



in this issue:

PricewaterhouseCoopers' Fifth Annual Alternative Investments Seminar Our Fifth Annual Alternative Investments Seminar was a great success and attended by approximately 1,000 clients and friends of the Firm 1

2006 Hedge Fund Outlook: Is the party over? Mark Casella, head of the PwC Alternative Investments practice, comments on the future of the hedge fund industry 2

Alternative Investment Funds: Proposed regulations on deferred compensation Failure to comply with the American Jobs Creation Act generally results in immediate taxation to the service provider when compensation is earned, a 20% penalty on the amount of the deferred compensation and interest retroactive to the time the compensation was earned and vested 4

Principles-based accounting: *An illustration of the impact of FAS 150 on hedge funds* Very few accounting standards contain "scope out provisions" for entities complying with US GAAP and they must be considered by those responsible for hedge fund financial reporting. 6

SEC issues new soft dollar guidance When the SEC issues a final release with respect to Section 28(e) of the Securities Exchange Act of 1934 relating to soft dollars, this guidance will be critical for hedge fund managers who have traditionally been aggressive users of client commissions to purchase both research and non-research items. 7

International update: Korean and Indonesian developments Korea's Ministry of Finance and Economy recently announced proposals to revise certain provisions in Korea's tax laws. 8



NY-PD-06-0730/600242

© 2006 PricewaterhouseCoopers. All rights reserved. PricewaterhouseCoopers refers to the network of member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity. *connectedthinking is a trademark of PricewaterhouseCoopers (US).

PricewaterhouseCoopers' Fifth Annual Alternative Investments Seminar and holiday party

On December 7, 2005, we held our Fifth Annual Alternative Investments Seminar and holiday party at the Marriott Marquis Hotel in New York City. The event was a great success and was attended by approximately 1,000 clients and friends of the Firm.

Clifford S. Asness, Ph.D., the Managing & Founding Principal of AQR Capital Management, LLC delivered the keynote address. His presentation, "An Alternative Future: An Exploration of the Role of Hedge Funds," focused on topics which included: what investors are looking for in hedge funds; why investors are considering hedge funds now and the further evolution of the hedge fund industry.

The agenda featured:

- A Welcome and Introduction by Mark Casella, Partner and Head of PwC's US Alternative Investments Group
- Regulation - What to Expect in 2006 by Tom Biolsi, Managing Director in PwC's Regulatory Compliance Group
- An International & US Tax Developments Panel
Moderator: Will Taggart, Tax Leader of the US Alternative Investments Group
 - Panelists: Partners Gina Biondo and Oscar Teunissen; and
- A Valuation and Accounting Update Panel - Moderator: Tony Artabane, Partner and Global Leader of PwCs' Alternative Investments Group
 - Panelists: Partners Mike Greenstein, Barry Knee and Scott Sulzberger.

Seminars were held in six other cities across the United States, including:

- Atlanta
- Dallas
- Boston
- Los Angeles
- Chicago
- San Francisco

Additional information about PricewaterhouseCoopers' Fifth Annual Alternative Investments Seminar is featured in this newsletter, in "2006 Hedge Fund Outlook: Is the party over?" by Mark Casella.

2006 Hedge Fund outlook

Is the party over?

Mark J. Casella

The \$1.1 trillion hedge fund industry, which saw dramatic growth during the go-go 1990s, has seen even greater growth in the so-slow 2000s, as investors desperately seek alpha in flat markets. But with regulators scrutinizing hedge funds, thousands of funds competing in a crowded space and new money coming from funds of funds catering to demanding retail investors, even hedge fund partisans are starting to ask: Is the party over? In December, this question was on the minds of 1,000 hedge fund managers, private equity executives and other industry attendees at PricewaterhouseCoopers' Fifth Annual Alternative Investments Seminar, held in New York and six other cities. Through polling conducted during the New York seminar—the first and largest of the seminars—we get a clear picture of what is on the minds of industry leaders as 2006 dawns.

Performance

Polling results in New York indicated that four in 10 attendees (41%) said that “performance” will be their biggest challenge during the next 12–18 months, and nearly a third (29%) cited “regulatory scrutiny” as their biggest challenge.

Given the lack of standardized industry-wide data and the fact that failing funds usually do not report data, there always has been some uncertainty about hedge fund performance. As a result, reported data are assumed to skew positively because they reflect the performance of successful, or at least surviving, funds.

Although there is little question hedge funds overall have had stronger performance than most other investments, some observers are concerned that the October 2005 decline in absolute performance related on major hedge fund indices may be a harbinger of things to come.

With 8,000 funds aggressively competing, obscure arbitrage opportunities—the hedge fund equivalent of the baseball axiom “hit ‘em where they ain’t”—will be harder to find. Moreover, many strategies are becoming increasingly correlated with conventional asset classes, reducing their advantage over embedded market return.

The top hedge funds, by definition, will continue to outperform the markets and other funds both on an absolute and a risk-adjusted basis. But to survive in a low-return environment, some funds may have to position themselves not as a source of outsized returns, but as a hedge against risk—a back-to-the-future approach that returns hedge funds to their original purposes.



Regulatory scrutiny

Effective February 1, 2006 most hedge funds will be required to register with the US Securities and Exchange Commission (SEC), and some fear this might be just the first step down a long path towards regulation that could stifle the outperformance that justifies higher fees. Their concerns may be warranted: Today's regulatory environment appears to be distinctly unfriendly.

The SEC clearly has a proenforcement mindset. Between 2003 and 2004, enforcement referrals stemming from investment advisor examinations, including many hedge fund managers, doubled from 4% to 8%. With a flood of information coming in through the hedge fund advisor registration process, no one expects referrals to subside any time soon.

In fact, the SEC is in the process of identifying “risk factors” for registrants. At present, these factors include:

- Having more than \$1 billion under management;
- Having an affiliated broker/dealer;
- Having management of a hedge fund and mutual fund under one roof;
- Previous regulatory violations;
- An adviser subject to customer complaints or litigation; and,

- Firm principals noted for touting performance in speeches or the media.

It seems clear that a hedge fund that has one or more of these factors is at a heightened risk of attracting SEC interest. Moreover, the spotlight on issues, such as soft dollars and gifts and entertainment, means that funds increasingly will be under the microscope regardless of risk factors.

In addition to the SEC, Connecticut attorney general Richard Blumenthal has made inquiries into hedge funds. It's not yet clear whether this is an isolated occurrence related to Greenwich's status as a hedge fund center, or signals greater interest in hedge funds on the part of state officials elsewhere.

Accounting and tax issues

Even as regulatory inquiries increase, accounting and tax issues faced by hedge funds continue to grow in complexity. When asked what is the greatest tax-related challenge facing their organizations, half of the seminar attendees (50%) said the development of policies and procedures to minimize tax risks, and a third (33%) said managing tax issues associated with global expansion.

The growing concern over accounting and tax issues by providers of alternative products results in part from the fact that prevailing Generally Accepted Accounting Principles (GAAP) rarely distinguishes among industries and products. This results in far-reaching, and perhaps unintended, financial reporting implications for hedge funds.

For instance, since few, if any, of today's GAAP standards offer any "scope-out provisions" for alternative products, close inspection of these standards often identifies provisions that must be considered by hedge funds.

The trend is clear for hedge funds: Accounting is getting more complex, auditing more challenging, regulators more assertive and investors more demanding in their due diligence. In a resource-constrained environment, these challenges cannot be addressed only by hard work.

Funds must put capable, senior people in charge of compliance, improve controls and compliance procedures and strengthen their back-office and technology infrastructure to meet the demands of numerous constituencies. Many hedge funds appear to be well-positioned to do this.

Seven in 10 seminar attendees (69%) said they already have a formal process in place to monitor their compliance against the investment and risk guidelines described in their offering documents and marketing materials.

Has the 'bar' been raised?

The hedge fund industry's growth means that the issues confronting them are essentially the same as those facing other financial institutions. This makes sense, as many hedge funds are no longer boutiques but the equivalent of major financial institutions with needs, issues and challenges similar to those faced by bigger firms. As a result, the significant drivers that have helped hedge funds succeed to date are not likely to suffice as the industry and environment continue to evolve.

Back to the question: Is the party over for hedge funds? The answer is No—but a few funds may hear "last call" if they are unable to adapt to new demands for governance, compliance, disclosure and transparency without losing the ability to benefit from individual skill and nontraditional strategies.

Hedge funds as a class are here to stay. In fact, as Clifford S. Asness, PhD, managing and founding principal of AQR Capital Management, said in his keynote remarks at the New York seminar: "It is possible that hedge funds may be the future of active management, with index funds at the other end of the spectrum—but many things have to change before this occurs. A hedge fund industry that implements common-sense improvements and adapts to changing times will take the first step to this future." ■

Alternative Investment Funds: Proposed regulations on deferred compensation

Michelle Ingber

The American Jobs Creation Act, which includes section 409A and imposes new requirements for deferred compensation arrangements, was signed on October 22, 2004. Failure to comply with the new law generally results in immediate taxation to the service provider when compensation is earned, a 20% penalty on the amount of the deferred compensation and interest retroactive to the time the compensation was earned and vested.

On December 20, 2004, Treasury and the IRS released Notice 2005-1 to provide interim guidance on the deferred compensation rules. In Volume 1, Number 1 of this newsletter, we discussed the impact of those rules on alternative investment funds. On September 29, 2005, Treasury and the IRS issued Proposed Regulations under section 409A. The Proposed Regulations are very complex and lengthy. The purpose of this article is to focus on the items in the Proposed Regulations which we think are of particular interest to alternative investments funds and on a few of the most significant rules of general applicability. Given the harsh penalty provision, it is critical to comply with these rules and to be sensitive to when they potentially apply. Section 409A has widespread application – it applies not only to deferral fees between an offshore fund and a management company, but to deferred compensation arrangements with any employee.

Hedge fund managers are not exempt. Prior to the Proposed Regulations, there was uncertainty as to whether hedge fund managers with multiple unrelated clients were subject to section 409A. The Proposed Regulations make clear that hedge fund managers may be covered by section 409A. They do so by treating a service provider as related to a service recipient if the service provider provides management services to the service recipient. “Management services” means “services that involve the actual or *de facto* direction or control of the financial or operational aspects of a trade or business of the service recipient, or investment advisory services provided to a service recipient whose primary trade or business includes the management of financial assets (including investments in real estate) for its own account, such as a *hedge fund* or a real estate investment trust.”

Relief for back-to-back arrangements. It is not uncommon for a management company to defer fees owed to it by the fund and for the employees of the management company to defer fees owed to them by the management company. When payment becomes due to an employee upon separation from the management company, the management company accelerates some of the amounts it has deferred in order to make payment to the employee.



When a permitted triggering event occurs, the Proposed Regulations allow payments from a fund to the management company where the time and form of payment is the same as under an arrangement subject to section 409A between the management company and the specified employee, if the arrangement between the management company and the fund expressly provides for such time and form of payment and otherwise satisfies the requirements of section 409A. There is no guidance on what it means for arrangements to be the “same,” which results in some uncertainty. For example, if the arrangement between the employee and the fund has a vesting provision but the arrangement between the management company and the fund does not, are they the “same” for these purposes?

The permitted triggers for back-to-back arrangements are “separation from service”, disability, death or changes in control (in the case of a service recipient corporation). “Separation from service” is a defined term which includes retirement and “termination of employment”, but not short term sick leave. “Termination of employment” is determined based on facts and circumstances with presumptions if an employee continues to do specified amounts of work. Disability is also defined for these purposes.

To benefit from this provision, a back-to-back arrangement must be provided for in advance. Care should be taken to satisfy the requirement that the arrangements be the “same” and that any triggering events satisfy the definitions.

Initial deferral elections. In order to comply with section 409A, deferral elections must be made on a timely basis.

- In general, an election to defer compensation must be made by the end of the service provider’s taxable year prior to the year the compensation is earned.
- For the first year in which a service provider is eligible to make the election, the provider can make the election within 30 days of becoming eligible (pro ration applies to any delay between eligibility and the election date).
- The Proposed Regulations provide a more lenient election rule for “performance-based compensation”, generally allowing initial deferrals to be made within the first 6 months of a 12 month performance period. A service provider who does not complete 12 months of service or who receives other compensation that is not performance-based could fail to comply with section 409A and incur penalties. Accordingly, it would be prudent to follow the general rule and make initial deferral elections for performance-based compensation by the close of the preceding year.
- Where a service recipient (i.e., a fund) has a fiscal year other than a taxable year, “fiscal year compensation” may be deferred only if the election is made not later than the close of the fund’s fiscal year prior to the year in which the services to which the compensation relates are performed. Bonuses which are based on fiscal year results would generally be fiscal year compensation; however salary generally is not fiscal year compensation, even if it is paid pursuant to an employment agreement with a fiscal year term.
- The Proposed Regulations provide for various deferral deadlines for special circumstances (including short-term deferrals and deferrals with respect to forfeitable rights), which are not discussed herein.

Open items. Despite the great length of the Proposed Regulations, Treasury and IRS have reserved on certain topics.

- Under section 409A(b), assets set aside in an offshore trust (or other arrangement determined by the Secretary) to fund a deferred compensation obligation, may violate the deferred compensation rules. The preamble to the Proposed Regulations says that in future regulations, the Treasury Department and IRS intend to address what other arrangements should be treated as a trust for these purposes and to elaborate on such treatment.
- The Proposed Regulations reserve on treatment of partners providing services to a partnership. Based on the favorable treatment of back-to-back arrangements, it seems that certain accelerations might be permitted. This topic remains open.

- The Proposed Regulations are silent on the calculation and timing of income inclusion amounts.
- Reporting requirements for Forms W-2 and 1099.

Effective dates. The statute does not apply to deferred compensation that was both earned and vested before January 1, 2005. The Proposed Regulations are not proposed to become effective prior to January 1, 2007. In the interim, Notice 2005-1 remains in effect.

Transitional rules. There are several transitional rules in the Notice, some of which have been extended by the Proposed Regulations and some of which have not. A few of the most significant ones are:

- Plans have until December 31, 2006 to make amendments that would bring them into compliance with section 409A as long as in the interim, the plan is operated in good faith compliance with the statute, Notice and the Proposed Regulations.
- The Proposed Regulations extend, through December 31, 2006, the ability to make a change in payment election. However, during 2006 a change may not be made with respect to payments that would otherwise have been received in 2006 and the change may not cause payments to be made in 2006.
- The Proposed Regulations did not extend the time for terminating an arrangement and distributing amounts of deferred compensation, in order to avoid application of 409A. Accordingly, terminations and distributions must be done by December 31, 2005.

The foregoing is a general summary highlighting portions of the Proposed Regulations which may be relevant to alternative investment funds. We do not purport to address all rules which may impact funds. You are strongly encouraged to contact your PricewaterhouseCoopers tax advisor to discuss how these rules apply to your particular circumstances. ■

Principles-based accounting

An illustration of the impact of FAS 150 on hedge funds

Dov Adler and Barrett Brown

At first blush, much of the authoritative accounting guidance issued today may seem to focus on nuanced accounting issues which wouldn't impact hedge funds or other types of alternative investment products. Yet very few accounting standards contain "scope out provisions" for entities complying with US GAAP and these standards must be considered by those responsible for hedge fund financial reporting.

One example is FASB Statement 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*, ("FAS 150"), which was released in May, 2003. FAS 150 requires that certain Mandatorily Redeemable Financial Instruments be reclassified as a liability on the balance sheet of the business entity including corporations, partnerships and LLCs. Shortly after the release of the Standard, the FASB Staff Position issued FSP 150-3 ("FSP 150-3"), which deferred implementation of FAS 150 for calendar year-end nonpublic entities until 2005, and then only to be considered for instruments that are **mandatorily redeemable on a fixed date, for amounts that are either fixed or determined by an external reference index.**

When considering the impacts of FSP 150-3, many in the hedge fund industry quickly concluded that redemptions paid after year end, but based upon year-end net assets, must be considered a liability (e.g., recognition of redemptions payable on the balance sheet). This is an accurate assessment. However, the analysis doesn't stop there. Upon further analysis of FSP 150-3, many other implementation issues come to light.

For example, it could be assumed that all hedge funds meet the criteria of being nonpublic. However, FSP 150-3 defines SEC registrants as "entities, or entities that are controlled by entities, (a) that have issued or will issue debt or equity securities that are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local or regional markets), (b) that are required to file financial statements with the SEC, or (c) that provide financial statements for the purpose of issuing any class of securities in a public market." Does this mean that a hedge fund that is consolidated by its publicly traded general partner is thus "controlled" by that general partner and therefore does not meet the criteria of being a nonpublic entity? Is a hedge fund that has shares listed on the ISE or other exchange for a "convenience", but is never actually expected to be traded on that exchange, now an "SEC registrant" for the purposes of applying FAS 150?

The questions do not stop at the scope of FSP 150-3. Consider the criteria of having a fixed date and fixed amount of redemption. What if the fund receives a redemption notice of \$1 million, but it is not to be honored for 3 months? Is that \$1 million a liability of the fund in the intervening period? Or does the impact of the incentive make the amount variable and thus outside the scope of FSP 150-3? If recorded



as a liability, does that impact the threshold of disclosing 5% positions in the schedule of investments, or the calculation of financial highlights, as prescribed by SoP 03-4?

These examples illustrate an emerging trend in the authoritative literature and practitioners must wrestle with these issues as they prepare for their upcoming year-ends. Prevailing GAAP rarely makes a distinction among industries and products, and there could be financial reporting implications for hedge funds, even when they may not have been the initial focus of the Standard. We expect these trends to be even more pronounced as the FASB and IFRS standards converge.

The lesson to be learned is that the astute practitioner must be wary of all issued financial reporting standards, not only those focusing solely on the investment management industry. As for the issues surrounding FAS 150, currently each case must be independently analyzed. Depending on the facts and circumstances, the answers to some of the questions raised above may vary. However, reflecting redemptions based on year end net asset amounts as a liability will likely be the minimum requirement. The interpretation of these issues is still being considered. Please consult with your local PricewaterhouseCoopers audit partner to determine the suitable response for your situation. ■

SEC issues new soft dollar guidance and requests comments

Kent Knudson

On October 20, 2005, the SEC released proposed interpretive guidance with respect to Section 28(e) of the Securities Exchange Act of 1934 relating to soft dollars. After the SEC issues a final release, this guidance will be critical for hedge fund managers who have traditionally been aggressive users of client commissions to purchase both research and non-research items.

Background

As fiduciaries, advisers (registered and unregistered) are required to act in their clients' best interests. This principle generally precludes using client assets, including commission dollars, for an adviser's own benefit, at least without obtaining clients' informed consent. Congress enacted Section 28(e) to provide a safe harbor from a liability where clients pay more than the lowest available commission rate in order to receive "brokerage and research services" if the adviser determines in good faith that commissions are reasonable in relation to the value of services received.

Since 1975, technology and market practices have eclipsed the original understanding of the products and services that constitute "brokerage and research" within 28(e); thus the SEC was compelled to propose up-to-date guidance. *Even if an adviser plans to use soft dollars outside of 28(e), the question of whether a particular product or service is 28(e)-eligible is critical, because advisers acting outside of the safe harbor greatly increase their disclosure obligations.*

Highlights of proposed interpretive guidance

The release largely reiterates past SEC guidance while offering an updated framework for determining whether a product or service falls within 28(e). According to the release, to be considered "**research**" a product or service must constitute "advice," "analyses," or "reports" that reflect substantive content (i.e., reasoning or knowledge). Such content must be advice as to the value of securities or the advisability of investing in securities. Reports concerning issuers, industries, economic factors and trends are also eligible.

Significantly, the SEC stated that market data, such as stock quotes, last sale prices, and trading volumes (e.g., Bloomberg and Instinet services), constitute "reports concerning securities" within 28(e). Analytical software and conferences and seminars relating to investment information are also eligible.

The SEC reserved judgment on two issues, mass-marketed publications (e.g., *The Wall Street Journal*) and proxy voting services, and whether these should be considered part of a firm's overhead. These questions will be addressed after the comment period.



An important part of the guidance is that physical items used to read, receive or deliver reports (e.g., computer hardware, cables, peripherals and communication devices), which do not reflect the expression of reasoning or knowledge relating to investment information, are outside of 28(e). In addition, traditional "overhead" items are not research or brokerage within 28(e).

The SEC specifically mentioned that the following are examples of products and services that are **ineligible** for the safe harbor:

- Travel, entertainment or meals associated with a research conference
- Website design
- Office equipment
- Business supplies
- Office furniture
- Telephone lines
- Salaries (including research salaries)
- Rent
- Marketing
- Legal fees (unrelated to investment decisions)
- Back-office functions, hardware and software
- Compliance tools
- Consulting (unrelated to investment decisions)

- Accounting fees
- Membership dues
- Utilities

The SEC also amplified its interpretation of what constitutes permissible “**brokerage**” services under 28(e). According to the SEC, Congress intended “brokerage” services under the safe harbor to relate to the execution of securities transactions - a process which begins when an order is transmitted to a broker and ends at the conclusion of clearance and settlement of the transaction. Under this “temporal standard,” communications services between the adviser, broker and custodian that are related to the execution, clearing, and settlement of securities transactions and other incidental functions are eligible under 28(e). Specific example of eligible items include: dedicated lines between the broker and the adviser’s order management system; dedicated lines providing direct dial-up service between the adviser and the broker’s trading desk; and message services used to transmit orders to brokers for execution.

In contrast, advisers’ order management systems and hardware, such as telephones or computer terminals, are examples of ineligible

“brokerage” items because, in the SEC’s view, they are not sufficiently related to the order execution sequence.

Finally, the Commission provided guidance on step-outs, or commission sharing arrangements where one broker executes and shares commissions with another broker who has provided research to the adviser. The proposed guidance emphasizes that to be eligible, third-party soft dollar arrangements must be “provided by a broker”, meaning the broker must be obligated to pay for the product or service. Both brokers must perform substantive functions in effecting trades beyond merely receiving commissions for research.

The full release can be viewed at www.sec.gov/rules/interp/34-52635.pdf. ■

International update: Korea developments

Han-Jun Chon and Hae Young Kim

Proposed tax law changes to address international issues

Korea’s Ministry of Finance and Economy (“MOFE”) recently announced proposals to revise certain provisions in Korea’s tax laws, including the Law for the Coordination of International Tax Affairs (LCITA); the Individual Income Tax Act (IITA); and the Corporate Income Tax Act (CITA).

“Substance Over Form”

There are no provisions in the tax laws to allow tax authorities to “look through” companies which lack economic substance. So, MOFE has proposed introducing specific language into the LCITA that would allow tax authorities to disregard interposed companies with no economic substance, whose main function is to claim treaty benefits.

New withholding tax rule

Where a foreign company located in a designated tax haven (to be determined by the MOFE) derives Korean sourced income and gains from its Korean investments through a jurisdiction which has concluded a tax treaty with Korea, a withholding tax is required to be deducted at the domestic withholding tax rate of generally 27.5%, without regard to the relevant treaty.

The foreign company is then able to claim a refund for any overpaid tax within 3 years if the fund can substantiate that it has the beneficial



ownership of the income in the jurisdiction in which the treaty benefits are claimed. As an alternative, a fund can apply to seek a pre approval from the National Tax Service (“NTS”) that it qualifies for the treaty benefits.

Tax haven definition

Under the LCITA, residents with an ownership interest of 20 percent or more in an entity located in a tax haven is deemed to have receive a pro rata dividend distribution from

the entity. A tax haven is a jurisdiction in which the effective tax rate on taxable income has been 15 percent or less for the past three years, or 50 percent or more of the income is tax-exempt. Korea's own corporate tax rate on the first KRW 100 million of taxable income is 14.3 percent. Note the discrepancy of deeming jurisdictions that impose a tax rate of 15 percent as tax havens while Korea imposes a lower tax rate on the first KRW 100 million of taxable income.

As a result, MOFE has also proposed that the tax haven rule should not apply if the taxable income of an entity located in a tax haven is KRW 100 million or less. Another revision requires the NTS to designate specific jurisdictions as tax havens in a manner similar to that of other OECD countries.

Tax haven holding companies

MOFE has proposed that the tax haven rule should not apply to holding companies located in tax havens if the subsidiaries of those holding companies are not located in jurisdictions that are considered to be tax havens. However, if there is a business purpose of having a holding company in a tax haven, rather than for tax-motivated reasons, the tax authorities would not enforce this rule.

Indonesian developments

Robertus Winarto and Tomy Harsono

Conduit companies under attack: Payments to offshore companies may be subject to scrutiny

Foreign residents (non-Indonesian tax residents) who earn income from Indonesia are by law liable to income tax in Indonesia. In this respect, the tax liability is to be settled through withholding by the Indonesian party paying or providing the income.

Article 26 of the Income Tax Law specifies the withholding tax rate to be 20% for dividend, interest, royalties, service fees, prizes and rewards and pension payments. Subject to a further implementing regulation from the Minister of Finance (MoF), the same withholding tax rate also applies to the estimated net income from the sales of assets in Indonesia and insurance premiums payable to foreign insurance companies.

If there is a double tax agreement

(DTA) between Indonesia and a specific country, a resident of that specific country may be entitled to withholding tax reduction or exemption in respect of his or her income generated from Indonesia. To date, such DTA benefits can generally be obtained upon presentation of a Certificate of Residence (CoR) of the foreign resident concerned that is issued by the competent authority of that specific country. This practice has historically been based on the guideline of the Director General of Taxation (DGT) set out in SE-03/PJ.101/1996 of March 29, 1996.

Domestic company definition

MOFE has proposed adding a provision to the CITA whereby a foreign company would be regarded as a domestic company if the effective management of the company is exercised in South Korea. However, the proposal would not treat a company established in Korea but managed in a foreign country as a foreign corporation and so the provision may raise discriminatory issues under many tax treaties.

Professional services

The MOFE has proposed revising the IITA and CITA to exclude any reimbursements of out of pocket expenses (such as airfares) incurred in earning professional services income from being subject to Korean withholding tax. Currently, such reimbursements are subject to withholding tax. ■



Recently the DGT issued another internal guideline (SE-04/PJ.34/2005 dated 7 July 2005) relating to the implementation of DTA provisions. Acknowledging that there was a perception that a foreign resident could automatically enjoy DTA benefits merely by presenting a CoR, the DGT asserted that the benefits were actually intended for the beneficial owners of the income concerned. In this context, the DGT stated the following principles:

- A beneficial owner is the actual owner of the income in the form of dividend, interest, and or royalties, either as an individual or corporate taxpayer, who has the full right to directly enjoy the benefit of those income items.
- Special purpose vehicles, such as conduit companies, paper-box companies and pass-through companies, are not considered to be beneficial owners.
- Indonesian parties who pay dividend, interest, and/or royalties to foreign parties other than the beneficial owners, are required to withhold income tax at 20% in accordance with Article 26 of the Indonesian Income Tax Law.

SE-04 might have been issued by the DGT due to its concern over DTA abuses through conduit companies or similar companies. The purpose of combating such practice should not contradict with any DTAs concluded by Indonesia and therefore, as far as that purpose is concerned, there should be no objection from other DTA partners.

In implementation, SE-04 could potentially give rise to some pertinent issues. For instance, are there any documents required to prove that a foreign party claiming DTA benefits is the beneficial owner of the income concerned and not a mere conduit company? And who should bear the burden of proof?

The competent authorities of certain countries have set a policy of not issuing any CoR to conduit companies established in their countries. Hence, CoRs issued by such authorities should imply that the parties referred to therein should not be mere conduit companies used by other interested parties. We believe that, unless there is evidence to the contrary, such CoRs should be accepted as an adequate basis for obtaining DTA benefits and therefore no further evidence should be required. ■