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# Alternative Investments – Current Trends

## **New Financial Services Model**

- Traditional FS institutions are diversifying their investment and capital raising strategies and/or taking strategic stakes in alternative investment managers

## **Liquidity Crisis**

- Alternative Investments industry provides liquidity for world's markets
- For example, global hedge funds assets, according to a recent McKinsey report, have tripled since 2000, reaching an estimated 1.5 trillion dollars at the end of 2006 and 1.7 trillion dollars by the middle of 2007

## **Flow of Investment Capital**

- Around the world both individuals and institutions are pouring funds into alternative investments.
- Asian and Middle Eastern countries in particular are making major investments

## **Initial Public Offerings**

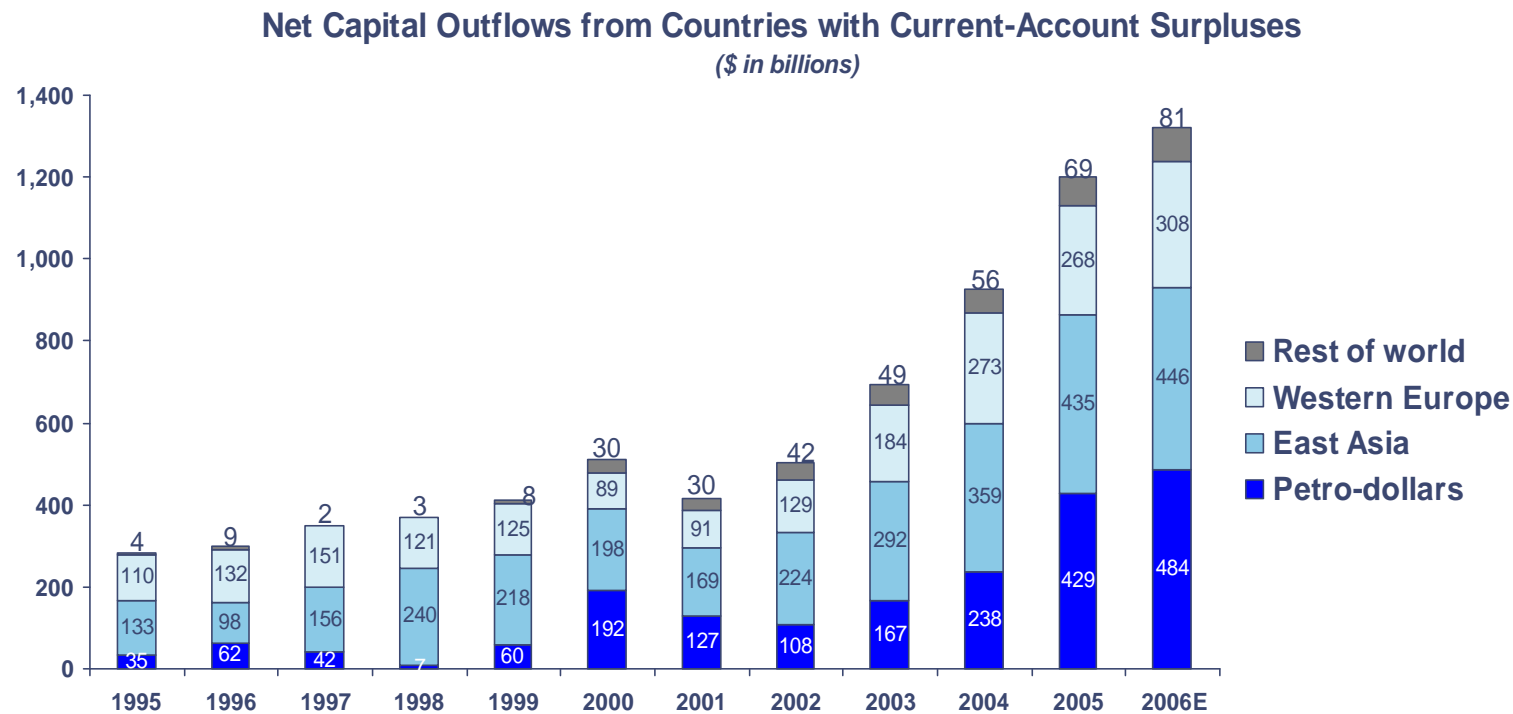
- Listing of three alternative investment powerhouses on the New York Stock Exchange

## **Global Growth in Brazil, Russia, India and China (“BRIC”)**

## **Convergence**

# What is Happening in the Industry Across Alternatives?

Macro-Trends: Where is investment capital coming from?

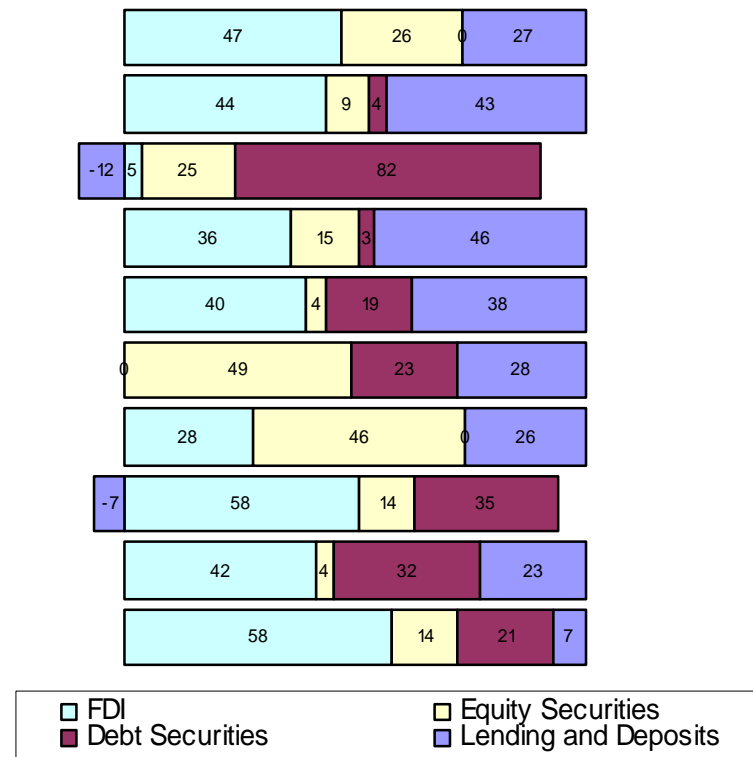
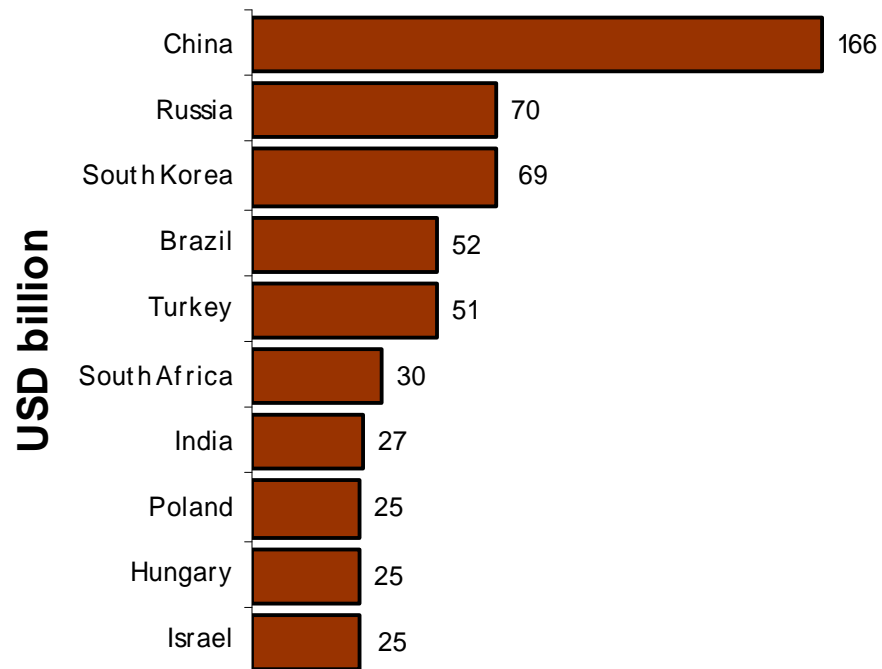


- More investment capital flowing in from non-US investors
- Petro-dollars and East Asian countries are the largest source of net global capital flows in the world.

# What is Happening in the Industry Across Alternatives? (continued)

## Where is Investment Capital Going In Emerging Markets?

### Total Capital Inflows 2006



Source: McKinsey Global Institute Capital Flows Database

Note: Some numbers do not add up to 100% due to rounding.

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# What is Happening in the Industry Across Alternatives?

## *(continued)*

### **Tax Environment**

- Opportunities
  - Increased competition of governments around the world has led to new safe harbors, exemptions and favourable tax rates
  - Strategic allocation of investment management functions and operations with a view towards tax optimization
- Risks
  - Increased tax audits related to transfer pricing and permanent establishments
  - Increased anti-abuse legislation
  - Beneficial ownership requirements in treaty structures lead to higher substance requirements
  - Legislative proposals targeting the industry
    - U.S. proposals to tax carried interest as ordinary income and treat listed hedge funds management partnerships as corporations
    - Increase of capital gains tax rate from 10% to 18% in the U.K. and elimination of taper relief as from April 6, 2008
    - Introduction of GBP 30,000 annual charge for individuals claiming remittance basis of taxation in the U.K.
    - Increased audits related to PE and transfer pricing

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## What is Happening in the Industry Across Alternatives? *(continued)*

### **Considerable opportunities in the credit markets post-credit crunch?**

Traditional banks are in a state of paralysis and are turning down lucrative lending opportunities where the creditworthiness of the underlying borrower is in fact “sound” – opportunity for Hedge and PE funds to venture into this space without the legacy issues banks have to deal with. Some may consider setting up domestic/foreign banks to exploit this opportunity – take advantage of certain benefits afforded to the regulated banking industry (e.g., cheap funding from the Fed)?

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## What is Happening in the Industry Across Alternatives? (continued)

- Asset classes are becoming more exotic and esoteric given increasing scarcity of alpha opportunities in developed markets
- Industry consolidation (e.g., Blackstone's recent acquisition of a hedge fund credit specialist GSO) to diversify its trading strategies
- Total leverage buy out volume in 2008 is down 2/3rds year on year [FT 2/28/08]. This has led to more creative deals in the market place (e.g., Blackstone's recent \$2 billion JV with First Reserve/Petroplus, PIPEs and other minority stake strategies)
- New sources of capital given the prevailing paralysis in the developed credit markets (e.g., sovereign wealth funds)
- Catalyst for future IPOs – As asset managers look to other sources (aside from leverage) to finance organic growth and acquisitions

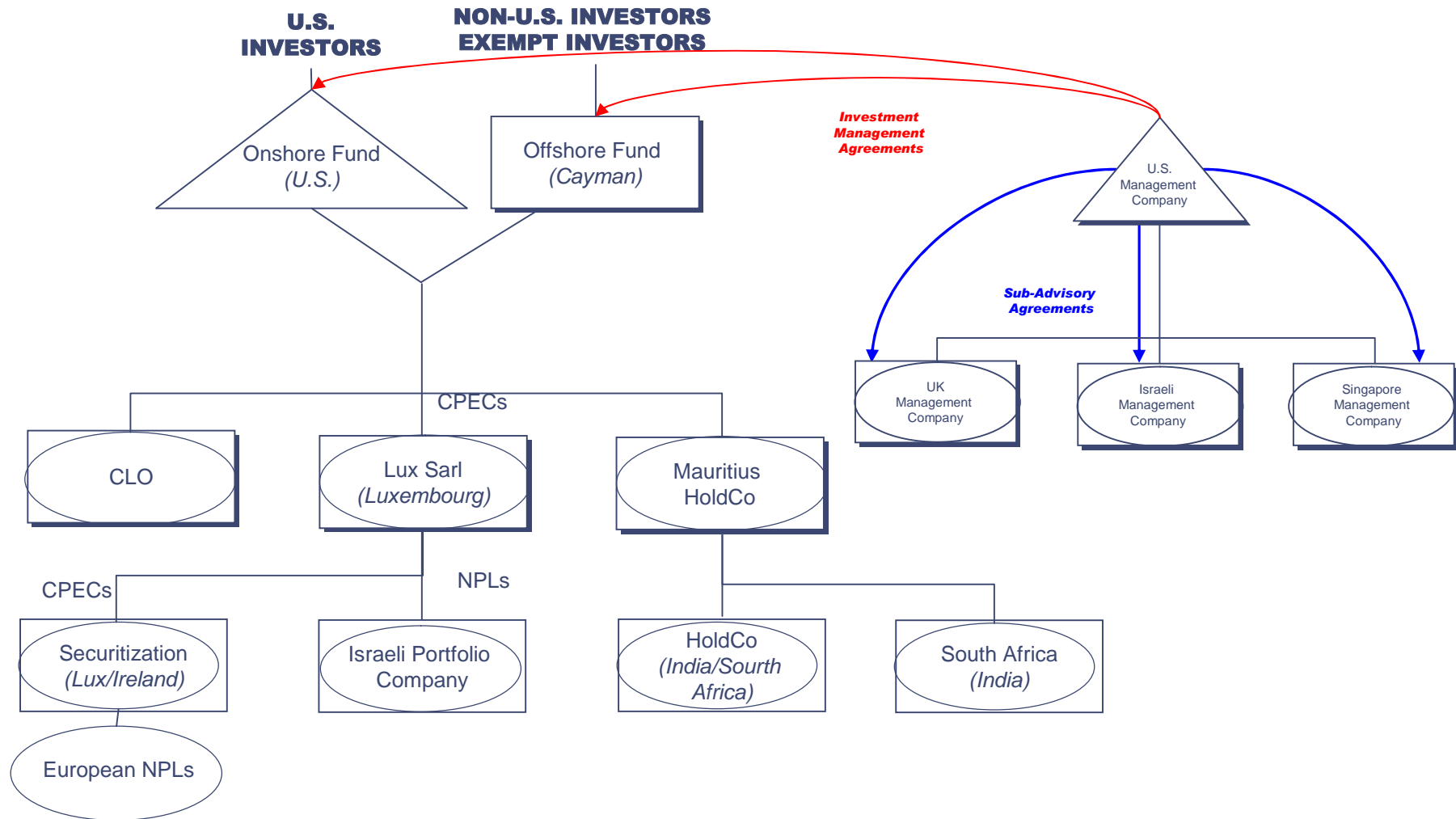
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# Traditional & New Hedge Fund Structures

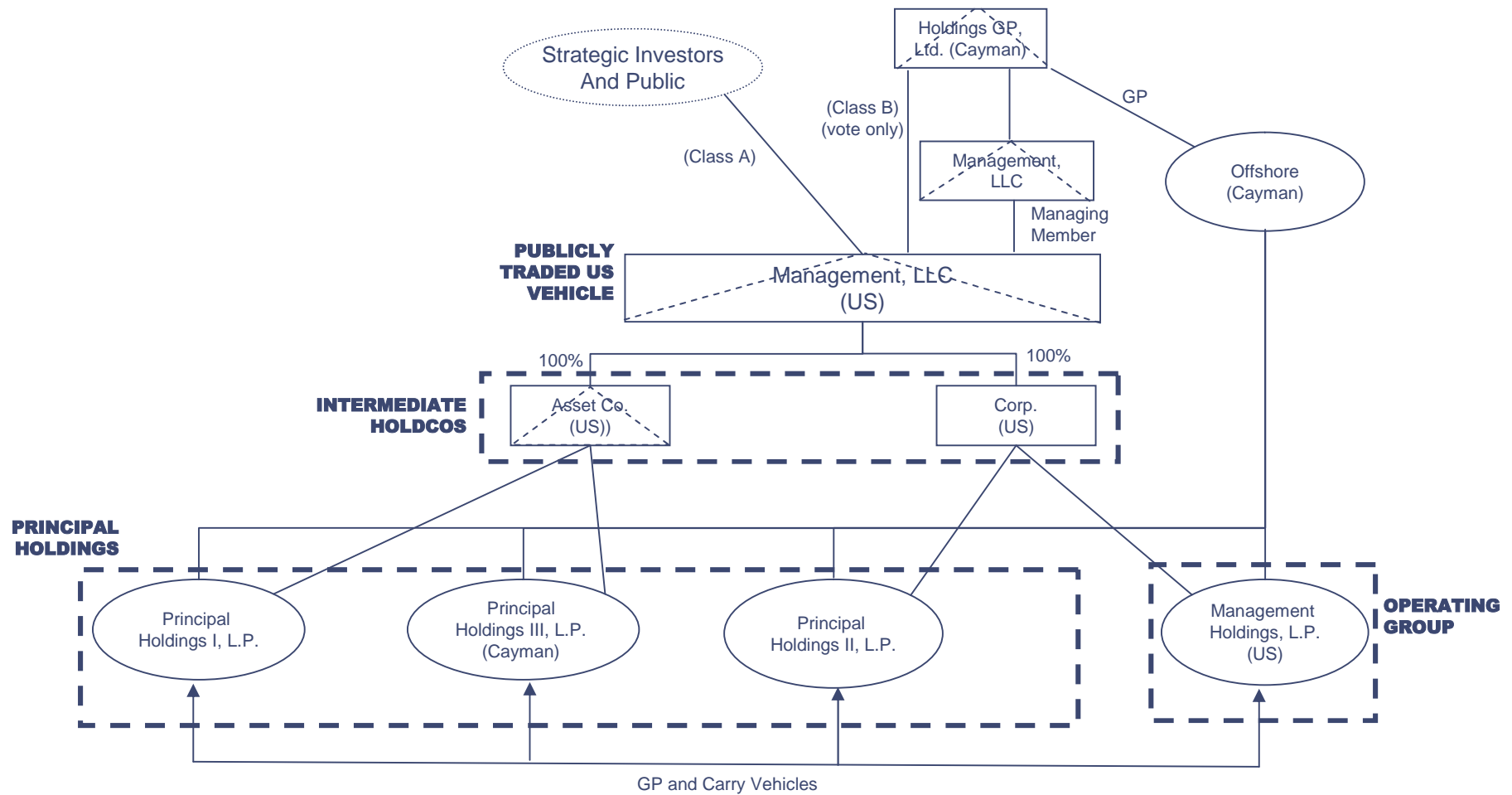
## Key Considerations

- Investor base
- Underlying asset classes
- Facilitating future liquidity and/or exit events for the principals and investors
- Managing source taxation and local permanent establishment risk

# Strawman Investment Fund Structure



# Publicly Traded Management Company Structure



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# Publicly Traded Management Company Structure

## Key Considerations

- Maintain partnership status for U.S. tax purposes
- Shield Non U.S. investors from U.S. filing requirements and any Effectively Connected Income exposure
- Enable U.S. investors to qualify for 15% Long Term Capital Gains treatment or Qualified Dividend Income on partnership distributions
- Allow principals to monetize a portion of carry related returns without triggering an immediate tax liability

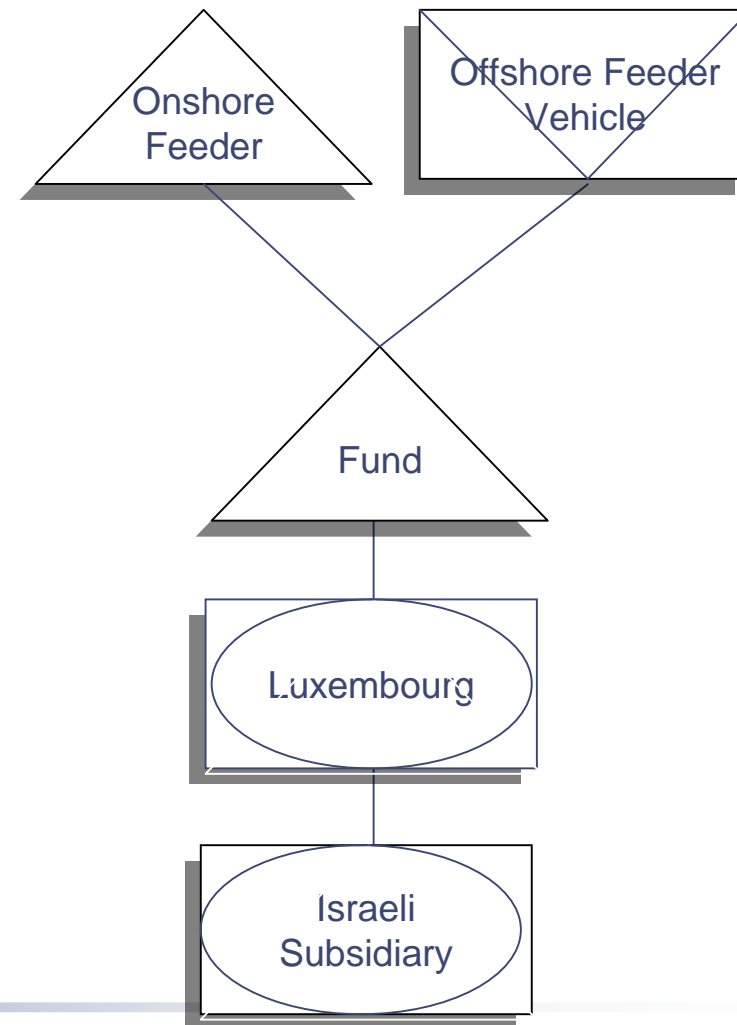
# Capital Gain Tax Exposures – Treaty Planning

## Objective

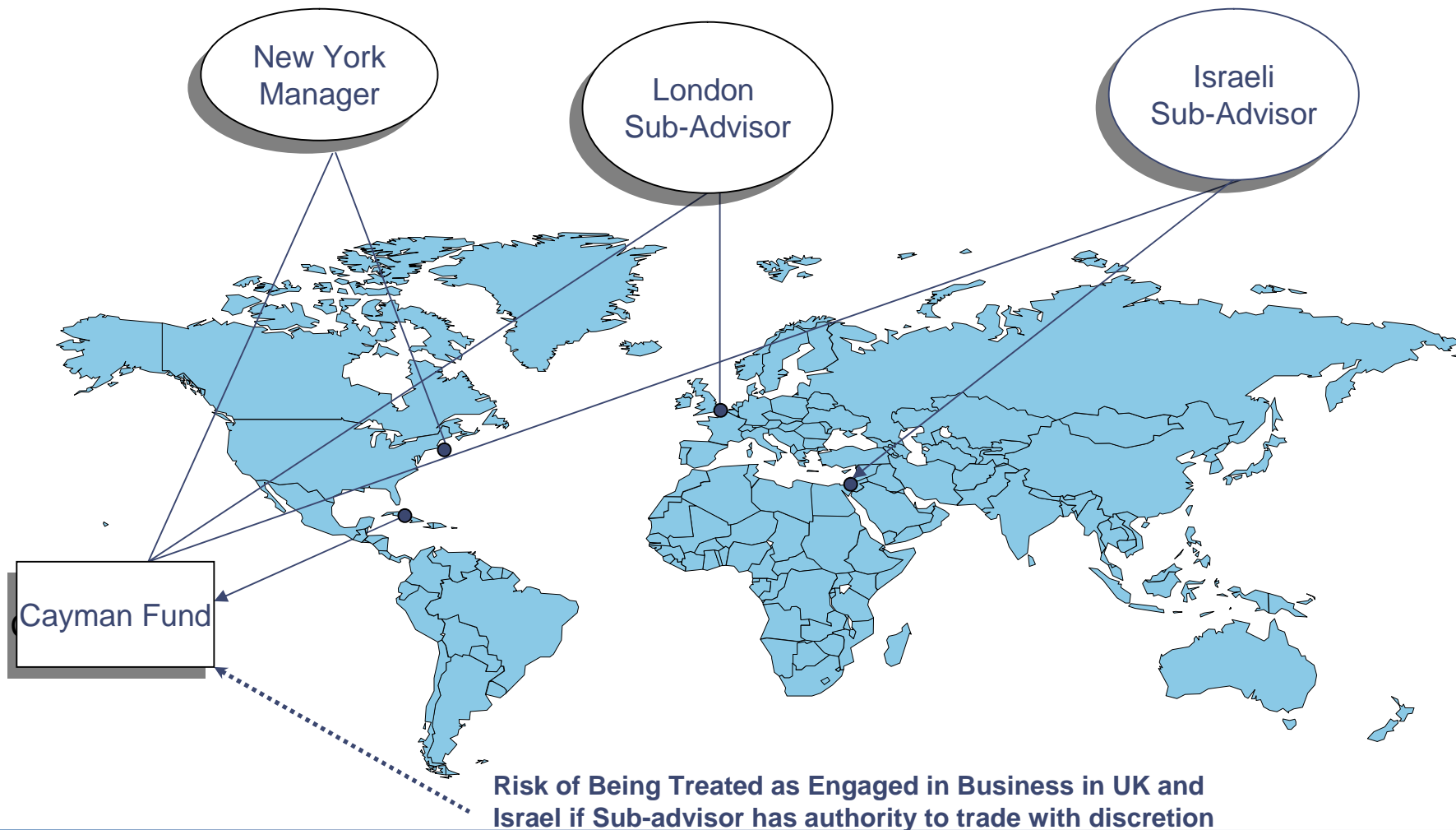
- To mitigate exposure to source country capital gains tax by investing through a treaty-protected special purpose holding company (“Treaty SPV”)

## Issues:

- The country of investment may require that Treaty SPV have substance in the treaty country:
  - Local office
  - Local board meetings
  - Local bank accounts
- Shifting policies regarding beneficial ownership
- Treaty SPV must avoid being viewed as “managed and controlled” from within certain jurisdictions



# Tax Nexus by Reason of Presence



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# Tax Nexus by Reason of Presence *(continued)*

## **Problem**

- Will foreign taxing jurisdiction treat the fund as “doing business” within its jurisdiction?

## **Relevant Factors**

- Does the local agent exercise discretionary authority to contract or trade on behalf of fund within the jurisdiction?
- Does the fund perform active lending, “trade” in stocks and securities, or engage in other types of activities that might fall outside of the concept of “investing”?
  - Some jurisdictions grant (limited) statutory exemptions (safe harbors) if the fund’s activities are limited to certain protected activities

## **Potential Consequences**

- Local taxation on income and gains attributable to the permanent establishment.
- Tax return filing requirements.
- Fund manager or local sub-advisor jointly or secondarily liable for fund’s income tax liability as the fund’s tax agent.

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# Safe Harbors from Tax Nexus

## Countries *with* Safe Harbors

- Investment managers must make sure to limit activities to those protected by the safe harbor
  - U.S.
  - U.K.
  - Hong Kong
  - Singapore

## Countries *without* Safe Harbors

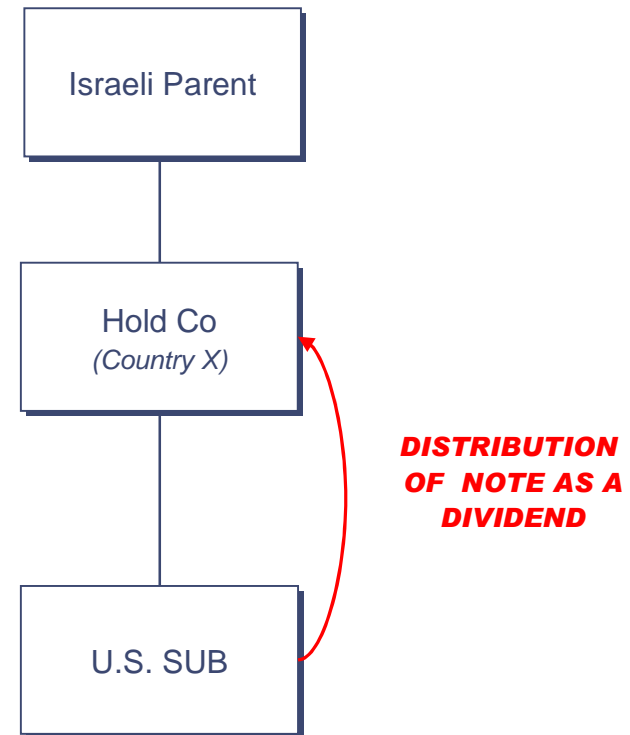
- Investment managers should not invest with discretion from within these jurisdictions (e.g., sub-advisory activities only)
  - Japan
  - Germany
  - France
  - China
  - India
  - Israel

# U.S. Inbound Strategies

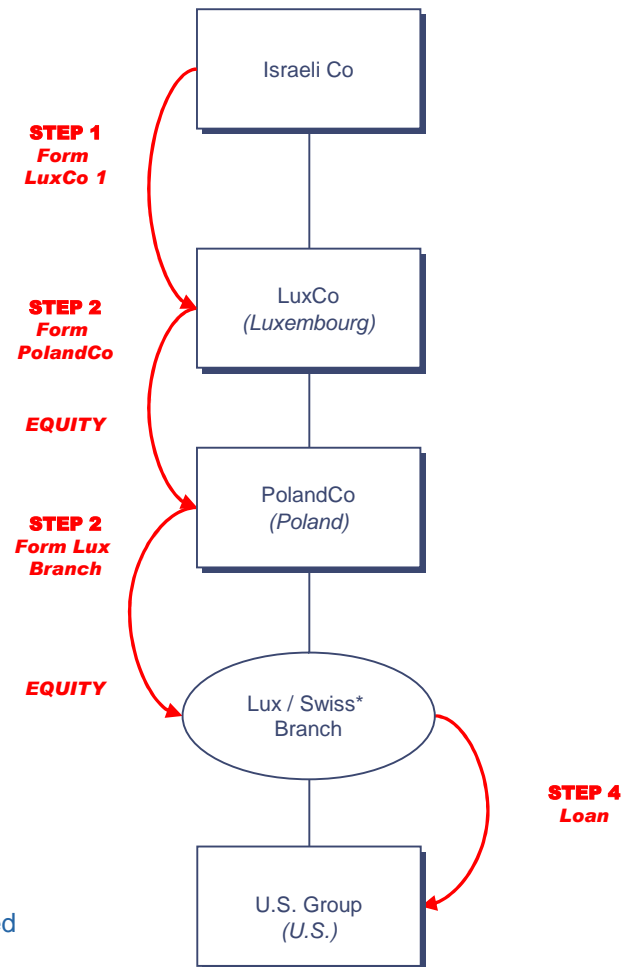
# Distribution of a Note

## TRANSACTION STEPS

1. U.S. Sub distributes a note (as a dividend distribution) to Foreign HoldCo.
2. The distribution of the note may be subject to withholding tax to the extent of the earnings and profits of the U.S. Sub. Thus, it is important to determine the amount of E&P of the U.S. Sub.
3. Consider foreign tax consequences of note distribution – efficient if dividend is not taxed in foreign jurisdiction (e.g., participation exemption)
4. Consider Israeli CFC implications.

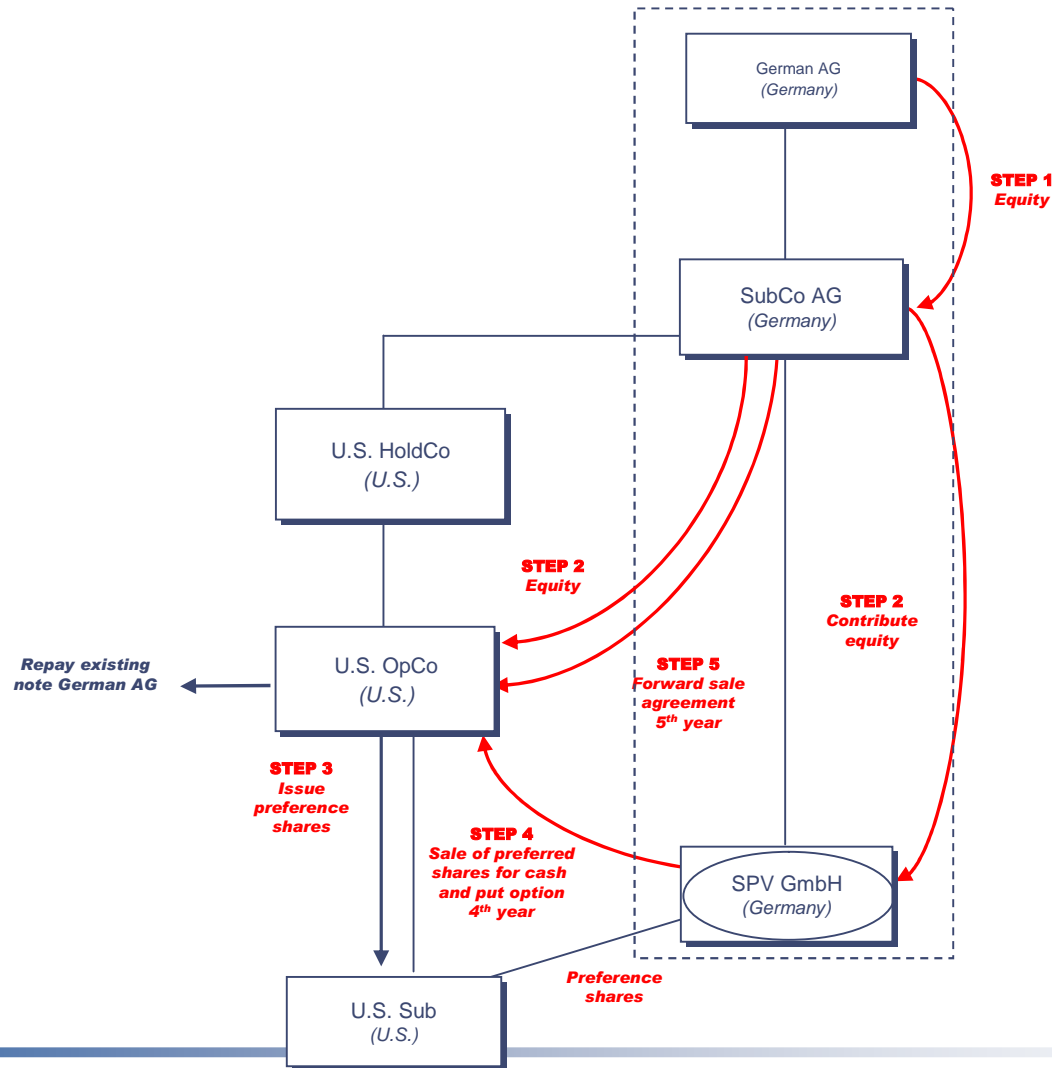


# Polish Holding/Financing Structure

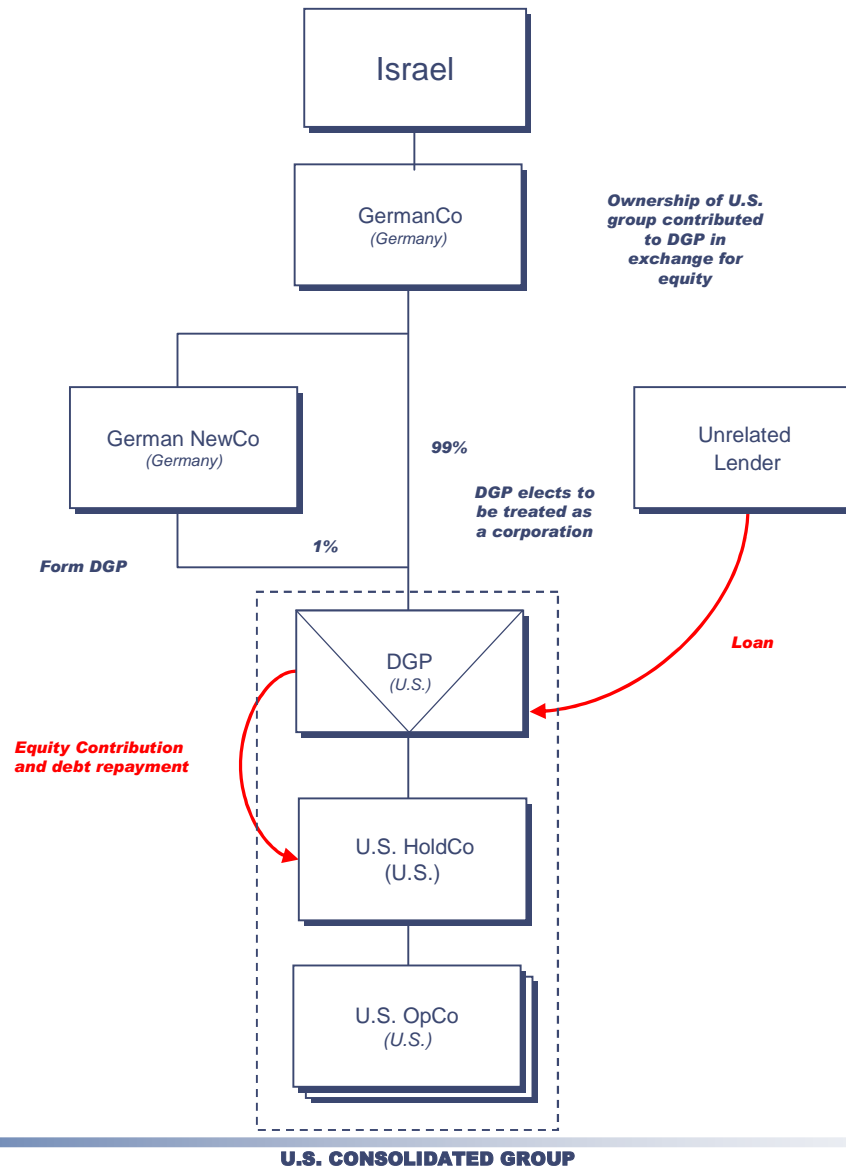


\* Note: Polish/Luxembourg Structure could be used only to finance operations.

# REPO Structure (Germany as an Example)



# Domestic Reverse Hybrid with Outside Financing



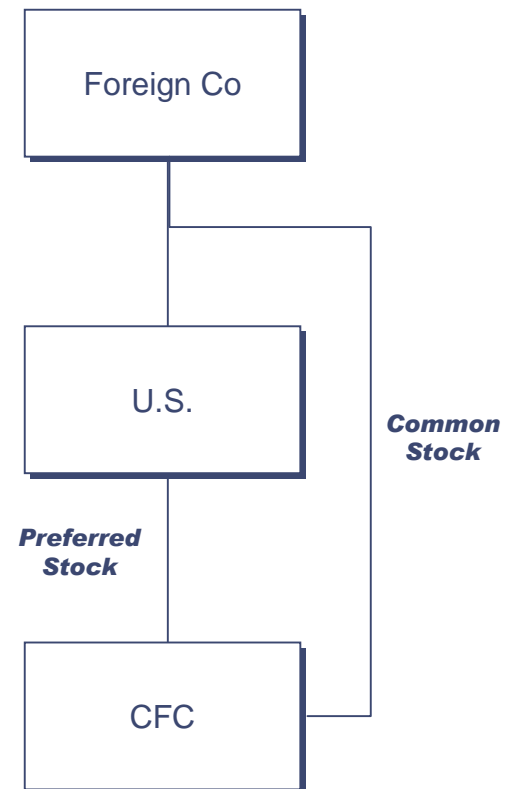
# Preferred Stock Freeze

## TRANSACTION STEPS

1. U.S. exchanges all or part of its common stock in CFC for preferred stock of equal value in a recapitalization transaction.
2. Foreign Co, a foreign parent acquires (by purchase or distribution) CFC common stock.

## CONSIDERATIONS

- Business purpose required.
- Foreign appreciation related to CFC inures to the benefit of Israel Co.
- The preferred stock generally should pay fixed dividends. Hence, any Subpart F income derived by CFC should not be taxed to U.S. in excess of its preferred dividend entitlement.
- The preferred stock generally should be structured to avoid classification as Section 351(g) non-qualified preferred stock, fast-pay stock, or Section 305 or 306 stock.
- The recapitalization is intended to qualify for tax-free Section 368(a)(1)(E) treatment.
- Common stock held in CFC must be substantial in relation to U.S.' preferred stock.
- If CFC's CFC status is lost, Section 367(b) issues may arise.



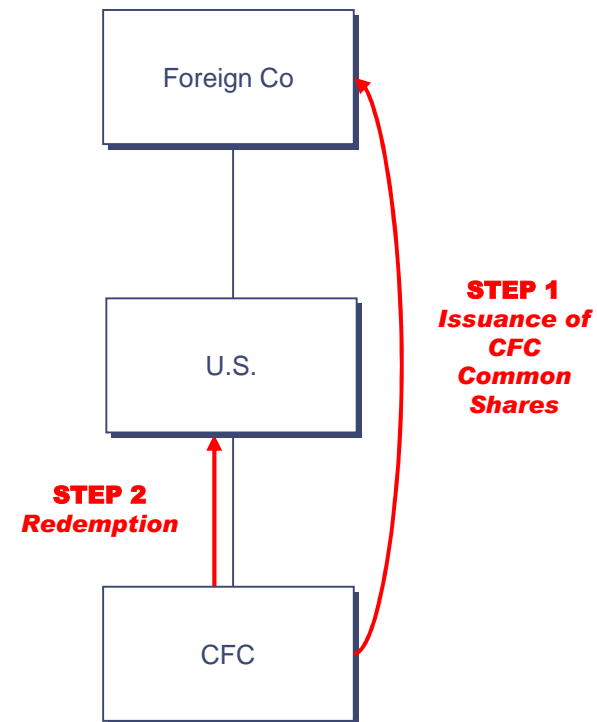
# Cash Contribution with Redemption

## TRANSACTION STEPS

1. Foreign Co contributes cash to CFC in exchange for CFC common shares.
2. Periodically, CFC redeems shares held by U.S.
3. If decontrol or a freeze is desired, CFC issues non-voting preferred stock to U.S.

## CONSIDERATIONS

- Business purpose required.
- Redemption should be taxed as a distribution under Section 301, i.e., as a dividend to the extent of the E&P of CFC (potentially carrying deemed paid credits), reduction in basis to the extent in excess of E&P, and gain subject to Section 1248(c) rules (potentially accessing lower-tier E&P) upon exhaustion of basis.
- CFC recognizes Section 311(b) gains upon distribution of appreciated property.
- U.S.'s ability to claim FTCs may be affected by existing OFLs and future Section 861 allocations.
- Retention of cash may raise PFIC issues.



# Thank you

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