Publication: Economic Times Mumbai; Date: 2009 Apr 30; Section: Policy; Page Number: 17

ActivePaper

Dampener on zeal of fund managers

OBAMA'S BUDGET PROPOSALS MAY RESULT IN TAXING TIMES FOR US FUND MANAGERS RELOCATING TO INDIA

MIHIR SHEDDE & PARUL JAIN

US PRESIDENT BARACK OBAMA'S budgetary proposals have caused quite a stir among US fund managers. In his management and budget statement, Obama has included "taxing carried interest as ordinary income" in his table of proposed "loophole closers." The proposal, if implemented, could prove to be even more detrimental to fund managers who have relocated to India and continue to have an interest in an offshore entity which serves as a general partner to an offshore fund.

Pursuant to the flexibility provided by the US law, a typical offshore fund structure enables fund managers to enjoy the lower rate of tax. Such offshore funds are often established as limited partnerships in an appropriate jurisdiction with the fund manager serving as the general partner. Typically, a profit earned by the fund is distributed to the limited partners (investors) and the general partner (fund managers) in the ratio of 80:20. The portion to which the fund manager is entitled, that is 20%, is termed as 'carried interest'.

Currently, the carried interest received by the individual members of the General Partner is taxed at the long term capital gains tax rate (in case of income consisting of capital gains arising on sale of shares of the portfolio company, being held for a period exceeding one year) as opposed to the rate applicable to ordinary income, a "loophole" which President Obama seeks to close.

Typically, profits earned by investment funds are distributed to the investors and the fund manager in the ratio of 80:20. Carried interest is that portion to which the fund manager is entitled, that is, twenty percent. When that income consists of qualified dividends or long-term capital gains, US taxes the manager at the 15 percent rate applicable to those forms of income. Obama's proposed amendment seeks to categorise this income as "ordinary income" which is taxed at a significantly higher rate of 35 per cent. The argument is that since the managers are being compensated for their labour, the payments should be taxed at the same rates as other labour income (ordinary income) rather than at the lower rate for qualified dividends or long-term capital gains.

In recent times, there has been an increasing amount of interest from many fund managers of Indian origin to relocate back to India. While Obama's proposal to tax carried interest as ordinary income could have significant US tax consequences, the situation gets worse for such fund managers since, on one hand, they continue to be US citizens or green card holders and on the other hand, having relocated to India, qualify as Indian tax residents as well. Such a manager could end up paying tax in India and also in the US since India taxes the worldwide income of its "residents" and US applies the same principle to its citizens or green card holders. While the 'residency' issue may be solved to some extent by applying the tie-breaker rules under the India-US tax treaty, the situation gets trickier for US citizens since under the provisions of the Indian US tax treaty, US gets a right to disregard the provisions of the treaty. In fact, such a right applies for a period of ten years even in case of US citizens who have given up their citizenship.

The situation is further complicated on account of the differential treatment accorded by India and the US with respect to the carried interest payment received by the fund manager. While, the managers, being US citizens, will currently pay dividend/capital gains tax in the US on the carried interest received, characterisation of the income in India would depend on a number of factors, including the structure adopted for receipt of the carried interest. This could result in the fund managers not being eligible for a tax credit on their personal income taxes in India in respect of the tax earlier paid in the US both due to a difference in timing of receipt of such income as well as the difference in characterisation of such income in the two jurisdictions and thus, they would end up paying taxes both in India and the US. If President Obama's proposal to tax carried interest as ordinary income goes through, the global tax rate applicable to the said managers will be significantly higher.

There are indeed several issues surrounding president Obama's proposal and questions have been raised regarding its implementation. Although there is much uncertainty as to the manner of implementation of the proposal, significant changes in the structures adopted by

US fund managers may be expected. Meanwhile, Obama's proposals combined with the recent proposed bill aimed at regulating all international private funds being marketed to US investors, could act as a dampener on the spirits of many fund managers.

(The authors are with Nishith Desai Associates)