March 6, 2009

TAX ALERT

SENATOR INTRODUCES LEGISLATION THAT WOULD SIGNIFICANTLY AFFECT U.S. TAX TREATMENT OF FOREIGN INVESTMENT IN THE UNITED STATES

EXECUTIVE SUMMARY

On March 2, 2009, Sen. Carl Levin, D-Mich., introduced S. 506, the "Stop Tax Haven Abuse Act," a bill that, if enacted, would effect significant changes to the taxation of inbound foreign investment. Concurrently, a companion bill (H.R. 1265) was introduced in the House of Representatives by Rep. Lloyd Doggett, D-Texas, with 59 co-sponsors. Sen. Levin described his bill as an "improved" version of legislation that was co-sponsored by Sens. Levin and Coleman, R-Minn., and then-Sen. Obama in February 2007. Congress took no action on the earlier bill or on a companion bill that was introduced in the House of Representatives.

Although presented as a "loophole closer," the Stop Tax Haven Abuse Act would, if enacted, bring about fundamental changes to long-standing tax policies. Moreover, despite its name, the bill would have far-reaching implications that would not necessarily be limited to entities and transactions commonly termed "tax havens" or "tax shelters." For example, the bill could—

- fundamentally alter the corporate residence provisions of the Internal Revenue Code with respect to certain foreign entities taxed as corporations for U.S. federal income tax purposes, including many offshore feeder or blocker entities commonly employed by both hedge funds and private equity funds. Such a change would upset the settled expectations of many foreign investors in investment funds and would override well-established common law principles and statutory provisions, including the securities and commodities trading safe harbors described in Section 864(b)(2). If enacted in their current form, the amendments relating to the corporate residence provisions would be effective for taxable years beginning on or after two years from the date the bill was enacted.

- add a new subsection to Section 871 that would expand the term "dividend" to include "dividend equivalents" and "substitute dividends," with the goal of treating all U.S. corporate dividend-based payments to foreign persons as taxable income subject to withholding under the Code. As discussed below, "dividend equivalents" and "substitute dividends" would encompass a broad spectrum of dividend-based derivative payments, including certain payments made under notional principal contracts (e.g., equity swaps) or pursuant to certain securities lending transactions or sale-repurchase transactions. If enacted in their current form, these amendments would apply to covered payments—including payments made pursuant to existing transactions—made on or after 90 days after the bill was enacted.

- enact a variety of measures designed to curtail offshore tax haven and tax shelter activity, including increased reporting requirements with respect to "passive foreign investment companies," strengthened penalty provisions, expanded enforcement authority for the Treasury Department and the Securities and Exchange Commission against jurisdictions or financial institutions that impede U.S. tax enforcement, and a partial codification of the economic substance doctrine.

> At the present time, the prospects for enactment of the bill are unclear. However, the current political climate, including the recent Department of Justice investigation of UBS, the existence of a deepening financial crisis and the public statements of support for the bill by the Obama administration, suggest that the proposed legislation may have a better chance of passage than it did two years ago. This is particularly so because Sen. Max Baucus, D-Mont., the Chairman of the Senate Finance Committee, recently indicated that he intends to introduce legislation similar to the Levin bill, stressing his own ongoing concern with the "tax gap" and offshore tax compliance. Accordingly, taxpayers and their advisers should closely monitor the progress of the bill and should be prepared to address the consequences should the bill be signed into law.

The following discussion addresses certain provisions of the bill that are particularly relevant for offshore hedge and private equity funds. The bill contains many other provisions that are not discussed in this memorandum.

DETAILED DISCUSSION

TREATMENT OF CERTAIN FOREIGN CORPORATIONS "MANAGED AND CONTROLLED" IN THE UNITED STATES AS DOMESTIC CORPORATIONS

Under current law, an entity treated as a corporation for U.S. federal income tax purposes (a "corporation") is treated as domestic (and subject to U.S. income tax on all of its income) if it is created or organized in the United States or under the law of the United States or of any state thereof. Any corporation that is not treated as a domestic corporation is treated as a foreign corporation and is subject to tax only on (i) income which is "effectively connected" with a U.S. trade or business and (ii) certain types of passive income (generally excluding interest and capital gains), which is subject to a gross-basis withholding tax. Under the bill, a foreign corporation would be treated as a domestic corporation for U.S. federal income tax purposes if the foreign corporation is directly or indirectly "managed and controlled" "primarily" within the United States and either (i) its stock is regularly traded on an established securities market or (ii) its aggregate gross assets, including assets under management for investors, total $50 million or more. A foreign corporation would be covered under the gross assets test if it (or any of its predecessors) held, directly or indirectly, $50 million or more in gross assets at any time during the taxable year in which the test was being applied or in any preceding taxable year. It is unclear whether the gross assets test would be applied on an aggregate basis in the case of corporations under common management or control.

The bill directs the Secretary of the Treasury (the "Secretary") to prescribe regulations to determine whether the management and control of a foreign corporation is properly treated as occurring "primarily" within the United States. However, the bill specifically mandates that such regulations provide that if the assets of a foreign corporation, whether held directly or indirectly, consist primarily of assets being managed "on behalf of investors," and decisions about how to invest the assets are made in the United States, then the foreign corporation will be treated as managed and controlled primarily within the United States. Based on the literal language of the bill, corporations primarily holding investment assets managed on behalf of investors apparently would be treated as managed and controlled primarily within the United States if any decisions about how to invest the assets were made in the United States. Presumably, the exact scope of the provision will be clarified when regulatory guidance is issued, but the bill does not direct the Secretary to issue guidance within any particular time frame.

Although its precise scope is not entirely clear, the provision of the bill addressing foreign corporations for which investment decisions are made in the United States appears to be aimed primarily at offshore "feeder" corporations for hedge funds and private equity funds. Foreign investors often invest in private equity and hedge funds through an offshore corporate feeder entity or a similar vehicle. In general, under existing law, a foreign corporation is not treated as engaged in a U.S. trade or business as a result of trading or investment activities and, hence, is not subject to any U.S. tax other than a withholding tax on dividends and certain other types of income. By causing such a corporation to be treated as a domestic corporation, the bill would subject the corporation to full U.S. tax on all of its income, and would also subject its foreign shareholders to a 30 percent withholding tax (subject to potential reduction by treaty) on dividends paid by it. This treatment represents a fundamental departure from long-standing principles of tax policy, and, if the bill were enacted, it seems very likely that it would have a chilling effect on foreign passive investment in the United States.

If the bill were enacted, it also would be likely to have an adverse impact on the use of offshore corporate feeder vehicles by U.S. tax-exempt investors. U.S. tax-exempt investors often invest in funds through such vehicles, since such investors are subject to tax on "unrelated business taxable income" (UBTI) and UBTI generally does not "pass through" corporate entities to such investors. As described above, if an offshore corporate feeder vehicle were to be treated as a domestic corporation, the vehicle would become subject to full U.S. tax on all of its income, which would reduce the U.S. tax-exempt investors' return on their investment.

It is worth noting that substantial political opposition is likely to form around this provision of the bill, especially since the provision would, in effect, force many U.S.-based investment management firms to consider moving their management operations to more tax-favorable foreign jurisdictions.

It is, however, possible that the bill could be interpreted somewhat more narrowly, so as to encompass offshore corporations that function effectively as vehicles for managed accounts, while not applying to offshore feeder fund vehicles. Ultimately, the scope of the bill remains to be seen.

There may exist planning devices consistent with the language and apparent intent of the bill that could mitigate the potential impact of the "U.S. managed and controlled" provision, and we are available to discuss such planning devices. It should be noted, however, that certain planning devices could be impeded or foreclosed by future regulatory guidance.

The bill contains a transition relief provision under which the amendments relating to the corporate residence provisions would be effective only for taxable years beginning on or after two years from the date on which the bill was enacted. Presumably, this two-year time frame would allow investment funds and other affected taxpayers time to adjust their current investment structures and operations.

TREATMENT OF U.S.-BASED "DIVIDEND EQUIVALENTS" AND "SUBSTITUTE DIVIDENDS"

Under current law, dividends paid by a U.S. corporation to foreign shareholders are generally subject to a 30 percent withholding tax (unless reduced or eliminated by treaty). On the other hand, payments pursuant to "notional principal contracts" (which generally includes swaps and certain other derivatives) are generally treated as foreign source income and are not subject to U.S. withholding tax. The use of derivatives to avoid tax on income that is economically similar to dividends has been under scrutiny for some time. In September 2008, the Senate Permanent Subcommittee on Investigations, chaired by Sen. Levin, held a hearing and issued a detailed staff report addressing this issue.

The bill would add a new subsection to Section 871 that would expand the term "dividend" to include "dividend equivalents" and "substitute dividends." Additionally, this provision would treat any dividend equivalent that was contingent upon, or referenced to, the stock of one or more domestic corporations as being sourced within the United States and also would source any substitute dividend payment in the same manner as dividends paid on the transferred security to which the substitute dividend related. The effect of this change in law would be to impose U.S. withholding tax on most payments under derivatives that are economically tied to dividends of a domestic corporation.

For purposes of the bill, a "dividend equivalent" would include any payment made pursuant to a "notional principal contract" (e.g., an equity swap) that was contingent upon, or referenced to, the payment of a dividend on stock or on property substantially similar or related to stock. A "substitute dividend" would include any payment made to the transferor of a security in a "securities lending transaction" or a "sale-repurchase transaction," if such payment was of an amount equivalent to a dividend distribution that the owner of the transferred security was entitled to receive during the term of the transaction. A "securities lending transaction" would be defined by reference to current law (i.e., as a transfer of securities pursuant to an agreement described in Section 1058 or a substantially similar transaction), and a "sale-repurchase transaction" would be defined as an agreement under which a person transferred a security in exchange for cash and simultaneously agreed to receive substantially identical securities from the transferee in the future in exchange for cash.

Although the purpose of this provision clearly is to ensure that all payments economically linked to dividends on U.S. equities bear U.S. withholding tax (subject to potential reduction by treaty), the practical impact of the provision is more difficult to assess. For example, although the bill grants the Secretary discretion to issue regulations to mitigate any overwithholding caused by this provision, the Secretary is not required to issue such regulations, and regulatory relief would not be granted unless a taxpayer could prove that a dividend tentatively subject to withholding was a dividend equivalent or a substitute dividend that previously had been withheld upon under the Code. Given the very complex nature of many equity-based derivative financial instruments, it is doubtful whether such a provision would, in fact, assist layperson taxpayers in avoiding overwithholding.

Because U.S. withholding tax is imposed on a gross basis, it can be particularly burdensome where the amount of gross income subject to withholding exceeds economic income because of associated expenses. This can occur, for example, where a position is highly leveraged or is part of an arbitrage strategy.

The bill directs the Secretary to issue final regulations relating to the dividend equivalent withholding provision within 150 days of the enactment of the bill into law, and such regulations are required to expand the scope of withholding imposed by the bill. Specifically, the regulations must require the imposition of withholding in cases where (i) dividend equivalent payments under notional principal contracts are netted with other payments under the same instrument, (ii) fees and other payments are netted to disguise the characterization of a payment as a substitute dividend and (iii) option or forward contracts (or similar arrangements) achieve the same or substantially similar economic results as the notional principal contracts explicitly covered under the bill. The extent to which regulations will expand the withholding net of the bill is less than clear, but it seems safe to conclude that the intended scope of withholding is quite broad, which again increases the risk of overwithholding and other detrimental consequences.

The bill contains a limited transition relief provision, under which the amendments relating to withholding on dividends would apply only to covered payments made on or after 90 days after the bill was enacted. However, the amendments would apply to payments made pursuant to existing transactions if such payments were made on or after such date.

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[1] All section references herein are to the Internal Revenue Code of 1986, as amended.

[2] There would be an exception from the gross assets test for controlled foreign corporations that are members of an affiliated group whose common parent is a domestic corporation with substantial assets (other than cash, cash equivalents or stock of foreign subsidiaries) held for use in the active conduct of a U.S. trade or business, but this exception would not cover offshore vehicles typically employed in the investment fund context or many other types of U.S.-managed offshore vehicles.

If a foreign corporation were covered under either of the two tests described in the text in a taxable year and, in a later taxable year, (i) its stock was not regularly traded on an established securities market and (ii) it had—and was reasonably expected to continue to have—aggregate gross assets (including assets under management for investors, whether held directly or indirectly) of less than $50 million, the corporation would no longer be covered under this provision if the Secretary of the Treasury granted the corporation a waiver. The bill is silent as to the consequences that would occur under other provisions of the Code (e.g., the anti-inversion rules of Section 7874) if a foreign corporation that was previously treated as a domestic corporation under the bill qualified for and was granted a waiver and subsequently was treated as a foreign corporation for U.S. federal income tax purposes.

[3] Proposed regulations must be issued within 90 days of the enactment of the bill into law.

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