

PwC Alternatives*

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insights for the private equity and hedge fund communities

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Reminder to hedge funds and other investment vehicles: June 30 deadline approaching for foreign account reporting requirement

Severe penalties may apply for failure to report

Michelle Ingber

Since the passage of the federal Bank Secrecy Act in 1970, increased emphasis has been placed on requirements for reporting of foreign accounts held by U.S. citizens and entities. Originally meant to help identify drug traffickers seeking to launder money and individuals trying to evade taxes or creditors, the reporting requirements have taken on new significance in the post-9/11 world, as government officials hunt suspected terrorists.

Although the purpose of foreign account reporting is to identify potential criminals, it is relatively easy for hedge funds and other investment partnerships – especially those with a significant international presence – to run afoul of its reporting requirements. For example, an investment in a hedge fund could arguably be an interest in a financial account where the assets (stocks and securities) are held in a commingled fund and the account owners hold equity interests in the fund.

Given that the deadline for reporting foreign accounts held during calendar 2005 is June 30, 2006, with no extensions possible – and given the severe civil and criminal penalties for even an unintentional failure to file – hedge funds and other investment vehicles need to review their situation immediately and determine whether they must file.

The law appears straightforward: It requires that any “U.S. person” (defined as a (1) a citizen or resident of the United States, (2) a domestic partnership, (3) a domestic corporation or (4) a domestic estate or trust) who has a “financial interest” in or signature authority, or other authority over any “foreign financial account” must report the account by filing Form TD F 90-22.1. The filing is necessary if the aggregate value of *all* of the U.S. person’s foreign financial accounts exceeds \$10,000 at any time during the calendar year. Once the \$10,000 threshold is met, all of the U.S. person’s foreign financial account relationships during that year are subject to reporting.

Although the basic requirements are clear, the questions of which types of accounts qualify and what constitutes a financial interest are less so, especially as they might apply to hedge funds and other investment vehicles.

A “financial account” generally includes any bank, securities, securities derivatives or other financial instruments accounts. Such accounts generally also encompass any accounts in which the assets are held in a commingled fund, and the account owner holds an equity interest in the fund. A financial account will be considered “foreign” if it is in a foreign country (i.e., outside the U.S., Guam, Puerto Rico and the Virgin Islands).

A “financial interest” exists if a U.S. person is the owner of record or holder of legal title, whether the account is maintained for his benefit or for the benefit of others. A U.S. person is also considered to have a financial interest in a foreign financial account for which the owner of

record or holder of legal title is a corporation or partnership in which the U.S. person owns more than a 50% interest (by value of total stock in the case of a corporation and by profits percentage in the case of a partnership).

The chart below outlines typical hedge fund structures and our interpretation of how these rules apply to them:

| ENTITY/PERSON | FORM TD F 90-22.1 REQUIRED? | EXPLANATION |
|---|-----------------------------|---|
| Foreign fund (foreign corp.) in a parallel structure | no | A foreign fund is not a U.S. person and therefore does not need to file. |
| Domestic fund (U.S. partnership) in a parallel structure | probably | The domestic fund is a U.S. person with a financial interest in a financial account (because stocks and securities are held in a commingled fund) and, possibly, signature or other authority over such account. Such an account will be a “foreign” financial account if the domestic fund has any foreign holdings. If it is a foreign financial account, the domestic fund must file. |
| Foreign master fund (partnership) | no | A foreign fund is not a U.S. person and therefore does not need to file. |
| Domestic feeder investing in foreign master fund ¹ | yes | We assume that the foreign master fund is itself a foreign “financial account” because the assets (i.e., stocks and securities) are held in a commingled fund. The domestic feeder is a U.S. person with a financial interest in such foreign financial account. Accordingly, the domestic feeder must file. In addition, if the domestic feeder owns more than a 50% interest in the foreign master fund and the foreign master fund has foreign financial accounts, the domestic feeder would have to file for those accounts as well. |
| Foreign feeder investing in foreign master fund | no | The foreign feeder is not a U.S. person and therefore does not need to file. |
| General partner of domestic fund in parallel structure | no (unless >50% interested) | The domestic fund itself is not a foreign financial account, but we assume the domestic fund has financial interests in foreign financial accounts. The general partner, a U.S. person, only has a financial interest in such accounts if it owns an interest in more than 50% of the profits of the domestic fund. The general partner would not have signature or other authority over the account because an entity itself cannot have such authority. Without a financial interest or signature authority, the general partner would not need to file. |
| General partner of domestic feeder investing in foreign master fund ¹ | no (unless >50% interested) | The domestic feeder itself is not a foreign financial account, but the foreign master fund into which it invests is. The general partner, a U.S. person, has a financial interest in such foreign financial account only if it owns an interest in more than 50% of the profits of the domestic feeder. The general partner of the domestic feeder would not have signature or other authority over the foreign master fund because an entity itself cannot have such authority. Without a financial interest or signature authority, the general partner would not need to file. |
| Management company (U.S. limited partnership) | no | The management company does not have a financial interest in the funds and an entity itself cannot have signature authority (but designated employees can – see below). Accordingly, the management company does not need to file. |
| CFO or principals of the management company (or others with signature authority) who are U.S. citizens or residents | yes | Assuming these individuals have signature or other authority over the foreign financial account, they would have to file. |

¹ We assume there is no account/activity at the feeder fund level.

(chart continues on the next page)

| ENTITY/PERSON | FORM TD F 90-22.1 REQUIRED? | EXPLANATION |
|---|-----------------------------|--|
| Limited partner in domestic fund in parallel structure | no (unless >50% interested) | The domestic fund itself is not a foreign financial account, but we assume the domestic fund has financial interests in foreign financial accounts. A U.S. limited partner only has a financial interest in such accounts if it owns an interest in more than 50% of the profits of the domestic fund. Without a financial interest or signature authority, the U.S. limited partner would not need to file. |
| Limited partner in domestic feeder investing in foreign master fund ¹ | no (unless >50% interested) | The domestic feeder itself is not a foreign financial account, but the foreign master fund into which it invests is. A U.S. limited partner only has a financial interest in such foreign financial account if it owns an interest in more than 50% of the profits of the domestic feeder. Without a financial interest or signature authority, the U.S. limited partner would not need to file. |
| U.S. shareholders of foreign fund in a parallel structure | yes | The definition of a foreign financial account is broad enough to include the foreign fund itself, so that a U.S. shareholder in the foreign fund must file. In addition, if a U.S. shareholder owns more than a 50% interest in the foreign fund and the foreign fund has foreign financial accounts, the U.S. shareholder would have to file for those accounts as well. |
| U.S. shareholders of foreign feeder investing in foreign master fund ¹ | no (unless >50% interested) | The foreign feeder itself is not a financial account, but the foreign master fund into which it invests is. A U.S. shareholder has a financial interest in the foreign master fund only if it owns, directly or indirectly, more than 50% of the total value of shares of stock of the foreign feeder (corporation). |

¹ We assume there is no account/activity at the feeder fund level.

As in the past, the Form TD F 90-22.1 is due on or before June 30 of each year for the preceding calendar year, and no extensions are available. Multiple filings of Form TD F 90-22.1 may be required for a single foreign financial account; there is no exception for a partnership or fund that files on behalf of its partners or on behalf of employees or partners of a management company that have signature authority. There is an exception for employees or officers of a domestic corporation whose equity securities are listed on national securities exchanges or which has assets exceeding \$10 million and 500 or more shareholders or records. If an employee or officer of such a corporation has signature authority over an account but no personal financial interest in the account, and has received written notice from the CFO that the corporation has filed a current report, then the employee or officer is not required to file.

There is a consolidated filing rule for a corporation with a 50% interest in one or more other entities. Such corporation can file a consolidated Form TD F 90-22.1 on behalf of itself and such other entities (which must be listed on the form). There is also a consolidated filing rule for filers with financial interests in 25 or more foreign financial accounts. In such cases, the filer does not need to provide information about the individual accounts, but must be able to do so upon request. Signature authority over an account does not count for consolidation purposes, but where it is present along with a financial interest it does not prevent the filer from taking advantage of the simplified filing rule.

As concern over possible money-laundering by terrorists has grown in the post-9/11 world, penalties for failure to report foreign accounts have been strengthened. The American Jobs Creation Act of 2004 imposes a \$10,000 penalty for each violation of this requirement that occurs after October 22, 2004. Prior to this change, the penalty for failing to file this form applied only to willful violations and was rarely pursued by the government. However, the new civil penalty for failure by a taxpayer to report an interest in a foreign financial account applies to inadvertent violations and is intended to significantly increase compliance.

Hedge fund managers should review the filing requirements and make any necessary filings by June 30 to avoid any potential penalties. Please consult your PricewaterhouseCoopers tax contact for further information or guidance. ■

Fair value measurement: a closer look

Matthew Singer

[Fair value measurement... How does one define fair value?
What accounting and reporting standards are appropriate
in determining fair value?](#)

The Financial Accounting Standards Board (“FASB”) is anticipated to issue by the end of June 2006: Statement of Financial Accounting Standards No. 15X “Fair Value Measurements.” A working draft of the final Fair Value Measurement Statement is now available on the FASB website. This project was added to the FASB’s agenda in June 2003. The new standard defines fair value, establishes a framework for measuring fair value, and requires expanded disclosures about estimates of fair value.

This new statement will make significant changes to current practice and is expected to improve financial reporting in a number of ways. There now will be a single definition of fair value under Generally Accepted Accounting Principles (“GAAP”) that provides a framework for how to measure and determine fair value. The goal is to increase consistency and comparability in estimates of fair value.

The incremental information provided to users of financial statements through enhanced and expanded disclosures about the use of fair value should increase transparency of the fair value process. The guidance in the new statement builds on current practice and requirements; however, it will require some entities to make changes to comply with the requirements.

Definition of fair value:

“Fair value is the price that would be received for an asset or paid to transfer a liability in a current transaction between marketplace participants in the reference market for the asset or liability.”¹

The Statement clarifies common terms used in the fair value process such as market place participants, reference markets, the application of fair value to assets and liabilities, and transaction costs.

Fair value estimates at initial recognition and in subsequent periods:

The standard describes three different valuation techniques including:

- 1) Market approach;
- 2) Income approach; and
- 3) Cost approach.

The objective is to use a valuation technique or a combination of valuation techniques that are appropriate for the circumstances. An important consideration is the sufficiency of data available to estimate fair value. In addition, it sets an expectation that a consistent valuation technique be applied, unless however a change in valuation technique or its application would result in an estimate that is more reflective of fair value.

Market inputs:

“Valuation techniques used to estimate fair value shall maximize the use of market inputs and minimize the use of entity inputs, whether using the market approach, income approach, or cost approach.”¹

There are a variety of markets that can provide information for inputs, including:

- Exchange markets (i.e., Securities traded on the New York Stock Exchange);
- Dealer market (i.e., Over-the-counter (OTC) markets);
- Brokered market (i.e., Brokers attempt to match buyers with sellers but do not stand ready to trade for their own account); and
- Principal-to-principal market (i.e., trades negotiated independently with no intermediary).

Fair value hierarchy

The hierarchy has three levels. Ranging from Level 1 - items with quoted prices for identical assets or liabilities in active markets, to Level 3 items valued using models with significant entity derived inputs (examples include inputs that are derived through extrapolation or interpolation but that are not corroborated by other market data).

¹ Statement of Financial Accounting Standards No. 15X, Fair Value Measurements—October 21, 2005 Working Draft

In October 2005, the FASB issued Proposed FSP no. FAS 133-a “Accounting for Unrealized Gains (Losses) Relating to Derivative Instruments Measured at Fair Value under Statement 133) - comment period ended on November 21, 2005. The proposed FSP addresses fair value estimates at initial recognition specifically for derivative instruments. Simply stated, if the entity is not trading in its reference market and falls within Levels 1-2, the unrealized gain (loss) resulting from day one profit shall be recognized in income.

If Level 3 is the hierarchy level used at initial recognition of the derivative instrument, an unrealized gain (loss) shall be recognized as a deferred credit or debit, separate from the derivative instrument. The unrealized gain (loss) shall be recognized only when the instrument moves into Levels 1-2 (when the minimum threshold for the estimate is met) or when the contract expires due to maturity or exercise. Any unrealized gain (loss) that is deferred shall not be amortized into income or equity.

At a recent FASB Board meeting on May 3, 2006, the FASB Board decided to eliminate the proposal of deferring Level 3 unrealized gains (loss), as mentioned above. Accordingly, all initial unrealized gain (loss) will be recognized as profit or loss. The FASB Board decided to

eliminate the proposed FSP and the clarifying guidance will be included in the final standard on fair value measurement. Additionally, transition provisions and disclosure requirements will be included in the final standard on fair value measurement.

This discussed exposure draft is a complicated standard, so if you think it may affect your business, we suggest that you carefully read through the working draft for more details and contact PricewaterhouseCoopers for additional information. ■

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

Ralph Mittl

Effective February 1, 2006, most hedge funds were required to register with the U.S. Securities and Exchange Commission (SEC). According to media reports, SEC Chairman Christopher Cox said that more than 2,400 hedge fund advisers, with about 11,500 hedge funds, had registered with the SEC by the end of March 2006.

Typically, the SEC examines newly registered advisers within 12 to 18 months of registration. This timeline may be extended because of the large influx of hedge funds, but funds with significant assets under management or high public profiles may rise to the top of the SEC’s examination list.

The SEC currently is in the process of examining hedge fund advisers. For hedge funds, new to the regulatory process, this process may seem overwhelming. What should hedge funds expect from these inspections? What actions can they take to prepare, navigate and survive the process?

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.

The newly registered funds are required to have in place written policies and procedures and a chief compliance officer (CCO), and also must ensure compliance with the SEC’s rules for custody of client funds and securities. In addition, new registrants must comply with the Advisers Act, including the rules applied to registered advisers, such as limits on performance fees, maintenance of books and records and the proper use of advertising materials.

What to expect before the SEC arrives

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 Form ADV-Part II.

Steps to take:

- Immediately request recent SEC document request lists from outside counsel to help prepare for requests
- Immediately review all parts of Form ADV for accuracy
- Designate one legal or compliance person, typically the CCO, to serve as a coordinator and to manage the exam and the document request response
- Collect, organize and review documents
- Review the document request list to gain insight into the exam's focus
- Respond swiftly to the document request list, including timeframes for documents that cannot be accessed quickly
- Study previous reviews (internal and those done by third parties) for further insights

Knock, knock: getting started and conducting interviews

Once the SEC inspection team arrives and is onsite, it will take steps to assess the overall compliance program, review policies and procedures, request access to additional books and records and interview key personnel.

If the team's initial assessment of the hedge fund's compliance program design and execution is excellent, the SEC may limit the scope of its exam. However, if the compliance program is perceived to be weak, the SEC will likely expand the scope of the exam.

Interviews will begin with the CCO and senior management. The SEC also may include key personnel, including portfolio managers and their supervisors, traders, marketing and sales managers and legal staff.

During the interviews, the SEC will ask about the backgrounds and experiences of personnel as well as their knowledge of relevant policies and procedures. The SEC will also assess the CCO's role, responsibilities, authority and independence.

Steps to take:

- Inform all staff of the SEC's presence
- Provide the SEC team with a suitable conference room or other space that is onsite, private and away from the center of operations to prevent distractions

- Identify personnel to be interviewed by the SEC, make them readily available for interviews and personally attend the interviews (rather than have legal counsel do so)
- Request that the SEC provide at least one day's notice of interview requests so preparations can be made and normal business operations are not disrupted
- If time permits, prepare personnel to be interviewed in advance by reviewing likely areas of inquiry; Make it clear that responses to questions from the SEC team must be truthful, complete and concise
- Personnel not in interviews should not have substantive discussions with the SEC

Document, documents and more documents

As the SEC team proceeds with its examination, it is likely to request copies of additional documents and books and records, including e-mails. These requests typically are intended to confirm what the team has learned during interviews and to supplement its initial document list review. Due to the recordkeeping requirements of the Advisers Act, the SEC expects that documents be provided promptly (within 24-48 hours). Often, the SEC may request documents that are privileged and/or confidential.

Steps to take:

- Control the process of fulfilling all document requests and keep track of documents provided, with documents readily available should questions arise
- Log privileged documents to protect privilege; however, the SEC may assert their right to access the documents
- Review e-mails for privileged communications
- Closely coordinate internal review and related documents with legal counsel before submitting documents to the SEC; this includes annual compliance program review documents

- Make every effort to resolve issues identified during the exam before the inspection's end and inform the onsite examiners as progress is made

After the exam

Once the SEC completes the exam, the hedge fund can expect to hear from the SEC within 90 days. Many hedge funds may receive a deficiency letter. The most common deficiencies are likely to include:

- Form ADV and disclosure failures
- Ineffective internal controls
- Failure to maintain adequate books and records
- Issues with trade allocations, brokerage arrangements and best execution
- Improper personal trading
- Failure to comply with custody rules
- Inaccurate past performance results
- Inaccurate fee calculations
- Failure to supervise

The SEC's deficiency letter will highlight areas for improvement based on the SEC's observations and their assessment of industry standards. Recently, the SEC has been aligning the tone of its deficiency letters more closely with the severity of the problems. It also is trying to document all efforts that have been made to date in resolving the problems.

Steps to take:

- Debrief interviewed staff and document lessons learned
- Verify that all immediate modifications and solutions to the deficiency or problem are reflected in the SEC's deficiency letter
- Decide who will draft a response to the SEC's deficiency letter and who will comment and review (e.g., auditors, outside counsel)

- Respond appropriately and promptly to the SEC (within 30 days)
- Look at a deficiency letter as an opportunity to address and make changes
- Review policies, procedures and disclosures and update as needed
- Plan to train staff on changes to policies and procedures
- Incorporate areas of deficiencies into the annual compliance review process

The SEC's reviews of hedge funds unquestionably will add costs and complexity to operations. Compliance is mandatory, but hedge funds should go beyond simply complying with the letter of the law and use the review process as a way to identify operating shortcomings, enhance business practices and put in place improved controls. Regardless of what practical changes are implemented, compliance with regulatory requirements will represent an achievement that should enhance investor confidence.

Look for Part II of this article, which will address the specific areas of inquiry by the SEC (e.g., brokerage allocations, internal management structure) in the next issue of PwC Alternatives. ■

International developments

Paula Eastwood, Anuj Kagalwala and Oscar Teunissen

Singapore

On February 17, 2006, Singaporean Finance Minister Lee Hsien Loong presented the government's budget to Parliament. The budget recommended several key changes which are relevant to the wealth management industry, and they are summarized below.

“Onshoring” offshore funds

Currently, foreign funds that meet certain criteria are protected from Singaporean tax, even if the discretionary management of the funds is carried out in Singapore. To qualify as a foreign investor under these rules, the fund must not be tax-resident in Singapore nor have more than 20 percent of its share capital (where it is a company) owned by Singapore residents or citizens, either directly or indirectly. This latter standard is known as the 80:20 rule.

A typical fund structure has to involve a fund that is set up *and maintained* outside of Singapore. This is clearly not ideal since it reduces the incentive for an otherwise attractive move to Singapore by ancillary services such as processing, custodian services, legal, accounting and audit.

In order to mitigate this disincentive, the Finance Minister has proposed that the protection for funds be extended to funds which are set up in Singapore as companies. However, this likely means that the 80:20 rule will remain in place, and it has been confirmed that the company still would need to be “substantially owned by foreigners.” Unfortunately, compliance with this rule is beyond the control of existing shareholders or managers in a global marketplace, and a fund could be in compliance one day but not the next.

It also is not yet clear whether Singapore-based managers managing the new onshore entities will qualify for the concessionary 10 percent rate of tax on their fee income. This is available to them for qualifying offshore funds. As a result, it is uncertain whether this will encourage funds to come onshore where they will be much more open to scrutiny and control. If the concessionary rate is not available for the manager, the answer is likely to be that they will not.

Designated Unit Trusts (DUTs)

Introduced in 1995, the Designated Unit Trust (DUT) plan has been instrumental in helping Singapore's investment funds market grow from virtually nothing to the thriving industry it is today.

In essence, certain specified income and gains from DUTs are not taxed at the trust level and only Singapore companies are taxed on any distributions.

One area of contention is the qualification for this status. After controversy over the original criteria, a circular issued by the Monetary Authority of Singapore (MAS) in November 2003 specified that a trust has to be “a collective investment scheme constituted under section 286 of the Securities and Futures Act (SFA),” and had to be “opened to the public for subscription” in order to qualify as a DUT.

However, through market developments and a desire for limits on the volume of issue documentation and procedures, issues targeting “sophisticated” investors began to evolve. Such issues were given life under section 305 of the SFA, not section 286, and thus did not qualify for DUT status, despite technically being “opened to the public for subscription.”

The Finance Minister has attempted to address this anomaly by allowing section 305 plans to qualify for DUT status. Although untested, this could be of interest to fund managers who are not averse to using a trust structure and/or situations in which the 80:20 rule is not satisfied.

Islamic finance

The budget proposal also sought to better align the tax treatment of Islamic contracts with that of other financing. Islamic law prohibits the earning of interest, and financial institutions use various mechanisms to comply with prohibition, yet earn profits. For example, a bank will purchase a house and sell it to a buyer at a premium on an installment basis – earning a profit without actually charging interest. However, such profits have been taxed at disadvantageous corporate rates.

The new budget proposes to level the playing field, treating profits earned instead of interest on the same basis as interest income. This should enhance Singapore's appeal as an investment funds market to Islamic financial institutions.

Other matters

Several other changes were announced by the Finance Minister, including those affecting REITs, qualifying foreign trusts, qualifying domestic trusts and other matters.

There was no mention of expanding the definition of designated investments to include loans, which was something that had been lobbied for and largely expected. Thus, profits and gains from loan trading would be potentially exposed to tax if discretionary management is carried on in Singapore.

India

Sunil Gidwani, Gautam Mehra and Oscar Teunissen

Impact of the union budget 2006 proposals

The Indian Finance Minister presented the 2006-2007 Union Budget to Parliament on February 28, 2006. There were several proposals and policy changes that could affect domestic mutual funds and offshore funds investing in India.

Policy measures and increased investment limits

- Increase in the ceiling on aggregate investments by mutual funds in overseas instruments from US\$1 billion to US\$2 billion, and removal of the requirement of 10 percent reciprocal shareholding
- A limited number of qualified Indian mutual funds would be allowed to invest, cumulatively up to US\$1 billion, in overseas exchange-traded funds
- An Investors Protection Fund would be set up by Securities and Exchange Board of India (SEBI) and funded by fines and penalties recovered by SEBI to safeguard the interests of retail investors
- An increase in the overall ceiling on Foreign Institutional Investor (FII) investment in government securities to US\$2 billion (from US\$1.75 billion) and in corporate debt to US\$1.5 billion (from US\$0.5 billion)

Securities Transaction Tax

The Securities Transaction Tax (STT) is a levy that is required to be paid on certain specified securities transactions carried on the recognized Stock Exchange in India at prescribed rates. The same tax would be payable by purchaser/seller, as the case may be.

The budget proposes that the Securities Transaction Tax be increased by 25 percent for all categories with an effective date of June 1, 2006. Accordingly, the revised Securities Transaction Tax rates are below:

| Taxable securities transaction | Current rate (%) | Proposed rate (%) | Payable by |
|--|------------------|-------------------|--------------------|
| Purchase and sale of equity shares in a company or units of an equity-oriented fund, settled by way of actual delivery | 0.10 | 0.125 | Purchaser & Seller |
| Sale of equity shares in a company or units of an equity-oriented fund, settled other than by actual delivery | 0.02 | 0.025 | Seller |
| Sale of derivatives | 0.0133 | 0.0166 | Seller |
| Sale of units of an equity-oriented fund to mutual fund | 0.20 | 0.25 | Seller |

Tax on distributed income

Currently, there is no tax on distributed income for any income distributed to unit holders of open-ended, equity-oriented funds in India. The new budget proposes to extend the exemption from levy of this tax to all equity-oriented funds in India.

The proposal defines the term “equity-oriented fund” (as against or opposed to “open-ended, equity-oriented fund” provided earlier) to mean a fund where the investable funds are invested by way of equity shares in domestic companies to the extent of more than 65 percent (as against 50 percent provided earlier) of the total proceeds of such fund.

Minimum Alternate Tax on corporations

In the event that the tax payable by companies under normal provisions of the Indian domestic tax law is less than the threshold identified in the Minimum Alternate Tax, companies are required to pay a Minimum Alternate Tax calculated at 7.5 percent of their “book profits” – defined to mean profits reflected in accounts prepared in accordance with Indian corporate law requirements, as increased/reduced by certain prescribed adjustments.

The budget proposal includes an increase in the Minimum Alternate Tax rate to 10 percent of book profits. The definition of “book profits” now also would include long-term capital gains on transactions in listed securities on which Securities Transaction Tax is payable which currently are otherwise exempt from tax under the normal provisions. In computing interest on delayed/deferred payment of advance tax or delay in filing of tax return, the budget proposes to give credit for excess Minimum Alternate Tax paid over the normal tax.

It is unclear whether the proposal would apply to foreign corporations. In the past, the Authority for Advance Rulings has ruled to the effect that the Minimum Alternate Tax provisions apply to foreign companies. Though the rulings are legally binding only on the applicant taxpayer, these rulings have persuasive value. Based on the facts of each case, and the interpretation of the provisions, foreign companies need to examine the applicability of the Minimum Alternate Tax and whether protection under a tax treaty, if applicable, would be available.

If Minimum Alternate Tax provisions *do* apply to foreign companies, the effective tax rate for long-term capital gains would be 10.46 percent, including surcharge and education cess. Since the proposed amendment would be effective from assessment year 2007-2008 (i.e., the financial year commencing on April 1, 2006), any gains arising out of securities sold on or after April 1, 2006 would attract the Minimum Alternate Tax provisions.

Service tax

The budget proposes increasing the rate of service tax from 10.2 percent to 12.24 percent, and to introduce new categories of services, including those provided by share transfer agents and registrars for issues.

Ireland

Liam Diamond, Oscar Teunissen and Mary Walsh

U.S. and Ireland agree on tax transparency of common contractual funds

The U.S. and Ireland have entered into an agreement (published on February 28, 2006) regarding the treatment of Common Contractual Funds (CCFs) under the two nations' double-tax treaty. The agreement confirms that a CCF will not be viewed as a "resident" of Ireland for the purposes of the treaty and that an Irish resident unit holder in the CCF will be entitled to treaty benefits (subject to satisfying the normal Limitation on Benefits provisions).

Ireland introduced the CCF (a tax-transparent legal entity) in 2003 to allow pension funds to pool and administer their assets in a cost-effective, tax-efficient manner. The regime initially applied only to pension assets pooled through a UCITS CCF; this was extended in 2005 to include all institutional investors and allow the use of non-UCITS CCFs.

The tax transparency of the CCF is respected for Irish purposes when the investors are institutions and certain reporting requirements are met. When a CCF invests in U.S. securities, for example, the relevant double-tax treaty between the U.S. and the investor country would apply.

An issue arose for Irish investors because the terms of the Ireland-U.S. double-tax treaty suggested that Irish nationals might not be in a position to access the benefits of the treaty in respect to their share of assets held via a CCF, if the CCF itself was viewed as a "resident" of Ireland for treaty purposes.

In the case of Ireland, a "resident" includes a Collective Investment Undertaking (CIU). While the term "Collective Investment Undertaking" is not defined in the treaty, a CCF is treated in Ireland as a CIU for legal purposes.

However, there was uncertainty about whether Irish resident investors could benefit from treaty benefits for their share of assets held through a CCF on the same basis as they could in respect to direct investments in U.S. securities.

Ireland and the U.S. have agreed that a CCF will not be treated as a resident of Ireland pursuant to Article 4.1(d) of the Ireland-U.S. treaty.

Accordingly, a unit holder in a CCF will be entitled to benefits under the treaty, provided the unit holder is a resident of Ireland that satisfies the requirements of Article 23 (Limitation on Benefits). As such, the treaty access position of an Irish investor in a CCF which invests in U.S. securities should replicate the position were they to invest directly.

In addition, it also has been agreed that a CCF will not be entitled to treaty benefits in its own right because it will not be a resident of Ireland. This is fully consistent with the transparent treatment of the CCF, in that it should effectively be ignored for tax purposes.

The CCF has been used by significant players in the funds management industry (as well as multi-national groups) seeking to gain economies of scale in asset management, and is likely to be increasingly important in the drive to achieve greater efficiency in pan-European pension pooling and global investment management, in general.

Much work has been done to verify that the CCF should be viewed as tax-transparent in key investment/investor jurisdictions (including Canada, Netherlands and the United Kingdom), although this position should be confirmed on a case-by-case basis for each CCF. ■

PricewaterhouseCoopers' Alternative Investments Group

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Our industry leadership

PricewaterhouseCoopers is a recognized leader in serving both traditional and alternative investment management products. Our Alternative Investments industry group provides clients with:

- A unique combination of coordinated accounting, tax and advisory expertise;
- Tax and business expertise—domestically and internationally—on the tax planning and structuring issues associated with alternative investment strategies and products;
- Industry knowledge to allow you to benchmark your practices against others in the industry; and
- Established relationships with the major participants in the marketplace.

Your knowledge center

PricewaterhouseCoopers is committed to helping our clients determine what successful firms will need to do to stay at the forefront in an increasingly competitive and dynamic industry. We set the pace in providing best practice and benchmarking information to the leaders in the alternative investments industry through our seminars, special studies and thought leadership that examines key industry trends. Our goal is to serve as a catalyst for ideas and provide insights from various perspectives in areas of interest to you. A select list of resources relevant to private investment funds and their sponsors includes:

- *Alternative Investments Seminar—Accounting, Tax and Regulatory Update*: Our annual seminar addresses key regulatory, tax, accounting and reporting developments impacting private investment funds.
- *CFO Roundtable Series—Private Equity and Hedge Funds*: A periodic roundtable to allow senior finance/administrative personnel to discuss key industry issues.
- *PwC Alternatives*: A quarterly publication, which provides insightful, thought provoking articles on topics affecting the hedge fund and private equity fund communities.
- *Private Investment Funds—Under the Microscope*: Our industry monographs focused on new challenges and scrutiny facing the industry.
- *Money Tree™ Survey*: The venture capital industry's premier survey and barometer of investment activity.

- *nextwave™*: A newsletter which provides ideas for private equity investors and entrepreneurs in the technology industry.
- *Venture Capital Best Practices™*: A survey series that reflects the practices, policies and views of US venture capital firms.

Our services

The foundation of many of our client relationships includes independent audits and pro-active global tax services. The advisory services we offer the industry, however, range well beyond these cornerstones, and they include:

- Regulatory Compliance Consulting
- Product Structuring
- Transaction Services/Due Diligence
- Operational and Systems Advisory Services
- Risk Management Services
- Investment Performance Measurement
- Internal Audit Services

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