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TAX ALERT

HOUSE PASSES EXTENDERS BILL THAT INCLUDES SEVERAL REVENUE-RAISING PROVISIONS OF NOTE TO INVESTMENT FUNDS AND THEIR SPONSORS

On December 9, 2009, the U.S. House of Representatives passed the "Tax Extenders Act of 2009" (H.R. 4213), which would extend a number of tax provisions that are set to expire. Of particular note to investment funds and their sponsors, the bill also includes revenue-raising provisions that would—

- tax income from a service provider's profits interest in an investment fund (i.e., a "carried interest") at ordinary rates
- create an expansive reporting and withholding tax regime that would effectively force "foreign financial institutions," including offshore investment fund vehicles, to obtain detailed information as to the identity (and, in some cases, the direct and indirect ownership) of their account holders and investors, including their foreign investors (the so-called Foreign Account Tax Compliance Act (FATCA) provisions)
- impose U.S. withholding tax on "dividend equivalent payments" made to non-U.S. persons, including payments made under certain notional principal contracts (e.g., equity swaps) where the payment is contingent upon, or determined by reference to, the payment of a U.S. source dividend.

At present, prospects for enactment of the bill are unclear. The bill is currently pending in the Senate. Although President Obama has expressed support for the bill, the Senate is expected to be consumed with health care reform through the end of the year. Therefore, it seems likely that the Senate will not take up the bill until 2010. Sen. Max Baucus, D-Mont., the chairman of the Senate Finance Committee, has stated publicly that he supports passage of the extenders legislation. However, we understand that Sen. Baucus has not taken a position on taxing carried interest at ordinary income rates; rather, he has indicated that he intends to propose paying

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for the extenders legislation by (i) imposing a tax on "black liquor" (i.e., cellulosic fuel) and (ii) enacting the FATCA provisions. It is unclear whether Sen. Baucus would seek to modify the FATCA provisions as set forth in the bill, or whether other revenue-raising measures would be proposed or modified in the Senate version of the bill.

TAXATION OF CARRIED INTEREST AT ORDINARY INCOME RATES

The bill would generally treat partnership allocations to investment fund managers as ordinary income, unless such allocations were proportionate to invested capital and met certain other requirements. Gain on disposition of such interests would generally be treated in the same manner. This provision would generally apply to a general partner's carried interest or incentive allocations.

If the bill is enacted, these provisions would be effective for taxable years ending after December 31, 2009. No relief is provided for existing carried interest arrangements.

REPORTING AND WITHHOLDING FOR FOREIGN ACCOUNTS AND ENTITIES

In general, the bill would impose a punitive withholding tax on any "foreign financial institution" (FFI) that did not enter into an agreement with the Internal Revenue Service (IRS) under which the FFI would agree (i) to obtain (and verify, in accordance with procedures to be prescribed by the IRS) information as to the identity of its account holders, (ii) to report on an annual basis certain information with respect to each "U.S. account" maintained by the FFI and (iii) to withhold, at a rate of 30 percent, on certain payments made to account holders who did not provide adequate information as to their identity. For this purpose, a "financial institution" would include banks and similar businesses, as well as entities engaged primarily in the business of investing or trading in securities, partnership interests, commodities or derivative interests therein (e.g., offshore hedge or private equity fund vehicles), and a "U.S. account" would mean any financial account held by one or more "specified U.S. persons" or "U.S.-owned foreign entities." "Specified U.S. persons" would encompass a broad spectrum of U.S. persons, including individuals, non-publicly traded corporations, partnerships and trusts, but would exclude certain tax-exempt organizations and certain other entities (e.g., REITs and RICs). "U.S.-owned foreign entities" would include any foreign entity with one or more "substantial U.S. owners."

Although the intended purpose of these provisions is to enhance compliance by U.S. persons who hold accounts in FFIs, in practical terms, the most significant impact of the bill on most offshore hedge funds and private equity funds is likely to be with respect to their foreign investors. The bill does not specify how FFIs would be required to determine whether an account holder was a specified U.S. person or a U.S.-owned foreign entity, but the Joint Committee on Taxation's Technical Explanation of the Bill (the "JCT Report") suggests that FFIs generally would need to obtain from all of their

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investors (including foreign investors) certifications as to their identity and that of their direct and indirect owners. The JCT Report also suggests that FFIs would need to comply with "know-your-customer," anti-money laundering, anti-corruption and other similar rules in making this determination. Typically, many foreign persons have resisted identifying themselves on forms issued by taxing authorities, particularly the IRS.

If an FFI did not enter into an agreement to comply with the requirements described above, any "withholdable payment" made to such FFI would become subject to 30 percent U.S. withholding tax. The term "withholdable payment" would include (i) any payment of interest (including OID), dividends, rents, salaries, wages, annuities and other similar U.S. source payments and (ii) any gross proceeds from the sale or other disposition of any property of a type that could produce U.S. source interest or dividends (e.g., securities). Thus, the 30 percent U.S. withholding tax would apply to interest that, under current law, is exempt from withholding under the "portfolio interest" exemption and, in the case of proceeds from sales, could reach amounts that do not constitute economic income.

Under the bill, the FATCA-related provisions generally would apply only to payments made after December 31, 2012. Additionally, payments made under an "obligation" outstanding on the date two years after the bill is enacted into law would qualify for a "grandfathering" exception under the bill.

WITHHOLDING ON "DIVIDEND EQUIVALENT PAYMENTS"

Under current law, payments on equity swaps made to a non-U.S. person generally do not attract U.S. withholding tax, even if the payments are determined by reference to dividends on U.S. equity securities that otherwise would have been subject to U.S. withholding tax when paid to the foreign counterparty under the swap. Many foreign persons have relied on this rule to avoid withholding tax on dividends by holding the underlying stock "synthetically" rather than directly (although, in some cases, the IRS has sought to recast a swap as another type of transaction, such as a securities loan). The bill would eliminate this technique by providing that any payment made pursuant to an equity swap that (directly or indirectly) is contingent upon, or determined by reference to, the payment of a U.S. source dividend (a "dividend equivalent payment") generally would be subject to U.S. withholding tax, except to the extent that the Treasury Department determined otherwise. For swaps covered by the bill, the withholding tax would apply to the gross dividend equivalent payment, and, thus, the withholding tax might exceed the total amount of the payment. The withholding tax would be imposed at a rate of 30 percent, but would be subject to potential treaty reduction or elimination.

Under the bill, this provision would apply to swap payments made 90 days or more after enactment. Thus, payments under a currently outstanding swap could become subject to this provision if the bill is enacted into law (i.e., there is no general "grandfathering" provision for swaps outstanding on the date of enactment).

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OTHER PROVISIONS

In addition to the provisions described above, the bill would—

- require individuals to report on their U.S. income tax returns certain information with respect to "foreign financial assets," including financial accounts maintained by foreign financial institutions, stocks or securities issued by non-U.S. persons and financial instruments or contracts issued by a non-U.S. person or held by a non-U.S. counterparty (however, the bill would apply only to the extent that the aggregate value of an individual's foreign financial assets exceeded $50,000)
- repeal the foreign-targeted bearer bond exception of the Tax Equity and Fiscal Responsibility Act (TEFRA), as well as the related exception to the portfolio interest exemption, that effectively would prevent debt sold on the international capital markets from being issued in bearer form.

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