

## US Legislative Update

December 2009

Tax and securities law legislation has been moving through the two houses of the US Congress that if enacted would have a significant impact on many private funds organized outside of the US, such as hedge funds and private equity funds, as well as on the investment managers of such funds. We have provided below a brief summary of these congressional initiatives.\*

### **Tax Extenders Act of 2009**

On December 9, 2009, the US House of Representatives approved wide ranging tax reform that may have substantial impact on hedge funds and international investment by US taxable investors. The legislation seeks generally to increase the federal government's ability to tax offshore entities, accounts and transactions that are connected to US taxpayers. The legislation has now been submitted to the US Senate where it will be debated.

The bill imposes additional reporting obligations on foreign financial institutions with regard to US-held foreign assets. Specifically, foreign financial institutions, foreign trusts and foreign funds will have to obtain information from each of their account holders to determine if any account is American-owned. Foreign financial institutions would be required to verify the information and to report annually to the US Treasury Department certain information regarding any US accounts maintained by the institution. Foreign institutions are required to withhold 30% of any payments made to accounts that refuse to provide the requested information. Further, any foreign financial institution that does not comply with the new verification and reporting standards would be subject to a 30 percent withholding tax on income from financial assets held in the US by the foreign institution. It appears that the tax would not be added to items of income, such as dividends from US companies, that is already subject to withholding tax but instead would be imposed on items of income, such as interest payments, where there is currently no withholding tax. The proposed Act would not require the financial institutions to

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#### **\* IRS Circular 230 Disclosure**

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report information regarding US accounts in foreign institutions where the aggregate value of the account did not exceed US\$10,000.

The Act would also require any individual US taxpayer to report on their tax returns the existence of any foreign depository or custodial account maintained by a foreign financial institution exceeding US\$50,000 in value. US taxpayers are already required to report a wide range of investments but this provision would broaden the scope of reporting to pull in additional types of accounts. The penalty for failure to report a foreign financial asset would be US\$10,000 and could possibly increase to as much as US\$50,000.

Further, US shareholders of passive foreign investment companies (PFIC) will be forced to file an annual report with such information as required by the US Treasury Department. US shareholders in PFICs typically make QEF elections and voluntarily report income attributable to their investments in PFICs but this new law would require such shareholders to report their PFIC holdings even if they do not make the QEF election.

The Act would eliminate the tax advantages of using total return swaps and other derivatives to avoid US withholding taxes by requiring withholding of tax on dividend equivalent payments received by foreign individuals. This will eliminate a number of creative structures that funds have used to reduce US withholding tax obligations.

The new legislation would also change the way that carried interest (*i.e.*, the percentage of fund profits allocated to the investment managers – as referred to as performance allocation) is taxed to the individual US owners of fund managers by treating carried interest allocated to US investment managers as ordinary income (once it is allocated to the individual US owners) rather than as capital gains for US federal income tax purposes. This would also impact individual US taxpayers who own foreign advisers that are organized as partnerships or have elected to be treated as partnerships. Carried interest is currently taxed at a rate of 15% with respect to the portion of the performance allocation that consists of a flow-through of net long term capital gain. If taxed as ordinary income, that tax rate could increase to 35%, plus state and local taxes. The worldwide reach of the US federal income tax laws will prevent a US individual from circumventing this tax by relocating his investment management business outside of the US. For other US tax reasons, the carried interest method of performance compensation is still likely to be used in funds that have taxable US investors.

### **Registration of Hedge Fund Investment Advisers**

Legislation has been introduced in the US Senate by Senator Dodd that would result in registration and additional disclosures for certain private fund advisers. The bill is known as the Hedge Fund Investment Advisers Registration Act of 2009. There are a number of competing bills in the Senate and House of Representatives. This bill appears to be gaining wider support.

Under this proposed Act, advisers to private funds with an aggregate net asset value over US\$100 million will be required to register with the SEC under the Investment Advisers Act of 1940 and to disclose financial data needed by the US government to monitor systemic risk and protect investors. Advisers with less than US\$100 million would be required to register with the state authorities in the state where the adviser maintains its principal office. (All foreign advisers that are required to register would presumably register with the SEC directly regardless of the amount of assets they manage since they do not have a state regulator with which to register.) Private funds are defined as any investment companies operating pursuant to the 3(c)(1) or 3(c)(7) exemptions under the Investment Company Act and where 10 percent or more of their investor equity is held by US persons. Venture capital and private equity funds are excluded from the definition of private fund in the proposed Act and therefore advisers to these types of funds will be exempt from registration and reporting requirements.

In addition, “foreign private advisers” will be excluded from the registration obligation. This term is defined as advisers with no place of business in the US, fewer than 15 US resident clients, that manage less than US\$25 million in assets attributable to US persons and that do not hold themselves out to the public in the US as providing investment advice. It is not entirely clear whether foreign private advisers would be required to register with the SEC if any of their US clients is a “private fund” regardless of whether the adviser had fewer than 15 US clients in total. Under current SEC rules each US-based fund should count as a one US client and investors in the US fund as well as US investors in offshore funds are generally not counted as clients of the adviser to the fund. The proposed legislation does not address this issue.

Further, the legislation is silent on whether the SEC should maintain the “registration lite” regime for foreign investment advisers that have registered with the SEC under the Advisers Act. Currently, those advisers are subject to fewer SEC regulatory requirements than domestic US advisers. We have not received any indication that the SEC is considering changing this regime. Note that for domestic US advisers there will no longer be a de minimus exemption for advisers with fewer than 15 customers. On the other hand, earlier proposals to create a self-regulatory organization for investment advisers have been dropped.

For those advisers that are required to register, the financial data that must be reported would include the amount of assets under manage, the use of leverage, counterparty credit risk exposure, valuation, side letters and other information as may be requested by a new US super-regulatory agency that will focus on systemic risk. The information will be shared internally within the US government but should otherwise be kept confidential.

The Act would require the SEC to increase the definition of “accredited investor” from the current financial thresholds of US\$200,000/\$300,000 in annual income and US\$1 million in net worth. This increase would almost certainly reduce the number of US persons who would be eligible to participate in private funds. Senator Dodd has not given any guidance on what those numbers should be although the SEC has in the past

suggested changing the net worth test into an investment portfolio test and increasing the threshold amount to US\$2.5 million.

### **The Wall Street Reform and Consumer Protection Act**

The House of Representatives has passed this piece of populist legislation and presented it to the Senate for consideration. This bill contains a number of features including the creation of a so-called Consumer Financial Protection Agency to review and approve financial products and services offered to retail investors and consumers. It does not appear that this agency would have any jurisdiction over hedge fund products unless they are sold to retail investors. The bill also contains provisions requiring advisers to private funds (including private equity funds, unlike the Dodd bill described above) to register with the SEC under the Advisers Act. The assets-under-management threshold for adviser registration with the SEC is US\$150 million as opposed to the US\$100 million cut-off in the Dodd bill. As in the Dodd bill, advisers to private funds will need to provide extensive information to key regulators in Washington although unlike the Dodd bill this bill does not propose to create a super-regulator to consolidate all regulation of the financial sector. Otherwise, the private fund aspects of this bill are quite similar to those of the Dodd bill.

Lastly, this bill would also require greater regulation of the over the counter derivatives market and specifically require that many types of standardized swap transactions, such as credit default swaps, be cleared and traded on a formal exchange. The regulation of these instruments would fall to the CFTC. This change may also require more compliance by foreign funds and managers participating in the formerly largely unregulated US OTC derivatives markets.