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Obama Administration Tax Proposal - Relevant Provisions for Private Equity and Other Investment Funds

May 2009
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The Administration's previously released outline of its 2010 budget had projected $210 billion in additional revenues over the next decade by increasing international enforcement, reforming deferral, and "other tax reform policies." It is expected that these tax proposals would have a dramatic impact on private equity and other investment funds with cross-border activities.[1]

The Administration's current tax proposal includes several provisions that are of particular interest to private equity and other investment funds. First, the proposal includes a provision to change the federal income taxation of "carried" interests. Similar to other recent bills and proposals addressing the same issue, under this proposal, a fund manager's income derived from, and gain recognized from the sale of, its carried interest received in exchange for services provided (or to be provided) to the fund would be taxed as ordinary income for the performance of services, regardless of the character of the income at the partnership level. Individuals deriving income from a carried interest would also be required to pay self-employment taxes. In addition, like other recent bills, this proposal does not seek to recharacterize income derived from, or gain from the sale of, a fund manager's invested capital in the fund, to the extent the fund's allocation of income and gain in respect of such invested capital is reasonable. However, unlike previous versions of carried interest legislation, this proposal expands the types of partnership interests that would be covered under the new rules so that many partnerships that are not investment funds would likely also be affected. Finally, this proposal also contains an anti-abuse rule designed to prevent avoidance of these rules through the use of compensatory arrangements other than partnership interests, including the use of convertible or contingent debt, an option, or any derivative instrument with respect to the fund. It remains to be seen whether any tax planning opportunities would be available if carried interest legislation is eventually enacted.

Second, for private equity and other investment funds with foreign investments or operations, the proposal seeks to (i) defer deductions for interest and other expenses relating to foreign operations until the earnings from those foreign operations have been repatriated and (ii) close loopholes through which it believes some U.S. businesses are artificially inflating or accelerating the use of foreign tax credits to offset U.S. tax. Under current law, certain deductions related to foreign investments and operations may

generally be claimed when the underlying costs are incurred but the corresponding foreign income earned by the U.S. taxpayer is not subject to immediate U.S. taxation until the income is repatriated. In addition, many U.S. taxpayers with cross-border activities, including private equity-backed multi-national corporations, are currently claiming foreign tax credits in respect of foreign taxes paid on income that is not subject to U.S. tax. While no details have been provided, these proposed changes to the timing of foreign tax credits and tax deductions related to foreign operations could affect how funds, and particularly leveraged buy-out firms, structure their offshore acquisitions and investments because such transactions would become more expensive.

Third, after expressing concern that the "check-the-box" elections have been used to migrate earnings to low-tax jurisdictions without a corresponding income inclusion to a U.S. taxpayer, the proposal seeks to mandate U.S. corporate taxation of certain overseas subsidiaries. Under the proposal, a foreign entity could only be treated as a disregarded entity for U.S. tax purposes if the foreign entity and its sole owner are both formed under the laws of the same jurisdiction. In other cases, a foreign entity with a single owner would be treated as a per se corporation for U.S. tax purposes, subject to a general exception for first-tier foreign entities that are wholly-owned by a U.S. person. If enacted, this provision could also significantly affect how funds structure their offshore investments and operations. For example, a foreign fund's wholly-owned foreign subsidiary may become subject to U.S. corporate taxation at the subsidiary level, creating a significant additional cost to the fund's non-U.S. operations. It remains unclear whether the final version of this provision, if enacted, would provide any potential tax planning opportunities.[2]

Fourth, the proposal notes that foreign portfolio investors seeking to benefit from the appreciation in value and dividends paid with respect to the stock of a U.S. corporation may enter into an equity swap instead of holding stock in such U.S. corporation, without being subject to gross-basis withholding tax as would be the case if the stock itself had been held. With respect to such equity swaps, the proposal would cause any dividend equivalent amount with respect to a domestic corporation paid under an equity swap contract to be U.S. source income, resulting in such amounts being generally subject to U.S. withholding tax to the extent paid to a foreign person. Investment funds, particularly hedge funds, with these kinds of equity swaps in their portfolios would be adversely affected.

Finally, other provisions in the proposal would affect the day-to-day management of private equity and other investment funds on a going-forward basis. These other provisions include heightened tax reporting requirements in respect of foreign activities and certain financial transactions.

Morrison & Foerster's Federal Tax Department will continue to monitor related developments closely. For questions or comments, you may contact Robert A.N. Cudd (rcudd@mofo.com) or Arthur Man (aman@mofo.com) of the Federal Tax Department or any member of the Private Equity Fund Group.

Footnotes

[1] The Administration released a statement last week reaffirming its goals to toughen U.S. international tax rules in a number of respects. For more details, *see* Morrison & Foerster LLP Legal Update, Obama Administration Proposes Broad International Tax Reforms (May 5, 2009).

[2] For instance, if a fund's wholly-owned foreign subsidiary would be covered by the proposed rules, query whether adding a second owner so that the subsidiary is no longer wholly-owned would leave the subsidiary outside the scope of the proposed rules.