Govt to Ease Safe Harbour Rules to Attract PE Funds

New norms may make it easier for fund managers to shift base to India without getting taxed

The government is set to ease a few pre-set conditions for offshore fund managers to allow private equity investors to shift base to India without attracting a tax on capital gains by relaxing safe harbour rules, people familiar with the matter said.

The government is likely to allow a `see through' so that the 10% limit on individual investors does not apply to special purpose vehicles and relax the arm's length condition that allows only third party fund managers to rekindle investor interest in the scheme as it has failed attract a single fund manager even eight months after announcing what is known as safe harbour rules, people in the know said.

After finance minister Arun Jaitley had announced the outlines of safe harbour norms during his budget speech in February, the government had come out with some 15 conditions that the fund managers had to meet if they wished to shift their base to India.

Fund managers and their tax consultants found many of those conditions restraining and potential trigger for litigations.

Now the government plans to relax some of these clauses. A major change that the government is looking at this stage includes allowing a "look through" or a "see through" for the investors of the funds, a person close to the development said.

Now, one of the conditions for availing the safe harbour benefit is that an investor should not own more than 10% in the fund. This disqualifies several funds that qualify as broad-based funds but where the immediate member is a single institutional fund such as pension fund, university or mutual fund. Also, globally investors combine forces to form a special purpose vehicle (SPV) or an investment arm that invests in fund. Under current norms, an SPV would be treated as one investor (investing in a fund) rather than a conglomerate of investors.

"The government is considering that they look at the ultimate investors," the person said.

This is referred to as see through, where a regulator sees through the structure to find out the ultimate investor. Market regulator does allow a see through and so could the government for fund managers after the government relaxes the current rules.

"Apart from that the government could relax the arm's-length condition, giving leeway to the funds," said the person quoted earlier.

Currently, only third party fund managers are permitted and an employee or other person connected to a fund is not eligible to become the fund manager.

Rajesh H Gandhi, partner, tax, at Deloitte Haskins & Sells, said this clause could disqualify foreign portfolio investors (FPIs) that have captive fund management business. "Also the condition that the fund show pays the fund manager an arm's length remuneration could become a recipe for controversies and reason for denial of the tax exemption since transfer pricing litigation is not uncommon in India,“ he said.

“Accordingly, this time around the government should ideally come out with amendments in law and merely issuing certain clarifications may not have the desired impact,“ said Gandhi.

The government had sought suggestions from industry experts including FPIs and tax and legal experts around the issue in the last few months.

Gautam Mehra, partner, India tax leader, at PwC, said practical issues with the safe harbour conditions can be broadly put in three baskets -investor diversification, investment diversification, and issues related to fund managers. “Industry representations have been made, requesting clarification on various aspects, which include the fund manager norms around the arm's-length price, the look through concept for investor, and investment diversification,“ he said.

Recently, in conversation with ET, a senior government official said the government is serious about attracting the fund managers, but it was disappointed due to the poor response.

Another senior government official, who had recently called top tax experts, said some of the norms around safe harbour would be amended. “But only some, if they don't come this time, that's it,“ he apparently told the tax experts.

Industry trackers said if the government add a couple of more changes to the rules it would make life easier for fund managers.

“There are some changes which the government can make easily and it could have a far reaching impact. These include removing or reducing the minimum threshold of 25 investors, doing away with the restriction of 10% limit per investor, and minimum fund size of Rs 100 crore,“ said Gandhi of Deloitte.

Under the current norms the fund should have at least 25 investors. “Even the SEBI regulations require only 20 investors in a broad based fund, and the government can relook at this one,“ said a senior tax consultant who requested not to be named.

“The only hope is that the government does amend the norms and not just come out with a notification, as the later just creates confusion as it's open to interpretation,“ said the tax consultant who is advising two fund managers that are keen to shift to India if the rules are relaxed.

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