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Insights for the private equity and hedge fund communities

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Accounting, financial reporting, and risk management issues associated with hedge fund restructuring

by Christopher McBryan

After the market events in the third quarter of 2008, many hedge funds received redemption requests which, had they been honored, would have significantly impaired the capital base of many open ended hedge funds. This situation was exacerbated, in many cases, by funds that impose gates, or limitations of the amount of capital that can be withdrawn from a fund at a given redemption date (often quarterly, but in some cases monthly). The fear of a gate being shut caused many investors—themselves in need of liquidity—to request redemptions to assure their place in line should the gate come down.

Funds dealt with this flood of redemption requests in many different ways. Certain funds elected to suspend redemptions entirely pending their ability to calculate a net asset value (NAV) that they felt was indicative of true fair value. Others imposed gates to limit the flow of redemptions from the funds. Still others restructured in such a way as to minimize the impact of the current market conditions by creating side pockets and/or special purpose vehicles (SPVs) to house illiquid assets, revising management and incentive fee structures to incentivize shareholders who elected not to request redemptions, or extending lock up periods to investors in the funds. Finally, several funds elected to facilitate an orderly wind down of fund operations after the decision was made that the fund could not continue to operate in pursuit of its stated investment objectives with such significantly reduced capital bases.

There are many issues for management, service providers, and other parties to consider when undertaking a fund restructuring. Decisions related to accounting, operational issues, and financial statement disclosures are critical in order to continue the flow of information related to the fund and its operations.

First and foremost, maintaining an open line of communication with investors regarding the fund's intentions in both the short and long term. It is recommended that the fund's counsel be consulted on all critical decisions related to the restructuring. Compliance with the offering memoranda, private placement memoranda, limited partnership agreement, or other fund governing documents is important to consider prior to undertaking a restructuring. Additionally, significant communications from management to investors regarding the fund's plans should also be reviewed by legal counsel prior to their release.

Compliance with covenants, particularly those present in International Swaps and Derivatives Association, Inc. (ISDA) agreements, is an area that has been the point of particular focus for many fund managers. Many standard ISDA agreements contain covenants that require a certain level of net assets (either on an average basis or periodically), or have performance triggers. Significant redemptions or declines in NAV due to performance can cause the fund to be in violation of its ISDA covenants. Additionally, the ability of a fund to continue as a going concern (formally recognized in an auditor's opinion) can also cause funds to breach covenants. If the fund is in violation of its ISDA covenants, disclosure of the facts and the corrective action taken to cure the violation(s) should be disclosed in the financial statements.

As noted previously, one way that funds are dealing with the significant pressure brought on by the combination of redemptions and declines in net asset values is to impose gates on redemptions, or suspend redemptions entirely. Typically, gates limit the amount of redemptions to a percentage of the fund's net asset value, such as 10 percent, but may vary widely. Additionally, the priority of redemption requests subject to gates may vary depending on the procedures in place at the fund (i.e., are investors required to "get in line" again at each potential redemption date? Are investors allowed to rescind their redemption requests up to the redemption date?). Issues arising from the suspension of redemptions or the imposition of a gate vary depending on these circumstances, but can include various accounting and tax considerations. For example, should redeeming investors participate in profit and loss of the fund after the redemption date and how are redemption requests treated in the financial statements? Typically, only redemption amounts that are fixed and determinable would be classified as liabilities on the fund's balance sheet, with the remainder staying in equity.

Certain tax issues may arise from imposing a gate, however, depending on the terms under which investors request redemptions. If the fund requires that investors "get back in line" before redemption request dates, and if investors are allowed to rescind their redemption requests up until the date of redemption, the fund may be considered continually available for resale. This may cause the partnership to be classified as a publicly traded partnership (PTP) under the applicable treasury regulations, and subject the fund to significant tax liabilities. Depending on the circumstances under which the fund allows investors to redeem their interests, it is recommended that management consult with their tax advisors to ensure that they are in compliance with all applicable exceptions to the PTP rules.

Many funds are also using a combination of suspension of redemptions or imposition of gates along with the establishment of side pockets or SPVs to hold illiquid

assets. Historically, funds have used side pockets and SPVs to hold assets that were highly illiquid and had limited disposal opportunities (i.e., securities of companies in bankruptcy, etc.). Given current market conditions, funds are increasingly turning to side pockets in order to effect the liquidation of hard-to-value securities or securities that management feels are priced below fair market value. In lieu of side pockets, funds are also establishing an SPV in order to carve out specific assets that they feel are less liquid or are not priced at what they feel is fair market value.

There are several issues associated with side pockets and SPVs that management should consider when establishing these structures. Management should ensure that side pocketed or transferred assets are fair valued prior to their transfer, so as to ensure that losses are appropriately allocated to existing shareholders of the funds. If assets are transferred into an SPV, consideration should be made as to the applicability of sale accounting under FAS 140. Additionally, an evaluation as to whether the SPV should be consolidated into the fund should be performed based on the consolidation criteria in the various accounting literature. Finally, an evaluation of which specific assets are to be segregated should be performed so as not to harm existing shareholders or treat new shareholders inequitably.

In exchange for shareholders accepting revised liquidity terms or extended lock up periods, many funds have also elected to restructure the terms of their management and incentive fees. This can have a significant impact on existing shareholders of the funds, particularly when ensuring that existing and new shareholders are treated equitably from the perspective of ensuring that existing loss carryforwards are allocated appropriately. Additionally, financial highlight disclosures in the notes to the financial statements may need to be updated depending on the nature of the waivers and the class(es) of ownership interest to which they apply.

From a financial statement perspective, the more transparent the restructuring is on the face of the financial statements, the easier it will be for investors to understand. Disclosure considerations include details of the restructuring, disclosure of amounts of fees waived or reduced on side pockets or liquidating classes of shares, impacts to the financial highlights of the fund, and increased general risk disclosures.

Overall, it is important for management to be as transparent as possible with investors, address the risks and impacts from an accounting and operational perspective, and communicate throughout the process with their legal counsel, service providers, and auditors.

Partnership deferred compensation and carried interests

by Monte A. Jackel and Robert J. Crnkovich,
with foreword by Gina Biondo and Allison Tucciarone

The article below explores the interaction of the deferred compensation rules and the partnership allocation and distribution rules, and also examines some of the key issues that have arisen with the carried interest legislation under the Rangel bills and Levin bill, comparing and contrasting certain differences. President Obama's fiscal year 2010 budget includes a provision to change the tax treatment of the carried interest as a revenue raising provision, making it more likely that such a legislative change will occur in the near future, although it is still unclear whether such provision would be modeled after Rangel or Levin's proposal.

Many alternative investment partnerships have evaluated what effects the deferred compensation rules of sections 409A and 457A and the proposed carry interest legislation will have on their businesses. Historically, general partners of alternative investment funds have been able to earn a significant portion of their income as an "allocation" and were also able to defer a portion of their income relating to fees earned from offshore funds. While section 457A effectively ended hedge fund deferral, many funds also turned to holding assets through partnerships rather than corporate entities in order to minimize the impact of the deferred compensation rules relating to the use of "side pockets" or multi-year performance fees. More recently, some have questioned whether an allocation of income taxed under the carried interest legislation as ordinary income for services rendered could find its way back into the punitive deferred compensation rules, given the lag between the related services and respective compensation, especially with private equity funds or hedge funds with side pockets or other multi-year fee arrangements. The article summarizes the state of the law regarding the impact of the deferred compensation rules to a partner's share of profits.

The article also provides insights in the international arena where nonresident owners own a portion of the carried interest vehicle as to whether such amounts may now give rise to effectively connected income where the carried interest is attributable to services performed in the US, how the sourcing rules come into play, and the interaction of the trading for one's own account exception.

From a private equity perspective, sections 409A and 457A left room for deferral and character conversion using "cashless contribution;" however, the carried interest legislation will most likely put an end to this from a character perspective taxing the income earned as ordinary. There are exceptions for allocations from invested capital but cashless contributions have been carved out of this definition. Management fee "waivers" may still allow a deferral of income recognition if they can pass the "substantial risk of forfeiture" test, but based on the Levin bill and Rangel bills will be treated as ordinary income. General partner loans may come back

as a more viable option to meet cash flow needs of the general partners, although the loans will need to be obtained from a third party and not the partnership or other related partner.

The article below sheds light on how deferred compensation rules affect your business.

—Gina Biondo and Allison Tucciarone

A partnership is a flow-through entity, entitling its partners to recognize their shares of partnership income, gain, loss, and deduction as if earned directly by the partners. The character and timing of those items, as reported by the partners, will generally match those of the partnership. If a partner receives compensation in the nature of a partnership "profits interest" in exchange for services rendered to the partnership, the receipt of the profits interest is generally tax-free.¹ If the partnership to which the profits interest relates generates capital gains, this arrangement may entitle the service provider to the best of all worlds—tax-free receipt of the interest coupled with favorable timing (recognized when the partnership earns that income) and character (income taxed at capital gains rates).

To limit the timing benefits of certain deferred compensation arrangements, Congress enacted section 409A as part of the American Jobs Creation Act of 2004.² This provision imposes stringent requirements on the ability of taxpayers to defer income recognition under nonqualified deferred compensation plans. As discussed below, administrative guidance under this statute has dealt with the interaction of section 409A and the partnership allocation and distribution rules.

1 See *Rev. Proc. 93-27, 1993-2 C.B. 343, Doc 93-6562, 93 TNT 123-7*; and *Rev. Proc. 2001-43, 2001-2 C.B. 191, Doc 2001-20855, 2001 TNT 150-11*. In a typical private equity or hedge fund, the general partner will receive a share of profits (e.g., 20 percent) that is not proportionate to its capital interest (e.g., 1 percent). This excess profits interest, often referred to as a "carried interest," generally will be structured to satisfy the requirements of these revenue procedures.

2 P.L. 108-357, section 885(a), generally effective for amounts deferred after Dec. 31, 2004.

Additional complexity on the timing of income recognition was added when section 457A was enacted into law as part of the Tax Extenders and Alternative Minimum Tax Relief Act of 2008.³ This provision overrides the general rules on income realization and constructive receipt and requires an earlier inclusion of deferred compensation in gross income if the sponsor of the nonqualified plan is based in an offshore jurisdiction that functions, essentially, as a tax haven.

In addition to timing issues, the House has addressed the character issue as well, twice passing legislation to tax carried interests as ordinary income for the performance of services⁴ (collectively, the “Rangel bills,” after House Ways and Means Committee Chair Charles B. Rangel, D-N.Y.). This legislative proposal was also part of President Obama’s recently released proposed budget. And, on April 2, House Ways and Means Committee member Sander M. Levin, D-Mich., introduced H.R. 1935 (the Levin bill), which would, once again, tax allocations on a service-related partnership interest as ordinary income.

Those provisions have created tension in the application of the partnership allocation and distribution rules to service partners. Our purpose here is to examine some of the key issues that have arisen in the interaction of the new provisions with the partnership allocation and distribution rules and discuss issues that should be addressed if the Levin bill is enacted in its current form.

Timing issues

Regarding the impact of sections 409A and 457A to a partner’s share of partnership profits, the IRS has provided relief by excluding partnership allocations from the reach of the rules. Regarding section 409A, the IRS issued *Notice 2005-1*⁵ which, at A-7, provides the following:

[U]ntil additional guidance is issued, for purposes of section 409A taxpayers may treat the issuance of a partnership interest (including a profits interest)... granted in connection with the performance of services under the same principles that govern the issuance of stock.... Specifically, until additional guidance is issued, for purposes of section 409A, taxpayers may treat an issuance of a profits interest in connection with the performance of services that is properly treated under applicable guidance as not resulting in inclusion of income by the service provider at the time of issuance, as also not resulting in the deferral of compensation. Similarly, until additional guidance is

issued, for purposes of section 409A, taxpayers may treat an issuance of a capital interest in connection with the performance of services in the same manner as an issuance of stock.... In addition, until further guidance is issued, taxpayers may treat arrangements providing for payments subject to section 736 as not being subject to section 409A, except that an arrangement providing for payments which qualify as payments to a partner under section 1402(a)(10) are subject to section 409A. Finally, section 409A may apply to payments covered by section 707(a)(1) (partner not acting in capacity as partner), if such payments otherwise would constitute a deferral of compensation under a nonqualified deferred compensation plan.

Additional guidance was provided regarding guaranteed payments in the preamble to the section 409A proposed regulations:

Commentators have asked whether section 409A applies to guaranteed payments for services described in section 707(c). Until further guidance is issued, section 409A will apply to guaranteed payments described in section 707(c) (and rights to receive such guaranteed payments in the future), only in cases where the guaranteed payment is for services and the partner providing services does not include the payment in income by the 15th day of the third month following the end of the taxable year of the partner in which the partner obtained a legally binding right to the guaranteed payment or, if later, the taxable year in which the right to the guaranteed payment is first no longer subject to a substantial risk of forfeiture.⁶

The preamble to the section 409A final regulations⁷ provided further guidance, addressing the treatment of section 736 payments to retiring partners:

Commentators raised issues concerning the application of the provision in *Notice 2005-1*, Q&A-7 stating that until further guidance is issued, taxpayers may treat arrangements providing for payments subject to section 736 (payments to a retiring partner or a deceased partner’s successor in interest) as not being subject to section 409A, except that an arrangement providing for payments that qualify as payments to a partner under section 1402(a)(10) is subject to section 409A.... Commentators questioned the appropriateness of the inclusion of such arrangements under section 409A, because neither the statute nor the legislative history refers to section 1402(a)(10). However, the Treasury Department and the IRS believe it is appropriate for such arrangements to be subject to section 409A because such arrangements are purposefully created to provide

3 P.L. 110-343, section 801(a), Div C, effective for amounts attributable to services performed after Dec. 31, 2008.

4 See H.R. 6049, passed by the House in 2008, and H.R. 3996, passed by the House in 2007.

5 2005-1 C.B. 274, *Doc 2004-24026*, *2004 TNT 245-10*.

6 Section IIE to the Explanation of Provisions, *70 Fed. Reg.* 57,930.

7 Section III G to the Explanation of Provisions, *72 Fed. Reg.* 19,234.

deferred compensation, and do not raise issues regarding the coordination of the provisions of section 409A with the provisions of section 736, specifically the rules governing the classification of payments to a retired partner under section 736(a) (payments considered as distributive share or guaranteed payments) and section 736(b) (payments for interest in partnership).

After enactment of section 457A, questions arose whether the definition of “deferred compensation” under section 409A as it relates to partnership arrangements would apply for purposes of section 457A. In *Notice 2009-8*,⁸ A-2, the IRS answered in the affirmative, referring to the prior guidance:

[T]he term *nonqualified deferred compensation plan* has the meaning given such term under section 409A(d) and reg. section 1.409A-1(a). With respect to an arrangement between a partner and a partnership, taxpayers may rely upon the applicable guidance under section 409A, which... included *Notice 2005-1*, Q&A-7 (2005-1 C.B. 274), section II.E of the preamble to the proposed section 409A regulations published on October 4, 2005 (70 *Fed. Reg.* 57,930) and section III.G of the preamble to the final section 409A regulations published on April 17, 2007 (72 *Fed. Reg.* 19,234). [Emphasis in original.]

The section 409A guidance has limited application to partnership allocations/distributions, section 736 death/retirement payments, and section 707(c) guaranteed payments. With the sole exception of retirement payments under section 1402(a)(10) and guaranteed payments of cash method partnerships that are not paid on a current basis, all other partnership allocations/distributions and payments to partners, in their capacity as partners, are excluded from the deferred compensation rules of sections 409A and 457A.

Character issues

Turning our attention to recently proposed character-changing legislation, the proposed carried interests legislation generally would treat allocations from an “investment services partnership interest” made to a partner who directly or indirectly provides a “substantial quantity” of services concerning “specified assets” of the partnership as ordinary income “for the performance of services” of the partner.⁹ It is clear that the proposed legislation would not accelerate the timing of the income inclusion by the partner. It would merely change the

⁸ 2009-4 IRB 347, *Doc 2009-407*, 2009 *TNT* 5-5.

⁹ As noted below, the Levin bill would eliminate this semantic issue by omitting the words “for the performance of services” each place it would have otherwise appeared, merely characterizing the allocation or gain on disposition as “ordinary income.”

character of the partner’s allocation to “ordinary income” regardless of its character in the hands of the partnership under the rules of section 702(b). Thus, even though labeled as an allocation for the “performance of services” under the Rangel bills, allocations to partners under this proposed regime would not be treated as deferred compensation for purposes of sections 409A and 457A.

Levin and Rangel bills¹⁰

There are several differences between the Levin bill and the Rangel bills, with the Levin bill revealing an evolution in thinking since the first introduction of the Rangel bills in 2007. Following is a summary of the primary differences between the legislative pieces.

The Levin bill would add two new rules to section 83¹¹: (1) the fair market value of a partnership interest issued for services would be treated as equal to the liquidation value of the interest, unless the IRS provides another rule; and (2) the rule for a section 83(b) election would be reversed, with the election deemed made unless the partner elects out of the inclusion rule.¹² Left unaddressed, unfortunately, is whether the pre-existing partners of the partnership have a realization event under section 1001 if a share of appreciated or depreciated partnership capital shifts to the service partner as part of the transaction. This should be addressed in future legislative proposals.

Importantly, the Levin bill deletes the words “for the performance of services” each place it appeared in the Rangel bills’ versions of proposed section 710. There is no explanation of the Levin bill as of this writing, but presumably this change was made to avoid issues, particularly in the international area, in calling the income “ordinary income for the performance of services,” thereby potentially bringing into play the sourcing rules

¹⁰ There has been a significant amount of commentary on the carried interest provision since its first introduction several years ago. For a survey of the literature on the technical aspects of this subject, see New York State Bar Association Tax Section Report on Proposed Carried Interest and Fee Deferral Legislation (Sept. 24, 2008), *Doc 2008-20493*, 2008 *TNT* 187-42; Michael L. Schler, “Taxing Partnership Profits Interests as Compensation Income,” *Tax Notes*, May 26, 2008, p. 829, *Doc 2008-9190*, or 2008 *TNT* 103-40; Howard E. Abrams, “Taxation of Carried Interests,” *Tax Notes*, July 16, 2007, p. 183, *Doc 2007-15317*, or 2007 *TNT* 137-43; Abrams, “A Close Look at the Carried Interest Legislation,” *Tax Notes*, Dec. 3, 2007, p. 961, *Doc 2007-25737*, or 2007 *TNT* 233-35; ABA Section of Taxation Comments on H.R. 2834 (Nov. 13, 2007), *Doc 2007-25289*, 2007 *TNT* 220-25; Carol Kulish Harvey and Eric Lee, “A Technical Walk Through the Carried Interest Provisions Contained in Chairman Rangel’s Tax Reform Proposal,” *Taxes Magazine*, CCH, Feb. 2008.

¹¹ Section 83, “Property Transferred In Connection With Performance Of Services,” provides detailed rules for the inclusion in gross income of noncash compensation provided to a service provider.

¹² Section 83(b) provides for elections to include “unvested” property in income in the year of the election. The liquidation value proposed change to section 83 would provide statutory support for the IRS to provide for liquidation value to be the measure of income inclusion for partnership interests issued for services in appropriate circumstances.

for nonresidents and services. Although not defined in proposed section 710, the reference to “ordinary income” incorporates section 64.¹³ Thus, the term includes any gain from the sale or exchange of property that is neither a capital asset nor property described in section 1231(b).

The Rangel bills provided for ordinary income on the “disposition” of a partnership interest and said nothing about nonrecognition transfers triggering this rule. The Levin bill expressly provides that nonrecognition provisions are specifically overridden. Thus, if enacted in its current form, section 351 incorporations of partnership interests or the tiering down of partnership interests under section 721 would trigger ordinary income under this rule.

The services rule in the Rangel bills looked to actual services rendered in a trade or business by the service-providing partner, thereby raising the question of whether the partnership interest status as an “investment services partnership interest” would change from year to year if services were rendered in one partnership year but not in the next year, and what the reference to “trade or business” of the service partner meant. Also, the Rangel bills did not deal with services provided by a party related to the holder of the partnership interest. In contrast, the Levin bill looks to “reasonably anticipated” services to be provided by the service partner on the date of acquisition of the partnership interest and not to actual services, thereby intending to characterize the nature of the partnership interest once at inception by the service partner. The Levin bill also deletes the “trade or business of providing such services” reference, eliminating the confusing issue of whether trade or business was determined at the partnership or partner level. And, in a significant change, the Levin bill adds services provided by a party related to the holder (under sections 267 or 707(b)) as creating an investment-services partnership interest.

Of note to the real estate industry, the Levin bill changes the specified asset reference of “real estate” in the Rangel bills to “real estate held for rental or investment,” thereby exempting operating real estate businesses from the carried interest rule. The Levin bill also adds “interests in partnerships” to the list of “specified assets” without requiring a look-through to the assets of the partnership.¹⁴ This last provision seems targeted at attempts to avoid the ordinary income carried interest rule by dividing a partnership’s assets into separate tiered partnerships.

The Rangel bills separated capital from services by providing that a “reasonable allocation” of partnership items attributable to invested capital was not subject

13 Section 64 applies “for purposes of this subtitle,” as does this definition of “ordinary loss” in section 65.

14 Section 475 already includes partnership interests that are widely held in its definition of securities. See section 475(c).

to the carried interest rule, and then providing that the allocation to the service provider could not exceed any allocation on capital to a non-service provider. This rule had a cliff effect of apparently subjecting the entire partnership interest to the provisions if the allocation violated the “could not exceed” rule.

The Levin bill adds a new concept, a “qualified capital interest.” Under this rule, allocations of items to the service partner on the capital portion of the interest are exempt from the ordinary income rule if (1) they are allocated in the same manner to a nonservice providing partner who is not related to the service partner, and (2) the allocations to the nonservice partners are significant when compared with the allocations made to the service provider’s qualified capital interest. The Levin bill also greatly expands what is part of the capital interest. In addition to the fair market value of cash or property contributed to the partnership as was contained in the Rangel bills, there is also included any amounts included on grant of the interest under section 83, and the excess of net income allocated but undistributed to the partner.¹⁵

The loan rule in the Rangel bills is the same as in the Levin bill except that loans by related parties are added to the Levin bill. Under this rule, loans made to the service partner by other partners or by the partnership or by related parties will not be treated as capital of the service partner, but loans by nonservice partners to the partnership or by related parties thereto will be treated as capital of those other partners. It appears, however, that even though a loan from a prohibited source may be repaid by the service partner out of personal funds, the loan repayment will not be treated as increasing the qualified capital interest portion of the investment services partnership interest because the Levin bill affirmatively states that a prohibited loan is not taken into account and does not address loan repayments.¹⁶

The Rangel bills did not include S corporations in the disqualified interests list, whereas the Levin bill allows the IRS to add S corporations to the disqualified interest list. Thus, shares of stock in an S corporation holding

15 There appears to be a glitch in the proposed effective date. The addition for undistributed net income would apply only to income allocated that is subject to proposed section 710 when effective. However, no effective date is provided for capital contributions made before section 710 would become effective, thereby presumably including capital contributed many years ago but not including income allocated but not distributed in prior years. If this is the case, difficult tracing rules would come into play to determine what is capital contributed from prior years and what is undistributed net income from prior years.

16 Even if some loan repayments, such as out of personal funds, would create additional qualified capital, there would need to be complex tracing rules because, for example, if the loan was repaid out of a service partner’s allocated but undistributed partnership net income, no addition for the loan repayment should be made—in that case, it should be treated as a partnership distribution followed by a recontribution to the partnership.

specified assets may be treated as a disqualified interest if the IRS so provides.¹⁷

The Rangel bills did not contain a special rule for publicly traded partnerships (PTPs) because the income was proposed to be “compensation for the performance of services,” which is clearly not qualified income under section 7704(c). The Levin bill adds a special rule for these partnerships because section 710 would only treat the income as ordinary.

The Rangel bills only included the section 710 income as Self-Employment Contributions Act; section 710 losses would not have reduced SECA income. The Levin bill expressly allows section 710 losses to offset SECA income.

Effective date and transition rules

Although the effective date of the proposed carried interests legislation has not yet been determined, under the Levin bill the new provisions would apply to the lesser of (1) the net income of the partnership for the tax year, or (2) the net income of the partnership earned after the date of enactment of the statute.¹⁸

Also, the Rangel bills’ transition rule for PTPs differs from that of the Levin bill. The Rangel bills would apply to PTPs in 2011, whereas the Levin bill would grant a 10-year transition period.

17 The Levin bill would not change current law to the extent that an S corporation is a partner in a partnership and the S corporation provides services to the partnership holding specified assets. The shareholders of the S corporation will, based on the form of the transaction, not be subject to the self-employment tax because the Levin bill modification to the Rangel bills’ SECA rule under section 710 would subject only individuals to its reach. However, failure to pay reasonable compensation to the controlling shareholders could still create issues under the Self-Employment Contributions Act as under current law.

18 It is interesting to note that, if the first year after the date of enactment were to yield a net loss, the loss would not be deductible because losses on an investment services partnership interest could offset only net income from such an interest and the only tax years of the partnership that would be taken into account for this purpose are years after the date of enactment—a truly odd result. Compare this result to in-kind partnership distributions to a service partner that would be subject to the provision only if made after the date of enactment, as well as to sale or redemption payments that would be subject to the new regime only for sales or distributions after the date of enactment. As noted above, there appears to be an effective date issue relating to when capital contributions are counted in testing for a “qualified capital interest.”

Conclusion

The deferred compensation rules of sections 409A and 457A have, thankfully, left largely untouched the operation of the partnership rules of subchapter K. Rightfully so, in our view, because partnerships are not income deferral vehicles, since at least one partner will always report the income earned by the partnership each year. The carried interest proposed legislation, as reflected in its latest iteration in the Levin bill, would clarify several issues from the prior proposals in the Rangel bills, but would still bring significant new complexity into the operation of the partnership rules in subchapter K.

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Understanding the essential concepts of business continuity and disaster recovery planning

by Carmine Barbato

In light of prolonged market volatility, alternative investment managers are increasingly focusing on business continuity and disaster recovery (BC/DR) planning. How employees will communicate, where they will do their work, and how they will get their work done when a disaster or work stoppage occurs are core questions that all BC/DR plans should address. This article introduces the basic concepts that underpin the development and maintenance of BC/DR plans.

Where should alternative investment managers begin?

Virtually every BC/DR plan specifies the means by which it will be carried out in terms of determining data back-up and data storage logistics, and how a created or purchased technical solution will be implemented to facilitate the plan. Beyond these technical components, alternative investment firms should consider the business and operational components that factor into their BC/DR plans.

Before the development process begins, alternative investment firms may want to review their core functions and strategy to gain a high-level perspective on what needs to be done. For example, consider the fundamental resources required to operate the business and still align with the organization's overall strategy and mission. On a more tactical level, are the organization's multiple and integrated support services reflected in the current BC/DR plan? Further, have stakeholders from all business functions been involved from the start of planning to help ensure that enterprisewide assumptions and requirements have been addressed?

Generally, BC/DR plans can fail when they: 1) rely on staff members who had little or no input in formulating the plan; 2) use time horizons that are too short; 3) do not factor multiple conditions or situations occurring simultaneously into scenario planning; or 4) spend too much time, money, and effort on the technical infrastructure and

not enough on integrating the solutions into the business and operational areas of the organization. Avoiding these four pitfalls can help alternative investment firms develop strong, effective BC/DR plans.

Planning consideration No. 1: Seek experienced resources

A typical weakness of many BC/DR plans is that the team charged with implementing and managing the plan may have had only limited roles in its development. This disconnect can be avoided when the people who will rely on and manage the plan during a crisis are actively involved in developing it. The people who best know where to obtain the data that drives daily operations and business processing are vital to recruit when planning begins rather than looping them in when the plan needs to be implemented.

A practical construct for BC/DR planning

For an enterprisewide BC/DR plan to work effectively under adverse conditions, it should be:

- **Integrated**—A composite, or integrated, plan equally involves and addresses the operations, front office, finance, and IT functions within an organization.
- **Comprehensive**—The plan should be comprehensive and consistent in design and level of detail for each functional area.
- **Risk-based**—Knowledge of the organization's strengths and weaknesses will enable the plan to focus on the organization's key risk exposures.
- **Sustainable**—The plan should be focused on how the organization will perform, recover, and resume normal operating procedures during and after a crisis.

Although building an effective BC/DR plan can be complex, if it is developed while keeping in mind these four characteristics—integrated, comprehensive, risk-based, and sustainable—it will simplify the process and provide a strong foundation for educating and training the staff responsible for implementing the plan’s solutions during and after a crisis.

In addition, BC/DR plans should incorporate the operational, business, and technological aspects of the organization. Sustainable plans are balanced among all three areas, and there are inherent risks that must be addressed in each area:

Operations—To develop this part of the BC/DR plan, it is important to consider every major or critical support service that keeps the processing stream (i.e., trades, data acquisition, communications, logistics, etc.) running and sustainable, sometimes for longer than expected. Being able to conduct business is paramount, and this is why the operational component of the plan is crucial.

Business—Business planning is at the heart of a complete and well-conceived BC/DR effort. Alternative investment firm leaders need a solid grasp of which aspects of the business are in jeopardy when disaster strikes.

Technology—BC/DR plans need to address not only the physical and logistical requirements of data backup, but also how best to build redundancy into the infrastructure as well as a fully functional failover system that supports the operation’s needs. Technology seeps into all aspects of an alternative investment firm, so plans also should integrate technology into the business and operational areas.

Planning consideration No. 2: Factor in appropriate time considerations

When organizations go through the exercise of independent and integrated scenario planning, whatever the proposed alternate solutions are, it is important to consider two factors: the estimated time to operations or expected time to recover (ETO/ETR) thresholds, and the sustainability of the solutions.

Many BC/DR plans envision alternate solutions that accommodate only a portion of the required support services because planners believe that the crisis will be relatively short in duration. Given events of the past 10 years, time frames and conditions that are significantly beyond the norm also need to be calculated as potential variables in scenario planning.

Other factors to consider are:

- Is there an overall, integrated, and well-rehearsed enterprise BC/DR plan in place?
- Is the plan current?

- Does it clearly explain each person’s role and execution responsibilities?
- Does it take into account not only scenario planning, but also the possible cumulative effects and impacts of multiple events occurring simultaneously or sequentially (i.e., the “domino effect”)?

Planning consideration No. 3: Factor in the possibility of multiple, simultaneous adverse or correlated conditions

Events rarely occur in isolation. For example, a hurricane can knock out power to a data center and primary site, but it also may flood the highways that critical staff members use to access the backup or disaster-recovery sites.

To be effective, alternative investment firms’ BC/DR plans should incorporate this possible conflux of adverse conditions.

Planning consideration No. 4: Think holistically during development (technology/business/operations)

Firms should evaluate how the business functions and how data is acquired and processed. Technical and logistical support, such as access to applications and systems at the backup site, should be planned for each of the firm’s operations. Organizations also will need to pay special attention to:

- **Data sources**—Determine which data sources are used as feeds/inputs into the operational applications and systems so the backup location can continue to process the same volumes of data.
- **ETO/ETR thresholds**—This metric is used by IT for planning and testing. In order to meet these thresholds, hardware and connectivity issues must be resolved, and the same versions of the software applications must be in place and “active” in the backup site. When developing the BC/DR plan and during a plan’s execution, IT staff should establish and communicate the acceptable ETO/ETR thresholds for business and operations staff members.

Testing: the final phase of development

Finally, it is important to understand that before a BC/DR plan can be considered complete, it needs to be fully tested under simulated crisis conditions that mirror, as closely as possible, the anticipated disaster scenarios. It is important to be thorough in this testing phase but realize it is not possible to accurately plan for every possible contingency or scenario.

The following steps can help keep a BC/DR plan durable and flexible:

- Plan and provide for multiple layers of support
- Plan for sustainable solutions
- Examine practical support logistics for information, processing, and people
- Review the mechanics of the plan's execution:
Will it work in the real world?
- Communicate the BC/DR plans to management and staff
- Assign experienced people to specific BC/DR responsibilities
- Create an ongoing cycle of test, review, improve, and retest

As investors and regulators demand greater transparency from alternative investment firms, a robust, tested, and documented business continuity and disaster recovery plan can help organizations not only survive a disaster, but also thrive in its aftermath by rapidly initiating the plan and restoring critical operations.

Ireland emerging as an onshore investment platform

by Puneet Arora, Brian Leonard and Oscar Teunissen

Certain jurisdictions, including Ireland, have been traditionally utilized as locations for investment companies, owing to their flexible legal, regulatory, and tax environments. Now Ireland also can help satisfy the growing need for more onshore investment platforms with its access to the European Union (EU) market and a wide treaty network, low domestic taxation, and no withholding tax on outbound payments. This article addresses key considerations in choosing an investment platform location and type. It also provides a flavor of what Ireland can offer in this regard.

The location of an investment platform should be:

- Sound in standing in the international business community.
- Tried and tested.
- An easy place to hire investment professionals.
- Efficient and sustainable from a tax perspective.
- An attractive tax regime for holding and financing activities.
- A member of the EU and/or have an attractive treaty network and low or zero statutory withholding tax rates on interest and dividend flows.
- Attractive in terms of low establishment and operating costs.
- Relatively simple and cost-effective with respect to unwinding from legal and tax perspectives.

Ireland has become an attractive location for establishing investment platforms because of the provisions of its tax treaties; its flexible, favorable domestic law tax reliefs; and the absence of controlled foreign corporation legislation. Ireland offers similar flexibility to offshore operations within a regulated framework in a well-established international financial center. Its vehicles include Section 110 companies, qualifying investor funds, and super QIF structures, which are all explained below.

In addition to meeting the key considerations for an investment platform location, Ireland has:

- No tax ruling requirement. Instead, provision for investment platform vehicles is clearly set out in Irish tax legislation, which increases speed to market and reduces costs.
- Low operating and unwinding costs.
- Access to treaty benefits for Irish corporate and fund vehicles.
- No withholding tax on the repatriation of interest and dividends or redemption from an Irish vehicle to non-Irish investors (treaty or nontreaty resident).

Key highlights of commonly used Irish investment entities

The following is an outline of Irish vehicles that can offer an efficient investment platform.

Section 110 company

Ireland has a favorable tax regime for entities known as Section 110 companies. Section 110 refers to the relevant section in Irish tax law that applies to such qualifying companies. A Section 110 company is an Irish resident company that has no specific local management requirements and holds or manages financial assets.

A Section 110 company provides an onshore platform in an environment of increased international focus on tax havens and principles of the Organization for Economic Development, especially transparency. In practice, a Section 110 company can be almost tax-neutral from an Irish perspective. All profit-participating interest payments should be tax-deductible, as should swap payments, management fees, service fees, and other funding costs.

There is no withholding tax on interest payments made by a Section 110 company to persons resident in an EU/treaty country or on interest payments on “quoted Eurobonds” made to persons resident anywhere. A wide treaty network should limit or eliminate withholding tax on inbound flows into Ireland such as interest, dividends, and royalty payments.

As mentioned above, substance requirements for Irish tax residency purposes are minimal. A Section 110 company can hold a wide range of financial assets—for example, shares, loans, futures, options, swaps, and similar instruments (and partnership interests in same).

Applications

A Section 110 company has a number of applications as an investment platform. It can be used as an onshore vehicle for offshore investors; for example, an offshore fund would set up a Section 110 company and provide the investment in the company by way of a profit-participating loan. This is an attractive vehicle because of its low effective tax rate, onshore/EU and Eurozone status, and access to Ireland's treaty network with minimal substance requirements.

It can also be combined with other vehicles (such as a qualifying investor fund) and/or used as an investment platform into countries with favorable treaty provisions, such as China.

Qualifying investor fund (QIF)

The qualifying investor fund (QIF) is one of Ireland's most successful fund structures. Because of their flexibility, QIFs are the vehicles most frequently used for alternative investment funds including hedge funds, funds of hedge funds, venture capital/private equity funds, and real estate funds, as well as for holding investments directly (or via Section 110 companies) in their own right. Since 2007, the Irish Financial Regulator has approved more than 300 QIFs, which can be authorized within 24 hours.

A QIF can offer a tax-exempt, regulated entity in an environment where increased supervision and/or regulation is desired. In addition, it is not restricted to financial assets; it can hold an asset of any class. It can be formed as a company, unit trust, investment limited partnership, or common contractual fund, and it is often used by non-EU promoters to access the EU investor base and/or invest in EU assets.

As a tax-exempt entity, it is not chargeable to Irish tax on income or gains. Also, there is no withholding tax on payments from a QIF to a non-Irish resident, regardless of the recipient's residence. In many instances, a QIF is eligible to take advantage of the Irish treaty network.

“Super” QIF structure

The use of a super QIF structure, in which a QIF holds investments through Section 110 companies, allows investors to efficiently manage their assets while optimizing the tax treatment, eliminating withholding tax on outbound payments and mitigating or eliminating withholding tax on inbound payments within a tax-neutral structure.

As a taxable vehicle, the Section 110 company is eligible to take advantage of the Irish treaty network/EU directives. Tax-free payments may be made to shareholders more easily because there is no withholding tax on income distributed from a Section 110 company to a QIF and no withholding tax on the repatriation of interest and dividends or redemption from a QIF to non-Irish (treaty or nontreaty resident) investors.

In addition, no tax ruling is required from the Irish tax authorities for this structure, which increases speed to market and reduces associated costs.

Applications of QIF and super QIF

The QIF and super QIF are used by offshore investors to finance and hold investments onshore in a tax-efficient manner. The combination of an Irish QIF and a Section 110 company can facilitate a highly efficient, onshore platform structure through minimizing or eliminating inbound tax leakage, offering a low effective tax rate, and having no withholding tax on outbound payments.

The setup costs of a QIF or super QIF structure can be greater than for a Section 110 company because it is regulated and the regulator requires the use of a third-party service provider.

US tax considerations

A Section 110 company can be formed as a public or private company. However, a QIF can be formed as a public company, unit trust or a partnership, but not as a private company. As such, there is flexibility to set up the entity as an “eligible entity” under the US check-the-box rules and an election can be made to treat the entity as a fiscally transparent entity from a US tax perspective. The decision to make a check-the-box election may depend on a number of considerations. In order to get the benefit of direct foreign tax credits (under Section 901) for taxes paid in Ireland or the source country, a check-the-box election should be made. The source and character of income can also be preserved. Overall, a Section 110 company allows significant flexibility to be used as an investment platform entity, for a broad investor base.

Foreign investment funds investing in Russian assets regulatory and tax framework

by Ekaterina Lazorina, Dmitri Semenov and Oscar Teunissen

Extraordinary economic growth in Russia in recent years led to a phenomenal rise in foreign investment and significant gains for many funds. Like much of the world, Russia's economy is now faltering and with tax revenues declining, the Russian tax authorities are beginning to scrutinize foreign investment more closely. Indeed, they have already succeeded in challenging the nontaxable status of certain foreign investors and in taxing gains on the basis that they were attributable to a Russian Permanent Establishment (PE). In this environment, and with the Russian tax authorities likely to become more aggressive, proper structuring of investments into Russia is crucial for mitigating potential tax exposures.

Introduction

The Russian Federation (Russia) is the largest country in the world in terms of size. It has a population of over 142 million people, vast natural resources and rich human capital. Ongoing initiatives have been made to strengthen the tax and legal regulatory framework, which has been viewed positively by foreign investors. In this regard, a corporate governance code was recently introduced and the tax system has been overhauled. There is also a maturing initial public offering culture.

The flow of foreign investment over the last five years has been at record levels. In 2007, the rate of growth of foreign investment into Russia surged by a factor of 2.5, more than any of the world's 15 leading economies.¹ This indicates a growing trend in foreign investment in Russia. Recently, the pace of inbound investment slowed down due to the global financial crisis. However, despite the credit and liquidity crises, Russia continues to present attractive investment opportunities for alternative funds.²

¹ Source: "FDI Surged to Record Levels in 2007" UNCTAD Investment Brief, Number 1 2008.

² The term "alternative investment funds" refers to private equity and hedge funds.

This article addresses management company and fund structuring issues related to the Russian investment structuring for alternative funds.

Management company considerations

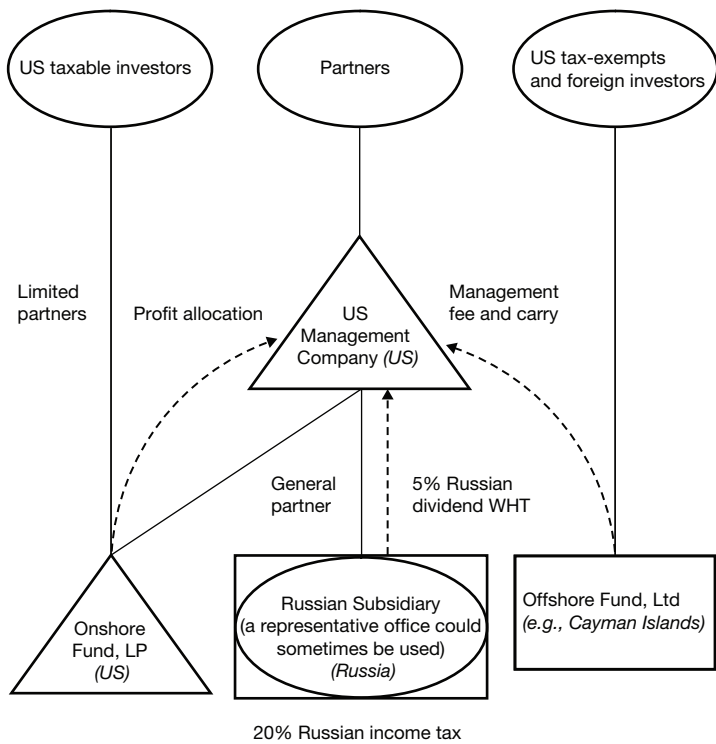
Because of the unique cultural and business aspects of the Russian economy, it is often necessary to set up local management companies to manage Russian investments.

Russian tax legislation neither contains any specific exemption for foreign investment funds investing in Russian assets, nor offers a trading safe harbor similar to that of the US³ to mitigate a local taxable presence. Therefore, the activities of local Russian management companies often need to be limited to research and advisory type activities in order to reduce the risk of having the income from Russian investments held by the funds be subject to 20 percent Russian tax. Operating guidelines could be developed in this respect.

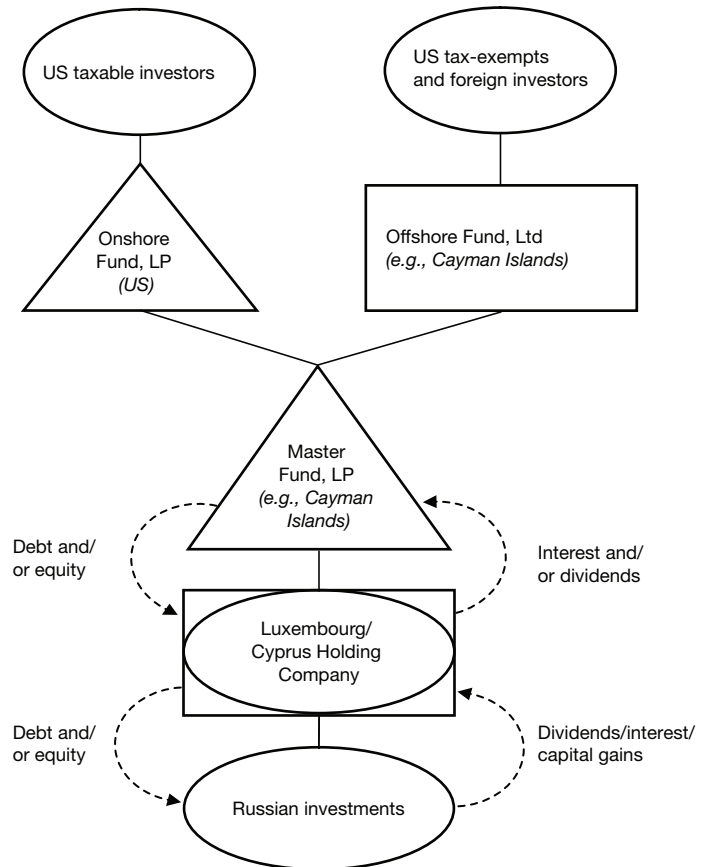
An arm's length sub-advisory fee should be allocated to the Russian management operations. This fee should be taxed at 20 percent income tax in Russia. US management companies often set up Russian subsidiaries, treated as disregarded entities for US federal income tax purposes. Therefore, a US foreign tax credit may be available at the level of the alternate US owners to the extent the Russian advisory business is structured as being fiscally-transparent for US federal income tax purposes.

A typical Russian management company structure could be illustrated as follows:

³ Sec. 864(b) Internal Revenue Code. Unless otherwise noted, all "Section" or "Sec." references herein are to the Internal Revenue Code (IRC or the Code) of 1986, as amended, or to the Treasury Regulations promulgated thereunder. All references to the "IRS" or the "Service" are to the Internal Revenue Service.



protection, financial reputation, reasonableness of the regulatory requirements, tax efficiency and the availability of the tax treaty benefits. Cyprus and Luxembourg have been historically popular as holding company locations for structuring Russian investments. A simplified structure that could be set up in Luxembourg or Cyprus for Russian investments is represented below.



General fund considerations

Alternative funds often invest in different types of assets, including portfolio investments, real estate, nonperforming loans and private equity. Income derived from such investments could be taxed on a gross basis (e.g., 20 percent for interest and 15 percent for dividends) or subject to net taxation (i.e., trade or business income is taxed at 20 percent). Profit derived from the sale of shares of Russian land rich companies (defined as companies with more than 50 percent of the value of their assets derived from real estate in Russia) is subject to tax at a rate of 20 percent.

In the event that the fund has a PE in Russia, then the general Russian corporate tax at a rate of 20 percent would apply on the net income earned by the Russian office (except for certain types of income, e.g., dividends, where the applicable rate is debatable / unclear due to ambiguities of the wording of the Russian tax legislation).

Structuring alternatives

To mitigate Russian withholding and capital gain tax implications outlined above, investment funds can rely on investment platforms set up in treaty jurisdictions.⁴ The critical criteria when choosing a jurisdiction to set up an investment platform in are likely to be property rights

Tax benefits under this treaty structure can be summarized as follows:

	Dividends	Interest	Capital gains
Russia (nontreaty)	15%	20%	As much as 20%
Cyprus	5% ¹	0% ³	0%
Luxembourg	10% ²	0% ³	0%

Notes:

- 1 The 5 percent withholding tax rate applies if the beneficial owner has directly invested in the capital of the company paying the dividends not less than the equivalent of 100,000 US dollars.
- 2 The 10 percent withholding tax rate applies if the beneficial owner holds directly at least 30 percent of the capital of the company paying the dividends and has invested in it at least 75,000 ECU or its equivalent in national currency.
- 3 Interest payments may be exempt from Russian withholding taxes if the beneficial owner of the interest does not carry on business in Russia through a permanent establishment.

⁴ Even though the US has a treaty with Russia, it is often very difficult from a procedural perspective for a US partnership fund to provide the certificate of residency for its partners and substantiate the fact that it should be entitled to DTT benefits.

Substance requirements

Until recently a “form over substance” approach predominated the approach adopted by the Russian tax authorities. However, recent changes in the Russian tax legislation, coupled with a change in the practice of the tax authorities, indicate a move towards a more substantive approach.

This was made evident by the introduction of the term “unjustified tax benefits” that was introduced into Russian law application practice by Resolution # 53 of the Plenum of the Supreme Arbitration Court dated October 12, 2006. This law application practice gives the Russian court the power to find a tax benefit “unjustified.” The characteristics of the unjustified tax benefits include, *inter alia*, inability to perform declared operations or lack of necessary economic conditions to achieve the result claimed by the taxpayer (e.g., absence of qualified personnel).

The Russian tax authorities use the aforementioned principle to determine whether a foreign holding company has sufficient substance to qualify for double tax treaty (DTT) benefits. Therefore, to make the holding company’s substance more robust and improve the chances of qualifying for a DTT benefit, it is generally recommended that the company set up a local office, hire a local employee (preferably one that has sufficient business acumen to make decisions on behalf of the company), and employ directors who periodically travel to the jurisdiction to make decisions. In addition to the nonlocal directors, it is also recommended that local trust directors be hired and that they account for a majority of the board. Although qualifying for treaty benefits is not a certainty, following the above substance guidelines can help to improve those chances.

Luxembourg investment platform

Under the Luxembourg investment platform, an investment fund, say a Cayman Islands based fund (the Fund), would set up a Luxembourg holding company (Lux HoldCo), which, in turn, would acquire Russian assets. Lux HoldCo may be formed as a S.à.r.l., which is a taxable entity entitled to benefits available under the Luxembourg–Russia DTT and the EU directive, provided Lux HoldCo has sufficient substance as defined by the Russian taxing authorities (refer to substance discussion above).

The Fund may capitalize Lux HoldCo with a combination of debt and equity. There are several debt instruments that can be used to fund Lux HoldCo, for example, a convertible preferred equity certificate (CPEC). A CPEC is a hybrid convertible instrument which could be structured so it is treated as debt from a Luxembourg

tax perspective, and equity from a US federal income tax perspective. An advance tax agreement with the Luxembourg tax authorities is usually necessary to secure the qualification of CPECs as debt for Luxembourg tax purposes, as well as the overall tax treatment.

CPECs bear an interest rate and are redeemable upon partial exit when cash extraction is needed. If structured properly, 99 percent of the income can be extracted via CPECs, and the remaining 1 percent should be considered return on equity.

Under Luxembourg domestic law, interest paid out under the CPECs should not be subject to withholding tax in Luxembourg. Thus, interest paid by Lux HoldCo to the Fund under the CPECs should not be subject to tax in Luxembourg.

Since the major portion of the income can be repatriated as interest on the CPECs, which is not subject to a withholding tax in Luxembourg, only a minimal spread, equal to a percentage of the principal of the CPECs, is taxable in Luxembourg, generally resulting in a very low effective tax rate (i.e., often less than 1 percent).

Under the Luxembourg participation exemption, provided certain criteria are met, dividends received by Lux HoldCo from Russian equity investments may be exempt from corporate income taxes in Luxembourg.

In addition, in January 2009, Luxembourg abolished capital duty, making Luxembourg even more attractive as a holding company jurisdiction.

Cyprus investment platform⁵

As an alternative to the Luxembourg investment platform discussed above, an investment platform in Cyprus may be considered. The major difference between the two jurisdictions is the withholding tax on dividends, i.e., in Cyprus the withholding tax on dividends can be as low as 5 percent, while in Luxembourg it is 10 percent.

Under the Cyprus investment platform, the Fund would form a Cypriot holding company (Cyprus HoldCo) and fund it with equity. Cyprus HoldCo would then acquire Russian assets.

⁵ On April 16, 2009, following a year’s intensive meetings and negotiations that concluded in a friendly atmosphere of mutual understanding, the governments of the Russian Federation and of the Republic of Cyprus initialed a final draft Protocol to the Double Tax Treaty between the two countries. This article does not discuss the new protocol in detail. One important change relates to disposals by a resident of one country of shares of companies which derive a substantial part of their value (more than 50 percent) from immovable property situated in the other country. In this particular case, the country in which the immovable property is situated will also have a right to tax the resulting gain. This change is in line with the OECD Model Tax Convention on Income and Capital.

Dividend income received by Cyprus HoldCo is exempt from income tax in Cyprus. It is also exempt from the Special Contribution for Defense levy provided that Cyprus HoldCo owns at least 1 percent of the Russian company and either (i) not more than 50 percent of the Russian company's activities result, directly or indirectly, in investment income, or (ii) the Russian tax suffered is not significantly lower than the tax rate payable in Cyprus. It is advisable to obtain a ruling with the Cypriot administration in this regard.

There are no withholding taxes on dividend payments made by Cyprus HoldCo to its non-Cyprus tax resident shareholders.

Any gain realized by Cyprus HoldCo on the disposition of shares in the Russian company should be exempt from Cypriot income tax, provided that the shares in the Russian company qualify as "titles" per relevant provisions of the Cypriot income tax law. Any gain arising from the disposal should also be exempt from capital gains tax provided that the Russian company does not own any immovable property in Cyprus, or, if it does, it is listed on a recognized stock exchange.

There is no Cypriot income tax on a disposition of shares in Cyprus HoldCo by the Fund. In addition, there is no capital gains tax on any such disposition provided that Cyprus HoldCo does not own any immovable property in Cyprus, or, if it does, it is listed on a recognized stock exchange.

Interest income which is derived from or closely connected with the trading activities of Cyprus HoldCo is generally subject to Cypriot income tax at the rate of 10 percent, after the deduction of any allowable business expenses. It should be noted that the Cyprus income tax law has provisions under which transactions with related parties should be performed on an arm's length basis. In this respect, loans to and from related parties should carry an arm's length interest rate.

Key US tax considerations related to Russian private equity investments⁶

Foreign tax credits (FTC)

The potential for double taxation exists because the US imposes income tax on its citizens and residents based on their income wherever earned in the world. Subject to many limitations, the US FTC regime mitigates double taxation by allowing a US taxpayer to claim a credit against the taxpayer's US tax liability for any foreign

taxes paid on foreign-source income.⁷ In general, Russian regular income, capital gain and withholding taxes on interest and dividends should be creditable.

While a US corporation can claim FTCs to reduce its US tax liability for taxes paid directly by it, or indirectly through its 10 percent or more-owned foreign subsidiaries, US citizens or tax residents can only claim credits for directly paid foreign taxes. As a consequence, the indirect FTC rules are often irrelevant for hedge funds and their management companies whose ownership does not normally include corporate entities that own a greater than 10 percent interest. Alternative investment funds and management companies often structure their investments through entities that are treated as fiscally transparent for US federal income tax purposes (discussed below). As a consequence, any taxes paid by fiscally-transparent entities should generally be available as FTCs at the level of their ultimate US owners.

US entity classification (check-the-box) rules

Under the US entity classification (the so-called check-the-box rules) regulations,⁸ owners of an eligible foreign or US entity (i.e., one that is not treated as a per se corporation under the regulations) can elect its classification for US federal income tax purposes by checking the box on a timely filed Form 8832 (Entity Classification Election). Treasury Regulations do not prohibit a Luxembourg S.à.r.l. from electing a classification for US federal income tax purposes.

US anti-deferral rules

To the extent equity investments are not treated as fiscally transparent for US tax purposes (refer to the discussion of the check the box rules above), the impact of the US anti-deferral rules needs to be considered. These rules are generally designed to prevent deferral of certain passive income (e.g., interest, dividends, rents and royalties) earned by foreign corporations. Controlled foreign corporation (CFC) and passive foreign investment company (PFIC) are the two main categories of anti-deferral rules.

⁷ To prevent the US Treasury from subsidizing operations abroad, the allowable credit generally should not exceed the applicable US taxes on the foreign source income. The limitation formula is provided under section 904(a) as follows:

$$\text{Maximum FTC Allowable} = \text{US Tax on Worldwide Income} \times \frac{\text{Foreign-Source Income}}{\text{Worldwide Income}}$$

The Code provides specific sourcing rules to compute foreign source income for purposes of the section 904(a) limitation formula. In the case of an advisory company, the income from the performance of services outside of the United States is treated as foreign source regardless of the place of organization of the management company or the location of the service recipient. To make matters more complicated, the FTC limitation applies on a separate category or "basket" basis, as well as on an overall basis. The current FTC limitation rules enacted in 2 separate baskets of income (passive and general limitation).

⁸ Treas. Reg. Sec. 301.7701-1 through Treas. Reg. Sec. 301.7701-3.

⁶ There are a number of changes currently proposed by the Obama Administration in the international tax area that may impact cross border structuring of Russian investments. This article does not discuss these or other proposals that may impact international tax structuring in detail.

The CFC anti-deferral rules apply to US shareholders of certain foreign corporations more than 50 percent of whose total combined voting power, or more than 50 percent of whose total value is owned directly, indirectly, or through attribution by US shareholders for at least 30 days during the taxable year.⁹ A US shareholder is any US person including a US citizen or resident individual, domestic partnership, corporation, trust, or estate that owns directly or indirectly¹⁰ 10 percent or more of the total combined voting power of all classes of stock entitled to vote in such foreign corporation.¹¹

US shareholders that own directly, indirectly, or through attribution more than 50 percent of the stock or value of a CFC, for at least 30 days in any particular year, may be required to include in income for US federal income tax purposes, his pro rata share of the so-called “Subpart F income” of such company for every year it qualifies as a CFC.¹² Also such US shareholders are required to include in income the amounts determined under section 956 (see below) for every taxable year for which any of his companies is a CFC (but only to the extent not previously included).¹³ In general, Subpart F income includes several categories of income of a CFC. One of the categories of Subpart F, foreign personal holding company (FPHC) income, generally includes dividends, interest, rents, royalties, and gains from sales or exchanges of property.

The PFIC regime is designed to tax shareholders of certain companies that generate primarily passive income and/or own primarily passive assets. In general, this regime was designed to tax US persons with respect to the income from companies that serve as “incorporated pocketbooks” and are used to hold or manage personal investments. Unlike the CFC or the FPHC regimes, there is no threshold ownership requirement necessary for the PFIC rules to apply assuming the company meets either the income test (75 percent or more of gross income is passive) or the asset test (more than 50 percent of assets are held for production of passive income).¹⁴ Once a company is considered a PFIC it will generally remain subject to the PFIC rules unless a so-called “purging

election” is timely made.¹⁵ If the purging election is not timely made, then the “excess distribution” rules would apply to the US person that holds stock of a PFIC whenever that shareholder receives a distribution with respect to his PFIC stock.¹⁶

The US shareholder receives an excess distribution if the amount distributed to such shareholder by the PFIC with respect to his PFIC stock for a taxable year exceeds 125 percent of the average distributions with respect to that stock for the 3 previous years.¹⁷ The amount of the excess distribution is first allocated ratably to each day in the US shareholder’s holding period of the PFIC stock.¹⁸ Then, for each year prior to the current year a foreign company is a PFIC after 1986, the so-called “deferred tax amount” and the “interest charge” are calculated.

The deferred tax amount is calculated by multiplying the amount of the excess distribution allocated to each year prior to the current year by the highest rate of tax on US corporations or individuals, whichever applies, in effect in each of those prior years, respectively.¹⁹ The interest that is charged on the deferred tax amount is computed through the due date of the current year tax return as if it were an underpayment of income tax in the prior years to which it relates.²⁰

Conclusion

Political stability and a decrease of the overall country risk, together with high current growth and potential future growth of the Russian economy, are attracting foreign funds’ investments in Russian assets. As described above, a holding company established in Luxembourg or Cyprus may accommodate a wide range of potential investors and can help to facilitate a tax efficient investment.

Through the use of similar investment platforms described above, tax exposure resulting from investments in Russia can be mitigated which may make such investments more attractive and profitable for the investment fund.

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The authors thank Alexander Blacklander and Oxana Yaroschuk for their assistance with this article.

9 Section 957(a).

10 Ownership of controlled or related entities or individuals is generally attributed to a US shareholder under section 958(a)(2) and section 318. For instance, in general, the stock of a foreign corporation owned indirectly through a controlled or a related foreign entity such as a corporation, partnership, trust or estate is attributed and treated as proportionately owned by the persons who are the shareholders, partners or beneficiaries. In certain circumstances, if a partnership, estate, trust, or corporation owns, directly or indirectly, more than 50 percent of the total combined voting power of all classes of stock entitled to vote of a corporation, it is considered to own all the stock entitled to vote (see section 958(b)(2)).

11 Section 951(b). Treas. Reg. § 1.951-1(g), section 7701(a)(30).

12 Section 951(a)(1)(A)(i); Treas. Reg. § 1.951-1(a).

13 Section 959(a)(2).

14 Section 1297(a).

15 Section 1291(d)(2). We understand that RHD did not make a “purging” or a qualified electing fund (QEF) elections under section 1295(a) for any of his entities. A purging election generally has the effect of having the US person recognize any built-in gain in the PFIC stock. A QEF election has the effect of causing the current earnings of a PFIC to be included in income of a US person on an annual basis.

16 Section 1291.

17 Section 1291(b).

18 Section 1291(a)(1)(A).

19 Section 1291(c)(2).

20 Section 1291(c)(3).

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