Recent Trends for Alternative Fund Investments in China

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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.[1] 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.

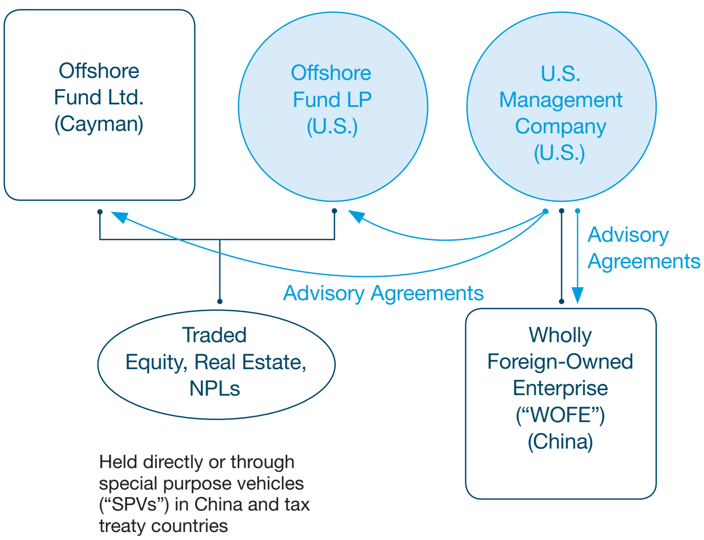
Since China does not have a trading safe harbor that would allow the employees of subadvisory entities to negotiate and conclude contracts on behalf of investment funds without creating a permanent establishment for the funds in China, the activities of the Chinese representative office must be monitored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

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.,[3] 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.[4] 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.[5]

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.[6]

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.

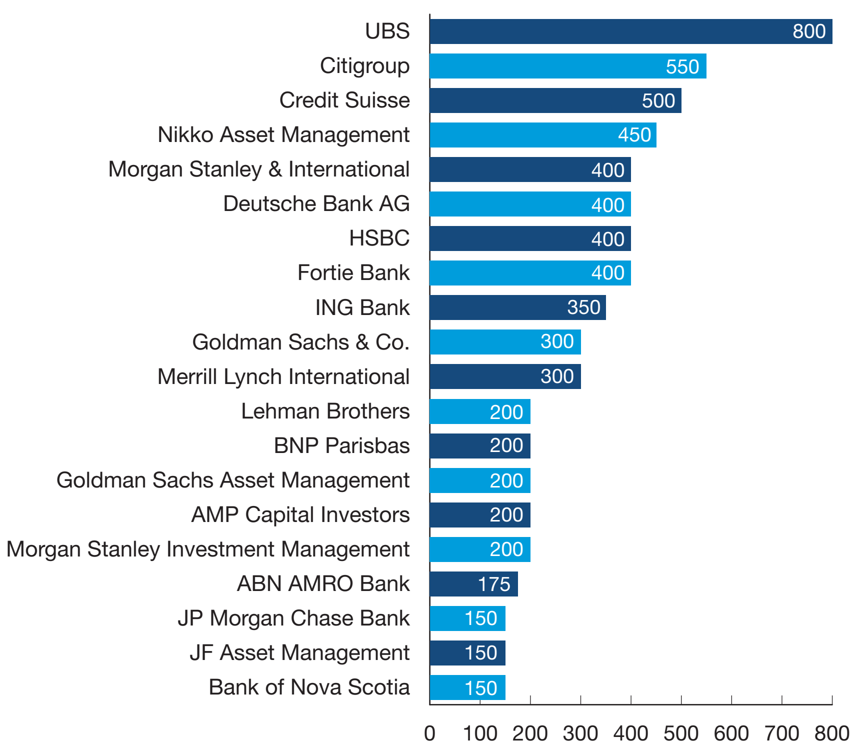
Foreign funds investing in B-shares or foreign shares (e.g., H-shares) are subject to a very favorable PRC tax regime. China introduced specific tax rulings as early as 1993 to offer PRC tax exemption on dividend income and capital gain derived from investment of B-shares and foreign shares.

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)[7]



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).

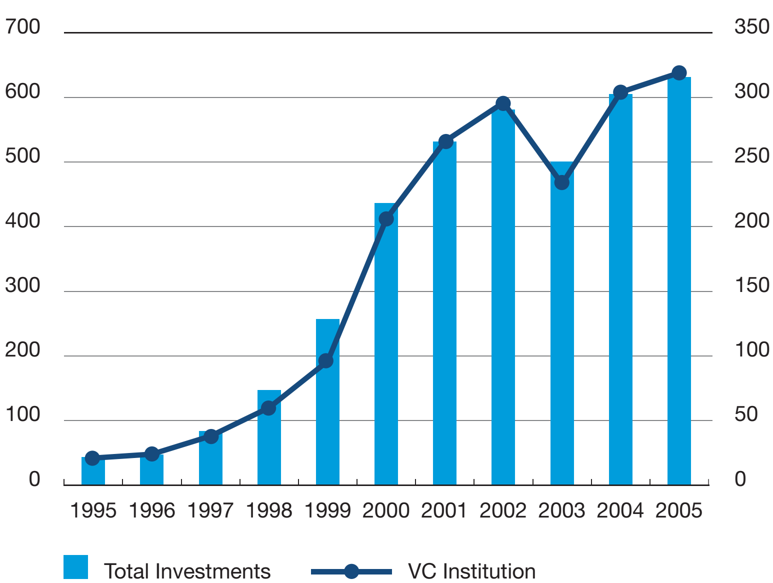
Dividends paid by foreign entities would qualify for the preferential QDI rate only if the entities are qualified foreign companies (QFCs). To be considered a QFC, the foreign corporation must be eligible for the benefits of a comprehensive U.S. tax treaty that has an exchange-of-information program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

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.[9]

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%†	10%	10%
Hong Kong (Non-Treaty)	0%	5.25%	0%
Treaty Rate	5%/10%‡	7%	0%/7%†‡

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

‡ 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.

†‡ 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,[10] 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.[11] 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.[12] 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.[13] 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,[14] 10 percent or more of the total combined voting power of all classes of stock entitled to vote in the foreign corporation.[15]

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.[16] 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).[17] 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).[18]

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 a deemed a PFIC, as to any given shareholder, the shareholder generally remains subject to the PFIC rules unless a timely "purging election" is made.[19] 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.[20]

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."[21] In general, NPLs should be considered securities.[22]

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[23] 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.[24] 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.[25] 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 QFIIs already may have received income or secured capital gain from their Chinese investment portfolios. Thus, there is a pressing need for a more developed QFII 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 QFII on Securities Trading in China," 17 JOIT 13 (February 2006). 0214

7 State Administration of Foreign Exchange (SAFE), 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.

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