

Investment Funds: Monthly Digest

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INVESTOR GIVEBACK FOR INDIA FOCUSED FUNDS: LEGAL CONSIDERATIONS

INTRODUCTION

A closed-end venture capital / private equity ("VC/PE") fund's governing documents typically stipulate an 'investor giveback' (also referred to as 'LP giveback') provision. The LP giveback provision imposes a binding obligation, with certain qualifications, on fund investors to return distributions received by them from the fund in order to meet certain obligations and liabilities of the fund.

Once the fund has no recourse to unfunded commitments, reserves or insurance, this provision may be triggered to meet the fund's outstanding obligations or liabilities. LP giveback satisfies the limited liability expectation of the fund investors, while achieving optimum returns for the fund.¹ It also protects the unlimited liability of the fund manager or administrators for such claims.²

In this issue of the digest, we have attempted to break down a typical investor giveback provision from a legal perspective in the context of India focused funds (i.e. funds receiving income from direct investments in India).

TRIGGERS OF INVESTOR GIVEBACK

Distribution of proceeds to fund investors is made after the fund's overall investment proceeds are reduced by the outstanding dues, expenses and liabilities of the fund. However, there is a likelihood of certain types of liabilities arising to the fund after such distributions are made.

A tentative projection of the types of liabilities that could arise to the fund post distribution to investors is helpful to determine broad contours of the provision. The types of liabilities may differ depending on various factors such as the sectors in which the fund intends to invest, the taxability of the fund vehicle, the risk of re-characterization of income of the fund, the fund's exit strategies and the fund's likelihood to borrow.

These liabilities may be classified broadly into tax and non-tax liabilities.

Tax liabilities

For tax liabilities, a segregation should be made between triggers of investor giveback for fund level tax liabilities, versus triggers of tax indemnity from specific investors for investor specific tax liabilities.

Specifically, taking the example of a Category I or II Alternative Investment Fund ("AIF") in India³, it is a tax pass through vehicle with a withholding requirement. The requirement to withhold from foreign investors is not at a fixed rate, and may vary depending upon the tax treaty between the foreign investor's tax residential jurisdiction and India (it could even be nil). Upon the representations of such foreign investor (as regards its tax status), the withholding tax rate may be reduced to nil; however, the tax authorities in India may reverse the exemption on grounds such as 'no treaty benefits' or 'income re-characterization'.

In this event, the tax authorities may raise a claim against the fund manager / trustee, (in its capacity as the representative assessee), as first recourse. The withholding agents should not ultimately bear this liability. However, this tax liability should also not be characterized a 'fund liability' or 'fund expense', as it pertains to a specific foreign investor and other investors in the fund are not expected to participate in such liability.

For a liability of this nature, the fund may not be required to trigger investor giveback, and is likely to rely on a specific tax indemnity provided by each investor to the fund and / or its manager / administrator.

All income of Category I and II AIFs other than income in the nature of profits and gains from business or profession is exempt from tax under the Indian Income Tax Act, 1962 (the "ITA"). Relying on certain clarifications issued by the Central Board of Direct Taxes ("CBDT"), any income arising to a Category I or II AIF from transfer of unlisted securities should be taxed as capital gains under the ITA, and should not run the risk of being classified as profits and gains from business or profession.⁴

Further, CBDT had issued a circular in June, 2015⁵ stating that no withholding taxes shall apply to income being distributed to a Category I or II AIF.

In the event that the income of the fund is re-characterized, or a withholding tax is imposed on distributions by AIFs, the investor giveback clause may need to be triggered.

Non-tax liabilities

Breach of representations and warranties, indemnification obligations, title claims – in each case, arising from the transaction / portfolio documents of the fund – are some of the examples of non-tax liabilities that may arise to the fund post distribution of proceeds to investors.

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Any damages or losses arising from a dispute at the fund level, i.e. between one or more of the investors and the fund / manager / trustee or inter-se between them, are generally not considered as triggers for investor giveback. Damages or losses arising from such disputes are settled by way of indemnities and limitation of liability provisions at the fund level.

LIMITATIONS OF INVESTOR GIVEBACK

The liability of the fund investors is generally limited to their respective unfunded capital commitments. This general rule is not applicable in cases of default on drawdown by the investor, tax indemnities (as discussed above) and investor giveback.

While the amounts for default and tax indemnities are not subject to any caps, the investor giveback provision generally does not impose an unlimited obligation. There are (i) quantum limits; and (ii) sunset provisions in-built into the investor giveback provision. Investment funds look to follow the same limits for limitation of their liability under the portfolio documents.

Quantum limits

If the fund follows a deal-by-deal distribution format, then the investor giveback obligation should also follow the same format. From a legal perspective, there are no caps prescribed for determining the quantum of the investor giveback obligation imposed on investors. From a tax perspective, LPs often expect the quantum in case of a tax liability arising from a deal, to not exceed the amount of distributions received by the investors for that deal. However, tax authorities may often charge a penalty and / or a recurring interest on the tax liability, owing to which the quantum for tax liabilities should be stipulated to have more flexibility instead of limiting it strictly to distributions received from the deal.

Sunset provisions

The statutory period of limitations for non-tax liabilities is currently at three years, whereas for tax liabilities, it is seven years from the date of expiry of the fiscal year in which the distribution was made. The tax authorities may reassess the taxation of a distribution during such period of limitation.

Upon issuance of a notice (whether for a tax or a non-tax liability), the sunset on the limitation period does not apply anymore.

A typical investor giveback provision should mirror, at least the statutory period of limitations along with the caveat for issuance of a notice in the interim.

IMPLEMENTATION OF INVESTOR GIVEBACK

The LP giveback provision gains more relevance upon liquidation of the fund. During the life of the fund, it may have recourse to unfunded commitments or reserves to satisfy any liabilities. If not for the investor giveback clause, a VC/PE fund may be required to set aside reserves for future liabilities even after liquidation of the fund, which could adversely impact the investor internal rate of return (IRR).

In fund documentation, the investor giveback provision generally survives termination of the contract.

Investor giveback is generally carried out in the reverse order of the waterfall. Accordingly, even the carried interest recipients (in a typical VC/PE distribution waterfall) would be required to participate in the giveback. Further, investor giveback may trigger a carried interest clawback for the carry recipients in order to adjust the waterfall to its accurate ratio of distributions between the investor and carry recipients.

This note provides only a few discussion points on the subject. It is important to understand that each fund requires a bespoke investor giveback clause depending on *inter alia* its intended asset class, type of investors, jurisdiction of incorporation and jurisdiction of investments. The market practice in this regard is also quite dynamic, given the absence of any legal or regulatory framework governing the provision in India (other than the statutory period of limitations).

– Nandini Pathak & Richie Sancheti

You can direct your queries or comments to the authors

¹As compared to other alternatives for dealing with liabilities of the fund, investor giveback provides the required balance between adequate coverage for liabilities and maintaining the IRR (Emerging Markets Fund Terms – How and Why do They Differ from Developed Markets Funds? Publisher: EMPEA).

²The private equity terms glossary by the Institutional Limited Partners Association (ILPA) states that an 'investor giveback' clause is to prevent the general partner (or the manager) from future claims and liabilities (<https://ilpa.org/private-equity-glossary/>). An alternative thought is that the liabilities of the fund, if arising when there are unfunded commitments, or reserves available, would be allocated as expenses of the fund to the investors. Therefore, even upon liquidation or unavailability of unfunded commitments, such liabilities should be treated as being allocable to the investors and not to the general partner / manager or fund administrator / trustee.

³As registered and defined under the under the SEBI (Alternative Investment Funds) Regulations, 2012 (the "AIF Regulations").

⁴CBDT F.No.225/12/2016/ITA.II dated January 24, 2017.

⁵Ministry of Finance, Department of Revenue, Central Board of Direct Taxes, Notification No 51 / 2015 dated June 25, 2015.

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