HUNTON& WILLIAMS

CLIENT ALERT

March 2009

The Stop Tax Haven Abuse Act

On March 2, 2009, Senator Levin introduced the Stop Tax Haven Abuse Act (the "Senate Bill"). Representative Doggett introduced a companion bill in the House. Both bills have been referred to committee. Treasury Secretary Geithner has indicated that President Obama supports the legislation. A link to the Senate Bill can be found at the end of this alert.

The stated goal of the Senate Bill is to combat offshore tax evasion. Senator Levin and Representative Doggett previously introduced similar bills in February 2007. Congress did not take any action on those prior bills. If enacted in its current form, the Senate Bill could have a substantial impact on offshore investment funds and securitization vehicles, particularly on U.S. tax-exempt investors investing in offshore feeder funds and offshore securitization vehicles holding mortgage-related collateral.

The Senate Bill contains three main provisions that were not included in prior proposals:

- taxing foreign corporations that are publicly traded or have assets of $50 million or more and that are managed or controlled in the U.S. as U.S. corporations;
- imposing withholding tax on dividend-equivalent payments and substitute dividend payments to non-U.S. persons that hold certain types of equity derivatives; and
- requiring passive foreign investment company ("PFIC") reporting not only by owners of PFICs, but also by those who have formed, transferred assets to, received money or property from, or benefited from a PFIC.

The Senate Bill also contains provisions that would, among other things, codify the economic substance doctrine, impose certain rebuttable presumptions regarding control of foreign entities, apply anti-money laundering rules to hedge funds and private equity funds, and extend Patriot Act measures to entities that impede U.S. tax enforcement. This alert focuses on the three new provisions described above.

Foreign Corporations Managed or Controlled in the U.S.

Under this provision, foreign corporations managed or controlled in the U.S. generally would be subject to U.S. federal income tax as if they were U.S. corporations. A corporation would be managed and controlled within the U.S. if (1) substantially all of the people responsible for day-to-day decision making are located in the U.S., or (2) the assets of the corporation consist primarily of assets being managed on behalf of investors and decisions about how to invest the assets are made in the U.S.

The Senate Bill would apply to foreign corporations that are publicly traded or have aggregate gross assets (including assets under management for investors) of $50 million or more. Although the Senate Bill is not entirely clear, it appears that once a corporation is subject to this provision, it would remain so for future years, unless it no longer met the above criteria and it was granted a waiver by the Treasury Secretary. The Senate Bill would not apply to most foreign subsidiaries of U.S. corporations where the U.S. parent is actively engaged in a U.S. trade or business.

This provision would apply to both existing and new foreign corporations for taxable years beginning on or after the date which is two years after the bill is enacted.

Withholding Tax on Dividend Equivalent and Substitute Dividend Payments

The Senate Bill revises the income sourcing rules for dividend equivalent payments under equity swaps and substitute dividend payments under securities lending and sale-repurchase transactions. These payments would be treated as U.S. source dividend income, and, therefore, subject to U.S.

withholding tax in the hands of a foreign recipient, if the underlying or reference asset is the stock of a U.S. corporation. This rule is intended to reverse the current treatment of dividend equivalent and substitute dividend payments, which generally allows such payments to be made offshore without the imposition of U.S. withholding tax. This provision would apply to payments made 90 days or more after the bill is enacted.

New Reporting for PFICs

Currently, the owners of a PFIC must report certain information regarding their investment in the PFIC. The Senate Bill would provide the IRS with the authority to impose reporting obligations on any person who forms, transfers assets to, benefits from, or receives money or property from, a PFIC.

Impacts on Funds and Securitization Vehicles

Hedge and private equity funds often allow investors, particularly foreign investors and U.S. tax-exempt investors, to invest through an offshore "feeder" fund structured as a foreign corporation. Foreign investors generally prefer to invest through an offshore feeder to avoid any U.S. tax reporting obligations. U.S. tax-exempt investors typically invest through an offshore feeder to avoid a flow-through of any debt-financed income from the underlying fund that would be treated as "unrelated business taxable income." To the extent that the offshore feeder fund is managed or controlled in the U.S., the Senate Bill would treat the offshore feeder as a U.S. corporation, which would make the use of such a feeder fund impractical from a tax cost perspective.

Foreign investors should be able to avoid this result by establishing their own foreign corporations, managed and controlled outside of the U.S., through which to make their investments in U.S.-managed funds. However, U.S. tax-exempt investors who make an investment of $50 million or more in a particular fund may not be able to set up their own offshore blocker corporation, because their management and control of such an entity in the U.S. generally would cause such corporation to be treated as a U.S. corporation.

Many securitization vehicles, such as collateralized debt obligation issuers, are organized as foreign corporations. To the extent that an offshore securitization vehicle is managed or controlled in the U.S., for example, as a result of the collateral manager being located in the U.S., the Senate Bill would treat the securitization vehicle as a U.S. corporation.

For securitization vehicles with non-mortgage collateral, such entities generally could elect to be treated as foreign partnerships or disregarded entities, which would allow them to continue to operate without an entity-level U.S. income tax. For a securitization vehicle with mortgage collateral, however, if the securitization structure involves time-tranching of debt obligations, such an entity would likely be treated as a taxable mortgage pool. In that event, the entity would be treated as a corporation and could not elect to be a pass-through entity for U.S. tax purposes. Consequently, it would be subject to tax as a U.S. corporation under the Senate Bill. This result would make impractical new mortgage-backed securitization transactions using foreign issuers and would trigger defaults and/or mandatory redemptions of outstanding securities in existing transactions.

If you would like to receive more information about the Senate Bill, please contact: George C. Howell, III at (804) 788-8793 or ghowell@hunton.com, or Cecelia Philipps Horner at (804) 788-7394 or chorner@hunton.com.

Please click here to view the Senate Bill.

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