

Hedge fund tax alert

Obama Administration's tax proposals would affect financial institutions and products

The Treasury's explanation of the Obama administration's tax proposals, released 11 May 2009, includes a number of proposals that could affect financial institutions and products, as well as, funds and their managers. Discussed below are a few of the proposals that were set forth.

Preventing avoidance of dividend withholding taxes through equity swaps

Background

Current law requires a withholding agent to withhold a 30% tax from the gross amount of all US-source fixed or determinable annual or periodical income, profits, or gains of a nonresident alien individual, foreign corporation, or foreign partnership. Dividends paid for domestic corporation stock are US-source dividends. Therefore, foreign investors holding stock in domestic corporations are subject to the 30% tax on dividends paid on that stock. If the dividends are paid to a resident of a jurisdiction with which the United States has entered into a tax treaty, the 30% rate may be reduced.

The investor's residence generally determines the source of income from notional principal contracts. Therefore, substitute dividend payments made to a foreign investor for an equity swap referencing US equities are foreign-source and are not subject to US withholding tax.



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Proposal

The proposal would treat income earned by foreign persons on equity swaps that reference US equities as US-source to the extent that the income is attributable to (or calculated by reference to) dividends paid by a domestic corporation. The proposal would provide an exception to this source rule if the swaps have the following characteristics:

1. The equity swap terms do not require the foreign person to post more than 20% of the value of the underlying stock as collateral;
2. The equity swap terms do not include any provision addressing the hedge position of the counterparty to the transaction;
3. The underlying stock is publicly traded and the notional amount of the swap is less than 5% of the total public float of that class of stock and less than 20% of the 30-day average daily trading volume;
4. The foreign person does not sell the stock to the counterparty at the inception of the contract or buy the stock from the counterparty when the contract terminates;
5. The equity prices used to measure the parties' entitlements or obligations are based on an objectively observable price; and
6. The swap has a term of at least 90 days.

The proposal would grant Treasury the regulatory authority to provide additional exceptions to implement the purpose of this rule.

The proposal would be effective for payments made after 31 December 2010.

Implications

This proposal would significantly impact cross-border equity swaps on dividend-paying

stocks. Currently, most such agreements could be caught because of both the collateral characteristic and the hedge-reference characteristic. Most equity swaps have cross-default and offset provisions that might be viewed as "posting collateral," even if the actual cash collateral called for is no more than 20% of the notional principal amount, which itself is somewhat low given recent heightened concern over counterparty credit risk. It is also common for agreements to key certain termination rights on the dealer's inability to hedge at a reasonable cost. Query whether that reference is enough to bring an equity swap within the scope of the proposal. Nonetheless, foreign investors seeking to invest in dividend-paying US stock on a leveraged basis may continue to demand equity swaps.

Carried interest

Background

Many partners who perform services for their partnerships receive partnership interests in exchange for those services. These partnership interests typically represent interests in the future profits (but not capital) of a partnership, or "carried interests." Historically, if the partnership earned long term capital gains and qualified dividend income and a share of such income was allocated to a partner holding a carried interest, the partner would be taxed on such income at reduced capital gains rates, as opposed to ordinary income rates, and would not be subject to self-employment tax on such income. In addition, upon a sale of the carried interest, the holder generally would recognize capital gains income (except, e.g., to the extent of the partner's share of the partnership's hot assets).

This treatment has been of interest to Congress for the past several years, as evidenced by a number of bills that have been

introduced - two of which were passed by the House of Representatives in the last session of Congress - seeking the modification of the tax treatment of carried interests. The Administration believes that the income associated with carried interests should be taxed at ordinary income rates and be subject to self-employment tax essentially because it is derived from the performance of services.

Proposed Changes

The proposal includes the following changes that, if enacted, will be effective for tax years beginning after 31 December 2010.

The proposal defines a carried interest as a "services partnership interest" (SPI), which is an interest in a partnership held by a person who provides services to the partnership. Unlike proposed legislation introduced in Congress, the Administration's proposal is not limited to investment fund managers. The proposal makes no distinction between profits interests issued to investment service providers and profits interests issued to persons who provide services to an operating business that is conducted thru a partnership. As a result, the proposal is much broader than versions we may have seen in the past.

A partner's share of income received with respect to an SPI would be subject to tax as ordinary income, regardless of the character of the income earned at the partnership level. In addition, the proposal would require the partner to pay self-employment taxes on income earned with respect to the SPI. Under the proposal, gain recognized on the sale of an SPI also would generally be taxed as ordinary income, not as capital gain.

To the extent that the partner who holds an SPI contributes "invested capital" (money or other property contributed to the partnership) and the partnership reasonably allocates a carried interest holder's share of its income and loss between such invested capital and

the remaining interest, income attributable to the invested capital would be eligible to be treated as capital gains income. In addition, the portion of any gain recognized on the sale of an SPI that is attributable to the invested capital would be treated as capital gain. However, contributed capital that is attributable to the proceeds of any loan or other advance or guarantee made by the partnership or another partner would not be treated as invested capital.

The proposal would treat as “disqualified interest” any convertible or contingent debt, an option, or any derivative instrument with respect to the entity (but not including a partnership interest or stock in certain taxable corporations). Any person who performs services for an entity and holds a “disqualified interest” in the entity is subject to ordinary income tax on any income or gain received with respect to the interest. This is designated as an anti-abuse rule designed to prevent the avoidance of ordinary self-employment income treatment through the use of compensatory arrangements other than partnership interests. The proposal includes a statement that these proposed changes are not intended to adversely impact qualification of a real estate investment trust owning a carried interest in a real estate partnership.

Implications

Under the proposal, partners who hold carried interests would no longer be able to be taxed on income generated with respect to the carried interest at capital gains rates. Instead, they would generally pay tax on such income at regular ordinary income tax rates (currently as high as 35%, potentially increasing to 39.6% if the Bush tax cuts for upper-income individuals expire, as is proposed in the budget outline) and would be subject to self-employment tax on carried interest income. This proposal could

have collateral implications with regard to state and local tax matters, as well as, possible implications for U.S. nonresidents.

These proposed changes will impose significant tax increases on partners earning affected carried interest income. Because the proposed changes would become effective for tax years beginning after 31 December 2010, partnerships should consider accelerating recognition of carried interest income so that partners receive such income before the law changes. Consultation is advised so that any such acceleration is structured in a manner that protects the interests of both the service partner and the partnership and its other partners.

In addition, the so-called “anti-abuse” rule may require changes to other compensatory arrangements that may have been put in place for certain service partners. Again, consultation with your service provider is advised as to the potential applicability of these rules.

Ordinary income treatment for certain dealers

Background

Currently, certain dealers in commodities, commodities derivatives, securities, and options are taxed at capital gains rates on income from certain of their day-to-day dealer activities. Section 1256 requires these dealers to treat 60% of their income (or loss) from their dealer activities as long-term capital gain (or loss) and 40% of their income (or loss) from their dealer activities as short-term capital gain (or loss). Dealers in other types of property generally treat the income from their day-to-day dealer activities as giving rise to ordinary income. The administration believes that dealers in commodities, commodities derivatives, securities, and equity options should be

treated the same as dealers in other types of property.

Proposal

Effective for tax years beginning after the date of enactment, commodities derivatives dealers, securities dealers, and dealers in equity options and commodities would be taxed at ordinary income rates on their income from day-to-day dealer activities.

Implications

This proposal would change a long-standing agreement on the character of certain types of dealer income, making it ordinary. In prior years, those dealers probably benefitted more from the 60% long-term capital gains character of Section 1256 contracts than they suffered from an inability to offset capital losses with ordinary income. Thus, this proposal should be viewed as a tax increase on affected dealers. ■

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