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Insights Into Recent Regulatory, Judicial and Legislative Developments

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Stop Tax Haven Abuse Act: If Enacted, Would Have Broad Implications

On March 2, 2009, Senator Carl Levin (D-MI) introduced the Stop Tax Haven Abuse Act, S. 506 (the "Bill"). A companion bill was introduced in the House as H. 1265. The Bill is based on a previous bill (cosponsored by then Senator Barack Obama), S. 681, which failed to garner sufficient support to become law. The stated goal of the Bill is to combat tax evasion through tax havens, money laundering and the use of tax shelters.

Congress and the Administration, more than ever, are eager to target so-called offshore tax abuses that are perceived to rob the U.S. Treasury of billions each year. Recent hearings and reports about abusive practices involving alleged tax sheltering activities by foreign banks (including UBS, which was alleged to have facilitated tax evasion by setting up shell companies for U.S. clients through its U.S. offshore branch) are evidence of the extensive and serious nature of offshore tax dodging.

Stop Tax Haven Abuse Act

For purposes of the Bill, a tax haven is a foreign jurisdiction that qualifies as an "offshore secrecy jurisdiction." An offshore secrecy jurisdiction is a jurisdiction that maintains corporate, bank and tax secrecy laws and industry practices that make it difficult for other countries to determine whether their citizens are using the jurisdiction to cheat on their taxes. The Bill creates an unprecedented blacklist of 34 offshore secrecy jurisdictions, including the most popular jurisdictions for offshore investment funds and special purpose vehicles.

The Bill's list differs substantially from the analogous list of the Organization for Economic Cooperation and Development (OECD). The OECD has reconfigured its list of suspect jurisdictions to reflect more than 30 countries on its "grey list"—countries that the OECD finds to have committed to the internationally agreed tax standards, although they may not have yet substantially implemented them. The OECD lists another 40 countries on a "white list"—countries where authorities are considered fully committed to international standards of information exchange.

Although the Bill is similar to its previous unpassed version, the most controversial provisions are new. In short, the Bill would

1. tax foreign corporations that are publicly traded or have assets of $50 million or more and are managed or controlled in the United States as U.S. corporations;
2. impose withholding tax on dividend-equivalent payments and substitute dividend payments to non-U.S. persons that hold certain types of equity derivatives; and
3. require passive foreign investment company (PFIC) reporting not only by owners of PFICs, but also by those who have formed, transferred assets to, received money or property from, or benefited from a PFIC.

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The provision that treats foreign corporations as domestic corporations represents a significant contraction of existing rules, which permit non-U.S. investors to trade in stock and securities for their own account through U.S. agents without incurring U.S. taxes. This provision is designed to target foreign hedge funds and foreign feeders that are managed by U.S. investment managers and foreign companies that have inverted (i.e., moved their place of organization to a tax haven jurisdiction). The provision, if enacted, would leave U.S. managers of foreign funds with a limited number of options. Primary management and control would have to be ceded to persons located outside the United States to avoid the rule.

The dividend withholding provision would close the offshore dividend tax loophole. The Bill would require dividend equivalent payments to be treated as dividends rather than as "other income" or "business profits" for purposes of U.S. income tax treaties. Accordingly, foreign investors would be taxed, albeit at a reduced rate, even if they are entitled to income tax treaty benefits.

The Bill also contains provisions that would, among other things, codify the economic substance doctrine, impose certain rebuttable presumptions regarding control of foreign entities, apply anti-money laundering rules to hedge funds and private equity funds, forbid tax patents and extend Patriot Act measures to entities that impede U.S. tax enforcement.

This legislation is in its early stages, and it is very uncertain whether the provisions will ultimately be enacted into law. They would make far-reaching changes in long-established rules of law for determining source of income and tax residence of corporations incorporated anywhere outside the United States—not just in offshore secrecy jurisdictions.

Baucus Bill

On March 12, 2009, Sen. Baucus (D-MT), chairman of the Senate Finance Committee, announced a more modest version of the Bill that focuses on additional tax reporting requirements in order to identify U.S. persons who may be using tax haven jurisdictions to avoid U.S. taxation. Baucus is concerned about offshore tax compliance and the tax gap; however, Baucus apparently favors a more targeted approach than Levin that would give the IRS added power to detect individual U.S. tax evaders, rather than condemning all offshore financial centers. And unlike the Stop Tax Haven Abuse Bill, there is no blacklist. The introduction of a competing bill by Senator Baucus may reduce the likelihood of the Bill's passing in its proposed form.

Conclusion

Because of both the recent tax scandals and the current economic crisis, legislation taxing abusive off shore entities and requiring greater fiscal/tax transparency may gain more political traction in Congress this time around. It remains to be seen whether a more targeted or generalized approach will be adopted.

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