

Funds Hotline

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PERSONAL WEALTH PLANNING IMPORTANT FOR CARRIED INTEREST

In 2007, the chief executive officer of a large US private equity fund racked up a bill of \$3-5 million in throwing a lavish 60th birthday party. Some months later, two US senators introduced a Bill, also referred to as the 'Birthday Party' Bill, with respect to tax on carried interest ('carry') earned by fund managers.

Ever since, carried interest has become a thorny issue that fund managers in developed economies have been grappling with. (In simple terms, carried interest is a general partner's share in a fund's profits. This is paid over and above the management fee.)

Given that a substantial number of private equity investments in India were made during 2006-09, and which would be ripe for exits in the near future resulting in potential carried interest distributions to the fund managers, it is a suitable time to take a relook at carried interest structures set up earlier by fund managers focused on investing in India.

Carried interest is also a perfect candidate for estate planning since over a period of time, it usually forms a major part of net worth of fund managers.

Most of the fund managers have personal holding companies or offshore trust structures to receive carry from offshore funds. This was historically done with two perspectives in mind.

First, senior personnel were often required to balance the requirements of multiple jurisdictions on account of the nature of their occupation, and personal carry structures would double as succession structures for the fund manager.

For example, if the beneficiary happened to be a US citizen who was resident in India, it was often important to set up a grantor trust structure from a US perspective. Similarly, if the beneficiary was an Indian resident who was expected to relocate offshore, the units would sometimes be held in a personal holding company to enable utilization of funds offshore in a manner that was in compliance with the exchange control provisions.

STAR trusts in the Cayman Islands (or trusts offering similar features in other jurisdictions) have also been set up for individuals who did not have specified beneficiaries in mind but who wanted flexibility to use the funds for offshore reinvestments in future.

Second, there was a preference among funds to distribute the carry to offshore structures, not just because this allowed for more regulatory flexibility in structuring but also because of a perception that payment of carried interest into India could result in a permanent establishment risk for the fund in India.

What is important to keep in mind, however, is that the tax environment in India today is far more challenging than it was earlier. Information exchange has become a norm rather than an exception, and it is more important than ever before to consider the administrative impact of disclosure requirements on offshore structures, not to mention the ability of the structure to demonstrate substance or comply with changing laws. For example, a new law is proposed to be introduced where an Indian resident shareholder could be taxed on income received by an offshore personal holding company, irrespective of whether dividends are distributed by such offshore entity.

Such 'controlled foreign corporation' provisions, however, do not currently apply to trusts, which means that carry structures using trusts may be in a better position to those relying upon personal holding companies.

Having the carry housed in a trust would also allow the beneficiary to provide a better business case for retaining the funds offshore, including that the funds will be professionally managed and used according to the individual's wishes in case of an untimely demise. For example, if the individual has minor children and wishes them to receive distributions from the carry, a trust could accomplish this without transferring the carry entirely into the guardian's hands.

Other justifications could be the future relocation of one or more beneficiaries requiring a use of funds offshore, ease of reinvestment of funds without regulatory restrictions, availability of high quality professional management for the trust, or ability to co-invest in other global funds sponsored by the same group. These may not have been factored in when carry structures were historically set up, but they are likely to be very important when distributions are made, particularly with the general anti-avoidance rule proposed to come into effect from financial year 2015 and exchange of information among countries becoming more regular.

Further, relooking at the existing structures becomes important since India abolished estate taxes in 1985 but there is no guarantee that the same will not be reintroduced.

The short point is that the world has changed since carry structures were historically set up. It is more important than ever before to re-evaluate whether there is adequate substance in the structure and robust legal documentation in

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place to articulate the commercial justifications, to enable the structure to survive scrutiny.

Whether the structure will tick the relevant boxes at the point when distributions are made, is likely to be the real “million dollar” question.

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– **Shreya Rao & Nishchal Joshipura**

You can direct your queries or comments to the authors

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