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Tax

March 24, 2010

New HIRE Act Will Impact Foreign Investment Vehicles

On March 18, President Obama signed the Hiring Incentives to Restore Employment Act (the "Act"). As a revenue offset, the Act includes provisions originally proposed as part of the Foreign Account Tax Compliance Act of 2009.

Several revenue offset provisions are likely to affect both fund managers and investors in non-U.S. hedge funds, commodity funds, private equity funds, securitization vehicles and other investment entities. These are:

1. **Withholding Tax on Dividend-Equivalent Payments**. Currently, payments on equity swaps to foreign persons generally are not subject to U.S. withholding tax even as to payments determined by reference to dividends paid on the underlying U.S. stock ("dividend-equivalent payments"). Under the Act, dividend-equivalent payments made to foreign persons on or after September 14, 2010, on equity swaps (except as described below) or pursuant to a securities lending or "repo" transaction (or other derivatives to be specified that may include certain forward contracts or other financial contracts referencing stock of U.S. corporations) will be subject to a 30% U.S. withholding tax. Currently outstanding instruments are not grandfathered.

   Dividend-equivalent payments on equity swaps made to foreign persons prior to March 18, 2012, will only be subject to 30% withholding if the swap involves any of the following: (i) in connection with entering the swap, the foreign person transfers the underlying security to the swap counterparty; (ii) upon termination of the swap, the swap counterparty transfers the underlying security to the foreign person; (iii) the underlying security is not readily tradable on an established securities market; (iv) in connection with the swap, the underlying security is posted as collateral by the swap counterparty to the foreign person; or (v) the swap is of a type specifically designated in future Internal Revenue Service (IRS) guidance. (This list is more inclusive than the list of equity swaps that the IRS had targeted in an Industry Directive issued January 14, 2010.) Beginning March 18, 2012, dividend-equivalent payments made to foreign persons on even equity swaps that do not involve any of the foregoing circumstances will be subject to a 30% U.S. withholding tax unless future IRS guidance identifies the applicable instrument or transaction as one not having the potential for the avoidance of U.S. withholding taxes on U.S.-source dividends.

   For equity swaps and other financial instruments covered by these rules, withholding will apply to the gross amount of each dividend-equivalent payment. Accordingly, a 30% withholding tax may be imposed on an amount which, under the terms of the applicable instrument, exceeds the actual net payment made to the foreign person.

2. **New Withholding Tax Regime**. Under current law, U.S.-source fixed or determinable annual or periodical (FDAP) payments made to non-U.S. persons such as interest and dividends are subject to a 30% U.S. withholding tax unless the withholding agent can establish that the recipient is eligible for an exemption from withholding or a reduced rate of withholding under an income tax treaty. However, capital gains and U.S.-source interest payments eligible for the "portfolio interest" exemption are not subject to the 30% withholding tax.

   Effective generally for payments made on or after January 1, 2013, a 30% U.S. withholding tax will be imposed on a broad category of U.S.-source payments ("withholdable payments") made to "foreign financial institutions" (FFIs) that have not entered into an agreement with the IRS to provide annual information concerning U.S. account holders. In addition to FDAP payments currently subject to 30% withholding (such as dividends and interest not eligible for the portfolio interest exemption), withholdable payments will now include all payments of U.S.-source interest and any gross proceeds from the sale of assets, such as stock and securities, that can generate U.S.-source dividends or interest. As defined in the Act, FFIs include not only foreign banks and foreign custodial agents, but also any foreign entity that is engaged primarily in investing in or trading securities, partnership interests, commodities or derivatives. Thus, foreign hedge funds, private equity funds, securitization vehicles and other foreign investment vehicles generally will be required to comply with the

annual tax reporting requirements described below in order to avoid the imposition of the 30% U.S. withholding tax on U.S.-source payments made to them that would not otherwise be subject to 30% withholding under current law. (It is expected that widely held foreign mutual funds will be exempted by future IRS guidance from having to comply with these rules.) The January 1, 2013, effective date is intended to provide sufficient time for fund managers to bring existing foreign investment vehicles into compliance with the new withholding tax regime.

Reporting generally will be required as to each U.S. person that holds any debt or equity interest in an FFI (other than an interest that is regularly traded on an established securities market) or that holds any financial account with an FFI. However, reporting is not required as to the following U.S. persons: publicly traded corporations; tax-exempt organizations and IRAs; the United States, a State or a U.S. possession or a political subdivision or wholly owned agency of either; a bank; a real estate investment trust (REIT); a U.S. mutual fund; or a charitable remainder trust (collectively, "exempted U.S. persons"). In addition to obtaining and providing information as to direct holders, FFIs will need to look through certain non-U.S. entities. Specifically, in the case of any non-U.S. entity holding a debt or equity interest in the FFI, the FFI must obtain and provide information as to U.S. persons that own more than 10% of such non-U.S. entity, or, if the non-U.S. entity is itself an entity that is engaged primarily in investing in or trading securities, partnership interests, commodities or derivatives, as to U.S. persons that own any interest in such foreign entity.

Similarly, a 30% U.S. withholding tax will be imposed on payments made to foreign entities, including foreign corporations, that are not FFIs, unless the foreign entity certifies that it does not have any non-exempted 10% U.S. owners or provides information regarding such owners. An exemption from these rules is provided for certain foreign entities, including publicly traded corporations and members of their affiliated group, entities organized under the laws of a possession of the United States, and any foreign government or political subdivision of a foreign government. Notwithstanding the general 2013 effective date, the foregoing expanded withholding tax provisions will not apply to debt obligations that are outstanding on March 18, 2012, nor will they apply to the gross proceeds from any disposition of such obligations.

3. **Foreign Account Reporting**. Effective generally for calendar years beginning 2011, U.S. individuals must report with their tax returns any interest in the following if the aggregate value of such assets exceeds $50,000: (i) foreign financial accounts (which includes interests in FFIs), and (ii) foreign issued stock, securities or derivatives with a foreign counterparty, in each case, unless held in an account maintained with a U.S. financial institution. This is in addition to the FBAR reporting of foreign bank and financial accounts.

4. **Annual PFIC Reporting**. Each U.S. shareholder of a passive foreign investment company (PFIC) will be required to file annually a statement of their PFIC holdings information statements with their tax returns, beginning (for individuals) with their 2010 tax returns. The form of such statement has not yet been disclosed.

If you have questions regarding these rules, please contact your Katten Muchin Rosenman LLP attorney or any of the following members of Katten's Tax Planning Practice.

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