



GlobalNote®

Impact of the Introduction of the Stop Tax Haven Abuse Act on the Private Fund Industry

TO: Clients and Friends of Tannenbaum Helpert Syracuse & Hirschtritt LLP¹
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On March 2, 2009, US Senator Carl Levin introduced the “Stop Tax Haven Abuse Act” (S. 506) in the Senate (the “Tax Haven Bill”). This Bill modified previously introduced legislation which had the effect of restricting the use of offshore tax haven and tax shelter abuses. While the likelihood of the passage of all or any portion of this bill is unclear, we note that previous legislation was supported by then-Senator Barack Obama in the last Congress, and that President Obama has endorsed the current legislation. A companion bill (HR-2136) was subsequently introduced in the U.S. House of Representatives by Rep Lloyd Doggett. The Tax Haven Bill includes a number of provisions that, if enacted into law, could significantly affect the US tax treatment of hedge funds. The following summarizes these provisions.

I. Treatment of US Managed Foreign Corporations as Domestic Corporations.

Section 103 of the Tax Haven Bill contains provisions for the treatment of foreign corporations managed and controlled in the US as domestic corporations for US income tax purposes. A corporation that is publicly traded or has aggregate gross assets, including assets under management for investors, of \$50 million or more during the tax year or the preceding tax year will be treated as a domestic corporation for income tax purposes if the management and control of the corporation occurs, directly or indirectly, primarily in the United States. Section 103 authorizes the Treasury Secretary to issue regulations providing that the management and control of a corporation shall be treated as occurring primarily within the US 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

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in the US. Accordingly, Section 103 would cause most offshore hedge funds that are managed by a US-based investment advisor to be treated as US corporations thereby becoming fully subject to the US net income tax regime otherwise imposed on domestic corporations. This proposal would be effective two years after the date of enactment, which should enable US fund managers to consider alternative structures for their funds.

II. Offshore Tax Dividend Loophole Closed.

Section 108 of the Tax Haven Bill closes an offshore tax dividend technique that enables non-US persons to avoid payment of US taxes on US stock dividends by ending the practice of using complex financial transactions to recast taxable dividend payments as allegedly tax-free dividend equivalent or substitute dividend payments. Section 108 defines "dividend" under Sections 871 and 881 of the US tax code (which govern the imposition of US withholding taxes on dividend payments to foreigners) to include "dividend equivalents" and "substitute dividends." The term "dividend equivalent" includes any payment that is made pursuant to a notional principal contract and is contingent upon, or is referenced to, the payment of a dividend on stock or the payment of a dividend on property that is substantially similar or related to stock. The term "substitute dividend" is defined as a payment, made to the transferor of a security in a securities lending transaction or a sale-repurchase transaction, of an amount equivalent to a dividend distribution which the owner of the transferred securities is entitled to receive during the term of the transaction. Offshore hedge funds are generally subject to a 30% withholding tax on dividends received from US corporations. The Tax Haven Bill would end the use by offshore hedge funds of equity swaps, offshore stock loans and similar transactions to avoid the payment of this US withholding tax on US sourced dividend payments. This proposal would be effective 90 days after the date of enactment.

III. Adoption of Anti-Money Laundering Programs Required by Hedge Funds.

Section 203 of the Tax Haven Bill would require hedge funds and private equity funds to adopt anti-money laundering programs and submit suspicious activity reports under regulations to be promulgated by the Treasury Secretary, in consultation with the SEC and CFTC. Such regulations must require such funds to exercise due diligence before accepting offshore funds and to comply with the same anti-money laundering procedures as other financial institutions if asked for records by a federal regulator. This proposal would be effective no later than 180 days after the date of enactment.

IV. Tax Return Reporting Requirements for PFICs Expanded and other Compliance Related Rules.

Section 109 of the Tax Haven Bill expands the tax return reporting requirements for passive foreign investment corporations ("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. An offshore hedge fund is generally treated as a PFIC for US tax purposes due

to the passive nature of the fund’s assets and income. The expanded reporting requirement in Section 109 is intended to prevent any U.S. person who established, capitalized, or profited from a beneficial interest in a PFIC from avoiding reporting obligation for that PFIC if such person did not have a formal ownership interest in the PFIC. This proposal would be effective on the date of enactment.

Additional compliance-related rules targeted at investments made through entities in “offshore secrecy jurisdictions” and other offshore investments are included in the Tax Haven Bill, including, in certain cases, adverse evidentiary presumptions, the extension of the statutes of limitations from three years to six years, additional reporting requirements and additional penalties.

The Tax Haven Bill has far reaching implications. If you have any questions regarding this memorandum, please contact the Tannenbaum Helpert attorney with whom you regularly work or one of the following partners in our Tax Department:

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