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Asia pacific private equity tax
April 2011

Insights into topical tax issues, trends and developments in the private equity industry throughout the Asia pacific region

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Introduction

With the recovery from the global financial crisis beginning to grip, the outlook is for some exacting and exciting times ahead for the private equity industry, although not necessarily without challenges. Specifically the devasting March 11 earthquake and aftermath is having its own immediate impact on the Japanese economy, with the longer term consequences for the global supply chain uncertain.

Welcome to our third edition of Asia pacific private equity tax.

We begin our series of articles with our traditional look at the state of the markets over the last year. We review the niche opportunities for greentech in China and microfinance market in India, complimented with an insight into the practical challenges posed by ethical investments from our guest author, the Centre for Asia Private Equity Research Ltd's Kathleen Ng.

While markets, funding and opportunities appear to have stabilised, the regulatory responses, in particular the wide-ranging Frank-Dodd, will invariably impact the scope, operations and reporting of private equity firms. Strained public finances continue to see governments and tax authorities' look for ways to expand their tax base, with changes in law (e.g., FATCA) and approach, the latter characterised by developments in Australia being the stand out example of tax authorities affirming their taxation rights on non-resident gains. Finally, we summarise the principal domestic fund options throughout the region, and consider the viability of two locations for regional holding company operations in Asia - Mauritius and Hong Kong - in place of the more common European forms.

As always, please feel free to contact any of our specialist authors listed, our country leaders or your usual PwC contacts.

With warmest regards

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Market update

Mergers and acquisitions (**M&A**) activity in the Asia Pacific region in 2010 continued to show signs of recovery as the impact of the global financial crisis (**GFC**) diminishes, boosted by several large transactions in Australia, China and Korea. The volume of global deals in 2010 increased by 3% (to 1,921 deals) however deal value declined by 10% to US$355 billion.

Total private equity (**PE**) related deal volumes in Asia Pacific in 2010 (see following tables) increased by 4% (to 176 deals) with total deal value increasing by 2% on prior year to US$34.8 billion according to the Merger Market group. However the volume and value of PE activity still has some way to go to achieve the levels seen in 2007.

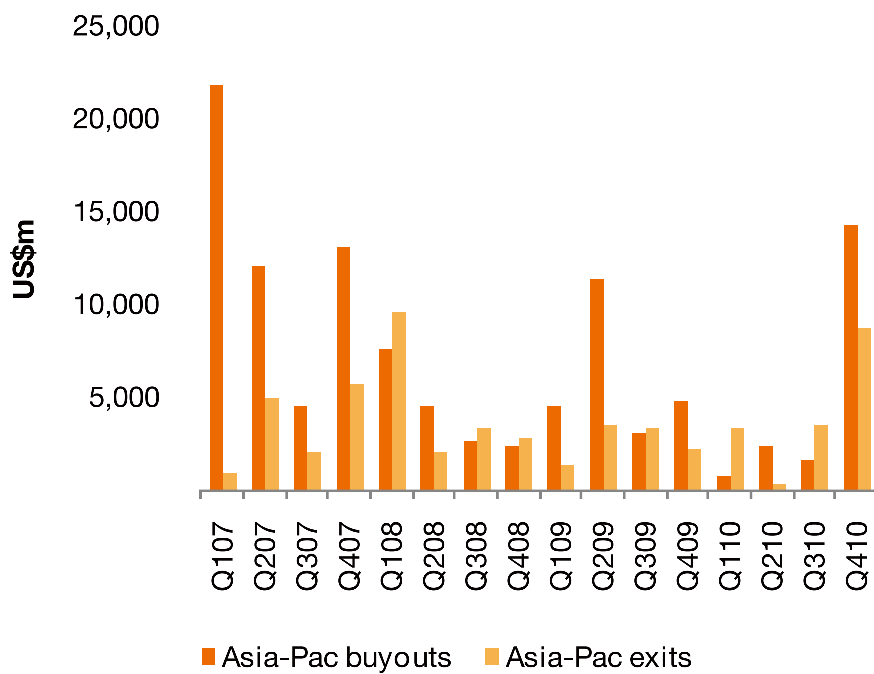
Despite a flurry of global activity at the start of 2010, the volume of exits via initial public offering (**IPO**) failed to meet expectations, with companies citing uncertainty and volatility in capital markets as the major concerns. Across the globe in 2010, 153 IPOs with an estimated value of US$43.3 billion were postponed or aborted.

IPO and exit activity in China and India in particular has been strong throughout 2010 and over US$23 billion of buyouts and exits were completed in Q4 2010 across the Asia Pacific region - a 227% increase over the same period last year. Exit highlights included the sale of a 51.02% stake in Korea Exchange Bank for US$4.1 billion and the sale of a 60% stake in China Network Systems Co. Ltd for US$2.4 billion. On the buyout front, Q4 2010 saw the sale of 51% of Daewoo Engineering and Construction Company Limited for US$5.27 billion and the disposal by the Australian based Government owned Port of Brisbane for US$2.1 billion.

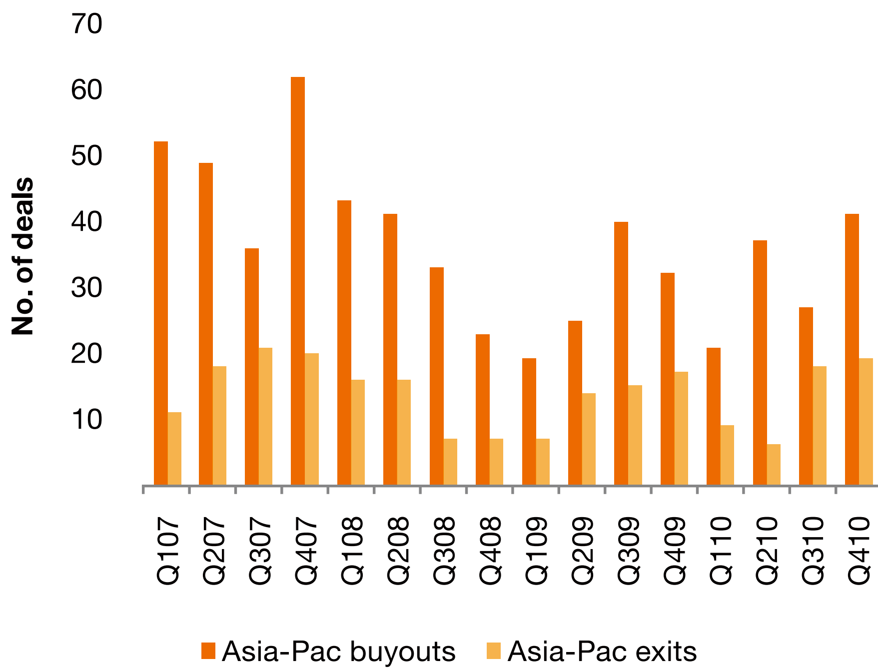
A globalisation strategy is evident across the PE industry with funds seeking both strategic advantages of holding portfolio companies in a variety of geographic locations as well as realising the potential of opportunistic acquisitions. Whilst recognising that the historic downturn following the GFC has been followed by strong pockets of economic recovery, many economic commentators are expecting weak short term GDP growth in developed markets. However, according to the IMF's World Economic Outlook January 2011 update, developing Asia is expected to continue to drive the global economic recovery, with projected economic growth of 8.5% in 2011. It is no surprise that the two economies expected to lead the charge in Asia during 2011 are China and India, with projected growth in 2011 of 9.6% and 8.4% respectively. Over the last two years, PE managers' eyes have turned to Asia as a vehicle for capturing one of the few remaining sources of strategic growth.

2010 was a record year for PE investments in China with a particularly strong second half. China has experienced significant growth in M&A activity with 2010 posting a new record with disclosed deal values topping US$200

PE - Asia Pacific - Deal Value



PE - Asia Pacific - Deal Volume



billion for the first time. Domestic PE Renminbi (**RMB**) denominated funds are assuming a greater level of importance particularly as a source of growth capital for business development. This trend results from the inherent preference of banks to lend to established companies or those with government backing. Consequently, PE deals are predominantly for minority stakes to provide growth funding with very few buyouts and fewer still LBOs. In recent years, the expanding Chinese capital markets have provided a robust exit mechanism for PE and 2010 has been no exception with approximately 200 PE/Venture Capital IPOs and around 50 exits by trade sale in China. The regulatory environment has continued to evolve in China to support a domestic and offshore – onshore PE industry, notably the favourable regulatory changes facilitating the setting up of local RMB funds. As a result, activity across China was strong during 2010 with PE funds raising US$18 billion of new capital of which nearly half was RMB denominated capital. This is yet another indicator of the trend towards domestication/localisation of the Private Equity industry in China. Global PE funds are reacting to this trend by opening new offices in China, recruiting and relocating staff to China and launching their own RMB denominated funds, usually in partnership with local city governments in China. Liquidity tightening measures are expected to increase opportunities for investments in China in 2011 and sectors likely to see PE activity include medical devices, chemical, insurance and consumer goods. Short term uncertainty over inflation and the speed of recovery in the West will have some impact on IPO activity but domestic IPOs and exits are likely to continue apace in 2011. RMB denominated fundraising is also expected to accelerate.

M&A activity in India topped US$65 billion in 2010 on 625 deals with 35% of the deals by value relating to the energy sector. Other active industries included manufacturing, information technology and healthcare. Domestic activity accounted for roughly half the deal flow, with outbound contributing 35% and inbound activity 13%. An acceleration in new PE capital raising appears likely with US$3.3 billion of new funds raised in 2010 and a further $25.4 billion of new fund raising proposed by various funds in 2010. The majority of PE deal flow of US$7.5 billion in 2010 relates to growth and late stage capital. PE exits principally leveraged public markets with 37 of the total 99 exits being by way of IPO, with 31 strategic sales, 17 secondaries and 14 buybacks. Hot topics that may impact both Private Equity portfolios and investment strategy in India include the introduction of a uniform goods and services tax and a Direct Taxes Code 2010 to replace the current law from 1 April 2012 and changes to business partnership laws to make them more practical for investors.

Japan evidenced a 13% year on year decline in M&A activity in 2010, equivalent to a 40% drop from peak activity levels in 2007. New fund raising is at its lowest level since 1998. Deal numbers are slightly down from 2009 with 31 deals (including nine restructurings) by end of Q3 2010 compared with 58 in 2009 full year – however there were only eight deals over US$100m (seven in 2009). Noticeably, whilst domestic deal activity is down 20% in 2010, Japanese strategic outbound deals have increased by 30%. Cross border activity as a percentage of all M&A has increased from 16% to 32%. Of all deals completed in Japan over the last five years approximately only 21% have been exited - the exit environment was no more liquid in 2010, with only 16 exits occurring compared with 30 in 2009. Activity by global PE funds is largely targeted at the secondary market, however only two such deals closed in 2010 (five in 2009). The main issue facing PE is deal flow and some commentators are concerned that the Japanese M&A market will remain sluggish until there is a move by Japanese companies to sell off assets to free up capital - at which point significant opportunities might arise for PE.

Korea has experienced increased M&A and IPO activity in 2010 with the most active sectors being banking, construction, food and beverage and automotive parts. Several global PE funds have noted an increase in activity levels, aided by sufficient availability of liquidity, and competition from local PE funds and investment funds. A number of Korean companies are considering spin-offs or sale of non-core activities through restructuring programs – this should provide deal flow opportunities for the PE industry.

PE activity in Taiwan has shown signs of recovery in 2010 off a very low prior year base. Recent PE deals have been concentrated in the media sector, with TV content and CATV in particular featuring prominently and involving a number of the larger players. There has not been a significant level of exit activity at a portfolio company level in 2010 however a number of major exits are planned for 2011.

Singaporean based PE funds investing across the South East Asian region are indicating strong interest in Malaysia and Indonesia. PE Funds raised US$0.9 billion in H1 2010 and whilst deal flow was relatively slow in H2 2010 there has been positive momentum over the last eight months and exits (largely through IPOs) are widely tipped to feature during

2011. The Hutchinson Group's primary IPO of US$4 billion in March 2011 is likely to attract a large portion of capital market funds which may impact the short-term availability of capital market funding for PE funds considering an IPO exit route for their portfolio companies.

M&A activity across the SEAPAN region (Malaysia, Thailand, Vietnam, Cambodia and Laos) has been positive with recent deal momentum in Malaysia, Vietnam and Thailand since July 2010. Global PE funds have shown particular interest in Malaysia and recent trends suggest fast moving consumer goods (**FMCG**), industrial products, and oil & gas will be the key sectors of interest across SEAPAN. Inbound M&A activity is also expected from Japan and South Korea in Vietnam and Malaysia.

Australian PE deal volumes increased by 46% in 2010 (albeit off a low base), reflecting the underlying stability in the economy, improved credit conditions and continued distancing of the financial crisis. While average deal sizes remain compressed the continued thawing of credit markets has seen an increase in average deal size to US$72 million in 2010. The completion of the US$2.4bn Healthscope private hospital transaction by a TPG and Carlyle consortium has evidenced that leveraged buy out funding (in this case from a broad syndicate of domestic and international banks) is available for the right type of deal – stable growth industry, asset backed, strong market position. There are more than 100 PE investee companies in the exit pipeline, which has resulted in a number of secondary transactions in the education (Providence Equity's acquisition of Study Group), logistics, FMCG and services sectors. 2011 should see further activity in the media, retail and services sectors.

New Zealand has reported improving M&A market conditions over latter half of 2010, principally in the food and agribusiness sectors, although financing options other than senior debt still appear to be restricted with little mezzanine debt being available. A positive outlook is forecast for PE exits with both New Zealand and Australian domiciled PE funds seeking to exit New Zealand based investee companies during 2011.

Recent deal activity in Indonesia has principally been driven by the mining industry (coal, mining contractor and supply chain) and financial services sectors (predominantly insurance and multi-finance). Deals comprise a mix of buyout and minority deals. A consortium investment by TPG, GIC and CIC in PT Delta Dunia Makmur Tbk (an Indonesia coal mining services company), underlines the PE's interest in the coal mining sector in the region.

The green shoots of recovery transformed into sustained momentum throughout the Asia Pacific region in 2010, and in the case of China and India record M&A and exit activity. The combination of improved liquidity and debt availability, PE fund dry powder seeking investment opportunities, more attractive valuations and regulatory improvements in key markets should drive accelerating levels of M&A and PE activity in 2011 across the Asia Pacific market. So here's to another record year!

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China greentech

Greentech refers to a broad range of sectors, segments and solutions that maximise the efficient and sustainable use of energy, including renewable energy, green buildings and cleaner transportation. This article takes a look at the private and public sources of finance available to support and enhance the greentech market in China.

According to the China Greentech Initiative Report of September 2009, the annual China greentech market is estimated between US$500 billion and US$1 trillion. This is approximately equal to 15% of China's estimated GDP for 2013. These numbers are unprecedented, and the tremendous market opportunity attracts interest from a broad range of investors, including private equity funds and specific greentech funds.

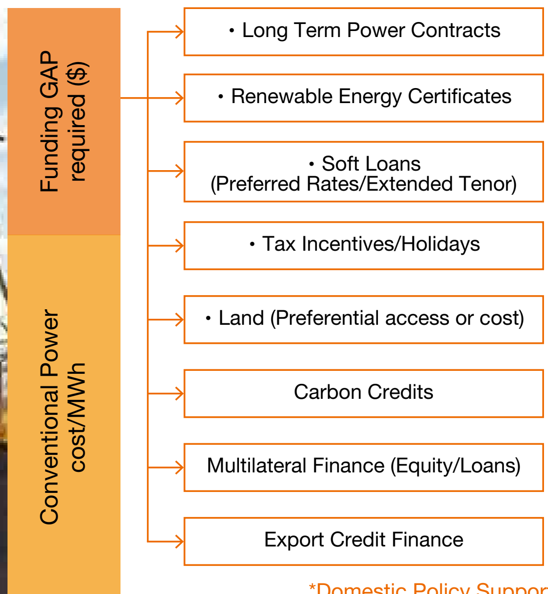
The projected volume and value of the greentech market can be attributed to the following factors:

- The economy in China shows average double digit growth propelling China into the largest global economy by 2020;
- Continuous urbanisation has improved living standards, and combined with the overall economic growth is one of the feeders of the expanding consumer market;
- China is and will continue to be the largest consumer of energy resources; and
- Based on the plans of the National Development and Reform Commission the share of renewable energy in China's primary energy supply is expected to rise to 15 % in 2020 and to 30 % in 2050 (in 2009, the percentage was 9%); key sectors include hydro, solar, wind and bio-energy and the 2020 targets may be increased for these sectors.

To meet the targets of the National Development and Reform Commission significant investment into China's greentech industry is required. The necessity for greentech resources has been recognised and acknowledged, and China is investing heavily into the industry through tax incentives, lowering entry barriers and direct investment, thereby attracting venture and private equity investors domestically and internationally.

The market potential seems unlimited but cannot be supported by public financing alone. Figure 1 depicts the financing sources that typically are available to greentech investments.

Figure 1



*Domestic Policy Support

Source: Capital Projects & Infrastructure Featured Articles Series, November 2010

Public landscape

The framework for China's commitment is governed by various governmental agencies (state and local), plans and guidelines, and a variety of rules and regulations. For example, the China Renewable Energy Law that came into effect on 1 January 2006, requires electricity generators to source electricity from registered renewable energy sources within their respective grids, while the purchasing cost incurred by sourcing generators will be guaranteed via so-called feed-in tariffs:

> *The feed-in tariff for electricity from biomass, for example, is legally guaranteed at 0.25 RMB per kilowatt / hour above the local electricity tariff which shall not exceed 0.75 RMB. To provide suppliers and investors with some stability in planning, this special supplement is to be paid for a period of 15 years. The 15-year feed-in period starts as soon as electricity is generated.*

Other state measures include a planning and development programme for rural energy supply, for instance the development of small-scale hydroelectric power plants, and a concession programme for wind energy plus financial assistance through special government bonds.

China's 12th Five-Year Guideline of Economic and Social Development covering the period from 2011 to 2015 aims to create a sustainable economy in China focusing on the development of energy-saving and new-energy technologies and curbing pollution likely supported by the introduction of an environmental tax.

These targets and measures and the continued growth of the Chinese economy suggests that the size of the greentech market in China should continue to expand.

Private financing

The greentech sector cannot develop and rely on public financing alone. Venture capital and private equity investors are key players in the development and funding of the greentech sector in China. Venture capital and private equity funds are re-emerging as an important source of (growth) capital for private enterprises in China. In 2010 investments by venture capital and private equity investors into the greentech industry surged. China was one of the larger countries for investments into greentech with a total of US$ 730 million spread over 47 investments (Alternative Energy Investments 2006 -2010, CV Source). A similar trend could be seen on the stock markets as China accounted for 68% of the volume and 61% of the value that was raised globally in greentech IPOs; mostly on Chinext, the small and medium sized board in Shenzhen (source: Cleantech Group).

China's foreign investment policy's overriding criteria is to restrict any foreign investment that will impair China's sustainable development. China aims to attract advanced technology, management know-how and talents. Greentech investments are thus mostly open to both domestic and foreign (private) investors. Certain barriers to foreign investors may apply, however, if a particular investment is considered strategically important to China, for instance state-owned grid or nuclear power plant.

The domestic Renminbi (**RMB**) fund structure has become a hot topic in recent years, partly because it may overcome certain regulatory restrictions. These funds facilitate capital raisings from foreign and domestic investors and allow the funds to capture the emerging trend to exit from China portfolio investments through the domestic IPO market. Moreover, a RMB fund may ease or eliminate the cumbersome approval process for M&A transactions and foreign exchange conversion issues.

The development of the Chinese private equity market is dynamic and has attracted significant interest from foreign private equity funds over the last years. Recent developments in the industry - such as the introduction of the foreign invested partnership scheme, the pilot measures rolled out in Shanghai allowing qualified foreign investors to form an RMB fund, Beijing's development policies for the finance and equity industry - in conjunction with the abundant availability of cash and access to local exit opportunities may attract foreign private equity funds to enter the Chinese greentech market. However, the Chinese market is still regulated by various government bodies, and the introduction and further development of tax rules and regulations together with stringent foreign exchange controls sometimes creates a maze of complex procedures and uncertainties.

Tax incentives

In China – as in other countries – tax plays a significant role in the development, promotion and ultimate success of the greentech sector. Tax efficiency is paramount to enhance the desired cash flow position of portfolio companies and to safeguard the economics / return on investment for investors and financiers. Tax incentives offered to greentech investments improve the economics and play an important factor when assessing investment into the greentech industry.

There is no stand-alone environmental tax regime in China but rather there are environment related elements, such as

tax incentives, exemptions and natural resources related taxes, embedded in the existing tax system aiming to promote environmental-friendly activities. The table below sets out some of the tax incentives available to the greentech industry.

Description of incentives	Eligibility
Income earned from certain types of environmental protection, energy and water conservation projects, shall be eligible for a three-year corporate income tax exemption and three-year 50% tax reduction (3+3 tax holiday).	- Public sewage treatment - Public refuse treatment - Comprehensive development and utilisation of methane - Technologies development for energy-saving and emission reduction - Seawater desalination
10% of Investments in qualified equipment for environmental protection, energy and water conservation may be offset against corporate income tax payable for the year. Any excess amount may be carried forward and deductible for the following 5 years.	Eligible equipment is set out in the "Catalogue of Equipment for Energy and Water Conservation Purposes Qualified for Corporate Income Tax Preferential Treatments (2008 Version)", the "Catalogue of Specific Equipment for Environmental Protection Qualified for Corporate Income Tax Preferential Treatments (2008 Version)" jointly issued by the Ministry of Finance, the State Administration of Taxation and the National Development and Reform Commission
VAT exemption or refund on products for comprehensive utilisation of resources	Utilising various waste water/gas/refuse as production inputs
Sales of electric power produced by a small-scale hydro plant is subject to simplified VAT treatment at the rate of 6%	Hypro plant with installed capacity lower than 50MW
Revenue from qualified Energy Management Contracts can be exempt from business tax (5%) and is eligible for the 3+3 tax holiday	There are various criteria for the "qualified project" and "qualified energy management company", including the relevant technology utilised, the form of the energy management contract, the scale of investment by the energy management company.

In addition to the above incentives, there is a more general High and New Technology Enterprises (**HNTE**) regime available to the greentech sector; more specifically, new energy and energy conservation technology plus resources and environment technology are amongst the industries that may benefit from the HNTE regime.

The regime provides a lower statutory corporate income tax rate of 15% if all the criteria of the regime are met. Qualified HNTE companies established after 1 January 2008 and based in the five Special Economic Zones (Shenzhen, Zhuhai, Shantou, Xiamen and Hainan) or in the New Area of Pudong in Shanghai, will be granted an additional '2+3 tax holiday'. In the first two years in which revenues are generated by the company a zero percent corporate income tax rate will apply. In the subsequent three years half the statutory corporate tax rate, i.e. 12.5% will apply. Upon expiration of the tax holiday, the reduced HNTE tax rate of 15% will apply.

The table below outlines the corporate tax rates that will apply for qualified HNTE companies.

Companies may also claim an R&D 'super deduction'. This allowance permits companies to take a deduction of 150% of expenditure on research and development of new technologies, new products and new processes.

Alongside the tax measures listed above, the Chinese government has launched a series of programmes to subsidise greentech industries. For example, the "Golden Sun" subsidy programme provides 50% of investment for eligible solar power projects connected to grid networks and 70% for independent PV power system in remote areas. The local government authorities also actively support the greentech development in their jurisdictions by providing preferential treatments, including financial subsidies, reduced land price and office rates.

Way forward

Greentech in China will continue to flourish due to the commitment and stimulus offered by the central government to this sector. Private investors will play a significant role in the further development and establishment of the greentech market and are supported by the various (cash) incentives made available by the central government to bridge any entry level barrier. Moreover, the investment threshold will come down due to the ongoing development of technology. The latter may also be stimulated through increased collaboration with foreign venture capital and private equity investors and technologies. To fully capture these abundant and government supported greentech investment opportunities, every investor should carefully plan, structure, implement and monitor the constant changing environment in China.

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	2008	2009	2010	2011	2012	2013
Tax rate	25%	25%	25%	25%	25%	25%
Tax holidays	Zero tax rate	Zero tax rate	50%	50%	50%	Reduced rate of tax
Effective rate of tax	0%	0%	12.5%	12.5%	12.5%	15%

Indian microfinance 2.0 – the new era

Microfinance Institutions (**MFI**) in India were, until recently, the poster boys for profitable lending to the poor, the Indian sub-prime. With the phenomenal growth recorded by these institutions, India claims the credit of having the largest microfinance industry in the world. High growth rates, an industry that seemed almost recession proof and the satisfaction of profitably lending to the poor resulted in a huge amount of commercial interest in this sector. However, in the last few months, this industry has entered into a crisis and is now struggling to survive. Today, it is seen as business greed disguised as social welfare.

At the root of an MFI are the Indian poor, women in particular, who have no access to banks. With no savings account, they have no track record based on which banks could lend to them. The average loan size ranges anywhere between US$100 to US$250 which is unattractive for banks to lend and manage. Unscrupulous moneylenders exploited this opportunity by lending at exorbitant rates which ranged from 30% to 100% or even more.

The MFIs changed the landscape by stepping in and lending at much more reasonable rates. They visited the doorsteps of the poor to complete transactions, thereby eliminating customers' travel costs and adding to their convenience. MFIs helped the women to organise themselves into small self help groups (**SHG**), made them financially literate enough for the purpose, and lent small amounts to these SHGs which in turn monitored peer performance and kept defaults at a minimum.

These MFIs began to provide superlative returns and an era which began with 'not for profit' institutions started to give way to 'for profit' institutions. In fact one company raised approx US$358 million in an IPO last year after pricing the sale of its shares at the top end of an indicated price band, and thereby valuing itself at US$1.6 billion, signalling strong investor appetite and the likelihood of more such offers coming to market.

This trend led Muhammad Yunus, the Bangladeshi Nobel laureate who revolutionised the microcredit sector in his country, to opine that profit-oriented MFIs were nothing but "loan sharks". Over the last six months, due to media exposes about the coercive methods used by a few MFIs for loan recovery, which had in some cases led to suicides, the Andhra Pradesh State Government, being the state which has the greatest number of MFIs, passed an Ordinance that significantly restricted the operations of MFIs. The Reserve Bank of India also set up a committee to study the issues and concerns of the sector. Amongst others, the committee recommended 'margin caps' with regard to the interest chargeable to the borrowers.

Tax considerations

Since microfinance was initially taken up as a development initiative rather than as a commercial activity, the voluntary agencies were registered as societies, trust or Section 25 companies. However, with the participation of commercial capital, entities are now being set up as non-banking finance companies (**NBFC**).

Under Indian tax laws, income of a trust from property held for public charitable purposes is exempt from tax on fulfilment of certain conditions. However, the trusts need to make an application to the Revenue and seek approval for exemption. There is a classic debate on what is 'charitable' and tax authorities have watched carefully for anything which falls beyond 'charitable' purposes. Similarly, Section 25 companies are a special species of companies set up for promotion of charity or any other useful purpose. Under corporate law, they are barred from sharing/distributing their surplus with shareholders. They too are exempt from tax provided they obtain necessary approvals from the Commissioner.

Often loans are required to be securitised to generate cash flow for further activities. In a typical securitisation transaction, the assets to be securitized are transferred by the asset owner (the originator) to a bankruptcy remote special purpose vehicle (**SPV** or the asset purchaser). The SPV issues securities to investors, which are backed (i.e. secured) by the income flows generated by the assets securitized and sometimes also by the underlying assets themselves. The net proceeds received from the issuance of the securities are used to pay the transferor for the assets acquired by the

SPV. One key challenge in such a transaction is to avoid costs to the Originator in the form of additional tax payments. Characterisation of these payments (business income or capital gain/loss) is another challenge. The tax treatment of the SPV through which the income from the underlying assets would be passed on to the investors, as well as the tax treatment for the investors investing in such SPVs by way of pass through certificates, are also key considerations.

While conducting MFI activity, as in any lending activity, non performing assets (**NPA**) are inevitable. The Reserve Bank of India requires NBFCs to make a provision in respect of NPAs in its books of accounts. However, tax laws do not allow a deduction for a mere provision; the debt needs to turn bad to be eligible for deduction.

Moreover, the classic debate has been whether tax should be imposed only on real income. In other words, does one recognise interest on NPAs and offer it to tax, even though the loan itself has turned out to be doubtful? The tax law permits public financial institutions, banks, state finance corporations and public companies to defer recognition of interest on NPAs. However, similar provisions do not exist for NBFCs. 'For profit' MFIs often face the challenge of paying tax on an income which is unlikely to be earned.

The biggest operational challenge, however, for an MFI is the provision relating to payments in cash. As mentioned earlier, MFIs operate in the most unbankable areas. Naturally, they have a lot of cash dealings, and expenses have to be incurred in cash. Indian tax law contains a unique provision which seeks to tax payments in excess of 20,000Rupees (approx US$400) if such payment is made other than by an account payee cheque/draft. While the tax is relatively small, as it is applied to each transaction it can add up to a significant amount. Similarly, the law also contains provisions which bar taking or accepting loans or deposits, or repayments thereof, in excess of 20,000Rupees other than by way of an account payee cheque.

In view of the increased political, social, and media attention on this sector, it is expected that tax and regulation will soon catch up with this so far largely unregulated aspect of financing in India.

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Managing credibility

Recent events have clouded the microfinance concept

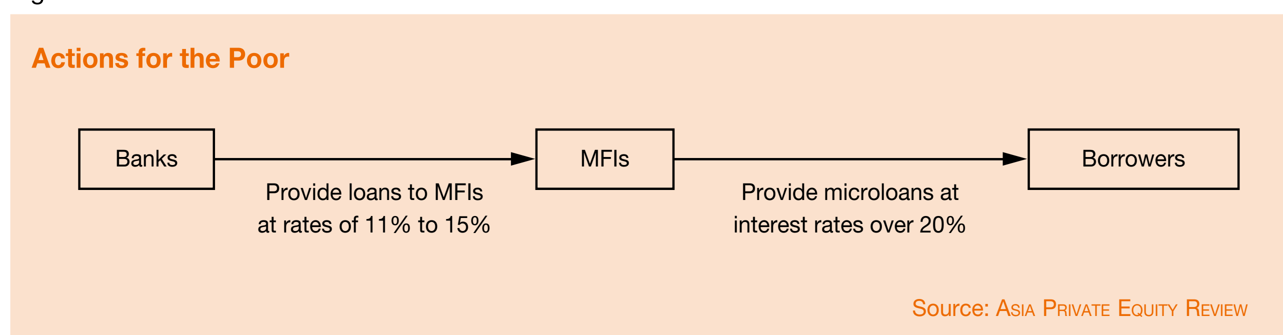
Ever since Muhammad Yunus was awarded the Nobel Peace Prize in 2006 for establishing microfinance in Bangladesh, extending small loans to the rural poor has been seen as an innovative means to alleviate poverty and bring about economic development. Microfinance was not only seen as an untapped market with great potential, but was propelled forward as an act of social philanthropy.

In India, microfinance has grown exponentially. Like many developments in emerging economies that enjoy vibrant activities, while regulators have failed to keep up with such pace, trouble is usually not too far away. Currently, the south-eastern rural state of Andhra Pradesh is India's microfinance hub. It has an estimated US$2.1 billion in outstanding microloan portfolios. Its capital city, Hyderabad, is home to the country's largest microfinance institutions (**MFIs**), including SKS Microfinance Ltd. (**SKS**), Spandana Sphoorty Financial Ltd. and BASIX.

In October 2010, Andhra Pradesh was enveloped in shock when 57 borrowers of microfinance committed suicide. The incident has led to a critical assessment of this growing nonbanking finance industry as to whether it is helping or exploiting the poor. The Andhra Pradesh authorities have thus stepped in and then immediately imposed a ceiling limit on interest rates charged for loans provided to the rural poor. As a result, the Andhra Pradesh Micro Finance Institutions (**Regulation of Money Lending**) Ordinance 2010 (**2010 Ordinance**) was implemented.

Once, microfinance was regarded as a solution to better distribute social wealth, but the recent spate of suicides has cast a dark shadow over microfinance institutions, which make money by the interest rate differentials between what they pay to creditor banks and what they charge from their borrowers (Figure 1). For SKS, India's largest MFI, a testing journey lies ahead.

Figure 1



Untapped market

Microfinance began to capture private equity investors' interest in 2001 when Acumen Capital became the first fund to focus on MFIs. Since then, at least five funds, sponsored by leading financial institutions such as CDC Group plc and the World Bank's International Finance Corp., have been launched to target MFIs in India (Figure 2).

On the investment front, private equity capital has been actively flowing into the microfinance sector. In 2010, US$112.4 million was known to have been deployed to MFIs. This, compared to only US$40.1 million for the entire 2009 speaks of the surging interest to back MFIs (Figure 3).

Figure 2

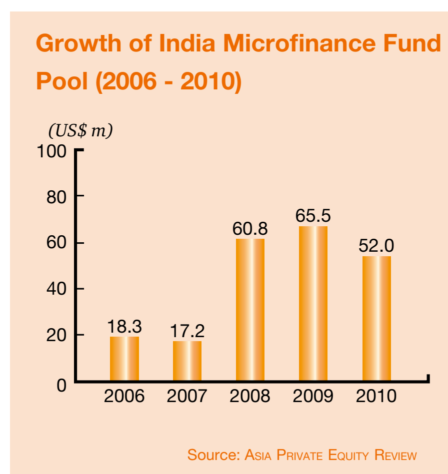
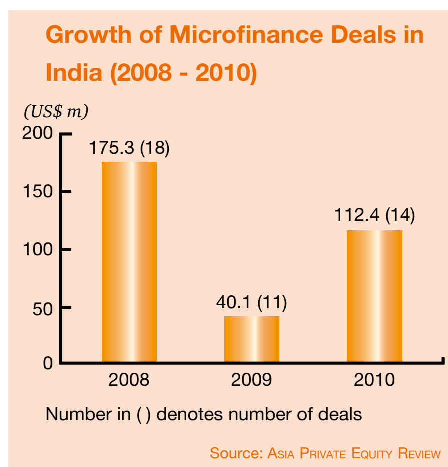


Figure 3



SKS, leader of the pack

SKS Microfinance is a shining example among MFIs. It is the country's largest microfinance institution with 7.7 million registered members, and a total revenue of 9.6 billion rupees (US$211 million) for 2010 year ended 31 March. Since 2006, SKS has attracted private equity investment in excess of US$67 million from the likes of Elevar Equity LLC, Kismet Capital and Sequoia Capital India.

In August 2010, SKS further elevated the microfinance industry when it became the first MFI quoted on the Bombay Stock Exchange. In its initial public offering, SKS raised US$348 million. On its trading debut, its share price closed 10.5% higher than its offer price, a testament to investors' warming to the potential of MFIs. But its honeymoon with the public market was made brief by the suicides that took place in Andhra Pradesh. SKS admitted that as many as 17 of those that took their lives were its customers but it was quick to add that none of them were defaulters. Andhra Pradesh currently accounts for 27% of SKS' total portfolio.

In response, on 15 October 2010, the Andhra Pradesh government announced that it had passed the 2010 Ordinance to better govern the operation of MFIs in the state. Two months later, the 2010 Ordinance was ratified. The Andhra Pradesh Micro Finance Institutions (Regulation of Money Lending) Act (**2010 Act**) now requires every MFI to obtain applicable registrations with local authorities. In addition, no MFIs shall recover from the borrower towards interest an amount in excess of the principal amount (Figure 4).

Figure 4

Andhra Pradesh Micro Finance Institutions (Regulation of Money Lending) Act (Stipulated on 14 December 2010)

Aim – to protect the interests of below-poverty line households and achieve greater transparency in the MFI sector in Andhra Pradesh.
Key Points:

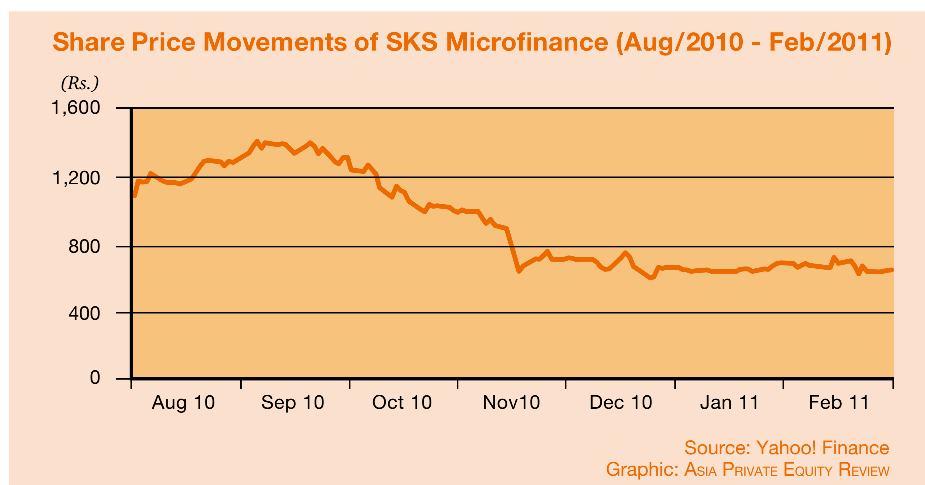
- every MFI has to register before the Registering Authority of the district
- no member of a SHG can be a member of more than one SHG
- all MFIs have to display the rates of interest in their premises
- the recovery towards interest cannot exceed the principal amount
- in each district, a Fast-Track Court is to be established for protection of debtors and settlement of disputes

MFI = microfinance institution
SHG = self help group
Source: Andhra Pradesh Legislative Assembly

The effects of the new regulation were felt immediately; SKS' shares dropped by 4.5% after the announcement of the said Ordinance. This was mid October 2010. By the end of that month, SKS announced a reduction of its annualised rate of interest to 24.55% from 26.69%. It also changed the loan repayment schedule from weekly to monthly. For SKS, these changes led to lower than normal debt collections. It also ominously added that such changes would have a material impact on the revenues and profitability of its Andhra Pradesh portfolio, unless the situation was redressed satisfactorily.

By mid February this year, three months after the Andhra Pradesh government sought to tighten its supervision over its MFIs through the 2010 Act, SKS felt the punishing impacts of the 2010 Act. Its share price tumbled by 41%, from its first trading day's closing price (Figure 5).

Figure 5



Source: Yahoo! Finance
Graphic: Asia Private Equity Review

Comments

The domino effect of the suicides in Andhra Pradesh and the negative sentiment that arose from this tragedy were immediate. Even the Reserve Bank of India has set up a sub-committee to review the country's microfinance practices. In a recent report covering issues, concerns, and addressed by this sub-committee of India's central bank, it proposed a Central Microfinance Bill that will regulate MFIs. The proposed Bill may put a limit on MFI's short-term returns, while ensuring the long-term viability of this non-banking finance sector (Figure 6). With each of the states in India having its own law, it now rests upon the Reserve Bank of India as the organ that shall define the country's central framework for microfinance which has been tarnished by scandals and the central bank's ability to manage the industry's damaged credibility (Figure 7).

Figure 6 - Recommendations by the Reserve Bank of India on MFIs

Report Name

Report of the Sub-Committee of the Central Board of Directors of Reserve Bank of India to Study Issues and Concerns in the MFI Sector

Report Date

19 January 2011

Chairman of Sub-Committee

Y.H. Malegam

Selected Recommendations

- Separate NBFC-MFI category: A separate category to be created for non-banking finance companies operating in the microfinance sector, designated as NBFC-MFI
- NBFC-MFI specification: NBFC-MFIs should not hold less than 90% of total assets (other than cash and bank balances and money market instruments) in the form of qualifying assets. A qualifying asset is a loan that satisfies the following criteria:
  - annual income of borrower's family doesn't exceed 50,000 rupees
  - maximum loan amount to single borrower is 25,000 rupees
  - loan tenure is one or two years with weekly, fortnightly or monthly repayment options
  - at least 75% of loans given by MFIs should be for income generation purposes
- Pricing of interest: A margin cap* of 10% for MFIs with a one billion-rupee loan portfolio and 12% for smaller MFIs. Individual loans are capped at 24%

Margin cap	MFI's outstanding loan portfolio at the beginning of the year
10%	1 billion rupees
12%	< 1 billion rupees

** a margin cap is the difference between the amount charged to the borrower and the cost of funds to the MFI*

- Capital adequacy ratio: NBFC-MFIs be required to maintain capital adequacy ratio of 15%
- Multiple-lending: borrowers must be a member of a joint liability group
- Transitory provision: 1 April 2011 may be considered as a cut-off date by which time the recommendations, if accepted, must be implemented

Source: Reserve Bank of India

Figure 7

Selected PE Investments in Microfinace

Year	Investee company	Investors	Transaction amount (in US$ m)
2006-2008	SKS Microfinace Ltd.	Elevar Equity LLC, Kismet Capital, Sequoia Capital India, SVB Capital Partners	127.0
2008-2010	Equitas Micro Finacce India Pvt. Ltd.	Aavishkar Goodwell India Microfinance Development Company, Canaan Partners, Caspian Advisors, CLSA Capital Partners, MVA Ventures, Sequoia Capital India	56.1
2010	Muthoot Finance Ltd.	Baring Private Equity Partners India, Kotak Private Equity Group, Matrix Partners India	42.8

Source: Asia Private Equity Review

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Regulatory impact of Dodd-Frank

Private equity managers in Asia that have US clients or US investors in the funds they manage may be required to register as investment advisers with the US Securities and Exchange Commission (**SEC**) due to changes brought about by the Dodd-Frank Wall Street Reform and Consumer Protection Act (**Dodd-Frank** or the **Act**), which became law in the US on 21 July 2010. Non-US asset managers that were formerly exempt from SEC registration will have to determine whether they continue to qualify for an exemption.

In late 2010, the SEC proposed new rules to implement Dodd-Frank that: (1) define new exemptions from the registration requirement: and (2) impose additional reporting requirements on certain advisers. Until the SEC issues final rules, significant open questions exist as to the application of the new registration requirement to non-US advisers and what the SEC will expect of non-US registered advisers with respect to their non-US clients.

All advisers that are required to register with the SEC must do so before 21 July 2011. As a registered adviser, managers will be subject to the requirements of the Investment Advisers Act of 1940 (**Advisers Act**), some of which are set out below. Registered advisers—including those located outside the US—are also subject to SEC examination oversight and possible enforcement action, and should be aware of increasing international enforcement efforts.

Many non-US advisers will have to register with the SEC

Dodd-Frank eliminated the existing “private investment adviser” exemption, whereby advisers to private funds are not required to register with the SEC if they have fewer than 15 US clients. Many non-US advisers had relied on this exemption. While this exemption has been eliminated, the Act adds several new exemptions the most relevant of which are described below.

Foreign private adviser exemption

Of most interest to non-US advisers, Dodd-Frank created an exemption for “foreign private advisers.” To qualify for this exemption, an investment adviser must meet ALL of the following conditions:

- It must not have a place of business in the US;
- It must have fewer than 15 clients and investors in the US in private funds advised by the adviser;
- It must have less than US$25 million in assets under management attributable to US clients and US investors in private funds advised by the adviser; and
- It cannot hold itself out generally to the public in the US as an adviser.

The exemption relieves the adviser from any reporting requirements to the SEC

and any SEC examination oversight, but as set out above, it is thus quite narrow and will be available only for advisers with few US clients and investors.

Exemption for Advisers to venture capital funds

Under currently proposed rules, the SEC has created an exemption for venture capital funds. In addition to defining what conditions a fund must meet to be a "venture capital fund" for purposes of the exemption, the proposed rule will allow many advisers to existing venture capital funds that do not meet these conditions nevertheless to qualify under a "grandfathering" provision. Under the proposed rule, advisers that qualify for this exemption will be known as "exempt reporting advisers." Exempt reporting advisers must file a periodic report with the SEC and are subject to SEC examinations.

Private fund adviser exemption

Under the proposed rules, advisers solely to private funds that manage less than US$150 million from a US place of business would be exempt from registration with the SEC. Thus, managers that have no US place of business, or that manage assets only from non-US places of business, will likely qualify. However, non-US advisers that qualify will also be "exempt reporting advisers" and subject to the reporting and examinations described above.

What obligations accompany registration?

Registration with the SEC is a significant undertaking, and not to be taken lightly. Advisers required to register with the SEC must comply with the Advisers Act. Advisers Act obligations include:

The fiduciary standard: Registered advisers must act as a "fiduciary" to advisory clients. The SEC describes the fiduciary obligation as follows:

> *As an investment adviser, you are a "fiduciary" to your advisory clients. This means that you have a fundamental obligation to act in the best interests of your clients and to provide investment advice in your clients' best interests. You owe your clients a duty of undivided loyalty and utmost good faith. You should not engage in any activity in conflict with the interest of any client, and you should take steps reasonably necessary to fulfil your obligations. …. Departure from this fiduciary standard may constitute "fraud" upon your clients.*

Filing Form ADV: Advisers must file Form ADV in an accurate and timely manner. Form ADV Part I includes information related to the adviser's business, ownership, and any disciplinary history. Form ADV Part II is a narrative statement requiring "plain English" descriptions of conflicts of interest and other matters, to be filed and provided to clients and prospective clients, and to be publicly available on the SEC's website.

Implementing a compliance programme: Advisers must: (i) adopt and implement a compliance programme reasonably designed to prevent violations of the Adviser's Act; (ii) designate a chief compliance officer (**CCO**); (iii) implement comprehensive written compliance policies and procedures; and (iv) perform an annual compliance review.

Code of ethics and personal trading: Advisers must adopt a written code of ethics that sets forth standards of business conduct expected from firm employees, and that addresses conflicts that arise from personnel and proprietary trading, gifts and entertainment, and other matters. Codes of ethics must require that certain firm employees report their personal securities transactions to the firm.

Books and records: Advisers must maintain certain specified books and records and keep them accurate and current for at least five years (and longer in certain cases). These records include advisory business and financial records, records reflecting advice given and transactions made on behalf of clients, advisory agreements, and records supporting and evidencing advertising and performance.

Custody rule: Registered advisers that have custody of client assets must keep them with a qualified custodian that sends account statements directly to clients. This custodian may also be required to have a surprise examination and internal controls report prepared by an independent accounting firm. Certain aspect of the Custody Rule may have implications for the independence of the fund's auditor, particularly where the auditing firm provides other services to portfolio companies.

Examination oversight and enforcement

Registered advisers are subject to examinations by the SEC. The purpose of SEC examinations is to determine whether the firm is in compliance with the Advisers Act, is adhering to disclosures made to clients, and is maintaining appropriate compliance programs to assure continued compliance. Registered advisers must produce records requested by the SEC and employees are subject to SEC questioning. Advisers and their employees may also be subject to legal actions by the SEC that could result in fines, disgorgement of profits from advisory business, and bars from the US financial

services industry.

Regulation "Lite"

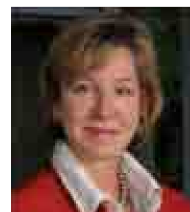
Prior to passage of Dodd-Frank, the SEC has historically provided non-US advisers with a means to reduce the regulatory burden of SEC registration. Regulation Lite relieves certain investment advisers from the obligation of complying with most of the substantive provisions of the Advisers Act, including the custody rule and the compliance rule, at least with respect to non-US clients, including private equity fund clients in which US persons invest. Unfortunately, the SEC has so far failed to confirm that it will continue to follow the Regulation Lite approach in the future.

Conclusion

Private equity fund managers in Asia should consult their advisors as to whether the changes under Dodd-Frank may require the manager to register with the SEC or to become an "exempt reporting adviser." Advisers that fail to register if required could face action by the SEC.

Prior to registration, managers that must now register with the SEC should undertake a comprehensive review of their operations to identify needed enhancements to controls and disclosures. Important steps include:

- Identifying all conflicts of interest associated with the adviser and its employees;
- Implementing a tailored compliance programme with written policies and procedures and an effective surveillance and testing programme;
- Designating a competent CCO and ensuring adequate compliance resources;
- Reviewing existing disclosure documents and identifying needed improvements;
- Drafting clear and accurate registration documents (Form ADV, Parts I and II); and
- Ensuring that newly required records will be created and maintained consistent with books and records requirements.



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Asset management industry implications of FATCA

The Foreign Account Tax Compliance Act (**FATCA**) was enacted into law on 18 March 2010 as part of Hiring Incentives to Restore Employment Act, and establishes new withholding and reporting provisions that are intended to allow the Internal Revenue Service (**IRS**) to better detect tax evasion by US persons who use offshore arrangements to shield their identities and US tax status from the US government.

FATCA's extremely broad scope poses unique challenges for the Asset Management Industry. Absent relief through the regulatory process, FATCA will expose every offshore fund that has direct or indirect US investments to new material tax risks and administrative burdens.

Congress has granted the US Department of Treasury (**Treasury**) broad discretion to limit FATCA's scope in order to achieve a balance between the basic goal of detecting US tax evaders and the goal of not disrupting the marketplace. On 27 August 2010, the IRS issued Notice 2010-60 (the **Notice**) which provides highly-anticipated initial insights into how the Treasury and IRS are approaching the new withholding and reporting requirements included in FATCA.

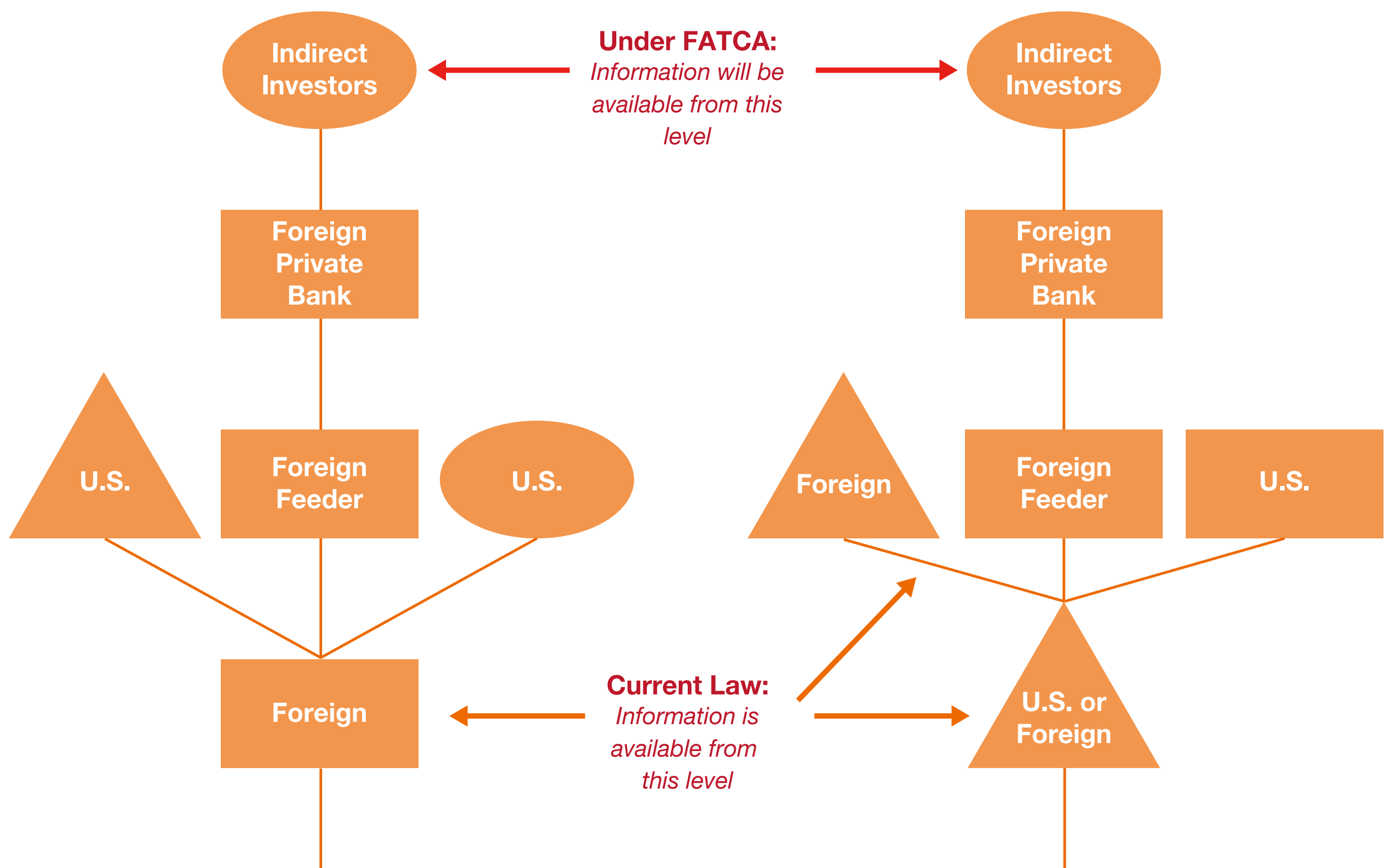
PwC has identified a number of specific and unique implications to onshore funds, fund investors, asset management companies and administrators arising from FATCA. PwC has also developed views regarding recommended industry-specific action steps that should be considered at this time. What we see as being the key action steps are considered in this article.

The new withholding and reporting rules - a new chapter in tax compliance

In general, beginning 1 January 2013, a 30% US withholding tax will apply to gross proceeds from the sale of US stocks and securities, US-source dividends and interest, payments under certain swaps on US equities and various other types of "withholdable payments" and "pass-thru payments" paid directly or indirectly to any offshore fund or other type of foreign financial institution (**FFI**) unless the FFI has entered into an agreement with the IRS which commits the FFI to certain US tax documentation, verification, due diligence, withholding and reporting obligations. Similarly, a 30% US withholding tax will apply to any "withholdable payment" paid to any non-financial foreign entity (**NFFE**) unless the NFFE identifies each "substantial" US owner that owns a direct or indirect interest in such NFFE or certifies that it has no such substantial US owners. Tax withheld against an FFI may not be reclaimed or credited unless the FFI is the beneficial owner of the payment, is entitled to a reduction or exemption pursuant to an applicable tax treaty and provides the IRS such information as Treasury may require to determine the existence and identity of each "substantial" US owner that owns a direct or indirect interest in such FFI. Note that, generally, in the case of an offshore fund, any US person

that owns any direct or indirect interest in the fund is treated as a "substantial" US owner. Although the FFI may reduce or eliminate the tax by the application of a tax treaty, the tax may only be recovered by way of reclaim or credit (i.e., the FFI must file a US federal income tax return) and interest will not be paid with respect to the refund or credit.

Given the broadness of the FATCA legislation, most offshore Private Equity funds will likely qualify as FFI's which means that, absent compliance with FATCA, such funds (and of course their investors) would be subject to a 30% US withholding tax on US source income and gross proceeds from the sale of US investments, which, prior to 1 January 2013, may not have suffered any US taxation (e.g., gross proceeds on the sale of US portfolio companies or US source interest payments which currently qualify for the Portfolio Interest Exemption). This is just one area where FATCA could affect Private Equity firms. The legislation could also apply to and adversely impact other parts of the fund management structure, for example, existing 'carry' structures and waterfall agreements. Taking steps to understand now how FATCA could potentially impact any such existing commercial arrangements and who, ultimately, will bear any legal or economic exposures and have tax operational impacts arising as a result of FATCA, whether the fund manager, the principals and/or the investors, will be absolutely critical to avoid unpalatable surprises once the legislation becomes effective.



Implications to the asset management industry

In general, FATCA raises important implications for the asset management industry by:

- Significantly increasing the types of payments that could be subject to US withholding tax (i.e., direct or indirect payments of gross proceeds, payments on certain swaps, etc.);
- Significantly expanding the population of entities that could have liability for US tax on such payments (i.e., offshore funds and offshore distribution channel intermediaries that hold (or though which others hold) direct or indirect interests in US investments);
- Expanding the population of entities that will have US tax information gathering, withholding and reporting responsibilities and potential financial exposures for non-compliance;
- Increasing the business risks arising from: (i) third-party distribution intermediaries through which indirect investors hold interests in your funds: and (ii) service providers (e.g., administrators) upon which funds may depend for compliance;
- Imposing US tax documentation requirements upon direct and indirect US and non-US investors; and
- Increasing the business risks arising from certain types of investments (e.g., investment targets that are potential "foreign financial institutions" under FATCA).

Notice 2010-60

The Notice makes clear that FATCA will impose new withholding and reporting responsibilities on offshore funds and certain other foreign entities, certain direct and indirect investors in such funds and entities, as well as existing US withholding agents (e.g., US funds, brokers and administrators, asset management companies and administrators, qualified intermediaries). These responsibilities will be in addition to those that currently apply (and will continue to apply) under the non-resident alien withholding regime.

The Notice provides details regarding Treasury's views on

- The foreign entities that will be subject to the rules;
- The procedures a compliant offshore fund or other specified foreign entity will need to apply to identify US persons with interests in or accounts with the entity;
- The type of information an offshore fund or other specified foreign entity will need to provide to the IRS about US persons with interests in the entity; and
- The procedures a US withholding agent will need to apply to verify that it does not have an obligation to withhold on payments made to an offshore fund or other specified foreign entity.

Treasury has also requested further comments from the public about how the provisions should be implemented. At a later date, Treasury and the IRS intend to issue proposed regulations and related guidance incorporating the principles contained in the Notice and addressing other matters necessary to implement FATCA's new withholding and reporting regime.

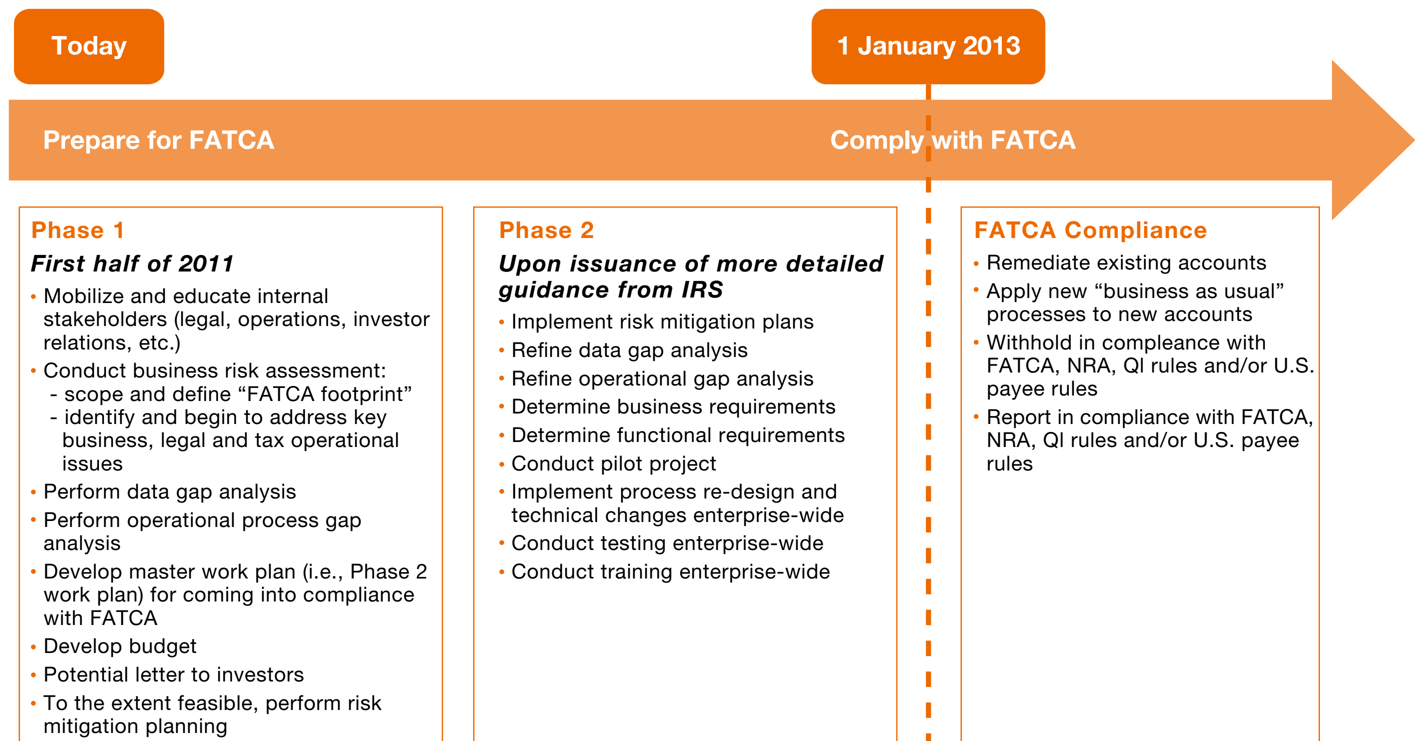
Recommended action steps

Many details regarding FATCA's implementation requirements will not be clear until further guidance is issued. Nevertheless, there are a number of action steps that fund groups should undertake

at this time to prepare for FATCA, including the following:

- Identifying the appropriate internal stakeholders (e.g., internal counsel, compliance, information technology and investor relations personnel) and educating them of FATCA's requirements;
- Outlining your firm's "FATCA footprint" (i.e., identifying the entities, "financial accounts" and payments within FATCA's scope);
- Identifying fund entities and management company affiliates that will have statutory or contractual compliance responsibilities and the nature of those responsibilities;
- Identifying business and legal issues raised by FATCA (e.g., adequacy of current subscription documentation, tax indemnity provisions, service agreement provisions, etc.);
- Performing a preliminary data and operational "gap" analysis;
- Identifying and addressing investor relations issues'
- Identifying potential technology enhancements; and
- Identifying areas where risks might be reduced.

The following timeline summarises recommended action steps for the industry. The specific steps that we recommend for any particular fund complex, fund management company, administrator or investor will vary depending on your specific facts and circumstances.



Conclusions

The Asset Management Industry will have unique challenges in complying with FATCA. Much will depend on the action steps taken today to prepare for these future dramatic changes. We have considered in-depth what specific challenges FATCA poses for the Asset Management Industry and have developed industry-specific action steps that should be considered.

For those private equity firms who wish to have or maintain the flexibility to make portfolio investments in the United States, complying with the provisions of FATCA will be of paramount importance. Failure to do so could cause the fund and its strategies to become untenable investment propositions.

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ATO elaborates on the tax treatment of gains made by foreign private equity investors

The history

On 11 November 2009, the Commissioner of Taxation (**Commissioner**) took steps to try and prevent the sale proceeds from an initial public offering (**IPO**) of Myer Holdings Limited (**Myer**) from being remitted to a non-resident private equity investor on the assertion that Australian tax was payable on the disposal.

The Australian Taxation Office (**ATO**) subsequently issued two draft Taxation Determinations (**TD**) in December 2009 which indicated the basis of the Commissioner's position with respect to the Myer IPO sale proceeds. These draft TDs indicated the ATO's views that:

- Australia's anti-avoidance rules can apply where an entity (resident in a country with which Australia has a double tax treaty) is interposed in a holding structure without sound commercial reasons and has the effect of exempting gains from Australian tax through the operation of the treaty (**TD 2009/D17**); and
- Foreign private equity investors can make an income gain, as opposed to a capital gain, from the disposal of assets (**TD 2009/D18**).

1 December 2010

Following much discussion and debate between the ATO and industry (including PwC) regarding the views expressed by the Commissioner, the two draft TDs were finalised on 1 December 2010.

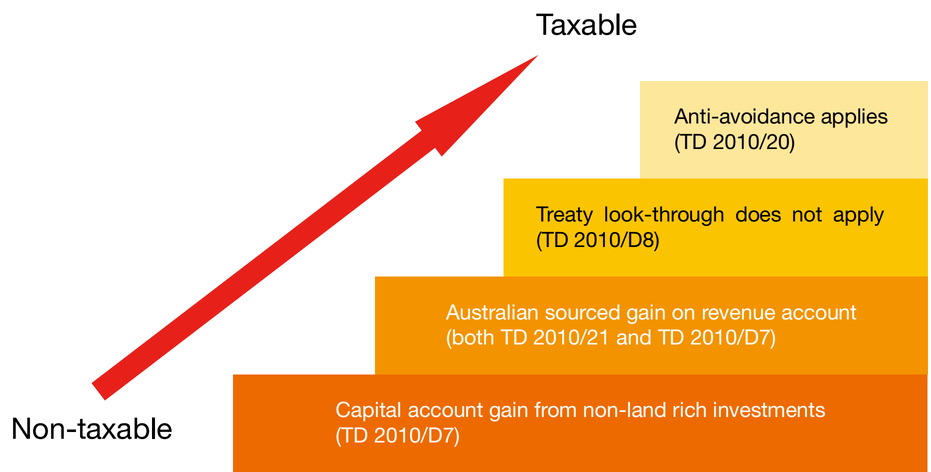
As a result of consultation on the original draft TDs, the ATO also issued two new draft Tax Determinations on 1 December 2010 in which the Commissioner set out preliminary views regarding the:

- Source of income derived from the sale of shares in an Australian company by an offshore private equity investor (**TD 2010/D7**); and
- Ability to "look through" certain non-resident fiscally transparent entities (such as a Cayman Islands Limited Partnership) to the ultimate investors, for the purposes of considering whether treaty benefits apply to that investor (**TD 2010/D8**).

The importance of these four TDs to certain inbound investment in Australia cannot be underestimated. The TDs, when considered together, provide us with the framework of steps which the Commissioner may need to climb before being able to impose Australian tax on certain foreign investors.

That said, what is clear from the language and examples used throughout the TDs is that the Commissioner has taken great care to make these determinations very specific to a particular set of factual circumstances (and ignores, for example, investing through a Managed Investment Trust). The TDs are predominantly focused on foreign private equity entities and leveraged buyout (**LBO**) investors, using a particular investment structure, and specific transaction arrangements.

Taxation of a specific tiered offshore PE or LBO investment into Australia



TD 2010/21: revenue or capital for foreign private equity investments?

Overview

The Commissioner has finalised his not unexpected views that the profit from the disposal of shares in a company acquired in a LBO may be treated as an income gain, rather than a capital gain.

Likewise, the Commissioner has stated that gains derived by a non-resident private equity entity from the disposal of shares in a company may also be income gains. This Determination was formerly issued in draft as TD 2009/D18.

Observations

This Determination confirms the Commissioner's view that gains made by non-residents in a LBO transaction and/or by non-resident private equity entities are likely to be on revenue account.

This TD does however acknowledge that the revenue or capital nature of a gain will depend on the circumstances of each particular case. An example has been included in the final TD that contemplates the disposal of an Australian entity by an off-shore entity which the ATO considers to be on capital account, which was not in the draft TD.

The facts outlined in this example however, appear to be of limited practical application to foreign private equity entities investing in Australia. The example considers an open ended fund that is not required to return funds to investors within a particular or indicative timeframe. It considers this fund acquiring a controlling stake in an Australian entity that holds large scale infrastructure assets. Neither the open ended nature of the fund, nor foreign private equity entities investing into Australian infrastructure assets are common in the Australian market, giving this example limited practical application.

This TD states that the profit making purpose of the foreign investor, which will determine the income or capital nature of the gain, should be considered from the perspective of the non-resident private equity entity itself. It is, according to the TD, a matter of considering the facts and is, therefore, an objective purpose that is to be determined.

The previous draft TD referred only to private equity entities making a gain from the disposal of assets. The finalised TD however refers to gains made by both private equity entities and separately, gains made on the disposal of companies acquired in LBOs. It is not immediately clear whether the Commissioner intended to broaden the scope of the ruling beyond gains made by private equity entities. Is the Commissioner saying that the use of leverage by a foreign entity in the acquisition of an Australian company provides an indication that the investment is more likely to be held on revenue, rather than capital, account?

Limitations and uncertainties

The TD does not provide certainty to a wide variety of investors. The TD is focused on the specific factual scenario in which a foreign LBO investor or private equity investor disposes of an Australian entity. In fact, the TD appears to be have been carefully drafted to ensure that it does not stray into other areas.

For example, the TD does not attempt to provide specific guidance for Australian resident LBO investors or private equity investors. In addition, it does not provide detailed comments on the factors the ATO believe will determine whether a gain will be on revenue or capital account rather, it simply refers back to a Taxation Ruling issued in 1992 .

TD 2010/D7 - source of income

Overview

Draft TD 2010/D7 sets out the Commissioner's preliminary view that the source of income derived from the sale of shares in an Australian company by an offshore private equity investor is not necessarily where the purchase and sale agreements have been executed. Rather, the gain will have an Australian source where the activities that, in substance, give rise to the gain take place in Australia.

In this context, the draft TD expressly mentions the following activities as being relevant:

- Obtaining debt funding;
- Research into the potential target;
- Selecting and acquiring the target, and
- Enhancing the target's profitability and ultimate sale value.

In the draft TD, the Commissioner states that it is his understanding that, "in a typical LBO arrangement", the relevant activities are undertaken in Australia and the respective profits will therefore have an Australian source.

The draft TD provides an example of an investor entity being a limited liability partnership established in a non-treaty jurisdiction, which derives a gain by selling an Australian target by way of an IPO. On the facts of this example, the investor entity uses a controlled Australian advisory company to undertake research into the target and to negotiate the debt funding for its acquisition. The Commissioner expresses his preliminary view that the respective gain would be sourced in Australia.

In the explanation to the draft TD, the Commissioner also expresses his view that the general anti-avoidance rules (contained in Part IVA of the Income Tax Assessment Act 1936) may apply where the taxpayer enters into a scheme under which the purchase and/or sale contracts are executed outside of Australia for the sole or dominant purpose of avoiding that an item of income has an Australian source.

Observations

In this draft TD, the Commissioner adopts an economic substance-over-form approach for the question of source in the private equity context. Case law (and existing ATO guidance), however indicates that where the essence of the taxpayer's business is the entering into of contracts for the purchase and sale of investments (as has been held to be the case for a share trader), the place where these contracts are made is generally decisive. The position of the Commissioner seems reconcilable with these authorities only where the investor entity performs – on Australian soil – significant business activities.

The draft TD attributes the activities carried out by the advisory company to the private equity investor entity for the purpose of determining the source of the investor entity's income. Question whether case law supports this position where the activities are performed by a contractor who is not in an agency or employment relationship with its client.

The draft TD notes an important factor in determining source of a profit on sale is the location where operational improvements are made which increase the ultimate sale value. However, where the local advisory company works with the board of the target enterprise to improve the profitability of the company should not be seen as relevant to the source of the gain. This is work carried out by the local advisory firm for a fee.

Limitations and uncertainties

The facts of the example included in the draft TD do not take into account activities of the non resident private equity fund in relation to matters such as the raising of equity, the decision to invest that equity and realise the equity, and arguably has taken an incorrect or at least overly simplistic view of the relationship between the advisory company and a private equity fund.

The question of apportionment of income where there are multiple significant sources is not addressed in the draft TD. In the example the execution of the sales contract outside of Australia may not be regarded as significant enough to require an apportionment of part of the income to sources outside of Australia, but if other activities take place outside Australia will it be necessary to look at apportionment and how practicably is this able to be done?

TD 2010/D8 - looking through entities

Overview

Draft TD 2010/D8 is a welcomed Determination from the Commissioner, providing taxpayers with a level of confirmation that the principles of the OECD partnership report (which provide for a "look through" approach to the ul-

timate investor for the purposes of treaty benefits) are recognised as inherent in Australia's broader treaty network.

When TD 2009/D17 was first released, there was much discussion and debate around whether the draft TD had taken into consideration the "look through" principles in reaching its conclusions in regard to treaty shopping. This raised a level of uncertainly amongst taxpayers, particularly in light of the number of existing ATO rulings and Interpretive Decisions which had acknowledged the principle, not to mention the recently negotiated Australian treaties which specifically include the "look through" principle.

Observations

The use of fiscally transparent entities (such as foreign partnerships resident in tax havens) is a common structure employed by many fund managers, including international private equity firms investing abroad. These structures are designed to address legal, regulatory and administrative issues, including reduced US compliance costs (but importantly, not US tax).

What this draft TD means for certain foreign taxpayers looking to invest in Australia, such as private equity funds, is that the practical requirement of using a vehicle in a jurisdiction which does not have a treaty with Australia (such as the Cayman Islands), can still enable protection from double taxation under a relevant treaty. This will be the case so long as the entity is a partnership and the ultimate investors, country of residence has a treaty with Australia and does treat the entity as transparent under its tax law.

An observation with the draft TD is the interaction it has with TD 2010/20 (treaty shopping). One interpretation of the draft TD implies that, where the limited partners are residents of a country which has a treaty with Australia and which treats a Cayman Limited partnership as fiscally transparent, the existence of a scheme involving the interposition of holding companies between the Cayman partnership and an Australian holding company, may not give rise to a tax benefit and therefore not attract the operation of the general anti-avoidance provisions.

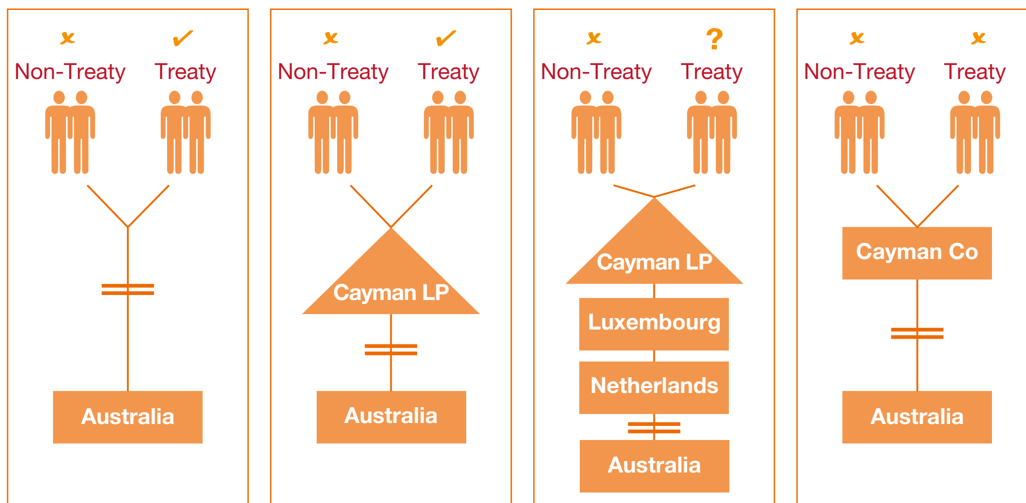
In contrast, where all facts remain the same, but for the Cayman entity being opaque for US tax purposes, TD 2010/20 would imply that the general anti-avoidance provisions could apply. This subtle distinction in the classification of a non resident entity would seem to be a trigger point for Part IVA to potentially apply.

Limitations and uncertainties

The draft TD 2010/D8 remains silent on a number of key issues relevant to non-residents investing into Australia through fiscally transparent entities, including:

- Whether the principles from the OECD report will extend more broadly to other fiscally transparent entities. Certainly, we have seen a number of recent ATO documents which have indicated that this is the case (e.g., ATO Interpretative Decision 2010/188).
- Will treaty benefits be available where the ultimate investors that invest through the transparent entity are tax exempt bodies (such as Sovereign Wealth Funds)? Indeed, the draft TD provides in the example that benefits will only be available to the extent the limited partners are liable to tax in the treaty country on "those profits" (it is not clear whether this would extend to exempt pension funds who should benefit from the Australia/US tax treaty). The relevance of this point is highlighted in the context of "treaty shopping" when one considers whether any investment structure actually achieves a tax benefit when the ultimate investor should not be liable to tax in the first instance.
- While there is no example in the draft TD on tracing through tiers of transparent entities, based on the principles of the OECD model it should be the case that a tiered structure would not disrupt the "look through approach", provided each interposed entity was transparent and the ultimate investor taxable in a treaty country. This point should be clarified by the ATO.
- It is unclear whether interposed entities which are legal form corporates but treated as fiscally transparent for tax purposes in the jurisdiction of the investor are treated as "look through" for the purposes of the draft TD.
- Naturally, there will be administrative challenges associated with tracing income through to the ultimate investor in order to determine whether the Commissioner will allow treaty benefits. A fund manager being able to provide proof of its investor base will be important, but how will this be done in practice?
- It will be interesting to see how the Commissioner seeks to administer this and how this will interact with the recent developments in regard to Collective Investment Vehicles, where similar issues of investor identification have been raised. There is the threat of the ATO issuing notices to withhold tax first and seek proof of residence

Illustration: availability of treaty benefits through fiscally transparent entities



before these funds are released.

TD 2010/20 - Treaty shopping

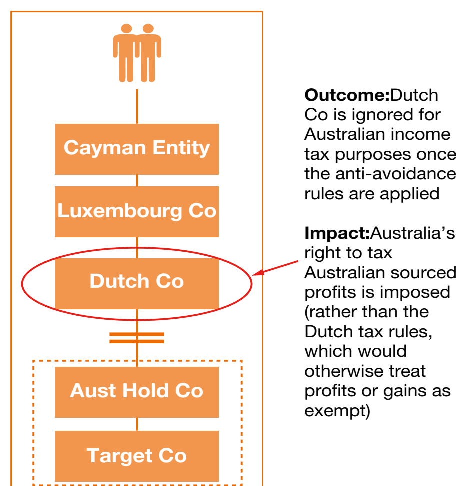
Overview

The Commissioner has confirmed his view that Australia's anti avoidance rules are likely to be invoked where the decision to insert an interposed treaty company in a holding structure lacks sound commercial reasoning.

Accordingly, the tax treaty benefits ordinarily available to an offshore investor (such as Dutch Co in the diagram above) will be ignored, and Australia will assert its right to impose income tax on Australian sourced profits realised upon disposal of the Australian group. This is the case, as neither the Cayman Islands nor Luxembourg has a tax treaty with Australia.

Observations

The conclusions and comments set out in TD 2010/20 are limited to a specific fact pattern and structure summarised in the diagram above, where the Commissioner has concluded that there are no evident commercial factors that support the interposition of holding companies between a non-treaty investor and an Australian investment. Rather than attempting to provide taxpayers with guidance on how the anti-avoidance rules are likely to apply for a range of private equity transactions, the Commissioner appears focused only on protecting the revenue base from arrangements similar to this particular scenario.



Outcome: Dutch Co is ignored for Australian income tax purposes once the anti-avoidance rules are applied

Impact: Australia's right to tax Australian sourced profits is imposed (rather than the Dutch tax rules, which would otherwise treat profits or gains as exempt)

Source: Adapted from the example included in TD 2010/20

The Commissioner's starting position is that non-treaty country investors deriving Australian sourced business profits (refer TD 2010/D8) would be subject to income tax in Australia.

However, a taxpayer may undertake a structuring arrangement which includes the incorporation of a holding company in a country that has a tax treaty with Australia, such as the Netherlands.

It follows that if a Dutch company buys and sells Australian assets and makes a business profit, the Netherlands / Australia tax treaty provides that the profit would be assessed in the Netherlands. Further, it is a feature of Dutch tax law that an exemption can apply to holding companies that make a gain on the sale of shares in a subsidiary. On this basis, the Australian and Dutch tax rules operate in combination to exclude any business profits derived by the Dutch holding company from income tax.

Therefore, where certain entities within a holding structure are included to merely enable the operation of a particular tax treaty in the context of a broader investment structure, the TD indicates that this may be a scheme that triggers the application of Australia's anti-avoidance rules.

The Commissioner advised in the TD that the following factors may indicate that such a scheme has been adopted:

- An unnecessary hierarchy of holding companies (in this case the Luxembourg and Dutch companies);
- The time at which the scheme is entered into corresponds with the timing of the acquisition and holding period of target assets;
- These entities serve no commercial or other economic purpose before, during or after the holding period;
- The insertion of entities into the holding structure is explicable only by taxation consequences thought to follow from their inclusion into the structure;
- Each of the interposed entities is a mere holding company; and
- The arrangement to adopt the interposed entities would result in a tax benefit when compared with an investment into Australia by a non-treaty entity (i.e., the Cayman Entity).

The key tax implication is that where these factors are present, any tax benefit obtained in relation to such a scheme is likely to be cancelled (on the basis that Australia's concluded tax treaties do not preclude the operation of Australia's general anti-avoidance rule).

Limitations and uncertainties

In order for a tax benefit to be cancelled, it is necessary to first establish whether a tax benefit exists. The Commissioner acknowledges that a tax benefit may not arise where the 'Cayman Entity' is in fact a Cayman LP with limited partners resident solely in countries that have a tax treaty with Australia, given the treatment of fiscally transparent entities outlined in TD 2010/D8.

Whether a tax benefit arises should be considered in the context of an alternative scenario. Does it follow that this alternative scenario needs to assess objectively the direct investment by the Cayman Entity in the context of the revenue/capital distinction outlined in TD 2010/21 and the analysis of whether an Australian sourced profit would have otherwise arisen (with reference to TD 2010/D7)?

2011 update

In February and March 2011 a number of articles were published in the Australian press concerning the ATO views on tracing through foreign funds to the ultimate investors for tax treaty purposes.

Broadly, the position has been reiterated that investors can trace through certain flow-through entities for the purposes of treaty application and where the ultimate investors are resident in treaty countries, the view remains that there should be no Australian tax levied on the gain.

However, questions have been raised by industry participants about how far the tracing to ultimate investors will need to go (and through what types of collective investment vehicles) to ensure appropriate disclosure.

The Commissioner has since asserted the expectation that private equity funds should be in a position to disclose the identity and residency of their investors to the ATO, and the Chief Executive of the Australian Private Equity and Venture Capital Association (**AVCAL**) has responded that AVCAL "will work closely with the ATO to assure them of the integrity of our investors."

Another issue requiring resolution is the tax analysis of the Australian source rules, noting that industry submissions have been provided to the ATO following the release of TD 2010/D7 in December 2010. In the context of determining the source of income either inside or outside of Australia, it is anticipated that the finalised guidance will more accurately reflect the different activities undertaken by a private equity fund compared with a manager and/or advisors.

Discussions between industry participants, their tax advisors and the ATO

will continue on a range of tax topics relating to foreign private equity investment into Australia, yet certainly for investors may be difficult to achieve until such time that workable legislative reforms are introduced, debated and adopted.

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Domestic fund vehicles across asia

The increased focus of regional tax authorities on offshore investment holding company structures used by private equity firms to make investments, and the eligibility of these structures for benefits under double tax treaties (as seen most recently in the TPG/Myer case) has led some private equity firms to consider alternative structures for private equity investments. A number of jurisdictions have recently introduced domestic structures and/or tax concessions that, while they may increase the overall tax and administrative burden, may provide more certainty for private equity investors.

This article considers four domestic structures that have been introduced, or have had their tax treatment clarified recently, and assesses whether these might be used by private equity funds to make investments in the particular jurisdictions.

Japan – investment business limited partnership

The investment business limited partnership (**IBLP**) was introduced into Japanese law (toshi jigyo yugen sekinin kumiai keiyaku ni kansuru horitsu, Law No. 90) in November 1998 to provide certain partners in investment business with limited liability. An IBLP consists of investors (**Investors**) and a manager (**Manager**) who is responsible for the management and operation of the business of the IBLP. The Manager of an IBLP is jointly and severally liable for partnership debts: however, the Investors are liable only to the extent of their investment. Generally, an IBLP may only acquire and hold the following types of assets:

- Investments in companies and joint ventures;
- Investments in stocks, bonds and warrants;
- Loans to businesses;
- Interests in partnerships and trusts; and
- Investments in foreign company shares and other securities issued by foreign companies.

Any profits and losses of an IBLP are allocated in proportion to the value of the contributions made by the Mangers and the Investors.

Tax treatment for investors (limited partners)

As an IBLP is generally viewed as a pass-through entity for Japanese tax purposes, the Manager and the Investors are generally viewed as directly investing into the underlying assets and are subject to Japanese taxation on income as it accrues. However, as the Manager of the IBLP carries on the business for and on behalf of the Investors in Japan, non-resident Investors are typically deemed to have a permanent establishment (**PE**) in Japan as a result of their investment in the IBLP. On this basis, non-resident Investors are generally subject to full Japanese taxation on income received from an IBLP.

The 2009 tax reform (**2009 Tax Law**) introduced a PE exemption for certain

qualified foreign individual or corporate partners (**Foreign Partner**) who invest in an IBLP. To be eligible for the exemption the Foreign Partner must meet the following requirements:

- The Foreign Partner must have limited liability with respect to the IBLP;
- The Foreign Partner must not be involved in the management or operation of the IBLP;
- The Foreign Partner's investment ratio in the IBLP is less than 25%;
- The Foreign Partner is not specially related to the general partner of the IBLP; and
- The Foreign Partner does not otherwise have a PE in Japan.

Where the Foreign Partner meets these requirements and files certain documentation with respect to its interest in the IBLP, the Foreign Partner will not be deemed to have a PE in Japan by virtue of its investment in the IBLP. On this basis, the Foreign Partner will only be subject to tax in Japan on certain Japan sourced income, including dividends and certain capital gains.

Generally, dividends paid by a Japanese company to a non-resident investor are subject to withholding tax at a rate of 20%. However, where the foreign investor is eligible for benefits under a double tax treaty concluded by Japan with the investor country of residence, the rate of withholding tax may be reduced. As the IBLP is viewed as a pass through entity, then provided the foreign investor meets the requirements described above and is exempt from the PE in Japan, the foreign investor may still be entitled to treaty benefits. Compared with the use of an investment holding company, where a single filing may be made, this would require each individual investor to file treaty documentation and can impose a significant compliance burden.

A foreign investor without a PE in Japan may be subject to tax on certain capital gains, including gains realized from the sale of shares in a Japanese company where the foreign investor (together with specially related persons) sells 5% or more of the shares in such corporation during a fiscal year and such foreign investor (together with specially related persons) owned or has owned 25% or more of the shares in during the fiscal year of sale and two prior fiscal years (**25/5 Rule**). Generally, for the purposes of the 25/5 Rule specially related persons includes partners in a partnership, and where the IBLP holds more than 25% of the shares in a Japanese companies, Investors would generally be subject to tax on capital gains realised from the sale of Japanese portfolio companies.

However, in addition to the PE exemption discussed above, the 2009 Tax Law also introduced a provision to allow for the testing of the 25/5 Rule thresholds to be made at the Foreign Partner level provided the Foreign Partner meets the conditions above (**25/5 Rule Exemption**) and files certain documentation in lieu of their tax return. While this position may provide greater certainty when compared with a claim by an investment holding company, this would again require each individual investor to file documentation and can impose a significant compliance burden.

Where the immediate Foreign Investor is a foreign fund whose general partner is also responsible for the management of the IBLP, or holds the Managers interest in the IBLP, the foreign fund may not meet the requirements for the 25/5 Rule Exemption and as such the 25/5 Rule thresholds would be tested at the foreign partnership level. In this regard, it may not be possible for a foreign limited partnership to make direct investments of greater than 25% in a Japanese company via an IBLP, but rather may need to use the IBLP as a side vehicle for investments in Japan.

Tax treatment for managers (general partners)

The Manager of the IBLP will not generally qualify for the PE exemption or the 25/5 Rule Exemption and as such will generally be subject to tax on gains realized from its investment. In this regard, a foreign investment fund would generally be subject to Japanese tax on any carried interest earned in respect of investments held by the IBLP. As the Management interest in the IBLP gives rise to a PE in Japan, a double tax treaty concluded by Japan with the Managers country of residence would not provide any protection.

Conclusion

While the IBLP may provide Investors with greater certainty with respect to their Japanese tax positions, it may also impose significant compliance obligations when compared with an investment holding company structure. Further, as no exemption applies for the Manager of an IBLP, this structure may significantly increase the tax burden for foreign investment managers. For these reasons, the use of an IBLP may only be practical where a foreign private equity firm otherwise has a significant presence in Japan.

China – foreign-invested equity investment enterprises

Since March 2010, private equity firms looking to raise funds from both domestic and foreign investors have the option to use a foreign invested partnership (**FIP**) structure to invest in China private equity. However, the FIP structure is not

without its problems. China's legislation and practices relating to the establishment and operation of a Renminbi (**RMB**) fund are still evolving and often comprise fragmented policies, ministerial regulations and incentives introduced by local governments. Each regulatory department usually focuses on different issues and there is often a lack of coordination among the various regulatory departments. These create various practical and operational issues (such as conversion of foreign currencies into RMB for investment) when establishing and operating a RMB fund.

In January 2011, the Shanghai Municipal Finance Service Office, the Shanghai Ministry of Commerce and the Shanghai Administration Bureau for Industry and Commerce jointly promulgated the Implementation Measures on the Pilot Programme for Foreign-invested Equity Investment Enterprises (the **Pilot Measures**). Shanghai is the pioneer city to set up a unified governmental organization to focus on and handle operational issues of foreign-invested equity investment enterprises which are allowed to make investments in RMB, their general partners (**GPs**) and foreign management company (**FMC**).

Under the Pilot Measures, a RMB fund enterprise could be established in the form of a partnership, whereas the FMC could either be established in the form of a corporation or partnership. Qualified foreign investors (**QFI**) may contribute with freely convertible currencies or with legitimate RMB revenues or earnings generated in China while domestic investors may only contribute in RMB. QFIs may include sovereign wealth funds, pension funds, endowment funds, charitable funds, fund of funds, insurance companies, banks, security companies and other approved foreign institutional investors. In addition, the Pilot Measures require each RMB fund enterprise to engage a qualified custodian bank in China to supervise its funding.

Like other foreign investment vehicles, a RMB fund enterprise set up under the Pilot Measures is generally required to observe the existing foreign investment industry guidelines in China in carrying out its portfolio investment if it takes in money from foreign investors. This RMB Fund Enterprise is prohibited from:

- making investments in the foreign-prohibited industry sector in China;
- purchasing stock or corporate bonds exchanged in the secondary market;
- making investments in futures or other financial derivative transactions;
- making investments directly or indirectly in non-self used real estate;
- using other funding except for its own capital to make investments; and
- providing loan or security to other parties.

Under the Pilot Measures, a qualified FMC may engage in capital raising and establishing an equity investment enterprise (i.e., establishing a RMB fund enterprise). This is in contrast to the past where a FMC is only allowed to provide fund management and consulting services. The qualified FMC is also entitled to enjoy certain preferential treatments such as the relaxation of foreign currency conversion in relation to its capital contribution to an RMB fund enterprise. In this regard, a qualified FMC can use its own foreign currency, up to a maximum of 5% of the total subscribed capital of the RMB Fund Enterprise, to invest in a RMB Fund Enterprise. In addition, such foreign currency capital contribution, if invested in a "domestic" RMB fund enterprise (i.e., a RMB fund enterprise that only has domestic investors), will not taint the "domestic" nature of the RMB Fund Enterprise and cause it to be subject to the industry restrictions mentioned above.

Taxation of investors (limited partners)

A partnership is generally regarded as a tax transparent entity for China tax purposes. However, since the detailed tax rules for an FIP have not yet been issued, many uncertain tax issues currently surrounding the FIP structure apply to a RMB fund enterprise or FMC established in the form of FIP under the Pilot Measures. For example, will the foreign corporate partner (i.e., the foreign limited partner) be subject to 10% withholding tax in respect of the allocated taxable income or will the prevailing corporate income tax rate of 25% apply? Would the nature of income derived by the FIP flow through to the foreign partner? Will a foreign partner in a RMB fund enterprise established in the form of FIP that has entrusted all of its investment activities to a separate FMC be regarded as having a permanent establishment in China?

Taxation of GP

The taxation of the GP is similarly unclear. For example, should the carried interest allocated to a GP be treated as allocation of partnership income and therefore retains its character or as compensation for the GP's management role?

Conclusion

The Pilot Measures are generally seen as a breakthrough for the asset management industry in China. In addition to Shanghai, Beijing and Tianjin are also looking to introduce similar measures. This shows the commitment of the Chinese government in developing the asset management industry in China. While

there are still a lot of uncertain tax and regulatory issues surrounding a RMB fund enterprise established in the form of a FIP, it is generally believed that over time, there will be more development, clarification and guidance on the establishment and operation of a RMB fund enterprise in China.

Korea – private equity fund

Background

The Korean government introduced the private equity fund (**PEF**) regime in Korea in late 2004. As a regulated entity, a Korean PEF is subject to various disclosure requirements and restrictions under the Korean PEF law including leverage and outsourcing restrictions.

From a tax perspective, the main limitation of a Korean PEF was that the underlying income of the PEF is re-characterised as a dividend upon distribution by the PEF, which meant that underlying capital gain from shares, which may have been potentially exempt under a treaty if the Korean investment is held directly by an offshore PEF, would be subject to Korean tax as a dividend.

However, in the aftermath of the Lone Star and other similar cases in which the National Tax Service (**NTS**) challenged the treaty exemption of capital gains based on the beneficial ownership (**BO**) test, there appears to be increased market perception that using Korean PEF poses a lower risk than an offshore holding company structure as at least some tax is paid in Korea and compared to a capital gain, no application is required to be lodged to claim the reduced treaty rate for dividends and therefore it does not attract immediate attention from the NTS. However, it is noted that the BO test applies equally to dividends as well as capital gains and therefore from a pure technical perspective, the treaty shopping risk may not necessarily be mitigated by the use of the Korean PEF.

In terms of the potential permanent establishment (**PE**) risk, the Korean PEF structure should offer better protection since the structure consists of a Korean domiciled fund being managed by a Korean general partner (**GP**) and so there is no question of the Korean GP creating a PE of a foreign investor.

Taxation at the PEF level

The Korean PEF must be a corporate entity in the form of a *Hapja hoesa*, which is similar to a corporate limited partnership and accordingly, the Korean PEF is prima facie subject to corporate tax. However, under the dividend declared deduction (**DDD**) rule a Korean PEF is entitled to a tax deduction for declared dividend where 90% or more of the annual profits of the PEF are declared as a dividend. As a result of the DDD rule, a Korean PEF that pays out its profits is generally not subject to tax.

However the DDD regime has been repealed for PEFs set up on or after 1 January 2009. Instead a PEF may now elect to apply the partnership tax regime. Under the partnership tax regime, the Korean PEF is treated as a quasi transparent entity and no tax is levied at the PEF level. However, the limited partners (**LPs**) are subject to tax on their share of the profits as dividends, similar to the DDD regime.

Taxation of LPs

The profits allocated to the LPs are re-characterized as dividends and tax losses incurred by the PEF are not allocated to the LPs. However, such losses may be carried forward for up to 10 years and deducted from the future profits to be allocated to the LPs.

The profits allocated to foreign LPs are subject to Korean withholding tax as dividends at 22% (including resident surtax, hereinafter all tax rates are inclusive of resident surtax where applicable). The rate of withholding tax on dividends may be reduced by an applicable tax treaty.

Taxation of GP

A corporate GP is generally subject to Korean tax on their share of allocated profits at the normal corporate tax rate of 24.2%.

Conclusion

While a Korean PEF may potentially mitigate treaty shopping and permanent establishment risks, due to various restrictions and disclosure requirements under the Korean PEF law, a Korean PEF is generally more suitable for passive foreign investors rather than foreign private equity firms that want to actively manage Korean assets.

Australia – managed investment trusts

The managed investment trust (**MIT**) regime was introduced into Australian law as a means of enhancing the competitiveness of the Australian managed funds industry, increasing the level of foreign capital managed by Australian fund managers and supporting the export of Australian fund management services.

The regime attempts to facilitate these objectives by introducing a new regime for the taxation of trusts which qualify as MITs. This regime aims to provide certainty on the tax treatment of the realisation of investments (through a deemed capital gains tax election) and makes available a 7.5% final withholding tax on certain income / capital gains of MITs. However, a qualifying MIT will be

subject to additional rules regarding the tax treatment of investors and managers (i.e., carried interest).

MITs are collective investment trusts that are listed, widely held or held by certain collective investment entities. There are certain additional eligibility criteria relating to:

- the legal form of the trust;
- the nature of its investor base (i.e., whether it is widely held);
- the nature of its investments, of particular importance to private equity is whether the MIT carries on a trading business or controls entities which carry on such a business; and
- its nexus with Australia, in particular whether it is managed and controlled in Australia and whether its investment management activities are carried out in Australia.

which also need to be considered if investors wish to access the concessions under the MIT tax regime.

The prohibition from MITs controlling an active trading business means that this regime may be of limited use for certain private equity investment. Broadly, the MIT structure may not be an appropriate vehicle through which to acquire a majority interest (or exercise influence / control of an investee company at board level) in a trading business. It may also be an inappropriate vehicle for investment into Australia by a closely held non-resident investor group.

Tax treatment for investors (unit holders)

An eligible MIT will be a transparent (i.e., "flow-through") entity for Australian tax purposes. A beneficiary of the MIT will be assessable on its share of net trust income, and the character of the distribution to beneficiaries will match the character of the proceeds received by the MIT on its investments. The comments below relate to individual and corporate MIT investors. The Australian tax treatment of Sovereign wealth funds will need to be considered further.

Gains on investment

The MIT can make a capital gains tax (**CGT**) election in relation to the treatment on disposal of certain 'eligible assets'. These assets include shares, non-share equity interests, units in a unit trust, land or rights or options in relation to these assets. In effect, where this election has been made, any gain derived by the MIT on the disposal of eligible assets will be treated on capital account. As such, this gain will retain the same character in the hands of the investors.

Foreign investors should be able to benefit from Australia's non-resident CGT exemption which disregards a capital gain or loss unless the asset disposed of is "taxable Australian real property" (real property or greater than 10% interests in land rich companies). If the gain relates to the disposal of taxable Australian real property, the capital gain would be subject to withholding tax in Australia at a rate of 7.5% when distributed from the MIT to Investors resident in a country with an appropriate exchange of information agreement.

Australian investors would be subject to Australian tax on their share of gains made from the sale of investments on capital account, but depending on their own particular circumstances. Superannuation funds are entitled to apply a CGT discount of 33⅓% on capital gains where the trust has held the asset for more than 12 months.

Dividends

Foreign investors will be subject to 30% withholding tax on their share of unfranked dividends paid by the MIT (subject to any treaty relief available), unless the distribution is declared to be 'franked' or conduit foreign income. Where the distribution is declared franked or conduit foreign income, there should be no Australian withholding tax for foreign investors.

Australian investors will be required to include their share of dividend distributions in their Australian assessable income, grossed up for the receipt of franking credits (to the extent that those dividends have been franked). Australian residents should be entitled to claim a franking tax offset for any franking credits attached to franked dividends.

Interest

Interest distributed to foreign investors is usually subject to 10% Australian withholding tax, subject to variation by the relevant tax treaty, where applicable.

There should be no withholding tax on interest paid to Australian investors; however, any interest income would be included in the assessable income of the recipient.

Tax treatment for manager

Broadly the manager of a MIT is liable to pay tax on any part of the taxable income not assessable to the investors. In addition there are additional rules covering situations where a beneficiary holds a "carried interest" in the MIT.

A carried interest arises where a CGT asset was acquired because of services to be provided to the MIT by the holder of the CGT asset or an associate, as a manager of the MIT, an employee of a

manager or an associate of such an employee or manager.

The CGT provisions do not apply to distributions on "carried interest" units in an eligible MIT. Instead these returns are included in the assessable income of the carried interest holder for Australian tax purposes (to the extent that they are not already included in assessable income other than under the CGT provisions and are not a return of contributed capital on the carried interest).

Board of Taxation review – collective investment vehicles

The Board of Taxation (**BOT**) is undertaking a review of collective investment vehicles (**CIVs**) on behalf of the Federal Government. This is in response to a recommendation of the Johnson Report that the BOT review the scope for providing a broader range of tax flow-through CIVs.

The BOT was also asked to consider the effectiveness of specific tax rules relating to Australian Venture Capital Limited Partnerships.

A Discussion Paper was released by the BOT in December 2010, and since this time PwC has assisted with submissions in response to the Discussion Paper.

It is anticipated that the review will allow for further reforms of CIVs (including both MITs and Australian Venture Capital Limited Partnerships) in the future. However, in the interim the existing tax laws will be applied.

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Asian holding company locations

Mauritius

Mauritius is widely viewed as an ideal location for investment holding. Mauritius has more than 35,000 companies holding assets outside Mauritius including more than 400 investment funds, a modern institutional and legal framework with laws complying with international norms and standards, and is also viewed as a well regulated financial centre and is not on the blacklist of international organisations like the OECD and the Financial Authority Task Force. Mauritus has a hybrid legal system of common law and civil law with the Privy Council as the ultimate Court of Appeal. Mauritius has also a well educated workforce with a pool of professionals, and a sound local and international banking environment.

Mauritius has signed more than 36 tax treaties, and this tax treaty network facilitates forms of tax planning that are not generally open to traditional offshore centres. Tax treaties entered into by Mauritius generally provide for low or nil withholding taxes on receipt of dividend and interest. There is no capital gains tax in Mauritius. Most of the tax treaties signed by Mauritius prevent capital gains taxation of the Mauritian vehicle in the foreign country. There is no withholding tax on repatriation of profits from a company holding a Global Business Category 1 Licence (**GBC1**), which is the preferred type of vehicle to act as holding company.

Domestic tax regime

GBC1 companies are subject to corporate income tax on their worldwide income at a flat rate of 15%. However, a foreign tax credit (**FTC**) would be available to off-set against the Mauritius tax levied on any foreign source income. The FTC would be the higher of the actual foreign tax paid and 80% of the Mauritius tax charged with respect to that income. Therefore, the maximum tax rate which applies to foreign source income is 3%, and, where it can be shown that the actual foreign tax paid is 15% or more, no Mauritius tax will arise.

Moreover, under Mauritius domestic tax legislation, where 5% or more of the share capital is owned in an overseas resident company, and a dividend is received from it, underlying tax representing the foreign tax charged on the income out of which the dividend was paid, together with any foreign withholding tax deducted at source, can also be considered as foreign tax paid for the purpose of the FTC.

A GBC1 frequently buying and selling securities are specifically exempt from tax on income from such share transactions.

A company holding a Global Business Category 2 Licence (**GBC2**) is not considered as tax resident in Mauritius for tax treaty purposes and are therefore not able to access the tax treaty network of Mauritius. However, GBC2 companies are exempt from all taxes in Mauritius and are not required to file tax returns.

Capital gains

There is no tax on capital gains in Mauritius. Moreover any profits derived by a resident company from sale of securities which it has held for more than six months will be considered as a transaction of a capital nature.

Deductibility of funding costs

The general rule is that the money borrowed by a Mauritius company must be utilised for the benefit of the company's production of taxable income, in order for interest payable on those borrowed funds to be tax deductible.

Dividends paid out of retained earnings are not an allowable expense. However, dividend payments which are charged to the Income Statement under IFRS are normally treated as interest and will generally be tax deductible.

Although Mauritius does not have specific thin capitalisation legislation (restricting the amount of debt borrowed with reference to the company's equity), it does have anti-avoidance provisions which effectively restrict the amount of interest that can be deducted from profits. However, it is understood from the tax authorities that these provisions will not be enforced by them.

Repatriation of profits

Dividends paid by a company resident in Mauritius are exempt from Income Tax. Interest paid by a GBC1 out of its foreign source income to a non-resident not carrying on business in Mauritius is exempt from tax. Any gains or profit from sale of securities in a GBC1 is specifically exempt from tax. There are no Mauritius tax consequences to associated with a liquidation.

Tax treaties

Mauritius has focused its development as an ideal location for holding companies on the use of its growing network of double tax treaties. Mauritius has comprehensive tax treaties with India, China, Singapore and Malaysia. The tax treaties signed by Mauritius are generally based on the OECD Model. According to the tax treaties signed with India, Singapore China and Malaysia, capital gain on sale of securities by a resident of Mauritius are taxable in Mauritius only. As there is no capital gains tax in Mauritius, the gains are effectively not subject to tax at all. It should be noted however that the above provision will only apply if the resident of Mauritius owns less than 25% holding in the Chinese resident company prior to the sale. The tax treaty with Malaysia and Singapore provides for a nil withholding tax on dividends paid to a resident of Mauritius while the treaty with China provides for up to a reduced rate of 5%. The treaty with Singapore also provides for a nil withholding tax on interest paid to a resident of Mauritius.

Hong Kong

Due to Hong Kong entering into a number of tax treaties in the last 18 months, Hong Kong has been attracting significant attention as an alternative regional holding company location.

Hong Kong has always been the favourite tax treaty holding company for investing into China, 5% withholding tax on the repatriation of dividends being the lowest of any tax treaty with China. Hong Kong also has a significant benefit as a holding company to invest into China due to the physical proximity to China, in addition most fund managers who invest in China (or elsewhere in the region) have an office in Hong Kong making it relatively easy to create substance in a

Hong Kong holding company so treaty benefits will be respected.

There are a number of compelling reasons for using Hong Kong as a regional holding company.

Advantageous tax system

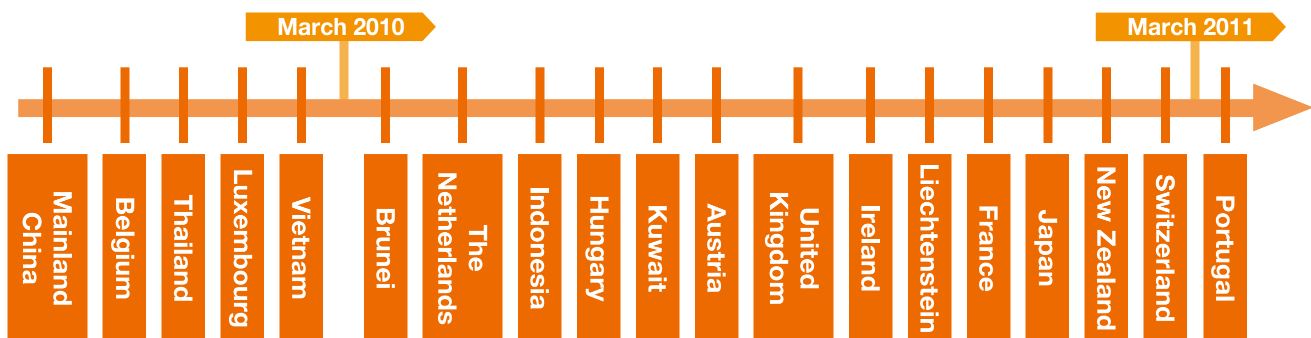
Hong Kong has a territorial basis of taxation, meaning only income sourced in Hong Kong is subject to Hong Kong profits tax. Dividends, whether received from a Hong Kong or overseas company are not subject to tax in Hong Kong. There is also no general capital gains tax regime in Hong Kong, although gains made by Hong Kong holding company as part of a private equity fund investment structure from the disposal of an investment is likely to be on revenue account and thus prima facie taxable. However, provided there is no source to a gain in Hong Kong, a Hong Kong holding company disposing of an investment should not be subject to tax in Hong Kong. To ensure there is no Hong Kong source all negotiations and the conclusion of contracts in relation to the Hong Kong holding company acquiring or disposing of an investment should not take place in Hong Kong.

There is no dividend or interest withholding tax from respective payments from Hong Kong; as a result, the repatriation of any gains derived from a Hong Kong holding company should not result in any Hong Kong tax implications.

Increasing number of tax treaties

Historically, the lack of Hong Kong's tax treaty network meant that Hong Kong was not an optimal regional holding company. However in recent years Hong Kong has been actively expanding its tax treaty network. As at March 2011, Hong Kong has concluded 19 tax treaties and was in the process of negotiating entering into tax treaties with another 11 countries, including India, Korea and Malaysia. The diagram below summarises Hong Kong's tax treaties concluded and in the process of negotiation.

Treaties signed



Some of the above tax treaties are still in the process of being ratified or due to the date of signing are not yet enforceable.

Treaties under negotiation

Czech Republic	India	Korea	Malta	Spain	Saudi Arabia
Finland	Italy	Malaysia	Mexico	UAE	

Beneficial tax treaties

The tax treaties which Hong Kong has entered into generally offer the lowest (or close to the lowest) withholding tax rates; compared with other treaties entered into by the treaty partners. The tax treaties with Hong Kong normally also provide for capital gains tax protection on the disposal of an investment (China being the major exception for holdings of 25% or greater).

The dividend withholding tax rate of 5% with China (as mentioned above) and Indonesia is the lowest of any tax treaties with the respective countries.

Substance in Hong Kong

Hong Kong as an international financial centre offers excellent infrastructure, cost competitiveness and a highly skilled labour force for a fund to set up its operations.

By having fund investment management companies in Hong Kong it is generally easy to create substance in a Hong Kong holding company. With the local regional tax authorities increasing focus on substance when allowing tax treaty benefits this makes Hong Kong very attractive as a holding company location.

Conclusion

Given the financial resources available and the ability to demonstrate substance for claiming tax treaty benefits, Hong Kong should be given serious consideration as a regional holding company from both a commercial and tax perspective.

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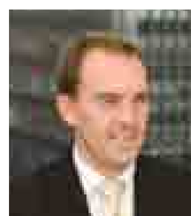

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