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Levin Bill Would Change Taxation of Non-U.S. Hedge Funds and Other Non-U.S. Corporations

Senator Carl Levin has introduced a bill (Stop Tax Haven Abuse Act, S.506) that would, if enacted, change substantially the tax treatment of non-U.S. hedge funds and likely other non-U.S. corporations that are managed in the United States. The consequence of the bill is that non-U.S. hedge funds, which are typically organized as corporations in the Cayman Islands or similar jurisdictions, would be treated as U.S. corporations for income tax purposes. The bill appears to be sufficiently broad that other corporations commonly used by hedge funds and private equity funds, such as non-U.S. blocker corporations that meet the size test described below, as well as non-fund related entities, could also be treated as U.S. corporations.

The bill would treat a non-U.S. corporation as a U.S. corporation if two tests were met. The first is that the corporation either is publicly traded or has gross assets (including assets under management) of at least $50 million. The second is that the corporation is managed and controlled primarily in the United States. A corporation is treated as managed and controlled primarily in the United States if substantially all of the executive officers and senior management of the corporation responsible for day to day decision making regarding strategic, financial and operation policy are located primarily in the United States. In the case of a non-U.S. corporation that owns primarily investment assets, the bill provides that the corporation will be managed in the United States if investment decisions are made in the United States. The bill would be effective for tax years beginning after the second anniversary of it enactment.

One result of the bill, if enacted, would be that non-U.S. investors, which are not subject to U.S. tax on most of the income and gains of the kind ordinarily generated by hedge funds, would find themselves indirectly subject to that tax. Presumably funds would restructure themselves as non-corporate passthrough vehicles in order to eliminate that result for non-U.S. investors.

Pension funds and other U.S. tax-exempt investors in hedge funds will find themselves in a different situation. Because of the substantial amounts of leverage ordinarily employed by hedge funds, unlike foreign investors, U.S. tax exempts would be subject tax on these investments if held through a passthrough, so that conversion of a fund to such an entity would not solve their problem. We anticipate that investors in that position might seek hedge fund managers outside the United States, in London for example, who would be able to continue to use the structures currently in place.

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This proposal is in its very early stages, but we wanted to bring it to your attention. We will keep you apprised of further significant developments.

This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. If you have any questions, or would like to pursue any of these strategies further, please feel free to call any of the Paul, Weiss Tax Partners:

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