



Transfer Pricing Nuances for Private Equity Groups

The Dbriefs Financial Services Industry series

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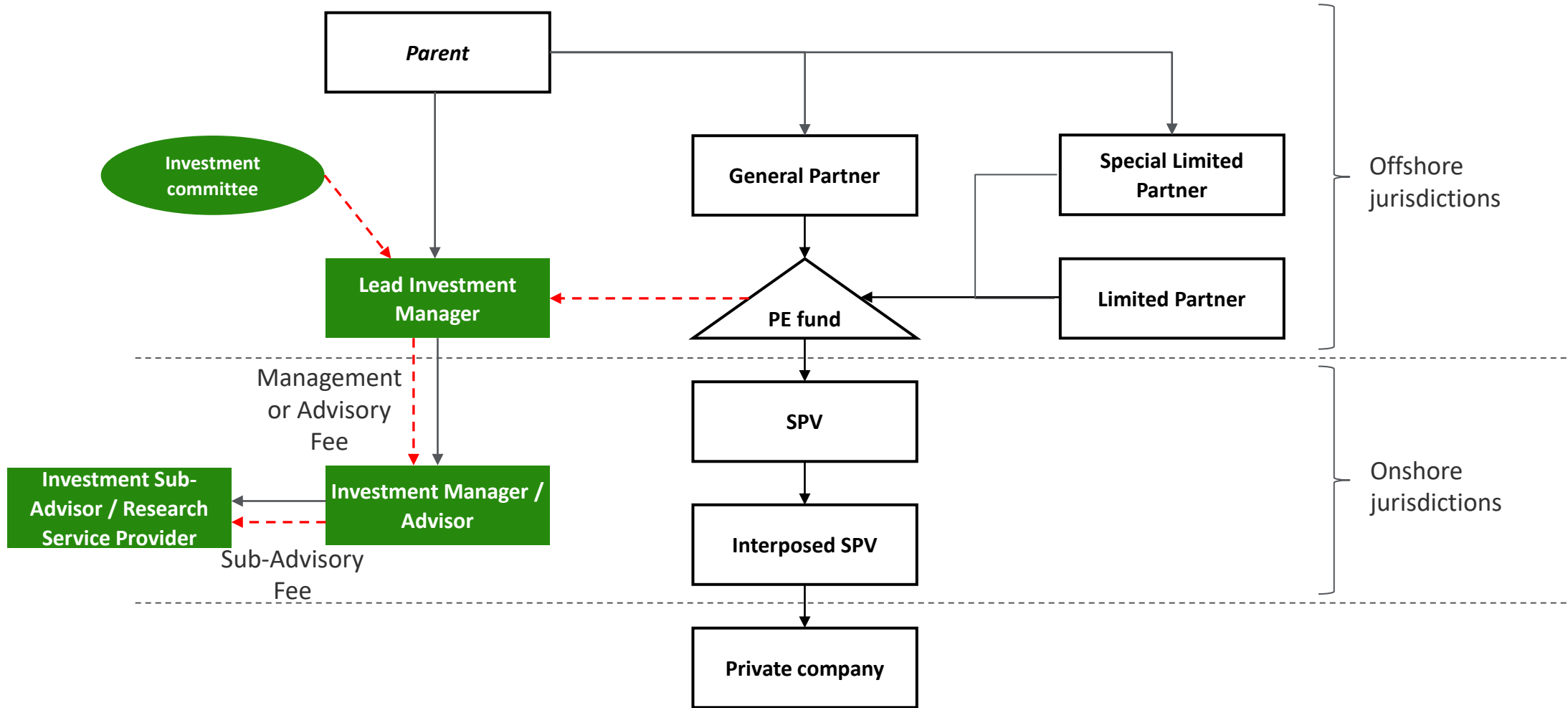
Agenda

- Typical Fund Structures
- Transfer pricing methodologies
- Treatment of carried interest
- Current focus of tax authorities and advance pricing arrangements (APAs)
- GIFT city
- Questions and answers

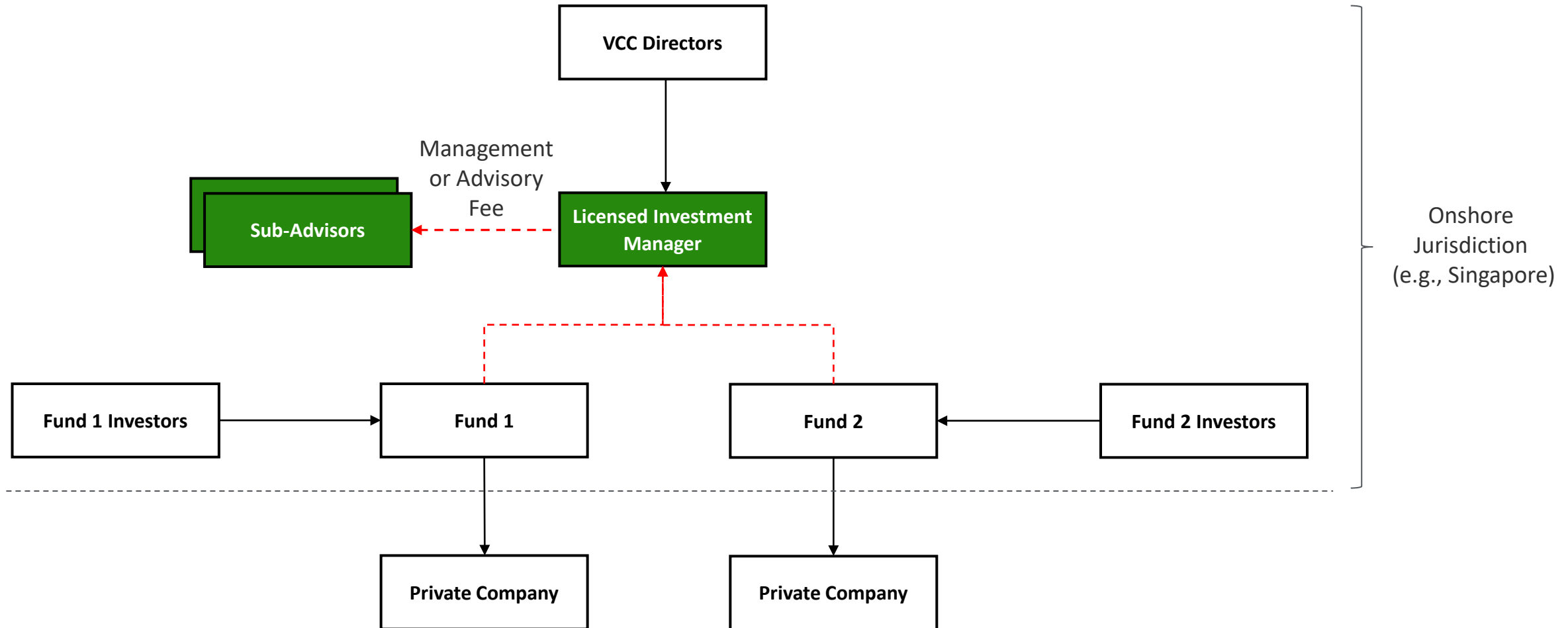


Typical Fund Structures

Typical Fund Structures – Example of an Offshore Typical Private Equity Fund Structure



Typical Fund Structures – Example of an Onshore Typical Private Equity Fund Structure in Singapore



Polling question 1

Which entities do you have in your structure?

- Lead Investment Manager
- Investment Manager
- Sub-Investment Manager
- Support Services Provider
- One or more of the above

Transfer pricing methodologies

Transfer Pricing Methodologies

Particulars	Discretionary investment advisor / sub-advisor	Non-binding investment advisor/ sub-advisor or research service provider
International Transaction	<ul style="list-style-type: none"> Provision of binding financial advisory services/ investment advisory services by investment advisors / sub-advisors to the investment manager 	<ul style="list-style-type: none"> Provision of non-binding financial advisory services / investment advisory services by the investment advisor / sub-advisors to the investment manager
Functional Characterisation	<ul style="list-style-type: none"> Investment advisor / sub-advisor - risk bearing entity (i.e., share of business / market risk) Investment manager - risk bearing entity (i.e., share of business / market risk) 	<ul style="list-style-type: none"> Investment advisor / sub-advisor / research service provider - limited risk bearing entity Investment manager - entrepreneurial entity bearing business and market risk
Tested Party	<ul style="list-style-type: none"> Investment advisor / sub-advisor 	<ul style="list-style-type: none"> Investment advisor / sub-advisor / research service provider
Most Appropriate Method	<ul style="list-style-type: none"> Profit Split Method (PSM) 	<ul style="list-style-type: none"> Transactional Net Margin Method ('TNMM')
Pricing Policy	<ul style="list-style-type: none"> Investment advisors / sub-advisors entities may receive a share of the management fees either via a revenue split or profit split type model 	<ul style="list-style-type: none"> Investment advisors / sub-advisors / research service providers operate on a cost-plus model (<i>definition of operating cost is important in certain jurisdictions e.g. India</i>) Mark-ups often seen in the range of 7% to 17.5%
External Comparables / benchmarking process	<ul style="list-style-type: none"> Identification of practical and supportable allocation keys in the PSM Challenges in sourcing comparable entities in the benchmarking studies due to <ul style="list-style-type: none"> Independence – ownership links between funds and fund managers/ advisors lead to non-independent data Adjustments – understanding and applying appropriate adjustments to comparables where needed (e.g. segmentation of management fees to recognise specific functions within the investment management value chain e.g., capital raising) 	<ul style="list-style-type: none"> Challenges in sourcing comparable entities in the benchmarking study due to <ul style="list-style-type: none"> Independence – not many independent comparable service providers Functional comparability – many investment management / wealth management / merchant banking entities not functionally comparable Adjustments – understanding and applying appropriate adjustments to comparables where needed

Polling question 2

Is your entity facing any litigation on the transfer pricing methodology / transfer pricing policy?

- Yes
- No
- Don't know/not applicable

Polling question 3

Which is the major transfer pricing challenge / litigation issues in your fund structure?

- Characterisation of investment advisory or sub-Investment advisory dealing
- The level of the mark-up on a cost plus arrangement
- The selection of specific comparables
- All of the above
- Don't know / not applicable

Treatment of carried interest

Carried interest / Carry – Concept

- Carried interest, or carry, is a share of any profits that GP of PE funds receive as compensation to align their interests with the fund's objectives
- GP also makes investment into the funds via co-investment vehicles alongwith the LPs – “skin in the game”
- **Carry is a performance-based incentive to motivate the GP (fund manager) to work toward improving fund performance**
- GPs spend significant time in developing strategies, fund raising, marketing/investors relations, improve management performance/efficiencies of portfolio companies and maximising valuations for initial public offering (IPO) or divestments, etc.
- GPs are assisted by Investment Managers who manage the Fund. GP is responsible for all investment/divestment decisions of the Fund. Typically, Investment Committee of the fund makes key decisions on investment or divestment
- GP is compensated through annual management fees - typically **2%-3% p.a.** of the fund's Assets Under Management (AUM)
- In addition to annual management fees, carried interest serves as a primary source of income for the GP - traditionally amounting to around **20% to 25%** of the fund's annual profit
- Carried interest vests over a number of years and is received by the GP periodically
- Carried interest is not automatic and arises only when the fund generates profits exceeding specified return levels i.e., “hurdle rate”. Carry can also be "clawed back" if the fund underperforms

Treatment of Carried Interest

Performance Fees

- If carried interest entitlement is seen as a consideration for **performance / employment** of individuals / team - then it is highly likely to be treated as ordinary income or salary income
- **India** - Needs to be part of operating cost base for “cost-plus model” - **Important observations in recent CESTAT ruling– refer next slide Hong Kong – Tax Concession for Carried Interest**



Characterisation of Carried Interest

Capital

- Principally, if carried interest entitlement is seen as **“return on investment” (ROI)** made by recipient, then it could be possible to argue “equity treatment” / “capital gains” characterization
- Important to analyse the terms “transfer”, “capital asset”(eg., “partnership interest” in Fund)

Important to analyse the structure / documentation before taking any tax position as it may have a domino effect in transfer pricing, indirect tax, regulatory and other aspects

Polling question 4

Has there been any scrutiny / questions posed by tax authorities on carried interest in your fund structure?

- Yes
- No
- Don't know / not applicable

Current focus of tax authorities and advance pricing arrangements (“APAs”)

Focus of Tax authorities / APAs

India	Hong Kong	Australia
Tax authorities allege that investment sub-advisory entity is engaged in actively managing the investments and not performing mere non-binding investment advisory services	The IRD is active in opening cases against discretionary investment advisors / sub-advisors in Hong Kong operating under a cost-plus model	<p>Australia’s Foreign Investment Review Board (FIRB) has been recently asked by the Australian Treasury to more strongly scrutinise the tax arrangements of foreign private equity funds buying and selling assets in Australia, while the Australian Taxation Office (ATO) has expanded their taskforce by establishing a dedicated private equity strategy team. As part of the FIRB approvals process prior to a deal being completed, funds may be asked to provide to the ATO (via the FIRB)</p> <ul style="list-style-type: none"> • Tax advice from their Australian advisors (e.g., accountants and lawyers) • Details of all anticipated related party transactions including terms of related party funding • Accept sets of tax conditions when bidding for assets, including agreeing to notifying the government about any future capital raisings and transfer pricing business restructures
Carried interest may be characterised as akin to performance fee / bonus and should form part of the cost base of sub-advisory entity	The IRD could look to characterise carried interest as a reward for services under audit, the impact of this being that the carried interest would be brought into the tax net for the Hong Kong investment advisor / sub-advisor	
Carried interest payment to key personnel signifies the presence of “Human Intangible” - Indian sub-advisor should get a split of excess profits/sales over the routine profit – PSM	The source of the income related to activities performed by investment professionals operating in Hong Kong, and the inter-play with the transfer pricing model	
Nominee director appointed on the board of investee companies are not acting in fiduciary capacity and are decision making authorities – Substance of the Indian entity questioned	The level of detail requested by the IRD under audit means taxpayers need to be able to provide such data to support their TP model (e.g. data related to allocation key drivers) which can be challenging for some groups	

Polling question 5

Are you exploring a Unilateral or Bilateral APA in your case?

- Already in APA
- Yes
- No

Gift City

GIFT City – Vision, Mission, and Objectives

The Government of Gujarat with a vision to catalyze India’s Financial Service Offering by leveraging Gujarat’s value proposition, has developed GIFT Project in a 3-phase approach destined to be completed by 2024



Vision

To tie-up with technology, to create a hub complete with Infrastructure, to meet the needs of modern Gujarat, modern India and to create a space in the global financial world.



Mission

- Provide International Banking Services in India and State of the art Infrastructure with excellent external connectivity, at or above par with globally benchmarked business districts.
- Create Large employment in the field of services industry in Gujarat



Objectives

To Create

- A Global Financial and IT Hub: with a Domestic Tariff Area and Multi Services SEZ
- To be at or above par with globally benchmarked business districts
- Employment opportunities for 1million people
- A Greenfield Smart City with state-of-the-art infrastructure
- A Vertical City: 1st of its kind in the country in scale, scope and quality

Why set up a fund in IFSC instead of India / Offshore Jurisdictions?

1

- Tax pass through for the GIFT Fund and one level of tax for LPs
- LPs: Credit in home country of India taxes
- Requirements for Foreign LPs on obtaining PAN and tax return filing – comparable to Offshore Funds

2

- Tax savings (income tax and GST) on management fees
- Risk of GAAR arguably contained as substance in IFSC is approved by IFSCA and thus, less chance of challenge by the IRA

3

- Moderate to significant cost saving in overall fund operation and administration as compared to Offshore Jurisdiction
- Ability to make India and overseas investments - comparable to Offshore Funds (and complete flexibility as against several restrictions applicable to non-IFSC India fund)
- Ability to take leverage for investments

4

- Better ability to structure carried interest participation for the Indian team in IFSC, as compared to Offshore Fund;
- Arguably low risk of carry recharacterization

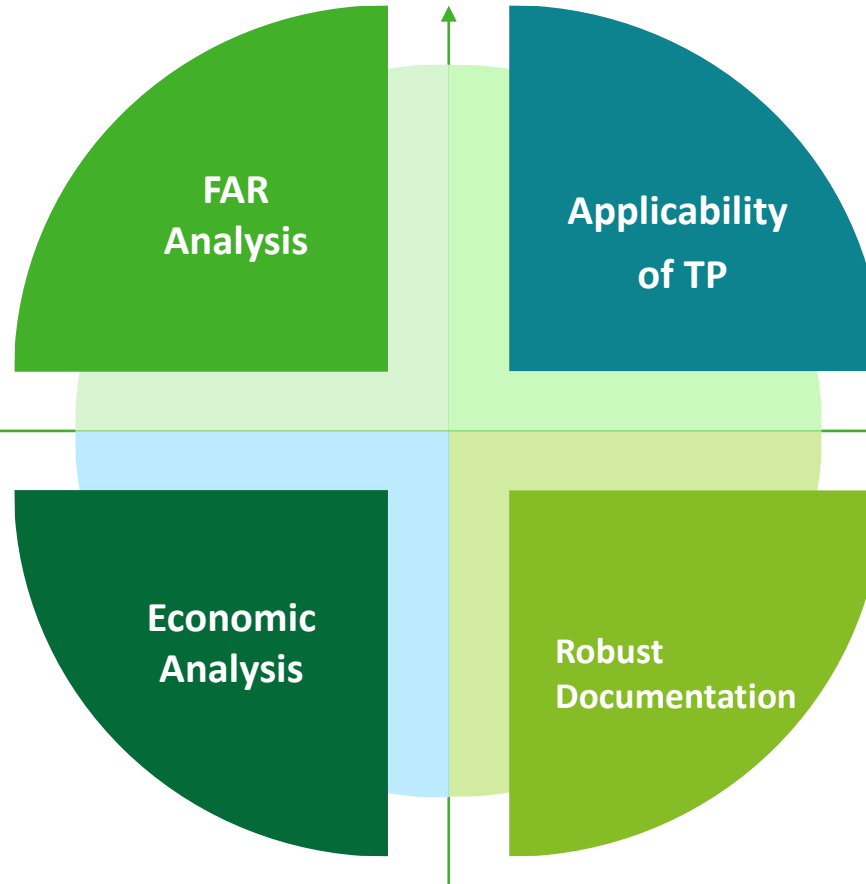
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- In-house team can effectively manage all operations on the ground in India – eliminates the need to appoint an external entity to act as Manager in Offshore Jurisdiction and POEM /PE related considerations for India team's activities

GIFT Fund has a unique characteristic of being a hybrid – it is considered as 'Indian resident' for income tax purposes though considered as a non-resident from exchange control perspective

Gift City – Interplay with Transfer Pricing

Understand the role of each entity in the Gift Structure including role of KMP, decision making for investments lies with which entity in the structure



Based on facts of case analyze applicability of SDT regulations

Determine arm's length split between GIFT and DTA using scientific basis

- Maintain robust documentation from TP/good governance standpoint
- Design a list of best practice documentation to be maintained by each entity

Polling question 6

Are you exploring to set up an entity in GIFT City?

- Yes
- Not as of now
- Not sure – would like to know more about it

Question and answers

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