

FOREIGN ACCOUNT TAX COMPLIANCE

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Foreign Account Tax Compliance

On March 18, 2010, President Obama signed the Hiring Incentives to Restore Employment Act into law (Public Law 111-147) (the “Act”). The Act imposes broad disclosure and reporting requirements on foreign financial institutions and other foreign entities including private equity funds, hedge funds, and certain investment vehicles (including foreign issuers of collateralized debt obligations or collateralized loan obligations), as well as entities engaged in banking or similar businesses. The language in the Act is based on proposals included in President Obama’s 2010 Budget and legislation introduced in October 2009 as the Foreign Account Tax Compliance Act of 2009 (“FATCA”).

The Joint Committee on Taxation estimates that FATCA will prevent U.S. individuals from evading \$8.5 billion in U.S. taxes over the next ten years.

Summary of the Act

- **Impose a 30% withholding tax on certain payments either to “foreign financial institutions” that fail to identify U.S. accounts and their owners and assets to the IRS, or to nonfinancial foreign entities (such as, corporations and trusts) that do not supply the name, address, and tax identification number of any U.S. person that owns more than 10% of the entity.**
- Subject dividend equivalent payments included in notional principal contracts, and substitute dividend payments in certain securities-lending and sales-repurchase agreements, in each case, paid to non-U.S. persons, to the same 30% withholding tax levied on dividends paid to non-U.S. persons.
- Extend bearer-bond tax penalties to any such bonds marketed to non-U.S. investors, and prevent the U.S. government from issuing bearer bonds.
- Impose penalties as high as \$50,000 on U.S. taxpayers who own at least \$50,000 in offshore accounts or assets but fail to report the accounts on their annual income tax return.

Summary of the Act (continued)

- Levy a 40% penalty on the amount of any understatement attributed to undisclosed foreign assets.
- Extend to six years the statute of limitations for omissions exceeding \$5,000 and 25% of reported income derived from offshore assets.
- Require U.S. shareholders in passive foreign investment companies to file annual information returns.
- Permit the IRS to mandate that financial firms file U.S. withholding tax returns electronically, even if they file fewer than 250 returns annually.
- Codify U.S. Treasury regulations that treat foreign trusts as having U.S. beneficiaries if any current, future, or contingent beneficiary is a U.S. person.

Summary of the Act (continued)

- Permit the IRS to presume that a foreign trust has U.S. beneficiaries if a U.S. person directly or indirectly transfers property to the foreign trust.
- Establish a \$10,000 minimum failure-to-file penalty for some foreign-trust-related information returns.

Withholding Tax and Information Reporting on U.S. Payments to Foreign Accounts

The Act adds new Code Sections 1471, 1472, 1473, and 1474 and amends Code Section 6611, to provide for withholding taxes to enforce new reporting requirements on specified foreign accounts owned by specified U.S. persons or by U.S.-owned foreign entities. The provisions establish rules for withholdable payments to foreign financial institutions and for withholdable payments to other foreign entities.

A “specified U.S. person” is any U.S. person other than (i) a corporation the stock of which is regularly traded on an established securities market (or its 50% affiliates), (ii) a tax-exempt organization, (iii) the United States, its wholly-owned agencies and the States, (iv) certain U.S. banks, (v) a real estate investment trust (a “REIT”), (vi) a regulated investment company (a “RIC”) and (vii) common trust funds and certain tax-exempt trusts (such as charitable remainder trusts).

Effective Date

Generally, the new withholding and reporting regime will apply to payments made after December 31, 2012. However, withholding under the Act will not apply to any payment under any obligation outstanding on March 18, 2012, or from the gross proceeds from any disposition of such an obligation. Nevertheless, taxpayers who would be affected by the new withholding and reporting requirements should consider how they will comply with the new provisions well before January 1, 2013, when they become effective.

Withholding Tax and Information Reporting on U.S. Payments to Foreign Financial Institutions (New Code Section 1471)

The Act imposes a 30% withholding tax on “withholdable payments” made to foreign financial institutions (and their 50% affiliates) unless the payee foreign financial institution enters into an agreement with the IRS under which it agrees to (1) disclose the identity of any U.S. person with an account at the institution (or the institution’s affiliates); (2) withhold tax (or to elect to have tax withheld) on any withholdable payment that is made to a recalcitrant account holder or another foreign financial institution that does not meet the requirements of the Act; (3) annually report on the account balance, gross receipts and gross withdrawals, and payments from such account; and (4) attempt to obtain a waiver of any applicable non-U.S. law that would prevent disclosure of this information by a holder (e.g., bank secrecy laws) and, if such waiver is not obtained from each such account holder within a reasonable period of time, close such account.

Foreign Financial Institution

- The term “foreign financial institution” is broadly defined by the Act and includes hedge funds, private equity funds, certain investment vehicles (including foreign issuers of collateralized debt obligations or collateralized loan obligations), and entities that, as a substantial portion of their business, hold financial assets for the account of others.
 - Does not include a financial institution that is organized under the laws of any possession of the United States
 - Includes entities that accept deposits in the ordinary course of a banking or similar business.
- According to the Joint Committee Explanation, the IRS may provide exceptions for certain classes of financial institutions .
 - Exceptions may include entities such as certain holding companies, research and development subsidiaries, or financing subsidiaries within an affiliated group of nonfinancial operating companies.

Foreign Financial Institution (continued)

- It is anticipated that the IRS may prescribe special rules addressing the circumstances in which certain categories of companies, such as certain insurance companies, are financial institutions.

Withholdable Payments

“Withholdable payments” include payments of interest (including original issue discount), dividends, rents, salaries, wages, and other items of fixed or determinable annual or periodical gains, profits and income, in each case, from sources within the United States, as well as gross proceeds from the sale of any property of a type that can produce interest or dividends from sources within the United States.

- For purposes of the Act, interest on deposits paid by a foreign branch of a U.S. financial institution is considered to be from sources within the United States.
- The term “withholdable payments” does not include payments of income that is effectively connected with the conduct of a U.S. trade or business.
- The Joint Committee Explanation for the Act notes that the IRS may determine that certain payments made with respect to short-term debt or short-term deposits, including gross proceeds paid, pose little risk of U.S. tax evasion and may be excluded from the definition of withholdable payments.

Reporting Requirements

To avoid the imposition of the 30% withholding tax on “withholdable payments,” the Act requires foreign financial institutions to enter into an agreement with the IRS under which they agree to disclose and report on specified U.S. persons, and foreign entities that have an account with the foreign financial institution and have substantial U.S. owners.

- It is anticipated that the IRS may require that a foreign financial institution entering into a reporting agreement with the IRS achieve certain levels of reporting and make reasonable attempts to acquire the information necessary to comply with the requirements of this provision or to close accounts, where necessary, to meet the purposes of this provision.
- Foreign financial institutions are not required to disclose and report on publicly traded corporations (or their 50% affiliates), tax-exempt organizations, certain banks, real estate investment trusts, and regulated investment companies.

Accounts Subject to Reporting

- For purposes of reporting under the Act, the term account includes:
 - any depository account maintained with a financial institution;
 - Any custodial account maintained with a financial institution; and
 - Any equity or debt interest in a financial institution (other than an interest which is regularly traded on an established securities market).

Substantial U.S. Owners

- Foreign entities with substantial U.S. owners include any foreign partnership or corporation with a U.S. owner that owns (directly or indirectly) more than a 10% interest (by vote or value), any foreign grantor trusts with owners that are U.S. persons, and, to the extent provided in regulations or other IRS guidance, other any other trust where a U.S. person holds (directly or indirectly) more than 10% of the beneficial interests of such trust.
- In the case of a foreign financial institution, such as a hedge fund or a private equity fund, that is engaged (or holds itself out as engaged) in the business of investing, reinvesting, or trading in securities, partnership interests or commodities (or any interests therein), such institution will be treated as having a substantial U.S. owner if any U.S. person holds an interest in such entity.

Refunds and Credits

- A beneficial owner generally will be able to obtain a refund or credit of taxes withheld pursuant to the Act (to the extent that such refund or credit would be permitted under existing withholding rules) by filing a U.S. federal income tax return.
- No refund or credit will be allowed or paid with respect to any tax properly withheld under the Act unless the beneficial owner of the payment provides such information as the IRS may require to determine whether such beneficial owner is a U.S.-owned foreign entity and the identity of any substantial U.S. owners of such entity. Additionally, no refund or credit will be available for withholding on payments to a beneficial owner that is a foreign financial institution that is not eligible for benefits under an applicable tax treaty with the United States.

Withholding Tax and Information Reporting on U.S. Payments to Nonfinancial Foreign Entities (New Code Section 1472)

- The Act requires foreign entities other than “foreign financial institutions” (as discussed above) to provide withholding agents with the name, address, and taxpayer identification number of any substantial U.S. owner (*e.g.*, an owner that owns more than 10% of a foreign corporation’s stock (by vote or value)).
 - Withholding agents are required to report this information to the IRS.
- Any withholding agent making a withholdable payment to a foreign entity that is not a financial institution and that does not comply with this disclosure and reporting requirement will be required to withhold tax at a rate of 30%.

Exemption

- The Act exempts publicly held corporations, entities organized under the laws of a possession of the United States that are wholly-owned by one or more bona fide residents of such possession, and certain other foreign entities from these reporting and withholding requirements, and provides the IRS with the regulatory authority to exclude other recipients that pose a low risk of tax evasion.

Circular 230 Disclaimer

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