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Clients&FriendsMemo

Stop Tax Haven Abuse Act (S. 506 and H.R. 1265)

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On March 2, 2009, Senator Carl Levin (D-Michigan) introduced the "Stop Tax Haven Abuse Act" (S. 506). The next day, Congressman Lloyd Doggett (D-Texas) introduced identical legislation in the House of Representatives (H.R. 1265). We refer to the bills collectively as "the bill." Several of the provisions in the bill were previously introduced by Senator Levin on February 17, 2007 and Congressman Doggett on May 3, 2007,[1] but the most controversial ones are new. President Obama was a co-sponsor of the 2007 bill introduced by Senator Levin. Treasury Secretary Geithner was quoted as saying that he "fully supports" the current version of the bill.[2]

In short:

- The bill would treat any offshore hedge fund, offshore feeder fund, or offshore CDO vehicle with $50 million or more of gross assets that is managed from within the United States (or any other foreign corporation with $50 million or more of gross assets that is "managed and controlled" from within the United States) as a U.S. corporation for federal income tax purposes, and subject to federal corporate income tax. This provision would be effective two years after enactment.

  This is a new provision. Although we believe that it is unlikely that the provision will be enacted in its current form, if it were enacted, many U.S. managers would either be forced to withdraw from the management of foreign funds or conduct that management activity from London or another offshore location.

- The bill would also impose a 30% dividend withholding tax on substitute dividend payments made on swaps that reference U.S. equity securities.

  This proposal is also new. It follows hearings on dividend withholding abuses conducted on September 11, 2008 by Senator Levin and the Permanent Subcommittee on

1 "Stop Tax Haven Abuse Act," S. 681, 110th Congress, 1st Sess. (February 17, 2007) and H.R. 2136, 110th Congress, 1st Sess. (May 3, 2007).

2 Tax Analysts, 92 Highlights and Documents 41, p. 1431 (March 5, 2009).

Investigations of the United States Committee on Homeland Security and Governmental Affairs.

- The bill would also codify the judicial "economic substance doctrine." Under the bill, unless a transaction changes a taxpayer's economic position in a meaningful way (apart from federal tax effects) and the taxpayer has a substantial non-federal-tax business purpose for entering into the transaction, the taxpayer will be denied the tax benefits sought and will be subject to a mandatory 30% penalty on the understatement (which is reduced to 20% if the taxpayer previously disclosed the transaction to the IRS).

  The provision is substantially similar to the provision in the prior bills and the analogous provision in H.R. 3970, which was introduced last year by Congressman Charles Rangel, the Chairman of the House Ways and Means Committee. President Obama's 2010 budget also contemplates codification of the economic substance doctrine.

The bill would also (i) presume (absent clear and convincing evidence to the contrary) that any United States person (other than a publicly traded entity) that forms, transfers assets to, is a beneficiary of, or receives money or property from an offshore entity (other than a publicly traded entity) located in certain designated offshore jurisdictions with secrecy laws (including Bermuda, the Cayman Islands, the British Virgin Islands, and Luxembourg) exercises control over the entity for purpose of civil tax and securities law proceedings, that any amount received by a United States person from such an entity (or an account in such a jurisdiction) is income in the year received, and that any amount transferred by a United States person to such an entity (or an account in such a jurisdiction) represents unreported taxable income, (ii) enhance passive foreign investment company (PFIC) reporting, (iii) increase tax shelter penalties, (iv) prohibit tax shelter patents, (v) prohibit tax practitioners from charging fees that are based on a projected or actual amount of tax savings or book losses, (vi) increase disclosure of tax shelter information to Congress, (vii) require the Treasury Department to issue additional standards under Circular 230 that would regulate "tax shelter opinion letters," (viii) deny deductions for certain amounts paid for violations or potential violations of any law, (ix) treat certain grantors of foreign trusts as the owner of the trust, certain recipients of trust property as beneficiaries, and loans by foreign trusts to certain United States persons as distributions from the trust, (x) prevent taxpayers from relying on a tax opinion to avoid penalties if the tax is attributable to a transaction involving an entity or financial account in certain designated offshore jurisdictions with secrecy laws, and (xi) establish a series of anti-money laundering and disclosure requirements for offshore accounts and entities.

The enhanced PFIC reporting provision is new. All of the other provisions were in the prior version of the bill.

This memorandum discusses the proposals that would (i) treat certain offshore hedge funds and other foreign corporations that are "managed and controlled" in the United States as U.S. corporations for federal income tax purposes, (ii) impose withholding tax on equity swaps, and (iii) codify the economic substance doctrine.

I. Foreign Corporations Managed and Controlled in the United States Treated as Domestic Corporations.

Under current law, an entity that is treated as a foreign corporation for federal income tax purposes is not subject to federal corporate income tax unless it is "engaged in a trade or business in the United States." Moreover, a foreign corporation (such as an offshore hedge fund or CDO) that limits its activities to trading in stocks, securities, or derivatives is not treated as engaged in a trade or business in the United States, even if the foreign corporation has an investment manager or employees in the United States who exercise investment discretion. Finally, tax treaties generally protect a foreign corporation that is entitled to a treaty's benefits from federal corporate income tax unless the foreign corporation has a "permanent establishment" in the United States.

Under the bill, if a foreign corporation is publicly traded, or has or at any time previously had more than $50 million of gross assets, and either (i) the corporation's direct or indirect assets consist primarily of assets being managed on behalf of investors and decisions about how to invest the assets are made in the United States or (ii) substantially all of the executive officers and senior management of the corporation who exercise day-to-day responsibility for making strategic, financial, and operational policies of the corporation are located primarily within the United States, then the foreign corporation is treated as a U.S. corporation for federal income tax purposes. As a result, the foreign corporation will be subject to federal corporate income tax (and possibly state taxes), and dividends paid to foreign investors will generally be subject to a 30% withholding tax.

This provision would be effective two years after enactment.

The provision does not apply to a foreign corporation if (i) its stock is not regularly traded on an established securities market, (ii) it has, and is reasonably expected to continue to have, aggregate gross assets of less than $50 million, and (iii) it receives a waiver from the IRS. The provision also does not generally apply to a "controlled foreign corporation" if 80% of its vote and value is directly or indirectly owned by a U.S. corporation that has substantial assets that are held for use in the active conduct of a trade or business in the United States.[3]

Senator Levin's introductory statement explains the rationale for this provision:

> Section 103 is intended to stop, in particular, the outrageous tax dodging that now goes on by too many hedge funds and investment management businesses that structure themselves to appear to be foreign entities, even though their key decisionmakers – the folks who exercise control of the company, its assets, and investment decisions – live and work right here in the United States. Too many hedge funds establish a structure of offshore entities, often including master and feeder funds, that make it appear as if the hedge fund's assets and investment decisions are offshore, when, in fact, the funds are being managed and controlled by investment experts located in the United States. It is unacceptable that such companies utilize U.S. offices, personnel, laws, and markets to make their money, but then stiff Uncle Sam and offload their tax burden onto competitors who play by the rules.
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> To put an end to this charade, Section 103 specifically directs Treasury regulations to specify that, when corporate assets are being managed primarily on behalf of investors and the investment decisions are being made in the United States, the management and control of that corporation shall be treated as occurring primarily in the United States, and that corporation shall be subject to U.S. taxes in the same manner as any other U.S. corporation.

The provision, if it is enacted, would principally affect foreign hedge funds and foreign feeders that are managed by U.S. investment managers, and foreign companies with U.S. subsidiaries that employ the offshore company's executives.[4] The provision does not, however, appear to override tax treaties. Accordingly, if a foreign corporation qualifies for the benefits of a tax treaty with the United States and does not have a permanent establishment in the United States, it appears that the foreign corporation will not be subject to federal corporate income tax, even if the provision is enacted.

If the provision is enacted as proposed, U.S. managers of foreign funds will have a limited number of options. First, if the $50 million threshold is interpreted strictly, it may be possible for each foreign investor to organize its own blocker corporation (and for the manager to ensure that the

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[3] A controlled foreign corporation is, very generally, a foreign corporation if more than 50% of the voting power and value of its stock is owned by United States persons that each own 10% or more of its voting stock.

[4] This structure is common for certain offshore insurance companies.

gross value of the assets of each such blocker do not exceed $50 million). However, if the enacted version of the bill contains or authorizes a rule that aggregates all blockers and similar parallel funds for purposes of the $50 million threshold, this strategy will not be possible. In that event, if the value of the U.S. investors' investment in the underlying fund equals or exceeds that of the foreign investors, it may be possible for all of the investors to invest in an Irish section 110 company that qualifies for the benefits of the U.S.-Irish tax treaty. In this case, the provision may not apply to impose federal corporate income tax on the Irish company. Finally, if this structure is not feasible or if the enacted version of the bill overrides treaties, U.S. managers effectively will either be prohibited from managing foreign funds or will be required to move to London or another offshore jurisdiction to continue managing foreign funds.

II. Substitute Dividend Payments Treated as Dividends for Withholding Purposes.

Under current law, dividends paid by a U.S. corporation to a foreign person are generally subject to a 30% withholding tax. However, substitute dividend payments on an equity swap are generally not subject to withholding.

Under the bill, any payment made under an equity swap or other "notional principal contract"[5] that is contingent upon, or references the payment of a dividend on the stock of a domestic corporation (or the payment of a dividend on property that is substantially similar or related to stock of a domestic corporation) would be subject to a 30% withholding tax.

The bill also would impose a 30% withholding tax on substitute dividend payments on securities loans and sale-repurchase agreements.[6]

The bill provides that, for purposes of tax treaties, the term dividend includes substitute dividend payments on equity swaps, securities loans, and sale-repurchase agreements.

In addition, the bill contemplates regulations that would impose withholding tax (1) even if the substitute dividend payments under a swap are netted with other payments (so that no net payment is actually made), (2) where fees and other payments under a swap are netted to disguise the characterization of a payment as a substitute dividend, and (3) on options and forward contracts

5 A notional principal is a financial instrument that provides for the payment of amounts by one party to another at specified intervals calculated by reference to a specified index upon a notional principal amount in exchange for specified consideration or a promise to pay similar amounts. Swaps are a type of notional principal contract.

6 Existing Treasury regulations currently provide for a 30% withholding tax on substitute dividend payments on securities loans and sale-repurchase agreements. However, under Notice 97-66 if the securities loan or sale-repurchase agreement is between foreign persons, the substitute dividend payment is subject to withholding tax only to the extent that the recipient's withholding rate exceeds the payor's. Notice 97-66, 1997-2 C.B. 328. The bill would overturn Notice 97-66.

(and similar arrangements) that achieve the same or substantially similar economic results as a swap or other notional principal contract.

Finally, the bill authorizes regulations that would reduce the amount of withholding that would otherwise be imposed under the bill, but only if the taxpayer can establish that the dividend for which the payment to be withheld upon is a substitute dividend payment that was previously withheld upon.

The provision would be effective 90 days after enactment.

The provision is overbroad, even in light of its purpose. Assume, for example, that an offshore fund loans U.S. equity securities to a second offshore fund which, in turn, sells them to a U.S. taxpayer that holds the securities unhedged and pays tax on the dividends. In this case, U.S. tax would be paid on the underlying dividends, but the bill would still impose a second tax on the substitute dividend payments made by the borrower to the lender (because no withholding tax was imposed).

III. Codification of the Economic Substance Doctrine.

Under the judicial economic substance doctrine, tax benefits may be denied if they arise from a transaction that does not result in a meaningful change to the taxpayer's economic position other than a purported reduction in federal income tax.[7] Some courts also deny tax benefits if the taxpayer did not intend the transaction to serve some useful non-tax business purpose.[8] (This doctrine is sometimes referred to as the business purpose doctrine.)

The bill would effectively require that both the judicial economic substance and business purpose doctrines be satisfied before tax benefits are granted. More specifically, the bill provides that if a court determines that the economic substance doctrine is relevant, then it will be satisfied only if (i) the transaction changes in a meaningful way (apart from federal tax effects) the taxpayer's economic position and (ii) the taxpayer has a substantial non-federal-tax business purpose for entering into the transaction.

A potential for profit is treated as a substantial non-federal-tax business purpose only if the present value of the expected pre-federal tax profit is substantial in relation to the present value of the expected net federal tax benefits. Reduction of non-federal-taxes is not treated as a substantial non-tax business purpose if the federal tax savings equal or exceed the non-federal-tax savings

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7 See, Staff of the Joint Committee on Taxation, Options to Improve Tax Compliance and Reform Tax Expenditures, JCS-02-05, p. 14 (January 27, 2005) ("2005 JCT Report").

8 2005 JCT Report at p. 15.

because of similarities between the federal and non-federal-tax laws. Finally, an accounting benefit is not treated as a substantial non-tax business purpose if it arises as a result of a federal tax savings. However, the provision does not apply to an individual taxpayer unless the transaction is entered into in connection with a trade or business or an activity engaged in for the production of income.

If a taxpayer enters into a transaction that fails to satisfy the statutory economic substance doctrine, under the bill, the taxpayer would be denied tax benefits and would be subject to a mandatory penalty equal to 30% of the understatement, unless the transaction was adequately disclosed to the IRS in the taxpayer's return, in which case the penalty would be 20% of the understatement.

The provision applies to transactions entered into after the bill is enacted.

The bill is substantially similar to the analogous provision in H.R. 3970, except that, under H.R. 3970, the maximum penalty is 40% of the understatement.

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