

# International Update

## Irish QIFs Speed Fund Time to Market

Ken Owens and Suzanne Senior

Ireland's Financial Regulator has amended Qualifying Investor Fund rules to improve the country's appeal to alternative investment funds, particularly through reducing fund launch times.

The Irish Financial Regulator introduced a new Qualifying Investor Fund (QIF) regime designed to improve the competitiveness of Ireland as a domicile, especially for hedge funds, in February 2007. A key enhancement has been the speed with which new funds can be launched. This is of paramount importance for many types of alternative investment funds.

Factors such as simple tax structures, an accommodating regulator and fund flexibility have helped Ireland to establish itself as a center of choice for many Europe-facing fund management companies.

### Levelling the Playing Field

Domiciles such as the Cayman Islands have been highly successful in attracting hedge funds and other alternative investment funds, due in part to allowing these funds to launch in a short time frame. Ireland's changes to QIF rules are designed to level the playing field.

The QIF is Ireland's chosen structure for alternative investments. It is a non-UCITS collective investment scheme, and is only open to investors fulfilling specific criteria. Individuals must have a minimum net worth, excluding main residence and household goods of €1,250,000. Institutional investors must own or invest on a discretionary basis at least €25 million, or belong to beneficial owners which are qualifying investors in their own right. The minimum QIF investment is €250,000. QIFs are exempt from the conditions and restrictions that apply to retail funds relating to investment objectives, policies and leverage.

### Authorization on a Filing-Only Basis

As a result of the amended regulations, the Financial Regulator will now authorize a QIF on a filing-only basis. This means that if the Regulator receives a complete application for authorization before 3:00 pm on a specific day, it will issue a letter of authorization the following day. An application is deemed complete if all parties to the fund are approved and the fund reflects the agreed parameters. The application form used for QIF's has also been simplified and codified. The Financial Regulator has indicated there will be spot checks conducted on applications post-authorization.

Looking forward, the amended QIF rules further enhance Ireland's attractiveness as a domicile, and illustrate the Regulator's willingness to help the investment industry achieve its business objectives. ■

# Singapore: Budget Proposal for 2007

Anuj Kagalwala and Oscar Teunissen

## Enhancements to Fund Management Tax Incentive Schemes

Singapore currently has incentives in place to attract fund managers onshore. Under this regime, specified income earned from designated investments derived by certain funds is exempt from Singaporean tax. In the past, the regime has been liberalized to address changing market needs. The 2007 budget proposes to liberalize the regime even further. The changes that have been announced are not altogether a surprise, since they previously have been raised with the authorities as potential areas for improvement, and indicate responsiveness to the market.

## Removal of the 80:20 Rule

Currently, funds that meet certain criteria are protected from Singaporean tax even if the discretionary management of the funds is carried out in Singapore. To qualify for exemption under these rules, the fund must not have more than 20 percent of the total number of its issued shares (when it is a company) owned by residents or citizens of Singapore, either directly or indirectly. This is known as the 80:20 rule.

The industry had lobbied the government to remove the 80:20 rule, since it is arbitrary and puts a drag on Singaporean fund managers who are required to monitor compliance even when many of the factors are largely outside their control. The recent changes in tax legislation which exempted individuals from taxation on most types of investment income made the 80:20 rule even more untenable. Individuals would be discouraged from investing in funds that potentially converted to taxable income returns that otherwise would have been tax-exempt, had they been the proceeds of direct investment.

The good news is that the 80:20 rule will now be removed, although no details of how it will be removed or what it will be replaced with are available. Whatever the outcome, this move should provide an impetus to the nation's fund management industry.

Notably, the announcement of the proposed change refers only to "nonresident funds." It is not clear whether the specific reference to nonresident funds (and not to qualifying resident funds as well) was intentional. If indeed the intention is only to remove the 80:20 rule for nonresident funds, it is unclear how this fits into the 2006 budget announcement encouraging fund managers to set up funds onshore. If an offshore fund is given more liberal treatment than an onshore fund, then this is likely to have the effect of encouraging fund managers to move offshore.

## Modification to the Definition of Designated Investments

The incentive regime exempting funds from Singaporean tax applies only to a very specific list of designated investments. Although this list is long and has been evolving, it does not include all possible types of financial investment products. Two asset classes missing from the list are "loans" and "commodities." After protracted discussions on the subject, it has been announced that, effective February 15, 2007, the list of designated investments will be expanded to include "qualifying loans" and "commodity derivatives and physical commodities."

The inclusion of "qualifying loans" in the definition appears to be the direct result of the growing nonperforming loans market in Asia, with Singapore eyeing a share of the fund management business in this specialized area. It is not clear what the qualifying criteria might be. However, there may be restrictions by reference to the currency in which the loan is denominated or where the borrower is a Singaporean entity. This remains to be seen.

The inclusion of commodity derivatives and physical commodities is in line with the government's effort to incentivize this area and is a natural progression from changes in the last few budgets.

Although the move to expand the definition to include loans and commodities is welcome, it is disappointing that the government produced an inclusion list for designated investments rather than an exclusion list. An exclusion list would be shorter than an inclusion list, which runs the risk of inadvertent omission in an ever-increasing and evolving products market.

## Collateralized Debt/Loan Obligations (CDO)

The budget speech noted that the tax exemption scheme applicable to fund managers also will be “expanded to cover Collateralized Debt/Loan Obligations.” It is not certain why this announcement was necessary, or what it was aimed at.

Securities, including bonds, notes, certificates of deposit and treasury bills, already are on the list of designated investments. Typically, a CDO arrangement will employ a special purpose vehicle (SPV), and this will obtain its funds through an issue of notes which are already covered under the existing definition.

The only other cash flows are income from the collateral, and the credit derivative payments between (usually) the bank and the SPV, although some gains may be recorded in the SPV on the replacement of certain investments forming the collateral. It is not clear what precisely is in danger of tax or in need of protection. Details may be forthcoming in the circular scheduled for May 2007.

## Investment Advisory Fees

Fund management and/or advisory fees derived from offshore funds and qualifying onshore funds by a company which is granted the Financial Sector Incentive (FSI) for fund management are taxable at the rate of 10 percent. The law is worded such that where the services are of an advisory nature, the contract should be with the fund directly in order to qualify for the 10 percent tax rate. If the contract is with an offshore fund manager, under a subadvisory agreement, the 10 percent tax rate will not be strictly applicable. This was clearly unreasonable, and probably was an oversight since, in substance, the role of the FSI company is identical in both instances. Only the contracting party is different.

This year’s budget clarifies the matter. Effective February 15, 2007, fees earned by an FSI company are taxable at the rate of 10 percent as long as they relate to providing investment advisory services to a foreign investor or to an offshore fund manager under a delegation arrangement. ■

# Turkey:

## Communiqué no: 263 Has Been Officially Announced

Faruc Sabunku and Oscar Teunissen

On March 8, 2007, the Ministry of Finance approved and published a revised Communiqué no: 263. The revisions to the draft communiqué included explanations regarding the taxation of depository receipts (i.e., ADR, GDR). This article summarizes the amendments the communiqué makes under the new withholding tax regime.

### Revised Requirements in Order to Benefit from 0 Percent Withholding

Under the revised requirements set forth in Communiqué no: 263, nonresident corporate investors are able to provide documents for incorporation (i.e., articles of association, certificate of establishment) in order to benefit from a 0 percent withholding tax.

Communiqué no: 263 states that foreign individual investors not submitting a certificate of residence will be treated as resident investors, and income derived by such investors will be subject to 10 percent withholding.

### Taxation of Depository Receipts

Based on Communiqué no: 263, depository receipts are treated as “financial instruments” within the scope of the new withholding tax regime and Turkish taxation of these instruments depends on the date of purchase rather than issuance.

Income derived by nonresident corporate and individual investors from disposal of depository receipts purchased after January 1, 2006 by canceling into ordinary shares, regardless of their issuance date, is subject to a 0 percent withholding tax if disposed of after July 7, 2006. Income derived from disposals made between January 1, 2006 and July 7, 2006 is subject to a 15 percent withholding tax.

For the application of a 0 percent rate, nonresident corporate investors should file documents for incorporation and nonresident individual investors should file a certificate of residence to the tax office.

Income derived by nonresident investors from disposal of depository receipts by nonresident corporate and individual investors purchased before January 1, 2006 by canceling into ordinary shares is taxed under permanent tax rules applicable as of December 31, 2005. Such investors should file a special tax return within 15 days.

The 37 percent effective tax rate applies to gains derived by nonresident corporate investors, and a progressive tax rate in the range of 15 percent to 35 percent applies to gains derived by individual investors. (Provisions of double tax treaties are reserved.)

Based on the wording, the tax base should be the difference between the cancellation price of depository receipts into ordinary shares and the purchase price of depository receipts by nonresident investors. Depositories and custodian banks will not be exposed to tax assessment with regard to capital gains derived by nonresident investors from the disposal of depository receipts purchased before January 1, 2006. ■

# Italy: Draft Law Proposal on Income from Capital and Other Investment Income

Alessandro Caridi and Oscar Teunissen

On September 29, 2006, the government, based on a proposal by the Minister of Finance, Tommaso Padoa Schioppa, approved a draft law to modify the Italian tax system, including the taxation of income from capital and other investment income. The proposal, which provides for a generic reform plan, is currently being discussed in the Parliament within the framework of the 2007 economic measures.

If approved, the law would allow the government to issue a number of new provisions within a period of six months (extendable to 12 months) that would modify the level, timing and methodology of tax investment income. The new tax regime may be implemented by July 1, 2007.

One of the substantial changes would be the introduction of a tax rate not exceeding 20 percent on financial investment income to replace the current 12.5 percent and 27 percent rates. The proposed change will unlikely be retroactive, and should result in an increase of the average tax burden on investment income. Under current tax law, with few exceptions (e.g., interest on bank accounts), financial income is taxed at a reduced rate of 12.5 percent.

The other proposed change relates to the timing of the taxable event for income derived from financial investments. The accrual basis principle could be adopted in lieu of the cash basis principle (currently the primary method used for income from capital and other investment-type income that is not treated as derived under the portfolio management tax regime).

The new proposal and the expected increase in tax revenue could be supported by equality and antiavoidance reasons. Accrual taxation of investment income, regardless of the tax regime that is adopted, should be treated similarly among investors. In the government's view, the lack of an option to accelerate realization of losses and defer income should limit tax-avoiding planning opportunities. However, it is an open question whether these benefits justify the increased complexity in monitoring and managing financial income (e.g., issues related to the valuation of the assets at year-end by unsophisticated persons, and the potential tax payments without the cash flows typically associated with disinvestments).

The methodology of taxing investment income is the third area of discussion. Certain changes to the existing tax regimes for investment income (self-assessment regime, administered and managed regimes, both in collective and individual forms) are currently being considered in greater detail. These changes are intended primarily to address issues associated with the adoption of the accrual basis principle, and considerations of the competitiveness of the Italian undertakings for the collective investment of transferable securities (such as UCITS).

The likely outcome of this process is not yet clear. The introduction of a unified 20 percent rate seems very likely, while the adoption of the accrual basis method for all investment income is still open. ■

# Germany: 2008 Tax Reform Update

Hans Martin Eckstein, Oscar Teunissen and Thomas Swoboda

More details of the 2008 German tax reform initiative have become available in addition to the reported new interest capping rules and amendment of transfer pricing legislation. The German government has drafted legislation to reduce (corporate) tax rates and change the trade tax and the loss limitation rules.

## Tax Rate Changes

- The corporate tax rate shall be reduced from 25 percent to 15 percent. The solidarity surcharge of 5.5 percent would still be levied on the corporate tax.
- The trade tax base rate would be reduced as the taxable income for trade tax purposes: It shall now be multiplied by 3.5 percent instead of 5 percent. Depending on the municipally determined local rate, this would result in an effective trade tax rate between 7 percent and 17 percent.
- The overall effective tax rate for a German corporation would range from 22.8 percent to 32.9 percent.

## Trade Tax Changes

- Unlike under the current tax law, trade tax shall no longer be recognized as a tax-deductible expense.
- Under the proposed rules, 25 percent of certain financing costs would not be tax deductible for trade tax purposes. This shall apply to, among other items:
  - All interest on debts that relate to the business;
  - 25 percent of leasing and rental payments for movable fixed assets;
  - 75 percent of leasing and rental payments for immovable fixed assets; and,
  - 25 percent of expenses for the use of rights (licenses and royalties), if the agreement has a fixed term.

Deductions would be disallowed only to the extent that the total of the respective expenses exceed €100,000.

## Miscellaneous

In addition to the above items, the 2008 tax reform proposal contains:

- Changes in the taxation of partnerships (e.g., tax relief for retention of profits);
- New rules on security lending transactions; in particular, the introduction of a withholding tax liability;
- Disallowance of the declining-balance method of depreciation;
- Limitation of the immediate write-off of low-cost assets to small and medium-sized companies; and,
- 25 percent taxation of income from capital investments (including any capital gain) for private investors.

Generally, the proposed rules would become applicable for the first time in 2008. ■

# Korea: Developments in Korean Taxation

Taejin Park and Oscar Teunissen

## Korea Designates Five Foreign Jurisdictions as Tax Havens

The National Tax Service announced, effective December 29, 2006, a list of five foreign jurisdictions (“designated tax havens”) subject to the so-called controlled foreign corporation rule (“CFC rule”). These jurisdictions include Liberia, Liechtenstein, Marshall Islands, Monaco and Andorra.

In addition to the designated tax havens, the CFC rule will apply to those jurisdictions where corporate income tax liability is less than 15 percent of any income before income taxes.

In brief, the CFC rule holds that any distributable earnings generated by a foreign corporation residing in one of the jurisdictions mentioned above shall be deemed to have been distributed to the Korean shareholder with 20 percent or more of share ownership in the concerned foreign corporation even if actual dividend payment is not made to the Korean shareholder.

## Plan for New or Amended Tax Treaties

The Ministry of Finance and Economy will negotiate agreements for the avoidance of double taxation of income with trading partners that currently lack such treaties with Korea. Among the candidates are Qatar, the Cayman Islands, Saudi Arabia, Cambodia, Azerbaijan and Hong Kong. In addition, the Ministry plans to amend treaties with several countries, including Belgium, India, Netherlands and Ireland. ■

# Recent Trends for Alternative Fund Investments in China

Oscar Teunissen, Dmitri Semenov, Michael Ho and Matthew Wong

U.S. fund managers can now explore a wide spectrum of Chinese opportunities covering capital market portfolio investment, private equity, distressed debts, real estate and other high-yield investment assets. However, the Chinese investment and tax environment is extremely challenging because of constantly changing regulations, ambiguous interpretation of tax policies and inconsistent enforcement practices.

China's miraculous economic growth has provided attractive investment opportunities for international investors, and will continue to do so. A strong economic infrastructure with ongoing reform has strengthened Chinese financial markets, and U.S. fund managers can now explore a wide spectrum of Chinese opportunities covering capital market portfolio investment, private equity, distressed debts, real estate and other high-yield investment assets. However, the Chinese investment and tax environment is extremely challenging because of constantly changing regulations, ambiguous interpretation of tax policies and inconsistent enforcement practices.

U.S.-managed alternative investment funds (e.g., hedge funds and private equity funds) have consistently been important players in the growth of the Chinese financial market. Due to their size, hedge funds often invest alongside established international financial institutions.<sup>1</sup> While the relevant issues pertaining to alternative investment funds are similar to those of other investors, the unique ownership and management structures of alternative investment funds require them to take into account additional considerations when planning for investments in the Chinese market.

This article highlights Chinese tax and regulatory considerations to account for when structuring acquisitions and holdings in various fast-growing Chinese investment asset classes. It also addresses key U.S. and Chinese issues that are particularly relevant to alternative investment funds.

## General Considerations

Alternative investment funds are set up to invest in a wide range of asset classes, including publicly traded securities, real estate, consumer loans, credit card and consumer debt, distressed debt and corporate debt. Separate funds are usually set up for U.S., non-U.S. and tax-exempt investors. U.S. investors generally invest through vehicles that are considered fiscally transparent for U.S. tax purposes. This structure allows U.S. investors to preserve the character of the underlying investment income earned by the funds with respect to foreign taxes, capital gains, certain dividend income and other items that may be taxed at preferential

rates in the hands of the investors. Non-U.S. and tax-exempt investors generally invest through offshore corporate funds to mitigate U.S. trade or business income tax or unrelated business income tax (UBIT) issues. U.S. individuals generally set up U.S. limited liability companies (LLCs) that are treated as partnerships to manage the funds in the U.S. This structure preserves a single level of taxation of investment income and also allows for the flow-through of tax preferential items.

At the management company level, alternative investment funds generally establish representative offices or wholly-owned Chinese subadvisory companies ("wholly foreign-owned enterprises," or "WFOEs") to provide advisory services to the U.S. management company. There are several differences between a WFOE and a representative office. As compared to a representative office, a WFOE can perform a wider range of activities. As a result, funds transition from a representative office to a WFOE subadvisory model as the level and scope of their activities in China expands.

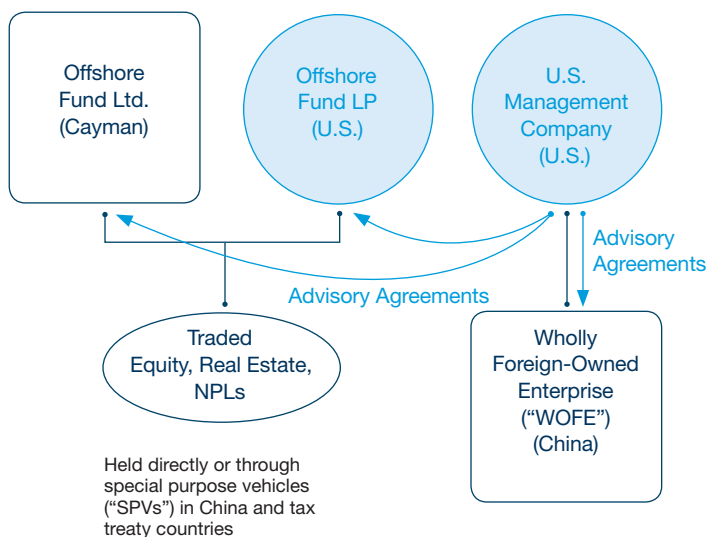
Since China does not have a trading safe harbor that would allow the employees of subadvisory entities to negotiate and conclude contracts on behalf of investment funds without creating a permanent establishment for the funds in China, the activities of the Chinese representative office must be monitored to manage Chinese permanent establishment exposure.<sup>2</sup>

The scope of the activities of the Chinese representative office would need to be defined in a subadvisory agreement between the U.S. management company and the Chinese subadvisory entity. Also, employment agreements between the Chinese subadvisory entity and local employees must be drafted carefully to limit the scope of employee activities.

Unlike China, the U.S.,<sup>3</sup> United Kingdom, Singapore and Hong Kong have implemented favorable trading safe harbors that allow advisory entities to trade on behalf of nonresident funds without creating a permanent establishment.<sup>4</sup> Therefore, discretionary management of Chinese investments is often carried out through these locations. The scope of local trading safe harbors in these countries must be monitored so that discretionary management activities (e.g., those related to Chinese investments) do not create permanent establishments or trade or business exposure in these jurisdictions. Transfer pricing planning requires that the Chinese subadvisory entity receive arm's-length compensation for its services.

At the fund level, a wide range of structures could be implemented with respect to cross-border investment planning, including treaty-based and local Chinese holding vehicles. Fund-level investment structures generally focus on managing income taxes, withholding taxes and capital gains taxes. Although these taxes can often be credited by U.S. investors, subject to the applicable U.S. foreign tax credit limitations at their level, they generally represent out-of-pocket costs for the offshore investors. Exhibit 1, illustrated below, is an example of a common management and fund investment structure.<sup>5</sup>

### Exhibit 1 Management and Fund Investment Structure



### Publicly Traded Investments

China has a very complicated share structure that allows for various types of tradable and nontradable shares. However, it also offers a relatively simple and favorable tax regime for foreign investors to deal with tradable shares (except for the A-share market, discussed below).

### Tradable Shares

Tradable shares include A-shares, B-shares, foreign shares, H-shares and red-chip shares.

A-shares are Renminbi (RMB)-denominated common stock listed and traded on the Shanghai or Shenzhen exchanges in China. They account for nearly 95 percent of total tradable shares in the People's Republic of China (PRC) stock exchanges. However, foreign investors normally are denied access to the A-share market except through the qualified foreign institutional investor (QFII) scheme.<sup>6</sup>

B-shares are foreign shares listed domestically. The face value of all B-shares is denominated in RMB, but these shares are subscribed and traded in foreign currencies (e.g., HK or U.S. dollar). Since 1992, B-shares have been issued and traded on both the Shanghai and Shenzhen stock exchanges.

B-shares allow Chinese companies to raise foreign currency from both Chinese and overseas investors. The B-share market was China's first step in internationalizing its securities markets. Due to the small-cap and the booming H-share and red-chip market, the B-share market has been marginalized and its markets lack depth.

In addition to listing domestically, capital-starved Chinese enterprises have been attracted by the vast foreign capital markets. Hong Kong has played a vital role for Chinese companies seeking to tap into foreign capital, including through H-shares. These are securities of companies incorporated in mainland China and approved by the Chinese Securities Regulatory Commission for listing and trading on the Hong Kong stock exchange. An example of an H-share company is PetroChina. By 2005, cumulative fund-raising from H-share initial public offerings exceeded US\$ 55.5 billion. Besides listing in Hong Kong, many Chinese companies also list on the New York Stock Exchange, Singapore Stock Exchange and other stock exchanges as "N-shares," "S-shares," etc.

A red-chip company is listed in Hong Kong and has at least 30 percent of its aggregate shares held directly by mainland Chinese entities or indirectly through companies controlled by them with the mainland Chinese

entities being the single largest shareholder in aggregate terms. The most important difference between a red-chip company and an H-share company is that a red-chip company is not mainland-registered. Examples of red-chip companies include China Mobile and CNOOC.

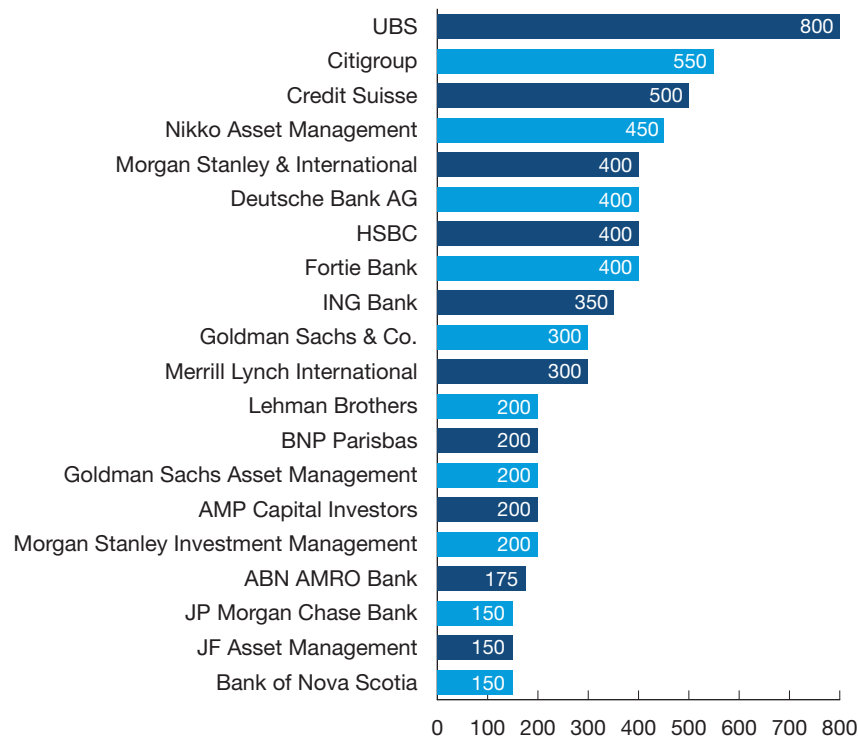
Foreign funds investing in B-shares or foreign shares (e.g., H-shares) are subject to a very favorable PRC tax regime. China introduced specific tax rulings as early as 1993 to offer PRC tax exemption on dividend income and capital gain derived from investment of B-shares and foreign shares.

## QFIIs

China did not open the A-share market to foreign investors until 2002. This significantly limited foreign funds' ability to tap China's growth through the domestic A-share market, which, as noted above, represents about 95 percent of total tradable Chinese shares. China's introduction of the QFII scheme in 2002 offered an opportunity for foreign funds to participate in the A-share market.

As of September 2006, PRC authorities have granted QFII licenses to 50 multinational financial institutions with a total investment volume of US\$ 8 billion. In May 2003, UBS and Nomura became the first firms to receive the QFII license (see Exhibit 2 below). Typically, QFIIs are allowed to invest in the RMB-denominated financial products, including A-shares, bonds, and warrants listed on Chinese stock exchanges as well as domestic securities investment funds.

**Exhibit 2 QFIIs with Investment Quotas Granted by SAFE—  
Top 20 (USD million)<sup>7</sup>**



The PRC government has always intended to use the QFII regime to attract long-term foreign investors to the Chinese domestic securities market. In August 2006, the original QFII rules were updated to lower the qualification criteria and improve other restrictions. The result has aroused a great deal of interest and encouraged applications from fund managers for new investment quotas.

However, the PRC taxation regime for QFIIs has not yet been clarified. In particular, various QFIIs may have already received income or secured capital gain from their Chinese investment portfolios. There is a pressing need for the Chinese authorities to develop the QFII tax regime to clarify the following issues:

- Who is the taxpayer in China? Should the QFII be identified as the taxpayer or can the QFII be treated as a flow-through entity so that the customer behind the QFII is taxed directly?
- Will the offshore QFII entity be treated as having a taxable presence in China because of its investment activities in China?
- Will QFIIs without a taxable presence or office in China still be subject to PRC withholding tax on income and capital gain derived from their Chinese investment portfolio?

Given the unclear PRC tax regime for QFII, the investors should assess the potentially negative tax impact with their prime brokers trading A-shares. The investors and their prime brokers may enter into a preagreed tax withholding arrangement on investment returns to be made through total return swaps.

## Chinese Publicly Traded Investments— Key U.S. Tax Issues

Under Section 1(h), net capital gain items are taxed at maximum rates of 5 percent or 15 percent on adjusted net capital gains. Net capital gains and adjusted capital gains are increased by qualified dividend income (QDI).

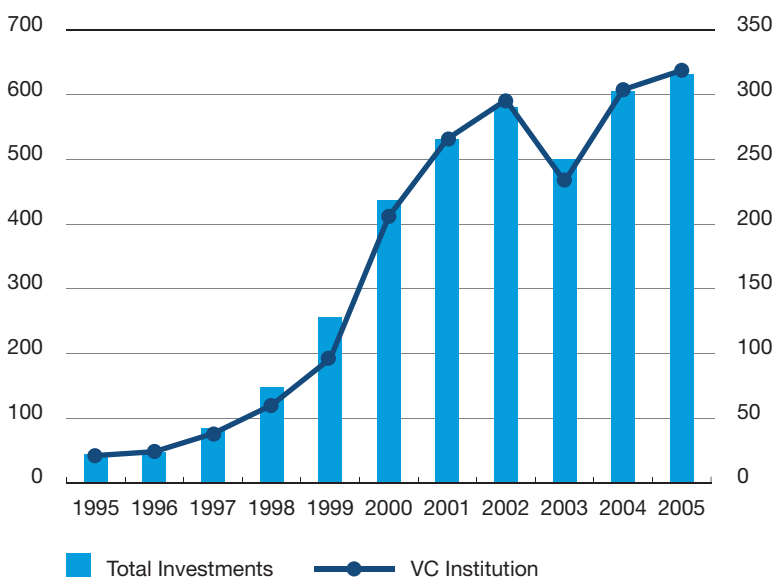
Dividends paid by foreign entities would qualify for the preferential QDI rate only if the entities are qualified foreign companies (QFCs). To be considered a QFC, the foreign corporation must be eligible for the benefits of a comprehensive U.S. tax treaty that has an exchange-of-information program with the U.S. Treasury Department.<sup>8</sup>

In general, a Chinese investee company should be considered a QFC. A foreign company also can be considered a QFC if its shares are readily tradable on the U.S. market. There also is a holding period requirement whereby the stock must be held for more than 60 days during a 120-day period (commencing on the date that is 60 days before the dividend is declared) for common stock or 120 days during a 240-day period (commencing on the date that is 120 days before the dividend is declared) for preferred stock. QDI treatment is not available for passive foreign investment companies (PFICs) (discussed below). Absent a dividend qualifying for preferential treatment (15 percent), the ordinary income tax rate applies.

### Private Equity Investments

To some foreign investors, investing directly in Chinese private ventures can be very risky, but it may achieve the best performance among the capital market options available to tap into China's growth. The Chinese private equity/venture capital industry has experienced annual growth of 30 percent over the past 10 years. Currently, foreign investors provide approximately one-third of Chinese private equity/venture capital. International private equity players have also been increasing their focus on large Chinese mergers and acquisitions deals as demonstrated below in Exhibit 3.<sup>9</sup>

**Exhibit 3 China Venture Capital Market Size and Number of Venture Capital Institutions (1995.12.31–2005.12.31)**



Typically, an offshore private equity fund may have the following Chinese tax exposure:

- Transaction taxes arising from entry and exit of Chinese target investments.
- Operational tax issues during the operating stage of the target investments.
- Chinese permanent establishment risk on the offshore fund and the fund manager, due to the activities of its employees, management team or investment committee located in China.
- Taxation and transfer pricing issues for the local investment advisor.

Robust tax due diligence work is required in the entry stages of a private equity investment to enable the fund to have a thorough understanding of the complex transaction taxes for the target investment and its hidden tax liabilities.

Use of a suitable offshore intermediate holding company structure for a Chinese project may not only increase flexibility in future exit options, but could also offer tax treaty protection on future repatriation of earnings and capital gains arising from the project.

Under the 2006 China-Hong Kong income tax treaty, investment through a Hong Kong intermediate holding vehicle can receive some withholding tax benefits (explained in Exhibit 4 below), whereas the 2006 protocol to the 1994 China-Mauritius income tax treaty reduces the capital gain tax protection on equity investments in China. Therefore, great care is required in selecting the right jurisdiction for an intermediate holding company for Chinese projects.

## Exhibit 4 China—Hong Kong Income Tax Treaty Benefits

	Dividend	Royalty	Interest
China (Non-Treaty)	0%/20% <sup>†</sup>	10%	10%
Hong Kong (Non-Treaty)	0%	5.25%	0%
Treaty Rate	5%/10% <sup>‡</sup>	7%	0%/7% <sup>†‡</sup>

<sup>†</sup> Dividends from foreign investment enterprises with at least 25% registered capital held by foreign investors are specifically exempt under the current Mainland tax law.

<sup>‡</sup> The 5% withholding tax rate applies to dividends paid by a Mainland company to a Hong Kong resident, provided that the recipient is a company that holds at least 25% of the capital of a Mainland company. 10% in all other cases.

<sup>†‡</sup> The 7% withholding tax rate applies to interest payable from the Mainland; the 0% rate applies to interest received by the Hong Kong government or recognized institutions.

Allocation of duties and location of the staff and management team among the fund, its manager, and local investment advisor can be made to minimize the offshore fund's footprint in China. This will help to minimize Chinese permanent establishment risk for the fund. Proper allocation is also important in supporting the transfer pricing policies adopted for the management, performance, and advisory fees charged by the fund manager and local advisor. Although there is currently no explicit restriction against treaty shopping in China, it is on the radar of the Chinese tax authorities, along with transfer pricing and permanent establishments.

### Chinese Private Equity Investments—Key U.S. Tax Issues

The tax considerations discussed above relating to the tax rate for capital gains, dividends and qualified dividend income, if applicable, are also relevant to private equity investments, as are the following.

**U. S. Check-the-Box Rules.** Under U.S. entity classification (check-the-box) regulations,<sup>10</sup> owners of an eligible foreign or U.S. entity (i.e., one that is not treated as a per se corporation under the regulations) can elect its classification for U.S. tax purposes by checking the box on a timely filed Form 8832 (Entity Classification Election).

The regulations provide that Gufen Youxian Gongsi is a type of Chinese entity which cannot change its classification from corporate status.<sup>11</sup> Since the consent of all owners of the entity making the election is required, alternative investment funds are often unable to change the classification of entities that they do not control. In such instances, it is vital that the alternative investment fund consider the impact of U.S. anti-deferral rules (*discussed below*).

**Foreign Tax Credits.** The potential for double taxation exists because the U.S. imposes income tax on its citizens and residents based on their income wherever it is earned in the world. Subject to many limitations, the U.S. foreign tax credit (FTC) regime mitigates double taxation by allowing a U.S. taxpayer to claim a credit against the taxpayer's U.S. tax liability for any foreign taxes paid on foreign-source income.<sup>12</sup> The rules related to determination of whether particular taxes are creditable are complex. Therefore, while it is clear that Chinese regular income, capital gain and

withholding taxes on interest are creditable for U.S. income tax purposes, it is less clear whether other taxes (*e.g., the land appreciation tax, discussed below*) are creditable.

While a U.S. corporation can claim FTCs to reduce its U.S. tax liability for taxes that it pays directly, or indirectly through its 10 percent-or-more-owned (by vote) foreign subsidiaries, U.S. citizens or tax residents can claim credits only for directly paid foreign taxes. Thus, the indirect FTC rules are often irrelevant for hedge funds and their management companies whose ownership normally does not include corporate entities that 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 U.S. tax purposes. Therefore, any taxes paid by fiscally transparent entities generally should be available as FTCs at the level of their ultimate U.S. owners, subject to the applicable limitations. For example, if a U.S. LLC management company owns 100 percent of a Chinese subadvisory entity, any taxes paid by the subadvisory company should be treated as paid by the owner of the U.S. LLC and thus should be creditable at their level subject to the applicable U.S. FTC limitations discussed above.

**U. S. Anti-Deferral Rules.** To the extent that equity investments are not structured through entities that are treated as fiscally transparent for U.S. tax purposes (see discussion of the check-the-box rules above), the impact of the U.S. anti-deferral rules must be considered. These rules are generally designed to prevent deferral of certain passive income (*e.g., interest, dividends, rents and royalties*) earned by foreign corporations. The anti-deferral rules apply mainly to controlled foreign corporations (CFCs) and PFICs.

A CFC is any foreign corporation if more than 50 percent of the total combined 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 “U.S. shareholders” on any day of the foreign corporation’s tax year.<sup>13</sup> A “U.S. shareholder” is any U.S. person including a U.S. citizen or resident individual, domestic partnership, corporation, trust, or estate that owns, directly or indirectly,<sup>14</sup> 10 percent or more of the total combined voting power of all classes of stock entitled to vote in the foreign corporation.<sup>15</sup>

U.S. shareholders that 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 U.S. 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.<sup>16</sup> These U.S. 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).<sup>17</sup> 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 generate primarily passive income or own primarily passive assets, or both. In general, this regime was intended to tax U.S. persons with respect to income from companies that serve as “incorporated pocketbooks” and are used to hold or manage personal investments.

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).<sup>18</sup>

U.S. shareholders of a PFIC should always consider making a qualified electing fund (QEF) election with respect to a PFIC. The election is made by attaching Form 8621 to the shareholder’s timely (original or amended) return. The benefit of the election is that ordinary income and net capital gain are passed through to the shareholder as ordinary income and long-term capital gains, respectively. Also, if a QEF election is made, U.S. shareholders will not be subject to the adverse anti-deferral rules under the PFIC regime.

Once a company is deemed a PFIC, as to any given shareholder, the shareholder generally remains subject to the PFIC rules unless a timely “purging election” is made.<sup>19</sup> Unless a QEF election is made, the “excess distribution” rules would apply to the U.S. person that holds stock of a PFIC whenever that shareholder receives a distribution with respect to his PFIC stock.<sup>20</sup>

## Distressed Debt Investments

The distressed debt market represents a unique and specialized asset class in the global hedge fund industry. Often, fund managers participate in the Asian distressed debt market in order to diversify their global portfolio.

China, which has substantial nonperforming loans (NPLs), has recently been gaining some momentum on the back of a steady stream of sales to foreign investors. During the PRC financial sector reform in 1999, four government-run asset management companies (AMCs) acquired NPLs of US\$ 170 billion from the commercial banking system, which needed to be resolved by the end of 2006. The secondary market for NPLs was opened in 2001, but there was a lack of sales activities during 2002-2004. It finally picked up in late 2005, and a push of deals between the AMCs and foreign investors has been announced since then.

Meanwhile, the PRC tax regime governing the distressed debt market is still in a state of flux. In 2003, the PRC tax authorities set out a preferential taxation framework for foreign investment in the Chinese NPL market under Tax Circular (2003) No. 3, which allows gain on disposal of NPLs to be recognized on a cost recovery method under a total portfolio basis (i.e., total purchase cost of the portfolio), and business tax to be exempt on disposition of NPLs by foreign investors. However, Circular No. 3 does not go into the detailed taxation issues for offshore NPL holding structures; in particular, the following questions have yet to be resolved:

- Can an offshore NPL holding company with minimal presence in China be accepted as having no permanent establishment in China?
- If so, can investors apply relevant tax treaty benefits to minimize the Chinese withholding tax on the NPL resolution proceeds?
- How should the resolution proceeds be characterized given that the withholding tax rules for “business profit,” “capital gain” and “interest” can be very different?

- If the offshore holding company is deemed to have a Chinese permanent establishment, how should the net taxable profit on disposition of NPLs be computed and what are the allowable tax deductions?
- When and where should relevant taxes be reported?

Without official taxation guidelines to deal with these grey areas, fund managers investing in the Chinese NPL market should review judicial precedent and best practices in the market to develop the right investment structure.

For funds intending to adopt an offshore holding structure, the ideal tax position would be:

- 1) To store the NPLs in an offshore jurisdiction that can offer (a) a “safe harbor” home-country tax position for the vehicle; and (b) a preferential tax treaty position on PRC withholding tax on repatriation of NPL resolution proceeds.
- 2) To minimize the funds’ footprint in China so that it has a strong argument in negotiating with the PRC tax authorities for a “no Chinese permanent establishment” position.

## Distressed Debt—U.S. Investment Issues

One issue that is particularly relevant in the context of distressed debt investments is the application of the U.S. trading safe harbor under Section 864, which provides that “trade or business within the United States” does not include “trading in stocks or securities for the taxpayer’s own account.”<sup>21</sup> In general, NPLs should be considered securities.<sup>22</sup>

The next issue is whether the fund is “trading” in NPLs. NPL-related investments could be viewed as trading for the fund’s own account. However, certain types of NPL activities could be viewed as “lending” rather than “trading” in securities. For instance, to the extent that NPLs are restructured after the acquisition, the terms of the loans could be modified<sup>23</sup> or investment funds could provide additional funding, participate in an official or an unofficial committee in connection with reorganization or bankruptcy, or exercise creditor foreclosure or similar rights. Also, if an investment fund is considered a “dealer” in securities, the trading safe harbor will be unavailable.<sup>24</sup> Further, certain investments in U.S. NPLs could “taint” the scope of the activities that could be conducted in the U.S. with respect to the non-U.S. NPL activities, since they could be viewed as part of a single trade or business.<sup>25</sup> Issues discussed above regarding application of the U.S. anti-deferral, foreign tax credit, check-the-box and capital gains are equally relevant here.

## Accounting Issues in the U.S.

As outlined above, the Chinese tax environment is somewhat uncertain and changing. U.S. accounting principals (FIN 4824) require a review of uncertain tax positions. An example of a tax uncertainty applicable to China

is that a risk for a purported nontaxable activity will be treated as a permanent establishment.

The recognition requirement is a “more likely than not” position, based solely on the technical merits of the position and assuming full knowledge by the tax authority. Failure to meet the recognition requirement may force taxpayers to accrue penalties and interest indefinitely on tax risks that grow every year but do not expire. Many of the typical permanent establishment-type issues exist within China, including those for activities conducted beyond the scope granted to representative offices for sales and services functions. Thus, companies should carefully evaluate their exposure to permanent establishment risks.

## The Challenge Ahead in China

The last few years have seen a rapid expansion in the Chinese-based investment strategies adopted by international hedge funds and private equity funds. This has presented a tremendous new challenges in Chinese taxation which will continue as other emerging Chinese investment asset classes (e.g., commodities and fixed-income securities) gradually open to foreign investors.

The upcoming Chinese tax reform creates new uncertainties and opportunities for foreign funds to develop tax-efficient Chinese investment structures. For example, the concept of tax-resident enterprise may be introduced. The tax-resident enterprise refers to an enterprise that is established within China or an enterprise that is established outside China but its effective management office is based in China. Tax-resident enterprises are subject to corporate income tax on worldwide income while non-tax-resident enterprises are taxed on Chinese-sourced income. Apparently, China is widening their tax net to tax non-PRC-source income derived by overseas vehicles. This extension is beyond the permanent establishment concept, which effectively taxes only PRC-source income. Increasing tax audit activities in China and additional transfer pricing documentation requirements pose a

new threat to foreign funds on tax compliance issues. Foreign funds critically need to perform an operational tax risk review on their business in China.

Various QFIs already may have received income or secured capital gain from their Chinese investment portfolios. Thus, there is a pressing need for a more developed QFI tax regime and the Chinese authorities must clarify open issues.

Thorough tax due diligence work is required at the entry stage of a private equity investment to enable the fund to have a thorough understanding of the complex transaction taxes for the target investment and its hidden tax liabilities

Allocation of duties and location of the staff and management team among the fund, its manager and the local investment advisor can be made to minimize the offshore fund's footprint in China so as to avoid the Chinese permanent establishment risk to the fund. ■

## End notes

- 1 It was reported that total hedge funds assets hit \$1.43 billion in 2006, up 29% from the end of 2005. See Ganahar and Mackintosh, "Wealthy Investors Move to Cut Hedge Funds Exposure," *Financial Times*, January 19, 2007.
- 2 Operating guidelines should be developed to educate employees of the Chinese advisory entities of potential adverse tax implications related to their activities in China.
- 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 "U.S. 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 U.S. 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.
- 5 The actual investment and management company structures are more complex and beyond the scope of this article.
- 6 See "Business Tax Exemption for QFI on Securities Trading in China," 17 JOIT 13 (February 2006). 0214
- 7 State Administration of Foreign Exchange (SAFE), [www.safe.gov.cn](http://www.safe.gov.cn)
- 8 Notice 2003-69, 2003-2 CB 851; Section 1(h)(11)(C)(i)
- 9 CAGR = Compound Annual Growth Rate
- 10 Regs. 301.7701-1 through -3
- 11 Reg. 301.7701-2(b)(8)(i)
- 12 To prevent the U.S. Treasury from subsidizing operations abroad, the allowable credit should not exceed the applicable U.S. taxes on the foreign-source income. The limitation formula under Section 904(a) is: maximum FTC allowable equals U.S. 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 of 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 make matters more complicated, 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).
- 13 Section 957(a).
- 14 Ownership of controlled or related entities or individuals is generally attributed to a U.S. 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)).
- 15 Section 951(b); Reg. 1.951-1(g); Section 7701(a)(30).
- 16 Section 951(a)(1)(A)(i); Reg. 1.951-1(a).
- 17 Sections 959(a)(2) and 951(a)(1)(b).
- 18 Section 1297(a).
- 19 Section 1291(d)(2). A qualified electing fund (QEF) election causes the current earnings of a PFIC to be included in income of a U.S. person annually.
- 20 Section 1291.
- 21 Section 864(b)(2)(A)(ii). See note 3, *supra*.
- 22 Reg. 1.864-2(c)(2)(i)(c) provides that "securities" means any note, bond, debenture, or other evidence of indebtedness, or any evidence of an interest in or right to subscribe to or purchase any of the foregoing.
- 23 For instance, if a loan is modified, under Reg. 1.1001-3, it could be considered a new security.
- 24 Reg. 1.864-2(c)(iv)(a) provides that a dealer in stocks or securities is a merchant of stocks or securities, with an established place of business, regularly engaged as a merchant in purchasing stocks or securities and selling them to customers, with a view to the gains and profits that may be derived therefrom.
- 25 A detailed discussion of the application of the U.S. trading safe harbor to the NPL investments is beyond the scope of this article.

# Capital Markets in India: Recent Proposals

Suresh Swamy and Puneet Arora

The Securities Exchange Board of India ('SEBI') has made certain proposals to better regulate the capital market in India and to enhance investor protection. Some of the key proposals that have recently been reported<sup>1</sup> are listed below:

## Background

The main objectives of SEBI are to protect the interests of investors in securities and to promote and regulate the development of securities markets in India. SEBI proposals are intended to achieve these objectives.

## Consultation paper to regulate Investment Advisers

SEBI does not presently require registration and regulation of investment advisers as a separate class of intermediary. However, investment advisory services rendered by market intermediaries such as portfolio managers, stock brokers, merchant bankers and credit rating agencies are regulated by SEBI through separate regulations. Portfolio Managers Regulations, in particular, cover investment advisers who have discretion over and hold custody of client assets. SEBI has floated a consultation paper which, among other things, invites comments from the public on whether all investment advisers or only those who get compensated directly (in the form of fees) or indirectly (in the form of commissions, etc.) should be regulated.

## Mandatory ratings of all IPOs

In April 2006, SEBI introduced guidelines which allowed companies to opt for IPO ratings from a third-party rating agency. The Primary Markets Advisory Committee recommended that a pilot project might be put in place and a limited number of IPOs might be rated. Based on further inputs received from the committee, SEBI recently made the obtaining of ratings mandatory for all IPOs.

## Spot market short selling by Foreign Institutional Investors ("FIIs")

"Institutional investors" (i.e., mutual funds and the FIIs) registered with SEBI, including banks and insurance companies, are expressly prohibited from short selling. FIIs are mandatorily required to settle on the basis of deliveries of securities owned and held by them.

In December 2005, SEBI issued a discussion paper acknowledging that a vibrant securities lending and borrowing market was necessary to provide sufficient impetus for short selling in India. More recently, the

Finance Minister announced in his budget speech that short selling by institutions, settled by delivery, would be permitted and a securities lending and borrowing mechanism would be put in place to facilitate delivery. A formal notification on this issue is awaited.

## Hedge funds may be able to invest directly in India

SEBI is working on a proposal to allow global hedge funds to invest directly in Indian equities. As an unwritten policy, SEBI does not currently grant FII status to hedge funds. However, many funds invest indirectly in the India market through Participatory notes. The SEBI chief in a recent press interview (transcript available on the SEBI web site) mentioned that SEBI would like hedge funds to trade directly in Indian stocks.

## Private equity funds to be regulated

SEBI and the Reserve Bank of India ("RBI") have formed study groups to analyze the structure and impact of private equity funds on investors, on the companies in which they invest, and on their effect on corporate governance. It is understood that the purpose of this study is to ascertain if the interests of investors in private equity funds are compromised during corporate leveraged buyouts, delistings and relistings.

## FII investment in pre-IPO placements of realty companies

The Finance Minister has recently sent a detailed proposal to the Cabinet Committee on Economic Affairs proposing to include pre-IPO placements to FIIs by realty companies under the Foreign Direct Investment ("FDI") Regulations. The Finance Minister's views on this issue were understood to be based on inputs received from the Reserve Bank of India to the effect that all forms of private

placements and preferential allotments by realty companies were in the nature of FDI and would therefore be subject to minimum area development, minimum capitalization and lock-in requirements. The SEBI view on this issue was that FII's investments in such pre-IPO placements should be considered as portfolio investments that are not subject to the FDI stipulations mentioned above. A formal notification on this issue is awaited.

#### End notes

<sup>1</sup> Certain proposals mentioned here are based on news reports appearing in the Indian Press.