WILLKIE FARR & GALLAGHER LLP

CLIENT MEMORANDUM

# TAX EXTENDERS ACT OF 2009: IMPACT ON HEDGE FUNDS, MUTUAL FUNDS AND INVESTMENT ADVISERS

On December 7, 2009, the House Ways and Means Committee introduced the Tax Extenders Act of 2009 (the "Act"). The Act has several provisions of key interest to investment funds and investment advisors, among them a 30% withholding tax on payments to certain foreign financial institutions, including offshore funds; the taxation of carried interests, including incentive allocations and other forms of carried interest earned by managers of hedge funds and private equity funds, as ordinary income rather than as an allocation of capital gains; and the imposition of withholding tax on dividend-equivalent payments made by U.S. payors to non-U.S. persons, including offshore funds. The Act also provides for the extension of certain investment-related provisions otherwise scheduled to expire on December 31, 2009.

*Withholding Tax on Payments to Foreign Financial Institutions*

The Act would impose a 30% withholding tax on certain "withholdable payments" made to an offshore fund, a non-U.S. bank, or a non-U.S. broker, each considered a "foreign financial institution," unless the institution entered into a disclosure agreement with the U.S. Department of Treasury regarding its U.S. account holders. "Financial institutions" would be defined as entities engaged primarily in the business of investing or trading in securities, partnership interests or commodities, or any interests therein, entities that accept deposits in the ordinary course of business, and entities engaged in the business of holding financial assets for the accounts of others. Under the Act, withholding would be imposed on "withholdable payments," defined as U.S.-source interest and dividends, plus gross proceeds from the sale or disposition of any property which could produce U.S. source interest or dividends. No withholding would be required for income already recognized as taxable income effectively connected with the recipient's U.S. trade or business.

The 30% withholding tax would be avoided if the offshore fund, bank or broker entered into an disclosure agreement with the U.S. Treasury. The agreement would require disclosure for each "U.S. account" maintained by the institution of (1) the identifying information of each "specified U.S. person" with an aggregate account value exceeding $50,000 and, if the account holder is a foreign entity, of each "substantial U.S. owner" of the entity; (2) the account number; (3) the account balance or value; and (4) the gross receipts and gross withdrawals or payments from the account. A "U.S. account" would be include any financial account held by a specified U.S. person or a U.S.-owned foreign entity. "Financial account" is defined to include depository accounts, custodial accounts, and non-publicly-traded equity or debt interests in the financial institution. Regulations may be written to provide that, for purposes of determining the aggregate value of various accounts held by an individual, multiple financial institutions may be treated as a single financial institution if they are members of the same expanded affiliated group.

A "specified U.S. person" would be defined as any U.S. person that is *not* a tax-exempt organization, publicly traded corporation, U.S. federal, state or local agency, bank, real estate investment trust or regulated investment company, common trust fund, or tax-exempt trust. A "substantial U.S. owner" would be a "specified U.S. person" owning at least 10% of the stock of a foreign corporation, 10% of the interests of a foreign partnership or 10% of the beneficial interests of a foreign trust. A special look-through rule would apply to upper-tier foreign entities that are themselves investment vehicles, such as funds of funds, such that the definition of "substantial U.S. owner" would include any "specified U.S. person" that holds any amount of interest in the entity, even if the interest is less than 10%. For this purpose, "investment vehicles" would be financial institutions primarily engaged in the business of investing, reinvesting, or trading in securities, partnership interests, commodities, or interests therein.

Despite generally exempting entities with a disclosure agreement with the U.S. Treasury from the withholding tax, the Act would still require these offshore funds, banks and brokers to withhold and pay over a 30% tax on any "passthru" payments made either to a "recalcitrant account holder" or to another foreign financial institution that has not entered into an agreement with the Treasury. "Passthru" payments are defined as payments that are attributable to other withholdable payments. A "recalcitrant account holder" is defined as an account holder who (1) fails to comply with "reasonable requests" for either the information that would enable the financial institution to identify the account as a U.S. account or the information that the institution would be required to be disclosed to the U.S. Treasury under the Act (*i.e.*, the identity of the account holder, the account number, the account balance, and the account transaction activity) or (2) does not provide to the financial institution a waiver from any foreign law that would prevent the reporting of this information. In addition, if such foreign law applies to an account and the financial institution cannot obtain such a waiver from the account holder within a "reasonable period of time," the Act would require the account to be closed.

Under certain circumstances, a foreign financial institution would be eligible to elect to be withheld upon rather than to withhold itself with respect to passthru payments allocable to recalcitrant account holders or noncompliant financial institutions. This election would be available only if the electing financial institution notifies the withholding agent of the election and waives any rights under a tax treaty to the amount deducted and withheld. Further, the U.S. Treasury may promulgate regulations limiting the right to make this election to certain classes of institutions or types of accounts of the foreign financial institution.

Payments to financial institutions would not be subject to the withholding tax, even if the institution did not have in place a disclosure agreement with the U.S. Treasury, if the institution either complied with certain procedures (to be prescribed by the U.S. Treasury) to ensure that the institution does not maintain U.S. accounts or was classified by the U.S. Treasury as an institution not needing to enter into an agreement. The Act would not require disclosure if

an account is also held by another financial institution that has in place a disclosure agreement with the U.S. Treasury or if the account holder is "otherwise subject to information reporting requirements" that would in the view of the U.S. Treasury make these reporting requirements duplicative.

Withholdable payments to nonfinancial foreign entities would also be affected by the Act. Withholding is required on these payments if the beneficial owner of the payment is either the entity itself or another nonfinancial foreign entity or if the beneficial owner does not provide the withholding agent with a waiver. The waiver must either certify that the beneficial owner does not have any substantial U.S. owners or disclose the identities of each "substantial U.S. owner." The withholding agent would not be permitted to rely on such a waiver if it knew or had reason to know that the information in the waiver was incorrect. Upon accepting a valid waiver, the withholding agent must report to the U.S. Treasury the identities of the foreign entity's substantial U.S. owners. The term "non-financial foreign entity" would be defined as any foreign entity that is not a financial institution but would not include publicly traded corporations, entities organized in a U.S. possession and wholly-owned by residents of the possession, foreign governments, international organizations, foreign central banks, and any other entities identified in U.S. Treasury regulations.

*Reporting of Foreign Financial Assets*

The Act would impose wide-ranging reporting obligations on U.S. taxpayers with any non-U.S. investments. It would require "any individual" to provide detailed disclosure of all "specified foreign financial assets" if the aggregate value exceeds $50,000 (or such higher amount specified by the U.S. Treasury). "Specified foreign financial assets" would include non-U.S. stocks, non-U.S. bonds, financial instruments and contracts issued by non-U.S. persons, and any financial account maintained by a "foreign financial institution," defined for this purpose as any financial institution that is a foreign entity and that is not organized under the laws of any U.S. possession. "Financial institution" would be defined the same as in the Act's withholding provisions (*i.e.*, any entity engaged primarily in the business of investing, reinvesting, or trading in securities, partnership interests, commodities, or any interest therein, that accepts deposits in the ordinary course of a banking or similar business, or is engaged in the business of holding financial assets for the accounts of others). The U.S. Treasury may promulgate regulations exempting certain classes of assets from the category of specified foreign financial assets. If an individual does not provide sufficient information to demonstrate the aggregate value of specified foreign financial assets, the Act would presume that the value is greater than $50,000.

The required disclosures would include, for a stock or security, the name and address of the issuer and the class or issue of the stock or security; for a financial instrument or contract, sufficient information to identify the instrument or contract, and the name and addresses of all counterparties; and for a foreign financial account, the name and address of the foreign financial account and the account number.

The penalties for failure to disclose are $10,000 per year, plus an additional $10,000 per month for up to five months if the taxpayer has been mailed a notice of a failure to disclose, such that the total maximum penalty would be $60,000. The Act contains a "reasonable cause" exception, but reasonable cause does not include "the fact that a foreign jurisdiction would impose a civil or criminal penalty on the taxpayer (or any other person) for disclosing the required information."

The U.S. Treasury may provide in regulations exceptions for nonresident aliens and bona fide residents of any U.S. possessions. Regulations may also expand the scope of the Act so that it applies not only to individuals but also to "any domestic entity which is formed or availed of for purposes of holding, directly or indirectly, specified foreign financial assets, in the same manner as if such entity were an individual."

Understatements of tax related to income from undisclosed foreign financial assets would result in a penalty of 40% of the underpayment of tax. The Act would also extend the statute of limitations on significant omissions of income from foreign assets. There would be a significant omission if either the amount omitted from the tax return is greater than 25% of the total gross income on the taxpayer's return, or the omitted amount is $5,000 or greater and is attributable to a specified foreign financial asset (without regard to whether the asset value is greater than $50,000, and without regard to whether the taxpayer would be exempted under regulations from disclosing the asset). All of the above provisions would be applicable to taxable years beginning after the date of the enactment of the Act.

*Carried Interest*

The Act would reintroduce a proposal to tax "carried interest" allocations by certain investment partnerships as ordinary income, regardless of the character of the allocated income. This proposal was last introduced in April 2009, and the current version is essentially identical. Carried interests are preferential allocations to a general partner of an investment partnership's profits. Under current law, carried interests take the character of the underlying partnership income, often long-term capital gains (currently taxed at 15%) or unrealized income, and are usually not subject to self-employment tax. Under the Act, these allocations would be fully taxed at ordinary income rates and subject to self-employment tax. An exception would apply to a "qualified capital interest," the portion of an interest that is attributable to (1) capital that the partner contributed to the partnership in exchange for the carried interest, plus (2) amounts already included in gross income at the time of the transfer of the carried interest, plus (or minus) (3) any net income (or net loss) previously allocated to the interest after enactment of the proposal, less (4) any distributions to the partner. Allocations made to such qualified capital interest are not taxed at ordinary income rates if the allocations are made "in the same manner" as allocations to other qualified capital interests held by nonservice partners, and either (1) the allocations made to such other interests are significant compared to the allocations to the qualified capital interest, or (2) the allocations made to the qualified capital interest are properly made under regulations relating to special rules regarding "no or insignificant allocations to nonservice providers." Associated underpayments of tax would be subject to a 40% penalty.

As drafted, this provision of the Act taxing carried interests would apply to taxable years ending after December 31, 2009.

*Dividend Equivalent Payments*

The Act would treat "dividend equivalent" payments as actual dividends, with the result that such payments would be subject to 30% withholding if paid by a U.S. corporation to foreign persons. "Dividend equivalent" payments are defined to include both substitute dividends and payments made pursuant to total return equity swaps, defined as "specified notional principal contracts" in which (1) a "long party" transfers the underlying security upon entering the contract, (2) a "short party" transfers the underlying security to a long party, (3) the underlying security is not readily tradable on an established securities market, or (4) the underlying security is posted as collateral by the short party upon entering into the contract. The term "long party" is defined as "any party to the contract which is entitled to receive any payment pursuant to such contract which is contingent upon, or determined by reference to, the payment of a dividend from sources within the United States with respect to such underlying security." The term "short party" is defined as "any party to the contract which is not a long party with respect to such underlying security." "Underlying security" is defined as the security with respect to which the dividend is paid.

The provision taxing dividend equivalent payments would be effective as to payments made on or after the date that is 90 days after enactment of the Act. However, after the date which is two year after the date of enactment, the term "specified notional principal contract" would include *all* notional principal contracts.

*Tax Extenders*

The Act would also provide for several one-year extensions for provisions that are set to expire at the end of 2009. First, certain expiring provisions applicable to dividend payments by regulated investment companies ("RICs") would be extended for one additional year. Since 2005, interest-related dividends and short-term capital gain dividends from RICs have been exempt from the usual 30% withholding tax that applies to payments of certain U.S.-source income to nonresident aliens and foreign corporations. Interest-related dividends are flow-through payments of interest that the RIC itself has received during the year, if it so designates such dividends to its shareholders as interest-related. Similarly, short-term capital gain dividends are flow-through payments of the RIC's net short-term capital gain. The Act would extend both exemptions such that RICs would not need to begin withholding on these payments in 2010.

Second, the Act would extend for one year the treatment of certain distributions by, and sales of stock of, domestically controlled RICs that are U.S. real property holding corporations (or would be if certain exceptions did not apply). The Act would also extend the current (post-2004) look-through treatment of RIC shares owned by nonresidents for U.S. federal estate tax purposes. Presently, a portion of these shares are treated as non-U.S. property for federal estate tax purposes and are thus excluded from the calculation of the amount of the shareholder's taxable estate.

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If you have any questions regarding this memorandum, please contact Joseph A. Riley (212-728-8715, jriley@willkie.com), or the attorney with whom you regularly work.

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