IMRENews*

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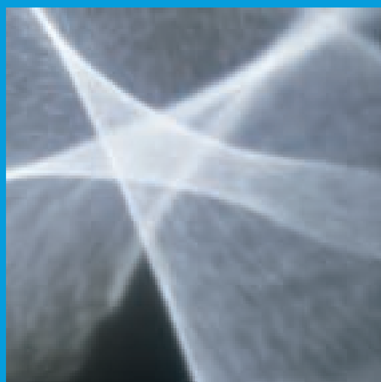
E U R O P E A N



EU equivocates on eligible assets

By downgrading forthcoming UCITS eligible assets rules from regulation to directive, the EU risks the stated aim of common rules across all member states. That said, some positive trends may emerge from the directive

More than two years after the EU Commission mandated the Committee of European Securities Regulators (CESR) to assist in clarifying the definitions of UCITS funds' eligible assets, the Commission proposes to issue a final directive in January 2007. Yet as a directive rather than a regulation, this leaves more scope for member state interpretation, raising the prospect that the goal of common national rules for eligible assets will not be achieved.

Following industry consultation, CESR's final technical advice to the Commission led to publication of draft rules in March 2006. These took the form of draft regulations, leaving member states little room for interpretation when transposing them into national legislation.

But then the Commission's September 2006 second draft, quite surprisingly, took the form of a directive, giving member states greater room for interpretation when forming national legislation. Whatever political or legal fight lies behind this change of mind, it surely works against the aim of having a common position on eligible assets across all member states.

The somewhat awkward reasoning behind the Commission's change of mind is, according to the accompanying background paper, twofold. Firstly, the proposed measure could "impact existing member states' rules implementing the UCITS

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The information in this newsletter represents our understanding at the time of going to press.

*connectedthinking

PRICEWATERHOUSECOOPERS

02

Robert Mellor: London +44 20 7804 1385 Debbie Payne: London +44 20 7213 5443

Striking a balance over hedge fund taxation

UK tax authorities are seeking to accommodate some of the newer hedge fund strategies within the UK's investment management "safe harbour" provisions. Considering London's position as Europe's hedge fund centre, this has important implications

Reacting to the hedge fund industry's evolution to include increasingly complex strategies, HM Revenue & Customs (HMRC) issued a draft statement of practice in late October 2006 to clarify the tax treatment of offshore hedge funds advised from the United Kingdom. Close reading reveals that HMRC is not seeking to catch hedge funds as a whole in the UK tax net, however some with newer 'trading' strategies may well have to think very carefully as to how they organise themselves or risk having the fund's profits subjected to UK tax.

The certainty provided by the UK Investment Manager Exemption (IME) has been an important factor in the growth of London's hedge fund industry, as it has provided a framework whereby the capital profits of non-UK investors from assets managed by UK-based asset managers fall outside of the UK's tax net.

HMRC clearly wants to strike a balance. While keen to support the development of the wider asset management industry, it wants to ensure a level playing field exists between the funds and onshore operations. The draft statement of practice makes it clear that some strategies, such as those trading in commodities or land, will not enjoy the IME's protection. But the draft also provides greater clarity in some newer areas, such as loan origination or debt syndication which HMRC have accepted fall within the IME.

Consultation process

In order to clarify uncertainty over the IME, the Alternative Investment Management Association's Tax Committee entered into informal consultation with The Treasury and HMRC at the end of 2005. During this process HMRC invested considerable time in seeking to understand the issues facing the industry. This led to the draft statement of practice, now subject to industry consultation prior to the HMRC issuing a formal statement expected in early 2007. This will replace Statement of Practice 1/01, issued in 2001, which has provided guidance on the application of the IME over the past five years.

Importantly, the draft document retains the differentiation between trading and investing. The point is made that active investment of a portfolio of investments may not constitute trading. Therefore the question for fund managers operating in areas such as commodities is: "What should I do to ensure the fund I manage is not trading?".

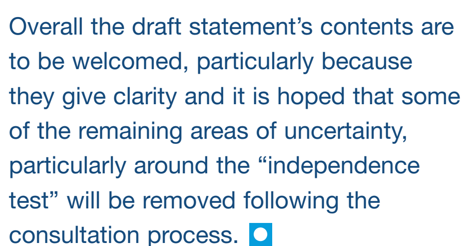
HMRC acknowledges that the current test for UK investment advisers regarding the permanent establishment of a fund conducting non-investment transactions may be harsh. As currently

drafted this is a 'cliff edge' test. Whilst HMRC is considering whether some form of proportionality could be adopted to do so would require legislative change, a process which cannot be achieved within the current consultation exercise, so for now this issue remains as a major concern for asset managers as, potentially, an inadvertent breach of the IME could taint the profits of the whole fund. Managers will need to build solutions in respect of this risk into both their structures and their operational framework.

Transfer pricing

But consulting with HMRC is not without risks, as can be seen in the redrafting of the customary rate test regarding passing fees from offshore fund to onshore investment adviser. HMRC have taken the opportunity to set out their view that the "customary rate" test within the IME is aligned with the OECD's arms length principal of transfer pricing. While this may seem more onerous than the previous test, the reality is that HMRC have been seeking to apply these principles in relation to asset managers for the last few years. It also accords with HMRC's desire for a level playing field.

Overall the draft statement's contents are to be welcomed, particularly because they give clarity and it is hoped that some of the remaining areas of uncertainty, particularly around the "independence test" will be removed following the consultation process.



F L A S H L I N E

EFAMA reviews IFRS

As part of its work on monitoring the implications of the possible development of International Financial Reporting Standards (IFRS) for investment funds, The European Fund and Asset Management Association (EFAMA) is working on the following projects:

- Updating its 2003 discussion paper on the 'Conditions for the application of IAS for investment funds in the European Union' in order to analyse the consequences of a potential application of IFRS rules to European investment funds, in particular regarding information benefits for the retail investor. To achieve this objective, certain changes or interpretations with respect to the current IFRS might be necessary.
- Lobbying by issuing comment letters to the International Accounting Standards Board (IASB) on Exposure Drafts that are important for the investment management industry.

It should be emphasised that, with the exception of the net asset value (NAV), none of the information affected by the application of IFRS is of major interest to retail investors.

Thierry Blondeau: Luxembourg
+352 49 48 48 2549

Kees Roozen: Amsterdam
+31 20 568 5281

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Inducements become top priority for MiFID working party

CESR is making inducements a top priority for its MiFID Work Programme, reflecting the importance of this issue for Europe's savings markets

Olivier de Vinck: Luxembourg +352 49 48 48 4122

When the Committee of European Securities Regulators (CESR) released its MiFID Level 3 Expert Group – 2006/2007 Work Programme on October 20th, 2006, it committed to address the issue of 'inducements', which has climbed to one of the top priorities of CESR's 'Intermediaries Sub-Group'. This is probably the last chance for the industry to have a say on this critical issue.

Following CESR's earlier consultation on its Level 3 Work Programme, CESR is shifting its priorities on issues having an impact on firm's processes and systems, and work that has a direct impact on cross-border provision of investment services. It is attempting to meet industry demand for much needed guidance by end of February 2007.

With regard to inducements, CESR intends to bring clarification and supervisory convergence on two issues: firstly, certain remuneration structures, scope and distribution channels and, secondly, practices of 'softing and bundling'. CESR started this project in the third quarter of 2006 and is expected to complete it by Q1, 2007. The first issue is probably the most critical and will therefore be given priority. CESR undertakes to consult the industry as soon as practicable – but no earlier than December 2006. In order to achieve such an aggressive timeframe, CESR will use much shorter consultation periods than its usual practice of three months.

MiFID impact on inducements critical

When assessing the key potential impacts of MiFID on the UCITS world, Article 26 of the implementing directive, relating to inducements, rapidly emerges as the most critical. Indeed, over the last 15 years, market demand, competitive forces and regulatory requirements have polarised product manufacturers and distributors of investment funds. Though open architecture is still in its infancy in continental European retail markets, those that manage funds and those that distribute them, even when in the same group, compete for their share of the profit.

The sharing of the revenues between manufacturer and distributors is often done in the form of a retrocession on front-end loads and management fees. Under Article 26 of the implementing directive, a retrocession paid to or received from a third party needs to meet three conditions. First it must be disclosed to the client prior to rendering the service, secondly it must be designed to enhance the quality of the relevant service to the client, and finally it should not impair compliance with the firm's duty to act in the best interests of the client.

Subject to interpretation

The three requirements are highly subject to interpretation. If supervisory convergence at EU level fails, pan-European fund promoters might have to comply with different requirements in different EU markets governing how they remunerate distributors. This could then necessitate diverse marketing practices. The future of open markets is also at stake – it could be impeded or boosted. The bet is on the ability of retail investors to value services provided by fund distributors or to make their own assessments and decisions regarding investment products.

Charlotte Worthington: London Tel +44 20 7804 3051

EU tax discrimination – increasing optimism for portfolio investors

The European Court of Justice has made several judgments against discriminatory withholding and corporate taxes. Investment managers choosing to pursue recoveries of these taxes could boost fund returns by 40-60 basis points per annum

The expected European Court of Justice (ECJ) judgments in two tax cases continue to focus attention on the opportunities for investors to recover such withholding tax.

The judgment in the Denkavit case (surrounding French withholding tax levies on dividends payment to a Dutch company) is expected to be announced before the end of January 2007, Given the Advocat General's favourable opinion in the case issued in April and the previous decision in the Fokus Bank case on the incompatibility of withholding taxes with the European Commission (EC) Treaty, (where the EFTA[1] Court found that it was discriminatory for Norway to withhold tax on dividends to UK and German investors), it is expected that the ECJ will determine that the French withholding tax system is discriminatory to European investors.

In a related development, the judgment in the Test Claimants in the FII Group Litigation Order case is due to be announced in mid- December. This case centres on the differential treatment of UK and European dividend receipts by UK groups under the historic Advance Corporation Tax regime. However the tax treatment in this specific circumstance is linked to the wider treatment of dividend income under the UK taxation regime: UK dividend receipts are tax exempt while receipts from other European countries are taxable at up to 30%. One of the questions referred to the ECJ in this case related to whether the differential UK treatment of dividends is a breach of the EC Treaty. Given the Advocat General's opinion in support of the taxpayer released in April, it is likely that the ECJ will follow the principles established in the Manninen and Verkooijen cases and find that the UK legislation is not in accordance with the EC treaty and therefore European Union (EU) source dividends should not be taxable for UK corporate recipients.

Investors file reclaims

A number of EU investors, including pension funds, UCITS and non-UCITS funds and life insurance companies have filed protective withholding tax reclaims with EU tax authorities, and also reclaims of corporate taxes, where applicable with their local tax authorities. While most authorities are still considering their responses to such claims, there has already been a referral from the Estonian court to the ECJ in respect of a withholding tax reclaim for a Luxembourg UCITS fund. Meanwhile the Dutch Government has announced its intention to abolish Dutch dividend withholding tax in the long-term and the Norwegian government is processing reclaims of withholding tax for European investors including pension funds and UCITS funds.

Many investment managers and investors are still considering their reaction to these developments. By reviewing the quantum of corporate tax and withholding taxes suffered by each investor, it can be established whether there is a benefit either at present or in the future in actively pursuing recoveries of such discriminatory taxes. Following such a review, some funds have found that ongoing investment returns could be boosted by 40-60 basis points per annum.

[1] European Free Trade Association

06

New insurers compete for UK pension assets

UK companies may not generally be too tempted by the offerings of the new insurers competing for their pension assets, but that could change if premium costs fall and as defined benefit schemes shrink

Andrew Evans: London +44 20 7804 3887

In the UK, a new type of insurance company is rapidly emerging as a competitor to the traditional managers of pension schemes. Offering to assume all of, or some of, the risks of defined benefit schemes, these new providers have attractive propositions. Yet, for now, the associated cost may prevent widespread take-up of these solutions.

Within the past 12 months a number of well-resourced start-ups have announced their intentions of entering this market. They join two established companies, which have bought out frozen defined benefit schemes for many years. Furthermore, some other insurers and investment banks are becoming active in this market.

But the high premiums that companies have to pay for removing pension fund risk completely from their balance sheets may be prohibitive to many for now. Not only do companies have to make up any deficits in their schemes before a full buyout, but also they have to pay premiums to eliminate their mortality and interest rate risks, as well as providing for all future scheme expenses. At present, there is no requirement to account for such risks and costs in annual company accounts, which makes the expense seem even greater.

Specifically a UK phenomenon for now

Currently, this is specifically a UK phenomenon within Europe because of the large size of pension deficits in the country. This results from a combination of the length of time privately funded defined benefit schemes have existed in the United Kingdom, and the equity culture that lulled many trustees into a false sense of security during the long bull market of the 1980s and 1990s.

The UK accounting standard FRS17 has thrown the size of these liabilities into sharp focus by requiring that surpluses or deficits be disclosed on balance sheets every year. Previously, an assessment of the pension fund's health had only been included in the balance sheet when linked to an acquisition. Reporting visibility now means that CFOs and CEOs – and their shareholders – appreciate the implications of the pension scheme on the company's prospective fortunes more than ever before.

Actively seeking assets

The new pension fund insurance companies are now actively seeking assets, offering a flexible set of solutions. These range from full pension buyouts, assuming all pension fund risk, to partial de-risking through assuming just an element of the risk, such as the interest rate or mortality risk.

Some of these partial solutions are similar to the liability-driven investment (LDI) solutions being offered by some investment companies and investment banks. The crucial difference is that the insurance companies will take full responsibility for specific risks, whereas LDI solutions merely offer cash flows intended to closely match future liabilities.

For now, companies generally will prefer to make adjustments to their defined benefits schemes, such as negotiating later retirement ages, rather than buying insurance. But the costs of this insurance may fall. And then there may come a time when finance directors see greater merit in choosing this option for frozen defined benefit schemes, especially where changing regulatory requirements mean there is a need for constant attention.

Distributing UCITS in Asia

As UCITS distributors look to increase Asian sales of these European savings products still further, they should consider how this affects the type of funds they can market from the same platform elsewhere

Mark Evans: Luxembourg +352 49 48 48 6203

Following the strong growth in UCITS sales in Asia over the past five years, a second wave of interest in the region is building. Those already in the region are looking to distribute beyond their existing jurisdictions and others are venturing into Asia for the first time.

The increasing trend towards distributing single UCITS platforms in as many countries across the globe as possible is partly responsible for resurgent interest. Other factors include the resolution of many of the issues surrounding UCITS III, a maturing of various Asian financial markets and anticipation of new markets such as China. Furthermore, regulatory and tax changes are making it easier to enter markets, encouraging the drive to develop further economies of scale and profits from distribution.

Even so, promoters entering Asia need to be aware that beyond the harmonised EU market place, local tax, regulatory and market practice issues may not only affect the success of their Asian strategy, but also have implications for UCITS distribution in Europe and elsewhere. Each Asian market has its own regulatory and tax environment, language, currency, distribution processes and, most importantly, investor culture. A successful strategy is one tailored to local requirements.

Establishing a presence in Asia

This new advance into Asia follows great expansion of the UCITS geographical distribution footprint globally over the past five years. In 2005, some 42% of total net UCITS sales came from outside the EU, according to FERI Fund Market Information. For some years the larger fund promoters of UCITS have targeted selected Asian jurisdictions, with distribution supported by establishing local offices.

In 2000, a mere handful of UCITS promoters actively distributed their platforms into Asia. Today, approximately 65% of the top 50 UCITS (by distribution) are sold in the three Asian jurisdictions of Hong Kong, Singapore and Taiwan. Behind this distribution surge is a lack of competition to the UCITS brand. Both local regulators and investors accept that UCITS represent a secure product, backed by solid regulation while offering innovative features and product flexibility. In these three countries UCITS enjoy high levels of penetration (+75% of all authorised funds, see table below).

Potential impact of local regulations

As UCITS operators push into Asia, they need to be aware of the potential impact of local regulations on the operation of a globally distributed platform. For example, a jurisdiction's investment restrictions could impact an entire fund platform, especially if they are more severe than those under UCITS III. Moreover, local regulations may prevent offering funds with certain product features, or the tax rules in one country may act as a disincentive to offering a foreign product.

In these situations, the promoter needs to consider the commercial benefits of distributing the global platform in Asia, taking into account local restrictions regarding certain product features or investment objectives. In some circumstances, a local fund range may provide a better solution, at least for certain investor groups. As part of their planned Asian distribution, fund promoters should therefore analyse these issues to determine the most appropriate strategy.

Asia Pacific fund market (authorised funds)

Country	AUM (USD billion)	UCITS permitted	No of top 50 UCITS promoters	% UCITS penetration
Australia	717	Yes	4	<1
China	58	No	–	–
Hong Kong	551	Yes	31	79
Japan	468	Yes	11	15
Korea	199	Yes	9	4
Malaysia	26	Yes	NA	NA
Singapore	23	Yes	32	78
Taiwan	60	Yes	28	77
India	44	No	–	–

Sources: 11th Oceania Meeting of the International Investment Funds Conference (Beijing, 25-26 April, 2006); local regulators

Brendan McMahon: Jersey Tel +44 1534 838305

EU group points to need for private equity freedom

The EU Expert Group on private equity report has sparked debate about the need for freeing the industry from taxation and other regulatory obstacles across Europe's member states

At a time when private equity is becoming increasingly important to Europe's economy yet some countries are passing legislation that creates additional challenges for the industry, the European Commission (EC) recently appointed an Expert Group to review the industry in Europe. Broadly speaking, it identified several regulatory and tax obstacles holding back the industry's efficient development.

Consisting of a number of private equity practitioners and their advisers, the group's report related the sector's important role in supporting economic development and job creation, as well as its challenges in carrying out cross border transactions, and the need to streamline structures used by private equity firms in order to avoid unnecessary tax and regulatory constraints. The report was presented at an EC open hearing in July.

But the greatest challenge within the European Union (EU) member states is to ensure a pragmatic and sensible approach to the taxation and oversight of private equity business originating from other member states. Europe's national regimes do not interlink and are highly fragmented. They make few concessions to the growing cross-border or international dimension of the private equity industry. This causes the efficiency of the EU private equity industry to suffer from an overly complex and ill-suited fund structuring environment, which does not support cross-border investing.

A positive driver of European growth

To set this in context, private equity firms are currently raising record European funds and there is mounting evidence that their management techniques do promote growth. Annual figures compiled for the European Venture Capital Association (EVCA) by Thomson Financial and PricewaterhouseCoopers showed fund raising soaring to Euro 71.8 billion in 2005, up from Euro 27.5 billion in 2004. Early indications suggest a 2006 total exceeding Euro 75 billion.

Research carried out by the EVCA also indicates that between 1998 and 2003 buyout financed companies achieved higher growth in both revenues and employment than others. In particular, this suggests private equity has a role to play in solving an issue currently faced by many European family businesses – the passing of the business from one generation to the next.

Given this, it is surprising that private equity firms are increasingly concerned about the need to resort to complex structuring to mitigate tax risks. In a survey of more than 50 of Europe's larger private equity houses, PricewaterhouseCoopers' European M&A Tax Group found that 70% of respondents reported resorting to ever more complex structures. Respondents expressed the view that governments in many countries appear to be introducing rules that have a negative impact on private equity.

Key findings

In order to foster a friendlier environment for private equity, the expert group made the following key findings and recommendations:

- Policymakers should consider the characteristics of the private equity industry when reviewing or drafting legislation, and keep the industry in mind when developing policy objectives to avoid unintended consequences.
- National policymakers should use the levers available, and learn from each others' best practices, to develop private equity finance by creating the optimal conditions at local/national level through devices such as state aid or implementation of the Pension Fund Directive.
- For capital gains tax purposes each member state should look through the private equity vehicle to the ultimate investor to ensure that tax is suffered only in the home country of the investor. In doing so, they should ensure that tax is applied only in the home state of the investor in respect of funds that are deemed to be fiscally transparent in their own state.
- EU institutions and member states should facilitate the cross-border marketing and placement of private equity investments with eligible professional investors in other states. Appropriate steps should be taken to codify the mutual recognition of each other's fiscally transparent private equity fund structures for capital gains (similar to public equity investments).
- Member states should treat investments in vehicles that are used to pool private equity assets in the same way as they treat public equity investments. In particular, states should not use the local presence of managers to claim jurisdiction over capital gains accruing to private equity funds. Specifically, this implies not regarding a local advisor as a 'permanent establishment' for tax purposes.
- EU institutions and member states should consider establishing, in non-legislative form, a common understanding of the parameters of 'private placement'. This recognises that nationally-based rules are a major impediment to the cross-border marketing of private equity funds.

The EC panel receiving the report of the Expert Group acknowledged the issues relating to taxation and called for debate on the solutions that could realistically be achieved within sensible timeframes. Was it feasible to broker bilateral agreements between member states or would it be better to pursue EU level harmonisation around common fund structuring principles? The panel explored how mutual recognition might be made to work in the context of agreements at supervisory level, without the need for new European legislation.

The EC now plans to lay out its policy in a November White Paper (not published at time of writing). There is, however, general agreement that there is no need to super-impose European harmonising measures on the industry. Charlie McCreevy, European Commissioner for Internal Market and Services, stated in his closing remarks to the open hearing on the Expert Group findings: "What is needed is to free the industry from punitive double taxation and legal uncertainty that currently hold back onshore business – to the advantage of offshore structures".

Olga Huizinga: Rotterdam +31 10 407 6899 Kees Roozen: Amsterdam +31 20 568 5281

Comparison of investment property financial statements remains difficult

A PricewaterhouseCoopers survey of European investment property companies' financial statements showed that IFRS enhances the level of comparability, but room for improvement remains

While International Financial Reporting Standards (IFRS) enhances comparability across European property investment companies, this is diminished by the options allowed. This was the main finding of PricewaterhouseCoopers survey of 19 listed and unlisted large investment property companies across Europe. Additionally, the level of detail of disclosures varied between companies.

The survey found differences in the following areas:

- Use of the fair value model or the cost model;
- Disclosures on finance and operating leases;
- Presentation of service charges;
- Layout of the income statement;
- Disclosures on deferred taxes.

Use of the fair value model or the cost model

Under IFRS, investment property is initially measured at cost (including directly attributable costs), after which the company can choose between cost and fair value. Of the 25% of companies that chose the cost model, the fair value disclosures in the notes to the financial statements were not easy to compare.

Disclosures on finance and operating leases

An investment company leases out property either through financial or operating leases. In both cases disclosures have to be presented in accordance with IAS 17. Some 21% of the financial statements did not present lease disclosures. Whether these omissions were in accordance with IFRS was not easy to judge on the basis of the current disclosures of the entities' business activities.

Presentation of service charges

When a property company acts as principal service charges must be presented in the income statement on a gross basis, and when it acts as an agent on a net of expenses basis. But because companies did not always disclose whether they acted as agent or principal, it was difficult to assess whether the presentation in the income statement was supported by the actual role of the entity.

Layout of the income statement

Various income statement layouts did not enhance comparability. Some 63% of companies chose not to present revenue in the income statement as a separate line item. Further, in most cases lease incentives were deducted from gross rental income, but 37% did not disclose this. All companies presented valuation movements in investment property and disposal results separately from rental income, but some presented the valuation results as part of revenue.

Disclosures on deferred taxes

Re-measuring investment property at fair value creates a temporary difference between the carrying amount in the balance sheet and its tax base. This leads to a deferred tax liability, based on the rate at which this temporary difference will be recovered. An entity might expect to recover the carrying value of the investment property through use, sale or a combination of these. If the asset will be recovered through use, the corporate income tax rate applies. If it will be recovered through sale, the capital gains tax rate is used. For a combination of the two a blended approach is appropriate. Generally, we found financial statement disclosures of deferred tax treatment rather too concise, with the complexity of deferred tax accounting hardly divulged. Approaches taken were not clear. Further complicating matters was the difference in deferred tax treatments of business combinations and asset deals, where for the latter the initial recognition exemption is used. The notes of 85% of analysed companies did not disclose whether this exemption was used.

Conclusion

For many investment property companies the options IFRS offers diminish comparability. Although required note disclosures might counterbalance this, the survey found that the detail of both accounting policy and note disclosures varied between companies. In particular, items such as leases, service cost and deferred taxes would have benefited from more detail. Therefore, comparing investment property financial statements is still not easy.

Identifying the VAT consequences of IFRS in real estate

IFRS reporting may encourage real estate companies to pay less attention to VAT processes and procedures, reducing awareness of potentially substantial VAT liabilities across their European operations

Wanda Otto: Amsterdam + 31 20 568 4142 Lisa Tuip: Amsterdam + 31 20 568 4329 Bart Scholten: Amsterdam + 31 20 568 6602

The implementation of International Financial Reporting Standards (IFRS) involves far more than just technical book-keeping changes. Above all, IFRS provides investors with a more transparent and comparative basis for financial disclosure that is only to be welcomed. But in practical terms IFRS may have adverse VAT consequences for real estate companies of which they need to be aware.

In the past, real estate investments were valued at fair market value or cost price. In the case of cost price valuation, and depending on local VAT rules and the VAT liable or exempt use of the investment, VAT was either part of the cost price or not. As a result, it was important for real estate companies to keep track of VAT.

Nowadays, IFRS encourages real estate company investments to be valued at fair market value. One of the main reasons for this is to make it easier for investors to compare the financial position of similar stock exchange securities. While we realise that this benefits capital market transparency, we notice an associated tendency towards less attention to VAT processes and procedures.

Financial reporting consequences

How can this indifference towards VAT have financial reporting consequences for the company? To answer this question we need to examine the preparation of the annual accounts.

Each company should, when drafting the annual accounts, assess all its risks and determine whether there are reasons to include certain debts or provisions. This is in order to ensure the reliability of a company's published figures. The process usually starts with a risk analysis identifying risks of material misstatements, including misstatements of taxes. The company determines whether this could be an area for potential provisions according to accounting standard IAS 37.

Should VAT appear to be a risk area, the company should take action to make sure that the VAT process is under control.

The VAT position is of particular importance to real estate companies because VAT can be an important component of the purchase price of a real estate investment. Depending on the VAT regime applicable in the country of investment, the VAT liable or exempt use of the building, and the compliancy of all tax and legal procedures to be followed, VAT can either be a cost to the company or not.

For real estate companies where VAT on purchase, development, lease or sale of real estate is always material, it is key to manage the VAT return process efficiently and embed controls in the accounting/ SAP system. This avoids VAT exposures and so avoids application of IAS 37.

Advantages of a VAT scan

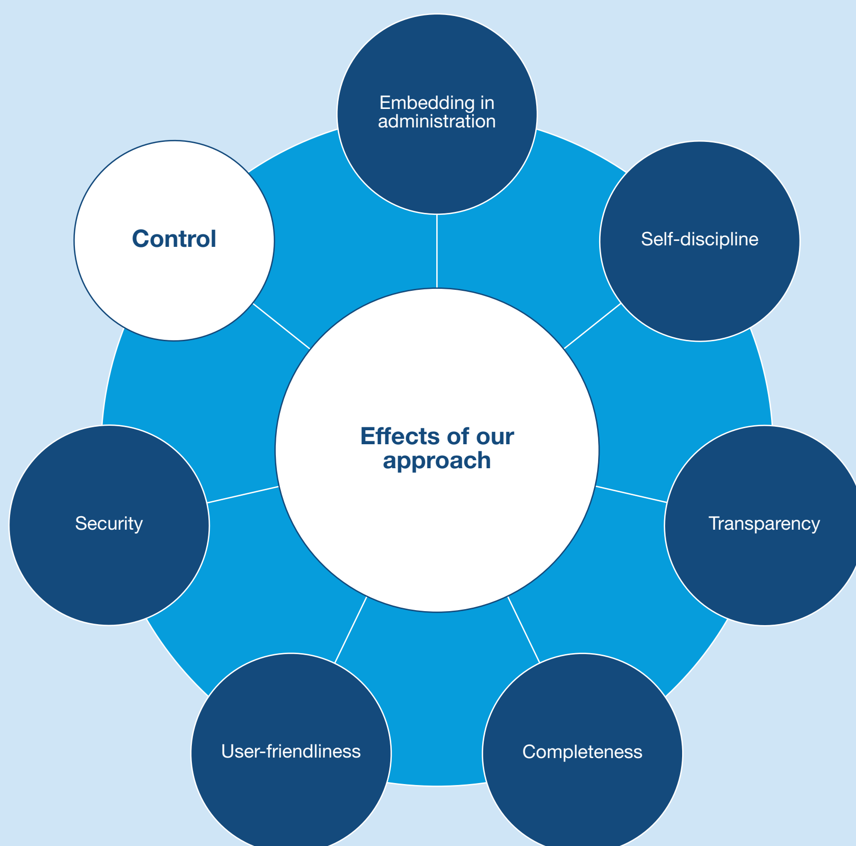
Real estate multinationals can introduce transparency to their VAT liabilities through a European VAT scan. This assists them in managing the processes relating to VAT returns and provides a tailor-made manual to roll out internally.

The objective of the VAT scan is to determine whether VAT principles and key controls are included correctly in a company's VAT process, ensuring that no VAT exposures occur. The scan is based on a fact-finding exercise performed on the situation 'as is'.

Four different phases in the VAT scan are defined to meet the following objectives: reviewing the VAT position, checking key controls and providing recommendations.

Based on the specifics of the multinational real estate company, questionnaires are prepared in the first phase. In phase two, local real estate tax specialists in each country participating in the survey have one day interviews with key local staff, collecting the data necessary for the assessment and identifying possible VAT exposures.

Benefits of European VAT approach for real estate companies



Source: PricewaterhouseCoopers

In phase three, the information collected in phase two is processed and assessed by a local VAT specialist. The preliminary results from this country analysis are then discussed with the local branch before drafting the final report.

Finally, an in-depth technical analysis is performed in each of the participating countries by a local VAT specialist, and a report is written containing the maximum risk of assessments, interest and penalties for the key findings concerning VAT compliance, the purchase, the lease and the sale of immovable property. Based on the report, recommendations are made and a manual is drafted to guide the organising and managing of VAT processes.

The scan helps management to regain control of the VAT return process and embeds key controls in financial administration, so avoiding unexpected VAT and IFRS exposures. ◘

David Pirouet: Jersey +44 1534 838302

UK offshore islands reinvent themselves for alternatives

After losing much of their retail business to onshore EU centres, the UK offshore islands are successfully reinventing themselves as highly competitive jurisdictions for the surging alternative fund industry

Threatened by the success of European Union (EU)-based territories in attracting fund assets, the UK offshore islands of Jersey, Guernsey and the Isle of Man have all had to reinvent themselves, building highly competitive offerings to meet the emerging needs of a rapidly evolving alternative investment industry. Recently revealed figures show their success in doing so, with substantial growth in the assets domiciled on the islands, and the expansion driven by the alternative investments of private equity, property and hedge funds.

In the year to June 2006, Jersey, Guernsey and the Isle of Man respectively announced annual growth of 42%, 37% and 75%. Together, the three islands service net assets of £292 billion.

This growth partly reflects the overall expansion of the alternative investment industry in recent years, much of which has occurred in Europe. Furthermore, for tax reasons alternatives managers based in London, Europe's leading hedge fund centre, increasingly favour domiciles within easy travelling distance. But the islands have made the most of their opportunity, introducing a raft of accommodative legislative, regulatory and strategic changes over the past five years.

All three islands were at the forefront of the traditional retail 'long equity' fund boom in the 1980s and '90s, but the EU-based UCITS legislation heralded the end of this sector as a number of funds were either transferred to or set up in EU territories, particularly Dublin and Luxembourg. As the retail market gradually moved onshore, the islands looked to build on their specialist fund knowledge by concentrating on the then niche area of alternative investments.

Fierce competition

With competition rife among offshore centres, the islands had to respond to industry developments in order to attract their share of this alternative business. The authorities in each jurisdiction built closer links with alternatives industry participants already in the islands in order to develop streamlined, flexible and competitive offerings. Such moves have resulted in the islands winning a significant share of the alternative funds market.

At first glance, this has led to very similar offerings across the islands. Any significant attempt by any offshore jurisdiction to differentiate its offering is quickly copied by its competitors, leveraging the flexibility of the responsive legislative and regulatory structures now in place in these jurisdictions. However, first mover advantage does exist. For example, in the property fund arena the Jersey property unit trust (JPUT) stole the march on its Guernsey rival (the GPUT) arguably because the UK structural advisers chose Jersey to set up the first structure of this type.

Once a path exists for a particular structure, then there is a tendency for others to follow. Guernsey offered the

Protected Cell Company at a time when other jurisdictions did not possess the flexible regulatory and legislative structures they have now and reaped the benefits. Only recently have the other islands responded by offering similar structures. This inter-island competition for first mover advantage is healthy. It ensures that, together, they remain highly responsive to industry developments, so keeping them at the forefront of the alternatives market.

The differentiation of the UK offshore islands in relation to other offshore jurisdictions has focussed around quality. Each is a well-regarded offshore finance centre with substance and depth in the fund services industry. This specialist knowledge continues to drive their success.

Rapid European growth

The European alternatives market has seen some of the most significant growth in recent years. The islands' location in the Euro time zone and their proximity to the key European business centres is proving to be very attractive. Global players are increasingly targeting this European business and are using the islands as bases for their tax efficient operations.

The recent focus from the UK tax authorities on UK hedge fund managers, and the issue of central management and control of offshore funds, has created another opportunity for the islands.

The islands' proximity to the UK enables UK-based fund managers and/or their advisors to participate in any strategic meetings held regarding the offshore fund. The sheer geographical distance between other offshore jurisdictions and the UK can make it difficult for directors of funds domiciled there to demonstrate that all strategic decisions, which are likely to require the input of various advisors to the fund, are taken at such board meetings.

Having reinvented themselves as specialists in the alternative fund industry the islands remain well positioned to adapt to the challenges and changing demands of the global alternative funds industry. While they are exposed to competitive threats from both EU-based jurisdictions and other offshore centres, as long as they continue to provide quality specialist offerings they will stay at the forefront of the industry.

Seeking the right balance – hedge fund valuation

The hedge fund industry is working to improve valuation practices, but there is a need to ensure that the costs do not outweigh the benefits and that the right balance is achieved

Olwyn Alexander: Dublin, Ireland +353 1 704 8719

For hedge fund managers seeking to retain a degree of opaqueness to protect investment positions, strategies and ideas, there is a natural tendency towards secrecy. Hence the inherent "push-pull" over valuations in the industry, as due diligence teams and regulators push for greater transparency and managers often hold back. Where then does the right balance lie between protecting sources of alpha and ensuring healthy transparency?

Following the role of weak valuation procedures in certain hedge fund failures in recent years, investors, regulators, accountants, administrators and even managers are becoming ever more aware of the potential pitfalls. They are grappling with the subjectivity that can be involved and, obviously, the implications of any errors.

With hedge funds undoubtedly entering the investment mainstream, institutional investors are shining a bright light on valuation methods during fund due diligence. In addition, the world's regulatory and accounting bodies are seeking to limit the scope for incorrect valuation. So while growth in assets could potentially increase aggregate mis-valuation risk, management of this risk is improving on an ongoing basis.

Better standards

Both the industry and regulators have done a lot of work to this end. The Alternative Investment Management Association (AIMA) issued 20 valuation recommendations in early 2005, and expects to release an update on this work in early 2007. Also in 2007, the International Organisation of Securities Commissions (IOSCO), a worldwide association of regulators, is due to release a set of hedge fund valuation principles. Separately, the UK Financial Services Authority and US Securities & Exchange Commission have been focusing on valuation for some years, issuing, for example, papers on illiquidity and side pockets.

From an accounting perspective, the recently issued US GAAP, FAS 157, 'Fair Valuation Measurements' statement strives to improve consistency and comparability in fair value measurements, and will seek greater disclosure in hedge funds' financial statements. Effective from November 2007, it introduces the concept of a fair value hierarchy that distinguishes between observable and unobservable inputs.

Asking more questions

Among investors, funds of hedge funds are performing far more due diligence, with a sharper focus on valuation. But are they getting the information they require? Are they asking questions such as is there a documented pricing policy; are there escalation procedures; what are the practices regarding governance, oversight and reporting of deviations from the valuation policy?

'Side pockets' are very topical, as they enable illiquid investments to be removed from the 'net asset value' process, suspended for dealing purposes and 'frozen' until they can be liquidated and the proceeds paid to investors who existed when the side pocket was created. Sensitive issues include the accounting requirement that fair value be applied to an obviously illiquid investment; whether performance fees should be levied on the investment; and whether this is simply a device for sidelining poorly performing investments? Positive aspects to side pockets include isolating illiquid investments to existing investors and also not levying fees on investments expected to perform poorly for some time, while maintaining the rest of the portfolio's liquidity.

Such attention to valuation is warranted and, in time, should lead to improved governance, oversight and consistency in valuation processes. But the right balance needs to be struck – to ensure that there is not too great a cost in terms of opportunity or expense.

Laurent de La Mettrie: +352 49 4848 3204 Thierry Braem: +352 49 4848 5106

Tax uncertainties surround carbon investing

As the EU carbon emissions trading market resumes its growth path after the price falls of summer 2006, market participants should be aware of differing tax treatments across member states

Just as the crash in EU carbon prices in early summer 2006 demonstrated this relatively new market's structural growth pains, so there are issues that should be dealt with at some point concerning lack of coordinated regulation. In particular, these regard corporate income tax, and even VAT – generally a far better coordinated tax in Europe.

Following the January 2005 inception of the EU Emissions Trading Scheme, a number of financial institutions positioned themselves early in what they judged a growth market. Under the scheme national EU governments would allocate companies permits or rights each equivalent to one ton of carbon dioxide. Rights could be traded, enabling companies exceeding their rights to buy from those with surplus rights.

For the SICAVs, special purpose vehicles, hedge funds and investment banks already actively trading carbon, there are several uncertainties regarding the income tax treatment of emissions trading profits and losses in many EU countries. There are also uncertainties over VAT. As more participants start to trade carbon permits, so these tax issues will become more pressing. In part, they may be a factor in more participants choosing to trade carbon through derivatives, which as financial instruments have more straightforward tax regimes.

Tax issues

While the summer 2006 carbon price crash illustrated the market's lack of maturity, tax issues are neither so serious nor as dramatic. Carbon prices corrected after it emerged that some countries had issued too many permits to companies. With a surplus of permits, the price of them fell sharply.

Even so, tax issues hinder efficient entry into the market. For example, in many EU member states there are several uncertainties regarding the treatment of trading profits and losses for income tax purposes. In particular, there are significant differences between countries regarding the allocation of the emission rights and the tax deductibility of penalties.

Even with respect to VAT there are still numerous questions pending. On 19 October 2004, a European VAT committee decided to treat transactions as located where the purchaser (when being a VAT taxpayer) is established, thus avoiding most of the VAT issues (management of VAT reclaims, pre-financing of the VAT). This pragmatic solution seems to have been endorsed by most of the EU tax administrations, either officially or in practice. Nevertheless some questions are still pending such as the VAT treatment of the initial allocation of emission rights (subject to VAT in some countries but not in most), or the treatment of emission right derivatives.

Optimal structuring

As tax coordination between member states is a lengthy process, these differences of interpretations and positions in tax matters will certainly be a key element to consider when deciding the optimal structuring of any investment platform in emission rights for many years.

Hungary introduces major changes to tax treatment of fund proceeds

Individuals' interest income and investment fund proceeds are not longer tax free. It may now be more tax-efficient to hold investments directly than through a fund

Dr. Marc-Tell Madl: Budapest +36 1 4619721 Dr. Tibór Szabó: Budapest +36 1 4619717

Investment funds, including the foreign entities, are transparent for corporate income tax purposes in Hungary, and do not have to file any tax returns in the country. Below we set out the new tax regulations impacting the income of Hungarian private individuals deriving from investment funds.

In order to promote investment activity, interest income and investment fund proceeds have also been tax free for Hungarian individual beneficiaries until quite recently. But with effect from 1st September, 2006, a 20% tax has been introduced on all interest income and on income deriving from investment funds.

Proceeds from publicly marketed investment fund units qualify as 'interest income' under Hungarian law and, similar to interest, they are subject to a flat tax rate of 20%. Proceeds mean both received dividends and realised capital gains. Yields earned on units of foreign investment funds are subject to the same tax rules as gains deriving from local funds – i.e. losses occurring in the given tax year (or earlier) may not be offset against current profits of the individual beneficiaries.

Private placements taxed differently

Income deriving from investment fund units that are not registered for public offering (i.e. the ones that are marketed via private placement) in Hungary shall be taxed differently. Private placement is defined by Hungarian laws in accordance with Directive No. 2003/71/EC. In such cases, dividends distributed to Hungarian resident individual unit holders are taxed at 25% and 35% respectively. Capital gains that do not qualify as 'interest income' from a tax perspective are taxed at 25%. In the event the fund cannot separate the interest, dividend and capital-gain-like components of the income, the proceeds shall be taxed according to the thresholds at a maximum rate of 36% as part of the overall income of the private individual. Again, no losses may be offset against current profits.

Dividend income deriving from securities listed on a European Union (EU) regulated market is subject to only 10% tax. Dividend is the income qualified as such by the laws of the EU member state where the regulated market is operating. We believe that there is a tax planning opportunity for investment funds listed on several European stock exchanges.

Capital gains (that do not qualify as 'interest income' from a taxation point of view) realised on securities listed on a regulated market of an EU or Organisation for Economic Co-operation & Development (OECD) country are subject to 20% tax. Losses occurring in the given year and the two preceding tax years may be offset against current taxable gains. Therefore, from a tax perspective making direct investments may be more advantageous than making the same investments via an investment fund.

Kees Roozen: Amsterdam +31 20 568 5281

Do foreign investment funds face more supervision in The Netherlands?

The amended Dutch Act on the Supervision of Collective Investment Schemes places additional information requirements on foreign investment funds from countries judged to have adequate supervision, but these are no more extensive than rules for domestic Dutch funds

Foreign investment funds (with the exception of UCITS) need in general a license before marketing in The Netherlands. Foreign investment funds from countries judged to have adequate supervision are now subject to new rules which require them to add to their prospectuses and financial statements information and disclosures. They have to apply these new rules for approval of their prospectuses and simplified prospectuses from 1st July 2006, and for their financial statements and semi-annual accounts from 1st September 2006.

Specifically, these new requirements apply to foreign investment funds from jurisdictions judged to have adequate supervision by the Minister of Finance, who is advised by the Dutch Supervisory Authority (AFM). Like UCITS, funds from these jurisdictions – currently Luxembourg, Guernsey, the United States and recently Ireland – require only notification rather than a full license before marketing in The Netherlands.

The questions arise (1) why these funds have to apply these new rules, due to regulation in their own jurisdiction, that was found adequate by the Ministry of Finance and (2) whether these funds are subject to more supervision than domestic Dutch funds. The answer to the first question is that the Dutch investor receives the same information for the foreign fund and the domestic fund. For the latter we would advise that this is not the case because Dutch funds also have to fulfil these information and reporting requirements.

The new rules

The new rules mean that an investment fund in Luxembourg for example has to add the Dutch information requirements to its financial statements. This can be done by either supplying this additional information in an addendum or by including it in the Luxembourg financial statements. If an audit opinion is required for the Dutch information furnished, this will also be the case for these additional information requirements.

For the prospectus, the simplified prospectus and the financial statements/semi-annual accounts, only the additional information requirements of the Dutch Act on the Supervision of Collective Investment Schemes (ASCIS) have to be fulfilled. For the prospectus this is detailed in appendices A and B of the ASCIS Decree. For the financial statements/semi-annual accounts, the additional information is detailed in sections 43 to 48 of the Decree. As an example, this means that for the financial statements additional disclosures on the expenses, the Total Expense Ratio and the portfolio turnover rate have to be made.

Conclusion

Foreign investment funds in the Netherlands from jurisdictions judged to have adequate supervision have only to supply additional information requirements (as mentioned earlier, this does not apply to UCITS). These same rules apply to domestic Dutch funds.

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directive and member states should hence be given the freedom to transpose the measure in their legal order in the most appropriate way." Secondly, "[…] some provisions of the directive are addressed to member states' authorities and not applicable directly to individuals, leaving member states' authorities some margin of appreciation."

Emerging trends

Provided the document does not undergo substantial changes, one can see a few trends emerging:

- The end of the famous 'look-through' approach for structured financial instruments (SFI). This approach identifies the assets which back an SFI, or drive its performance, judging whether these are eligible assets. Many asset managers would indeed be interested in having a listed synthetic bond linked to oil or gold in their UCITS fund. Will the new rules make that possible, assuming the text remains as is?
- Similarly, the draft's current wording would, under certain conditions, make financial indices admissible whatever their underlying assets. CESR had already opened the door for commodity and property indices, and many regulators had already followed this approach. Does this mean that even hedge funds indices, currently under CESR review, will soon flourish in UCITS III funds?
- Contrary to current interpretations in many European countries, a closed-ended fund would become a real 'transferable security' subject to several conditions. However, conditions such as the existence of sound corporate governance principles in the fund and regulated asset management activities are often difficult to verify for auditors, regulators and clients alike.

According to the Commission, the draft directive is expected to become final in January 2007. With several months (or years?) to go before transposition occurs into national legislation, diverging interpretations will probably continue to cause asset managers severe headaches. Furthermore, nothing in the current draft directive prevents a country from 'gold-plating' its legislation by imposing additional requirements. If that really happens, it will increasingly look like this long process has been for nothing.

Odile Renner: Luxembourg + 352 49 48 48 2615

Anne Mergeai-Laurent: Luxembourg + 352 49 48 48 2131

Editor: Rupert Bruce

If you would like to receive copies of this newsletter or would like further information about PricewaterhouseCoopers Investment Management and Real Estate publications, please contact Merryn Stewart at merryn.stewart@uk.pwc.com

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Contact Name	Location	Position	Phone Number	Email Address
Marc Saluzzi	Luxembourg	Global Investment Management Industry Group Leader	(352) 49 48 48 2511	marc.saluzzi@lu.pwc.com
David Newton	London	Global Investment Management Tax Leader	(44) 20 7804 2069	david.newton@uk.pwc.com
Uwe Stoschek	Berlin	Global Real Estate Tax Leader	(49) 30 2636 5286	uwe.stoschek@de.pwc.com
Marc Saluzzi	Luxembourg	European Investment Management Industry Leader	(352) 49 48 48 2511	marc.saluzzi@lu.pwc.com
Henrik Steinbrecher	Stockholm	European Real Estate Industry Leader	(46) 8 555 330 97	henrik.steinbrecher@se.pwc.com
Barry Benjamin	Baltimore	North American Investment Management Industry Leader	(1) 410 783 7623	barry.p.benjamin@us.pwc.com
Robert Grome	Hong Kong	Pacific Rim Investment Management Industry Leader	(852) 2289 1133	robert.grome@hk.pwc.com

Location	Contact Name	Phone Number
Austria	Andrea Cerne-Stark	(43) 1 501 88 1720
Belgium	Emmanuele Attout	(32) 2 710 40 21
Channel Islands	Brendan McMahon	(44) 1534 838234
Cyprus	Costas Mavrocordatos	(357) 2 555 202
Czech Republic	Petr Kriz	(420) 2 5115 2045
Denmark	Mikael Sørensen	(45) 3945 9102
Estonia	Urmas Kaarlep	(372) 614 1801
Finland	Tuukka Lahkela	(358) 9 2280 1333
France	Jean-Pierre Bouchart	(33) 1 5657 1702
Germany	Arno Kempf	(49) 69 9585 2367
Gibraltar	Edgar C Lavarello	(350) 78267 73520
Greece	Nicos Komodromos	(30) 210 6874 671
Hungary	David Wake	(36) 1 461 9514
Iceland	Hjalti Schiöth	(354) 550 5337
Ireland	Marie O'Connor	(353) 1 662 6308
Isle of Man	Mike Simpson	(44) 1 624 689 689
Israel	Joseph Fellus	(972) 3 795 4683

Location	Contact Name	Phone Number
Italy	Elisabetta Caldirola	(390) 2 7785 380
Latvia	Juris Lapshe	(371) 709 4400
Lithuania	Chris Butler	(370) 5 239 2303
Luxembourg	Thierry Blondeau	(352) 49 48 48 2549
Malta	Joseph Camilleri	(356) 25 647 603
The Netherlands	Sonja Barendregt-Roojers	(31) 10 407 6639
Norway	Geir Julsvoll	(47) 23 16 0540
Poland	Antoni F Reczek	(48) 22 5234 339
Portugal	António Assis	(351) 213 197 013
Romania	Vasile Iuga	(40) 21 202 8800
Russia	Richard Gregson	(7) 095 967 6327
Slovak Republic	Peter Vazan	(421) 25441 4101
South Africa	Pierre de Villiers	(27) 11 797 5368
Spain	Antonio Greño	(34) 91 568 4636
Sweden	Sussanne Sundvall	(46) 8 555 33 273
Switzerland	Thomas Huber	(41) 58 792 2436
United Kingdom	Pars Purewal	(44) 20 7212 4738

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