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## Asian Governments Actions May Affect Hedge Funds

### Proposed Japanese Legislative Changes

The Japanese Diet is expected to pass legislation to create a new corporation law in 2006, revising parts of the current Japanese commercial code. The legislation, which passed the lower house of the Diet on May 17, 2005 and is awaiting consideration by the upper house, has two provisions that could affect US investors: Elimination of Yugen Kaishas, one of the two main types of corporate entities; and limits on the use of Japanese branches of shell companies.

#### *Yugen Kaisha Changes*

The legislation would end the Yugen Kaisha class and make existing Yugen Kaishas special entities under the other main type of corporate entity, the Kabushiki Kaisha. Currently, Yugen Kaishas are eligible to elect disregarded entity (or partnership) status for purposes of US check-the-box regulations. Conversely, the Kabushiki Kaisha is a *per se* corporation for US tax purposes and is not eligible for the elective entity classification treatment.

No US government guidance has been issued for this proposal, and none is expected before passage. Consequently, investors are unsure whether existing Yugen Kaishas would retain their US tax transparency; whether they should convert to another type of corporation to do business in Japan; about the timing for such transactions; and the likely US and/or Japanese tax implications of such transactions.

#### *Limits on Foreign Companies*

Currently, some businesses effectively avoid Japanese corporate governance by establishing an entity abroad, such as in the Cayman Islands, even though the entity will conduct its business mainly in Japan. The foreign head offices of these "Giji Gaikoku Kaisha" (or "para-foreign corporations") have little or no operational substance. A second proposal in the new legislation would hinder foreign corporations from doing business in Japan in branch form if they have their head office in Japan or if the main purpose of the foreign corporation is to conduct business in Japan.

This proposal would have a significant impact on many foreign corporations that conduct their business in Japan through Japanese branches where there is little or no operational substance in the foreign head office.

Currently, it is unclear what level of activities would be required outside Japan to allow a Japanese branch to operate within these provisions or what level of activities such a Japanese branch could perform. Giji Gaikoku Kaisha and their representatives would be subject to monetary fines and penalties for breach of these new provisions. Affected corporations may wish to discuss the implications of these legislative proposals further with Japanese legal and tax advisors.

For a more detailed explanation on the Japanese implications of these proposed changes, PwC Japan will be issuing a separate newsletter

shortly.

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### **India Takes Regulatory Action against Foreign Institutional Investor**

On “Black Monday,” May 17, 2004, the Indian stock market plunged, erasing US\$27 billion of value, and trading was stopped twice. The Securities and Exchange Board of India (SEBI) investigated and found that certain Foreign Institutional Investors (FII) executed substantial sale trades that day. These institutions suffered cash losses from these trades, but profited subsequently from short positions in derivatives. SEBI suspected that the trades were executed mainly on behalf of hedge funds and asked these institutions for details of their major clients – a request which was refused based upon assertions of client confidentiality.

In a decision released one year to the day later, the SEBI held that a leading financial institution involved in the trading activities did not comply with requirements associated with the issuance of participatory notes (P-Notes), or similar derivatives, to entities outside India. These requirements include that FII issue these instruments only to regulated entities, comply with “know your client” rules and cooperate with SEBI inquiries.

The SEBI prohibited this financial institution, its affiliates and agents, from issuing any derivative instruments to overseas clients for a one-year period and renewing or rolling over already-issued instruments for the same period. The SEBI also directed it to establish the highest standards of customer due diligence processes in line with regulations.

The SEBI decision has proven controversial, with supporters saying that it proves no institution is above the law and opponents claiming that the institution is being scapegoated. The institution indicated its intent to appeal the decision.

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### **PwC Alternative Investment Group-Global Tax Structuring Team:**

PwC’s Global Tax Structuring Services team has built a strong track record in developing tax-efficient cross-border structures for large financial services groups and hedge funds. The team is focused on analyzing tax aspects of both traditional and alternative investments and aims at designing structures for tax efficient investment in various jurisdictions. The network provides access to most recent tax news and advice on current trends in cross-border operations for hedge funds and their management companies, including permanent establishment and controlled foreign corporation planning, VAT, transfer pricing, profit repatriation, cross border financing, and platform company structures.

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