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Tax implications of the HIRE Act for the alternative investments industry

Brief overview of the HIRE Act and impact on the alternative investments industry

The HIRE Act ("Act") was signed into law by President Obama on March 18, 2010. The Act introduces new initiatives aimed at reducing offshore noncompliance, including increased reporting requirements and new withholding requirements. These provisions are intended to finance tax incentives for hiring new employees and making capital investments, which are also included in the Act.

Various provisions in the Act may affect hedge funds, management companies, and individual investors. The facts and circumstances of your structure and/or the structure of your investee funds will ultimately determine the application of the Act's provisions to your situation.

Detailed analysis of the Act

The requirements related to offshore activity featured in the Act are discussed as follows:

- Reporting on Foreign Accounts. The Act imposes a 30% withholding tax on certain income paid after December 31, 2012 from assets held by a "foreign financial institution."

  "Foreign financial institutions" include foreign entities which engage in at least one of the following:

  - Accept deposits in the course of a banking business,
  - Hold financial assets for the account of others, or
  - Function as "investment vehicles," which engage in the business of investing, reinvesting, or trading in securities, partnership interests, commodities or trade in any "interest" in such securities, partnership interests, or commodities. An "interest" includes a futures contract, a forward contract, or an option.

  Any U.S. assets from any depository or custodial account maintained by a foreign financial institution or an equity or debt interest in a foreign financial institution owned by "specified U.S. persons" or a "U.S. owned foreign entity" may be subject to withholding. "Specified U.S. persons" include any domestic individual or any entity other than a publicly traded corporation, a tax-exempt organization, an individual retirement account (IRA), a real estate investment trust (REIT), a regulated investment company (RIC), a common trust fund, or a tax-exempt trust. In most cases, a "U.S. owned foreign entity" is a foreign entity with one or more "substantial U.S. owners," which include specified U.S. persons having a greater than 10% capital or profits interest in a partnership, owning greater than 10% of the outstanding stock of a corporation, or holding greater than 10% of the beneficial interests of a trust. However, if the U.S. owned foreign entity meets the definition of an "investment vehicle," the definition of "substantial U.S. owners" is expanded to include specified U.S. persons having any capital or profits interest in a partnership, owning any of the outstanding stock of a corporation, or holding any beneficial interest of a trust.

  The withholding tax will be collected on gross proceeds from the sale of interest and dividend producing property and interest on deposits at a foreign financial institution, unless such institution agrees to disclose the following to the IRS:

  - The identity of any specified U.S. person with an account at such institution,
  - The identity of any U.S. owned foreign entity (and the identity(ies) of substantial U.S. owners thereof) with an account at such institution, and
  - Annual reports on the account balance, gross receipts, and gross withdrawals from any account belonging to a specified U.S. person or U.S. owned foreign entity.

- Reporting on U.S. Persons by Withholding Agents. The Act imposes a burden on withholding agents

that is similar to that imposed on foreign financial institutions for payments made after 2012. Withholding agents will be required to withhold at 30% on gross proceeds from the sale of interest and dividend producing property earned by a U.S. owned foreign entity unless such withholding agent agrees to disclose the name, address, and tax identification number of all substantial U.S. owner(s) of such U.S. owned foreign entity.

- Foreign Financial Asset Reporting. The Act requires a specified U.S. person to disclose offshore depository or custodial accounts and certain offshore assets not held in such an account, which may include stocks or securities issued by foreign persons, other financial instruments held for investment issued by or has a counterparty that is a non-U.S. person, and any interest in a foreign entity. This requirement must be met if the aggregate value of all such assets exceeds $50,000 in a given year and will be satisfied by attaching a disclosure statement to the U.S. person's income tax return. The Act will require foreign financial asset reporting in tax years beginning after March 18, 2010. As such, a 2010 short-year tax return may be affected if the entity begins activity after March 18, and entities filing under a calendar year may be affected starting in 2011. Current guidance suggests that this disclosure will be handled in a manner similar to Form TD F 90-22.1, Report of Foreign Bank and Financial Accounts ("FBAR"). The IRS will likely streamline the new disclosure process to avoid duplication of information that is already being reported on an FBAR. Nonetheless, the new requirements could have far-reaching implications with regard to foreign investment disclosures, including investments in other hedge funds, foreign futures contracts, foreign equity securities, foreign debt securities, etc.
- New Penalties and Statute of Limitations. The Act introduces new penalties and a longer statute of limitations for inadequate disclosures of items discussed in the previous section. The penalty for failure to disclose is $10,000 plus 40% of any understatement of income related to an undisclosed item. The $10,000 penalty could be increased to $50,000 if the failure to disclose continues after formal notification by the IRS. Penalties may be abated if the specified U.S. person can establish that the failure to disclose was due to reasonable cause and not willful neglect. Be aware that a foreign law prohibition against disclosure has already been specified as not constituting reasonable cause. The Act also extends the statute of limitations from three to six years for any omission of a foreign financial asset-related item that exceeds $5,000 and clarifies that the statute of limitations does not begin until the taxpayer files the information return disclosing the taxpayer's reportable foreign assets.
- New Passive Foreign Investment Company ("PFIC") Reporting Rule. The Act requires each U.S. person who is a shareholder of a PFIC to file an annual information return. It is our understanding that this will be an expanded version of Form 8621, Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund, which was previously required only in certain circumstances or in making certain tax elections. As with the foreign financial asset reporting, this change may first impact certain short-year returns in 2010 and calendar year returns in 2011.
- Dividend Equivalent Payments. The Act, for purposes of payments made after September 14, 2010, treats dividend equivalent payments as a dividend from U.S. sources for purposes of the U.S. withholding tax under Sec. 1441. For purposes of this provision, a dividend equivalent payment includes, but is not limited to, a substitute dividend made pursuant to a securities lending transaction, a sale-repurchase transaction that is contingent upon the payment of a dividend from U.S. sources, and a payment made under a specified notional principal contract that is contingent upon the payment of a dividend from U.S. sources. The Act also grants the IRS authority to determine that any other payment is substantially equivalent to one described previously. Accordingly, withholding could be now imposed on a wide range of derivative transactions such as equity swaps.

A brief discussion of the tax incentives included in the Act is also included as follows:

- Payroll Tax Holiday. Private sector employers who hire a new employee in 2010 may be eligible for exemption from paying the employer portion of the Social Security tax on such an employee for the final three quarters of 2010. Employees eligible for the tax holiday must be hired between February 3, 2010 and December 31, 2010, must be unemployed for at least 60 days, may not be hired as a replacement unless the previous employee left voluntarily or was terminated for cause, and must not have been used to claim another employment tax credit.

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- Tax Credit for Hiring Unemployed Workers. Employers eligible for the payroll tax holiday may also be eligible for an additional tax benefit in 2011. Employers who retain one or more employees hired in compliance with the terms of the payroll tax holiday for a continuous 52-week period can take up to $1,000 per such employee as a nonrefundable tax credit.
- Enhanced Business Expensing (Extension). The Act extends, through 2010, the applicability of the 2009 limits on the Sec. 179 election which allows a deduction for a portion of capital expenditures on fixed assets (such as office equipment), which are usually subject to capitalization and depreciation over a specified period. If the election is made, the maximum allowable deduction is generally the smallest of $250,000, $250,000 less the amount total capital expenditures exceed $800,000, and the current year's taxable income.

Summary

The new foreign compliance requirements will place an increased reporting burden on alternative investment structures. In some cases, such as the foreign financial asset and PFIC disclosures, it is our understanding that the new requirements will be expansions of information already being disclosed. In other cases, particularly with regard to withholding on foreign entities, entirely new requirements have been legislated; however, the industry does have time to adjust as several changes do not take effect until after the 2010 tax year.

It is our intention to provide subsequent updates relating to formal guidance from the IRS. Unfortunately, little is available at this time as the Act was signed into law recently. Once such guidance becomes available, we will be able to provide further analysis of the Act's impact on the industry as well as your respective situations.

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This industry update on "Tax implications of the HIRE Act for the alternative investments industry" was written by the Tax Department's Fund Group of Arthur Bell, Certified Public Accountants. Should you have any questions, please do not hesitate to contact Alex Cummings, director of the Tax, Fund Group, at alex.cummings@arthurbellcpas.com or 410.771.0001.

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