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Regulatory changes in the US and the EU directive

by Stefanie Neches and Andrew Thorne

On Wednesday, June 17, 2009, the Obama administration released its plan for financial regulatory reform built around five key proposals. The first of these proposals to “promote robust supervision and regulation” of financial firms was designed by the administration to correct the “gaps and weaknesses” that were perceived to exist in the regulatory system. These gaps and weaknesses were highlighted by a number of high-profile frauds and a perception that a lack of transparency into the financial dealings of private investment funds posed an unknown threat to the overall economic financial stability. Embedded in their plan, therefore, was a proposal that would require the registration of advisers to hedge funds and other private investment funds. On July 15, the Obama administration, following on the heels of the earlier broad proposal sent to Congress, proposed legislation under the Private Fund Investment Advisers Registration Act of 2009 requiring the registration of nearly all investment advisers to private investment pools (hedge funds, private equity funds, venture capital funds).

Across the Atlantic a few months earlier, on April 30, the European Commission proposed its own changes to its alternative investment industry when it issued the European Directive on Alternative Investment Fund Managers (AIFM). Like the Obama administration’s plan, the aim of the directive was to bring regulatory reform to AIFM through a series of far-reaching proposals. Given the potential for far-reaching implications, it is important that advisers begin to pay careful attention to both the proposed US legislation and the European Commission directive, particularly if their current or future plans are to expand the investor base to residents of the European Union (EU).

Proposed US hedge fund registration

Under the draft Obama administration legislation, advisers to hedge funds and other private investment funds with more than \$30 million under management (i.e., nearly all AIFMs located or doing business in the United States) will have to register with the Securities and Exchange Commission (SEC), with smaller advisers registering and becoming regulated by individual states. Once registered with the SEC, investment advisers to private funds will be subject to requirements that will require not only additional oversight, but also significant investment in meeting the reporting and compliance requirements of registration. Managers already registered should take note because the proposal will require greater reporting requirements than are currently contemplated in the existing rules if passed.

For example, advisers will be required to report confidentially to the SEC (and indirectly to the Federal Reserve and the Financial Services Oversight Council) the amount of assets under management, borrowings, off-balance-sheet exposures, counterparty credit risk exposures, trading and investment positions, and other important information relevant to determining potential systemic risk and potential threats to our overall financial stability. Reporting to investors, creditors, and counterparties will also be required.

Based on the proposals from the Obama administration, the SEC would also share required nonpublic disclosures with the Federal Reserve and the Financial Services Oversight Council. This information, the regulators believe, will help determine whether systemic risk exists among private funds. While not written specifically to capture private funds or their advisers, such reporting could possibly result in advisers or private funds meeting the standard of a Tier 1 financial holding company as described in the regulatory reform proposals. While the definition and the regulatory oversight mechanism specific to Tier 1 financial holding companies has not yet been established, it is expected that these entities will be subject to stricter requirements concerning capital, liquidity, and risk management standards than other financial firms.

These new proposals will impact US and foreign advisers alike. Within the rules' changes is the proposal that "foreign private advisers" would be exempt from registration. A "foreign private adviser" is defined as any adviser that has no place of business in the United States, does not hold itself out in the United States as an investment adviser, and during the preceding 12 months has had fewer than 15 US clients and less than \$25 million in assets under management attributable to clients in the United States. This is a very narrow exemption, which most foreign AIFMs with US investors will have difficulty meeting.

Finally, regardless of whether an adviser will be required to be registered or is already registered, the SEC has proposed rule changes requiring that advisers deemed to have custody over their clients assets will be required to engage an independent audit firm to conduct an annual surprise verification of assets. This verification will be required regardless of whether a qualified custodian provides statements to investors or the private investment funds issue financial statements annually. It is expected that most advisers of private investment funds will be deemed to have custody over client assets and will therefore be required to have the verification performed.

Registration will require that advisers establish a comprehensive compliance program with strong conflict-of-interest and anti-fraud prohibitions. Advisers should be prepared to undergo regular SEC examinations to monitor compliance and assess potential risk.

The European directive

US managers should also spend time understanding the impact of the EU directive. While it is expected that the earliest effective date will be 2011 with a 3-year grace period for nonmembers until 2014, US investment advisers who currently market or expect to market to residents of the European Union should plan carefully around the proposed rule changes. Targeted to AIFM, the directive is a far-reaching piece of legislation that will significantly impact all advisers, regardless of whether they are based in the European Union. Designed to allow regulators to monitor those advisers it believes pose a potential systemic risk to the economy, the directive will be targeted at advisers with assets under management in excess of €100 million where the manager uses leverage or €500 million where the manager doesn't use leverage and has a 5-year lock-up period.

The impact of this directive will be more far reaching than the proposed US legislation. This is because the directive includes portfolio and leverage disclosure requirements, capital requirements based on assets managed, independent valuation agent requirements, limitations on the use of non-EU depositories for the fund's assets, and, potentially, limitations on the amount of leverage that advisers will be able to utilize.

Perhaps more important to US managers will be limitations on their ability to market in the European Union. The proposed directive will require that non-EU advisers obtain an EU passport allowing them to market their funds in the European Union. Note that, while there is theoretical provision for non-EU domiciles with comparable regulatory oversight structures to obtain reciprocity arrangements with the European Union, history suggests that this will not be an easy provision to enact. For several decades, regulators have been unsuccessfully attempting to have reciprocal access for Undertakings for Collective Investment in Transferable Securities (UCITS) and US mutual funds with little progress, and it is therefore difficult to envision a scenario under which a reciprocal arrangement could be quickly reached between the United States and European Union for private funds. Based on how the rules are currently written, marketing in the European Union will likely require that US advisers establish a place of business in the European Union and become authorized to continue marketing to EU investors.

For the immediate future, investment advisers should continue to monitor the evolution of both proposals. While it is likely that both will go through some changes as the various regulatory agencies and constituents weigh in and propose amendments, we expect that fundamental changes are coming and that many in the industry must invest the time to understand and prepare for additional oversight and regulatory reporting.

The “Big Bang” Protocol and its effects on credit default swaps

by Rebecca E. Lee

Many alternative investment funds buy or sell protection on bonds (or a portfolio of bonds) through credit default swaps (CDS). Recent changes in documentation and market practice for CDS may affect the terms or tax characterization of these products. Many of these changes were optional and may not affect alternative investment funds that did not “opt in” to change their practices. The facts and circumstances surrounding each fund’s changes should be evaluated to determine the tax effect, if any.

For example, the so-called “Big Bang” Protocol has changed the execution of credit default swaps for many alternative investment funds. Prompted by the calls for standardization in the credit markets in light of the credit crisis and the failure of Lehman Brothers Inc., the Big Bang Protocol may have a substantial commercial impact on our clients. The discussion below highlights some of the tax considerations implicated by the Big Bang Protocol and other recent events in the CDS market.

The Big Bang Protocol and related market practice changes for CDS

On April 8, 2009, a number of changes were made to CDS documentation and market practice (referred to collectively here as the Big Bang Protocol) that may affect alternative investment funds’ structures for both new and existing CDS. These changes come at a time when the Obama administration has been considering substantial regulatory reform of the financial markets as a whole.

Changes to the standard ISDA documents

On April 8, 2009, the International Swaps and Derivatives Association Inc. (ISDA) issued the 2009 Supplement to the 2003 ISDA Credit Derivatives Definitions, the governing documents for most ISDA-documented CDS. These changes related

primarily to the determination of whether a credit event has occurred and the manner of settlement, rather than on the determination of the settlement price on the occurrence of such event.

The 2009 Supplement applies to CDS entered into on or after April 8, 2009. CDS participants can opt in and apply the 2009 Supplement for existing CDS. The period to modify CDS ran from March 12, 2009 to April 7, 2009. Certain kinds of credit derivatives, such as standardized CDS including LCDS and LCDX, are excluded from the new protocol.

As a follow-up to the Big Bang Protocol, in mid-July 2009, ISDA published the 2009 ISDA Credit Determinations Committees, Auction Settlement and Restructuring Supplement to the 2003 ISDA Credit Derivatives Definitions and proposed supporting revisions to the Credit Derivatives Determinations Committees Rules. These additional changes, referred to in part as the “Small Bang” Protocol, are intended to provide further stability to the CDS market by standardizing the terms and pricing of the settlement of CDS triggered by debt restructurings.

Changes in market practice

At the same time, CDS dealers have agreed to make changes to market practices for North American corporate CDS to create new standardized products for this market. The changes bring these practices in line with prior changes in the CDS index market.

The most visible change is the standardization of the coupon payments on CDS to fixed payments of either 100bps (for investment-grade credits) or 500bps (for high-yield credits). For the vast majority of CDS, this will require an upfront payment by one counterparty to the other to customize the coupon rate to match the credit profile of the underlying bond.

Other changes to make CDS uniform include standard quarterly settlement dates, standardized accrual terms, and a prohibition against restructuring the CDS during its term.

Market participants still have freedom to execute nonstandardized CDS transactions in certain circumstances.

Additional regulation

Two additional developments may affect the CDS market.

First, as part of its financial regulatory reforms, the Obama administration has proposed the regulation and oversight of over-the-counter derivatives. These regulatory measures, if enacted, likely would cover CDS.¹ These measures have been gaining popularity in Congress as well.²

Second, certain exchanges have already received permission to begin processing and clearing CDS. A CDS may begin as an exchange-traded transaction or may begin “off-exchange” and be moved onto the exchange during its term.

Tax considerations

There are three primary tax considerations from the changes in ISDA documents and market practice described above.

Section 1001 considerations

Many alternative investment funds may choose to adopt the standardizing changes with respect to existing CDS. In most cases, this requires amendments to the terms of the CDS (for example, changing the coupon rate to the standardized rate, coupled with an upfront payment). Changes to existing CDS must be tested to determine whether they rise to the level of a material change in kind or extent (i.e., a realization event under section 1001). Unlike in the debt modification area, there are no bright-line tests for determining whether a realization event has occurred.³

In general, the changes in the contractual terms of the swap, such as changes to the manner in which

the final payment is determined and the time in which final settlement must be paid, likely do not represent “material changes in kind or extent” on the CDS unless the particular change (or set of changes) is economically significant.

Similarly, cumulative changes to the terms of the CDS (like an upfront payment paired with a change in coupon rate to the standardized rate) that keep the economics of the CDS identical to the economics of the old CDS (for example, keeping the coupon rate and exposure the same) likely do not rise to the level of a section 1001 event.

Resetting the pricing of the coupon payments to current interest rates and credit spreads on the underlying risk may result in a realization event under section 1001. Other changes, such as an effective change in counterparty when a CDS becomes exchange-traded, may rise to the level of a section 1001 event. Evaluating whether a section 1001 event has occurred, however, is a facts and circumstances analysis and must be done on a CDS-by-CDS basis.

Treatment of upfront payments

The new standardized CDS form will result in significantly more CDS providing for upfront payments (to adjust the 100 or 500 bps coupon to reflect the credit spread on the underlying bond). Given the uncertainty on the tax treatment of CDS, consideration must be given to the appropriate timing treatment of this payment.⁴ The controlling principle is that the deduction (or inclusion) of the upfront payment must be spread over the term of the CDS.

One straightforward approach for an alternative investment fund treating CDS as notional principal contracts (NPCs) could be to mechanically apply the rules for upfront payments under the NPC rules.⁵ In general, this would require that the upfront payment be broken up into deemed level payments over the term of the CDS (based on a particular interest rate). This calculation may be time and labor intensive, especially for an alternative investment fund entering into a high volume of CDS.

¹ The Obama administration included these proposals as part of its white paper on financial regulatory reform. See Department of the Treasury, “A New Foundation: Rebuilding Financial Supervision and Regulation,” released June 17, 2009. The white paper recommendations were incorporated into the “Over-the-Counter Derivatives Markets Act of 2009,” unveiled by the Treasury Department on August 11, 2009.

² See Release by Congressman Collin Peterson, Chairman, House Agricultural Committee, and Congressman Barney Frank, Chairman, House Financial Services Committee, July 30, 2009.

³ C.f. Treas. Reg. § 1.1001-3.

⁴ See Notice 2004-52, 2004-2 C.B. 168 (IRS soliciting comments on the treatment of CDS for tax purposes; no guidance has been issued since 2004).

⁵ See Treas. Reg. § 1.446-3(f).

It is not clear, however, that a CDS satisfies the definition of an NPC.⁶ Further, this calculation is not necessary for an alternative investment fund treating its CDS as a series of options rather than an NPC, because there are no specific rules for allocating a gross premium paid to a series of individual options.

The absence of specific rules for CDS (as opposed to the specific rules for NPCs) may permit more flexibility in determining the proper method to spread the upfront payment. Where financial accounting principles require an amortization of the upfront payment over the term of the CDS, this amortization may present a reasonable approach to spreading the upfront payment on the CDS for tax purposes.

Section 1256 considerations

The mark-to-market and character rules of section 1256 apply to regulated futures contracts. The definition of a regulated futures contract requires that a contract (1) is traded on, or subject to rules of, a qualified board or exchange and (2) requires the posting of variation margin.⁷ Although it is counterintuitive, the definition of a regulated futures contract does not require that the contract actually be a *futures* contract.

As CDS contracts become more heavily regulated and more commonly exchange traded, alternative investment funds need to assess whether their CDS contracts now represent regulated futures contracts. Section 1256 requires an annual mark-to-market to realize unrealized gain or loss and generally treats such gain or loss as 60 percent long-term capital and 40 percent short-term capital, regardless of holding period.

In the current market, CDS are generally not exchange traded. The question raised is whether the “clearing” of a CDS contract over a qualified board or exchange is sufficient to make it “traded on, or subject to” the rules of that exchange. The core benefits of exchange trading—such as reduced credit risk and standardized price determinations—extend to CDS contracts cleared through the clearinghouse mechanism.

It is important to note, however, that these considerations are not novel to CDS. Other kinds of over-the-counter derivatives, such as commodity swaps, now may be cleared through clearinghouse mechanisms such as ClearPort, which is part of the New York Mercantile Exchange. The literal language of the definition of regulated futures contract might be read as broad enough to include these exchange-cleared contracts.

It is clear, however, based on the Internal Revenue Service’s interpretation of many of the definitions under section 1256, that the determination of whether a type of contract is subject to section 1256 is based on not only the literal language of the statute, but also a thorough investigation of the legislative history.⁸ In the absence of further guidance from the IRS, it may be reasonable to consistently adopt either interpretation.

Alternative investment funds must continue to assess the tax consequences of their CDS transactions as the market evolves.

6 See Treas. Reg. § 1.446-3(c). This matter has been hotly contested by commentators. See, e.g., New York State Bar Association, Tax Section, Report on Credit Default Swaps, September 9, 2005, reprinted at 2005 TNT 176-21.

7 Section 1256(g)(1).

8 For example, the IRS has taken a narrowly tailored view of the definition of a foreign currency contract under section 1256(g)(2) based on the legislative history. See Notice 2007-71, 2007-35 I.R.B. 472, modifying and superseding Notice 2003-81, 2003-2 C.B. 1223 (concluding that foreign currency contracts, although literally included in the definition of “foreign currency contract,” should not be treated as subject to section 1256 based on the legislative history).

Prepare for transition— the FASB codification

by Brian Flynn

After decades of having a multitude of accounting pronouncements that defined generally accepted accounting principles (GAAP), the Financial Accounting Standards Board (FASB) has launched the FASB Codification of US GAAP (Codification). The Codification was launched July 1, 2009 as the sole source of authoritative nongovernmental US GAAP. The Codification will become effective for financial statements that cover interim and annual periods ending after September 15, 2009. The Codification is not supposed to change GAAP, but is a new structure that takes accounting pronouncements and organizes them by approximately 90 accounting topics.

The Codification compiles all accounting authoritative guidance in one place. This should help reduce the amount of time and effort required to research and resolve accounting issues. Having all guidance related to a specific topic in one place will reduce research time and should help mitigate the risk that a relevant piece of guidance is overlooked. The Codification includes all standards issued by a standard setter within levels A through D of the current GAAP hierarchy, as defined by Statement on Auditing Standards No. 69, *The Meaning of "Present Fairly in Conformity with Generally Accepted Accounting Principles."* The FASB will no longer issue FASB Statements, FASB Staff Positions, FASB Interpretations, and Emerging Issues Task Force Abstracts. Updates to the Codification will be through numbered references updated via Codification update instructions (CUIs). The numbered references within the Codification will begin with the year the update occurred. The Codification will continue to provide a Basis for Conclusions in the CUIs that evidence the board's rationale in reaching conclusions on new accounting guidance. All guidance included in the Codification will be considered authoritative, even guidance that comes from what is currently deemed to be a nonauthoritative section

of a standard, such as the Basis for Conclusions. There will then be two levels of US GAAP: authoritative and nonauthoritative. Relevant authoritative guidance issued by the Securities and Exchange Commission (SEC) and selected SEC staff interpretations and administrative guidance will also be included within the Codification.

The Codification is presented in a hierarchy with four basic levels: Topics, Sub-topics, Sections, and Sub-sections. The highest level, Topics, is aggregated into Presentation, Financial Statement Accounts, Broad Transactions, and Industry Specific-Guidance accounting areas. Familiarity with the format of the Codification is key to using it efficiently. Paragraphs in existing standards will be located in different places throughout the Codification. As an example, FASB Statement No. 157, *Fair Value Measurements*, is now referenced as Accounting Standard Codification (ASC) 820 (820 is the topic) under the Codification. Examples of other relevant guidance commonly referenced in financial statements are as follows: FASB Statement No. 161, *Disclosures About Derivative Instruments and Hedging Activity* (effective for interim and fiscal year-ends beginning after November 15, 2008), is now ASC 815; and FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*, is ASC 740. A tutorial of the Codification is included on the FASB's website.

The Codification is available on the Codification website (<http://asc.fasb.org/home>) and certain basic views are free. It is also available through PwC Comperio to subscribers. Users should begin planning now to understand the changes the Codification will bring to the way accounting research is performed and the impact on the guidance references as currently disclosed within the financial statements. Reporting periods beginning after September 15, 2009 should begin to reference guidance, if applicable, using the Codification's reference scheme

versus historical standard references. US GAAP does not require a company's financial statement disclosures to refer to particular accounting standards by name, standard number, or Codification reference number. Preparers will need to use judgment in determining where numerical references to the Codification would contribute to a financial statement user's understanding of a particular disclosure. PwC's view is that companies should strive to describe and reference accounting standards and SEC requirements in their financial statements using plain English instead of specific numerical references. We believe that some preparers will decide to remove numerical referencing altogether, while others will continue to refer to accounting standards using appropriate Codification reference numbers. Both ways are acceptable, as long as the disclosures are sufficiently clear and transparent. The result of the Codification will be, primarily, a change to the way we research accounting, rather than to the form in which guidance is presented.

Dark pools of liquidity

by Keith Caplan, Robert P. Cohen, Jimmie Lenz,
and Christopher Pullano

Dark pools, once the domain of big-block trading, have evolved into a venue that supports high-frequency trading of smaller and medium-sized orders. They are frequently considered part of an alpha protection strategy for asset management and alternative investment firms.

However, some caution is in order since the regulatory light is now shining on dark pools. Recent increases in volume, a lack of transparency for price discovery, and the perception that the retail investor is disadvantaged have all contributed to the increased scrutiny.

Definition and structure of dark pools

The rapid development and continued maturation of the dark pool model are important factors in the evolution of the US and global market structures. Recently, more than 8 percent of all trading volume in US equities was done through dark pools, up from just 3 percent a few years ago.

A dark pool is a source of liquidity that is nondisplayed, or, in other words, does not publicly disseminate quotes. The many benefits of a dark pool include:

- Anonymous trading with minimal market impact
- Price improvement and opacity
- Lower transaction costs
- Less information “leakage”
- Access to as much liquidity as possible through technology

The nature of the dark pool industry has centered on expansion, with various ownership structures supporting many combinations of “matching” characteristics, membership complexion, and order types.

The two predominant types of ownership structures are (1) large broker-dealer-owned dark pools, which have

been successful because of consolidating of internal liquidity and opening up to external sources of order flow, and (2) exchange-owned dark pools, which have been a reactionary move resulting from loss of volume and revenue.

Three basic dark pool structures are employed by the providers:

- Scheduled crossing networks
- Continuous blind crossing networks
- Indicated markets

As for pricing, dark pools use three primary mechanisms, which set the price at which the execution will take place once two sides of a trade are matched:

- Automatic pricing (usually at the midpoint of the best bid and offer)
- Derived pricing (for example, average price during the last five minutes)
- Negotiated pricing

Dark pools have moved significantly from their initial purpose and have matured into a venue that has supported, if not created, a new investment/execution strategy: the “high-frequency” style. Although high-volume trading styles have existed in the past primarily to support statistical and risk arbitrage strategies, these new high-frequency styles operate at a much broader level that relies on speed measured in milliseconds.

As a result, liquidity and transparency in the marketplace are reduced for the small investor and enhanced for the alternative investment firms and other institutional market participants with dark pool access. Reduced liquidity may result in less opportunity for “price improvement,” wider spreads, and, ultimately, more costly executions.

Risk management practices

Because the objective of a dark pool is to reduce market impact, the risks of gaming and front-running are significant concerns of the dark pool operators. As a result, many dark pools use sophisticated antigaming logic, computer programs within algorithms that detect suspicious behavior and prevent crossing at an adverse price.

To provide clients with an additional level of assurance regarding the confidentiality of their orders, some brokers have sought independent verification of their operating procedures and processes.

Industry trends

Overall, dark pool volumes have grown steadily because of technology advances and changes in the regulatory environment promoting competition and electronic trading.

Because exchanges have seen a significant decrease in average trading volume, many exchanges see dark pools as a threat. Matching in a dark pool may allow for execution at a better price with less market impact, and dark pools have made it easier to trade small or midcap stocks that are often lower profile and harder to trade publicly (because they are less liquid). What several exchanges have done to cope with this is develop their own dark pools, in the form of anonymous crossing networks.

Although dark pools historically developed and grew substantially in popularity in the United States, these execution venues have spread rapidly recently in European and Asian markets. A factor of the dark pool proliferation among different regions appears to be their initial success, leading a large number of existing dark pools to provide investors multiple venues for trades.

The consumer interest, as measured by the corresponding volume changes in these execution venues, indicates that this trend will continue.

Competitive impact

The dark pool model is moving away from the notion of a “crossing network” and opening up to algorithms, smart routers, high-frequency traders, and exchange and retail flow. This marks a fundamental shift, from interest in dark pools as institutions for trading less liquid stocks to a new paradigm, in which high volume, liquidity, and speed appear to be the drivers.

Further, providers are using algorithms to tap into several dark pools at one time, continuing the trend of linking and partnering with each other pioneered by Goldman Sachs, UBS, and Morgan Stanley. It is still a challenge for traders to connect to multiple trading venues, hence the fragmented dark pool market. But as the partnership trend continues and smart order-routing technology advances, the market share of dark pools will continue to grow and M&A activity may be inevitable.

Regulatory debate

Along with their growth trends, dark pools have attracted heightened regulatory attention. Several questions concerning the basic nature of “hidden” liquidity, access, and cost/rebates are being reviewed by the Securities and Exchange Commission and the Financial Services Authority in the United Kingdom—which may chart the direction of these execution venues.

Specifically, concerns range from the nonstandardized reporting requirements of dark pools to the automated indications of interest (IOIs) sent among them. The IOIs are sent to seek liquidity from other dark pools to increase the executions within the original dark pool.

Some regulators believe IOIs could affect competition among trading centers and contribute even more to market fragmentation—potentially leading to development of private markets that exclude the public (i.e., retail) investor and hinder regulatory visibility into best execution rule enforcement.

Additionally, the lack of standardized reporting requirements among dark pools has led to inconsistent and unreliable volume statistics. The SEC has suggested that reporting practices, or lack thereof, present a critical transparency issue that should be given more attention. Volume from most dark pools is identified merely as nonexchange or over-the-counter trades, which may lead the SEC to impose post-trade reporting requirements on dark pools.

Further, it has been reported that New York Stock Exchange executives may consider pressing regulators in Washington to look into dark pools, which they believe are continuing to eat into trading volume of the exchange. Since dark pools fall under Regulation ATS and exchanges under Regulation NMS, dark pools have much less stringent requirements, particularly around volume reporting.

Recently, Senator Charles Schumer (Democrat, NY) told the SEC that he will move to limit “flash” orders for stocks if the agency takes no action against them.

The practice routes stock trades through private liquidity pools before they are sent to other exchanges for filling. Critics contend that flash ordering creates a two-tiered system of investors, where those with access get a better price than those without.

Conclusion

Dark pools have historically proven to be popular, useful venues for trading with less market impact for those investors interested in less liquid stocks.

To the extent they are being utilized by alternative investment companies as an important part of an execution strategy, consideration should be given to potential regulatory changes and their effect on investment philosophies that rely primarily on high-volume trading.

All aboard! The impact of the NYS MTA payroll tax on alternative investment fund managers

by Brian J. Rebhun and Allison Wong

On May 7, 2009, New York Governor David Patterson signed into law Assembly Bill A08180, establishing the Metropolitan Commuter Transportation Mobility Tax (MTA payroll tax).¹ This bill was written to alleviate fare increases and service cuts that were adopted in April as part of the Metropolitan Transportation Authority's budget. The bill imposes a new tax on employers and self-employed individuals engaging in business within the 12 counties of the Metropolitan Commuter Transportation District (MCTD), which consists of all five boroughs of New York City, Nassau, Suffolk, Westchester, Orange, Dutchess, Putnam, and Rockland counties.²

The payroll tax is in addition to the MTA surcharge, which is imposed on corporations, transportation and transmission companies, banks, and insurance companies under Articles 9, 9-A, 32 and 33 of the New York tax law.³ Similar to the MTA payroll tax, the surcharge was enacted to help finance mass transportation expenditures in the district. Although originally enacted in 1982 as a temporary surcharge, it has been extended year after year. For corporate taxpayers, the 17 percent surcharge is calculated based on the 9 percent corporate franchise tax rate in effect since 1997.⁴

Undoubtedly, the MTA payroll tax further adds to the high tax burden on alternative investment fund managers doing business in the transportation district. While the intent of the tax is to fund vital mass transportation expenditures without having to significantly raise commuter fares, it may have the unintended effect of driving out alternative fund managers and prolonging the economic recession in New York. This article will discuss the self-employment issues associated with the new MTA payroll tax.

Imposition of MTA payroll tax on self-employed individuals

Effective for tax years beginning on or after January 1, 2009, individuals, including members of partnerships and LLCs that are treated as partnerships, who have net earnings from self-employment allocated to the transportation district are subject to the MTA payroll tax.⁵ The tax is 0.34 percent of the total net earnings from self-employment allocated to the district for the tax year. The tax applies only if the individual's net earnings from self-employment allocated to the transportation district are greater than \$10,000 for the tax year. The \$10,000 threshold test must be applied on an individual basis regardless of the taxpayer's filing status.

"Net earnings from self-employment" means an individual's net earnings from self-employment as defined under Internal Revenue Code (IRC) Section 1402, which defines self-employment income subject to Social Security taxes.⁶ However, the annual limitation on the amount of net earnings from self-employment subject to Social Security tax in computing the amount of net earnings from self-employment subject to the MTA payroll tax does not apply.

"Net earnings from self-employment allocated to the MCTD" means an individual's net earnings from self-employment that are attributable to a business carried on within the district.

"Business activity" is carried on within the transportation district if an individual has, maintains, operates, or occupies desk space, an office, a shop, a store, a warehouse, a factory, an agency, or other place in the

1 NY Assemb. B.A08180, enacted 5/7/09 as Article 23 of NY Tax Law; NY TSB-M-09(1)MCTMT (6/1/09).

2 NY Tax Law § 800(a); NY Public Authorities Law § 1262.

3 NY Tax Law §§ 209-B, 183-a(1), 184-a(1), 1455-B, 1505-a.

4 NY Tax Law § 209-B(1).

5 NY Tax Law § 801(b)(1).

6 NY Tax Law § 800(e).

district where his or her business matters are systematically and regularly carried on. Similarly, business activity is carried on outside of the MCTD if the individual has, maintains, operates, or occupies desk space, an office, a shop, a store, a warehouse, a factory, an agency, or other place outside the district where his or her business matters are systematically and regularly carried on.

Allocation of net earnings from self-employment

An individual is allowed to allocate net earnings from self-employment if business activities are carried on both in and out of the transportation district. If all of an individual's business activity is carried on within the district, all of the individual's net earnings from self-employment are allocated to the district.

An individual who has net earnings from self-employment from activity both in and out of the transportation district must allocate those net earnings for purposes of determining whether the \$10,000 annual threshold has been met and the amount of Metropolitan Transportation Authority payroll tax due. For this purpose, net earnings are allocated using the same rules that apply for purposes of the allocation of business income earned in and out of New York state under the personal income tax rules. Accordingly, if the individual keeps books and records that fairly and equitably show net earnings from self-employment from business activity in the transportation district, the individual may determine the part to be allocated to the district from those books and records.

If the books and records do not fairly and equitably show the net earnings from self-employment in the district, the individual must allocate his or her net earnings from self-employment using the three-factor (property, payroll, and receipts) equally weighted statutory formula method or another method that has been authorized by the New York state commissioner. Members of a partnership or an LLC treated as a partnership will need to obtain allocation information, if applicable, from the partnership or LLC. Individuals, partners, and members of an LLC should focus on the calculation of their three-factor allocation formula, as this will impact the amount of net earnings subject to tax. Partners and members should attempt to receive accurate flow-through income and apportionment information from the partnership and LLC. This is especially important when several tiers of partnerships and LLCs exist.

Estimated MTA payroll tax payments⁷

Individuals, including members of a partnership or an LLC treated as a partnership, who will owe MTA payroll

tax for the tax year must make estimated payments. The estimated payroll tax payments are due April 30, July 31, and October 31 of the current year, and January 31 of the following calendar year. An individual may pay all of his or her estimated MTA payroll tax with the first payment or pay it in four equal installments.

Safe Harbor Rule for 2010

The estimated tax rules that apply for purposes of New York state personal income tax apply to the MTA payroll tax except that there is no exception from estimated payments for taxpayers who expect to owe less than \$300 of MTA payroll tax for the tax year. Therefore, to avoid a penalty for underpayment for the tax year, the individual's total MTA payroll tax payment(s) must be: (1) at least 90 percent of the amount of the payroll tax due for the tax year; or (2) 100 percent of the payroll tax reported for the prior tax year or 110 percent if the individual's net earnings from self-employment allocated to the transportation district for the prior tax year is more than \$150,000. However, this rule does not apply for tax year 2009.

The estimated MTA payroll tax payments cannot be combined with any estimated New York state personal income tax payments.

Special rule for 2009

The MTA payroll tax is imposed on an individual's net earnings from self-employment allocated to the transportation district if those earnings are more than \$10,000 for tax year 2009. However, the individual's MTA payroll tax liability for the 2009 tax year will be computed using ten-twelfths of the total net earnings from self-employment allocated to the district. In the case of a member of a partnership that operates on a fiscal year basis, the partner will include in the computation ten-twelfths of the net earnings from self-employment allocated to the district for the partnership's entire fiscal year that ends in the 2009 tax year.

If an individual is subject to the MTA payroll tax for 2009, the initial estimated payment is due November 2, 2009, (due to October 31, 2009, falling on a Saturday). The estimated payment due November 2, 2009, should reflect 75 percent of the tax due for the 2009 tax year.

Annual MTA payroll tax reconciliation

An individual with net earnings from self-employment must file an MTA payroll reconciliation return to reconcile his or her estimated payroll tax payments. The return is due on or before the 30th day of the fourth month

⁷ NY Tax Law § 804(b).

following the close of the tax year. (For calendar-year taxpayers, this will be April 30.)

The MTA payroll tax reconciliation return must indicate the actual amount of tax due for the tax year and the estimated payments made during the year. Any additional payroll tax due must be remitted with the reconciliation return.

Any overpayment will be refunded or may be applied to the individual's estimated MTA payroll tax for the next tax year. However, the department will keep all or part of any overpayment (refund) if the individual owes: (1) a New York state tax liability; (2) New York City or Yonkers personal income tax liability; (3) a past-due support or a past-due legally enforceable debt to the IRS, a New York state agency, or to another state; (4) on a defaulted governmental education loan, state university, or city university loan; or (5) a New York City tax warrant judgment debt.

An automatic extension of time to submit the reconciliation return may be granted if an individual with net earnings from self-employment cannot meet the due date for filing the MTA payroll tax reconciliation return. However, an extension of time to submit the reconciliation return does not extend the time to pay the tax. Full payment of any balance due must be made with the request for extension.

Group composite returns allowed

In August 2009, the department released information regarding a partnership's ability to file a group return on behalf of its electing partners. The group return filing for the NY MTA payroll tax is available **for all partners, both New York residents and nonresidents.** The group return filing for MTA payroll tax is separate from the NY nonresident composite income tax return filing (Form IT-203-GR). A partner may participate in the group return filing for MTA payroll tax and still elect to file separately for New York state personal income tax purposes. When electing into the New York state group return for personal income tax purposes, one loses the ability to claim itemized deductions and exemptions versus filing separately. However, there is no difference in the calculation of the MTA payroll tax between filing separately and electing into the group return. Therefore, for the principals of alternative investment funds, it would most likely be advisable to elect into the group return to avoid the administrative burden of filing an annual reconciliation.

To qualify for the group filing, the partnership must have two or more qualified partners who want to file as a group, and all partners in the group must have the same filing period. Partnerships must file form MTA-599, *Application for Permission to Make Metropolitan Commuter Transportation Mobility Tax Group Estimated Tax Payments and File a Group Return*. For the 2009 tax year, Form MTA-599 must be filed by September 15, 2009. For all subsequent tax years, Form MTA-599 must be filed by March 15 of the tax year. Once approved, the partnership will be issued a special MTA payroll tax identification number, which must be used on the payroll tax group filings. An approval to file on a group basis will remain in effect unless it is revoked. Annual approvals are not required.

MTA payroll tax payments are made with Form MTA-5, *Estimated Metropolitan Commuter Transportation Mobility Tax Payment Voucher*. The estimated group payments are due at the same time as the employer payments. The group return will be filed on Form MTA-505, *Metropolitan Commuter Transportation Mobility Tax Group Return*, and is due April 30 for calendar year-end partnerships.⁸ Please note that any overpayments of the payroll tax cannot be refunded and can be applied only to the group estimated payroll tax account for the following year.

Partnerships and partners

If a partnership, including an LLC treated as a partnership, is doing business within the Metropolitan Commuter Transportation District, each partner will be subject to the MTA payroll tax based on his or her share of the partnership's net earnings from self-employment allocated to the district if his or her net earnings from self-employment allocated to the district are more than \$10,000 for the tax year.

The partnership must provide either the actual amount of net earnings from self-employment allocated to the transportation district or the allocation percentage to each partner so that the partner can determine the amount of the MTA payroll tax due. To determine the amount of net earnings from self-employment allocated to the district or the allocation percentage, see the methods described in the "Allocation of Net Earnings from Self-Employment" section. Basically, allocation of net earnings can be based on accurate books and records or based on application of the three-factor (property, payroll, and receipts) equally weighted statutory formula method.

⁸ Fiscal year partnerships must file on or before the 30th day of the fourth month following the close of the fiscal year.

The MTA payroll tax does not address how the new law applies to alternative investment fund managers, who may have complex partnership structures. For example, with regard to alternative investment funds, if the fund is carrying on a trade or business in the transportation district (i.e., loan origination), then the income received by the general partner would be considered earnings from self-employment. Generally, most investment managers are structured as limited partnerships under law, with the principals directly invested as limited partners and an LLC as the general partner. The principals of the investment manager are generally members of the general partner LLC. Based on the new law, the guaranteed payments made by the investment manager to its principals as limited partners would be considered net earnings from self-employment as well as the principals' share of the management and incentive fee earned through the general partner vehicle. The principals' guaranteed payment and general partner income from the investment manager would be subject to the MTA payroll tax based on the investment manager's apportionment to the MTA zone. The principals' general partner income will be subject to the payroll tax based on the allocation to MTA zone of the fund's trade or business income.

Estimated MTA payroll tax payments on behalf of nonresident partners

Partnerships that do business within the transportation district are required to make estimated MTA payroll tax payments on behalf of individual partners who are nonresidents of New York state except under the following circumstances: (1) any partner whose estimated MTA payroll tax required to be paid for the tax year by the partnership is \$300 or less; (2) any partner if the partnership files a group return and the partner has elected to be included on the group return; and (3) any partner who certifies to the partnership that he or she will comply in his or her individual capacity with the department's MTA payroll tax estimated tax filing requirements.⁹

Due to the different estimated due dates as well as the separate annual reconciliation required, estimated MTA payroll tax payments cannot be combined with any estimated New York state personal income tax payments the partnership may be required to make on behalf of nonresident partners.

Please note that the estimated payment requirement is allowed only for nonresident partners. As stated above, if a partner goes into the group return, estimated payments are not required, thus making the group return option more attractive from an administrative basis.

⁹ The partner must submit form MTA-405-E, *Certificate of Exemption from Partnership Estimated Metropolitan Commuter Transportation Mobility Tax Paid on Behalf of Nonresident Individual Partners*.

Modifications for the MTA payroll tax on New York state tax returns and reports

When preparing New York state tax returns, any deduction permitted for federal income tax purposes for the MTA payroll tax must be added back,¹⁰ and any refund of the payroll tax must be subtracted, for purposes of computing New York state taxes imposed by Articles 9-A (corporation franchise tax), 13-A (petroleum business tax), 22 (personal income tax), 32 (bank franchise tax), and 33 (insurance franchise tax) of the New York tax law, and New York City administrative code Sections 11-602 (general corporation tax), 11-641 (banking corporation tax), 11-712 (commercial rent or occupancy tax), and 11-1718 (city personal income tax). An interesting note is that the addback is not required for the New York City unincorporated business tax (UBT), pursuant to New York City administrative code Section 11-501. It is unclear as to why the UBT was not one of the enumerated taxes included.

A partnership must provide each member with his or her share of any addition or subtraction modification relating to the MTA payroll tax.

The penalties under Article 22 of the New York state tax law (personal income tax) also apply to the MTA payroll tax. These penalties may include, but are not limited to: (1) late filing penalty; (2) late payment penalty; (3) failure to file penalty; and (4) penalty for underpayment of estimated tax (self-employed individuals only). Interest also applies on any MTA payroll tax that is not remitted on or before the payment due date.

Conclusions

As described above, the MTA payroll tax is complex in how it is applied and calculated. While the tax is imposed on employers and self-employed individuals, employers face unique issues as do self-employed individuals. Employers must apply a series of tests to determine whether an employee's services should be allocated to the Metropolitan Commuter Transportation District. Basically, the tests try to determine where an employee conducts most of his or her business activities. Opportunities exist for tax planning as the locations for some employees are not easily determinable. Businesses may also be tempted to move some or all of its operations outside the transportation district.

¹⁰ NY Tax Law § 292(a)(8).

While the MTA payroll tax is calculated on 100 percent of a covered employee's payroll expense despite the fact that the employee may work both inside and outside of the district, the tax is calculated differently for self-employed individuals, partners, and LLC members. Only the net earnings allocated to the transportation district, typically by applying an apportionment factor, is subject to the tax. Accordingly, an accurate calculation of the allocation factor will have a significant impact on that entity's MTA payroll tax liability. Other issues that partnerships and LLCs must deal with include nonresident withholding tax requirements and electing to file group composite returns. Clearly, the payroll tax does not address how the new law applies to specific industry groups, such as alternative investment funds, that may have more complex partnership structures.

With the enactment of the MTA payroll tax, alternative investment fund managers operating in New York City will be subject to an additional tax burden. As the tax cannot be collected from employees, fund managers who are already hurting from the recession are likely to absorb the tax as an operating cost. While the proceeds from the tax will help keep mass transportation fares from significantly increasing, businesses within the transportation district will bear the financial burden, and these businesses may pass on the burden to consumers. Although there is no simple solution to budget deficits during a recession, the MTA payroll tax may be the final straw that enables alternative fund managers to leave New York City and other areas in the district, such as Westchester and Long Island, for the greener pastures of Connecticut, New Jersey, or even to a no personal income tax jurisdiction such as Florida.

Service permanent establishment

Recent developments in China have increasingly focused on the potential exposure to service permanent establishment (PE) status of foreign fund managers and the tax treatment of employees seconded there.

Specifically, many of the local tax authorities in China are requiring taxpayers in their respective districts to provide additional details on the activities of employees seconded from overseas parties to China. The requested details range from the number of days employees have been in China in 2008 and 2009 to the nature of the contracts entered into with overseas parties (if any), the fees payable under the contracts, and the basis of how the fees were determined. The Chinese tax authorities are also focusing on the activities of seconded employees and paying particularly close attention to whether these employees are performing services for the local Chinese entity or in fact are working for the overseas entity.

The increased scrutiny on these activities may lead to an increased risk of the Chinese tax authorities considering an employee a dependent agent of the overseas entity (for example, the management company or fund), thus creating a service PE and subjecting the income of the overseas entity to tax in China.

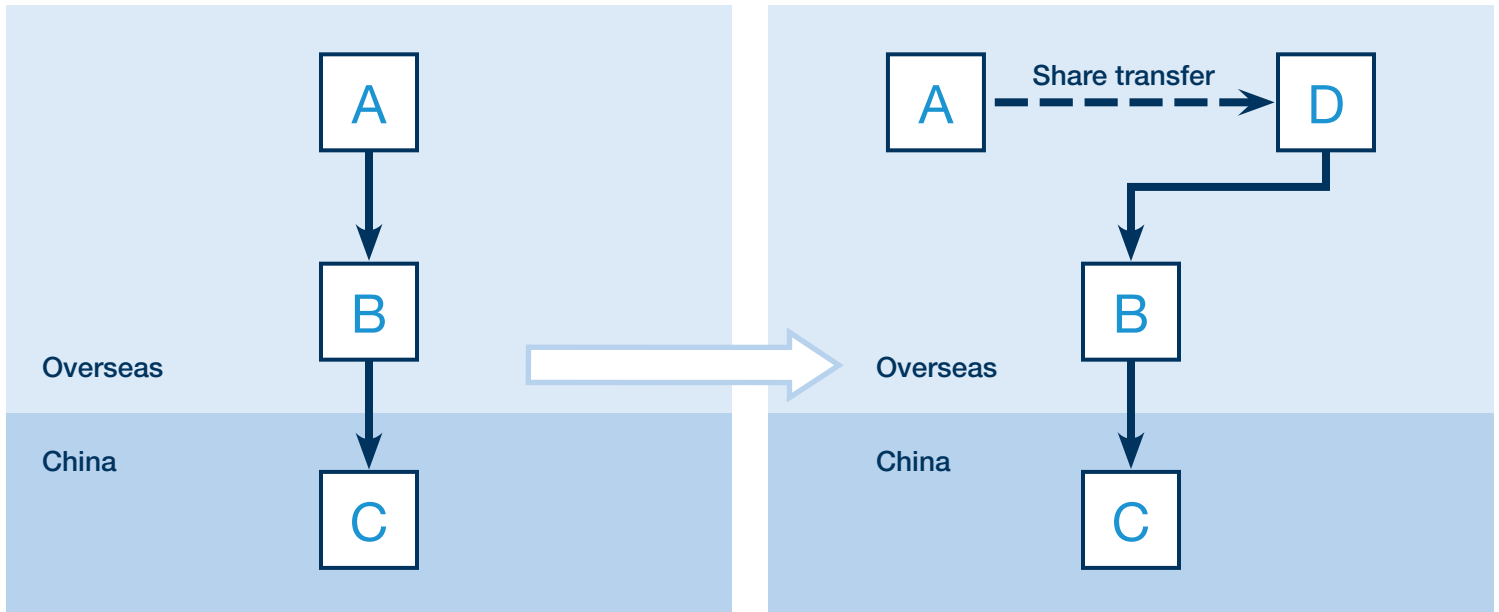
Capital gains on the indirect transfer of shares

In addition to the widely debated Chinese tax avoidance cases of Chongqing and Jiangxi last year, the Chinese State Administration of Taxation (SAT) is preparing a tax policy that covers, among other things, the “indirect transfer” of Chinese equities by non-Chinese tax resident enterprises (non-TREs) outside China. Although the policy has not yet been released, the SAT has prepared a draft of the policy to inform non-TREs of the potential tax implications of these indirect transfers. It should be noted that the policy is expected to be retroactively effective from January 1, 2008.

The draft policy states that upon the indirect transfer of Chinese equities (such as those held through a holding structure) by one non-TRE to another non-TRE, certain documents and information (including the commercial purposes of the holding company) must be provided to the SAT regarding the transfer. Such documents must be provided when the holding company location is either (1) a low-tax jurisdiction with a benchmark rate (which may be half of the standard China corporate income tax rate of 25 percent) or (2) a jurisdiction that does not tax the foreign company on the capital gains upon the transfer of the holding company’s shares.

The SAT will review the relevant information to determine if the transaction was effected to avoid Chinese withholding tax. Then the agency may invoke the general anti-abuse rules or general anti-avoidance rules (GAAR) and disregard the holding company to collect the 10 percent withholding tax.

The following diagram illustrates what the draft policy intends:



The illustration involves non-TRE¹ A, which disposes SPV B (a special purpose vehicle that is also a non-TRE), which holds China subsidiary C, to another non-TRE, D. Upon transfer of SPV B, non-TRE A is required to provide a list of requisite documents and information (including the commercial purposes for the use of SPV B) regarding the transfer. This is required only when SPV B is located in a jurisdiction that has the following specified tax features:

1. a low-tax jurisdiction with a benchmark rate (which may be half of the standard China corporate income tax rate of 25 percent), or
2. a jurisdiction that does not tax a foreign company (i.e., non-TRE A) in respect to the gains on transfer of SPV B's shares.

With the requisite documents and information, the Chinese tax authorities can examine the true nature of the transfer. Should the transfer of the China subsidiary C's equity be achieved through a transaction deemed to be "abusive use of company structure" (i.e., transfer of SPV B) to avoid China withholding income tax, then the Chinese tax authorities can invoke GAAR and disregard SPV B. Once SPV B is disregarded, then the transfer may effectively be treated as a non-TRE, SPV A, transferring China subsidiary C's equity. Accordingly, the gain may be considered China sourced and, therefore, subject to China withholding income tax.

¹ A TRE is a Chinese tax resident enterprise. A foreign entity deemed by the Chinese tax authorities to be managed and controlled from China may be considered a TRE and subject to tax in China.

The key implications of the draft policy are as follows:

- An offshore holding company structure that has been used over the past years to obtain favorable tax rates upon exit of Chinese investments may not be as effective under the new proposed policy.
- Sufficient substance is required to maintain the Chinese tax efficiency of offshore structures. Thus, appropriate documentation should be maintained to be able to provide backup information if the SAT questions the holding structure.
- If it appears likely that the holding company may be disregarded for Chinese tax purposes based on the draft policy, it may be necessary to accrue for Chinese capital gains tax under US FIN 48 principles.

The changes for seconded employees and capital gains are among several significant developments in China recently that impact the asset management industry. These developments are similar to those in other emerging markets in Asia. As such, companies should give careful consideration while structuring investments and operations into China.

Legislative developments in India: New tax code and limited liability partnership legislation

by Puneet Arora and Oscar Teunissen

New Indian tax code

As announced in the India budget presented in July 2009, the Indian authorities have circulated for public comment a draft of the proposed Direct Tax Code (DTC).

The DTC is intended to replace India's existing income tax laws and represents a significant structural change in Indian direct taxation. The code aims to moderate tax rates, remove certain exemptions, and simplify current tax laws to align them more closely with global tax principles.

Provisions in the DTC will affect specific financial services sectors, including investment vehicles such as mutual funds, venture capital funds, and domestic investment trusts; banks and other financial institutions; insurance companies; and foreign institutional investors (FII). In addition, general provisions will impact cross-border transactions across the financial services industry. New general provisions (detailed below) expected to affect all investors include changes in criteria for determining the residential status of foreign companies and the introduction of general anti-abuse provisions.

One significant proposed change affects private equity funds and hedge funds investing in India under the FII regime. The proposed DTC eliminates the current FII regime and mandates that FIIs be governed by the general provisions applicable to other nonresidents. This change would eliminate the favorable capital gains taxation currently available to FIIs and result in capital gains being taxed at the proposed uniform rate of 30 percent.

Other significant highlights from the proposed DTC include:

Tax rates

- The tax rate for domestic and foreign corporations is proposed to be reduced to 25 percent from the existing rates of 33.99 percent and 42.23 percent, respectively.
- Foreign companies will be subject to branch profits tax of 15 percent.
- Dividend distribution tax levied on Indian companies declaring dividends would be retained at a marginally reduced rate of 15 percent.
- Following these proposals, the effective tax rate for Indian companies (after considering the dividend distribution tax) and for Indian branches of foreign companies (after considering the branch profits tax) will be approximately 34.78 percent and 40 percent, respectively, versus the current approximate rate of 42 percent.
- The base for computing minimum alternative tax (MAT) is proposed to be shifted from "book profits" to the "value of gross assets." MAT will be levied at 0.25 percent on banking companies and 2 percent on all other companies. MAT will now be a final tax and will not be allowed as a tax credit in subsequent years.

Residency rules

- Currently, foreign companies are treated as resident in India if their control and management during the year are situated wholly in India. A proposed change in the residency rules would deem foreign companies as tax resident in India even if only partial control and management of their affairs is in India at any time during the year.

Capital gains

- The DTC proposes to eliminate the existing distinction between short-term and long-term capital gains based on the period of holding an asset. In addition, capital gains will no longer be taxed at concessional rates.
- The proposed abolition of the Securities Transaction Tax will also eliminate the rule allowing for the exemption/lower rate of tax on capital gains on listed shares.
- Currently, unused capital losses can be carried forward eight years. Under the new DTC, unused capital losses may be carried forward indefinitely.
- The deemed cost of acquisition of an investment asset will be nil if it is not capable of determination, and capital gains will be computed accordingly.
- The DTC proposes to construe income accrued from the direct or indirect transfer of any capital asset situated in India as income “deemed to accrue” in India.

Transfer pricing

- The DTC proposes to introduce an advance pricing agreement (APA). The APA will represent an arm’s-length price as prescribed under the DTC, subject to necessary adjustments, and will be valid for a maximum of five consecutive years. An APA will not be binding in case a law changes, and that law formed the basis for entering into the APA.
- The DTC would tighten the threshold limits for considering two enterprises as “Associated Enterprises,” and therefore subject to the transfer pricing regulations.

General anti-avoidance rules (GAAR) to counter tax avoidance

- The DTC proposes to introduce GAAR, empowering the commissioner of income tax (CIT) to declare an arrangement as impermissible if it has been entered into with the objective of obtaining a tax benefit and lacks commercial substance. The onus of establishing substance lies with the taxpayer.
- The concept of thin capitalization is proposed to be introduced to disregard specific types of debt arrangements and recharacterize interest as dividends in certain circumstances.
- Other arrangements covered by GAAR include round-trip financing and lifting of the corporate veil.

Tax treaty provisions

- Currently, Indian domestic law provides taxpayers the option of applying the provisions of applicable tax treaties to the extent such provisions are more beneficial.
- The DTC proposes a treaty override provision that determines the interaction between the DTC and the treaty and states that the provision that is later in point of time shall prevail.
- In addition, the DTC proposes to mandate the furnishing of a tax residency certificate for claiming relief under a tax treaty.

Limited Liability Partnership Act of 2008

Limited liability partnerships (LLPs), introduced in 2008 through the Limited Liability Partnership Act of 2008 (LLP act), are relatively new entities from an Indian perspective and may provide investors with greater flexibility in structuring investments in India. However, it should be noted that Indian regulatory authorities have yet to provide clarity with respect to whether foreign investors can be partners in the LLP.

Similar to corporations, LLPs are considered separate legal entities and allow for perpetual succession. However, LLPs are not subject to India’s onerous tax and regulatory compliance requirements, nor are they required to appoint independent directors. Further, LLPs can have an unlimited number of partners with limited liability but must designate at least two partners as unlimited partners.

Although the tax treatment of LLPs is still unclear in certain respects, they offer a number of tax advantages compared with traditional vehicles used to invest in India:

- LLPs are viewed as partnerships from an Indian tax perspective. Thus, Indian corporate income tax is payable at a rate of 30.90 percent only at the LLP level.
- Distributions of profits by the LLP are exempt from tax in the hands of the partners.
- No surcharge, resulting in 3.09 percent savings on the base tax rate (30.90 percent vs. 33.99 percent for corporations)
- No dividend distribution tax
- No minimum alternative tax
- Mitigating the cash trap that occurs as a result of the requirement for companies to transfer to a reserve 10 percent of their net profit (after tax) prior to the declaration of dividends
- No tax with respect to distribution of profits or capital
- No deemed dividend issues

On an Indian legislative front, several key proposals are being considered that would have a significant impact on the financial services industry. These proposals should be carefully examined to determine the impact on operations and investments in India.

PricewaterhouseCoopers Alternative Investment Fund Group

United States

Atlanta, GA

Dennis Goginsky 678 419 8528 dennis.goginsky@us.pwc.com

Boston, MA

Greg Collins 617 530 7012 greg.collins@us.pwc.com
Dan Feheley 617 530 6333 dan.feheley@us.pwc.com
Dave Foss 617 530 7878 david.foss@us.pwc.com
Kristin Francisco 617 530 7507 kristin.francisco@us.pwc.com
Timothy Grady 617 530 7162 timothy.grady@us.pwc.com
Patricia Jabar 617 530 7387 patricia.jabar@us.pwc.com
Mark Rosenblatt 617 530 7240 mark.rosenblatt@us.pwc.com
Michael Savelloni 617 530 7722 michael.b.savelloni@us.pwc.com
Paula Smith 617 530 7906 paula.e.smith@us.pwc.com

Chicago, IL

Chris Cornwall 312 298 4816 chris.cornwall@us.pwc.com
James Lelko 312 298 5768 james.s.lelko@us.pwc.com

Dallas, TX

Michael Bohling 214 756 1734 mike.bohling@us.pwc.com
Robert Collins 713 356 6851 robert.c.collins@us.pwc.com
Scott Moore 214 754 7268 scott.moore@us.pwc.com

Denver, CO

Hugh Armstrong 720 931 7207 hugh.armstrong@us.pwc.com

Houston, TX

Ricky Smith 713 356 8219 ricky.g.smith@us.pwc.com
Hadassah Wagner 713 356 4124 hadassah.wagner@us.pwc.com

Los Angeles, CA

Brian Flaherty 646 471 2131 brian.flaherty@us.pwc.com
John Mattos 213 356 6727 john.mattos@us.pwc.com
Alison Monahan 213 217 3374 alison.monahan@us.pwc.com
Tomoko Nagashima 213 356 6601 tomoko.nagashima@us.pwc.com
Andy Nolan 213 217 3830 andrew.nolan@us.pwc.com

Minneapolis, MN

James Kolar 612 596 4428 james.kolar@us.pwc.com
Jennifer Ward 612 596 6382 jennifer.l.ward@us.pwc.com

New York, NY

Dov Adler 646 471 3963 dov.adler@us.pwc.com
Murray Alter 646 471 0556 murray.alter@us.pwc.com
Puneet Arora 646 471 1691 puneet.arora@us.pwc.com
Anthony Artabane 646 471 7830 anthony.artabane@us.pwc.com
Virginia Benson 646 471 7940 virginia.benson@us.pwc.com
Tom Biolsi 646 471 2056 thomas.biolsi@us.pwc.com
Gina Biondo 646 471 2770 gina.biondo@us.pwc.com
Frank Calabro 646 471 7842 frank.m.calabro@us.pwc.com
Mark Casella 646 471 2500 mark.j.casella@us.pwc.com
Gregory Culloo 646 471 7504 gregory.culloo@us.pwc.com
Judith Daly 646 471 5292 judith.daly@us.pwc.com
Lyn Desantis 646 471 2084 lyn.desantis@us.pwc.com
Scott Dillman 646 471 5764 scott.dillman@us.pwc.com
Philip Fried 646 471 4788 philip.fried@us.pwc.com

United States (continued)

New York, NY (continued)

Joni Geuther 646 471 4526 joni.geuther@us.pwc.com
Bruce Graber 646 471 1447 bruce.graber@us.pwc.com
Mike Greenstein 646 471 3070 michael.s.greenstein@us.pwc.com
Michael Guarnuccio 646 471 2949 michael.guarnuccio@us.pwc.com
Michael Hayes 646 471 4429 michael.f.hayes@us.pwc.com
Robert Kelley 646 471 2066 robert.c.kelley@us.pwc.com
Barry Knee 646 471 5898 barry.m.knee@us.pwc.com
Lye-Sim Lam 646 471 4108 lye-sim.lam@us.pwc.com
Gary Meltzer 646 471 8763 gary.c.meltzer@us.pwc.com
Peter Michalowski 646 471 5259 peter.michalowski@us.pwc.com
Tim Mueller 646 471 5516 timothy.mueller@us.pwc.com
Marvin Nagler 646 471 8429 marvin.nagler@us.pwc.com
Gerard O'Callaghan 646 471 8833 gerard.m.ocallaghan@us.pwc.com
Michael O'Neill 646 471 5556 michael.j.oneill@us.pwc.com
Cindy Price Gavin 646 471 2148 cindy.gavin@us.pwc.com
Brian Rebhun 646 471 4024 brian.rebhun@us.pwc.com
Maureen Renick 646 471 3049 maureen.renick@us.pwc.com
John Reville 646 471 7845 john.reville@us.pwc.com
Thomas Romeo 646 471 8048 thomas.romeo@us.pwc.com
Allison Rosier 646 471 5511 allison.rosier@us.pwc.com
Michael Ruggeri 646 471 7588 michael.ruggeri@us.pwc.com
Dan Ryan 646 471 8488 daniel.ryan@us.pwc.com
Pinchas Schwartz 646 471 3347 pinchas.schwartz@us.pwc.com
Milan Shah 646 471 2251 milan.r.shah@us.pwc.com
Michael Spiryda 646 471 7597 michael.spiryda@us.pwc.com
David Steiner 646 471 3836 david.a.steiner@us.pwc.com
Scott Sulzberger 646 471 7410 scott.r.sulzberger@us.pwc.com
William Taggart 646 471 2780 william.taggart@us.pwc.com
Oscar Teunissen 646 471 3223 oscar.teunissen@us.pwc.com
Belanne Ungarelli 646 471 5431 belanne.marie.ungarelli@us.pwc.com
Joe Wiggins 646 471 7378 joe.wiggins@us.pwc.com

Philadelphia, PA

Chris May 267 330 1398 christopher.r.may@us.pwc.com
Bill McGinley 267 330 3140 william.c.mcginley@us.pwc.com

San Francisco, CA

Gregory Eckert 415 498 7443 gregory.eckert@us.pwc.com
Laura Martinez 415 498 7656 laura.e.martinez@us.pwc.com
Lucinda Powers 415 498 6210 lucinda.powers@us.pwc.com
Paul Roberts 415 498 6161 paul.a.roberts@us.pwc.com
Matt Stolte 415 498 6232 matt.stolte@us.pwc.com
Ted Wilm 415 498 8005 ted.wilm@us.pwc.com

Seattle, WA

Michele Godvin 206 398 3801 michele.l.godvin@us.pwc.com
Chris Hugo 206 398 3070 christopher.j.hugo@us.pwc.com

Tampa, FL

Mike Quackenbush 813 222 7067 mike.p.quackenbush@us.pwc.com

Washington DC

Thomas Holly 703 918 3085 thomas.j.holly@us.pwc.com
David Sapin 703 918 1391 david.sapin@us.pwc.com

PricewaterhouseCoopers Alternative Investment Fund Group (cont'd)

Asia

Hong Kong

| | | |
|--------------|---------------|-------------------------|
| Robert Grome | 852 2289 1133 | robert.grome@hk.pwc.com |
| Shirley Xie | 852 2289 1035 | shirley.xie@hk.pwc.com |

Shanghai

| | | |
|--------------|-----------------|----------------------------|
| Matthew Wong | 86 21 2323 3052 | matthew.mf.wong@cn.pwc.com |
|--------------|-----------------|----------------------------|

Singapore

| | | |
|------------|--------------|-----------------------|
| Justin Ong | 65 6236 3708 | justin.ong@sg.pwc.com |
|------------|--------------|-----------------------|

Tokyo, Japan

| | | |
|--------------|----------------|---------------------------|
| Raymond Kahn | 81 3 5251 2909 | raymond.a.kahn@jp.pwc.com |
|--------------|----------------|---------------------------|

Canada

Toronto

| | | |
|------------------|--------------|-------------------------------|
| Chris Pitts | 416 947 8964 | chris.pitts@ca.pwc.com |
| Rajendra Kothari | 416 869 8678 | rajendra.k.kothari@ca.pwc.com |

Europe

Channel Islands

| | | |
|-----------------|----------------|----------------------------|
| Brendan McMahon | 44 1534 838234 | brendan.mcmahon@je.pwc.com |
|-----------------|----------------|----------------------------|

Dublin, Ireland

| | | |
|-----------------|----------------|------------------------------|
| Damian Neylin | 353 1 792 6551 | damian.neylin@ie.pwc.com |
| Olwyn Alexander | 353 1 792 8719 | olwyn.m.alexander@ie.pwc.com |

Frankfurt, Germany

| | | |
|------------------------|-----------------|----------------------------------|
| Hans-Ulrich Laueremann | 49 69 9585 6174 | hansulrich.laueremann@de.pwc.com |
| Jurgen Kuhn | 49 69 9585 5779 | juergen.kuhn@de.pwc.com |

Geneva, Switzerland

| | | |
|--------------|---------------|-------------------------|
| Thomas Huber | 41 58792 2436 | thomas.huber@ch.pwc.com |
|--------------|---------------|-------------------------|

London, England

| | | |
|---------------|-----------------|---------------------------|
| Pars Purewal | 44 20 721 24738 | pars.s.purewal@uk.pwc.com |
| Robert Mellor | 44 20 780 41385 | robert.mellor@uk.pwc.com |

Luxembourg

| | | |
|--------------|------------------|-------------------------|
| Kees Hage | 352 49 4848 2059 | kees.hage@lu.pwc.com |
| Marc Saluzzi | 352 49 4848 2009 | marc.saluzzi@lu.pwc.com |

The Netherlands

| | | |
|-----------------------|----------------|----------------------------------|
| Frank van Groenestein | 31 10 4076 444 | frank.van.groenestein@nl.pwc.com |
|-----------------------|----------------|----------------------------------|

Paris, France

| | | |
|----------------------|-----------------|---------------------------------|
| Jean-Pierre Bouchart | 33 1 56 57 1308 | jean-pierre.bouchart@fr.pwc.com |
|----------------------|-----------------|---------------------------------|

Offshore

Bahamas

| | | |
|------------------|--------------|-------------------------------|
| Clifford Johnson | 242 302 5307 | clifford.a.johnson@bs.pwc.com |
|------------------|--------------|-------------------------------|

Bermuda

| | | |
|--------------|--------------|-------------------------|
| Andrew Brook | 441 299 7126 | andrew.brook@bm.pwc.com |
|--------------|--------------|-------------------------|

Cayman Islands

| | | |
|-------------|--------------|--------------------------|
| Noel Reilly | 345 914 8600 | noel.t.reilly@ky.pwc.com |
|-------------|--------------|--------------------------|

Curaçao

| | | |
|-----------|----------------|------------------------|
| Cees Rokx | 599 9 430 0105 | cees.f.rokx@an.pwc.com |
|-----------|----------------|------------------------|

