



Alternative investment funds – key transfer pricing issues in turbulent times

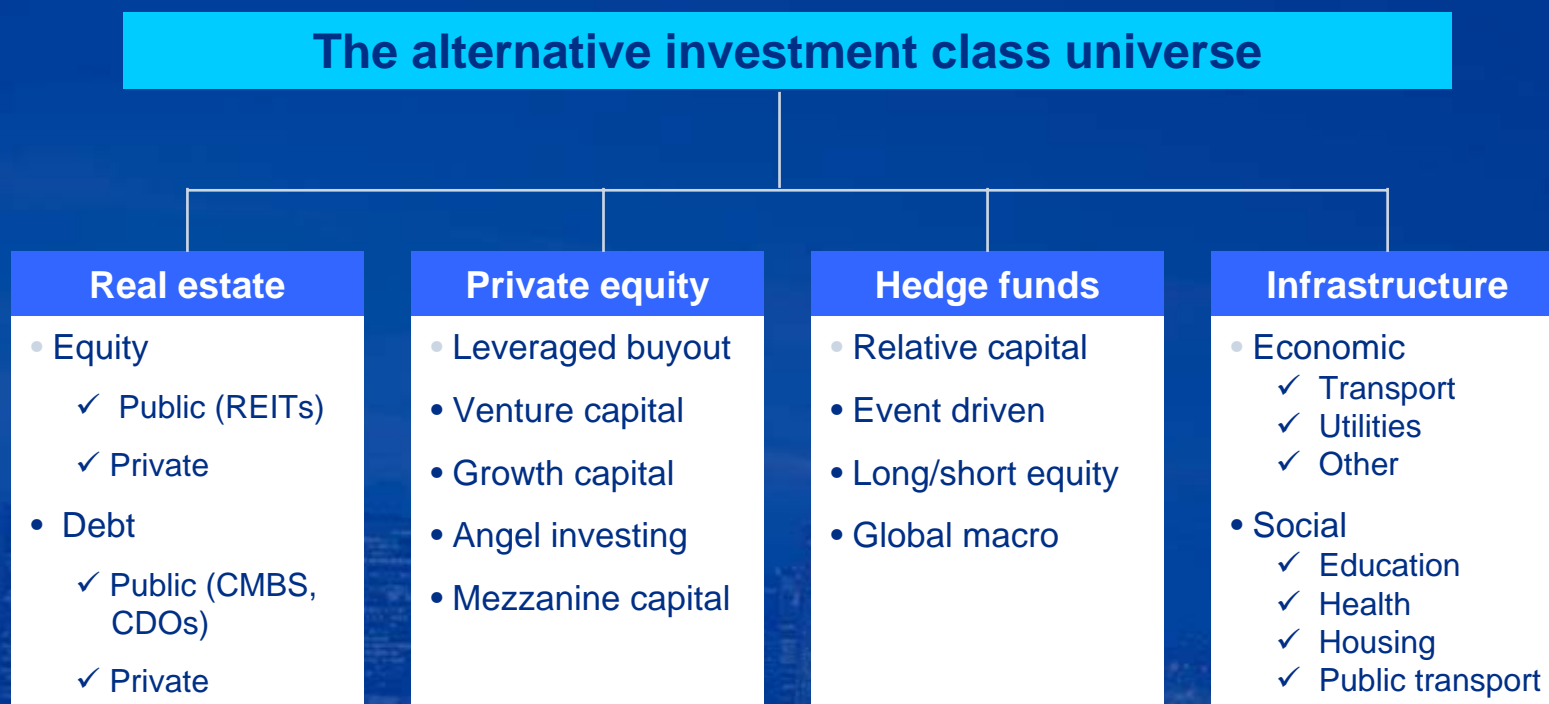
20 November, 2008

TAX



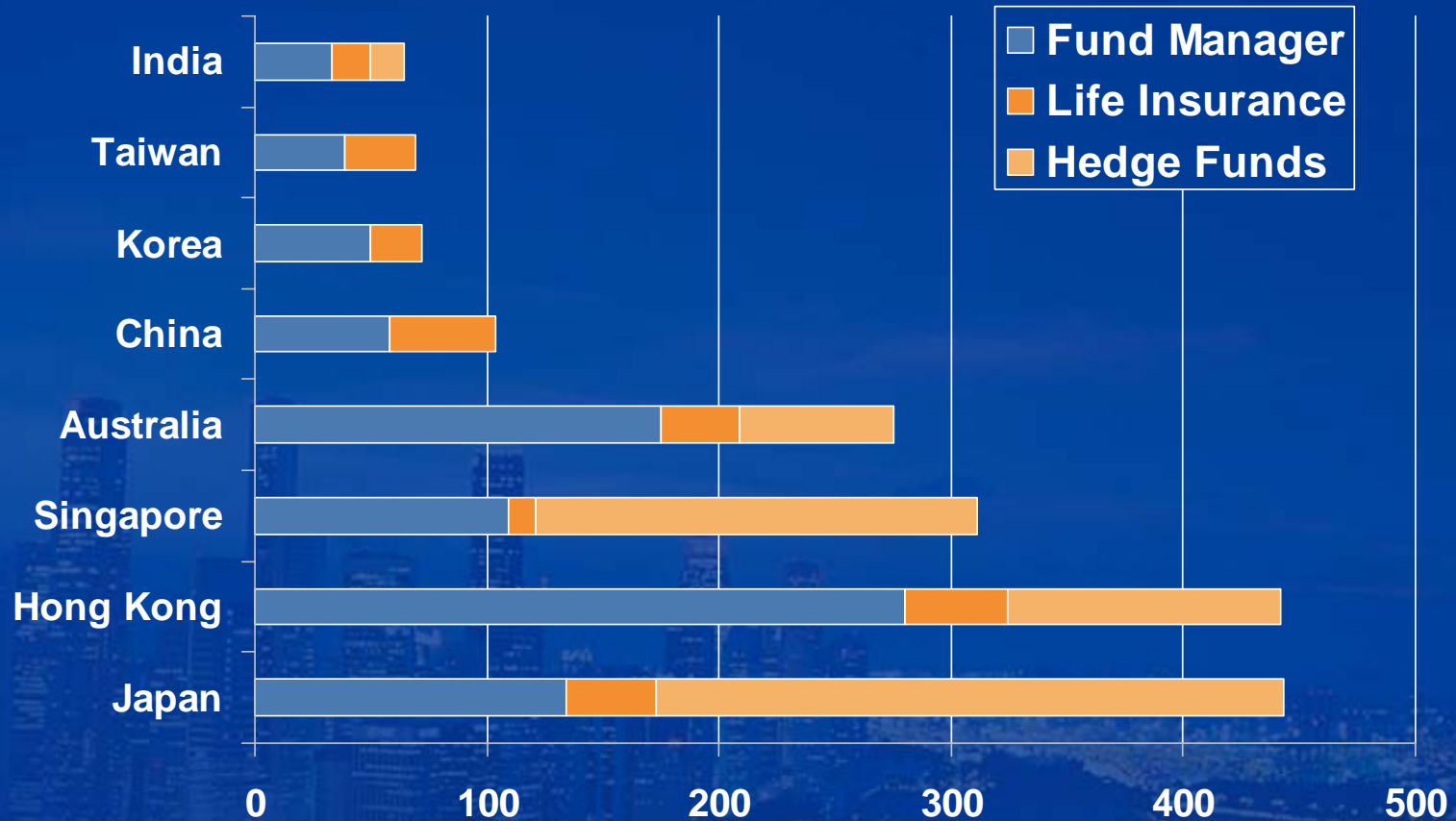
Overview of alternative investment funds industry

The alternative investment class universe



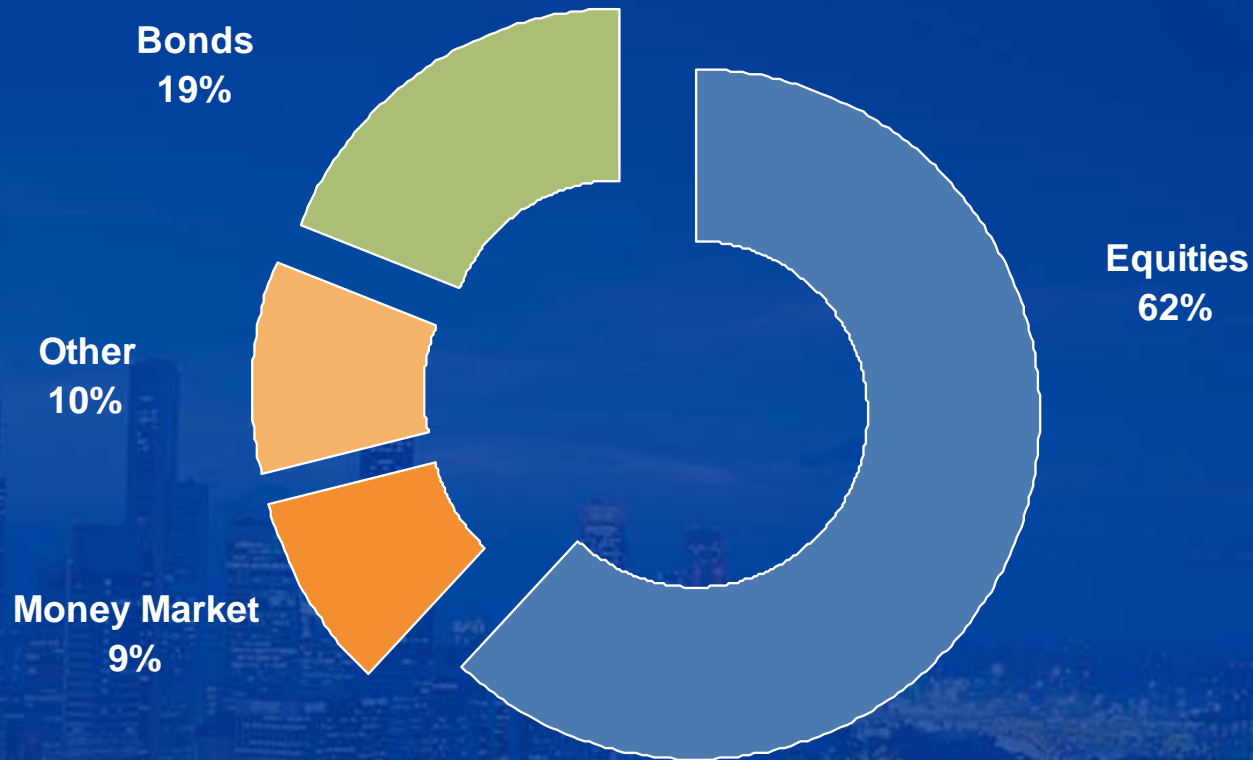
Source: RREEF Alternatives

Number of companies, 2007



Source: "State of the Investment Management Industry in Asia Pacific," KPMG International, 2008.

Asian assets by investment type

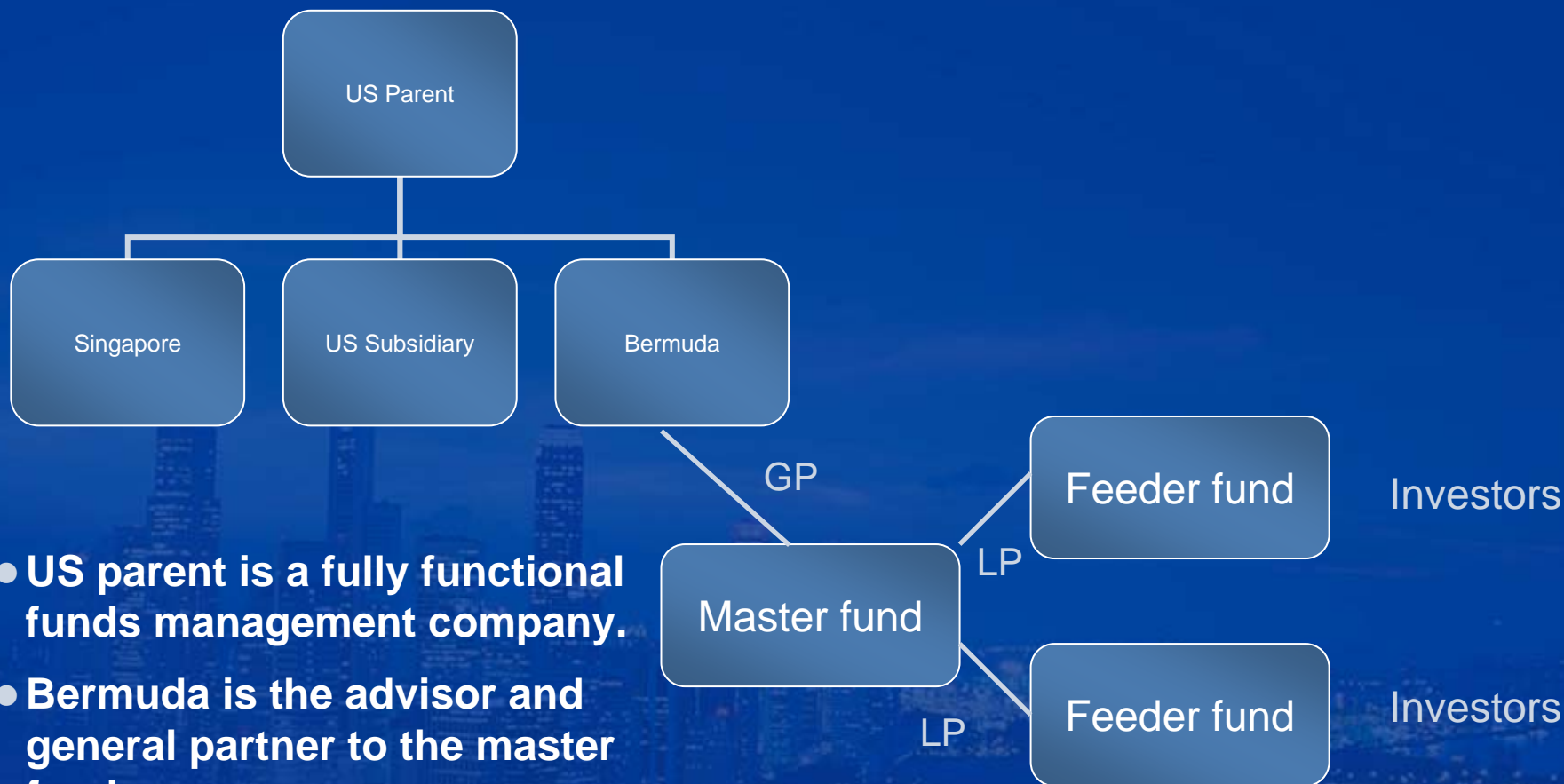


Source: "State of the Investment Management Industry in Asia Pacific," KPMG International, 2008.



Key transfer pricing issues for hedge funds

Common structure for hedge funds



- **US parent is a fully functional funds management company.**
- **Bermuda is the advisor and general partner to the master fund.**

Economic characteristics of hedge funds industry

- **Revenue: management fees + profit share**
- **Relatively flat or declining average cost curve, marginal cost of managing additional funds is low**
 - A rational funds manager will accept assets to manage whenever the marginal revenue exceeds the marginal costs
- **Revenue may scale up more steeply than cost, so profit potential is large**
- **Even in downturn, management fee levels typically keep fund managers moderately profitable (in the absence of redemptions)**

Functions of hedge funds management

- **Transactions between fund and fund manager are third party transactions**
- **Sales and client service**
- **Portfolio management**
 - Advisor (includes making the investment decisions or hiring sub-advisors to make investment decisions)
 - Sub-advisor
 - Research
 - Trading
- **Fund administration (back office functions)**

The sales and portfolio management functions and especially the role of sub-advisor is the likely source of controversy for tax authorities.

What is the role of the advisor?

- **The advisor is the general partner to the fund and may perform all the functions: sales, research, portfolio management, and fund administration.**
- **The GP/advisor may hire sub-advisors to manage portions of the funds under management.**
- **The GP/advisor may contract out all or part of the sales function.**
- **When an GP/advisor contracts out the sales function and hires sub-advisors to manage all of the funds under management, then the GP/advisor's role is primarily entering into the legal agreement with the fund (partnership) and not much else.**
 - In this case, the GP/advisor's role may require little labor or capital

CUPs - an example

Total fee is 100 bps	
Function	CUPs
Sales	20 to 30
Sub-advisor	30 to 70
Residual (GP)	0 to 50

If the GP/advisor pays a related party for the sales effort and then hires a related party sub-advisor to manage 100% of the funds, what should the GP/advisor earn?

- 0?
- 50?
- Something in between?

The tax authorities of the sales and sub-advisor likely to assert for maximum fees for these functions, leaving close to 0 to GP

Takeaways

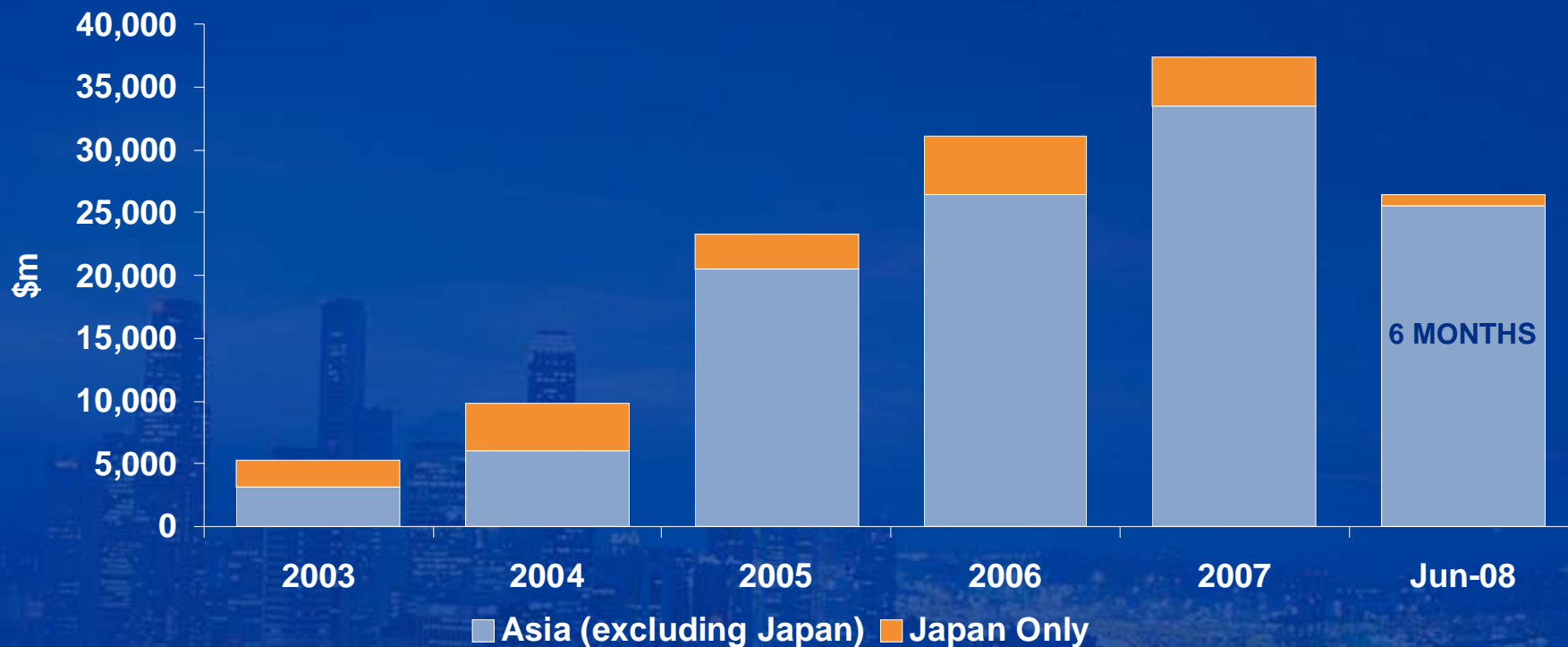
- **Sandwiching large profits to offshore GP a substantial risk**
- **Observe a wide range for CUPs for both sales and for sub-advisory. However, these can be very tricky in practical application**
- **Cost plus may be a risky strategy for sales function**
- **Profit splits are common and tend to represent most reasonable outcomes**
- **Profits vary widely among market participants across time making TNMM (or CPM) an unreliable**



Key transfer pricing issues for private equity

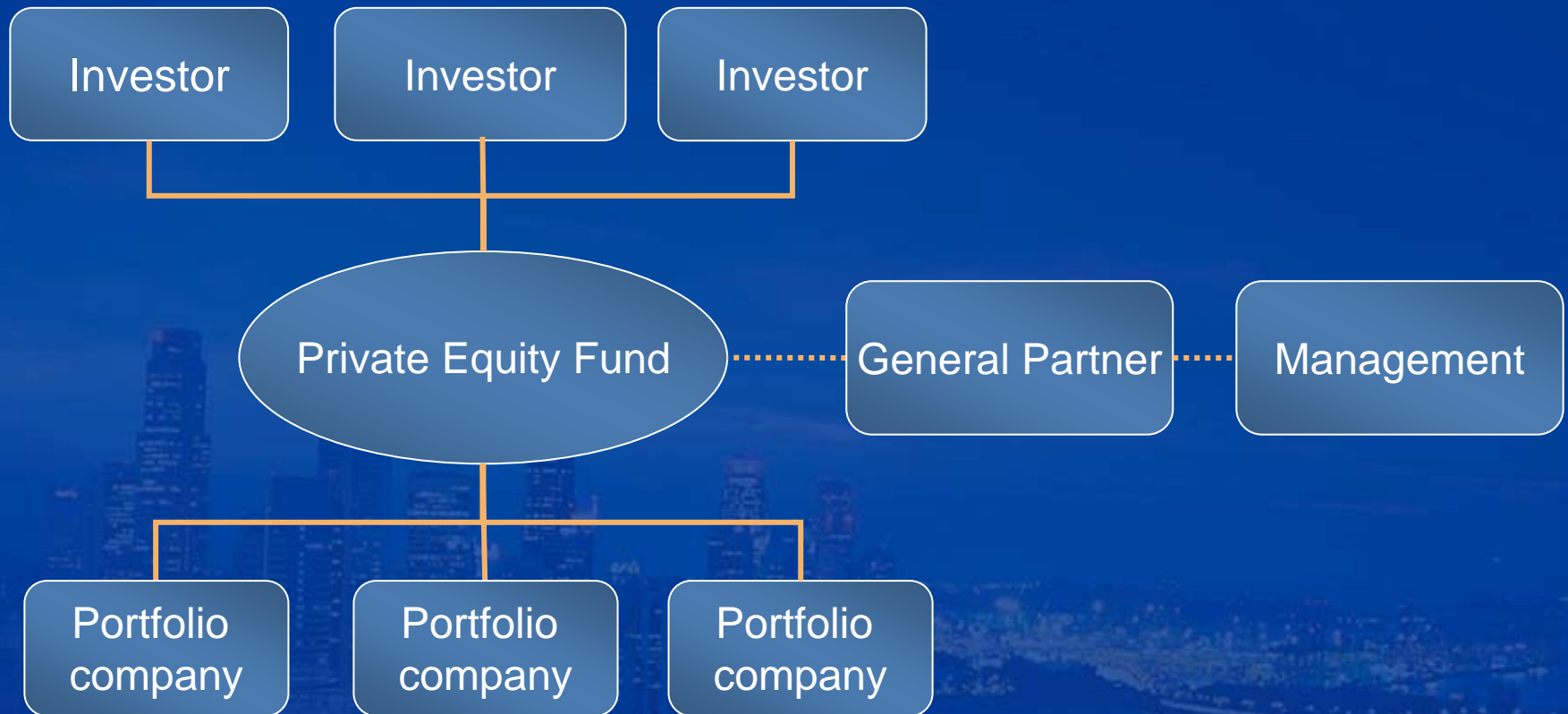
Annual growth of Asian private equity AUM

Millions of USD, 2003 – Jun/2008



Source: Asia Private Equity Review 2008 Mid-Year Review

Structure of a typical Private Equity Fund



Private equity in the current environment

- **Revenue: management fees + profit share (carried interests)**
- **Marginal costs tend to be somewhat higher than for many other funds**
- **Profits really driven by successful exits, but similar to hedge funds, basic management fees can support moderate profitability**
- **Crunch is likely to hit these funds but different from hedge funds**
 - Redemptions/draw-downs more restricted
 - However, new fund raising/profit sharing likely to be constrained
 - Most effect still on portfolio companies
 - Loss of the leverage component

How to remunerate deal origination function

- **Private equity typically has no ongoing sales (i.e. fund raising function)**
- **Typical transfer pricing issue arises with deal origination/deal making in another market where the GP is located**
 - Not always explicitly separately subcontracted (may take place without a local legal entity)
- **Common view among taxpayers: cost plus**
- **Potential local authority view**
 - Permanent establishment and/or substantial profit contributor

How to remunerate deal origination function

- **Fundamentally, does the mere fact that investments decisions are made elsewhere justify a cost plus for the origination?**
- **If not, CUPs/profit splits come into play**
 - CUPs may often replicate profit split outcomes
- **Carried interests: is this primarily a corporate vs a personal tax issue?**
- **Who bears/controls the risk of loss?**

Target funding

Typical Capital Structure for Leverage Buyouts		
	Leveraged buyouts % of total capitalization	Listed Company % of total capitalization
Equity	30	60
Debt	70	40
● <i>Senior debt</i>	50	
● <i>Subordinated debt</i>	10	
● <i>Mezzanine debt</i>	10	

Previous boom in credit markets enabled debt structures up to 90%

Target funding

- **Fund and target deemed as related parties**
- **Debt push downs: raise funds on behalf of and/or push debt to target parent/operating subsidiaries (in the absence of tax consolidation)**
 - can create complex push-downs chains
- **Thin cap vs transfer pricing attack**
 - what is the arm's length capital structure in current environment?
- **If cross-border, arm's length interest rates**
 - how do you approach CUPs in current environment?

Takeaways

- **Origination compensation is/likely to become a key transfer pricing risk for private equity**
 - Cost plus models have already been challenged in several jurisdictions

- **Portfolio company funding is likely to draw attention in current market as authorities may seek to limit interest deductions**
 - Roll over funding which maintains heavy leverage levels may be challenged or past transactions may be reconstructed



Transfer pricing in turbulent times

Expected contraction in funds and AUM

Economist.com

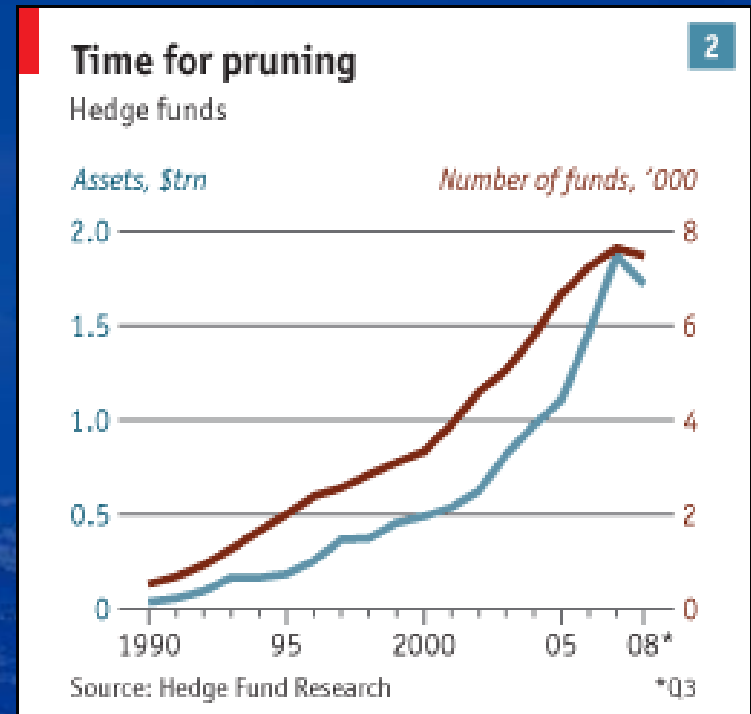
FINANCE & ECONOMICS

Hedge funds in trouble The incredible shrinking funds

Oct 23rd 2008

From The Economist print edition

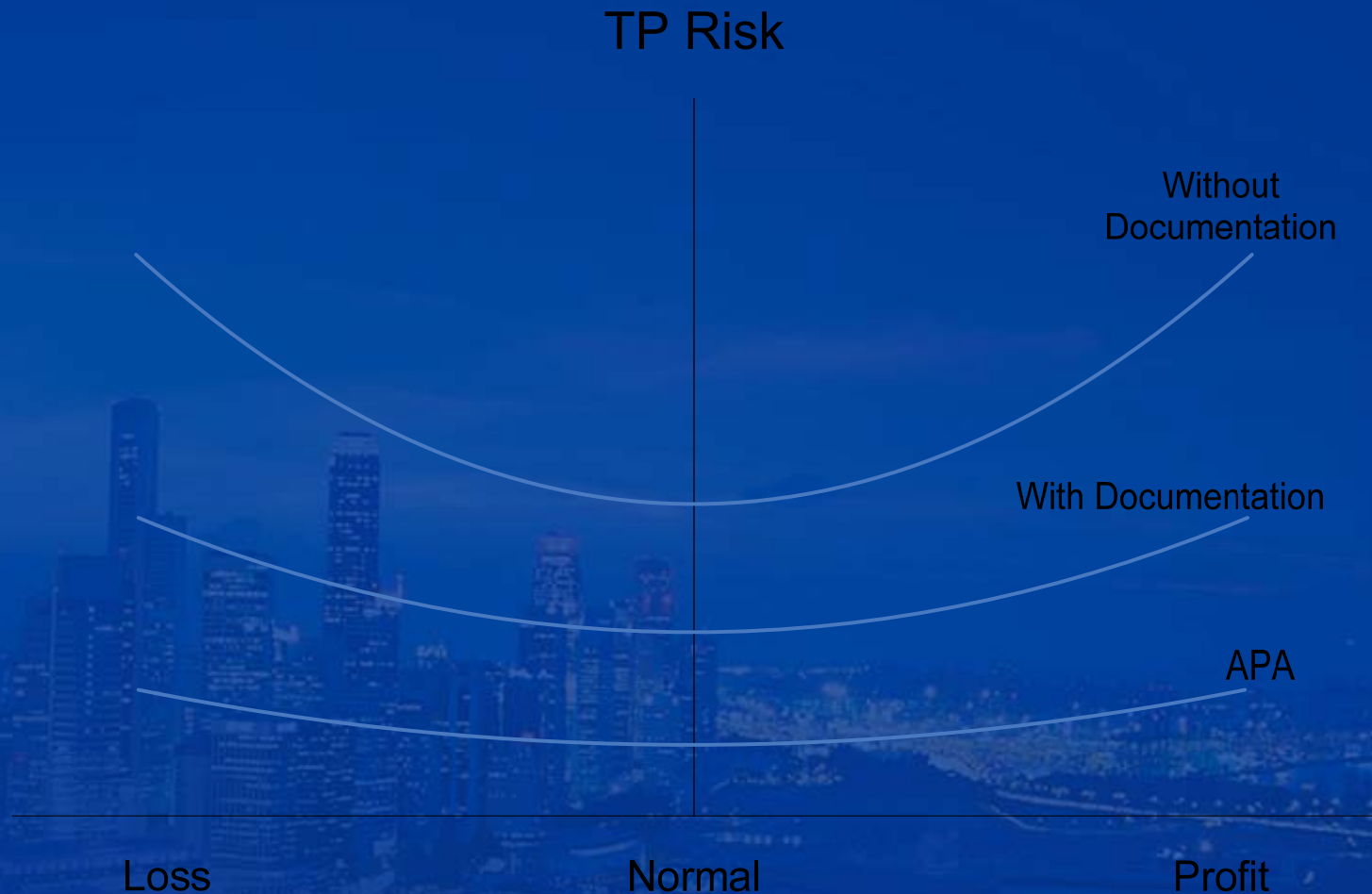
High borrowing and the credit crisis
are bad enough for hedge funds.
Panicky clients are worse



Tax authorities response in downturns

- **Vigorous protection of the tax base**
- **Losses/reduced profits may cause to:**
 - reverse established positions;
 - resort to new triggers/interpretations;
 - generally increase enforcement
- **As a result, both transfer pricing and corporate tax based challenges can be expected**
 - Private equity and hedge funds will offer a high profile targets with perceived high profits

Managing transfer pricing exposure: The tax director's decision

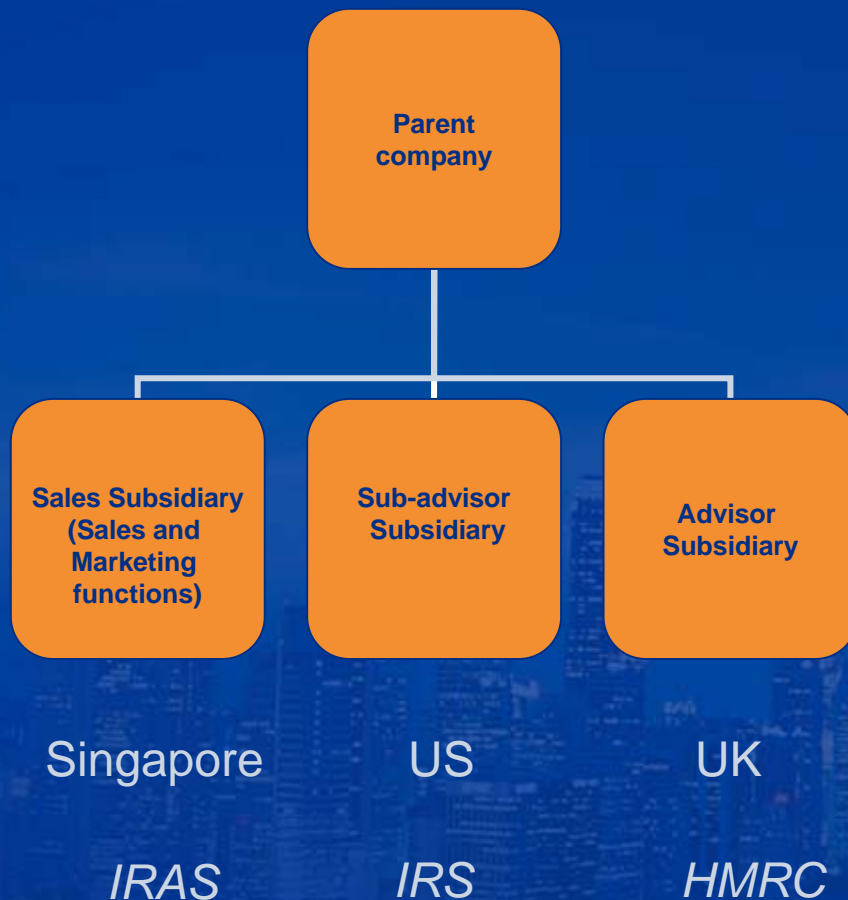


The main issues

- **What is the impact of losses on tax risk?**
 - Will my deduction be respected or challenged?
 - Will I get my deduction in at least one jurisdiction?
 - Are the losses so large that net operating losses (NOLs) exceed likely future income?
Can I book the tax asset?

- **Are the current market prices usable as CUPs for transfer pricing?**

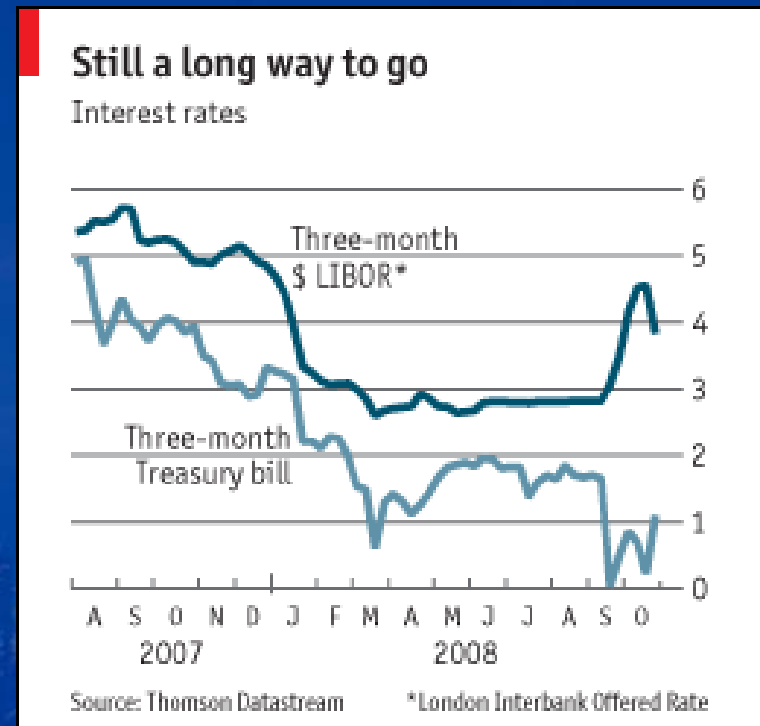
Fund transfer pricing issues



- **Sales Subsidiary sells the fund creating income for its sister, the management company**
 - UK pays Singapore
- **Sub-advisor subsidiary assists the Advisor in the investment function**
 - UK pays US
- **Compensation could be a commission, cost plus or possibly a share of the profits**

Impact on transfer prices

- Are the current market prices usable as CUPs for transfer pricing?
 - Short-term disequilibrium prices create a challenge especially for prices normally set by reference to CUPs such as interest rates on related party loans.
 - There is a greater need to consider what a rational economic agent would do when facing such a distorted market?



Takeaways

- **Transfer Pricing is a hot topic in the ASPAC region**
- **Asset Managers are an “easy” target for tax authorities**
 - cross border flows conceptually easy to analyze
 - blamed for some of the turmoil
 - more likely than some banks to pay tax!
- **TP risk increased during times of loss/low profitability**
- **TP policies may need to be reconsidered in the light of:**
 - changed perspective
 - changed de facto tax profile

Presenter's contact details

Jane McCormick

Tax Partner

KPMG in the U.K.

+44 (0)20 7311 5326

jane.mccormick@kpmg.co.uk

Kari Pahlman

Director, Global Transfer Pricing Services

KPMG in Hong Kong

(+852) 2143 8777

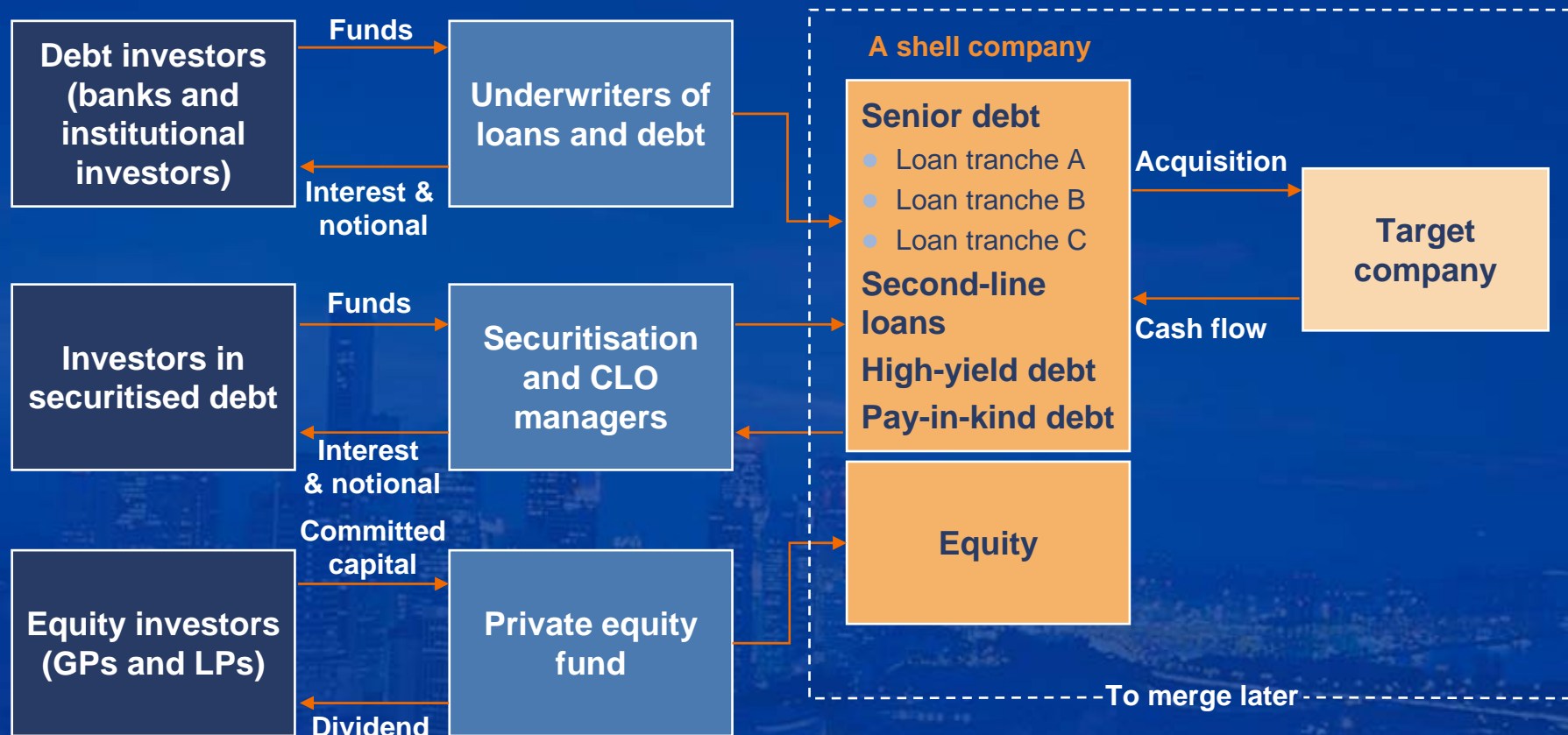
kari.pahlman@kpmg.com.hk



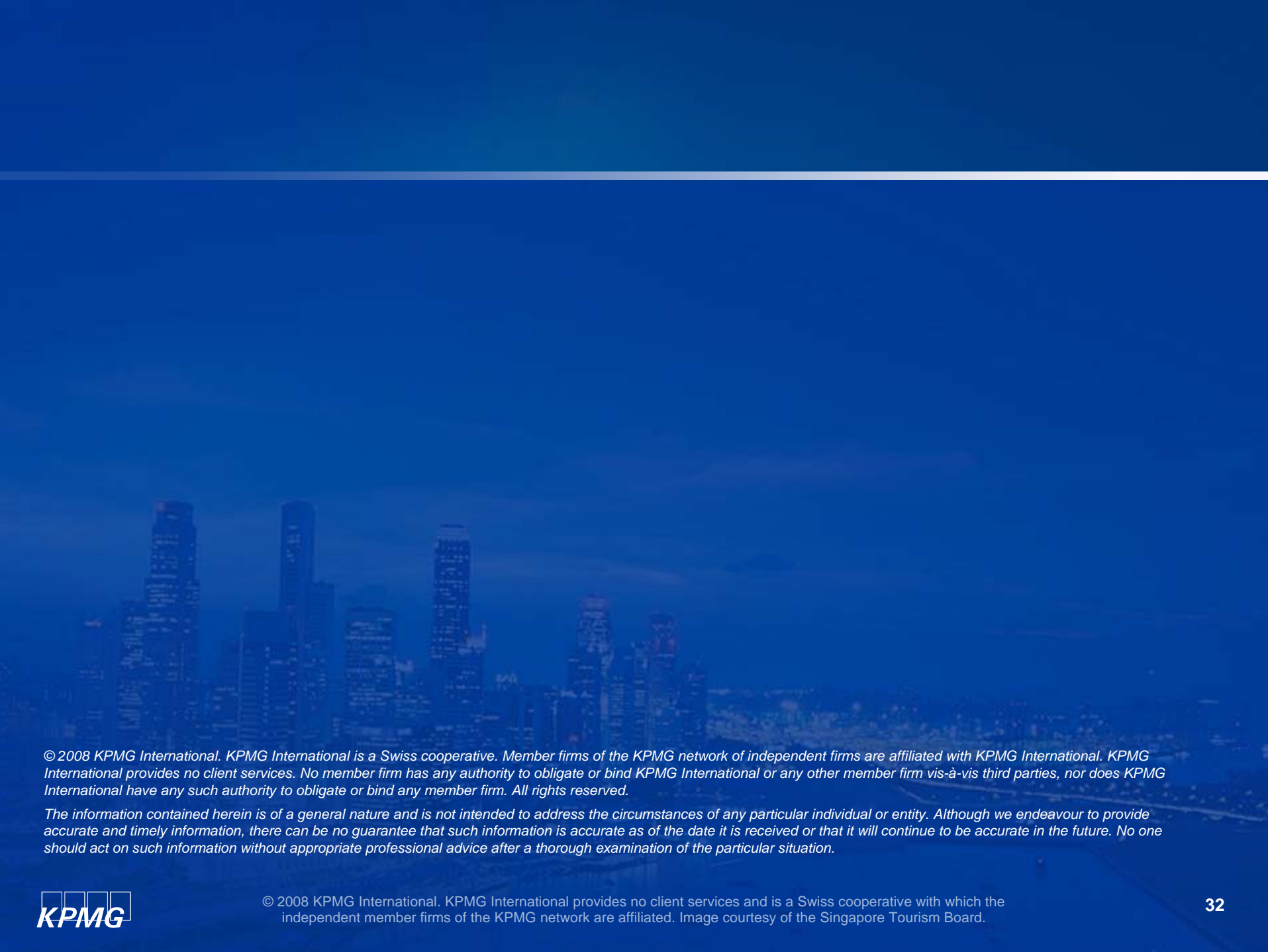
Appendix

Illustration of a LBO Structure

Typical structure of a LBO transactions



Source: BIS – July 2008



© 2008 KPMG International. KPMG International is a Swiss cooperative. Member firms of the KPMG network of independent firms are affiliated with KPMG International. KPMG International provides no client services. No member firm has any authority to obligate or bind KPMG International or any other member firm vis-à-vis third parties, nor does KPMG International have any such authority to obligate or bind any member firm. All rights reserved.

The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavour to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act on such information without appropriate professional advice after a thorough examination of the particular situation.