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Client Alert

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March 2009

Levin Proposes Broad Legislation that Would Severely Restrict Use of Offshore Vehicles by Private Equity and Hedge Funds

On March 2, 2009, Senator Carl Levin introduced the "Stop Tax Haven Abuse Act" (the "Bill").[1] As the name implies, the legislation is intended to curtail the use of entities formed in certain non–U.S. jurisdictions for transactions that are perceived as giving rise to tax abuse. The Bill is quite broad, however, and in its current form the Bill would effectively eliminate the current practice by many U.S.-based private equity and hedge funds of including within their structures vehicles organized in certain jurisdictions (such as the Cayman Islands[2]) by treating such vehicles as taxable in the U.S. as corporations. If enacted in its current form, the Bill would cause many private equity and hedge funds to restructure their funds. Such restructurings could have drastic unintended consequences, such as causing fund managers to move their operations offshore or causing investors to redeploy their capital to funds that are not managed by U.S. persons.

Although the Bill appears to have the support of the President and the Congressional Democratic majority, given the breadth of the legislation it likely will be subject to change. For example, Senate Finance Committee Chairman Baucus has announced that he will also propose legislation addressing offshore tax compliance.

Bill Would Treat Non-U.S. Corporations as Taxable in the U.S.

Section 103 of the Bill would classify as a U.S. corporation any non-U.S. corporation which meets two tests:

- First, the non-U.S. corporation must be either a corporation that has stock that is regularly traded on an established market or has aggregate gross assets under management for the benefit of investors at any time during the taxable year of at least $50 million.

- Second, the corporation must be managed and controlled primarily in the U.S. A corporation is treated as managed and controlled primarily in the U.S. if substantially all of the executive officers and senior management of the corporation responsible for day to day decision making regarding strategic, financial and operational policy are located primarily in the U.S. In addition, this test is presumed satisfied for any non-U.S. corporation which has investment assets held for the benefit of investors where investment decisions are made in the U.S.

Thus, under the Bill, an investment fund that is treated as a corporation for U.S. federal income tax purposes, is

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[1] S.506, 111th Cong. (2009); also available at: http://levin.senate.gov/newsroom/supporting/2009/PSI.StopTaxHavenAbuseAct.030209.pdf. A companion House bill was introduced by over 40 members, led by Rep. Doggett and Rep. DeLauro.

[2] In addition to the Cayman Islands, the initial list of jurisdictions, which are referred to as "offshore secrecy jurisdictions," includes: Anguilla, Antigua and Barbuda, Aruba, Bahamas, Barbados, Belize, Bermuda, British Virgin 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 & the Grenadines, Singapore, Switzerland, Turks and Caicos, and Vanuatu.

managed by a U.S.-based advisor, and meets the gross asset test generally would be subject to U.S. income tax liability on its worldwide income.

This provision in the Bill would be effective for tax years beginning after the second anniversary of its enactment. The two-year time frame may be intended to provide some time for investment funds to reorganize their current investment structures (e.g., to change jurisdiction of domicile or convert non-U.S. corporations into entities treated as partnerships for U.S. federal income tax purposes).

Why Treating Non-U.S. Corporations as Taxable in the U.S. Is Significant for Private Equity and Hedge Fund Structuring

A significant part of the institutional investor base for private equity and hedge funds consists of non-U.S. persons and U.S. tax-exempt entities, such as universities, pension plans and endowments. When these investors make a decision to invest in a fund, a key consideration are the tax costs, both directly as well as indirectly such as tax return compliance costs. To mitigate these costs, non-U.S. persons and U.S. tax-exempt entities routinely employ a structure that includes holding an interest in the underlying investment fund through a non-U.S. entity treated as a corporation for U.S. income tax purposes (frequently referred to as a "feeder corporation" or a "blocker corporation").

For non-U.S. investors in private equity and hedge funds, their share of fund income generally is not subject to tax in the United States. In certain circumstances, however, these non-U.S. investors would have U.S. federal and/or state tax return filing obligations through their participation in the fund. To avoid these filing obligations, non-U.S. investors will typically hold their investment in a private equity or hedge fund through a feeder or blocker corporation, with the result that the U.S. tax return filing obligations are imposed on the feeder or blocker corporation rather than the U.S. investor itself.

Similar to non-U.S investors, tax-exempt investors generally are not subject to tax on their share of investment fund income. This tax-exempt status is limited, however, and income and gains from an investment acquired with leverage potentially will be subject to tax as "unrelated business taxable income" (UBTI). Under these so-called "debt-financed income" rules, a tax-exempt entity may be subject to tax on its share of income and gain from an investment fund employing leverage at the fund level (as opposed to leverage used by the underlying porfolio company).

To avoid the realization of UBTI under these circumstances, tax-exempt entity's adopt the same approach employed by non-U.S. investors, and hold their interest in leveraged investment funds through a feeder or blocker corporation. This structure has been passed upon approvingly by the Internal Revenue Service in several private letter rulings, and is not new or novel. In fact, legislation was introduced in 2007 that would have effectively repealed the application of the debt-financed rules in the context of investment funds, thereby eliminating the need for private equity and hedge funds to a feeder or blocker corporation structure.[3] Unfortunately, this legislation was not adopted and has not been reintroduced in the current session of Congress.

If the Bill were enacted in its current form, a feeder or blocker corporation for a fund managed by U.S. persons potentially would be subject to tax in the U.S. on its worldwide income. The resulting tax cost would almost certainly outweigh any benefits of the feeder or blocker corporation. Without a feeder or blocker corporation, investors would be left with the difficult of decision of either accepting the U.S. tax compliance costs of the investment or, more likely, simply investing their capital through a corporation structure that is not managed by U.S.-based fund managers and therefore not subject to the rules set forth in the Bill.

Other Tax Proposals Incorporated in the Bill

The Bill also includes the following major provisions:

- Closing of the "offshore dividend tax loophole" by taxing (i) substitute dividend payments in respect of U.S. stocks under securities lending and sale repurchase transactions,

[3] For a discussion of the proposed legislation, see our Client Alert dated September 7, 2007 at http://www.proskaueratwork.com/Public/news_publications/client_alerts/content/2007_09_10_b.

and (ii) dividend equivalent payments made under notional principal contracts in respect of U.S. stocks in the same manner as U.S. source dividends (i.e., subject to a 30% U.S. withholding tax or a reduced rate under an applicable income tax treaty), with special rules to avoid overwithholding.

- Expansion of the reporting requirements relating to passive foreign investment companies ("PFICs") to include 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.

- Requirement that unregistered funds, including private equity and hedge funds, establish anti-money laundering programs and submit suspicious activity reports.

- Establishment of certain legal presumptions for entities and transactions involving offshore secrecy jurisdictions, including a presumption that any account in an offshore secrecy jurisdiction contains sufficient funds to trigger an FBAR filing.[4]

- Requirement that withholding tax agents disclose information about beneficial owners of non-U.S. owned accounts and accounts established in offshore secrecy jurisdictions.

- Allowing increased time for investigations involving accounts in offshore secrecy jurisdictions.

- Imposition of special measures against non-U.S. jurisdictions, financial institutions, and others that impede U.S. tax enforcement.

- Codification and strengthening of the "economic substance doctrine" to invalidate transactions that have no meaningful economic substance or business purpose apart from tax avoidance or evasion.

- Strengthening of tax shelter penalties.

- Enhancement of tax opinion standards applicable to written advice pertaining to tax shelters and transactions having a potential for tax avoidance or evasion.

We will continue to monitor this Bill and the other federal and state bills that are pending and that have been referenced in prior Client Alerts.

[4] Under current law, U.S. taxpayers have an obligation to report to the IRS any foreign financial accounts containing at least $10,000 (known as an FBAR filing). See our June 2008 Private Investment Funds Update for further information. (http://www.proskauer.com/news_publications/newsletters/PrivateEquity/2008_06_18).

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Client Alert

Proskauer's Private Investment Funds Group comprises more than 100 lawyers and advises clients worldwide on all of the legal and business issues important to private equity and hedge funds and their managers, including structuring investment vehicles of all types, portfolio company investments, institutional investor representation and secondary purchases and sales.

Please feel free to call any of the Proskauer lawyers listed below at any time if you have additional questions, or if we can be of additional assistance with the issues raised in this alert.

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