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CLIENT
MEMORANDUM

PROPOSED LEGISLATION WOULD TAX MANY OFFSHORE HEDGE FUNDS AND CERTAIN OTHER NON-U.S. CORPORATIONS MANAGED IN THE UNITED STATES

Legislation introduced this week in the Senate (by Senator Carl Levin and others as S. 506) and the House of Representatives (by Rep. Lloyd Doggett as H.R. 1265) entitled the "Stop Tax Haven Abuse Act" includes, among its extensive proposals, a measure that would, if enacted, subject many non-U.S. hedge funds and other types of non-U.S. corporations managed in the United States to regular U.S. corporate income taxation, unless they reorganize to avoid that result. Allowing time for these reorganizations, the bill proposes that this provision would apply to taxable years beginning on or after two years following enactment.

Scope of the Proposal as Currently Drafted

The bill would treat a non-U.S. corporation as a U.S. corporation, subject to regular U.S. taxation, if:

- Management and control of the corporation occurs directly or indirectly primarily in the United States, and
- Either (1) the stock of the corporation is regularly traded on an established securities market, or (2) the aggregate gross assets of the corporation (or any predecessor), including assets under management for investors, whether held directly or indirectly, at any time during the current or a past year are at least $50,000,000.

The "management and control" part of the test generally would be met if substantially all of the executive officers and senior management exercising day-to-day responsibility for strategic, financial and operational policy decisions are located primarily in the United States. In addition, corporations that own primarily assets managed on behalf of investors would be treated as managed and controlled in the United States if investment decisions with respect to those assets are made in the United States. The bill would also contain very limited exceptions from the $50,000,000 asset test.

The Proposal's Unclear Purpose and Likely Prospects

The proposal's purpose, as applicable to offshore funds, is not self-evident from the current bill text. If it were enacted in its current form, there would be many obvious ways for U.S.-managed offshore hedge funds to avoid it, and its delayed effective date seems to anticipate and encourage non-U.S. corporations to reorganize themselves to do so. In that respect, raising revenue seems not to be the proposal's primary aim.

For example, many offshore funds would likely respond to the proposal's enactment by simply reorganizing themselves as flow-through entities. To protect themselves from U.S. tax reporting on income from such pass-through funds, non-U.S. investors would likely invest in them through non-U.S. blocker corporations that they control and manage outside of the United States, putting themselves in the same position as they are now under current law. Similarly, to protect themselves from U.S. tax on unrelated business taxable income from the funds' debt-financed assets, U.S. tax exempt investors would invest in the pass-through funds through their own non-U.S. blocker corporations controlled and managed outside of the United States, also putting themselves in the same position as under current law. To improve their position that they are not managed and controlled in the United States, these blocker corporations might invest in a mix of funds managed inside and outside the United States (in addition to making their own investment decisions outside the United States). In cases where these strategies are not practical, or if the proposal is modified to make these strategies ineffective (for example, by imputing fund-level management to fund investors), many of these investors would likely forego investing in U.S.-managed funds and hire non-U.S.-based fund managers to manage their assets.

Since the proposal's purpose is unclear, it is equally unclear (1) which avoidance strategies are inconsistent with that purpose and therefore will likely be shut down through amendments to the bill and (2) why the intended avoidance strategies are desirable and should be encouraged. It is also possible that the proposal will simply be abandoned as it becomes more widely recognized that, at its core, it significantly favors non-U.S. money managers over those based in the United States and thus, if enacted, would encourage the re-location of that business overseas. Enacting the proposal would be a significant change in U.S. tax policy, which since 1966 has favored the use of U.S. money managers by non-U.S. investors as a way to encourage non-U.S. investment in the United States. We nevertheless caution that the legislative process is unpredictable and note that a version of this bill, without this proposal targeting U.S.-managed non-U.S. corporations, was supported by President Obama when he was a Senator. In addition, Treasury Secretary Geithner has expressed general support for the bill.

Other Provisions of the Bill

The bill includes a variety of tax related provisions, not all of which are aimed at "tax haven abuse." For example, it proposes to codify the economic substance doctrine, new standards for written tax opinions and new penalties for understatements of tax liability that are attributable to transactions lacking economic substance. In addition, it proposes to impose a 30% withholding tax on U.S. dividend-equivalent payments on swaps and securities lending and sale-repurchase transactions.

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