

PwC Alternatives*

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insights for the private equity and hedge fund communities

in this issue:

FIN 48: Will it change accounting for alternative products? 1

FIN 48 affects all U.S. GAAP financial statements for public and private enterprises including domestic and offshore funds and management companies.

SEC issues soft dollar interpretive release ...5

On July 18, 2006, the SEC issued an interpretive release providing guidance on “soft dollars”—the use of client commissions to pay for brokerage and research services under the safe harbor of Section 28(e) of the Securities Exchange Act.

What to expect from an SEC inspection of newly registered hedge funds, part II.....8

Part I of this article series discussed the examination process and actions that can be taken by hedge funds to prepare, navigate and survive the SEC’s inquiries. Part II provides an overview of the areas of review and the recent potential issues of concern to the examiners.

Germany: New protocol to U.S.—Germany income tax treaty 11

On June 1, 2006, the U.S. and Germany signed a protocol amending the 1991 income tax treaty between the two countries. Amendments to dividend taxation, branch profits tax, limitations on benefits, transparent entities and pension plans are discussed.

Germany: Treaty override provisions proposed to be changed..... 13

On July 10, 2006, the German government issued a draft of the 2007 Tax Bill. The bill proposes changes to the current anti-treaty and anti-EU-directive shopping provisions.

FIN 48: Will it change accounting for alternative products?

David Steiner

In June 2006, the Financial Accounting Standards Board (FASB) released Interpretation No. 48 (“FIN 48”), Accounting for Uncertainty in Income Taxes—an Interpretation of FASB Statement 109, to provide consistent guidance on the recognition of uncertain tax positions.

FIN 48 affects all U.S. GAAP financial statements for public and private enterprises including domestic and offshore funds and management companies, and is effective for fiscal years beginning after December 15, 2006 (e.g., January 1, 2007 for calendar-year companies). Although it interprets an existing statement, FIN 48’s effects are widely regarded as significant. FIN 48 explicitly states that it applies to pass-through entities, so that even nominally tax-exempt entities such as partnerships can experience fundamental changes in their approach to considering the effect of income taxes in their financial statements.

FIN 48 may significantly increase the focus on taxes during the audit process. Given FIN 48’s imminent effectiveness, tremendous effort may be required to inventory and analyze worldwide tax positions within a short period.

To understand why the changes under FIN 48 are so sweeping, it is important to understand that FIN 48 uses a two-pronged approach to evaluating uncertain tax positions: recognition and measurement.

Recognition:

An enterprise would be required to recognize the best estimate of the impact of a tax position in its financial statements if the position has a “more likely than not” (that is, greater than 50 percent) likelihood of being sustained upon examination based solely on its technical merits. This is known as “initial recognition.” If a position does not meet the “more likely than not” criterion, then the entity must accrue 100 percent of the liability.

A tax position is defined as a position that has been or will be taken on a tax return that is “reflected in measuring current or deferred income tax assets and liabilities.” Of particular importance to the alternative investments industry, tax position also includes, but is not limited to:

- 1) A decision not to file a tax return;
- 2) An allocation or shift of income between jurisdictions;
- 3) The characterization of income or a decision to exclude reporting taxable income in a return; and
- 4) A decision to classify a transaction, entity or other position in a tax return as tax-exempt.

FIN 48 sets further standards for recognition of benefit:

- 1) It must be presumed that the tax position will be examined: Enterprises cannot justify non-accrual of a liability for an uncertain position simply by asserting that they have a high probability of escaping the “audit lottery.”
- 2) Technical merit does not consist of adhering to the relevant tax law; the legislative record, regulations, rulings, case law and “past administrative practices and precedents” of taxing authorities in dealing with the enterprise or similar enterprises that are “widely understood” shall be taken into account. This exception, based on past administrative practices, should have very limited application, if any, given the unique issues faced by funds.
- 3) Each tax position must be evaluated individually, without regard to offsets or aggregation with other positions.

Measurement:

Once it has been determined that a tax position meets the recognition threshold, its effect on tax liabilities must be measured. Under FIN 48, a position should be measured as the largest amount that is cumulatively greater than 50 percent likely of being realized upon settlement with a taxing authority. The amounts and probabilities of the outcomes must be considered using all facts, circumstances and information available at the reporting date. FIN 48 provides an example in which a taxpayer assesses the possible outcomes of a position and associates individual percentage likelihoods with each possibility. An outcome whose individual probability, when added to other possibilities, exceeds 50 percent is recorded.

Other aspects:

FIN 48 requires that, if a benefit is not recognized in the period a position was taken due to the fact that it did not meet the “more likely than not” threshold, it should be recognized in the first interim period the position meets any of the following conditions:

- 1) The “more likely than not” threshold is met by the reporting date.
- 2) The matter is settled through negotiation or litigation.
- 3) The statute of limitations for the relevant taxing authority to examine and challenge the tax position has expired.

Additional provisions of FIN 48 include:

- 1) Enterprises must derecognize previously recognized benefits (i.e., recognize additional liabilities) in the first period in which it is determined that they no longer meet the “more likely than not” recognition threshold.
- 2) Subsequent changes in judgment should be based on evaluation of new information (e.g., actual settlement with a taxing authority of other open years, adjudication of a similar case involving another taxpayer or issuance of a private letter ruling), not simply a reassessment or reinterpretation of previously known information.
- 3) Enterprises must accrue interest and penalties on any underpayment of tax, if the law requires, in the first period the interest would begin to accrue under the relevant tax law. The amount is computed at the applicable statutory rate, based on the difference between the benefit of the tax position recognized under FIN 48 and any larger benefit claimed on the enterprise’s tax return.

Possible impacts on alternative investment funds:

There are many areas where FIN 48 could affect alternative investment funds:

- Offshore fund/international tax considerations:
 - Since many offshore funds do not file U.S. tax returns, the statute of limitations has not begun. All tax positions for all years may be subject to examination and interest and penalties on underpayment of tax may need to be accrued. Funds should consider their individual facts and circumstances and determine whether filing “protective” tax returns in order to start the running of the statute and preserve the ability to deduct expenses is appropriate.

- Exposures may arise where entities organized in tax-advantaged jurisdictions take certain tax positions regarding availability of a treaty, thereby minimizing taxes (i.e., cross-border treaty structures).
 - A fund's operations may be taxed in a jurisdiction by virtue of having an office or agent in that locale (i.e., a subadvisor) commonly known as "permanent establishment" risk.
 - Tax on foreign trading activities such as dividends, interest and capital gains should be assessed and measured both on a paid and accrued basis.
- State and local income tax considerations:
 - Funds may have a "nexus" to particular states or cities that could subject them to entity-level income tax. One example is the New York City unincorporated business tax on non-trading protected investments.
 - Many domestic vehicles may not file in a particular state until a minimum threshold of income is reached. This may create filing penalties. While such penalties are not necessarily a FIN 48 exposure, they are penalties resulting from non-tax filings that should be considered and assessed independently.
 - Portfolio activity considerations:
 - Activities that may not be covered under the trading "safe-harbor," including, but not limited to, loan origination and real estate activities.
 - Certain swap transactions.
 - Fees (e.g., consent) and other ordinary income which may be subject to 30 percent gross income tax.
 - Funds also should ensure that interest payments received on U.S. debt or loans satisfy the exception to 30 percent withholding tax otherwise known as "portfolio interest."
 - Investments in flow-through entities, such as publicly traded partnerships.
 - Other considerations:
 - A common concern is that FIN 48 may require funds to accrue liabilities that ultimately may not be paid (if, for example, the statute of limitations runs its course). As a result, there will be an impact to net asset value both when the liability is recognized and when it is derecognized. In an open-ended fund, the owners and/or their ownership percentages likely will change, and this may have benefits or detriments for certain investors, depending upon their entry and exit. What are the consequences?
 - Ensuring properly executed withholding forms are on file with counterparties.
- Ensuring check-the-box forms are properly executed and filed.
 - Certain positions may relate to questions about whether a domestic fund itself is, or is not, a publicly traded partnership (which would result in the fund being taxed as a corporation).
 - For a domestic fund of funds, which generally does not have an entity-level tax liability, are there reporting obligations to investors with respect to any tax positions?
 - "Blockers" used to hold certain investments should be assessed under FAS 109/FIN 48. While such blockers will be subject to tax on a current basis, such holdings also should take into account deferred taxes on a fair market value basis. This could result in the reporting of an income tax liability at the fund level if the blocker is consolidated from a GAAP perspective.
 - On a practical level, the approach for evaluating measurement will be difficult in light of the lack of settlement history to use as precedent for many tax positions.

Given that FIN 48 will be effective soon, companies need to assess all material open positions for all open years in all tax jurisdictions as of the adoption date and determine the appropriate amount of tax benefits or liabilities that are recognizable under FIN 48. Any difference between the amounts previously recognized and the benefit or liability determined under FIN 48, including changes in accrued interest and penalties, has to be recorded through a direct charge to retained earnings on the date of adoption. For funds of all types, adoption is considered to be required as of the first computation of net asset value in the year of adoption. For example, hedge funds with calendar year-ends and monthly determinations of net asset value would be required to implement FIN 48 as part of their January 31, 2007 valuations.

The requirement to assess all material uncertain positions against the recognition threshold and subsequent measurement of the qualifying tax impact will increase the focus on the reasonableness of conclusions and the reliability of applied processes.

Questions that fund management needs to address include:

- How is management ensuring that all material positions are identified and assessed?
- How is management ensuring appropriate monitoring of such positions in subsequent periods?
- How is management identifying and processing relevant new information that could change a judgment about the sustainability of a position or the measurement of a tax benefit?

Another matter of concern for many companies is the level of effort and documentation that will be required as part of the recognition and measurement process under FIN 48. Due to the large number of possible exposures and the number of relevant taxing authorities, it is very difficult to develop applicable guidance. Consistent with the current practice, management will need to provide its auditors with an assessment of all material uncertainties and their expected outcomes. However, judgment will be required in determining how the company should document those uncertainties.

A final significant area of concern is the amount of effort required to assess and evaluate existing exposures in open years for transition purposes. Funds' tax specialists will likely be required to re-review all open tax returns and underlying workpapers to identify, catalog and evaluate their uncertainties—in effect, to build a tracking record from scratch in a matter of months. Therefore, the analysis of open tax years is required to begin almost immediately for fund families of any size or complexity.

Conclusion

FIN 48's adoption is expected to have a fundamental impact on the way enterprises of all types approach their accounting for income taxes and the rigorous effort required. Furthermore, taxpayers investing in partnerships may require more transparency surrounding the tax positions taken, as a result of the FIN 48 analysis that must occur at the partner level. Because of FIN 48's significance and its imminent effective date, prompt consideration of its effects is vital to complying with financial reporting requirements.

In the end, FIN 48 may well have benefits for alternative products by requiring structured decision-making over the rationale for various tax positions. FIN 48 compliance is likely to shine a light on an area that frequently has been an afterthought because of the products' presumed tax-exempt status. This, in turn, will provide an opportunity to enhance internal controls over the entire area of fund taxation. Such improved controls will reduce the potential for adverse tax consequences being detected when a taxing authority performs an audit and the options for addressing the issue are more limited and the consequences more severe. ■

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SEC issues soft dollar interpretive release

Anjali Kamat

On July 18, 2006, the Securities and Exchange Commission (“SEC”) issued an interpretive release providing guidance on “soft dollars”—the use of client commissions to pay for brokerage and research services under the safe harbor of Section 28(e) of the Securities Exchange Act. The release clarifies the scope of “brokerage and research services” and the boundaries of Section 28(e) in light of changing market conditions and current industry practices.

Although similar to the proposed “soft dollar” interpretive release issued in October 2005, the new release offers greater flexibility concerning commission-sharing arrangements and third-party research than had been proposed previously.

The interpretive release reiterated a three-step approach for money managers to determine whether a product or service constitutes “research or brokerage” within the safe harbor of Section 28(e):

- A determination that the product or service meets the eligibility criteria in Section 28(e);
- A determination that the product or service provides lawful and appropriate assistance in the performance of investment-making responsibilities (for mixed-use items, a reasonable allocation must be made according to use); and
- A good-faith determination that the value of any such service is reasonable in relation to the commissions paid.

Research services

Eligible “research services” are limited to products and services that assist the manager in his or her investment decision-making process. Inherently tangible products generally do not qualify. Examples of eligible and ineligible research services are included in Appendix A to this article.

Notably, the SEC now considers mass-marketed publications to be ineligible, concluding that newspapers, magazines and other low-cost, mass-marketed publications are not intended to serve managers’ specialized interests. As such, these mass-marketed publications should be considered overhead expenses of the manager. However, specialized publications, such as financial and economic newsletters and similar high-cost publications, may be considered an eligible research service.

Additionally, the SEC concluded that proxy services would best be treated as a mixed-use service, given the range of products typically offered by proxy voting services. Some of the products offered, including reports and analyses on issuers, securities and the advisability of investing in securities, may be considered eligible research under Section 28(e). However, the administrative aspects of voting, such as casting, counting, recording and reporting votes, which are also handled by proxy services, should be considered overhead expenses of the manager and ineligible under Section 28(e).

The SEC also discusses “market research” (separate from “market data”) as a potentially eligible product if it satisfies the statute’s subject matter criteria and provides lawful and appropriate assistance in the investment decision-making process. Examples of potentially eligible market research include pre-trade and post-trade analytics, research on optimal execution venues and trading strategies, advice from broker-dealers on order execution (including advice on execution strategies), market color and the availability of buyers and sellers. The delivery mechanisms of market research could include order management systems and trade analytical software.

Brokerage services

Brokerage services that facilitate trade execution are protected under Section 28(e). Trade execution is driven by a “temporal standard” which begins when an order is placed and extends through execution, clearance and settlement. Brokerage services falling outside this temporal standard are considered overhead expenses of the manager.

The SEC did clarify the issue of short-term versus long-term custody as an eligible brokerage service:

- Short-term custody falls within the safe harbor of Section 28(e) since it relates to trade processing within the “temporal standard.”
- Long-term custody is viewed as a post-settlement service that relates to the maintenance of securities. Since long-term custody is a benefit to the client, any expenses relating to such service are normally borne by the client, who enters into a contractual arrangement with the custodian bank directly. The custodial service is unrelated to effecting securities trades for the client, so the SEC concluded that, if a client’s long-term custody expenses are paid for with that client’s commissions, Section 28(e) does not apply.

Mixed-use services

The SEC cautioned that appropriate bases must be documented for mixed-use services. The lack of documentation raises questions as to how a good-faith allocation between eligible and ineligible services was achieved.

Commission-sharing arrangements and third-party research

The SEC increased flexibility for introducing broker arrangements to fall within the safe harbor. The SEC reiterated its position that a broker “effecting” transactions must “provide” the research to fall within Section 28(e) but has eased the requirements for meeting this definition.

The SEC recognizes that low-cost and efficient trade execution can be separate from the function of providing research ideas, both of which benefit client accounts. In order to be considered “effecting” a transaction, the broker must execute, clear, settle trades or perform one of the following four functions, rather than all functions, as originally proposed:

- Take financial responsibility for all customer trades until the clearing broker-dealer has received payment (or securities);
- Make and/or maintain records relating to customer trades required by SEC and SRO rules, including blotters and memoranda of orders;
- Monitor and respond to customer comments concerning the trading process; and
- Monitor trades and settlements.

The “provided by” element will be satisfied by the broker “effecting” the trade if the following requirements are met:

- The broker-dealer pays the research preparer directly;
- The broker-dealer reviews the services to be paid for with client commissions under the safe harbor for red flags that indicate the services are not within Section 28(e) and agrees with the manager to use client commissions to pay only for those items that reasonably fall within the safe harbor; and

- The broker-dealer develops and maintains procedures so that research payments are documented and paid for promptly.

The SEC will also allow broker-dealers to pool commissions received from a manager until the manager directs the broker-dealer to pay for research (a practice also permitted by the Financial Services Authority in the United Kingdom).

The release also reminds managers and broker-dealers of their legal responsibility to assess whether they and/or other parties involved in the soft dollar arrangement are contributing to a violation of law. As a specific example, the release explains that, if a broker-dealer is aware that a manager has represented to clients that he or she will operate solely within Section 28(e) and then asks the broker-dealer to pay for items that are not eligible under the safe harbor, the broker-dealer may risk aiding and abetting liability.

Additional guidance on commission-sharing arrangements

In its interpretive release, the SEC requested comments on industry practices relating to client commission arrangements in order to determine whether additional guidance is required. Based on comments received, supplemental guidance may be issued in the future.

Effective dates

The interpretive release is effective July 24, 2006. However, managers may continue to rely on prior SEC guidance for a six-month period ending January 24, 2007.

The full text of the interpretive release is available at: <http://www.sec.gov/rules/interp/2006/34-54165.pdf>

Appendix A

The following is a list of “eligible and “ineligible” research and brokerage services based on examples provided by the SEC in the interpretive release. This is not intended to be a comprehensive list.

Eligible research services:

- Traditional research reports analyzing the performance of a particular company or stock
- Discussions with research analysts as to the advisability of investing in securities
- Meetings with corporate executives to obtain oral reports on the performance of a company
- Seminars or conferences are eligible so long as they truly relate to research and provide substantive content relating to the subject matter in the statute
- Software that provides analyses of securities portfolios
- Corporate governance research and analytics and corporate governance rating services could be eligible if they reflect the expression of reasoning or knowledge relating to the subject matter of the statute (for example, if they provide reports and analyses about issuers, which can have a bearing on the companies’ performance outlook)
- Market data such as financial and economic data

Ineligible research services:

- Computer hardware, computer accessories and delivery mechanisms associated with computer hardware, i.e., telecommunications lines, transatlantic cables
- Office furniture and equipment
- Business supplies
- Telephone lines
- Expenses for travel, entertainment, and meals associated with attending research seminars and meetings with analysts or corporate executives
- Salaries (including research staff)
- Rent and utilities
- Accounting and legal expenses
- Software (including email software), web design and internet service
- Personnel management
- Marketing
- Membership dues and professional licensing fees
- Software to assist with the manager’s administrative functions
- Mass-marketed publications such as newspapers and magazines

Eligible brokerage services:

- Communications services related to the execution, clearing, and settlement of securities transactions and other functions incidental to effecting securities transactions including:
 - Connectivity service between the money manager and the broker-dealer and other relevant parties such as custodians
 - Dedicated lines between the broker-dealer and the money manager’s order management system
 - Lines between the broker-dealer and order management systems operated by a third-party vendor
 - Dedicated lines providing direct dial-up service between the money manager and the trading desk at the broker-dealer
 - Message services used to transmit orders to broker-dealers for execution
- Trading software including:
 - Software used to route orders to market centers
 - Software that provides algorithmic trading strategies
 - Software used to transmit orders to direct market access (“DMA”) systems

(Note: Unlike research, brokerage services can include connectivity services and trading software if they are used to transmit orders to the broker since the transmission is considered an inherent part of the brokerage service. On the other hand, mechanisms used to deliver research are considered separate from the research information and the decision-making process.)

- Post-trade services including:
 - Post-trade matching
 - Exchange of messages among broker-dealers, custodians, and institutions
 - Electronic communication of allocation instructions between institutions and broker-dealers
 - Routing settlement instructions to custodian banks and broker-dealers’ clearing agents

Ineligible brokerage services:

- Order management systems used by money managers to manage their orders
- Hardware including telephones or computer terminals, such as those used in connection with OMS and trading software
- Software functionality used for recordkeeping or administrative purposes
- Quantitative analytical software used to test “what if” scenarios related to adjusting portfolios, asset allocation, or for portfolio modeling (whether or not provided through OMS)
- Software used to meet compliance responsibilities, including:
 - Performing compliance tests that analyze information over time in order to identify unusual patterns, including for example, an analysis of the quality of brokerage executions (for the purpose of evaluating the manager’s fulfillment of its duty of best execution)
 - Analysis of the portfolio turnover rate (to determine whether portfolio managers are overtrading securities)
- Analysis of the comparative performance of similarly managed accounts (to detect favoritism, misallocation of investment opportunities, or other breaches of fiduciary responsibilities)
- Creating trade parameters for compliance with regulatory requirements, prospectus disclosure, or investment objectives
- Stress-testing a portfolio under a variety of market conditions or to monitor style drift
- Trade financing, such as stock lending fees, and capital introduction and margin services
- Error correction trades or related services in connection with errors made by money managers. ■

What to expect from an SEC inspection of newly registered hedge funds, part II

Ralph Mittl

[Part I of this article series discussed the examination process and actions that can be taken by hedge funds to prepare, navigate and survive the SEC’s inquiries. Part II provides an overview of the areas of review and the recent potential issues of concern to the examiners.](#)

Background

As a result of the SEC’s adoption of rule 203(b)(3)-2 and amendments to rules 203(b)(3)-1, 203A-3, 204-2, 205-3, and 222-2, “Registration Under the Advisers Act of Certain Hedge Fund Advisers,” many previously unregistered hedge funds were required to register by February 1, 2006.

Although the rule was recently vacated and remanded by the United States Court of Appeals for the District of Columbia Circuit¹, many, and possibly a majority, of these recently registered advisers currently are electing to remain registered, and thus are subject to examination by the SEC. Prior to the court’s decision, the SEC planned to examine 100–150 newly registered hedge fund advisers within nine to twelve months, with emphasis on funds with significant assets or highly public images. According to media reports, the SEC brought over 30 hedge fund enforcement actions in 2005.

Once a hedge fund adviser has been identified for examination, the SEC will formally request specific documents, including those that its examiners intend to review during the inspection. The SEC’s primary focus will be to assess the hedge fund’s controls and procedures. A hedge fund should also expect the SEC to visit and review its website and evaluate its publicly available Form ADV-Part I prior to arriving onsite for the examination.

Areas of review

There are several broad areas of review which the SEC will undertake during the examination, including:

- Registration & Disclosure (e.g., offering memoranda)
- Portfolio Management & Trading (e.g., trade allocations)

¹ See *Goldstein v. Securities & Exchange Commission*, 451 F.3d 873 (D.C. Cir. 2006)

- Marketing & Solicitations (e.g., advertising materials)
- Conflicts of Interest & Insider Trading (e.g., personal trading)
- Legal & Management (e.g., advisory agreements)
- Privacy Standards (e.g., protection of customer information)
- Know Your Customer (e.g., anti-money laundering)
- Books & Records (e.g., accounting and trading records)
- Operations & Custodians (e.g., trade settlement)
- Internal Controls (e.g., policies and procedures)

These categories should be familiar to registered advisers who have been examined in the past. Given the knowledge the SEC has gained from their hedge fund questionnaires and their most recent on-site inspections of hedge funds, there are specific areas with perceived deficiencies. Newly registered hedge funds and high profile hedge funds need to be aware of these potential areas of concern.

Potential trouble: Institutional and personal conflicts

Given the nature of the hedge fund business and the inherent potential conflicts, firms are required to identify and disclose these conflicts in Item 9 of ADV Part II. During the examination, the examiners will review how these conflicts are monitored and tracked as well as inquire about potential conflicts that may have been missed and how they are managed.

For example, hedge fund advisers are often investing in different parts of the capital structure while managing multiple portfolios with different investment strategies. On the debt side, this may require that they join creditor committees which often acquire material, non-public information. Section 204A requires adequate supervision of investment adviser personnel who have access to the information and requires policies and procedures highlighting how to handle the information appropriately.

Some questions that the CCO must consider in these instances include:

- Does the CCO restrict issues when a private deal is being worked?
- When is the restriction lifted?
- Are there other opportunities for personnel and principals to acquire insider information?
- Who and what do confidentiality agreements cover?

Another area of focus for SEC examiners includes a review of the firm's code of ethics and personal trading policies. For example, while some hedge funds ban or severely limit personal trading, other hedge funds permit personal trading. For those funds that allow personal trading, the burden then falls on the firm to demonstrate that the trading is reported and monitored for conflicts, such as front running and trading along with

the funds being managed. In addition, the SEC will inquire whether personnel are permitted to invest in private funds and whether the investments are pre-approved.

Other inquiries regarding potential conflicts include:

- Principals having ownership in administrators and custodians
- Allocation of due diligence costs, salaries, and expenses across accounts
- Use of soft dollars and the allocation of hard dollars vs. soft dollars
- Hidden fee arrangements and side letters
- Solicitation agreements for client referrals
- Rights of debt holders to equity holders in bankruptcy matters
- Principals investing in other funds

What is it worth: Asset valuation

The examiners will assess whether the fund's valuation policies and procedures appear to be fair, disclosed and board approved (when appropriate). They will ask who is initially responsible for determining the valuation of portfolio holdings and will take note of those prices. For example, receiving a single price from the counterparty who originally sold the security to the fund, or traders and portfolio managers who price their own instruments are potential red flags to the examiners. The examiners may also compare recent sale prices against the fund's carrying prices to determine whether the valuations were improper or inaccurate.

Other valuation-related inquiries that may lead to more in-depth discussions with examiners include:

- Varying prices across accounts, including those at different custodians
- Pricing services used
- Impact of downgrades on sole-priced instruments
- Large sales of thinly traded instruments

How does the firm solicit assets: Marketing & distribution

The examiners will review advertising materials, brochures, pitchbooks, offering documents and the fund's website. They will assess whether any guidelines discussed in pitchbooks are implemented and monitored over time. Recently the SEC has focused on determining who brings in business and how they are compensated. Additional potential areas of concern include:

- Performance calculations and performance record keeping
- Use of another fund's performance for marketing new funds
- Accounts included in performance composites
- Side pocket arrangements

How does the firm trade: Trading practices

Deeper scrutiny of trading practices appears to be an evolving trend with the SEC. For example, trade allocations as disclosed under Item 9 of ADV Part II are a definite area of focus, and may be considered a potential weakness. The examiners are being instructed to review allocations across strategies and the allocations within each strategy to determine whether allocations are fair and correct.

Hedge fund firms that also have separate accounts and registered investment company clients will be scrutinized when the manager receives incentive fees for profit performance or when the management fee structure varies across the various accounts. The primary concern is whether these incentives impact the allocations to the fund.

Additional allocation concerns include:

- Documentation of allocations, particularly exceptions to stated policies
- Determining and recording pre-allocations prior to execution
- Disclosure of allocation and pre-allocation processes

The SEC is also assessing whether hedge funds are performing (or not performing) reasonable trading practices. For example, the examiners search for instances of short selling five or fewer days before a secondary offering (Reg M). Acting as a group with other funds or advisers without adequate filings and disclosures (Section 13) is another current concern.

Is the firm following policy: Results of the annual assessment

Under Rule 206(4)-7, the SEC requires advisers to perform an annual assessment to determine if they are following their stated policies and procedures. The examiners will review the assessment and evaluate its level of quality and the adequacy of forensic testing. Some questions that are typically considered include:

- Has the firm demonstrated its compliance throughout the year?
- Did compliance take appropriate actions when exceptions/violations occurred?
- Were policies and procedures adjusted appropriately?
- Are forensic tests being performed on trading to detect inappropriate trading patterns?
- The examiners will probe more deeply during an examination if the annual assessment program is perceived as weak or inadequate.

The SEC's approach to reviewing hedge funds will continue to evolve over the next 12-18 months. And, new areas of concern will undoubtedly surface, requiring hedge funds to once again assess their risks and compliance effectiveness. Many hedge funds will likely receive deficiency letters and some hedge funds will be referred to enforcement. However, hedge funds with strong and robust compliance programs will minimize their risks, respond swiftly to business and regulatory needs and survive the scrutiny of SEC examinations. ■

Germany: New protocol to U.S.— Germany income tax treaty

Oscar Teunissen, Pia Dorfmueller, Hans-Martin Eckstein and Tom Swoboda

On June 1, 2006, the U.S. and Germany signed a protocol amending the 1991 income tax treaty between the two countries. Select amendments are reviewed below.

Dividend taxation

The protocol completely exempts from withholding tax certain dividends from subsidiaries to parent corporations. The exemption applies only if the parent “directly” owned 80 percent or more of the voting power of the subsidiary for the 12-month period ending on the date the entitlement to the dividend is determined. In addition, the parent must either:

- (1) Satisfy the limitation on benefits provisions relating to companies that: Are publicly traded (or are more than 50 percent owned by five or fewer qualifying publicly traded companies) and:
 - (a) Are at least 50 percent owned by qualifying residents of their home country;
 - (b) Derive the dividend in connection with or incidental to an active trade or business in their home country; and
 - (c) Meet a base erosion test; or,
- (2) Meet a new “derivative benefits” provision described below; or,
- (3) Obtain a determination from a competent authority that the company’s primary purpose is not to secure the benefits of the treaty.

The protocol also completely exempts dividends paid to a qualifying pension fund and not derived from one of the fund’s business activities. For dividends not eligible for exemption, the withholding rate generally continues to be 5 percent (if the recipient is a corporation that “directly” owns at least 10 percent of the voting stock of the payer) and 15 percent in other cases. Germany has a strict interpretation of “direct ownership,” and ownership through a tax-transparent partnership or limited liability company does not qualify as “direct.” (In contrast, the IRS in the U.S. has issued a ruling to one company that ownership through a disregarded entity satisfies the comparable “direct” ownership requirement in the U.S.-U.K. treaty.)

Since Germany no longer allows individuals a tax credit for dividends paid by German companies, the protocol deletes the current treaty’s provisions granting an additional 5 percent reduction in German withholding tax on dividends to U.S. recipients entitled to the 15 percent rate (and requiring grossed-up income inclusions and credits for U.S. tax purposes).

The protocol has implications for dividends from certain German regulated mutual fund vehicles (German Investment Funds and

Investmentaktiengesellschaft), U.S. regulated investment companies and U.S. real estate investment trusts (REITs):

- Neither the parent-subsidiary exemption nor the 5 percent rate applies;
- The exemption for dividends received by qualifying pension funds applies (apparently even if paid by German mutual funds, many of which are not treated as “companies”), but dividends from German real estate investment companies will not qualify for this exemption if Germany institutes a regime that exempts such companies from tax;
- Dividends from U.S. regulated investment companies and German mutual funds are eligible for the 15 percent rate; and
- The 15 percent rate applies to dividends from REITs only in the case of (a) an individual owning a 10 percent or smaller interest in the REIT; (b) dividends on a publicly traded class of stock to a person owning a 5 percent or smaller interest in any class of stock of the REIT; or (c) dividends paid by a diversified REIT to a person owning a 10 percent or smaller interest in the REIT.

Branch profits tax

A complete exemption from branch profits tax applies to companies that satisfy specified limitations on benefits provisions similar to those that apply to the new parent-subsidiary dividend exemption; for all other companies, the rate continues to be 5 percent.

Since the tax rates for resident and non-resident companies are now equal, the protocol deletes the current treaty provision that limits the imposition of German branch profits tax when the rate of German tax on German branches exceeds the rate on distributed profits of German companies.

Limitation on benefits

The protocol adds a new “derivative benefits” provision under which a company is eligible for treaty benefits if:

- (a) At least 95 percent of the total voting power and value of the company’s shares are owned by seven or fewer persons who are either:
 - (i) Qualifying residents of states within the European Union, the European Economic Area or NAFTA and, in the case of dividend, interest and royalty payments, who would be entitled to the same or a lower withholding rate if they received such payments directly, or,
 - (ii) U.S. or German residents that meet certain specified provisions under the limitations on benefits article; and,
- (b) The company satisfies a base erosion test.

Other changes to the limitation on benefits article include:

- In the case of a publicly traded company, either its principal class of shares must be traded in, or its “primary place of management” must be located in, its home country;
- A company that is at least 50 percent owned by five or fewer qualifying publicly traded companies would no longer have to satisfy a base erosion test;
- Limits are imposed on relief for a permanent establishment in a third country that is subject to a lower tax rate than applies in the home country; and
- In the case of a German investment fund or *Investmentaktiengesellschaft*, at least 90 percent of the shares or other interests in such entity must be owned by German residents who satisfy specified limitations on benefits provisions. (Procedures for determining ownership are to be established by the competent authorities.)

Transparent entities

The protocol provides that income derived by or through partnerships or other entities that are fiscally transparent for either U.S. or German tax purposes is treated as income of a resident of the U.S. or Germany to the extent the item is treated as income of a resident by such country. Accordingly, income of a limited liability company that is treated as a partnership (or disregarded if there is a single member) for U.S. tax purposes may qualify for treaty relief to the extent the income is attributable to U.S. resident members, even though Germany might otherwise treat the limited liability company as a corporate entity.

Pension plans

An individual who participates in a qualifying pension plan in one country and thereafter is employed (or self-employed) for a period in the other country will not be subject to tax in the first country on contributions (whether by the individual or the employer) to the plan, or benefits accruing under the plan, during the period.

The employer may deduct any contributions it makes to the plan when computing its business profits in the other country. In each case, the relief is limited to the relief the other country provides to its own residents and to pension plans of a type recognized by the other country. (The protocol includes a list of recognized types of plans.) In addition, if an individual resident of one country participates in a qualifying pension plan in the other country, income earned by the plan is taxable only when and to the extent paid to or for the benefit of the individual (and not rolled over to another plan in the other country).

Additional benefits are provided to U.S. citizens who reside in Germany, are employed by a German employer and work and pay tax in Germany. Such individuals can participate in a German pension plan subject to section 1 of the German law on employee pension plans (*Betriebsrentengesetz*) without being subject to current tax in the U.S. on contributions (whether by the individual or the employer) to the plan or benefits accruing under the plan. These benefits are available only to the extent the contributions or benefits qualify for tax relief in Germany and may not exceed the relief allowable by the U.S. to U.S. residents with respect to contributions or accrued plan benefits. There is no corresponding provision for German citizens who work in the U.S. ■

Germany: Treaty override provisions proposed to be changed

Oscar Teunissen, Pia Dorfmueller, Hans-Martin Eckstein and Tom Swoboda

On July 10, 2006, the German government issued a draft of the 2007 Tax Bill. The bill proposes changes to the current anti-treaty and anti-EU-directive shopping provisions.

In a May 2005 decision published this year, the highest German tax court took a taxpayer-friendly position on the application of the present German anti-shopping provisions. German tax authorities are now considering changing the anti-treaty and anti-EU-directive shopping provisions and have drafted revised legislation that potentially could become applicable in 2007.

Under the July 2006 draft, a foreign company is entitled to a full or partial treaty or EU directive relief from withholding taxes only:

- To the extent it has shareholders who would be entitled to the same relief if they received the income of the foreign company under review directly; or
- The foreign company under review passes the three tests outlined below.

Under these tests:

- 1) There must be economic or other important, non-tax reasons for the interposition of the foreign company;
- 2) The foreign company must derive more than 10 percent of its gross income from its own commercial activities; and,
- 3) The foreign company must have its own business premises enabling it to participate in the business community.

The rules will not apply to foreign companies if their main share classes are materially and regularly traded at a recognized stock exchange.

If these rules are enacted, it could become very difficult to obtain an exemption from German taxes in cases in which the ultimate beneficiary is not entitled to the same relief. In particular, this is applicable to certain private equity investments in Germany as well as to strategic investments from certain countries.

PricewaterhouseCoopers will provide an update on this topic as soon as more information becomes available. ■

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