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Stop Tax Haven Abuse Act – Tax Provisions of Interest to Private Funds and Fund Managers

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Last week, Senator Carl Levin (D – Mich.) introduced the *Stop Tax Haven Abuse Act* (S. 506) (the "Bill").[1] As the Bill's name implies, it is aimed at curbing offshore tax haven and tax shelter abuses. [2] U.S. based investment managers should take note of the substance of the Bill, however, since the proposed legislation, if enacted in its current form, would have a significant impact on the U.S. federal tax treatment of U.S. managed offshore private funds, including hedge and private equity funds.

Related Practices:

- Corporate
- Federal Tax
- Private Equity Fund Group
- Tax

Morrison & Foerster will be following the progress of the Bill carefully, given that a similar bill introduced by Senator Levin in 2007 was co-sponsored by then-Senator Barack Obama (D – Ill.), among others.[3] It is also noteworthy that Treasury Secretary Timothy Geithner's recent testimony before the Senate Committee on Finance indicated his support for the Bill.

We discuss below provisions of the Bill that we believe may have particular relevance to private funds and their investment managers.

Recharacterization of Certain Offshore Corporations as Domestic Corporations

Of significant importance is Section 103 of the Bill, which proposes to treat foreign corporations that either (i) are publicly traded or (ii) have gross assets of $50 million or more and are "managed and controlled" in the United States as domestic corporations for U.S. federal tax purposes, subjecting such corporations to entity-level U.S. net income taxation. For these purposes, a foreign corporation is "managed and controlled" in the United States if substantially all of the executive officers and senior management of the corporation who exercise day-to-day responsibility for making strategic, financial and operational decisions and policies of the corporation are located primarily in the United States. In addition, for foreign corporations primarily holding investment assets, such corporations are treated as managed and controlled in the United States if the assets of such corporation consist primarily of assets being managed on behalf of investors, and the decisions about how to invest the assets are made in the United States.

This provision would affect many offshore hedge funds organized as corporations that are managed and controlled in the United States. It could also affect offshore "blocker" corporations used by private equity funds. Such corporations could be treated as domestic corporations for U.S. federal tax purposes subject to entity-level U.S. net income taxation.

Rebuttable Evidentiary Presumptions in Respect of Offshore Secrecy Jurisdictions

The Bill permits U.S. tax and securities law enforcement to use certain rebuttable evidentiary presumptions in civil judicial, administrative tax or securities enforcement proceedings brought against U.S. persons involved with entities, transactions and accounts located in "offshore secrecy jurisdictions." The "offshore secrecy jurisdictions" listed in the Bill include some of the most common jurisdictions in which private funds are established.[4]

Civil Tax Enforcement Proceedings. In a tax proceeding against a U.S. taxpayer, tax authorities may employ three evidentiary rebuttable presumptions:

- **Control**. A U.S. taxpayer who "formed, transferred assets to, was a beneficiary of, or received money or property" from an offshore entity (other than a publicly-traded corporation) is in control of the entity;

- **Transfers of Income**. Any funds or property transferred to or from a U.S. taxpayer (other than a publicly-traded corporation) to or from an account or entity located in an offshore secrecy jurisdiction is taxable in the year of transfer; and

- **Foreign Financial Accounts**. Any account controlled by a U.S. taxpayer in an offshore secrecy jurisdiction contains sufficient funds (i.e., at least $10,000) to trigger FBAR[5] filing and reporting requirements.

Securities Enforcement Proceedings. In a securities proceeding to enforce U.S. securities laws, federal authorities may presume that securities nominally owned by an offshore entity are beneficially owned by any U.S. person who controls the offshore entity directly or indirectly.

In order to rebut any of the above presumptions, a U.S. taxpayer would need to provide clear and convincing evidence to show that the presumption is factually inaccurate. Evidence provided by a non-U.S. person must be personally presented at the proceeding.

Increased Disclosure of Offshore Accounts and Entities by U.S. Financial Institutions

Section 105 of the Bill generally proposes to increase required disclosures of offshore accounts, transactions and entities. Specifically, the Bill would require any financial institution directly or indirectly opening a financial account or creating an entity in an offshore secrecy jurisdiction for a U.S. client to report the transaction to the IRS, and require any bank or securities firm that has a U.S. taxpayer as the beneficial owner of one of its foreign-owned financial accounts to report account income of that U.S. taxpayer to the IRS.

This would create additional reporting and disclosure requirements applicable to certain hedge and private equity funds and could increase their cost of doing business.

Closing the Dividend Tax Loophole

Section 108 of the Bill proposes to, according to Senator Levin, "close the offshore tax dividend loophole." The Bill seeks consistent tax treatment of dividends, dividend equivalents (paid under swap contracts), and substitute dividend payments (paid under a securities lending or a sale-leaseback transaction) by defining a "dividend" for U.S. withholding tax purposes to include dividend equivalents and substitute dividend payments. In addition, the Bill provides that any dividend equivalents with respect to stock of a domestic corporation is U.S. source income and that any substitute dividend payment is sourced in the same manner as the dividend distribution with respect to the underlying stock. As such, any dividend equivalents and substitute dividend payment paid to non-U.S. persons with respect to stock of domestic corporations would be subject to U.S. withholding tax.

To the extent that hedge and private equity funds use derivatives or other financial or structured instruments, this provision could increase the fund's U.S. withholding tax obligations on income derived from such transactions or instruments paid to non-U.S. persons.

Additional PFIC Reporting Requirements

The Bill also proposes to expand the reporting requirements for passive foreign investment companies ("PFICs") to include not only U.S. persons who are shareholders in a PFIC, but also U.S. persons who directly or indirectly form, transfer assets to, are a beneficiary of, have a beneficiary interest in, or receive assets from a PFIC.

This provision would create new reporting and disclosure requirements applicable to certain private equity and hedge fund managers.

Anti-Money Laundering Programs for Private Funds and Company Formation Agents

Section 202 of the Bill would require the Treasury Department to issue final anti-money laundering regulations applicable to unregistered investment companies, such as hedge funds and private equity funds, within 180 days of the Bill's enactment. The regulations would require hedge funds, private equity funds and other funds not registered as "investment companies" under the Investment Company Act of 1940 to establish anti-money laundering programs and submit suspicious activity reports (SARs). Section 203 of the Bill would impose anti-money laundering obligations on company formation agents as well.

If the proposed Section 202 is enacted as drafted, private funds, including hedge funds and private equity funds, would be required to adopt anti-money laundering policies and would have increased anti-money laundering obligations.

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While it is unclear what the likelihood of passage is of some or all of these provisions, it is clear that Congress is taking a closer look at the U.S. federal taxation of private funds and their investment managers. As mentioned above, a similar version of the Bill was originally introduced in 2007 with then-Senator Obama's support. That year, legislation was also introduced proposing to tax a fund's "carried interest" at ordinary income rates.[6] Thus, change in the U.S. federal taxation of private funds, including hedge funds and private equity funds, and their investment managers is being carefully considered by Congress. Morrison & Foerster's Federal Tax Department will continue to monitor these events closely.

For questions or comments about or related to the Bill, please contact Robert A.N. Cudd (rcudd@mofo.com) or Arthur Man (aman@mofo.com).

Footnotes

[1] A copy of the Bill is available at: http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:s506is.txt.pdf
[2] A companion bill has also been introduced in the U.S. House of Representatives by Representative Lloyd Doggett (D – Tex.). Senate Finance Committee Chairman Max Baucus (D – Mont.) is preparing his own legislation addressing issues relating to offshore tax noncompliance, which is less comprehensive in scope than the Bill. Specifically, Baucus' bill does not include the provision recharacterizing certain U.S.-managed foreign corporations as U.S. corporations for U.S. federal income tax purposes.
[3] The Bill has three additional provisions not included in the 2007 proposed legislation. These provisions would (i) treat foreign entities managed and controlled in the U.S. as domestic corporations for income tax purposes, (ii) close an offshore tax dividend "loophole" relating to U.S. stock dividends, as further explained in our Client Alert dated March 9, 2009, and (iii) increase the tax return reporting requirements for passive foreign investment corporations ("PFICs") to include U.S. persons who have formed, sent assets to, received assets from or otherwise benefited from a PFIC.
[4] The Bill presents an initial list of 34 offshore secrecy jurisdictions, and authorizes the Treasury Department to update the list as necessary, taking into consideration (i) whether the jurisdiction's secrecy laws and practices unreasonably restrict U.S. access to U.S. taxpayer information, and (ii) whether the jurisdiction maintains an effective tax information exchange process with the U.S. The offshore secrecy

jurisdictions listed in the Bill are: Anguilla, Antigua and Barbuda, Aruba, Bahamas, Barbados, Belize, Bermuda, British Virgin Islands, Cayman Islands, Cook Islands, Costa Rica, Cyprus, Dominica, Gibraltar, Grenada, Guernsey/Sark/Alderney, Hong Kong, Isle of Man, Jersey, Latvia, Liechtenstein, Luxembourg, Malta, Nauru, Netherlands Antilles, Panama, Samoa, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines, Singapore, Switzerland, Turks and Caicos, and Vanuatu.

[5] A "FBAR" is IRS Form TD F 90-22.1, a "Report of Foreign Bank and Financial Account."

[6] For more information about "carried interests", please see Morrison & Foerster LLP Legal Update, New Proposed Legislation to Tax Income Derived From "Carried" Partnership Interests as Ordinary Income, (June 2007).