends or capital gains) or holds 50% or more of its assets for the production of passive income, then the non-U.S. corporation will be treated as a PFIC with respect to all relevant U.S. taxable investors, regardless of the size of shareholding and amount of voting power (or lack thereof). If a U.S. taxable investor is invested in a PFIC, then, very generally, it can elect to (i) defer U.S. taxation until it actually disposes of its shares, at which time it will pay taxes at ordinary income rather than long-term capital gains rates, plus an interest charge (the "excess inclusion" regime), or (ii) make a "qualified electing fund" (QEF) election with respect to the PFIC (and any lower-tier PFIC owned by the PFIC), which will require the U.S. taxable investor to take into account its *pro* *rata* share of all of the PFIC's earnings and profits for the year, but continue to recognize long-term capital gains on the disposition of shares (the QEF regime). U.S. taxable investors that hold a direct or indirect interest in a PFIC are required to report annually certain information regarding their ownership of the PFIC on IRS Form 8621. U.S. taxable persons that make a QEF election are required to obtain a PFIC annual information statement, as prescribed in the applicable U.S. regulations, from each non-U.S. corporation with respect to which an election is being made and to make/maintain such election, and to take into account its *pro rata* share of the PFIC's earnings and profits, on an annual basis on IRS Form 8621. The CFC and PFIC filings, and in particular the making of the QEF election, are made by the first U.S. person (individual, corporation, partnership or taxable trust) in the chain of ownership above the offshore fund, and under certain circumstances duplicate filings may be required.

Even if CFC and PFIC filings are not required, certain U.S. persons transferring money offshore or investing in foreign partnerships and corporations may be required to file information reports with the IRS, including on IRS Form 926 and IRS Form 8865, among others.

In the context of an India-focused private equity fund, investment in the upper-tier fund entities themselves (namely the offshore fund and the onshore fund, and any other entity within the chain of entities holding shares in the portfolio company) will not be subject to the CFC or PFIC rules, so long as those entities are treated as pass-through entities for U.S. tax purposes. However, the underlying portfolio companies may qualify as CFCs or PFICs with respect to U.S. taxable investors, and their status as such will generally need to be tested on an annual basis with respect to each portfolio company (and certain subsidiaries owned by each portfolio company). In general, Indian portfolio companies held by a private equity fund structured as an offshore fund in Mauritius tend not to be CFCs (given the diversity of ownership within the private equity fund). Even if they qualify as CFCs, their income generally constitutes "active" income from sales or services within India, or is otherwise not treated as a subpart F income. This renders the application of the CFC income inclusion rules without practical effect. Further, if a portfolio company is a CFC, then gain recognized on the disposition of the portfolio company may be recharacterized as dividends for U.S. tax purposes and taxed, in part, at ordinary income rates unless they are treated as qualified dividends by reference to the U.S.-India tax treaty and certain other conditions are met.

Similarly, Indian portfolio companies, as operating companies, tend not to be PFICs, although the application of a "passive assets" test under the PFIC rules and the per se treatment of cash on hand as a passive asset may render an otherwise active Indian operating company as a PFIC. As a result, U.S. taxable investors investing in an India-focused private equity fund should be mindful of the potential application to them of the CFC and PFIC rules. In this regard, they should ensure that the offshore fund and India-based manager are aware of the potential application of these rules, have procedures in place to monitor the circumstances under which these rules may apply and to provide U.S. taxable investors with the information that they require in order to comply with the rules and properly report their income. Commitments regarding CFC and PFIC monitoring, and the provision of information of related information, are generally obtained through side letters with the offshore fund or the fund sponsor.

Conclusion

Structuring investments to increase tax efficiency has always been a difficult task for funds with a diverse investor base and involves the consideration of multiple tax rules as they apply in varying circumstances. In the cross-border context, this task becomes even more challenging. In the case of an India-focused private equity fund, fund sponsors and their U.S. tax advisors will need to monitor closely Indian tax developments imposed on investment income/gains, as well as the tax status of each portfolio company within the platform for U.S. tax purposes. Special consideration also should be given to the rate at which Indian tax is imposed, as FTCs may not be available to be utilized by U.S. taxable investors, and U.S. tax-exempt investors would likely experience any Indian tax as a non-creditable/non-deductible investment expense.

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