

REAL ESTATE WEEKLY

A NEW WITHHOLDING TAX CREATED

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The recently enacted Hiring Incentives to Restore Employment Act (“HIRE”) created a new withholding tax with respect to certain payments to foreign financial institutions.

Although the Treasury Department has not yet provided guidance on implementing these new rules, the new withholding tax and related reporting obligations have already started to affect pooled investment vehicle structures.

HIRE Act’s Withholding Tax

Effective January 1, 2013, HIRE requires a “foreign financial institution,” which includes a bank, broker-dealer, hedge fund or commodity pool formed under the laws of a non-U.S. country, to enter into an agreement with the IRS to report certain information about its “United States accounts” or be subject to a 30% U.S. withholding tax on U.S. source income, including dividends, interest, and rents and proceeds from the sales of U.S. securities.

A United States account is generally any account held by one or more U.S. persons or held by a foreign entity which is more than 10% owned by a U.S. person.

However, a United States account excludes accounts held by publicly-traded entities, banks, tax-exempt organizations, IRAs, federal, state and local governments, REITs and mutual funds.

In order to avoid the withholding tax, the foreign financial institution must enter into an agreement with the IRS. New IRC Section 1471(b) provides that the agreement must (i) provide information to determine whether each of the foreign financial institution’s accounts is a “United States account,” (ii) comply with verification and due diligence procedures with respect to its United States accounts, (iii) annually report certain information about its United States accounts, and (iv) obtain a waiver from each United States account holder of any foreign law confidentiality provisions with respect to the holder’s United States account.

In addition, the agreement must require the foreign financial institution to withhold 30% of the relevant income or proceeds attributable to any account holder that is either (i) a foreign financial institution that does not have an IRC Section 1471(b) agreement with the IRS, or (ii) an account holder that refuses to provide the foreign financial institution the mandatory information.

Essentially, the result is that a foreign financial institution with U.S. accounts must either enter into a Section 1471(b) agreement with the IRS and report to the IRS on its U.S. accounts or be subject to the 30% withholding tax.

Impact on Hedge Fund Structures

For several reasons, hedge funds frequently are formed with both a U.S. fund and an offshore fund. The new law and the attribution rules among affiliates will impact how these fund groups are structured. The two most common structures are side-by-side or master-feeder.

Side-by-Side Funds. Pooled investment vehicle structures vary depending on many factors. Fund managers seeking to accommodate U.S. taxable investors as well as non-U.S. investors and tax-exempt U.S. investors will generally want to establish two funds. One fund will be a domestic U.S. fund for the taxable U.S. investors and the other, an offshore fund for the non-U.S. investors and tax-exempt U.S. investors. The simplest structure is the side-by-side structure where the fund manager manages the U.S. fund and the offshore fund by allocating investments proportionally between the two funds.

Master-Feeder Funds. To ease the administrative burden and cost, fund managers frequently prefer the master-feeder structure. A simple master-feeder structure typically starts with an offshore master limited partnership and two feeder funds – one U.S. limited partnership and one offshore company.

The U.S. taxable investors typically invest in the U.S. feeder fund, and non-U.S. investors and U.S. non-taxable investors invest in the offshore feeder fund. Each feeder fund invests in the master fund. The HIRE Act's attribution rules, which are to be further clarified by the Treasury, will likely result in disuse of the master-feeder structure. The chance of incurring the penalty for failing to meet the Section 1471(b) safe harbor agreement is significant enough to utilize other structures, such as the side-by-side structure.

Conclusion

The expansive scope of the HIRE Act's reach for the fund group's affiliates puts the master-feeder fund group's investors at risk of the 30% withholding tax. Fund managers will need to review their fund group structures and consider whether the side-by-side structure is better suited for their particular investor base.