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INVESTMENT MANAGEMENT SERVICES

Tax Considerations for Indian Managers of U.S. Feeder Funds

How are Indian managers of U.S. feeder funds taxed?

As private investment funds continue to attract cross-border sponsors and investors, Indian investment managers increasingly seek to provide investment advisory and management services to U.S. feeder funds. Although these arrangements present attractive opportunities, they also raise complex tax issues involving both U.S. and Indian law. Determining whether the manager operates through an Indian corporate entity or as an individual, whether income constitutes Effectively Connected Income ("ECI"), and whether treaty protection under the United States–India Double Taxation Avoidance Agreement ("DTAA") applies can significantly affect both tax liability and ongoing compliance obligations.

In addition to U.S. federal income tax considerations, Indian managers must evaluate India's worldwide taxation regime, foreign tax credit availability, and the potential use of blocker corporations designed to shield foreign managers and investors from direct U.S. tax exposure. Careful planning during fund formation can substantially reduce unnecessary tax costs while avoiding burdensome filing obligations in multiple jurisdictions.

How does the India-U.S. tax treaty affect Indian find managers?

The starting point for analyzing cross-border management arrangements is the India–U.S. DTAA. Under Article 7 (Business Profits), profits earned by an Indian enterprise generally remain taxable only in India unless the enterprise conducts business through a Permanent Establishment ("PE") located within the United States. If a PE exists, the United States may tax the portion of business profits attributable to that establishment.

Where investment management services are performed by an Indian individual, Articles 14 and 15 of the DTAA govern professional and personal service income. Those provisions generally allocate taxing rights exclusively to India unless the individual maintains a fixed base within the United States or is physically present in the United States for more than the applicable treaty threshold, typically 183 days during the relevant period.

Accordingly, the DTAA provides significant protection for both Indian companies and individuals performing investment management services entirely from India. Absent a U.S. permanent establishment, fixed base, or sufficient physical presence within the United States, management fees generally remain taxable only in India.

When does effectively connected income become a concern?

Although treaty protection provides substantial relief, Indian managers must also consider the U.S. domestic rules governing ECI. Under the Internal Revenue Code, foreign individuals and foreign entities remain subject to U.S. federal income tax on income that is effectively connected with a U.S. trade or business. Whether activities rise to that level depends upon the nature, regularity, continuity, and location of services performed.

For investment managers, one of the most significant factors is where advisory services actually occur. Because compensation for personal services generally is sourced to the location where those services are performed under Internal Revenue Code Sections 861 through 865, management activities conducted entirely from India ordinarily produce foreign-source business income rather than ECI.

However, if investment professionals regularly travel to the United States to conduct due diligence, negotiate transactions, manage portfolios, meet with investors, or otherwise perform advisory services, the portion of income attributable to those U.S. activities may constitute ECI. In those circumstances, treaty protection may become unavailable or limited, resulting in U.S. filing obligations and federal income taxation.

Does the manager's legal structure affect the tax analysis?

Whether the investment manager operates through an Indian corporation or as an individual significantly influences the applicable tax analysis, although both structures often produce similar substantive results when services remain entirely offshore.

When management services are provided through an Indian corporate entity, the company generally will not have a U.S. permanent establishment if all advisory functions are conducted from India and the company maintains no U.S. office, employees, or dependent agents authorized to conclude contracts. Under those circumstances, management fees ordinarily constitute business profits taxable exclusively in India under Article 7 of the DTAA.

Conversely, if the company establishes a U.S. office, employs personnel located in the United States, or authorizes agents to negotiate or conclude contracts on its behalf, a permanent establishment may arise. Income attributable to that permanent establishment may become taxable in the United States as ECI, requiring the company to file IRS Form 1120-F while generally preserving the ability to claim foreign tax credits under the DTAA and Indian domestic law.

The analysis differs somewhat for Indian individuals because the sourcing rules focus primarily upon where services are physically performed. An individual performing all investment advisory services from India generally will not recognize U.S.-source income. However, services performed within the United States may generate U.S.-source income allocable to those workdays, potentially requiring the filing of IRS Form 1040-NR if the treaty thresholds under Articles 14 or 15 are satisfied.

How are management fees and capital gains taxed?

Regardless of whether the manager operates through a corporate entity or as an individual, India generally taxes its residents on their worldwide income, including management fees earned from U.S. feeder funds. Where U.S. taxation also applies, relief from double taxation generally is available through Article 25 of the DTAA together with Section 90 of the Indian Income Tax Act, 1961, allowing taxpayers to claim foreign tax credits for qualifying U.S. taxes paid.

Capital gains present additional planning considerations. Indian residents generally remain taxable in India on gains derived from both domestic and foreign investments, although the applicable tax rates depend upon the nature of the underlying assets and the applicable holding period. Listed securities often qualify for preferential long-term capital gains treatment, whereas gains associated with unlisted securities or private fund interests may be subject to different holding periods and tax rates.

Cross-border fund structures also may produce unique U.S. tax consequences. For example, gains recognized on the disposition of partnership interests holding U.S. assets may constitute ECI under Internal Revenue Code Section 864(c)(8), potentially subjecting foreign investors or managers to U.S. taxation despite otherwise favorable treaty treatment.

What administrative requirements apply?

Although Indian managers may avoid substantive U.S. taxation under the DTAA, they frequently remain subject to important administrative requirements. U.S. feeder funds typically request IRS Form W-8BEN-E from foreign corporate managers, or Form W-8BEN from individuals, to document foreign status and claim applicable treaty benefits. Proper completion of these forms generally allows the U.S. payor to avoid withholding where the income does not constitute ECI.

Maintaining accurate treaty documentation and coordinating tax reporting across jurisdictions remain essential to preserving treaty benefits while minimizing withholding and compliance risks.

How can blocker corporations reduce U.S. tax exposure?

Many cross-border fund structures utilize blocker corporations to shield foreign investors and offshore managers from direct exposure to ECI. A blocker corporation, often organized as a U.S. C corporation or a foreign corporation such as a Cayman Islands entity, is inserted between the feeder fund and foreign investors or managers. Rather than allowing ECI to flow directly through the investment structure, the blocker corporation recognizes the taxable income, pays U.S. corporate income tax, and distributes after-tax earnings to its shareholders.

This structure offers several practical advantages. Most importantly, it prevents foreign managers and investors from becoming directly subject to U.S. partnership taxation and substantially reduces individual U.S. filing obligations. Blockers also simplify compliance with FATCA, withholding rules, and other cross-border reporting requirements while providing greater administrative certainty for offshore investors.

These benefits, however, come at a cost. Blocker corporations introduce an additional layer of taxation because corporate earnings are taxed before distributions are made to shareholders, who may then become subject to dividend withholding taxes. Depending upon the jurisdiction in which the blocker is organized, additional tax considerations, including controlled foreign corporation ("CFC") rules or Global Intangible Low-Taxed Income ("GILTI") implications, also may reduce the overall tax efficiency of the investment structure. Consequently, advisers should carefully balance administrative simplicity against the economic cost of double taxation when evaluating whether a blocker corporation is appropriate.

What structure is generally most tax efficient?

When investment management services are performed entirely from India, both Indian corporate entities and Indian individuals generally avoid U.S. taxation on management fees under the India–U.S. DTAA while remaining fully taxable in India on their worldwide income. In those circumstances, the primary planning considerations involve preserving treaty protection, avoiding the creation of a U.S. permanent establishment, and maintaining appropriate documentation supporting foreign status.

Once advisory activities begin occurring within the United States, however, the analysis changes significantly. U.S. activities may create ECI, generate filing obligations, and expose managers to U.S. federal income taxation despite treaty protections. Accordingly, managers should carefully evaluate where investment services are performed and whether fund operations could inadvertently establish a U.S. trade or business.

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