

**Client Alert**

March 9, 2009

**Hedge Funds, Real Estate Funds and Other Investment Funds Face Detrimental Tax Consequences from Proposed US Legislation****Areas of Interest****Tax Transactions****Private Equity****Private Investment Fund****United States**

On March 2, 2009, Senator Carl Levin reintroduced a bill to the Senate and Representative Lloyd Doggett introduced a companion bill to the House, entitled the "Stop Tax Haven Abuse Act." The bill is similar to legislation introduced in February 2007, but contains several new provisions including one regarding treating certain foreign corporations as US domestic corporations for US federal income tax purposes. This provision could have a significant, detrimental impact on structures commonly used by hedge

funds, real estate funds and other investment funds.

Summary of Provision Regarding Treatment of Foreign Corporations as US Domestic Corporations

Section 103 of the Stop Tax Haven Abuse Act provides that certain foreign corporations that are managed or controlled, directly or indirectly, primarily in the United States would be treated as US domestic corporations for US federal income tax purposes. In order for the provision to apply to a foreign corporation, either (i) the stock of the foreign corporation must be regularly traded on an established securities market or (ii) the aggregate gross assets of the foreign corporation, including assets under management for investors, whether held directly or indirectly, must equal or exceed \$50 million at any time during a given taxable year or a preceding taxable year. A foreign corporation can seek a waiver where the provision is only applicable because the foreign corporation's assets exceeded \$50 million in a prior taxable year. In addition, the provision does not apply to a controlled foreign corporation that is a member of an affiliated group, the common parent of which is a US domestic corporation that owns substantial assets held for use in the active conduct of a trade or business in the United States.

Section 103 of the Stop Tax Haven Abuse Act would require the Treasury Department to promulgate regulations regarding when management and control of a foreign corporation is deemed to occur primarily in the United States. These regulations would provide that management and control of a corporation occurs primarily in the United States if substantially all of the individuals who exercise day-to-day responsibility for making decisions involving strategic, financial and operational policies of the corporation are located primarily within the United States. In addition, the regulations would provide that the management and control of a corporation occurs primarily within the United States if 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 United States.

Effective Date

If enacted, Section 103 of the Stop Tax Haven Abuse Act would apply to taxable years beginning on or after the date that is two years after the date on which the provision is enacted.

Potential Consequences of Section 103

If enacted, Section 103 could apply broadly to many foreign corporations. In addition, the provision could have a significant, detrimental impact on structures commonly used by hedge funds, real estate funds and other investment funds.

Hedge funds, real estate funds and other investment funds utilize offshore entities for a variety of purposes, as do many financing structures. Many hedge funds are organized as corporations so as to avoid having their foreign investors be partners in partnerships that invest in US stocks and securities. The use of a foreign corporate vehicle does not change the US tax liability of the foreign investors in the foreign entity. Whether the investors invest through partnerships or through foreign corporations, the "securities trading safe harbor" of Section 864 of the Internal Revenue Code of 1986, as amended, prevents the foreign investors from being subject to US tax on trading gains.

Investment funds also commonly use foreign corporations as "blocker corporations" that are organized to shelter US tax exempt investors from "unrelated business taxable income" (UBTI) arising from debt financed investments. The securities trading safe harbor also protects these blocker corporations from being subject to US tax. If Section 103 of the Stop Tax Haven Abuse Act were enacted, however, these foreign corporations could be subject to US federal income tax at regular corporate rates, on all of their income, whether earned in the United States or abroad. This provision could substantially reduce liquidity in the US markets at a time when the markets are already suffering.

For more information about the Stop Tax Haven Abuse Act, or any other matter raised in this Client Alert, please contact [Jim Barry](#) at +1 312 701 7169 or [Anne Marie Konopack](#) at +1 312 701 8467.

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