JACKO LAW GROUP, PC
SECURITIES & CORPORATE COUNSEL

Legal Risk Management Tip

April 2009

Proposed Taxation of Offshore Investments

The recent collapse of the financial markets has caused much public and political outcry. As a consequence, legislators and regulators alike are racing to introduce new legislation and regulations to govern those activities which are popularly perceived to have caused the current economic predicament.

One of the many focus areas of the subsequent race to regulate is offshore tax havens due to the strong public perception that many U.S. investors have sought to reduce their tax liability by investing in these jurisdictions. Although it is hard to see a direct causal link between this practice and the financial crisis, tax evasion is illegal. Unfortunately, due to the privacy laws of many of these offshore jurisdictions, the practice is often hard to detect.

In response to this situation, Senator Carl Levin has reintroduced a modified version of an earlier bill for the purpose of passing the Stop Tax Haven Abuse Act ("Act"). Although the previous attempt to introduce this legislation proved unsuccessful, the likelihood is strong that the bill will receive enough congressional support to pass this time around.

Despite seeking to regulate all types of offshore investment, one of the groups most likely to be affected by the passing of the Act will be hedge funds.

Taxation of Offshore Hedge Funds

If passed, Section 103 of the Act will subject many offshore funds to U.S. taxation by treating them as domestic corporations. This will occur if a fund has minimum assets of $50,000,000 and if "decisions about how to invest the assets are made in the United States."[1] While offshore funds are not typically administered in the U.S., many fund investments are managed by U.S. firms. As such these "U.S. Managed Funds" will be caught by this legislation.

Importantly, the proposed regulations will apply to all U.S. Managed Funds irrespective of whether they have accepted investments from U.S. tax payers or not. Arguably, it appears inequitable to subject non-U.S. tax payers to U.S. taxation in this way and many non-U.S. investors may react by withdrawing their assets from these funds. This may in turn result in a loss of revenue for the U.S. firms that manage these funds.

[1] Stop Tax Haven Abuse Act, S. 506, 111th Cong., 1st Sess. § 103 (a) (2009).

Recovery of Taxation from U.S. Investors in Offshore Funds

Of course, subjecting offshore funds to U.S. taxation will be of little consequence if the Treasury has no practical means of locating the assets and investors of these funds or of collecting payment. Therefore, in addition to the proposed section 103, the Act contains two important ancillary provisions.

Section 105 effectively requires U.S. custodians and brokers of certain offshore funds to withhold tax on income earned on U.S. investments. This requirement will apply if a "United States person has any beneficial interest in the" fund.[2]

In addition, Section 102 of the Bill will empower the Treasury to impose various financial sanctions on "jurisdictions [and] financial institutions [which] "impede United States tax enforcement."[3] These sanctions will be similar to the existing anti-money laundering sanctions imposed by the Patriot Act and will include the ability to "prohibit or impose conditions upon the opening or maintaining in the United States a correspondent account or payable-through account."[4] Consequently, the Treasury will be able to use these sanctions to force jurisdictions and financial institutions to provide information about U.S. tax payers' offshore investments, and where necessary, seek legal action against those investors to recover unpaid taxes.

Other Provisions Contained in the Act

As stated above, the Act is not solely concerned with the taxation of offshore funds but taxation of offshore investments generally. If you think that you or your clients may be affected by the proposed legislation, you should obtain advisement from a tax specialist. However, when doing so, you should exercise caution because the proposed Section 107 expressly prohibits the use of a tax adviser's opinion to demonstrate "reasonable cause for any portion of an underpayment" or "good faith with respect to such portion."[5] In other words, the Treasury will not allow a tax payer to rely upon a tax adviser's advice as a defense if they believe there has been an underpayment.

Jacko Law Group, PC will keep you advised as to developments with the Act. In the meanwhile, the industry should remain alert as to Congress' intent to prevent the use of offshore investments for tax evasion.

Author: Michelle Jacko, Managing Partner and Matthew Shepherd, Legal Assistant, Jacko Law Group, PC ("JLG"). JLG works extensively with investment advisers, broker-dealers, investment companies, hedge funds and banks on legal and regulatory compliance matters. For more information about this topic and other legal services, please contact us at (619) 298-2880, info@jackolg.com or visit www.jackolg.com. Thank you.

[2] Id. at § 105 (a).
[3] Id. at § 102 (1).
[4] Id. at § 102 (7).
[5] Id. at § 107 (a).