

PwC alternatives

volume 3 no. 4

Insights for the private equity and hedge fund communities

In this issue:

Hedge funds key to global market stability

Interview with Richard H. Baker,
President and Chief Executive Officer
of Managed Funds Association 1

Improving the valuation process for structured finance products

Recent credit events have significantly
changed the securitization and
fixed income landscape 5

FAS 157 implementation— focus on OTC derivatives

FAS 157 implementation requires an increased
focus on how credit risk is considered in
the valuation of OTC derivatives 10

Special report: Recent trends for alternative fund investments in Israel

Proper planning and structuring are key to
the success of alternative investment in Israel 12

Hedge funds to reconsider administrators for valuations and risk analytics

Hedge fund managers are being pushed as
never before to provide greater transparency
into the valuation of their portfolios 19

Significant new financial statements disclosures required in 2008 for sellers of credit derivatives

FAS 133 and FIN 45 included in new FASB
guidance for sellers of credit derivatives 22

International update

Recent tax developments in Europe,
Asia and Latin America 24

Hedge funds key to global market stability

Recently, Mark Casella, PricewaterhouseCoopers' US Alternative Investments Leader, interviewed Richard H. Baker, President and Chief Executive Officer of Managed Funds Association (MFA). Here are some highlights from their discussion.

Casella: What role should the industry play to help ensure the stability of the financial markets?

Baker: Industry participants need to be proactive in engaging in dialogue with policy makers about the vital role that hedge funds play in the stability of the global financial markets. This should include identifying areas of risk and being prepared to offer constructive solutions to address them. Good examples of industry efforts in this regard can be seen in initiatives related to short selling, credit default swaps and issues arising out of the Lehman Brothers insolvency. By working constructively with policy makers, the industry can continue to build its credibility and allow those policy makers to understand and appreciate the many benefits this industry brings to capital markets.

The industry must also be prepared to accept certain minimum expectations that policy makers have. One such expectation is widespread adoption and implementation of the President's Working Group's (PWG's) Asset Managers' Committee recommendation on best practices. Another expectation is that there will be a request for greater transparency from all financial industry participants, including hedge funds. Demonstrating the industry's commitment to best practices and greater transparency is a key initial step that will show the industry's willingness to work constructively on important issues. This will help ensure that the important role hedge funds play in stable, efficient markets is recognized and understood by policy makers as they work on regulatory reform.

Casella: What do you think will be the short-term and long-term impact of the two committees appointed by the President's Working Group on Financial Markets? What are the most challenging aspects of the recommendations for the industry?

Baker: Let me start off by saying that MFA applauds the efforts of the two private sector committees to develop detailed best practice recommendations for the hedge fund industry and to call on hedge fund managers and hedge fund investors to adopt those recommendations in all aspects

of their respective businesses. MFA believes industry best practices are the best means of achieving market discipline, preventing systemic risk, strengthening the US financial markets and enhancing investor protection.

Short-term impact

Upon the release of the PWG private sector committees' reports in mid-April 2008, their recommendations impacted the hedge fund industry significantly by establishing operational frameworks for the growth of the industry and by raising the bar in terms of industry best practice guidelines.

In particular, we believe that the PWG private sector committees' reports successfully heightened standards for improving transparency and accountability in hedge fund operations, building on the comprehensive best practice recommendations developed by many groups, including MFA, which published *Sound Practices for Hedge Fund Managers*. MFA is updating *Sound Practices* to incorporate the recommendations set forth in the PWG Asset Managers' Committee Report and to harmonize the document with the best practice reports and papers published by international groups, such as International Organization of Securities Commissions, Alternative Investment Management Association (AIMA) and the Hedge Fund Standards Board in the United Kingdom.

Long-term impact

In light of the economic crisis, US and non-US hedge fund regulation and supervision may undergo a sea change in 2009. Irrespective of market volatility and election results, MFA believes that the PWG private sector committees' recommendations for the hedge fund industry will remain relevant for hedge fund managers in overseeing their internal operations, helping guard against systemic risk and keeping the United States the most competitive financial marketplace in the world.

Challenging aspects of the recommendations for the industry

The most challenging aspect of the recommendations for the industry is the individual determination each manager must employ in tailoring and incorporating them into his or her existing policies and procedures. The PWG Asset Managers' Committee did not intend for its recommendations to be static, one-size-fits-all requirements that all hedge fund managers must follow in the same manner. Conversely, the committee intended that hedge fund managers sufficiently tailor the recommendations based on the size, nature and complexity of the organization, its strategies and resources. Similar to the implementation of *Sound Practices*, hedge fund managers must spend time examining their current operations and figuring out how to best incorporate the recommendations, and whether they make sense for their businesses.

Casella: The credit derivatives markets have been volatile during the past year, and many observers have called for changes to these markets. What can Congress or regulators do to address these concerns without compromising the usefulness of derivatives as part of managers' investment strategies?

Baker: The question you have asked presupposes that solutions to volatility concerns must come solely from policy makers or regulators. MFA believes that collaboration among policy makers, regulators, dealers, hedge funds and other market participants remains a good solution to address those concerns.

Credit derivatives are an essential tool for allowing hedge funds and other market participants to manage credit risk across a broad array of issuers and markets. For example, the defaults of major financial services companies highlighted the importance of these products, as they allowed hedge funds and other market participants to successfully hedge themselves against the impacts of credit defaults.

Although credit derivatives have come under an increasing amount of scrutiny and criticism, market reaction to recent credit events proves the market's ability to handle the settlement of defaults of large issuers and active derivatives dealers. The market has developed a number of mechanisms to mitigate counterparty risk and systemic risk. MFA acknowledges, however, that there may be ways to further mitigate counterparty and systemic risks as an evolution of this important market. For that reason, MFA is supportive of the work of the Federal Reserve Bank of New York's involvement in the establishment of a central counterparty for credit derivatives. The New York Fed has been working closely with the dealers, hedge funds, MFA and other industry participants to develop a central counterparty by the end of first quarter 2009. MFA believes that any central counterparty solution that is developed should address:

- Systemic risk
- Counterparty risk/collateral safety
- Market transparency and operational efficiency
- Liquidity
- Independence of central counterparty and appropriate governance of market

We support regulatory oversight of the central counterparty but believe it is important the credit derivative markets do not become over-regulated, so as to allow for market innovation.

Casella: Regarding the current liquidity crisis, what are your views on the benefits that funds are providing to the markets by being an additional liquidity provider?

Baker: Hedge funds are an important source of liquidity for capital markets. For example, hedge funds frequently provide liquidity to companies through the purchase of convertible bonds.

Convertible bonds are an important means by which companies, including distressed companies, seek to raise capital. Most investors in convertible bonds seek to hedge their market risk by shorting stock to maintain a sufficient “delta” hedge. As a result of the September emergency order issued by the SEC prohibiting short sales of financial companies, investors were not able to adequately protect themselves by hedging their exposure. Accordingly, potential convertible bond investors refrained from investing. The result has been that the market for convertible bonds has contracted, and companies – particularly distressed companies – have seen a reduction of an important potential source of capital. A stable regulatory structure will give hedge funds the flexibility to execute investment strategies that will provide needed liquidity to the markets.

Casella: What is your reaction to the proposals in Congress to tax carried interest allocations as ordinary income rather than capital gains?

Baker: MFA is concerned with the proposed change in the treatment of carried interest because it unfairly targets a particular form of business structure that has served this country immensely well by combining entrepreneurial sweat equity with financial capital in a broad cross-section of American business endeavors. Characterizing carried interest as compensation for services would overturn more than half a century of well-established tax law and fundamentally undermine the partnership business structure. Moreover, the proposed change would hurt the competitiveness of US-based hedge funds in an industry that is truly global, and it would do so at a time when the US economy and the US capital markets need more liquidity, not less.

Casella: MFA and the London-based AIMA recently announced that they will work together more closely. What kinds of collaborative initiatives are the two organizations planning?

Baker: MFA and AIMA are collaborating on a number of initiatives. From a regulatory standpoint, the two organizations have worked in a collaborative manner on the short sale rules that have been promulgated in the United States and the United Kingdom. MFA took the lead in addressing US rules, and AIMA took the lead in addressing UK rules.

Each organization took care to keep the other informed of their initiatives so that both groups of members could benefit from the efforts of both associations.

MFA and AIMA also worked together to try to bring about a timely and fair resolution to the issues surrounding the insolvency and subsequent administration of Lehman Brothers International (Europe) by engaging with US and UK regulators on the issue.

MFA and AIMA also have been collaborating on two major initiatives regarding industry best practices. The two groups, along with representatives from the PWG’s Asset Managers’ Committee and the UK Hedge Fund Standards Board, launched an independent website that contains a matrix of the groups’ best practices documents. This matrix will make it easier for industry participants to compare the recommendations in the various documents. The groups are also working to better harmonize the existing recommendations to lead toward truly global best practices. While regulatory and business differences around the globe likely will lead to some distinctions in recommendations, we believe there will be significant convergence for many of the recommendations.

MFA and AIMA are also collaborating on creating best practices recommendations specifically tailored for funds of hedge funds.

Casella: Aside from managing performance through a period of market volatility, what do you see as the three most challenging issues confronting the alternative investments industry during the next five years, and what should be done to meet those challenges?

Baker: The three most challenging issues confronting the alternative investment industry over the next five years are: deepening our policy engagement to help construct a balanced regulatory framework; achieving a global set of industry sound practices; and demonstrating to policy makers and the media the benefits that hedge funds provide to the markets and the economy. The keys to each of these challenges are education and collaboration.

Part of MFA’s mission is to encourage a constructive dialogue with policy makers and regulators to pursue reforms that will maintain or enable positive investment performance for our members and their investors. This has been a challenging year for maintaining a level playing field in the markets for our members to achieve their performance goals.

Meeting the challenge to establish global sound practices for the hedge fund industry is already under way. Although MFA is widely recognized for its guidance, *Sound Practices for Hedge Fund Managers*, there are additional sets of best practices recommendations

around the world. As I mentioned earlier, MFA recently collaborated with AIMA, the PWG Asset Managers' Committee, the Hedge Fund Standards Board and the International Organization of Securities Commissions to create the Hedge Fund Matrix—a joint initiative and the first step toward harmonization of existing hedge fund industry sound practices. In fact, the Hedge Fund Matrix launched its website in early October 2008 at www.hedgefundmatrix.com. The site provides an online resource that brings together the best practices guidance of the host organizations with the means to compare the core principles and to drill down to the guidance for each. We believe this is an important first step toward our goal of harmonizing sound practices, and we will continue to press forward to establish a single set of guiding principles for the global hedge fund industry.

The third challenge—demonstrating to policy makers and the media the benefits that hedge funds provide to the markets and the economy—will be driven by data. There is a clear need to provide more data about the industry in order to tell our story. For example, we would like to collect basic information about where hedge funds have offices and how many people they employ in each location. This information can be powerful when talking to Congress. We also want to collect data about pension funds and endowment funds that invest in hedge funds and the positive impact of those allocations to their funds' performance. This information also will be powerful when talking to Congress and help us to demonstrate how hedge funds add value on Main Street, not just Wall Street. While we already have anecdotal evidence, we realize that it is the job of an association to be a resource of information about the industry it represents, and we will endeavor to collaborate with data collectors to help us secure the data we need. Then we will tell our story on the Hill, through the media and around the world to clear up misperceptions about the industry.

Casella: What do you think the industry should do to address the negative perception that it has with Congress and the media?

Baker: The industry should continue to educate Congress and the media to address the misperceptions. Hedge funds are very private, and both Congress and the media didn't pay much attention to them until around 1998 when Long-Term Capital Management (LTCM) rocked the system. Today, industry scrutiny is at an all-time high, especially as we all struggle with the current financial crisis. As I said earlier, MFA is intent on setting the record straight about the important benefits that hedge funds provide to the economy: liquidity and price discovery, and, most importantly, the benefits that accrue to Main Street because pensions, endowments and foundations are now significant investors in the funds. Congress should consider the importance of hedge fund strategies

to the teachers, firefighters and hospital workers in their home districts that are beneficiaries of pension funds that have allocations to hedge fund strategies. And right now, when market indices and mutual funds are suffering losses, we can discuss how important is it for these pension and endowment funds to capture the benefits of diversification that hedge fund strategies provide. MFA spends a great deal of time on Capitol Hill with policy makers and their staffs to provide insight into the industry. We also encourage our members to make visits to the Hill to put a "face" on the industry. Members of Congress are pleased to meet face to face with hedge fund managers and get the chance to learn firsthand about how their businesses operate. MFA also spends a lot of time talking to journalists. This is an ongoing process and a constant challenge, but I think we are making progress. In addition, as I mentioned before, I think we can address the negative perception by increasing the provision of data about the industry. Numbers help to tell a story, and data collection is one of MFA's initiatives for that reason. The more data we can provide, the better we can create a more accurate and positive image for the industry.

Casella: What is your vision of the role that the MFA can—and should—play in the hedge fund industry, and how do you plan to get there?

Baker: All industries benefit in many ways by having an effective association. An association brings industry participants together to set goals and establish an agenda to promote growth and prosperity. I envision MFA as a catalyst for positive change, and I see us as an important, unifying voice for the alternative investment industry. MFA's most critical role is to represent the industry with policy makers in the United States and around the world. MFA will strive to deepen its policy engagement. Historically, the industry has weathered several calls for increased regulation, but I believe we will not be able to avoid regulatory reforms next year following the current crisis in the markets. MFA will represent the industry and work hard to participate in constructing a new framework. We have recently added to our infrastructure, and we have a highly experienced team of professionals who will help the industry through the next phase of its evolution. MFA will grow and thrive through collaboration, dedication and hard work.

The opinions expressed by individuals quoted in this article do not necessarily represent the opinions of PricewaterhouseCoopers.

Improving the valuation process for structured finance products

by Dave Lukach, Christopher Merchant and Frank Serravalli

Background

For nearly three decades, the structured finance industry enjoyed growth and success driven by steady improvements and innovative developments. But in mid-2007, everything changed, and we are now witnessing an unprecedented period for the industry.

Low global financing rates, relaxed underwriting, an increase in new market entrants, and an increase in demand by investors combined to fuel US mortgage origination growth from 2005 to 2007.

During that two-year period, the mortgage market expanded rapidly in response to consumer demand for financing and the opportunity to sell the product through the securitization markets to investors. Historically low mortgage rates and government support provided an opportunity for a wide range of new borrowers and increased home ownership in the United States to a record level of nearly 70 percent of households.

The lending and borrowing euphoria was driven by an expectation of the continued rise in home prices combined with historically low interest rates. In addition, a wide range of new mortgage products offering various payment schedules provided borrowers with a menu of financing alternatives to match their financing needs. The products were premised on a combination of refinancing at a later date combined with the expectation of rising home prices.

As the mortgage market grew, the discipline around underwriting and credit evaluation weakened based on an assumption that the housing market's momentum would continue. Worst case, borrowers would refinance their debt or sell the property. The notion was the collateral appreciation would compensate for increased borrower risk.

The industry demand for new mortgage products resulted in alternatives to the traditional origination process performed by mortgage lenders and banks. The independent broker network expanded, and market participants aligned themselves with broker networks to capitalize on the opportunities to originate and package securities. A significant portion of the new activity in the mortgage market was subject to little or no regulation. The increased activity led to several niche service providers and functional specialists. The traditional process of credit assessment and underwriting, origination, and servicing a portfolio by a bank or mortgage company grew by leveraging third-party specialists.

Originators and investors expanded their appetite for product and ventured down the credit curve. In contrast to the positive and predictable behavior of mortgage borrowers, the industry entered a period with very different fundamentals. The end result was a change in the underlying credit risk leading to dramatically different payment performance.

While these fundamental changes were occurring, originators, investors, guarantors, rating agencies, and regulators continued to rely on historical payment default and delinquency patterns to predict future performance even though the fundamental credit evaluation process was dramatically different from historical practice.

The mortgage security markets were driven largely by Fannie Mae, Freddie Mac, and Ginnie Mae from the early 1980s to late 1990s. From 2000 to 2007, their share of the market decreased as issuers explored other sources for credit support and/or enhanced the structures to incorporate credit support in the form of subordination and prioritizing cash flows. The private transaction market grew as investors became more comfortable with structural credit enhancements and an expectation that credit risk could be reliably forecasted.

Over time the trend continued with more complex structures and increased leverage. Securities with lower investment grade ratings were used to issue higher-grade investment securities. Pricing and structuring models relied on historical credit and housing data and did not fully contemplate the impact of macroeconomic trends on consumer behavior.

The market frenzy led to an inadequate assessment and pricing of credit risk. The softening of the housing market shed light on the weaknesses in the process. The housing downturn has exacerbated the rate and severity of losses, and they have quickly exceeded the historical expectations used to structure and price the securities. The effects were first observed in the US subprime mortgage market and have migrated into a wider range of mortgage products. Now, those effects are impacting the consumer credit and the global fixed income markets.

Higher levels of defaults and increasing levels of loss severity have resulted in numerous high-profile events in the global marketplace, including the failure of numerous capital market participants, historic government intervention in the global financial markets, the failure of investment funds and vehicles due to liquidity pressures, dramatic tightening of credit and lower levels of lending activity, severe strain on leveraged entities, and a flight to high-quality fixed income investments.

Impact of illiquidity

As of October 2008, the global markets remained in a severe credit and liquidity crunch.

What is driving the liquidity crunch? Global financial institutions and investors have lost faith in the fixed-income markets. The lack of confidence in data and performance has resulted in unprecedented levels of volatility. The lack of functional markets precludes normal purchase and sale activity. Everyone is building cash reserves and seeking only high-quality investments.

In the past, investors in fixed-income products relied heavily on external information to make investment decisions such as research reports and credit ratings. In many cases, investors did not independently perform detailed quantitative assessments of their investments.

When the performance of structured products started to deteriorate, a lack of transparency in underlying deal data led to generalizations about performance. In general, pre-2005 deals continue to perform as expected, while mortgage-backed deals originated in 2006 and 2007 are broadly labeled as higher risk.

The lack of timely and detailed loan level data to evaluate performance and risk combined with little to no trading activity has left the market in a frozen state. Currently, levels of trading remain low, and the only significant transactions have involved entities that needed to access cash and reduce their credit risk exposure.

The absence of trading activity has forced investors to seek alternative information to price many of their structured product investments. Current market conditions have added a new level of complexity and uncertainty to the valuation process.

Market contagion

What started as strain primarily in the mortgage product space has spread to the global credit markets. Credit has tightened on a global scale as evidenced by historic rises in overnight bank lending rates and a reluctance of institutions to lend to consumers and one another.

The tightening of credit has led to a rising home inventory, and home prices continue to fall. The good news is that the rate of change in home prices has started to slow. The effect on household wealth and homeowner equity is impacting consumer spending, triggering a negative feedback loop.

Deleveraging in the financial segment has resulted in major changes to notable players in the financial industry. The Lehman Brothers' bankruptcy, Bank of America's purchase of Merrill Lynch, JP Morgan's purchase of Bear Stearns and Wells Fargo's acquisition of Wachovia are the most prominent examples. Experts believe there will be further consolidation in the banking sector as it goes through structural change in response to the effects of the credit crisis. It is clear the financial services landscape will be radically different.

The credit assessment process

Low borrowing costs seen from 2000 to 2007 and readily available credit provided originators with increased leverage to expand their lending businesses, and the securitization markets provided an expedient outlet for transferring assets while maintaining little or no exposure to the underlying assets.

As the exit market tightened, investors initially required substantially higher yields and shortly thereafter exited the market for structured product. Since the later half of 2007, the securitization markets have contracted, and there is virtually no new mortgage issuance with the exception of government-sponsored enterprise products.

The prominence of “reduced” and “no-doc” loans, piggyback loans for down payments, and a frenzied market for investment properties has resulted in many highly leveraged homeowners. Dramatic house price depreciation on a national scale has left many homeowners with minimal equity.

So where does this take us? The origination and underwriting processes need an overhaul with an emphasis on the basics. The tightening in credit standards since summer 2007 has led to an improvement in the underwriting process.

Investors need more information to reduce the uncertainty that has driven up the market yields on securities. While some of the spread widening is clearly attributable to credit issues, many highly rated securities are trading at very high yields. Consistent and reliable pool information will permit an assessment of the current performance of the investment pools and a more rational assessment of the inherent risks.

The information used to originate product generally is not updated, and some have questioned the predictive value of FICO scores and other credit measures.

FICO scores reflect the history of borrower repayment behavior and do not include any forward-looking information. In addition, some believe that the scores can be managed. Pool performance is driven by several factors, including occupancy type, geographic concentrations, and house price appreciation. These are widely considered important factors in assessing and estimating the pool cash flows.

Underwriting guidelines should consider all of the factors that will affect borrower behavior. The market has responded by reducing or eliminating low- and no-documentation loans and requiring an assessment of the borrower’s ability to meet the most onerous terms. Critical borrower information may need to be updated and made available to investors, rating agencies and regulators.

As an expanded information data set is distributed by underwriters and servicers to the investor community, uniform standards for data content and transmission will be needed to make the process efficient. Automated data sets will facilitate data mining and stratification to better evaluate and measure risk.

Although there is significant information in the markets around economic factors, an industry effort is needed to centralize and make available key macroeconomic information such as housing price appreciation and unemployment rates, which will facilitate the analysis of longer-term performance.

Lenders also should clearly explain their underwriting, surveillance, and loss mitigation processes. Strengthening such processes and making it known to the investor community will reduce the information gap.

The whole loan market

Historically, loans remained on balance sheets for a short period resulting in institutional exposure to the most recent originations. As the market shifted away from an originate-to-sell model, institutions have been left with larger whole loan portfolios.

Many originators also act as the servicer so they have the granular loan performance data necessary for evaluating risk. In addition, the ability to service the loans and implement risk mitigation strategies is not constrained by off-balance-sheet accounting requirements.

Transaction surveillance

Investors need access to current, reliable information to assess risk. Periodic investor reports generally provide high-level information on asset performance and trends and the current capital structure.

Advances in the credit markets have resulted in simple to complex capital structures. As structural complexity increases, the types and level of information required expand extensively. Credit and performance analysis is grounded in the same principles:

1. Loan level performance
2. Current credit status of the borrower
3. The current pay status and aging profile of borrowers
4. Current collateral values
5. Home price appreciation levels
6. Structural credit support (initial and current)
7. External credit support
8. Macroeconomic conditions

The market’s ability to assess risk and derive values will be efficient only when sufficient data is available to drill down to the loan level. That level of detail is known to a limited segment of the market. Until we achieve more balanced distribution of information to the marketplace, there will continue to be a wide range of values and a premium demanded for the information uncertainty. Timely and consistent reporting of borrower and deal performance is essential. Consistent data formats and templates will allow efficient analysis and comparison of deals.

On the front end, enhanced communication of deal structure and attributes should be considered. The key question is: How can the process be simplified to enable investors to better understand the risks and incorporate changes into their estimates on a timely basis?

In addition, market participants should enhance their quantitative and qualitative assessments. Investors need to be able to independently assess their deal performance and evaluate information provided by market makers and pricing services for reasonableness. In addition to deal level data, investors need to understand the governing documents and deal attributes to ensure the model appropriately reflects the transactions terms.

A model can be used in a variety of ways to understand a structured product. The most common way is to run sensitivity analyses using a range of inputs for key variables. The model provides a level of independence to the investor by allowing them to derive values using data from multiple sources.

In light of the recent market events it is important to consider how scenario analyses are developed and the probability and effect of outlier events.

Fair value

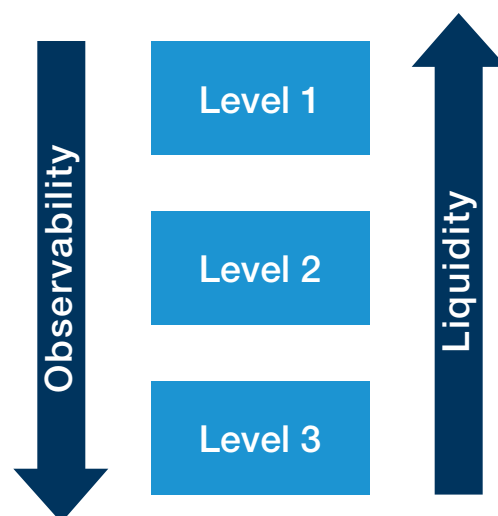
The recent market conditions have caused nearly everyone to step back and assess the concept of fair value. In liquid and transparent markets, the concept is neither complicated nor controversial. In illiquid, inactive, and nontransparent markets the process is complicated.

The accounting standards define fair value as an exit price in an orderly market between a willing buyer and a willing seller. The guidance focuses on the price received to sell an asset or transfer a liability, not the price paid to acquire an asset. When markets are functioning properly, observable trades for identical assets provide the best estimate of fair value. Recently, illiquidity and a decrease in trading levels have resulted in a lack of transactions and a decrease in observable data points.

The accounting framework prioritizes the process used to determine and report fair value with a focus on market-based measurements. Specifically, fair value should be based on assumptions and information market participants would utilize in pricing an asset or liability. Hence, the current dilemma: What do you do when there is limited or no market activity?

It has become apparent that participants have different access points to the market and different levels of information. The result is an information imbalance with pricing levels that often reflect a wide disparity

of valuations. If transparency increases, the market should migrate to a narrower range of values, which in turn should decrease the current liquidity premium as investors become more confident in the pricing process.



In response to current market conditions, the SEC and FASB recently released additional guidance providing clarification on application of the fair value standard in illiquid markets. The guidance clarifies how quotes should be used when markets are illiquid. If quotes are not current or are based on nonobservable data points, they are deemed to be a level 3 input or valuation.

In addition, market participants should seek out relevant market data to make their own estimates when quotes or pricing services are not deemed to be representative of market values or are classified as level 3. The FASB Staff Position discusses the notion of weighing the relevant information to determine the best estimate of value.

Valuation considerations

Many lessons can be learned from the unprecedented market events. First, historical data needs to be monitored to assess its predictive value based on current market conditions. As market conditions evolve, historical data and relationships may no longer be relevant.

The anxiety in the markets has highlighted the need to assess liquidity and its short- and long-term impact on values. As liquidity concerns increase, the market demands a premium. We attribute this to two concerns.

The first concern is an inability to compare risks across deals (information uncertainty), and the second concern is that the ability to exit a position will be constrained by a lack of buyers at a price they believe is reasonable.

The following highlights specific factors to be incorporated into fundamental credit analysis. We focused on three areas, origination and borrower data, transaction surveillance, and entity level strategies.

Origination and borrower	Transaction surveillance	Entity level
Full documentation loans	Asset level performance data	Alternative exit strategies (whole loan sales, loan investments)
Underwriting standards and standard documentation	Benchmark industry data	Formalized policies and procedures
Current FICO or similar credit scores	Pool level due diligence	Identify and implement controls over valuation
Servicer performance	Static pool data	Periodic portfolio surveillance
Back testing the underwriting and origination process	Stratify and assess risk based on vintage, collateral type, layered risk factors	Outlier and variance analysis
Detailed borrower performance data	Governing documents and amendments	Servicer due diligence
Impact of macroeconomic events on historical trends and data		Evaluate macroeconomic factors into models
Loan modifications		Benchmark investment and underwriting against deal performance
Updated appraisals		

Government intervention

In response to the unprecedented activity in the markets, the US government has undertaken numerous actions to quell the credit crunch, encourage lending, and improve confidence in the financial markets. The Troubled Asset Relief Program, direct investments and loans to troubled institutions, and increased FDIC deposit insurance limits have been put in place to stabilize the markets.

The coming weeks and months are likely to see additional action by the US government, US Central bank, and the central banks of other nations in response to the financial crisis. It will take time before the full impact of these measures can be assessed.

Summary

Recent credit events have significantly changed the securitization and fixed income landscape. We are in a transition period that will take us into a new environment. Investors have been reminded that yield is driven by risk. The market also has been reminded of the risks of using leverage.

The investor community has moved toward more granular, credit-based valuation processes with a keen focus on drivers of fundamental cash flows. Increasing the volume, quality, and timeliness of data available to market participants will facilitate a more rational capital allocation process.

In addition, market standards for data and electronic formatting will increase the efficiency of the data transfer process, which will improve the market pricing process. Rational, informed decisions are based on access to detailed and relevant information on a timely basis. The market has already started to implement some of these suggestions. The positive momentum must continue with the longer-term goals of making the markets transparent.

The securitization market has a longstanding reputation as an important and integral part of the global financial markets. Reducing market uncertainty and calming investors' concerns will allow the securitization market to regain its role in the global economy as a distributor of risk and capital.

FAS 157 implementation—focus on OTC derivatives

by Chip Currie and Sergey Volkov

Background

FASB Statement No. 157, Fair Value Measurements (FAS 157) became effective for most companies for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. One of the more significant FAS 157 implementation issues our alternatives clients continue to work through is an increased focus on how credit risk is considered in the valuation of Over-The-Counter (OTC) derivatives, including interest rate swaps, foreign currency derivatives, total return swaps and credit default swaps. FAS 157 requires reporting entities to consider the impact of a counterparty credit risk and nonperformance risk, and changes therein, when determining the fair value of OTC derivatives. Counterparty credit risk represents the risk that the counterparty will fail to perform under its obligation. Nonperformance risk represents the risk that the reporting entity will fail to perform under its obligation. Recent clarifying guidance from the Financial Accounting Standards Board (FASB) and the US Securities and Exchange Commission (SEC) has placed additional emphasis on assessing this impact on valuation.

Prior to the issuance of FAS 157, many entities have valued many over-the-counter derivatives by discounting expected future cash flows by a benchmark interest rate (e.g., LIBOR). The impact of counterparty credit risk may have been considered on a qualitative basis. Reporting entities frequently post initial margin and variation margin to protect the counterparty from entity's own credit risk. Entities generally manage counterparty risk by transacting with high credit quality counterparties, executing ISDA Master Netting Agreements, and receiving collateral or other credit enhancements. However, counterparty credit risk and nonperformance risk may still affect the uncollateralized net exposure, and the impact on valuation may be material under current market conditions.

Recent developments

The SEC has recently issued a number of comment letters to reporting entities seeking clarification on how the impact of counterparty credit risk was considered in valuing derivative assets and how the risk of nonperformance (entity's own credit risk) was considered in the fair value of derivative liabilities. The SEC letters made reference to guidance in FAS 157 that requires the measurement to consider attributes specific to the asset or liability.

In addition, the SEC issued a "Dear CFO" letter in September 2008 that suggested reporting entities consider certain disclosures. More specifically, guidance suggested reporting entities consider disclosing:

- How credit risk affected valuation of derivative liabilities and the resulting gain or loss that [entity] included in earnings relating to the changes in that credit risk.
- How counterparty credit risk affected entities valuation of derivative assets and the resulting gain or loss that [entity] included in earnings relating to the changes in that credit risk.
- How deterioration in the counterparty's credit and [entity's] ability to collect on a derivative asset will impact [entity's] financial statements.

On October 10, 2008, the FASB issued FSP FAS 157-3, Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active. The FSP illustrates the requirement within FAS 157 to incorporate appropriate risk adjustments that market participants would make when measuring fair value, including nonperformance and liquidity risks. FSP FAS 157-3 also refers to the above SEC "Dear CFO" letter guidance.

At least one entity has restated its financial statements for failing to consider impact of nonperformance risk on the value of its OTC derivative positions in 2008.

Potential changes to the valuation process

Many reporting entities continue to assess and monitor the impact of FAS 157, FSP FAS 157-3 and SEC's guidance on the valuation of Over-The-Counter derivatives.

Reporting entities that have legal right of offset under ISDA Master Agreements often assess potential impact by determining net exposure by legal counterparty and considering collateral received and posted. Determining net exposure is complex. Reporting entities should work with counsel to determine whether netting across products or, in some cases, entities, is allowed within the ISDA Master Netting Agreements when determining the net exposure.

When net exposure to a counterparty is positive (i.e., in a gain position), after considering the collateral received from the counterparty, reporting entities determine the impact of nonperformance risk based on best available information about the market price of credit of the counterparty.

When net exposure to a counterparty is negative (i.e., in a loss position), after considering collateral posted by the reporting entity, the entity determines the impact nonperformance risk based on the best information available about the market price of its own credit.

Due to the highly technical and often complex nature of this assessment, including the calculation of credit risk valuation adjustments, many entities consult with valuation experts or engage pricing services to assist with the assessment of impact.

Looking forward

The challenges of applying fair value accounting and reporting under FAS 157 will continue as standard setters and regulators issue further clarifying guidance on its requirements, seeking to address issues arising from changing market conditions and industry practice.

FAS 161 became effective for fiscal years beginning after November 15, 2008, requiring significant additional disclosures associated with derivatives to be presented in the notes of the financial statements. FASB is also discussing issuing further guidance requiring additional fair value disclosures, seeking to further enhance transparency within fair value measurements, including the effect of credit risk on valuations.

Reporting entities will continue to further enhance disclosures with respect to how counterparty credit risk and nonperformance risk are considered in their valuations, providing additional transparency within related fair value disclosures. As reporting entities continue working through the implementation process and related valuation issues, changes in market conditions and market participant behavior changes, the approaches to include counterparty credit risk and nonperformance risk in the valuation of OTC derivatives will continue to evolve.

Technical references

- PwC DATALINE 2008-06 - Assessing the Impact of Nonperformance Risk on Derivative Instruments Included in a Master Netting Arrangement
- PwC Guide to Fair Value Measurements
- PwC DATALINE 2008-24 - Third Quarter Considerations Given Current Market Conditions
- FASB Statement No. 157, Fair Value Measurements
- FSP FAS 157-3, Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active

Special report: Recent trends for alternative fund investments in Israel

by Josh Ashman, Philip Fried, Kevin Liss, Ran Niego, Doron Sadan and Oscar Teunissen

“With 80 active funds and over \$10 billion under management in over 1,000 Israeli start-ups, Israel’s venture capital industry thrives like no other country—except for Silicon Valley. In 2006, 402 Israeli hi-tech companies raised over \$1.62 billion—the highest amount in the past five years and a 21 percent increase over the previous year versus an 8 percent growth in the US market and a 6 percent growth in the European market. This growth prompted both the IMD (International Institute for Management Development) and WEF (the World Economic Forum) to rank Israel as second in the world for the amount of funds raised by technology start-ups, following only the US.”¹

This article highlights some of the relevant US and Israeli tax and regulatory considerations for structuring acquisitions and investments in the fast-growing Israeli venture capital-private equity market.

The Israeli financial market, which operates in a sophisticated, regulated forum influenced by globalization and Anglo-American culture, provides an array of opportunities for international investors. Increasingly favorable reports of economic growth indicate that irrespective of Israel’s geopolitical climate, the opportunities for investment materialize on a regular basis.

One area that has experienced enormous growth is the venture capital and private equity sector. In 2007, 462 Israeli high-tech companies raised \$1.76 billion from local and foreign venture capital investors, an increase of 8.5 percent over the \$1.62 billion raised in 2006 and a 31.5 percent increase over 2005 levels.

In the second quarter of 2008, 115 Israeli high-tech companies raised \$465 million from venture investors—both local and foreign. The amount was up 7 percent from the second quarter of 2007 but was 25 percent below the unusually high first quarter of 2008. In the first half of 2008, capital raised was \$1.08 billion, up 28 percent from the first half of 2007.

Currently, foreign investors account for approximately two-thirds of Israeli private equity-venture capital. International private equity players have also been increasing their focus on large Israeli merger and acquisition deals.

Highly qualified entrepreneurs, many of whom are veterans of both the Israeli military and Silicon Valley, enhance the success of Israel’s high-tech industry. These individuals possess not merely the requisite technical knowledge for success in the field, but also the business acumen so critical to such success.

Additionally, Israel’s high-tech success story thrives on the strong presence of major multinational corporations. The presence of such companies in Israel has set an example for investors throughout the world. Israel is home to 80 active venture capital funds, and these and other funds are responsible for commitments in excess of \$10 billion, representing an increase in 2007 of 8.5 percent over 2006.

Excluding the United States, Israel ranks second in the world in the money raised by technology start-ups. Also, according to NASDAQ records, as of December 31, 2007, Israel has the most companies listed for trade on the NASDAQ after the United States.

In addition, the Israeli government promotes the growth of Israel’s high-tech industry by offering incentive programs, including tax reductions (providing a total exemption in certain cases) and grants for research and development programs.

¹ www.investinisrael.gov.il

General considerations

In general, as is the case with most alternative investments, separate investment vehicles are set up to accommodate the strategies of US, non-US, and tax-exempt investors.

US investors generally invest through funds that are considered fiscally transparent for US tax purposes. This structure allows US investors to preserve the same tax attributes of the underlying investment income the funds earn with respect to foreign taxes, capital gains, certain dividend income, and other items that may be taxed at preferential rates as when such investors earn it directly.

Non-US and tax-exempt investors generally invest through offshore corporate funds to reduce the risk of establishing a US trade or business through attribution of the activities of a US adviser or, in the case of tax-exempts, of being exposed to unrelated business income tax issues. US funds are usually managed out of the United States, although it is also common for them to have subadvisers in a financial center such as London, Singapore, Tokyo or Hong Kong.

The US management companies that manage funds in the United States are generally formed as US partnerships or as limited liability companies (LLCs) that are treated as partnerships for US federal income tax purposes. This structure results in a single level of taxation of investment income and also allows for the flow-through of tax preference items.

Offshore investors in such funds investing in the United States typically rely on a so-called trading safe harbor, which provides an exemption for certain income from being treated as effectively connected income in the United States. This income generally arises in situations where the nonresident alien engages in a trade or business within the United States and derives his income from sources within the United States. As discussed below, Section 864(b) contains specific safe harbor rules designed to provide nonresident aliens guidance on how to avoid being engaged in a trade or business within the United States with respect to a particular activity.

Not all countries have safe harbor rules that would shield foreign investors from the risk of being taxed by virtue of their activities within their borders. Examples of countries that offer safe harbors to mitigate permanent establishment or trade or business exposure are the United Kingdom, Singapore and Hong Kong. Most European countries, however, do not embrace the safe harbor concept.

Because Israel is one of the many countries that do not have such rules, the activities of the Israeli subadviser should be carefully monitored (see below). Alternative investment funds generally establish either representative offices or wholly owned Israeli management companies to provide advisory services to the US management company. Management companies can perform a wider range of activities than representative offices. As a general rule, funds tend to start with a representative office and then transition to a wholly owned Israeli management company as the subadviser as the level and scope of their activities in Israel expand.

As noted above, Israel, like most countries outside the United States, does not have a trading safe harbor that would allow the employees of subadvisory entities to negotiate and conclude contracts on behalf of the investment funds without giving rise to an Israeli permanent establishment, thereby creating a basis for taxing the funds in Israel. Under these circumstances, the activities of the Israeli representative office must be continuously monitored to manage the exposure. Alternatively, it may be possible to procure a tax ruling allowing a representative office to operate in Israel with relatively few constraints (see detailed discussion below).²

The scope of activities of the Israeli management company should be clearly defined in a subadvisory agreement with the US management company. Also, any employment agreement between an Israeli subadvisory entity and local employees should be drafted carefully to limit the employees' scope of activities.

As briefly noted earlier, a favorable trading safe harbor under US domestic tax law³ allows advisory entities to trade on behalf of nonresident funds without creating a US trade or business in the United States.⁴ By virtue of this provision, it is permissible for discretionary management of Israeli investments to be carried out from an office based in the United States. The outer boundaries of similar trading safe harbors in other

² Operating guidelines should be developed to educate employees of the Israeli advisory entities of potential adverse tax implications related to their activities in Israel.

³ Section 864(b)(2) generally provides that "trade or business within the United States" does not include "trading in stocks or securities for the taxpayer's own account." This provision is often referred to as the "US trading safe harbor." Though it is to be interpreted broadly, the legislative history also indicates that a determination of whether an investment company is conducting a trade or business in the United States remains a question of fact and does not completely free investment companies from the possibility of being considered engaged in a trade or business. The volume of the taxpayer's transactions is ignored in applying this rule. Certain activities, such as loan origination, are not covered by the safe harbor.

⁴ Detailed discussion of these safe harbors is beyond the scope of this article.

jurisdictions must be carefully considered so that discretionary management activities (e.g., those related to Israeli investments) do not create permanent establishment or trade or business exposure in these jurisdictions. Transfer pricing considerations generally require an Israeli subadvisory entity to receive arm's-length compensation for its services.

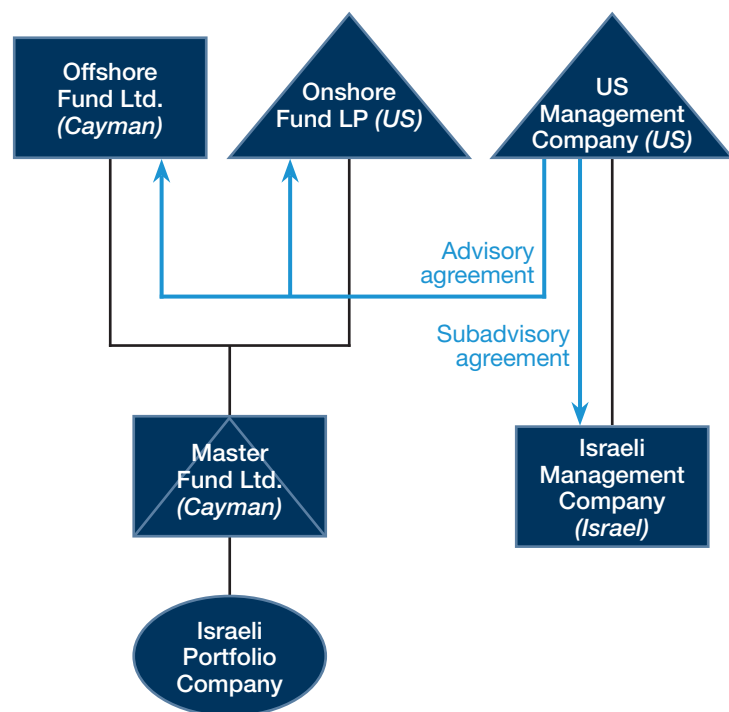
At the fund level, a wide range of structures could be utilized with respect to cross-border investment planning, including treaty-based and local Israeli holding vehicles.

Fund-level investment structures pay close attention to mitigating income tax, withholding tax, and capital gains tax liabilities. Although these tax liabilities can often be claimed as credits by US investors against their respective US tax liabilities, subject to a complex set of US foreign tax credit limitations, foreign taxes generally represent out-of-pocket costs for the offshore investors.

Under certain circumstances, the fund may be able to receive an advance tax ruling from the Israeli tax authorities (ITA). A tax preruling, insofar as one is available, can be an effective way not only to manage income taxes, but also to gain certainty with respect to the operational guidelines for the fund's activities in Israel.

The exhibit below provides a diagram of a common management and fund investment structure.

Management and fund investment structure



Israeli taxes—overview

In general, under Israeli law, a non-Israeli resident is subject to Israeli tax only on income accrued or derived in Israel (i.e., income from an Israeli source). Dividend income paid by Israeli corporations is generally considered Israeli source income and subject to tax rates ranging from 20 percent to 25 percent.⁵ Capital gains from nontraded Israeli securities derived by a non-Israeli resident individual are generally subject to a 20 percent tax rate, which may be reduced under an applicable tax treaty or, in certain cases, under a domestic law exemption. A 25 percent rate applies to capital gains generated by any person who directly or indirectly holds at least 10 percent of the disposed company's shares during the 12 months preceding the sale.

As further discussed below, foreign investors are generally exempt from capital gains tax on the sale of securities traded on the Tel Aviv stock exchange.

Domestic exemptions

Tax preruling

(1) ITO Section 16(A)

Rulings granted under Section 16(A) of the Israeli Tax Ordinance (ITO) offer a measure of certainty for funds with respect to their tax positions in Israel, so the rulings may assist in facilitating a fund's tax structuring.

Generally, the ITA may grant rulings exempting foreign investors in venture capital funds from capital gains tax in Israel as well as providing rate relief to investors in private equity funds (a rate of 15 percent for individuals, 25 percent for corporations, and exemption for tax-exempt entities). To be eligible for the ruling, the fund will generally need to meet the following main conditions:

- The fund should have at least 10 investors (foreign and Israeli), and each investor should hold no more than 20 percent of the fund's capital.
- No more than 15 percent of the fund's total investment in Israel should be devoted to a single entity. In other words, the fund is required to hold no less than seven Israeli portfolio companies. However, recently some relief from this requirement has been achieved.
- For venture capital funds, at least 75 percent of the investment in each Israeli portfolio company should be made through a capital contribution (and not by purchasing shares from existing shareholders).
- Generic investor information (e.g., entity type, name, residence) should be submitted.

⁵ The rate is mainly determined by the holding percentage in the company and may be reduced under a tax treaty.

Regarding the last point, the ITA is aware that funds are commonly reluctant to share such information. This is particularly relevant to private equity funds that benefit only from reduced tax rates as opposed to outright exemptions, depending on the type of entity and residency of its investors; therefore, the ITA requires more information regarding both direct and indirect investors.

Another advantage of the ruling is that it may make it possible to address and obtain certainty with respect to ancillary, procedural, and other issues (e.g., reporting and tax withholding, etc.). Finally, the tax ruling may also include a provision that enables the fund to have a permanent establishment in Israel. Consequently, the fund may also have a local representative carry out “unrestricted” activities without jeopardizing the tax benefits the ruling accords.

(2) ITO Section 97(b3)—Exemption for treaty investors

ITO Section 97(b3), on the other hand, generally exempts nonresidents of Israel, regardless of their percentage holding in the disposed Israeli company (excluding rights in real estate associations holding real estate rights), from tax on capital gains from the sale of securities (even where not traded on a stock exchange in Israel), provided that those securities were purchased between July 1, 2005, and December 31, 2008, and that certain additional conditions are met, mainly:

- The capital gains were not derived by the seller’s permanent establishment in Israel;
- For 10 continuous years preceding the date of purchase of the security, the individual seller was a resident of a country having an effective tax treaty with Israel. In the case of a sale by a foreign company, at least 75 percent of any of its “means of control,” directly or indirectly, must have been held by individuals who were residents of a tax treaty country for 10 continuous years preceding the purchase of the security;
- The securities must not have been purchased from a related person (as defined in the ITO) or been acquired by means of a tax-free reorganization; and
- The nonresident must comply with certain reporting and tax filing requirements (including those in the seller’s country of residency).

It should be noted that insofar as one of the requirements under Section 97(b3) is that the capital gains must not have been derived by the seller’s permanent establishment in Israel, a ruling under this section would

generally not be granted whenever there are ongoing activities in Israel.

(3) ITO Section 97(b1)—Research and development company

An additional exemption from capital gains tax may be available to foreign investors from the disposition of shares in an “intensive research and development company.”⁶

This exemption is generally available without regard to whether the foreign resident is a resident of a treaty country, as long as the investor acquired his ownership interest through an allotment of shares and not from an existing shareholder.

The main virtue of this exemption is that it applies with respect to the company that receives the investment, without regard to the identity of the investors in the company.

(4) Section 97(b2)

Under Section 97(b2) of the ITO, foreign residents are exempt from tax on capital gains on the sale of securities traded on an exchange in Israel. This rule applies only to the extent that the gain is not attributable to a permanent establishment in Israel.

Tax treaty exemption

Non-Israeli residents may be entitled to relief from, or a reduction of, tax on capital gains under an applicable tax treaty. Under the US-Israel tax treaty, for example, gain from the sale, exchange, or other disposition of capital assets is generally exempt from tax if the gain has not been generated from the US resident’s permanent establishment in Israel, as long as the US resident did not own 10 percent or more of the voting power of the corporation whose stock was sold.⁷

Additionally, a proper offshore intermediate holding company structure should be considered as a way to provide greater flexibility in future exit scenarios as well as to attain tax treaty protection for future repatriation of earnings and capital gains arising from the investment. For example, under the Israel-Luxembourg income tax treaty, investment through a Luxembourg intermediate

⁶ Israeli income tax regulations include a detailed definition of an intensive research and development company.

⁷ There are other factors that might disqualify the gain from being exempt from capital gains tax.

holding vehicle may provide certain withholding tax benefits (explained in the exhibit below).

Israel-Luxembourg Income Tax Treaty Benefits		
	Dividend	Capital gain
Israel (Nontreaty)	20% – 25% [†]	20% – 25%
Treaty rate	5% – 15% ^{††}	0%

[†] The rate is mainly determined by the holding percentage in the company

^{††} The 5 percent withholding tax rate applies if the beneficial owner is a company (other than a partnership) that holds directly at least 10 percent of the capital of the company paying the dividends

Certain qualifications must be met so that the putative treaty beneficiary truly merits relief based on the substance of the business arrangement. Unfortunately, there is no bright line test or safe harbor under Israeli tax law, and no guidelines have been published by the ITA clarifying what constitutes sufficient substance. This is a developing area of law, and the determination of substance is examined on a case-by-case basis, based on the facts and circumstances involved. Therefore, some residual risk of tax liability in Israel may exist if the ITA successfully challenges issues such as residency and beneficial ownership.

Decisions concerning the proper allocation of duties and responsibilities, as well as where to locate the staff and management team with respect to the fund, its manager, and local investment advisers, must be made with a view toward minimizing the offshore fund's footprint in Israel. Proper allocation of personnel is also important in supporting the transfer pricing policies adopted for the management, performance, and advisory fees charged by the fund manager and local adviser.

Although Israel does not explicitly restrict treaty shopping currently, the issue is a growing concern for Israeli tax authorities, along with issues concerning transfer pricing and permanent establishments.

Israeli venture capital-private equity investments—key US tax issues

The tax considerations discussed above relating to capital gains and dividends are equally relevant to private equity investments, along with the following other issues.

Foreign tax credits

The potential for double taxation exists because the United States imposes income tax on its citizens and residents based on their worldwide income. Subject to many limitations, the US foreign tax credit (FTC) regime

mitigates double taxation by allowing a US taxpayer to claim a credit against the taxpayer's US tax liability for any foreign taxes paid on foreign-source income.⁸ The rules related to the determination of whether particular taxes are creditable are complex. Therefore, although it is clear that Israeli regular income, capital gains, and withholding taxes on interest should be creditable for US income tax purposes, it is less clear whether other taxes (e.g., *the land appreciation tax*) are creditable.

Even though a US corporation can claim FTCs to reduce its US tax liability for taxes that it pays directly, or indirectly through its 10 percent-or-more-owned (by vote) foreign subsidiaries, individuals who are US citizens or tax residents can claim credits only for directly paid foreign taxes. Thus, the indirect FTC rules are less important for hedge funds and their management companies whose ownership normally does not include corporate entities in which they own a greater-than-10 percent interest.

Alternative investment funds and management companies often structure their investments through entities that are treated as fiscally transparent (under the check-the-box rules) for US tax purposes so that investors can avail themselves of direct FTCs. Under US law, taxes paid by fiscally transparent entities can generally be claimed as direct FTCs with respect to their ultimate US owners, subject to the usual limitations applicable to FTCs. For example, if a US LLC management company owns 100 percent of an Israeli subadvisory entity, and both entities are tax-transparent under US tax law, any taxes paid by the subadvisory company should be treated as paid by the owners of the US LLC and thus should be creditable by the owners subject to the applicable US FTC limitations discussed above.

US antideferral rules

To the extent that equity investments are not structured through entities that are treated as fiscally transparent for US tax purposes, the impact of the US antideferral rules must be considered. These rules are generally designed to prevent deferral of certain passive income (e.g., interest, dividends, rent, and royalties) that foreign corporations earn. The antideferral rules apply mainly to certain US

⁸ To prevent the US Treasury from subsidizing operations abroad, the allowable credit should not exceed the applicable US taxes on the foreign-source income. The limitation formula under Section 904(a) is: maximum FTC allowable equals US tax on worldwide income multiplied by foreign-source income divided by worldwide income. The code provides specific sourcing rules to compute foreign-source income for purposes of the Section 904(a) limitation formula. For an advisory company, the income from the performance of services outside the United States is treated as foreign source regardless of the place of organization of the management company or the location of the service recipient. To further complicate matters, the FTC limitation applies on a separate category or "basket" basis, as well as on an overall basis. The current FTC limitation rules, as amended by the American Jobs Creation Act of 2004, P.L. 108-357, October 22, 2004, reduced the number of foreign tax credit baskets to two (passive and general limitation). See Brinker and Sherman, "Relief From International Double Taxation: The Basics," 16 JOIT 16 (March 2005).

investors in controlled foreign corporations (CFCs) and passive foreign investment companies (PFICs).

A foreign corporation is a CFC if more than 50 percent of the total voting power of all classes of stock entitled to vote or the total value of the corporation's stock is owned, or considered as owned, by "US shareholders" on any day of the foreign corporation's tax year.⁹ A "US shareholder" is any US person including a US citizen or resident individual, domestic partnership, corporation, trust, or estate that owns, directly or indirectly,¹⁰ 10 percent or more of the total combined voting power of all classes of stock entitled to vote in the foreign corporation.¹¹

US shareholders that cumulatively own directly, indirectly, or through attribution more than 50 percent of the stock or value of a CFC, for at least 30 days in any particular year, may be required to include in their income for US federal income tax purposes their *pro rata* share of the Subpart F income of the CFC for every year that it qualifies as a CFC.¹²

These US shareholders are also required to include in their income the amounts determined under Section 956 (see below) for every tax year in which any of their companies are CFCs (but only to the extent not previously included).¹³ In general, Subpart F income includes several categories of income of a CFC. One of the categories is foreign personal holding company (FPHC) income, which includes dividends, interest, rents, royalties, and gains from sales or exchanges of property.

The PFIC regime is designed to tax shareholders of certain companies that primarily generate passive income or primarily own passive assets, or both. Unlike the CFC regime, there is no threshold ownership requirement necessary to invoke the application of the PFIC rules. The test is whether the company meets either the income test (75 percent or more of gross income is passive) or the asset test (more than 50 percent of assets are held for production of passive income).¹⁴

9 Section 957(a)

10 Ownership of controlled or related entities or individuals is generally attributed to a US shareholder under Sections 958(a)(2) and 318. For instance, in general, the stock of a foreign corporation owned indirectly through a controlled or a related foreign entity such as a corporation, partnership, trust, or estate is attributed and treated as proportionately owned by the shareholders, partners, or beneficiaries. In certain circumstances, if a partnership, estate, trust, or corporation owns, directly or indirectly, more than 50% of the total combined voting power of all classes of stock of a corporation, it is considered to own all of the stock entitled to vote (Section 958(b)(2)).

11 Section 951(b); Reg. 1.951-1(g); Section 7701(a)(30)

12 Section 951(a)(1)(A)(i); Reg. 1.951-1(a)

13 Section 956 amounts generally include the US shareholder's share of any increase in the earnings of the CFC invested in US property. (See also Section 951(a)(1)(b)). These amounts do not include previously taxed income under Section 959(a)(2).

14 Section 1297(a)

US shareholders of a PFIC should always consider making a qualified electing fund (QEF) election with respect to the PFIC. The election is made by attaching Form 8621 to the shareholder's timely (original or amended) return. The result of this election is that ordinary income and net capital gains are passed through to the shareholder and taxed on a current basis. US shareholders who have made QEF elections will not be subject to the adverse anti-deferral rules under the PFIC regime (see below). It should be noted, however, that as a practical matter, the QEF election may be made only if the PFIC agrees to make available the information necessary to determine inclusions under the QEF rules and to assure compliance. Consequently, the ability to make the election is subject effectively to a "veto" by the PFIC.¹⁵

Once a company is deemed a PFIC as to any given shareholder, the shareholder generally remains subject to the PFIC rules unless a QEF election, and if need be (in the case of a late QEF election) a timely "purging election," is made.¹⁵ Unless a QEF election is made, the adverse "excess distribution" rules would apply to the US person who holds stock of a PFIC whenever that shareholder receives a distribution with respect to his PFIC stock.¹⁶

According to these rules, excess distribution or gain derived from the sale of the PFIC stock is spread over the years in which the shareholder held the PFIC stock, and any amounts allocated to years prior to the current taxable year are taxed at the highest ordinary income tax rates in effect in those prior years. In addition, according to these rules, the IRS imposes interest charge as though these payments had actually been taxable in early years. This amount is aggregated by the taxable year of the US investor to which it relates.

Qualified dividend income

Individual US investors may benefit from a 15 percent tax rate for dividends under qualified dividend income (QDI). Dividends may qualify for QDI treatment if they are received from a qualified foreign corporation (QFC). A QFC is any corporation that qualifies for benefits under a detailed income tax treaty with the United States that includes an exchange of information program.

To be eligible for the benefits of a US income tax treaty, a QFC must meet the limitation of benefits provision of the respective income tax treaty. This treaty provision is intended to prevent a person who is not a "qualified resident" of either country (in our case, Israel or the United States) from seeking benefits under the income tax treaty between the two countries. For instance, an Israeli

15 See Regs. Section 1.1295-1 for details rules about making and revoking QEF election.

16 See Section 1291(b).

company may be treated as a qualified resident of Israel if its shares are publicly traded or more than half its shares are owned by US residents or citizens or Israeli residents and certain other requirements are met.

US accounting issues

Financial Accounting Standards Board (FASB) Interpretation No. 48 (FIN 48) clarifies the accounting for uncertainty in income taxes recognized in a company's financial statements. FIN 48 is part of US generally accepted accounting principles (US GAAP) and, as such, affects public companies and nonpublic companies whose financial statements are prepared in accordance with US GAAP.

Under FIN 48, companies must identify all tax positions, which are given labels ranging from highly certain to highly uncertain, under a two-step process. Under these steps, the company must first evaluate its tax position and determine whether it is "more likely than not" to sustain the tax return position, based solely on the position's technical merits. Then, assuming the tax position meets the "more likely than not" standard, the tax position's benefit is measured as the largest amount of tax benefit that is greater than 50 percent likely to be realized upon ultimate settlement with a taxing authority, assuming it has knowledge of all relevant information.

Failure to meet these requirements may force taxpayers to accrue penalties and interest indefinitely on tax risks. An example of a tax uncertainty concerning Israel is the risk that a purported nontaxable activity will be deemed to give rise to a permanent establishment in Israel. This also includes activities conducted beyond the scope granted to representative offices for sales and service functions.

Thus, companies should carefully evaluate their exposure to permanent establishment risks prior to preparation of financial statements, to the extent these statements are made in accordance with US GAAP.

Conclusion

Proper planning and structuring are crucial to the success of alternative investment in Israel. Additionally, it is important to perform a thorough tax due diligence at the entry stage to obtain an understanding of the complex transaction taxes for the target investment and its hidden tax liabilities. Careful consideration of a proper allocation of the duties, responsibilities, and location of the staff and management team among the fund, its manager, and the local investment adviser should be undertaken with a goal of minimizing the offshore fund's footprint in Israel to avoid any Israeli permanent establishment risk to the fund.

Israel offers a wealth of benefits to foreign investors. Foreign investors can tap into these benefits through myriad structuring alternatives, such as obtaining an advance tax ruling from the ITA and/or including a tax treaty-eligible entity. The effective use of the available structuring alternatives greatly enhances the prospects for success and promotes a positive outcome for the fund and its investors when investing in Israel.

Hedge funds to reconsider administrators for valuations and risk analytics

by Laurence Best, Keith Caplan, Scott Dillman and Ian Drachman

What are the issues?

The lingering credit crisis has surfaced issues for hedge funds that will have reverberations far into the future. The immediate impacts are already telling, for example in valuation. Hedge fund managers are being pushed as never before to provide greater transparency into the valuation of their portfolios. In addition, the risk profile of counterparties has increased as they are under increased scrutiny for their creditworthiness. Hedge funds struggle with new requirements, triggered by all of these issues, for on-demand reporting and decision making, reflecting adequate risk technology.

These are important issues not only for hedge funds, but also for the third party fund administrators that hedge funds rely upon for an ever-increasing portfolio of services. And, as hedge funds buy distressed securities resulting from the credit crisis, they increasingly rely on fund administrator assistance to address complex issues associated with these securities.

Hedge funds need to ensure that current or prospective fund administrators have the characteristics and capabilities to match a future state dominated by emerging demands for decisive action to address root causes of the current crisis. Of particular importance are valuation and risk management.

Background

The credit crisis has surfaced the need to closely examine valuation and risk management capabilities, which are increasingly provided by fund administrators. Hedge funds need better risk management, encompassing technology architecture/solutions that provide stronger credit and market risk analysis. They need to be able to understand the level of counterparty risk at all times, since trading rooms are handling large volumes of high value transactions. They need the ability to quantify a position's value and then identify and predict changes to market

and counterparty conditions on demand. In addition, they need to be able to quickly on-board new products/transaction types (for example, due to acquisition of distressed securities), while providing consistent and accurate computation of risk exposure across counterparties, products, transactions and trading strategies.

The valuation of a fund's positions is clearly a particularly important issue for hedge funds.

- The diverse nature of investing by hedge funds makes asset valuation a key issue because hedge funds trade in complex financial instruments that have greater valuation subjectivity than the more traditional investments favored by mutual fund and asset managers.
- Investors are demanding more transparent pricing, even while challenges remain in valuing complex transactions, private equity deals and illiquid securities. The increased use of derivatives (including CDOs, CLOs, structured transactions and private equity investments) makes it increasingly complex to measure and monitor financial exposure and to provide valuations of illiquid assets.
- Valuation affects financial reporting, NAVs, performance fees for investment advisors, administrative fees paid to service providers, prime broker collateral requirements, risk profiles and more.
- Reflecting these trends, the International Organization of Securities Commissions has defined principles for the valuation of hedge funds and FAS 157 has raised the bar by requiring more transparent valuations.

Hedge funds are increasingly turning to fund administrators for valuations. Most large funds are already paying to receive independent valuations. Even when traditional broker valuations are employed, third parties are usually brought in to validate that prices are fair or consistent with the market. The Hedge Fund Working Group, AIMA,

the President's Working Group Best Practice Guidelines and the Managed Funds Association's *Sound Practices for Hedge Fund Managers* suggest that the valuations process should be carried out by an independent specialist, generally a hedge fund administrator and be governed by a valuation committee within each fund, with clear escalation processes to rapidly resolve pricing and portfolio valuation issues. Because fund administrators are not market participants, they can provide greater independence in their valuations. For example, the AIMA Sound Practices Guide states that "quotations should wherever possible be multiple, sourced consistently and accessed by the Valuation Service Provider independently without intervention by the Investment Manager." FAS 157 will be a major driver in fair value measurement for hard to price securities, and hedge funds will seek external valuations to remain compliant.

What is our response?

Hedge funds should carefully consider the valuation and risk management capabilities of their current and prospective fund administrators.

Valuation. The ability to consistently value positions aggregated across divisions and asset classes is paramount in understanding a hedge fund's credit exposure. Hedge fund managers should consider the following actions:

- Review processes for monitoring and validating external valuations. These processes ensure that prices provided by custodians, broker dealers and fund administrators are reconciled against in-house pricing to ensure a fair market valuation is applied to each position or contract.
- Review options for sourcing valuations, including reliance on traders, prime brokers, fund administrators, pricing vendors and valuation agents for hard-to-price instruments. Is all necessary and ongoing due diligence in place? Do all transaction (product) processing systems use a consistent pricing analytics engine? Does the provider have dedicated data management groups to aid automated reconciliation and portfolio pricing?
- Implement a governance model to support valuations including roles and responsibilities of valuation committee members and detailed escalation procedures to manage issues as they arise.

Risk. Hedge funds should carefully consider the capabilities of current and prospective fund administrators for providing risk analytics to determine if sourcing is the best alternative.

- Fund administrators are increasingly supporting exposure and risk analytics across a vast range of trading strategies and asset classes including credit, equities, fixed income, commodities, derivatives and mortgages.
- Many offer a variety of risk management analytics and reporting tools to help fund managers with pre-trade investment decisions and post-trade position management.
- Beyond the norm of risk position and exposure reporting (VaR), many fund administrators are providing risk analytics engines that facilitate what-if analysis, scenario analysis, and stress testing, and addressing increased hedge fund demand for improved credit and market risk analysis.

These tools are increasingly critical because an "end-of-day" perspective on risk and performance attribution is no longer sufficient. Value-at-Risk views of global risks across asset classes should not be limited to a single end-of-day snapshot. This is not frequent enough for most products, given rapidly changing market conditions. Fund administrators are thus increasingly supporting on-demand, proactive processes and infrastructure for calculating exposure. This in turn requires that all trade capture and processing systems interface on demand with an enterprise risk system.

Control reports (e.g., SAS 70) are an important tool for understanding a fund administrator's risk management standing, considering:

- Scope: does the administrator address the risk, valuation and IT controls needed?
- Results: what exceptions have been noted?
- Frequency: has the administrator moved to a six month rolling SAS 70?

What does this mean?

As a result of the current crisis in the financial industry, hedge funds are suddenly facing liquidity issues due to slowdowns in new investment capital, and capital withdrawals, triggered by recent action by institutions to cover liquidity issues, and redemptions from high net worth investors. The result is a much more challenging business environment as the competition for a newly shrinking capital pool has suddenly become a race for survival. Hedge funds, accustomed to explosive capital growth for over a decade, are suddenly faced with a critical need to defend from investor flight. Fund performance is not the most important reason for deselecting a fund. Investors are considering both quality of compliance and risk management process and transparency over performance as the primary factors for deselecting a fund.

Even as regulatory, investor and competitive demands on hedge funds increase, available valuation transparency and risk management services from fund administrators have been broadening. Hedge funds have also gained an increasing number of options for acquiring support services from multiple sources. The current conditions challenging the financial markets highlight the need for a timely review of valuation and risk management support options.

Following are next steps that a hedge fund can take to review how valuation services provided by a fund administrator are meeting regulator and investor demands for increased transparency and appropriate processes, controls, and risk management analytics:

- Obtain a copy of the administrator's SAS 70 control report.
- Secure documentation of the valuation and risk management services from current and prospective administrators to understand where your administrator falls in the continuum of support.
- Secure the list of valuation and risk management vendor software packages the administrator is using and research industry reviews of their effectiveness. If proprietary, gain an understanding of functional scope and understand what is not covered.

As addressed in the PwC Point of View "Evolution of investment management sourcing," third party relationships are enabling hedge funds to expand capabilities by leveraging mobility of processing to optimize operations globally across people, process, technology and information. Hedge funds with mature, well-integrated fund administrator relationships can balance resources globally and deftly shift different types of work across time zones, and into low cost jurisdictions, as circumstances change. More than ever, hedge funds have an opportunity to leverage fund administrator depth and economies of scale to meet the challenges of a business and regulatory environment denoted by accelerating change.

Significant new financial statements disclosures required in 2008 for sellers of credit derivatives

by Kwame Lewis, Shyam Patkar and Andrew Thorne

Over the last decade, the use of credit derivatives has expanded significantly. This growth, and concerns that the existing guidance did not adequately address the potential adverse effects of changes in credit risks for sellers of credit derivatives, led the Financial Accounting Standards Board (FASB) to issue new guidance for sellers of credit derivatives on September 12, 2008. The new guidance is included in FSP No. FAS 133-1 and FIN 45-4, *Disclosures about Credit Derivatives and Certain Guarantees: An Amendment of FASB Statement No. 133 and FASB Interpretation No. 45*; and *Clarification of the Effective Date of FASB Statement No. 161* (the FSP).

For calendar year-end funds, the FSP is effective for the year ending December 31, 2008 and requires enhanced disclosures by sellers of credit derivatives. The FSP also clarifies that FAS 161 would be effective for the first-quarter interim period ending March 31, 2009.

Recognizing that credit risk lies primarily with the seller of credit derivatives, the FASB specifically focused its attention in this FSP on sellers. While acknowledging that risk-related disclosure requirements for all financial instruments would be an improvement, the FASB concluded that current guidance already addresses the risks inherent to the buyers. As a result, the FASB narrowed the scope of this guidance and focused its attention on the party assuming the credit risk. These include the providers of credit protection in an option-type contract, a credit default swap or any other credit derivative contract.

A credit derivative is defined in the FSP as a derivative instrument in which the underlying is related to the credit risk of a specified entity (or a group of entities) or is an index based on a group of entities and exposes the seller to potential loss from credit-risk-related events specified in the contract. Credit derivatives within the scope of the FSP include, but are not limited to, credit default swaps and credit index products as well as to hybrid instruments that have embedded credit derivatives (e.g., credit-linked notes).

The new disclosures for credit derivatives require the inclusion of both qualitative and quantitative data for each credit derivative (or group of similar credit derivatives), even if the likelihood of the seller having to make payments under the arrangement is remote. The grouping of similar credit derivatives may be primarily made by major types of contracts (for example, single-name credit default swaps or traded indexes) and secondarily, and to the extent material, additional subgroups for major types of referenced/underlying asset classes such as corporate debt, sovereign debt and structured finance.

The significant disclosure requirements include:

- a. The nature of the credit derivative, including the approximate term, the reason for entering into the credit derivative, the events or circumstances that would require the seller to perform under the credit derivative and the current status (that is, as of the balance sheet date) of the payment/performance risk of the credit derivative. For example, the current status could be based on either recently issued external credit ratings or current internal groupings used to manage risk.
- b. The maximum potential amount of future payments (undiscounted) the fund could be required to make under the credit derivative. That maximum potential amount of future payments cannot be reduced by the effect of any amounts that might possibly be recovered under recourse or collateralization provisions in the credit derivative.
- c. The fair value of the credit derivative as of the balance sheet date.
- d. The nature of (1) any recourse provisions that would enable the fund to recover from third parties any of the amounts paid under the credit derivative and (2) any assets held either as collateral or by third parties that, upon the occurrence of any specified triggering event or condition under the credit derivative, the fund can obtain and liquidate to recover all or a portion of the amounts paid under the credit derivative.

The FSP also requires the seller of an embedded credit derivative to disclose the required information for the *entire* hybrid instrument, not just the embedded credit derivative.

While much of the standard focuses on credit derivatives, there is also an amendment related to FIN 45 and a clarification of the effective date of FASB Statement No. 161. The FSP amends paragraph 13(a) of FIN 45 to require disclosure of the current status of the payment/performance risk of the guarantee. For example, the current status of the payment/performance risk of credit-risk-related guarantee could be based on either recently issued external credit ratings or current internal groupings used by the guarantor to manage its risk. A fund that uses internal groupings should also disclose how those groupings are determined and used for managing risk.

Management may expend significant effort to assemble the information required by these new disclosures and should consider whether existing systems, processes and internal control policies and procedures can be adapted, or need to be modified, to properly collect, verify and disclose these instruments in consideration of the FSP's requirements.

Europe

Italy

by Alessandro Caridi and Oscar Teunissen

The 2008 Annual Budget Bill brings changes to alternative funds investing in Italy

The 2008 Bill contains many changes that could also affect the Italian alternative market, including changes potentially affecting Italian investments, repatriation to foreign investors, and Italian management companies or funds.

The changes call for a review of the existing structures to ensure intended tax benefits and costs are in line with the original planning.

On the asset side, changes in tax rates and interest deduction limitations are potentially material. The tax rate was generally reduced from 33 percent to 27.5 percent for corporate income tax purposes and from 4.25 percent down to 3.9 percent for local income tax (IRAP) purposes. Interest deduction rules were also significantly changed, with a new limitation capping the deduction on net interest expenses to an amount that is approximately 30 percent of EBITDA. Italian and foreign private equity funds lobbied vigorously against these changes, yet obtained only a slight relaxation of the limitations that were initially proposed.

Important changes were introduced for payments to foreign investors. With respect to dividends paid to EU corporations, the withholding was reduced in most cases from 27 percent down to 1.375 percent. Certain transitional rules limit the applicability of these favorable reductions to dividends paid out of profits realized after 2007. There is some uncertainty as to whether these pool limitations are acceptable under EU laws.

Other changes that may impact foreign investors concern the previous list of tax haven countries, which will be

repealed. A new list of cooperative countries (the “white list”) will be introduced to replace it. Investing from a white-listed country would allow for specific exemptions or more favorable tax treatments compared with those applicable to unlisted countries. EU member states and most of the tax treaty countries (with adequate exchange of information procedures) are expected to be included in the new list. Cayman, Bermuda, or other tax havens will not be included in the new white list.

A number of other changes were introduced. Fund managers are invited to consider the potential impact that the new rules may have on current or target investments.

Luxembourg

by Wim Piot and Oscar Teunissen

Draft 2009 budget and new tax measures

On October 1, 2008, the Luxembourg government sent a new proposal to Parliament for new tax measures (provided for in the draft budget and in a separate bill). This proposal confirmed some of the previous announcements made by Luxembourg’s prime minister in the traditional “state of the nation” address delivered in May 2008. The proposal also introduces new tax measures that are of significant importance to the business community.

New tax measures

Exemption from withholding tax on dividends paid to treaty country “corporate” shareholders

According to the bill, the scope of the Luxembourg domestic law providing for an exemption from withholding tax on dividends paid to “corporate” shareholders (under certain conditions) would be extended to “corporate” entities located in countries that have signed a double tax treaty with Luxembourg. The exemption would be granted only to foreign entities that

are subject to a tax similar to Luxembourg corporate income tax in their country of residence.

The goal of the suggested amendment is to increase and promote Luxembourg's international tax competitiveness while creating an investment environment comparable to some of its neighboring countries.

IFRS and tax

Since reconciling IFRS with the Luxembourg tax regime is a complex exercise, the introduction of IFRS in Luxembourg companies' accounts raises a number of questions. In summary, the bill proposes to focus as much as possible on the accounting and limiting the tax adjustments. The IFRS accounts would therefore be the basis for the computation of Luxembourg corporate taxes. Certain tax adjustments would however be possible, as the objective of the bill is to make IFRS accounts as tax-neutral as possible.

Although IFRS accounts have been possible for several years (if certain requirements are met), the bill has no retroactive effect.

Confirmation of initial proposals

Repeal of capital duty

In May 2008, Luxembourg Prime Minister Jean-Claude Juncker announced that capital duty would be repealed as of 2009 and a bill formalizing this announcement was put to Parliament in early September. The draft budget confirms the measure, which would become effective on February 1, 2009, rather than January 1, 2009, as provided for in the bill. Further developments in this respect will be monitored closely.

Corporate income tax rate to decrease by 1 percent

The corporate income tax rate should decrease by 1 percent, from 22 percent to 21 percent. This is in line with the previous announcement made in May. The aggregate corporate income tax rate was also set to decrease in several stages, from 29.63 percent (for Luxembourg City, including municipal business tax) to 25.5 percent.

Consequently, the combined rate for Luxembourg City would, as a first stage, decrease to 28.59 percent in 2009.

Company cars

In order to follow the current trend of new measures aimed at fighting polluting vehicles, the tax on automobiles (other than buses and taxis) would no longer be tax deductible from corporate income tax.

Norway

by Aleksander Grydeland and Oscar Teunissen

On November 20, 2007, the Finance committee in the Norwegian Parliament issued its recommendation on the proposals made by the Norwegian government regarding narrowing the scope of the tax exemption method for dividends (including withholding tax) and capital gains. As the committee made no adjustments to the proposal, it is now all but certain that the proposal will be enacted by Parliament.

1. Dividends paid by Norwegian corporations to corporate shareholders resident within the EEA

Currently a foreign corporation equivalent to a Norwegian limited liability company (and certain similar entities) will not be subject to Norwegian withholding tax on lawful distributed dividends from a Norwegian tax resident limited liability company (and certain similar entities), provided the foreign corporation is the real owner of the shares according to Norwegian private law and a tax resident within an EEA jurisdiction.

For the income year 2008, an additional substance requirement will be introduced. It will be required that the shareholder be genuinely established in an EEA state and also performs a genuine economic business activity there.

According to the white paper and the recommendation from the Finance committee, the condition, "being actually established and carrying out genuine economic business activity in another EEA state," implies that an overall evaluation will have to be made, where relevant factors will include, among others:

- Whether the company has the disposal of offices/premises, furniture and fixtures, and equipment in the state of establishment
- Whether the company has a "permanently" employed management and other employees in the state of establishment that carries out the actual business activity there and whether the mentioned employees have sufficient qualifications, competence, and authority to run the company's business activity and also actually make the relevant decisions
- Whether the company's activity has sufficient economic substance

If Norway, according to tax treaty or other treaties or conventions, requests information from the state of establishment, the shareholder's obligation would be to prove that it is established in the EEA state and is actually carrying out an economic business activity in the EEA state. If no such tax treaty or other treaties or conventions

exist, the shareholder must present a declaration from the tax authorities in the other EEA state that confirms that the documentation is correct.

In our view the new rule may be in breach of Norway's obligations under the EEA treaty ("the four freedoms and also be discriminatory based on nationality").

2. Dividends paid by corporations resident within the EEA (and outside of Norway) to corporate shareholders resident in Norway

Currently lawful dividends from and capital gains deriving on shares in a limited liability company (equivalent to a Norwegian limited liability company and certain similar entities) tax resident in a state within the EEA to a Norwegian tax resident limited liability company is exempt from Norwegian taxation. Correspondingly, losses on such shares are not deductible.

For the 2008 income year, the tax exemption for lawful dividends and capital gains on shares in a company resident in an EEA state will be amended, so that if the EEA state (in which the company invested into is a tax resident under Norwegian tax law) is considered to be a low-tax jurisdiction, the tax exemption for lawful dividends and capital gains will only apply if the company invested in is actually established in an EEA state and carries out genuine economic business activity there.

We believe that this new rule also will be in breach of Norway's obligations under the EEA treaty ("the four freedoms and the prohibition on discrimination based on nationality").

3. Other amendments

Other amendments, including amendments to the Norwegian CFC regulations, new rules governing exit taxation when SE companies transfer head office, and the new shipping taxation rules, were approved by the majority in the Finance committee.

Spain

by Carles Farre, Joaquín Latorre and Oscar Teunissen

Amendments to Spanish tax legislation to foster economic activity: publicly traded debt exemption

In light of the current international economic situation and the recent reform of Spanish tax and accounting rules, the Spanish government has broadened the exemption for income relating to publicly traded Spanish debt.

Effective April 22, 2008, income on Spanish-traded debt, including both public debt and publicly traded debt issued by private companies, is exempt in accordance with the new wording of the Spanish Nonresident Income Tax Act, irrespective of the tax residence of the beneficial owner of the income.

Prior to this amendment, income derived from publicly traded Spanish public debt (i.e., debt issued by the Spanish Treasury, government agencies, regions, municipalities, etc.) realized by nonresidents was exempt only where the nonresident holder of the debt was not incorporated or resident in any of the listed tax haven territories (e.g., Cayman, Bermuda, etc.). It should be noted that Spain has a closed but quite extensive list of tax haven jurisdictions and traditionally the country's policy has been to disallow tax benefits or exemptions to companies from those territories. Private companies' publicly traded debt was previously only exempt when held by EU residents.

This measure represents an important deviation from the long-established Spanish tax policy, and this policy is adverse to tax havens. Note that in 2006, the US-Spain Tax Treaty was amended to allow entities incorporated in tax havens to benefit under very limited circumstances from the treaty reduced rates.

The change in the tax law is intended to reduce the potential impact of the recent turmoil in the financial markets on Spanish public debt. To a certain extent it also responds to the reality that the majority of tax haven entities investing in public debt are simply "special purpose vehicles" used by companies and individuals resident in territories that are not tax havens, such as the US, the EU, the Middle East, and Asia. To continue limiting access of such special purpose vehicles to this exemption could result, under the current market conditions, in a smaller pool of investors, and a need to increase yields on public debt during times of potential budget deficits.

Uncertainty remains as to how the exemption would operate in practice. One question includes whether the requirement for a certificate of tax residence will continue. Nonresident companies that may have difficulty in obtaining a certificate of tax residency might want to consider applying for a tax ruling. This category includes, for example, US flow-through entities with a large number of investors, or entities in tax havens where local tax law does not contemplate the issuance of certificates of tax residency.

Sweden

by Aleksander Grydeland, Jörgen Haglund
and Oscar Teunissen

Amended proposal for anti-debt push down rules in Sweden

The Swedish Ministry of Finance has amended the proposals restricting interest relief on affiliated loans for the acquisition of affiliated companies that would be effective beginning January 1, 2009. The changes narrow the scope of affected loans and introduce wider exemptions to the new rules.

On August 25, 2008, Sweden's Ministry of Finance released an amended version of a previous proposal from the Swedish tax agency for anti-debt push down rules in Sweden. The amendments were made following a short consultation process that drew extremely negative comments from a wide range of large Swedish groups and industry federations.

Details of the amended proposal

According to the latest proposal from the Ministry of Finance, deductions shall be denied for interest accruing in periods from December 31, 2008, on loans from affiliated companies where the loans are for the acquisition of shares from an affiliated company. Existing loans will not be grandfathered, as the prohibition of deduction applies to all interest accruing during 2009 and in subsequent years.

Contrary to the previous proposal, the limitation shall not apply to interest on loans for the acquisition of receivables, nor shall it apply to interest on loans that enable companies to pay dividends or make capital contributions. The Ministry of Finance recognizes that some cases may nevertheless be caught by the general anti-avoidance provisions.

Intra-group loans for the acquisition of shares directly from external parties remain outside the scope of the rules, as are loans from external parties, such as banks, for the intra-group acquisition of shares (unless there is a rather clear "back-to-back" loan or a temporary external loan replaced by an intra-group loan).

Exemption envisages: Subject to 10 percent tax or "commercially justified"

The main amendment to the previous proposals is in the exemptions. In the new proposals, deductions shall *not* be denied in cases where:

- The interest income is taxed in Sweden or abroad at a tax rate of at least 10 percent or, alternatively
- The intra-group acquisition and the intra-group loan are principally "commercially justified."

The 10 percent requirement will be met even when a tax loss has been used.

However, the test will not be met in the following circumstances:

- Where interest is picked up by a conduit and the beneficial owner of the interest is enjoying a tax rate lower than 10 percent
- In hybrid structures where the interest is received as a tax exempt dividend
- Where interest is received by a company that can deduct its payments of dividends (like Swedish investment companies, one of which won a case before the Supreme Administrative Court in 2007). The Ministry of Finance has confirmed "similar features abroad" will be captured.

What happens now?

The Swedish business community and others had until noon of September 1, 2008, to comment on the amended proposal. Although there may still be other amendments, we believe the final proposal will be in line with what has now been suggested. Hence, we expect the Ministry of Finance to deliver its proposal to the Council on Legislation within the next few weeks. The government will then likely send a bill to the Parliament to be enacted before year end.

One might foresee future disputes in cases where there is no 10 percent foreign tax on the recipient and the commercial justification is not obvious. European Community law aspects may also present issues.

by Tony Kwan, Charles Lee, Edward Shum and Oscar Teunissen

1. China announces new thin capitalization ratios

Chinese authorities recently issued a new circular that specifies thin capitalization ratios for Chinese tax purposes and provides detailed requirements on the application of the thin capitalization rules.

The new China Corporate Income Tax (CIT) law introduced the concept of thin capitalization. Its purpose is to disallow the deduction of interest expense in the case of interest-bearing debt from related parties when the ratio of debt to equity exceeds a certain prescribed debt-to-equity ratio. The recently published Circular 121 sets out the following details regarding the new thin capitalization rules:

- There are two prescribed debt-to-equity ratios:
 - 5-to-1 for companies in the financial industry
 - 2-to-1 for companies in the nonfinancial industry

If the ratio of the debt from related parties to the borrowing company's equity exceeds the prescribed debt-to-equity ratio in any year, the interest expense pertaining to the excess debt from related parties shall be permanently disallowed as a deduction (i.e., it will not be carried forward to future years), except in situations where the criteria set out in the following point are met.

- The excess interest expense may still be deductible if a company can provide documentation to support that:
 - The inter-company financing arrangements comply with the arm's-length principle; or
 - The effective tax rate of the borrowing company is not higher than that of a "domestic" lending company.
- If a company carries on both financial and nonfinancial businesses, it has to segregate the related party interest expense between the two businesses on a reasonable basis; otherwise, it has to follow the prescribed 2-to-1 debt-to-equity ratio.
- The lending company shall be subject to CIT on the interest income received including the disallowed interest expense, as prescribed above.

2. Working guidelines issued in China for assessment of eligibility for the preferential 15 percent income tax rate for new/high tech enterprises (NHTEs)

A new circular issued by the Chinese authorities provides important guidance on assessment of NHTEs, which are entitled to the preferential 15 percent corporate income tax rate under China's new CIT regime.

A Chinese company can be qualified under the rules applicable to NHTEs if it meets all of the following six criteria as defined under the "Administration Measures for Assessment of NHTEs" or "Measures":

- Ownership of core proprietary intellectual property (IP) rights or securing an exclusive licensing of such IP rights;
- Products or services within the scopes of the following eight new high-technology domains:
 - Information technology;
 - Biological and new medical technology;
 - Aviation and space;
 - New materials;
 - High-tech services;
 - New energy and energy conservation;
 - Resources and environment; and
 - Transformation of traditional sectors using new high-technology.
- Prescribed proportions of headcount of scientific technology personnel and R&D personnel to the total workforce;
- Qualified R&D expenditures should reach a certain percentage of total revenue for the last three years;
- Income from the new/high tech products/services must be more than 60 percent of the total annual income, and the new/high tech products/services generating the income should fall into the encouraged domains; and
- NHTEs should obtain a high rating under the grading system provided in the Assessment Guidelines.

On July 8, 2008, the Ministry of Science and Technology, the Ministry of Finance and the State Administration of Taxation issued the "Working Guidelines for Assessment of NHTEs," which provides clarification on criteria set forth in the Measures. The rules for NHTEs represent a new tax incentive regime in China, effective January 1, 2008. Consequently, applicants are advised to meet with local authorities to discuss their local positions, implementation policies, and application procedures.

India

Regulators seek to strengthen Indian capital markets for investors

by Puneet Arora, Dwaraknath Narasimhan, Punit Shah and Oscar Teunissen

The rapidly changing capital markets have forced regulators globally to consider modifying existing regulations with a view toward spurring growth and boosting investor confidence. India has been no different in this respect. The Securities and Exchange Board of India (SEBI) has consistently reviewed and updated the regulations with the goal of strengthening the Indian capital markets. This article focuses on some of the initiatives and changes that the SEBI has been making in the last year.

Participatory Notes (P-Notes)

P-Notes are over-the-counter products issued by funds registered as Foreign Institutional Investors (FIIs) to investors who are not registered in India. P-Notes have enabled investors to take positions in the Indian market without going through registration with the SEBI. Further, from a tax perspective, since P-Notes transactions were entered into outside India, a position was taken by the taxpayers that no income should accrue in India because of those transactions.¹

In October 2007, the SEBI issued a press release seeking to regulate the use of P-Notes. SEBI stated that the reason for this change in policy was to encourage foreign investors to register as FIIs rather than trading anonymously using the P-Notes route so as to promote better disclosure. The key proposals included:

- FIIs and subaccounts were barred from issuing/renewing P-Notes with underlying as derivatives. Current positions were required to be wound up over 18 months (i.e., by March 2009).
- Subaccounts of FIIs were prohibited from a further issuance of P-Notes, with current positions to be wound up over 18 months (i.e., by March 2009).
- P-Notes could be issued only to “regulated entities”² as opposed to “registered entities.”

1 Although Indian domestic law provides specific guidance on the taxation of American Depositary Receipts and Global Depositary Receipts, the tax treatment in India of P-Notes is not clearly discussed. However, a position was generally taken by the taxpayers that P-Notes should not be subject to tax in India.

2 SEBI defined a regulated entity to mean:
i. Any person who is regulated/supervised and licensed/registered by a foreign central bank;
ii. Any person who is registered and regulated by a securities or futures regulator in any foreign country or state;
iii. Any broad-based fund or foreign portfolio or proprietary fund of a registered FII or university fund, endowment, foundation, charitable trust, or charitable societies whose investments are managed by a person covered by clauses i or ii above.

The SEBI also placed a cap on the quantum of P-Notes that could be issued by an FII at 40 percent of Assets Under Custody (AUC)³ in India.

These policy measures were incorporated in the SEBI regulations issued on May 22, 2008. The restrictions placed a significant burden on funds seeking to take positions in India because they not only restricted the issuance of P-Notes by registered FIIs, but also required that a purchaser of a P-Note be a regulated entity. The policy change led to a flurry of applications being made to the SEBI for registration as an FII or as a subaccount of a third-party FII, and P-Notes were no longer considered attractive.

Although registration as an FII helped to overcome the regulatory hurdle that SEBI’s policy change had created, from a tax standpoint, it remained unclear whether the gains derived by an FII/subaccount were to be treated as capital gains or as business income for the purpose of taxation in India.⁴ Business income could be subject to tax in India only if the foreign investor has a Permanent Establishment in India, but capital gains could be subject to Indian tax by virtue of application of the source rule under Indian domestic law. Therefore, it was important to consider the possibility of using a treaty platform for investments into India to mitigate the exposure to capital gains tax under domestic law.

On October 6, 2008, SEBI issued a press release stating its intention to remove the above restrictions on the use of P-Notes and restore the pre-October 2007 position. This was given effect to by a Circular on October 7, 2008, that withdrew the restrictions on the use of P-Notes effective at the close of market hours on October 7, 2008.⁵

From a tax standpoint, the Indian tax authorities, in the case of Vodafone, attempted to tax profits made outside India on transfer of shares of a foreign company by one nonresident to another on the basis that the underlying asset is the “controlling interest” in the Indian company and the income should therefore be sourced to India. The case is pending adjudication before the Bombay High Court. Drawing support from this argument, the authorities have now started scrutinizing P-Notes transactions with a view to bring them to tax in India on

3 The effective date for calculation of the AUC for the purpose of determining notional value of P-Notes issued as a percentage of AUC is decided as at September 30, 2007.

4 There have been conflicting decisions by the Authority for Advance Rulings, holding in one case that the income was in the nature of capital gains (Fidelity Northstar Fund vs Director of Income-tax) and in another that income was in the nature of business profits (Fidelity Advisors Series VIII).

5 In a further relaxation of norms, SEBI has proposed amendments to the FII regulations to do away with the limit of a 70:30 ratio of investments in equity and debt, respectively. This amendment would help FIIs in structuring their Indian portfolios to optimize returns.

the ground that the value of the P-Note is derived from the underlying Indian security.

In light of this, it is important that transactions in P-Notes are carefully considered to see whether treaty benefits can be availed by the issuer and, more importantly, the purchaser of the P-Note to mitigate the exposure to capital gains tax in India.

Private equity

Historically, private equity investments in India have been primarily through the Foreign Venture Capital Investor (FVCI) route. The following key benefits are available to an FVCI:

- The pricing norms prescribed by the Reserve Bank of India (RBI) under the exchange control regulations do not apply. This provides greater flexibility for structuring entry and exits, ownership realignment, etc.
- A post-initial public offering lock-in period is not applicable to shareholding held for at least one year prior to the IPO.

The FVCI route requires the foreign investor to register with the SEBI and thereafter approach the RBI for approval.

Recent press reports suggest that the Indian government is considering moves to relax the registration procedures for FVCIs; this would eliminate the need to obtain approval from the RBI. The move appears to be aimed at injecting liquidity in the Indian markets.

From a tax standpoint, Indian law is silent on the tax treatment of FVCIs as pass-through entities or otherwise. However, domestic Venture Capital Funds (VCFs) are treated as a pass-through if investments are in nine specified sectors (i.e., nanotechnology, information technology, seed research and development, biotechnology, research and development of new chemical entities in the pharmaceutical sector, etc). Therefore, an argument could be made that the FVCI could be looked through with respect to investment in specified sectors and income directly taxable in the hands of the shareholders of the FVCI.

Press reports also suggest that the Indian government is considering the possibility of according FVCIs with a pass-through status to bring them up to par with domestic VCFs.

Investors considering the FVCI route need to consider the impact that the above change, if carried through, could have on their investment structures for investing into India, including the availability of treaty benefits should the FVCI be looked through.

Conclusion

India remains a very dynamic and challenging market for investors. The global business environment is changing rapidly, and the Indian government has been introducing frequent policy changes to adapt to this changing environment. The Indian tax authorities continue to be aggressive in their interpretation of the law and consistently seek to challenge taxpayers on positions that they feel result in a loss of revenue to the Indian government. While investments in India increase, so do the complexities associated with doing business there. Funds seeking to invest in India need to plan carefully, so that they factor in these frequent changes to the Indian regulatory and tax framework.

Japan

by Raymond Kahn, Stuart Porter and Oscar Teunissen

New independent agent exemption for discretionary investment managers: background, release of reference cases, Q&A and joint presentation by the FSA, NTA, and MOF

On December 21, 2007, the FSA announced the basic concepts of a plan for strengthening the competitiveness of Japan's financial and capital markets. Part of the plan called for encouraging foreign fund managers to participate in Japanese markets by removing taxation risk of the fund in carrying out business through independent agents in Japan. Under Japanese law, a non-Japanese resident may cause a permanent establishment (PE) to arise where it conducted business through an agent in Japan who acted in a discretionary capacity on its behalf regarding the conclusion or negotiation of contracts (Agent PE). For Japanese fund managers, unlike many other jurisdictions and the Organization for Economic Co-operation and Development (OECD) Model Tax Convention on Income and on Capital (Model Tax Convention), Japan had neither a general independent agent exemption nor the equivalent of a safe harbor trading rule or investment management exemption for the management of foreign-registered and domiciled funds (foreign funds) by Japan-based advisors. Since many foreign funds were not eligible under a double tax treaty with Japan or were not considered qualified for tax exempt status pursuant to Japanese tax principles, this lack of an OECD-standard independent agent exemption under Japanese law created a PE exposure for funds and their investors where the Japan-based investment advisors acted formally or in practice as decision makers.

The NTA had previously advised that discretionary trading in Japan on behalf of a foreign investor under Japanese tax law in the absence of any relief under a

double tax treaty creates an Agent PE because there is no independent agent exemption for trading activity. Moreover, the need for analyzing and reporting this risk to investors in foreign funds became acute with the adoption of FIN 48 “Accounting for uncertainty in income taxes” for US GAAP reporting, which required the accrual of tax liabilities on an assumed full disclosure basis to the relevant tax authorities.

In practice, this risk contributed to the restriction of investment management activities in Japan, and often the location of regional investment managers in Hong Kong and Singapore, with the Japanese team acting as nondiscretionary advisors and researchers. By comparison, other major fund management centers have safe harbor rules (in particular, the UK) that allowed investment managers to invest and trade in securities on behalf of foreign funds without subjecting them to the risk of Agent PE taxation.

Change to Japanese tax law

Following policy recognition of the detrimental effect the absence of an exemption was having on the Japanese fund management industry, and with active support by the FSA, an independent agent exemption was included in the 2008 Japanese tax reforms, which were passed into law on April 30, 2008, and became retroactively effective from April 1, 2008. Japanese law was amended upon the issue of Cabinet Orders to the existing Corporate Tax Law Enforcement Order 186, Individual Income Tax Law Enforcement Order 290 and Local Tax Law Enforcement Order 7-3-5, which defined an Agent PE for Japanese tax law purposes. The amendments made by these Cabinet Orders exclude from the definition of an agent:

“...a person who conducts business activities associated with the business of the foreign corporation independently of the foreign corporation....and in the ordinary course of his business.”

This exemption is broadly in line with Article 5 of the OECD’s Model Tax Convention, and is consistent with many other taxation regimes of OECD member countries. However, the amendment did not contain any language specifically defining the scope of the exception, nor did the change provide a safe harbor for certain activities conducted by an agent in Japan. Rather, a case-by-case analysis as to the independence of each agent is required. Further commentary and the equivalent of a safe harbor rule for foreign funds came with the issuance of the guidance.

The guidance: Independent agent and the four tests

Independent agent

The guidance begins with the OECD standard in the Model Tax Convention: for an agent to be considered an independent agent, such agent must be *legally* and *economically independent* and must be acting in the *ordinary course of its business* when providing services as an agent.

Whether an agent is independent is a question of facts and circumstances; however, the guidance provides the following indications of which facts would be relevant in making this determination:

Legal independence

- The agent must have sufficient discretion to act as an agent, relying on its own special skill and knowledge in carrying out the role of agent, and not be subject to detailed instructions or to comprehensive control by the principal.
- An agent who is a subsidiary of the principal does not, of itself, preclude the agent from being independent of its parent company.

Economic independence

- An element of entrepreneurial risk must be borne by the agent.
- While not determinative, the number of principals represented by the agent is relevant, as is the dependency on a single principal for the agent’s income.

Ordinary course of business

- This is to be considered by examining the business activities that the agent customarily carries out when acting as an agent.

The four tests for a discretionary investment manager

Next, the reference cases clarify the meaning of an independent agent in the context of an investment management business, that is, restricted to where a foreign general partner (FGP) or foreign investment manager (FIM) of a foreign fund enters into a discretionary investment agreement with a Japanese discretionary investment manager (DIM) registered under the Financial Instruments and Exchange law, and the DIM conducts certain investment activities.

These four tests are more of a safe harbor rule where the circumstances apply, since meeting the four tests is taken as satisfying the meaning of an independent agent in the context of a discretionary fund management business.

Where applicable, the DIM will be treated as an independent agent of the foreign fund if it satisfies all of the following four tests:

1. *Detailed instruction test*: The FIM may provide broad discretion to the DIM but not detailed instructions; and the DIM must have enough discretion to make decisions when acting as an agent in order to be considered legally independent. The guidance states that the DIM should be fully or partly entrusted to make decisions on: the kinds, issues, amounts, or process of securities to be invested, including the contents and timing of any derivative transactions to be conducted, as well as whether the securities shall be purchased or sold and by what method and at what timing. The guidance also provides examples of the application of this test in the areas of risk management, asset allocation, investment restrictions (e.g., negative limits), investment policy, investment approvals, exchange of information, and oversight.
2. *Shared officers test*: One-half or more officers of the DIM should not concurrently serve as officers or employees of the FGP or the FIM.
3. *Remuneration test*: The DIM receives remuneration that reflects its contributions made; and a DIM will fail this test if it does not receive remuneration that corresponds to the amount of the total assets to be invested under the discretion of the DIM or its investment income.
4. *Diversification capacity test*: The DIM should have capacity to diversify its business or to acquire other clients, without fundamentally altering the way the DIM conducts its business or losing economic rationality for its business where the DIM exclusively or almost exclusively deals with the foreign fund or the FIM (with exceptions for a start up period).

Comments

Scope

The guidance is prima facie limited to foreign funds that are established as foreign partnerships or foreign corporations without access to any double tax treaty with Japan. This is somewhat intentional, as the guidance is designed to deal with the interpretation of a change in Japanese domestic law. However, the approach to an independent agent in the guidance will generally assist in the application of the equivalent OECD/treaty-based test from the Japanese perspective.

The guidance only applies to specific investment activities, by which is meant activities of portfolio investment, and these do not extend to the advisory or management of investments particularly of note covering private equity, real estate, and nonperforming loans, where by comparison with portfolio investment, income is generated through control of the investment.

Flexibility

There are favorable comments and indications that the approach by the NTA as to what is an independent agent and the application of the four tests if applicable will be applied with some degree of flexibility and openness, where for certain reasons a foreign fund or fund manager's circumstances may not strictly meet all of the four tests enumerated. This extends to the NTA being willing to respond on a disclosure basis to individual inquiries by fund managers, either in the form of advance confirmation (written responses) or confirmation with a relevant tax office (oral response).

Policy changes and final remarks

Overall, the introduction of an independent agent exemption represents a positive step forward for the financial services sector in Japan and in particular the global and local fund management industry. The changes do not eliminate the taxation risks or the need to manage these risks; however, they do generally align Japan's taxation policy in this respect with the OECD and international fund management centers.

The change was also notable for the active involvement of the FSA in framing Japanese tax policy in consultation with MOF and the NTA, and also for the collaborative consultation process that involved discussions among government agencies, industry bodies, advisors, asset managers, and other interested parties.

Pakistan

by Soli Parakh and Oscar Teunissen

Capital gains tax exemption

The Finance Act 2008 was announced and will be effective from July 1, 2008. Pakistan's fiscal year runs from July through June.

Pursuant to the act, the capital gains exemption extended up to any accounting year ending on or before June 30, 2010.

Latin America

Mexico

by Jorge Gross, John Salerno and Oscar Teunissen

2009 proposed revenue law and budget

On September 8, 2008, the executive branch of the Mexican government submitted the proposed 2009 Revenue Law and Budget to the Mexican Congress.

Breaking with longstanding tradition, this proposal excludes major changes to the tax laws, and emphasizes that the Mexican economy, business community, and revenue system are all engaged in a process of adaptation to, and implementation of, the major tax reforms introduced in recent years (e.g., the flat tax, the cost of goods sold concept, and the tax on cash deposits). Nonetheless, the 2009 Revenue Law does contain some tax-related provisions, which are summarized below.

Withholding tax on interest and deposits

- The 4.9 percent income tax withholding rate on interest paid to banks resident in tax treaty countries would be extended for 2009.
- The withholding rate of 0.85 percent on deposits of Mexican residents would be maintained.

Tax incentives

No new tax incentives were included, and tax credits were not increased. However, some existing credits would either be modified or eliminated, as follows:

- **Research and development:**
The Revenue Law lifts the limit on the research and development credit, which through 2008 was restricted to a total amount that was proportionally shared among all taxpayers with qualified investments/expenses.
- **Excise tax on diesel fuel:**
The credit continues to apply to industrial and merchant marine use of diesel fuel and transportation companies using diesel fuel, while the credit for diesel fuel for locomotives is repealed.
- **Natural gas imports:**
The exemption for customs processing fees for natural gas imports would also be extended in 2009.
- **Toll road credit:**
Fifty percent of toll payments would be granted as a credit to transportation companies for freight and passengers.

Fines and penalties

To promote tax compliance and to provide an incentive to taxpayers to normalize their tax situations, certain penalties and fines would be reduced. There are some exceptions, for example, the penalty for not remitting withholding taxes, which would remain at current levels.

PricewaterhouseCoopers Alternative Investments Contacts

United States

Atlanta, GA

Dennis Goginsky 678 419 8528 dennis.goginsky@us.pwc.com

Boston, MA

Greg Collins 617 530 7012 greg.collins@us.pwc.com
 Dan Feheley 617 530 6333 dan.feheley@us.pwc.com
 Dave Foss 617 530 7878 david.foss@us.pwc.com
 Kristin Francisco 617 530 7507 kristin.francisco@us.pwc.com
 Timothy Grady 617 530 7162 timothy.grady@us.pwc.com
 Patricia Jabar 617 530 7387 patricia.jabar@us.pwc.com
 Mark Rosenblatt 617 530 7240 mark.rosenblatt@us.pwc.com
 Paula Smith 617 530 7906 paula.e.smith@us.pwc.com

Chicago, IL

Chris Cornwall 312 298 4816 chris.cornwall@us.pwc.com
 James Lelko 312 298 5768 james.s.lelko@us.pwc.com

Dallas, TX

Michael Bohling 214 756 1734 mike.bohling@us.pwc.com
 Robert Collins 713 356 6851 robert.c.collins@us.pwc.com
 Scott Moore 214 754 7268 scott.moore@us.pwc.com

Denver, CO

Hugh Armstrong 720 931 7207 hugh.armstrong@us.pwc.com

Houston, TX

Ricky Smith 713 356 8219 ricky.g.smith@us.pwc.com
 Hadassah Wagner 713 356 4124 hadassah.wagner@us.pwc.com

Los Angeles, CA

David Chrencik 213 356 6130 david.g.chrencik@us.pwc.com
 John Mattos 213 356 6727 john.mattos@us.pwc.com
 Alison Monahan 213 217 3374 alison.monahan@us.pwc.com
 Tomoko Nagashima 213 356 6601 tomoko.nagashima@us.pwc.com
 Andy Nolan 213 217 3830 andrew.nolan@us.pwc.com

Minneapolis, MN

James Kolar 612 596 4428 james.kolar@us.pwc.com
 Jennifer Ward 612 596 6382 jennifer.l.ward@us.pwc.com

New York, NY

Dov Adler 646 471 3963 dov.adler@us.pwc.com
 Murray Alter 646 471 0556 murray.alter@us.pwc.com
 Puneet Arora 646 471 1691 puneet.arora@us.pwc.com
 Anthony Artabane 646 471 7830 anthony.artabane@us.pwc.com
 Virginia Benson 646 471 7940 virginia.benson@us.pwc.com
 Gina Biondo 646 471 2770 gina.biondo@us.pwc.com
 Barrett Brown 646 471 3024 barrett.c.brown@us.pwc.com
 Frank Calabro 646 471 7842 frank.m.calabro@us.pwc.com
 Mark Casella 646 471 2500 mark.j.casella@us.pwc.com
 Gregory Culloo 646 471 7504 gregory.cullo@us.pwc.com
 Judith Daly 646 471 5292 judith.daly@us.pwc.com
 Lyn Desantis 646 471 2084 lyn.desantis@us.pwc.com
 Scott Dillman 646 471 5764 scott.dillman@us.pwc.com
 Philip Fried 646 471 4788 philip.fried@us.pwc.com
 Bruce Graber 646 471 1447 bruce.graber@us.pwc.com
 Mike Greenstein 646 471 3070 michael.s.greenstein@us.pwc.com
 Michael Guarnuccio 646 471 2949 michael.guarnuccio@us.pwc.com
 Michael Hayes 646 471 4429 michael.f.hayes@us.pwc.com
 Robert Kelley 646 471 2066 robert.c.kelley@us.pwc.com
 Barry Knee 646 471 5898 barry.m.knee@us.pwc.com
 Gary Meltzer 646 471 8763 gary.c.meltzer@us.pwc.com
 Peter Michalowski 646 471 5259 peter.michalowski@us.pwc.com
 Tim Mueller 646 471 5516 timothy.mueller@us.pwc.com
 Marvin Nagler 646 471 8429 marvin.nagler@us.pwc.com
 Gerard O'Callaghan 646 471 8833 gerard.m.ocallaghan@us.pwc.com
 Michael O'Neill 646 471 5556 michael.j.oneill@us.pwc.com
 Cindy Price Gavin 646 471 2148 cindy.gavin@us.pwc.com
 Brian Rebhun 646 471 4024 brian.rebhun@us.pwc.com
 Maureen Renick 646 471 3049 maureen.renick@us.pwc.com
 John Reville 646 471 7845 john.reville@us.pwc.com
 Thomas Romeo 646 471 8048 thomas.romeo@us.pwc.com
 Allison Rosier 646 471 5511 allison.rosier@us.pwc.com
 Michael Ruggeri 646 471 7588 michael.ruggeri@us.pwc.com
 Dan Ryan 646 471 8488 daniel.ryan@us.pwc.com
 Pinchas Schwartz 646 471 3347 pinchas.schwartz@us.pwc.com
 Michael Spiryda 646 471 7597 michael.spiryda@us.pwc.com
 David Steiner 646 471 3836 david.a.steiner@us.pwc.com
 Scott Sulzberger 646 471 7410 scott.r.sulzberger@us.pwc.com
 William Taggart 646 471 2780 william.taggart@us.pwc.com
 Oscar Teunissen 646 471 3223 oscar.teunissen@us.pwc.com
 Belanne Ungarelli 646 471 5431 belanne.marie.ungarelli@us.pwc.com
 Joe Wiggins 646 471 7378 joe.wiggins@us.pwc.com

United States (continued)

Philadelphia, PA

Chris May 267 330 1398 christopher.r.may@us.pwc.com
 Bill McGinley 267 330 3140 william.c.mcginley@us.pwc.com

San Francisco, CA

Richard Carson 415 498 7359 richard.g.carson@us.pwc.com
 Gregory Eckert 415 498 7443 gregory.eckert@us.pwc.com
 Laura Martinez 415 498 7656 laura.e.martinez@us.pwc.com
 Lucinda Powers 415 498 6210 lucinda.powers@us.pwc.com
 Paul Roberts 415 498 6161 lpaul.a.roberts@us.pwc.com
 Matt Stolte 415 498 6232 matt.stolte@us.pwc.com
 Ted Wilm 415 498 8005 ted.wilm@us.pwc.com

Seattle, WA

Michele Godvin 206 398 3801 michele.l.godvin@us.pwc.com
 Chris Hugo 206 398 3070 christopher.j.hugo@us.pwc.com

Washington, DC

Thomas Holly 703 918 3085 thomas.j.holly@us.pwc.com
 David Sapin 703 918 1391 david.sapin@us.pwc.com

Asia

Hong Kong

Robert Grome 852 2289 1133 robert.grome@hk.pwc.com

Shanghai

Shirley Xie 86 21 6123 2855 shirley.xie@cn.pwc.com

Singapore

Justin Ong 65 6236 3708 justin.ong@sg.pwc.com

Tokyo, Japan

Raymond Kahn 81 3 5251 2909 raymond.a.kahn@jp.pwc.com

Canada

Toronto

Chris Pitts 416 947 8964 chris.pitts@ca.pwc.com
 Rajendra Kothari 416 869 8678 rajendra.k.kothari@ca.pwc.com

Europe

Channel Islands

Brendan McMahon 44 1534 838234 brendan.mcmahon@je.pwc.com

Dublin, Ireland

Damian Neylin 353 1 792 6551 damian.neylin@ie.pwc.com
 Olwyn Alexander 353 1 792 8719 olwyn.m.alexander@ie.pwc.com

Frankfurt, Germany

Robert Welzel 49 0 699585 robert.welzel@de.pwc.com

Geneva, Switzerland

Thomas Huber 41 0 58792 2436 thomas.huber@ch.pwc.com

London, England

Pars Purewal 44 20 721 24738 pars.s.purewal@uk.pwc.com
 Robert Mellor 44 20 780 41385 robert.mellor@uk.pwc.com

Luxembourg

Kees Hage 352 49 4848 2059 kees.hage@lu.pwc.com
 Marc Saluzzi 352 49 4848 2511 marc.saluzzi@lu.pwc.com

The Netherlands

Frank van Groenestein 31 10 4076 444 frank.van.groenestein@nl.pwc.com

Paris, France

Jean-Pierre Bouchart 33 15 657 1702 jean-pierre.bouchart@fr.pwc.com

Offshore

Bahamas

Clifford Johnson 242 302 5307 clifford.a.johnson@bs.pwc.com

Bermuda

Andrew Brook 441 299 7126 andrew.brook@bm.pwc.com

Cayman Islands

Noel Reilly 345 914 8600 noel.t.reilly@ky.pwc.com

Curaçao

Cees Rokx 599 9 430 0105 cees.f.rokx@an.pwc.com

This document is provided by PricewaterhouseCoopers LLP for general guidance only, and does not constitute the provision of legal advice, accounting services, investment advice, written tax advice under Circular 230 or professional advice of any kind. The information provided herein should not be used as a substitute for consultation with professional tax, accounting, legal, or other competent advisers. Before making any decision or taking any action, you should consult with a professional adviser who has been provided with all pertinent facts relevant to your particular situation. The information is provided 'as is' with no assurance or guarantee of completeness, accuracy, or timeliness of the information, and without warranty of any kind, express or implied, including but not limited to warranties or performance, merchantability, and fitness for a particular purpose.

The information contained in this document is provided 'as is,' for general guidance on matters of interest only. PricewaterhouseCoopers is not herein engaged in rendering legal, accounting, tax, or other professional advice and services. Before making any decision or taking any action, you should consult a competent professional adviser.

© 2008 PricewaterhouseCoopers LLP. All rights reserved. "PricewaterhouseCoopers" refers to PricewaterhouseCoopers LLP (a Delaware limited liability partnership) or, as the context requires, the PricewaterhouseCoopers global network or other member firms of the network, each of which is a separate and independent legal entity. NY-09-0612-A