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Rain or shine?*

Alternatives Investment Funds Newsletter – GAIM SPECIAL EDITION

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June 2008

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Foreword

As we reported in our 2007 white paper entitled “The Regulation, Taxation and Distribution of Hedge Funds Around the Globe”, the activities of alternative investment funds have come increasingly under the spotlight from both regulatory and taxation authorities.

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This trend has continued throughout the last year, particularly on the governance/controls front. Both the Hedge Fund Standards Board in the UK and the US President's Working Group are proposing voluntary best practice regimes. It remains to be seen how much pressure will be exerted by investors to ensure adherence and the level of external assurance which investors require.

In the current markets some positions can be difficult to price such that valuations pose a huge challenge to the industry. Both AIMA and IOSCO have published sound practice guides to seek to promote a single set of valuation principles.

On the tax front the US President's Working Group identified tax risk as an issue which investors should consider. Tax authorities have also continued their interest in hedge funds and in alternative investment funds generally. This can be seen on two fronts.

First there are countries such as the UK, where the investment manager exemption continues to be developed with the introduction by HMRC of a pre-cleared list of investment transactions which is updated as new transactions are approved. Alongside this, countries such as Japan have felt the need to bring in new legislation to provide more certainty to investment managers, because the introduction of the "safe harbour rules" in Hong Kong and Singapore has led to a reduction in the number of investment managers locating their operations in Japan. Clearly, an increasing number of jurisdictions are seeking to encourage hedge fund managers to set up operations in their country or, in the case of the established jurisdictions, to prevent them feeling the need to relocate.

Secondly with the increasing complexity of investment strategies, there is a growing need to maintain more complex fund structures to minimise the tax leakage. In some cases funds can have a large number of subsidiaries located in

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various countries around the globe, whether for the purpose of facilitating tax-efficient financing of transactions or to minimise tax on cash flows both during the life of the investment and on exit.

Such structures bring with them an increased need for good corporate and regulatory governance as well as the requirement to identify and manage the tax risks inherent in these complex international groups; something which investors should be aware of. Whilst FIN48 requires a robust assessment of this issue Fiscal Authorities around the globe, particularly in the developed countries, are also focusing on substance and whether a company has sufficient presence in a territory to be viewed as the beneficial owner of the income streams it receives. Failure to satisfy this requirement will almost certainly lead to increased irrecoverable withholding taxes. We can only expect this trend to continue.

Similarly, a robust transfer pricing policy which is adequately documented is essential; the fact that countries such as Malta have flexible transfer pricing rules does not prevent a group from having to comply with the more restrictive legislation in countries such as the UK and the US if they have operations based in those territories.

All this means that the focus on corporate governance and robust operational controls, in their widest sense, is only likely to increase as both the authorities and potential investors subject fund managers to ever greater scrutiny.

If you would like to discuss any aspect of this publication, please speak to your usual contact at PricewaterhouseCoopers[1] or one of those listed in the following pages.

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Hedge fund standards and practices

The challenge and cost of demonstrating control

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This time last year the impact of the sub-prime crisis was just beginning to be felt and the credit crunch started. In January, the Hedge Fund Standards Board ("HFSB") in London published its 28 Best Practice Standards (the "standards") and the consultation period for the proposed best practices for hedge fund managers and investors (the "practices") developed by the asset managers' and the investors' committees of the US President's Working Group ("PWG") on Financial Markets ended recently on 13 June 2008.

The key question is whether the hedge fund industry will embrace these new standards and practices. Both initiatives are voluntary and adopt a market discipline approach, assuming that peer pressure and particularly investor pressure will encourage conformity. Of course, there is the risk that if this industry regime does not work, then there will be regulatory intervention. Whilst there are some similarities between these two initiatives there are also some interesting differences.

The HFSB approach is one of "comply or explain", and existing managers who intend to register their conformity with the standards have until 31 December 2008 to do so.

The UK "comply or explain" approach follows a similar regime in the UK for disclosure of compliance with governance standards for publically listed companies – the Combined Code of the London Stock Exchange. However, one important difference is that certain disclosures of compliance in a listed company's annual report have to be independently validated by auditors. There is no such provision in the HFSB Standards; it is a self-attest regime which necessarily carries with it the risk that less scrupulous managers will claim compliance but in fact act below the benchmark of the standards. There is, of course, no reason why a manager (or a fund's directors) shouldn't commission such independent validation work and this may be something that over a period of time investors will come to demand.

Similarly, the required HFSB explanatory statement covering those standards with which a manager does not comply is submitted privately to the HFSB and is therefore not

The proposed US PWG best practices do not have an enforcement or disclosure mechanism and will rely on voluntary conformity, which is perhaps contrary to the general perception of the US as a place of rules and regulations.

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automatically available to an investor; arguably this would be an interesting document for existing or potential investors and of course there is nothing to stop a particular manager from releasing this to investors.

The proposed US PWG best practices do not have an enforcement or disclosure mechanism and will rely on voluntary conformity, which is perhaps contrary to the general perception of the US as a place of rules and regulations.

A significant difference in the remit of the US PWG is that investors were involved in developing proposed best practices for both the decision to invest in a hedge fund and the ongoing monitoring of the hedge fund investment thereafter – there is both a Fiduciary's Guide (for those responsible for allocation of assets to hedge funds) and an Investor's Guide (for those executing and monitoring a hedge fund investment programme). This is a welcome development and addresses one of the criticisms of the HFSB Standards where there was no investor representation.

Implementing the standards and proposed practices will not be without cost – both human effort and perhaps new infrastructure. Hedge fund managers and the fund's directors will need to decide on their response, determine existing gaps in their procedures and controls and make the appropriate fixes. In all likelihood, the associated costs will need be absorbed by the hedge fund manager. But if this is a cost that must be paid to demonstrate to investors that well-run hedge fund operations have appropriate governance and controls and to satisfy the regulators' concern for investor protection and avoidance of systemic risk, then it is a cost of doing future business in this sector – a cost that must be met.

The development of fund of alternative investment funds in the UK

In the third quarter of this year, we expect the FSA to amend the Handbook to allow for fund of alternative investment funds ("FAIFs") within their existing Non-UCITS Retail Scheme ("NURS") rules.

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The revised NURS rules will facilitate the development of FAIFs by:

- Enabling funds to invest up to 100% in unregulated schemes (currently limited to 20%);
- Removing prescription of 15% circularity of investment into NURS and to extend this to the Qualified Investor Scheme;
- Applying due diligence criteria to the investment manager where they invest more than 20% into unregulated collective investment schemes.

We expect that the NURS rules will also permit the use of master feeder structures. Currently, there may be fund managers with existing offshore FAIFs which cannot easily be promoted to UK retail investors. With the proposed amendments to the NURS rules, such fund managers can establish onshore UK feeder funds into the offshore master.

Subject to the considerations on tax, the FSA anticipates that the UK will be able to compete with the established FAIFs regime in other EU countries. The expectation is that UK investors will in general prefer to buy a UK-domiciled fund to than an overseas fund. Changes may need to be made to the ISA regulations to make certain FAIFs eligible for inclusion.

One final consideration is the tax implication of a FAIF. At present, there is a major tax inefficiency in the proposed rules for so-called “Tax FAIFs”, investment by the FAIF in an underlying tax reporting fund will, on exit from the FAIF, effectively convert a capital gain (taxable at 18%) into income taxable at 40% in the hands of a UK higher rate taxpayer.

In summary, FAIFs provide greater product manufacturer flexibility and will enable managers to compete domestically with existing overseas funds. However, the uncertainty over the stance taken by HMRC may cause managers to critically review whether it would be preferable to retain their offshore version or indeed to try to use the wider powers contained within the UCITS III regime to obtain the same economic exposure.

Valuation

Valuation continues to be a hot topic and a huge challenge for the industry, particularly given the current market conditions, volatility and the ongoing credit crisis. Both the AIMA paper which was endorsed by the Hedge Fund Working Group and the IOSCO paper which deals with sound practices for hedge fund valuation aim to promote a single set of valuation principles that are applicable across a wide range of jurisdictions.

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Investment strategies which involve exposure to illiquid or complex financial instruments increase the challenges in determining an appropriate valuation. While there is no clear definition of "difficult to price" positions, it is very interesting to note that the more traditional money market and enhanced money market funds, which wouldn't be considered as having a strategy in illiquid or complex instruments and which were once perceived to be very low risk, have encountered significant valuation challenges in the current environment.

The current environment has focused attention on transparency, the need to fully understand the product and also the valuation process including the use of broker quotes and model valuations. In the fixed income space, illiquidity is a real problem which has led to a marked decrease in the level of observable data and to an increase in the demand for "fair valued" prices, use of broker quotes and model valuations.

We have also seen an increase in indicative and disclaimed quotes from market makers and also an increase in the price challenges raised by investment managers on broker and indeed vendor prices. It still remains very difficult to get transparency on broker prices and to get quality data on the fundamentals of the position as most market makers are unwilling to divulge their assumptions. Essentially broker quotes are model valuations but with less transparency on the model and inputs and they may be biased by the brokers' trading desk's own position in the instrument. Obviously the intellectual property of the model needs to be maintained but more transparency around the assumptions and inputs is needed and the "black box" is not the way forward in valuing illiquid or complex instruments.

Independence in the valuation process is also an area of focus currently and there is industry pressure on investment managers particularly in the USA to have third party independent valuation which can provide greater assurance to investors. Valuation is also having a direct impact on funds' liquidity due to its impact on margin calls and collateral management. The risks around the use of leverage also come into play where there is significant leverage, as a small market movement could put a fund out of business and unable to finance and trade itself out of difficulty.

FAS 157, the new US Accounting Standard on fair valuation, is effective for periods beginning on or after November 15 2007 and introduces the concept of a fair valuation hierarchy. FAS 157 requires "Fair Value" to be based on exit value. Hedge funds using US GAAP will be required to classify their portfolio into three levels, with level 1 being exchange traded instruments, level 3 being the esoteric complex instruments with unobservable inputs and level 2 somewhere in between those two extremes. This standard, while not changing the measurement of fair value, is expected to have a big impact on valuation disclosures. It will be very interesting to see how these valuation disclosures will square up with the liquidity/illiquidity of the instruments.

In conclusion, I think we will continue to see valuation challenges in our industry but the current environment and conditions have heightened awareness of the challenges facing us and also of the need for greater transparency in valuation methods and assumptions.

New Japanese independent agent exemption: 2008 tax reforms

Under Japan's tax law, a non-Japanese resident may have a permanent establishment ("PE") in Japan where, inter alia, it conducted business through an agent in Japan ("Agent PE").

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As part of the 2008 tax reforms the Liberal Democratic Party of Japan has introduced into Japan's domestic law an independent agent exemption to the definition of an Agent PE.

The independent agent exemption was introduced by a Cabinet Order, with the passage of the 2008 tax reforms.

The amendments made by the Cabinet Order exclude from the definition of an agent:

"The person who conducts independently operations relating to the business of a non-resident or a foreign corporation provided in the subsequent items one through three [relating to categories of Agent PE], and who conducts operations in the ordinary course of its business."

This exemption is broadly in line with Article 5 of the Organisation for Economic Co-operation and Development's ("OECD") Model Tax Convention on Income and on Capital ("Model Tax Convention"), and is consistent with many other taxation systems of OECD member countries.

Under the Model Tax Convention, for an agent to be independent, the agent must be both legally and economically independent, and must provide services to the non-resident in the ordinary course of its business. This approach to an independent agent exception does not provide any safe harbour for certain activities conducted by an agent in Japan such as those found in Singapore, Hong Kong, the US and the UK, but rather requires a case-by-case analysis as to the independence of each agent.

The revised Enforcement Orders will apply to PE determinations made on or after April 1 2008.

The independent agent exception was one of the many recommendations put forward by the Financial Services Agency in its plan issued on 21 December 2007 for strengthening the competitiveness of Japan's financial and capital markets. The implementation of this proposal represents a positive step forward for the financial services sector in Japan and in particular the global and local fund management industry with investment advisers and portfolio managers based in Japan. The changes do not eliminate the taxation risks or the need to manage these risks; however, they do generally align Japan's taxation policy in this respect with the OECD and international standards.

Further details regarding scope and application of the independent agent exemption are expected to be released soon, following continuing discussions amongst government agencies, industry bodies, advisers and other interested parties.

Tax reporting for funds in Switzerland

New tax circular for fund reporting expected shortly

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The Swiss Federal Tax Administration will soon publish a new circular letter dealing with the income tax reporting requirement for Swiss resident private investors in Swiss and foreign collective investment schemes.

According to Swiss law Swiss and foreign collective investment schemes ("CIS") are treated as transparent for Swiss income tax purposes such that the income of the CIS is taxed in the hands of the investors. Capital gains are generally tax exempt in the hands of the investors provided that the units are held for private investment purposes and that the capital gains are disclosed separately. Therefore it is important to ensure that taxable income from the CIS is reported correctly to the tax authorities. The Swiss Federal Tax Administration generally publishes the taxable income per unit either in the official rates list, in the case of a CIS authorised for distribution in Switzerland, or in the internal rates list, if the CIS is not authorised for distribution, but only if they have been provided with the relevant information by the manager of the CIS.

In the past, due to the lack of clear guidelines from the Swiss Federal Tax Administration, there was a great deal of uncertainty surrounding the methodology to be used when computing the income tax values, in particular in relation to Funds of Funds.

The new circular letter will introduce rules to be followed when calculating the income tax values. For example for Funds of Funds we expect the basic new rules to be as follows. A general look through provision will apply such that all attributable taxable income at the second fund level will be aggregated to Funds of Funds level. Further, any additional taxable income earned by the Funds of Funds will need to be added to the income from the underlying funds. The taxable income will have to be reported to the Swiss Federal Tax Administration by the end of January 2009 at the latest. If this deadline is not met there is a risk that the CIS will be subject to a relatively unfavourable taxation treatment. Overall the new rules for Funds of Funds will be rather cumbersome.

As a consequence it is likely that many CIS's will need to be restructured in order to take advantage of the new Swiss tax reporting rules.

The substance issue

Due to the particular tax-exempt status of most investment funds and the potential tax costs arising from their investments, there is often a need to consider appropriate tax structuring by using special purpose vehicles. Such vehicles can claim particular tax benefits (e.g. tax treaty eligibility, application of parent subsidiary directive, etc.) that can significantly mitigate tax costs arising from the investments and as a consequence improve the return of the fund.

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However, there is a growing concern regarding the use of such structures which is the requirement by foreign tax administrations for real substance. This issue has taken on greater significance following the introduction of FIN48 which requires the board to undetake a robust assessment of any tax positions taken by the fund.

The difficulty is that these substance requirements are determined primarily by the countries where the assets are located, rather than by the territory where the entity is established. This makes it difficult to provide a universally accepted definition of substance as the requirements vary from country to country.

There are nevertheless certain common features. Apart from regular board of directors meetings held in the country where these entities are supposed to be resident, these entities must be provided with sufficient “business substance” in terms of purpose of the business or economic presence, and sufficient “material substance”, i.e. office premises, equipment, staff, etc. A meaningful level of profits being effectively taxed or a significant level of capitalisation with equity are also indicators that an entity has the appropriate level of substance.

When the substance test is not met, this could lead a foreign tax administration to conclude that a specific entity is purely artificial and should be disregarded from a tax standpoint as being only a conduit vehicle.

It is interesting to see how this substance requirement has been translated into practice. In a recent internal survey conducted on 35 different funds, covering the private equity, real estate and hedge fund sectors, having legal structures in Luxembourg, it appears that a significant majority (29) of the funds have Luxembourg employees and have their own offices. A Further 22 of the funds have senior decision makers amongst their local employees.

Whilst only a small proportion, eight of the funds, has five or more Luxembourg employees, it can be expected that this number will increase significantly in the future as boards of the funds have realised the operational benefits attached to having local employees and are therefore actively recruiting.

It is also important to point out that the substance requirement impacts not simply a particular location, but potentially all locations. In this respect the human resources potential existing in a given jurisdiction and its connection facilities (e.g. in order to facilitate board of directors meetings) are, amongst others, critical factors to be considered when assessing the substance requirement and the practicalities of satisfying this in a particular country.

Sovereign wealth funds: Tax developments

Over the years sovereign wealth funds (“SWFs”) have become significant capital suppliers in the international (financial) markets. They have a wide range of investments such as financial and industrial securities, emerging market securities, real estate, infrastructure and natural resources. Their investment activity is spreading worldwide such that tax efficiency has become an integral part of the investment decision.

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An important tax issue surrounding international investment activity is taxation in the investment jurisdiction, where often local taxes apply to foreign investors with respect to income streams such as dividends, interest and capital gains. Applicable agreements for the avoidance of double taxation ("Double Tax Agreements or Agreements") can reduce this local taxation imposed by the investment jurisdiction.

Although under some Double Tax Agreements specific rules apply most Agreements do not apply to SWFs due to their tax-exempt status or, at best, their position is somewhat ambiguous. SWFs investing in jurisdictions with high (withholding) taxes for which no Double Tax Agreement applies may use investment entity structures to reduce taxation on investment income. Nevertheless, maintaining such structure in a jurisdiction which has a Double Tax Agreement with the investment jurisdiction requires local presence and operations ("substance") and furthermore beneficial ownership of the investment income needs to be assured. The Netherlands, for example, has several entities which may act as efficient investment platforms for SWFs.

Considering their expansion globally and the importance of SWFs as capital suppliers in the global markets, activities in the field of negotiating Double Tax Agreements have increased. To use the United Arab Emirates ("UAE") as an example: The UAE has concluded a Double Tax Agreement with Spain recently and is currently in the process of finalising agreements with Luxembourg and the Netherlands. These Agreements, like many others recently concluded by the UAE, expressly refer to SWFs (and other UAE gxovernment entities) when dealing with particular items of investment income. Depending on the strength of the negotiations, the Agreements either refer to the SWFs specifically by name or by way of a more general reference.

Even though authorities are still struggling in the field of governance the increasing investment activity and the strength of the SWFs as global investors of capital is now slowly being reflected in the text of Double Tax Agreements.

New UK tax authority information and inspection powers

Schedule 36 introduces new "information and inspection powers" and whilst much of this codifies and consolidates a range of existing information powers in relation to PAYE and VAT, it is clear that these new powers will also be very relevant to how HMRC responds to tax planning.

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The new Schedule 36 raises the very real prospect of HMRC Inspectors requesting information, inspecting business premises and copying documents in relation to tax planning around the time when a transaction is carried out, i.e. in "real time".

Perhaps the most significant of these changes, for those involved in direct tax, is the new power to inspect business premises, assets and documents. In summary this will entitle an officer of HMRC to enter any business premises and inspect those premises, assets on the premises and business documents on the premises "if the inspection is reasonably required for the purpose of checking the tax position of any person".

When combined with the draft power in paragraph 14 which entitles an officer to remove any documents which are produced on such an inspection – if it appears to the officer necessary to do so – it is possible to imagine a very different direct tax environment indeed.

While amendments to the bill are to be expected, and representations will continue to be made, it is possible that the Bill will pass largely in its present form. In that case, the guidance which HMRC has said that it will publish in the autumn will hopefully clarify not only points about when the power might be expected to be used, but also matters of procedure, such as how the inspections will be actually be carried out.

However, there has already been some indication from HMRC as to why the power is needed and this may guide thinking as to when it might be used. In the consultation document published on 10 January 2008 ("Modernising Powers, Deterrents and Safeguards: A New Approach to Compliance Checks: Responses to Consultations and Proposals") HMRC notes that looking at records in advance of a return is common practice for VAT, PAYE and NIC. It then indicates that IT, CT and CGT checks would take place in advance of a return in a number of circumstances and suggests some examples, including:

Of particular interest in the alternatives sector is the stated intention to compare records with business activity “to ensure those records fairly reflect the business”. Transfer pricing practitioners, for instance, will be particularly interested in the potential for attempts to carry out real time functional analyses.

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- to confirm that appropriate records are being kept;
- to compare record systems with business activity, including premises and assets, to ensure those records fairly reflect the business; and
- to check current actions which are relevant to a tax avoidance scheme.

Of particular interest in the alternatives sector is the stated intention to compare records with business activity “to ensure those records fairly reflect the business”. Transfer pricing practitioners, for instance, will be particularly interested in the potential for attempts to carry out real time functional analyses.

The inspection power only relates to business records which are records forming part of the business and are part of the business’ statutory records. Statutory records are defined as any records required to be kept for the purposes of the Taxes Acts. The Taxes Acts in Paragraph 21 Schedule 18 FA 1998 require, for corporation tax purposes, records to be kept to enable the taxpayer to deliver a company tax return. It is conceivable that the introduction of the inspection power will lead to the testing of the extent of “statutory records” before the tribunal (in addition, of course, to testing whether inspections are reasonably required and what exactly “checking the tax position” might entail).

Finally, with regard to the power of inspection, it should be noted that the formulation in the Bill of inspecting “any business premises…for the purpose of checking the tax position of any person” means that the power can be used to inspect third party premises. It will be interesting to see whether HMRC makes extensive use of the third party inspection power which is, of course, restricted to statutory records, but those providing outsourced company secretarial services, bookkeeping, fund administration and other services to clients in the alternative funds sector should take note of the possibility.

The hedge funds investing in Germany stock

Hedge funds seeking to invest in Germany need to understand the local tax framework and its implications for different types of investments such as equity, bonds, loans, commodities and illiquid investments. This article highlights the German tax implications for hedge funds investing in German equities.

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Capital gains derived by corporate offshore master funds (“offshore fund”) from the sale of shares in both listed and unlisted companies are subject to German corporate income tax if the direct or indirect investment amounted to at least 1% of the nominal share capital within a period of five years preceding the sale of the shares.

Under German income tax law, 95% of the capital gains realised by the offshore fund from trading in shares of a company incorporated and listed on a German stock exchange should be tax exempt, whereas 5% of the capital gains should be subject to corporate income tax and solidarity surcharge at a rate of 15.875%. The effective tax rate will therefore amount to approx. 0.78% (5%*15.875%). The tax is levied on an assessment basis, i.e. the filing of tax returns would be required. This is something which can be overlooked without careful monitoring but has been highlighted by FIN48 reviews for funds reporting under US GAAS.

Even though the effective tax rate may currently be as low as 0.78% of the capital gain, this risk should be considered when structuring investments into Germany. Typically European holding companies are interposed to mitigate this tax burden.

Alternatively, hedge funds employ swap agreements to expose themselves only to the economics of the underlying asset. Currently offshore funds should not be subject to withholding tax in Germany on swap payments. However, this may change from 1 January 2009.

Dividends are subject to withholding tax at a rate of 21.1% in Germany. From 1 January 2009 the withholding tax will increase to 26.375%. However, an offshore ound will be able to claim a refund of 10.55%. The offshore fund will be required to file a refund form which needs to be filed within four years of the end of the calendar year in which the dividends were received by the offshore fund.

If the shares are held through a European holding company the withholding tax may be reduced under the relevant treaty or the European Parent/Subsidiary Directive, unless the strict German anti-treaty-shopping rules apply.

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Under these rules full or partial relief from German dividend withholding tax is available only to the extent that a foreign company has shareholders who would be entitled to the same relief if they received the income directly from the German company, or alternatively, if the foreign company passes all of the following tests:

1. There are economic or other important non-tax objectives for the use of the foreign company. A recently issued circular indicates that objectives such as improved cost efficiency, coordination or internal organisation will not qualify.
2. The foreign company derives more than 10% of its gross income from its own commercial activities, not including income from shareholdings or income from commercial activities outsourced to third parties.
3. The foreign company maintains its own business premises and infrastructure sufficient for enabling it to participate in the business community. Typically, these situations are closely scrutinised by the German tax authorities, which may request copies of financial statements, rental agreements, employment contracts and telephone bills.

In practice, many hedge funds may find it difficult to comply with the new rules and to claim treaty or directive relief from withholding tax on dividends received from German entities.

There is debate over whether the scope of the new German anti-shopping provision might potentially violate EU law, since it could be viewed as going beyond what is covered by the anti-avoidance clause in the EU's parent subsidiary directive. However, these issues have yet to be resolved.

Finally if the fund borrows stock via a stock-lending transaction and subsequently disposes of these securities, any capital gain would be subject to tax, provided the interest in the underlying stock is at least 1% of the nominal share capital of the German company. Any dividend would as a matter of principle be attributable to the fund if the stock is borrowed (but not disposed of) over the dividend date.

Malta attracts hedge funds and their managers

Since Malta's accession into the EU in May 2004, it is emerging as an alternative domicile for both hedge funds and hedge fund managers.

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The Maltese Investment Services Act provides a comprehensive regulatory regime for investment services and collective investment schemes ("CIS") – which include private investment funds ("PIFs"). All hedge funds that have been set up in Malta are PIFs and these can take the form of open or closed-ended investment companies (SICAV or INVCO), limited partnerships or unit trusts. It is also possible for a fund established overseas to transfer its domicile to Malta and apply to be registered as a PIF.

The Malta Financial Services Authority ("MFSA") is responsible for the licensing, regulation and supervision of CISs, including PIFs. PIFs are subject to minimal regulation if their only activity is operating as a PIF and the PIF appoints "functionaries" (e.g., custodian, prime broker, investment adviser, etc.) to carry out licensable activities. However, if the PIF carries out licensable activities – for example, by acting as its own manager – those activities will be regulated. The MFSA only accepts regulatory responsibility for that part of the PIF's activity that constitutes licensable activity in Malta.

The PIF regime consists of three categories: PIFs promoted to Experienced Investors, PIFs promoted to Qualifying Investors and PIFs promoted to Extraordinary Investors:-

Experienced Investors

'Experienced Investors' are defined as persons having the expertise, experience and knowledge to be in a position to make their own investment decisions and understand the risks involved. An investor must state the basis on which he/she satisfies this definition in writing. Furthermore, the minimum investment threshold is €15,000 or equivalent in foreign currency.

PIFs promoted to Experienced Investors are not subject to any restrictions. Whilst borrowing on a temporary basis for liquidity purposes is permitted and not restricted, borrowing for investment purposes or leverage via the use of derivatives is restricted to 100% of the net asset value.

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Qualifying Investors

'Qualifying Investors' are defined as persons who have reasonable experience in the acquisition and/or disposal of (a) funds of a similar nature or risk profile, and (b) property of the same kind as the property to which the PIF in question relates. There are also various other criteria to be met to be classified as a 'Qualifying Investor'. However, the main criteria are that the investor must have more than €750,000 of net assets and the minimum initial investment is at least €75,000 (or equivalent in another currency).

PIFs promoted to Qualifying Investors are not subject to any restrictions on their investment or borrowing powers (including leverage) other than those which may be specified in their Offering Document.

Extraordinary Investors

'Extraordinary Investors' are required to meet various criteria, including the requirement that the investor must have more than €7.5 million of net assets and that the minimum initial investment is at least €750,000 (or equivalent in another currency).

Unless they invest in immovable property, PIFs promoted to Extraordinary Investors are not subject to any restrictions on their investment powers other than those that may be specified in their Offering Document/Marketing Document.

The MFSA has committed to processing applications for the authorisation of PIFs within seven working days, provided all relevant documentation (including the application form) has been properly completed and that all functionaries are based and regulated in a 'Recognised Jurisdiction' (i.e. members of the EU or EEA and some other specified countries).

As to the tax treatment of such funds, distributions to non-resident investors and capital gains on exit made by non-resident investors are exempt from Malta tax. A 15% final withholding tax is imposed on distributions and capital gains to Maltese resident investors.

Financial services is the fastest-growing sector of the Maltese economy and the MFSA estimates that the sector is growing at some 30% per annum. The creation of the MFSA as a single regulator was part of Malta's long-term strategy to become a mainstream finance centre and companies have benefited from streamlined procedures, lower fees and compliance costs and consistently applied standards. These, together with Malta's EU membership, make it an attractive alternative location for the registration of new funds or re-domiciliation of existing funds.

The emerging market for carbon emissions rights

In 1997, the Kyoto Protocol to the United Nations Framework Convention on Climate Change established a framework for the adoption of "cap-and-trade" systems to limit greenhouse gas emissions.

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Over the past several years, a market for carbon emissions rights ("carbon credits") has developed in Europe as an alternative to more conventional forms of regulation. Increasingly, US-based investment funds are trading in this market, but questions remain, particularly about the prospects for a US cap-and-trade system and the US tax treatment of carbon credits.

In 2005, the European Union ("EU") established a cap-and-trade system governing greenhouse gas emissions in the EU. Greenhouse gas emitters were granted an initial allocation of specific rights to emit carbon dioxide in Europe ("EU allowances" or "EUAs") based on prior emissions and governmental pollution reduction goals. Under this system, an industrial company becomes either a potential buyer or a potential seller of emission credits, depending on the market price of carbon credits and the company's costs for reducing its own carbon emissions. Companies that can economically reduce their emissions have an opportunity to sell their credits for profit. Companies that cannot reduce their emissions at a cost below that of the market price for emissions credits are likely to become buyers of credits.

Developers of greenhouse gas reduction projects can seek certification for these projects as producing transferable carbon emissions rights ("CERs") under UN standards. These carbon credits may be used to meet up to 10% of an EU emitter's need for carbon credits and may also be used in other non-EU jurisdictions. Projects that are not certified by either the EU or the UN may meet the certification criteria set by certain non-governmental organisations as voluntary emissions reductions ("VERs").

Many observers predict that the US will soon adopt a cap-and-trade system that will result in a sizeable US-based market for carbon credits. A recent New Carbon Finance report predicts the "United States will be home to a $1 trillion carbon emission market by 2020,"[1] assuming that federal and state lawmakers continue to pursue a comprehensive cap-and-trade programme.

Several cap-and-trade bills are on the US federal legislative horizon, including the widely discussed Lieberman-Warner Climate Stewardship Act, which would place mandatory caps on greenhouse emissions for power plants, industry and oil

[1] "Economic Researchers Predict $1 Trillion U.S. Carbon Trading Market by 2020," press release from New Carbon Finance, 14 February 2008.

With a head start on implementation, the UK has clarified the tax treatment of carbon credits in certain important respects. However, US tax precedents provide little guidance on carbon trading.

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refineries. Altogether, there are currently 13 climate change bills under discussion by the House of Representatives and Senate. Most propose cap-and-trade systems similar to those that already exist in the US for sulphur dioxide and nitrogen oxide.

Even in advance of federal action, several states have moved to implement either state-based or regional cap-and-trade systems to control and reduce various greenhouse gases. For example, the California Global Warming Solutions Act of 2006 targets a 25% reduction in the state's greenhouse gas emissions levels by 2020. In addition, many US-based companies have started making voluntary emissions reductions or purchasing VERs to move toward "carbon neutrality" in their business operations.

Even without a US-based cap-and-trade system, carbon credits are actively traded on the Chicago Climate Exchange and the newly operational Green Exchange, sponsored by the New York Mercantile Exchange and Evolution Markets. Both have sought varying levels of approval from the Commodities Futures Trading Commission for their activities. In addition, there is a growing principal-to-principal market for transactions in EUAs, CERs, and even VERs and increased interest in fund investments in projects designed to reduce emissions and yield saleable carbon credits. We anticipate that such activity will grow exponentially in the coming years.

With a head start on implementation, the UK has clarified the tax treatment of carbon credits in certain important respects. However, US tax precedents provide little guidance on carbon trading.

Neither law nor existing precedents provide much guidance on the appropriate US tax treatment of carbon credits. Without such guidance, potential investors in carbon emission rights have been left to form their own views on a variety of key issues, including whether carbon emission rights can be treated as "commodities," thus allowing favourable treatment for foreign investors under the US trading safe harbour. Among the issues to consider are (1) the strength of the analogy between carbon emission rights and traditional traded commodities and (2) the differences among various types of carbon emission rights (EUAs, CERs and VERs).

Other US-based entities have had to consider whether trading in carbon credits by their affiliates creates Subpart F income. While there are supportable arguments for a Subpart F exception because carbon emission rights are "commodities" or because they are operating intangibles, the technical support for either conclusion is unclear. The IRS has not issued any published guidance on this point, but some companies are considering requesting clarification.

Both industrial companies and investors in the US are showing increasing interest in carbon trading, and the IRS is expected to address the tax treatment of carbon emission rights as the carbon markets evolve in the US and the EU.