




Rain or shine?

Alternatives Investment Funds Electronic Newsletter






July 2009

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Is the UK now set to become the domicile of choice for hedge funds?

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Click on each PricewaterhouseCoopers author's name to contact them directly via email

By: Robert Mellor, PricewaterhouseCoopers (UK), T: +44 (0) 20 7804 1385, Lachlan Roos, PricewaterhouseCoopers (UK), T: +44 (0)20 7213 1309 and Debbie Payne, PricewaterhouseCoopers (UK), T: +44 (0) 20 7213 5443






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Is the UK now set to become the domicile of choice for hedge funds?

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The introduction of the Qualified Investor Scheme ('QIS') in April 2004 provided a regulatory framework for hedge funds which were looking to establish in the UK offering some of the features of an authorised scheme, whilst affording institutional and sophisticated investors the flexibility associated with a wholly unregulated fund in the scheme's operation. The FSA's approach to regulating a QIS is to rely more heavily on disclosure rather than using prescriptive rules. Whilst there are restrictions, for example on the use of derivatives, most hedge fund strategies would be able to be operated within a QIS, which also allows for performance fees to be charged.

To date the main barrier has been the UK tax regime. The availability of the investment manager exemption meant that little regard was paid to whether an offshore hedge fund was actually trading based on a UK tax analysis. Recent developments, including the introduction of the new Reporting Regime for offshore funds and the 'white list' for Authorised Investment Funds and equivalent offshore funds, have

focused attention on this issue, with a number of hedge fund managers concluding that their funds are not trading funds. In addition, if they are established as a UK AIF, provided there is diversity of ownership, the 'white list' provides certainty that the fund is not trading.






Whilst there are still indirect tax issues taken together with the introduction of the Tax Elected Fund ('TEF') regime, which moves the point of taxation from the fund to the investor, managers now have the opportunity to establish onshore funds, in the form of an authorised unit trust or open ended investment company.

Given the proposed draft EU Directive on Alternative Fund Managers establishing funds in the UK, which is actively seeking to enhance its competitiveness, appears to be a logical step to address the concerns of EU Regulators.

UK taxation and pensions: A climate of change

The Finance Act 2009 has introduced sweeping changes to the taxation of pension contributions into registered UK schemes, encouraging fund managers to consider whether the pension arrangements in their portfolio companies will continue to be fit for purpose.

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By: Victoria Robinson, PricewaterhouseCoopers (UK), T: + 44 (0) 20 7804 1771 and Matthew Wright, PricewaterhouseCoopers (UK), T: +44 (0) 20 7213 2124

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By: Victoria Robinson, PricewaterhouseCoopers (UK), T: + 44 (0) 20 7804 1771 and Matthew Wright, PricewaterhouseCoopers (UK), T: +44 (0) 20 7213 2124

Prior to these changes individuals and employers could generally contribute money into a registered pension scheme saving income tax on the contribution at 40%. The Finance Act will reduce tax relief on pension contributions for those who have earned over £150,000 in the previous two tax years. The tax relief will be tapered away, so that individuals with income in excess of £180,000 will receive only 20% relief. Although there are exceptions the reduction in tax relief has made contributions into registered pension schemes for most executives significantly less attractive to both employees and employers. Many are now considering alternative ways of funding their retirement outside of traditional UK-registered schemes.


These major tax changes are leading organisations to extend the shake up of defined benefits pension provision to defined contribution offerings. Many organisations are concluding that now is the time to re-evaluate the role that pensions play in the overall reward and business strategy. A recent Pensions survey by PricewaterhouseCoopers found that 96% of companies are planning changes to their workplace pension schemes.

In particular many private equity and infrastructure fund managers are looking at how legacy pension obligations in portfolio companies may affect their ability to raise debt finance. Financiers are increasingly examining the viability of pension arrangements as part of their due diligence exercise. These tax changes offer an opportunity to engage with pension trustees on the need for reform.

Obama administration international tax proposals

In May 2009, the US Treasury Department issued its 'Green Book', which provides general explanations of the Obama administration's revenue proposals. If enacted as proposed, these changes may have a dramatic effect on the private equity, hedge fund and venture capital industries.

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By: Oscar Teunissen, PricewaterhouseCoopers (US), T: + 1 (646) 471 3223, Joni Geuther, PricewaterhouseCoopers (US), T: + 1 (646) 471 4526 and Daniel Lobatto, PricewaterhouseCoopers (US), T: + 1 (646) 471 7507

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By: Oscar Teunissen, PricewaterhouseCoopers (US), T: + 1 (646) 471 3223, Joni Geuther, PricewaterhouseCoopers (US), T: + 1 (646) 471 4526 and Daniel Lobatto, PricewaterhouseCoopers (US), T: + 1 (646) 471 7507

The current proposals include a scheme to tax a partner's services partnership interest ('SPI') (as well as gains from the sale of SPI) or carried interest as ordinary income and not at reduced tax rates as allowed under current law. Unless specific exemptions are met, foreign entities that elect to be disregarded from a US tax perspective ('DE') will become regarded, and expense deductions, except for research and development-related expenses, allocable to unrepatriated foreign earnings will be limited. Furthermore, the proposal includes a limitation on foreign tax credits to the average foreign tax rate imposed on the taxpayer's CFCs income. There are also proposals to revoke current IRS rules that allow foreign investors, through the use of notional principal contracts and equity swaps, to avoid US withholding tax while continuing to receive the economic benefit.

It is clear that the proposed tax reforms will pose significant challenges for private equity, hedge fund and venture capital funds. With a proposed effective date of 31 December 2010 and a potential acceleration of the CTB and codification of economic substance proposals in early 2010, investment funds will only have a short period of time to assess the impact of the changes on their current structures and implement planning ideas as needed.

New guidance on control objectives for Private Equity and Hedge Fund Managers

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Click on each PricewaterhouseCoopers author's name to contact them directly via email

By: Karen Sharpe, PricewaterhouseCoopers (UK), T: + 44 (0) 20 7804 7473

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New guidance on control objectives for Private Equity and Hedge Fund Managers

Click on each PricewaterhouseCoopers author's name to contact them directly via email

By: Karen Sharpe, PricewaterhouseCoopers (UK), T: + 44 (0) 20 7804 7473

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Institutional investors have been unnerved by recent events. The economic crisis has resulted in returns from investments in alternative funds being lower than expected. Lehman's collapse highlighted structural problems, particularly with respect to managing liquidity and counterparty risks, and there has been an increase in fraud. These factors have led to a loss of investor trust and calls for greater transparency.



An increasing number of our alternative asset manager clients are being asked for more information about their operational controls and governance. Institutional investors are demanding an AAF 01/06 (UK) or SAS 70 (US) controls report in requests for proposals as a prerequisite to engaging alternative asset managers to manage their funds. These documents enable managers to report on the controls in place over their investment operations, and include an assurance report from an independent accountant. They have been commonplace for traditional asset managers ever since

the first standard, FRAG 21 was introduced in 1994, but until recently have been rare for alternatives.

Working together with stakeholders including the National Association of Pension Funds and service providers, the Institute of Chartered Accountants in England & Wales has recently updated its AAF 01/06 guidance "Assurance Reports on Internal Controls of Service Organisations Made Available to Third Parties". The expanded guidance now contains control objectives written specifically for private equity and hedge fund managers. Copies are available from the [ICAEW website](#).

HM Revenue & Customs is aggressively challenging private equity and funds clients on two VAT issues,

which may give rise to retrospective and future VAT costs

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Click on each PricewaterhouseCoopers author's name to contact them directly via email

By: Stephen Morse, PricewaterhouseCoopers (UK), T: +44(0) 20 7212 2728 and Antonia Sherratt, PricewaterhouseCoopers (UK), T: +44(0) 20 7804 1957

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By: Stephen Morse, PricewaterhouseCoopers (UK), T: +44(0) 20 7212 2728 and Antonia Sherratt, PricewaterhouseCoopers (UK), T: +44(0) 20 7804 1957

The issues are the use of offshore funds and deal fee VAT recovery made by portfolio companies on acquisition/ investment costs incurred within the last three years. Whilst you may have heard of these types of challenges before, they are much more focused and targeted challenges than those we have seen in the past, which have resulted in a large number of assessments being issued on clients for VAT plus the addition of interest, and in some cases, penalties.

Offshore funds






HMRC is challenging clients on the VAT treatment of operations which are located partly or wholly offshore. In one case this has led to an assessment by HMRC for £1m in back VAT, and in another to a refusal by HMRC to pay a client's back claim for £2m. This is likely to be a real issue for the vast majority of private equity fund and infrastructure clients which either have offshore funds or which manage offshore third party funds.

HMRC's challenge is on both specific VAT technical and broader 'tax avoidance' grounds. On the technical front, HMRC is arguing that the (fund) is properly established in the UK for VAT purposes based on the relationship between the onshore manager and the offshore fund and the various functions performed by each; the 'tax avoidance' argument focuses on the decision to have an offshore rather than an onshore fund. VAT case law and practice has developed in the past few years, and clients should review any offshore fund arrangements both from a structural and an operational perspective.

Deal fee VAT recovery

HMRC appear to be systematically carrying out an exercise to identify and then challenge deal fee VAT recoveries made by portfolio companies within the last three years. HMRC is being very robust in challenging VAT claims on a line by line basis, even where the VAT itself has already been repaid.

Assessments for repayment of VAT plus interest (and in some cases penalties) are following very quickly from the initial enquiry letter from HMRC.

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By: Stephen Morse, PricewaterhouseCoopers (UK), T: +44(0) 20 7212 2728 and Antonia Sherratt, PricewaterhouseCoopers (UK), T: +44(0) 20 7804 1957


Assessments for repayment of VAT plus interest (and in some cases penalties) are following very quickly from the initial enquiry letter from HMRC. In some cases HMRC is challenging the whole portfolio; there is some experience of HMRC questioning the VAT liability of transaction fees charged by the PE House/fund manager which, if successful, would impact on the House/manager itself.

Clients should review both the strategies used to maximise VAT recovery and the transaction documentation itself to assess the relative strengths of the respective arguments. Care should be taken in responding to HMRC to ensure that the strongest arguments are put forward at the earliest

possible stage, to reinforce the strengths of the arguments in favour of VAT recovery. Equally, if VAT is not considered early enough in the deal, the deal fee VAT recovery position is at risk going forward and action such as ensuring engagement formalities and engagement terms are as robust as possible will be required to prevent further challenges from HMRC. It is not inconceivable that this could also lead to a similar review of the corporate tax treatment of costs incurred.

The 50% UK tax rate

Higher rates of tax, smaller compensation packages and new regulatory regimes are focusing minds on the suitability of existing reward structures in the new economic situation.

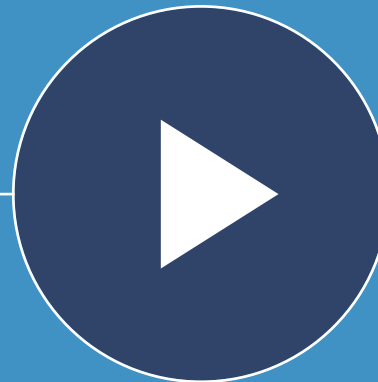
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Click on each PricewaterhouseCoopers author's name to contact them directly via email

By: Victoria Robinson, PricewaterhouseCoopers (UK), T: +44 (0) 20 7804 1771 and Matthew Wright, PricewaterhouseCoopers (UK), T: +44 (0) 20 7213 2124






The Finance Act 2009 will from 6 April 2010 increase income tax to 50% on earnings in excess of £150,000 per year. Those earning in excess of £112,950 will also lose their entitlement to a tax free personal allowance (basic currently £6,475), also increasing the personal tax burden in the UK. In addition, reduced tax relief on contributions into UK-registered pension schemes for those earning in excess of £150,000 will have a massive impact on the total reward packages of many senior executives.

This additional tax burden puts pressure on executive returns on compensation and incentive packages which have already been under strain over recent times. Declining asset values and income streams, coupled with increased regulatory pressure, mean many organisations are now considering whether their existing reward structures do incentivise their executives in the appropriate way and align to business strategy as necessary.

If the EU enacts the Alternative Investment Fund Managers Directive ('AIFM') in its current form,

it may impose a disproportionate regulatory regime on managers of alternatives funds that are not authorised UCITS.

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By: James Greig, PricewaterhouseCoopers Legal (UK), T: +44 20 7213 5766 and Graham Phillips, PricewaterhouseCoopers (UK), T: +44 20 7213 1719

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The AIFM is the EU's response to comments in the G20 Communiqué, which referred to the need for certain systemically important hedge funds to be regulated, and for financial regulators to have access to information necessary for the assessment of systemic risks and the tools necessary for effective macro-economic oversight. Macro-prudential risks associated with the use of leverage primarily relate to the activities of hedge funds. However, the Directive goes further, proposing the creation of a comprehensive regulatory environment for all alternative investment fund managers, including those managing private equity, commodity, real estate and infrastructure funds. In addition the Directive also has a key objective of ensuring a high level of consumer and investor protection. This will be achieved by specifying a detailed common framework for the authorisation and supervision of AIFM.

The Directive has the potential to be beneficial. There will be merits to a uniform platform of regulation and, certainly, a passport for funds and their managers in the AIF industry will

be an advantage. However, if enacted in its current form, the Directive risks imposing a disproportionate regulatory regime on the managers of all collective investment vehicles which are non-qualifying UCITS and which are intended only to be available to sophisticated investors, as well as seeking to achieve tax-related objectives which are inappropriate for a Directive intended to provide a framework for regulating managers. It also leaves the position of established funds that are already fully invested unclear.





The time for consultation on the Directive is likely to be very short. If political approval on the Commission's proposals is reached by the end of 2009, the Directive could come into force in 2011.

It is crucial that industry participants assess the potential impact of the proposed Directive immediately and act now, so that they can seek to influence the shape of the final Directive and its implementing regulations, and, to the extent necessary, start planning for the changes the Directive will require.

New tax on Chinese stocks for foreign investors

Prior to China's tax reform of 2008, China had a relatively simple and favourable tax regime for foreign investors to deal with B shares and overseas-listed Chinese shares.

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By: Matthew Wong, PricewaterhouseCoopers (China), T: 86 (21) 2323 3052

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Basically, foreign institutional investors were exempt from Chinese withholding tax ('WHT') in respect of dividends payable from overseas-listed shares and B shares, as well as capital gains arising from the sale of these shares.

Meanwhile, while there was no clear WHT exemption policy for dividends and capital gains derived from A shares invested in by Qualifying Foreign Institutional Investors, the Chinese authorities did not collect any WHT.

The corporate income tax law effective from 1 January 2008 significantly changed the taxation regime in relation to the taxation of Chinese listed shares. The broad guiding principle of the regime is that any preferential tax policy is abolished unless specifically re-enacted in the regime. As a result there were concerns that the favourable taxation treatment would not survive.

In August 2008 institutional investors started to feel the negative impact of the new laws when various Chinese companies disclosed that a 10% WHT would be deducted from dividend distributions to corporate shareholders. Thereafter other Chinese listed companies started to withhold income tax at 10% from dividends paid to foreign investors' holdings of A shares.

Subsequently Beijing released two tax rulings clarifying the position. The second of these confirmed that WHT at 10% should be withheld from dividends paid to overseas investors.

These rulings also allow overseas investors who are eligible for a preferential tax treaty rate to apply for a refund of the overpayment. So far no detailed information on the application procedures for treaty benefits has been published by the tax authorities.






In reality the tax authorities have been considering this issue and, in particular, the practical difficulties in enforcing the reporting and settling of withholding tax on capital gains derived from the disposal of overseas-listed Chinese shares by overseas tax payers.

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By: Matthew Wong, PricewaterhouseCoopers (China), T: 86 (21) 2323 3052


The tax rulings were silent on the position in relation to capital gains.

In reality the tax authorities have been considering this issue and, in particular, the practical difficulties in enforcing the reporting and settling of withholding tax on capital gains derived from the disposal of overseas-listed Chinese shares by overseas tax payers. These difficulties arise because the shares are traded outside of mainland China. Hopefully they will shortly resolve the uncertainty and introduce a simple and favourable tax regime to support China's continued capital growth.

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Why might UK investors be worried about the 50% income tax rate?

Gains realised upon disposal of investments into offshore funds can be taxed under income tax rates, currently 40% and increasing to 50% with effect from 6 April 2010, where the fund has not obtained 'qualifying status'.

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Click on each PricewaterhouseCoopers author's name to contact them directly via email

By: Elizabeth Stone, PricewaterhouseCoopers (UK), T: +44(0) 20 7804 9678, Lachlan Roos, PricewaterhouseCoopers (UK), T: +44 (0)20 7213 1309 and Debbie Payne, PricewaterhouseCoopers (UK), T: +44 (0) 20 7213 5443

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Click on each PricewaterhouseCoopers author's name to contact them directly via email

By: Elizabeth Stone, PricewaterhouseCoopers (UK), T: +44(0) 20 7804 9678, Lachlan Roos, PricewaterhouseCoopers (UK), T: +44 (0)20 7213 1309 and Debbie Payne, PricewaterhouseCoopers (UK), T: +44 (0) 20 7213 5443

Where the fund has obtained such status, gains will be taxed under capital gains tax rates which are currently at 18%.

'Qualifying status' currently means UK distributor status. It is expected that from 1 December 2009 this will change to the proposed 'reporting status'.

Is UK distributor status an option for the fund?

A number of hedge funds are considering whether they could obtain UK distributor status ('UKDS') for 2009. However, this will not assist existing UK investors in such funds, unless late applications for UKDS could be made for previous periods.

The main distributor status requirement is essentially that the fund must calculate net income per the accounts, compare this with net income under UK tax principles, and then physically distribute at least 85% of the higher of the two numbers within six months of the period end.

Whilst there are two exemptions from cash distribution this can be an issue for hedge funds which typically do not make distributions.

What about reporting status?

Reporting status is due to replace UKDS for fund accounting periods beginning on or after 1 December 2009.

Reporting status will require UK taxable income to be calculated and then reported to UK resident investors in the fund at the period end (it no longer matters whether or not a cash distribution is paid). The report would need to be issued within six months of the account period end of the fund. UK investors would then be taxed on this 'deemed' or 'reported' distribution whether or not they have received any cash.






The removal of the cash requirement means a number of hedge funds can seek UK reporting fund status. Some are already considering their investment portfolios and strategies in order to be ready to calculate UK reportable income.

Click on each PricewaterhouseCoopers author's name to contact them directly via email

By: Elizabeth Stone, PricewaterhouseCoopers (UK), T: +44(0) 20 7804 9678, Lachlan Roos, PricewaterhouseCoopers (UK), T: +44 (0)20 7213 1309 and Debbie Payne, PricewaterhouseCoopers (UK), T: +44 (0) 20 7213 5443

The removal of the cash requirement means a number of hedge funds can seek UK reporting fund status. Some are already considering their investment portfolios and strategies in order to be ready to calculate UK reportable income. UK investors are also beginning to ask fund managers whether they will be ready for the changes, and what their intentions are.






Like UKDS, if the fund were to be deemed a financial trader for UK tax purposes then all returns would be income and therefore require reporting.

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Dutch Ministry of Finance publishes consultation document on possible corporate income tax amendments

On 15 June 2009 the Dutch Ministry of Finance published a consultation document that included a package of corporate income tax measures.

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By: Martin Vink, PricewaterhouseCoopers (Netherlands), T: +31 20 568 6445, Clark Noordhuis, PricewaterhouseCoopers (Netherlands), T: +31 20 568 6717 and Johan Tammes, PricewaterhouseCoopers (Netherlands), T: +31 20 568 5508

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By: [Martin Vink](#), PricewaterhouseCoopers (Netherlands), T: +31 20 568 6445, [Clark Noordhuis](#), PricewaterhouseCoopers (Netherlands), T: +31 20 568 6717 and [Johan Tammes](#), PricewaterhouseCoopers (Netherlands), T: +31 20 568 5508

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In summary, the measures proposed include the introduction of a group interest box, measures to limit the deductibility on interest expenses (including debt taken out to finance participations), the abolishment of a number of complex rules that currently disallow interest expenses and a further improvement of the participation exemption.

The public is invited to comment on the proposals before 1 August 2009. Based on the responses received, the Dutch Ministry will decide which proposals will be included in a tax bill that, once approved by Parliament, should enter into force with effect from 1 January 2010.

The proposed measures would present an excellent opportunity to use the Netherlands as an international finance centre and head office location. The interest box regime would allow foreign operations to be leveraged from and through the Netherlands without incurring a significant Dutch tax burden. The impact of the proposed interest box regime,



subject to conditions, will result in an effective tax rate on net group finance income/expenses of 5%. In addition, the conditions for shareholdings to qualify for the participation exemption would be simplified and relaxed.

The measures to limit interest deductions may require amendments to existing Dutch leverage structures for certain strategies which use related party and bank debt. For example bank debt used in a private equity setting to acquire shares in a company may be restricted. Alternatives are currently being explored in order to mitigate adverse consequences for groups which may be affected.

Overall, the proposed measures provide a number of opportunities and will also change the way structures are funded in the Netherlands. We recommend reviewing the impact of the proposed measures on existing structures and potential opportunities under the proposed legislation.

The Jersey fund industry

Jersey's alternative fund industry has grown impressively over the past five years as changes to the island's regulatory regime coincided with increased demand, particularly in the real estate and private equity sectors, but what does the future hold?

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Click on each PricewaterhouseCoopers author's name to contact them directly via email

By: Wendy Dorman, PricewaterhouseCoopers (Channel Islands), T: +44 (0) 1534 838233, Louise Murphy, PricewaterhouseCoopers (Channel Islands), T: +44 (0) 1534 838284 and Garry Bell, PricewaterhouseCoopers (Channel Islands), T: +44 (0) 1534 838361

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Is Jersey well placed to take advantage of the inevitable strong demand for investment products as the population in the developed world ages and the global economy recovers, or will the recent growth prove to be temporary?

Following the G20 summit in London, and Jersey appearing on the Organisation for Economic Cooperation and Development (OECD) white list, the island can truly claim that its policy of transparency and cooperation has been endorsed. If sanctions are to be imposed on territories that do not meet the required standards, there is now a clear steer that Jersey will not be impacted. The IMF Report due to be released imminently is expected to confirm Jersey's position as a well-regulated jurisdiction. Any concerns over use of so-called tax havens should not apply, and it can be expected that Jersey will gain business from less cooperative regimes.

However, any euphoria that followed the G20 summit has to be tempered as Jersey begins to assess the potential impact of the draft Alternative Investment Fund Directive released by the EU Commission in May. Proposed changes to the European Savings Directive will also impact, as will tax and regulatory developments in the US under the new Obama administration. Jersey intends to continue its programme of Tax Information Exchange Agreements, and open dialogue with national and international bodies on these reforms.

When the dust settles and the global economy recovers the financial world will look very different. There is every reason to believe that Jersey's place in the new world will be stronger than ever before.

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