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## **Breaking Developments in Tax Law**

### **Proposed Federal Tax Legislation Would Alter U.S. Taxation of Foreign Entities 03/10/09**

Foreign investors, and particularly foreign hedge funds, should take note of recently introduced U.S. tax legislation. On March 2, 2009, the Stop Tax Haven Abuse Act was introduced by Senator Carl Levin as Senate Bill 506 ("S.506"). It seeks to eliminate the use of offshore tax havens and correct other abusive tax situations. S.506 is similar to the 2007 proposed legislation (S.681) introduced by Senator Levin and co-sponsored by then-Senator Obama. A companion bill (H.R. 1265) was introduced in the U.S. House of Representatives and co-sponsored by 59 Democrats. U.S. Treasury Secretary Geithner recently stated that the administration supports legislation to shut down offshore tax havens.

The proposed legislation, among other measures, would cause corporations formed in certain foreign jurisdictions that are managed and controlled in the U.S. to be treated as U.S. corporations for federal income tax purposes. If enacted, S.506 would also change the U.S. tax treatment of certain foreign trusts, eliminate a stock dividend loophole, add significant reporting and disclosure requirements, and broaden penalties and tax enforcement.

#### **I. Taxation of Certain Foreign Corporations as U.S. Corporations**

##### **U.S. tax consequences of having an interest in an "offshore secrecy jurisdiction" entity**

The proposed legislation creates a rebuttable presumption in a tax proceeding that any U.S. person who forms, transfers assets to, has a beneficial interest in, or receives money or property from an entity in an offshore secrecy jurisdiction ("OSJ") controls the entity. In addition, a rebuttable presumption is created in a tax proceeding that any amount or thing of value received by a U.S. person from the OSJ entity will constitute unreported income of the U.S. person.

##### **Foreign corporations subject to OSJ classification**

OSJ status will apply to foreign corporations having gross assets exceeding \$50 million or are publicly traded. The proposed legislation grants the IRS authority to issue regulations that determine whether the management and control of the foreign OSJ corporation occurs within the United States where:

- Substantially all of the executive officers and senior management who exercise day-to-day decision-making authority are located primarily within the United States.; and
- Individuals who are not executive officers or senior management but exercise day-to-day decision-making authority shall be treated as executive officers and senior management for purposes of applying the foregoing location test.

Hedge funds will be deemed managed and controlled in the United States if investment decisions are made in the United States.

While foreign participants in the OSJ entity will not become direct United States taxpayers, the proposed legislation adversely impacts their economic and investment return from the OSJ entity by subjecting the earnings of the OSJ entity to United States tax.

### **OSJ presumption**

S.506 deems virtually every low tax jurisdiction, including Hong Kong, Luxembourg and Singapore, to be an OSJ. Further, the IRS will be empowered to list other foreign jurisdictions as offshore secrecy jurisdictions if the foreign jurisdiction has corporate, business, bank or tax secrecy rules that unreasonably restrict the ability of the U.S. to obtain information to enforce its tax laws.

## **II. U.S. Persons Treated as Grantors of Certain Foreign Trusts**

The proposed legislation attributes trust protector or trust enforcer status to U.S. grantors of foreign trusts and requires any U.S. persons receiving property from a foreign trust to be treated as a beneficiary unless the exchange was for fair market value. Grantor trust status is applied to foreign trusts with current or future U.S. beneficiaries, including contingent U.S. beneficiaries. The legislation, if enacted, will greatly expand the U.S. tax obligations of U.S. persons having an interest or receiving property from a foreign trust.

## **III. Elimination of Stock Dividend Loophole**

U.S. corporate dividend-based payments to non-U.S. persons will be subject to withholding. Impacted are notional principal contracts ("swaps") and other derivative contracts between two foreign parties where one foreign counterparty receives an amount based on U.S. dividend but not the dividend itself. Certain payments under short sales of U.S. shares would become subject to U.S. withholding tax.

## **IV. Enhanced Reporting and Disclosure Requirements**

### **Reporting requirements for U.S. persons**

S.506 adds new reporting and disclosure requirements for banks and securities firms where a U.S. person is the beneficial owner of a foreign-owned financial account. Information to be reported for U.S. participants includes the following:

- Their agent, nominee or attorney;
- Their relationship to the foreign entity or account including the gross amount of income from sources within the U.S.; and
- Other information required by IRS regulations or guidance.

## **Reporting requirements for financial accounts held in OSJ**

U.S. parties establishing foreign accounts or forming foreign entities in an offshore secrecy jurisdiction must file an information return. The entities must report the foreign account or entity in the offshore secrecy jurisdiction and other information the IRS requires. Further, entities must provide investors or beneficiaries a statement of the information reported to the IRS.

## **Establishing anti-money laundering programs and updates to FBAR**

S.506 also requires unregistered investment entities such as hedge funds and private equity funds to establish anti-money laundering programs and submit suspicious activity reports. The proposed legislation would clarify that the IRS has the authority to use tax information when investigating Foreign Bank Account Reports under Form ("FBAR") TD F 90-22.1.

## **V. Enhanced Penalties and Enforcement**

S.506 authorizes penalties for failing to disclose foreign accounts or holdings in an offshore secrecy jurisdiction, and provides for broad enforcement.

### **Penalties applicable to covered transactions in offshore secrecy jurisdictions**

In addition to IRS penalties (*e.g.*, penalties for underreporting income, fraudulent filing, etc.), S.506 provides for a maximum fine of \$1 million under U.S. securities law for failure to disclose an offshore transaction when equity or debt instruments are involved. The proposed legislation also eliminates the penalty protection a legal opinion might provide when a transaction involves an OSJ.

S.506 also provides the IRS with greater authority to use tax evasion as a basis to restrict an individual's or entity's financial activities in the U.S. If the IRS finds an individual or entity to be engaged in money laundering or impeding U.S. tax enforcement, it can restrict the use of correspondent accounts, credit cards and debit cards issued by a foreign bank in the U.S. Thus, the IRS may restrict the economic and financial resources of an individual or entity involved in a covered transaction.

### **Broadened enforcement mechanisms**

S.506 provides the IRS with broad enforcement mechanisms to investigate potential covered transactions in offshore secrecy jurisdictions. The IRS has six years from the date a tax return is filed to investigate a transaction involving an OSJ.

In addition, S.506 provides the IRS with greater investigatory power to request records and summon individuals for interviews. For a covered transaction in an offshore secrecy jurisdiction, federal courts apply a presumption that there is a reasonable basis to find non-compliance with tax laws. Federal courts may issue a summons to any person involved in the covered transaction for up to three years. Federal courts can extend the period for an additional three years.

For more information, please contact the Tax Law Practice Group at Lane Powell:

206.223.7000 Seattle  
503.778.2100 Portland  
[taxlaw@lanepowell.com](mailto:taxlaw@lanepowell.com)  
[www.lanepowell.com](http://www.lanepowell.com)

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