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FATCA Provisions Enacted Into Law

New Withholding Tax, Ban on Bearer Bonds, and Withholding on "Dividend Equivalents"

By Thomas A. Humphreys, Stephen L. Feldman and Remmelt A. Reigersman

On March 18, 2010, President Obama signed into law the Hiring Incentives to Restore Employment Act (the "Act"). The Act incorporates the Foreign Account Tax Compliance Act including provisions which: (i) introduce a new 30% withholding tax on certain payments made to foreign entities that fail to comply with specified reporting or certification requirements, (ii) end the practice whereby U.S. issuers sell bearer bonds to foreign investors by repealing the U.S. bearer bond exception, and (iii) impose a withholding tax on "dividend equivalents" paid under equity swaps. This alert addresses these provisions of the Act and certain other provisions aimed at preventing offshore tax avoidance by U.S. persons. The new withholding tax applies to relevant payments made after December 31, 2012. Importantly, debt obligations outstanding on March 18, 2012 are "grandfathered" from the new withholding tax and from the repeal of the U.S. bearer bond exception.

NEW WITHHOLDING TAX

The Act introduces a new 30% withholding tax on any "withholdable payment" made to a foreign entity unless such entity complies with certain reporting requirements or otherwise qualifies for an exemption. A "withholdable payment" generally includes any payment of interest, dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodical gains, profits, and income from sources within the U.S. It also includes gross proceeds from the sale of property that is of a type that can produce U.S.-source dividends or interest, such as stock or debt issued by domestic corporations. Different rules apply to foreign "financial institutions" ("FFIs") and to other foreign entities.

Foreign Financial Institutions

The new 30% withholding tax on any "withholdable payment" made to an FFI (whether or not beneficially owned by such institution) applies unless the FFI agrees, pursuant to an agreement entered into with Treasury, to provide information with respect to each "financial account" held by "specified U.S. persons" and "U.S.-owned foreign entities." The new disclosure requirements are in addition to requirements imposed by a "Qualified Intermediary" agreement.

The term FFI includes banks, brokers, and investment funds, including private equity funds and hedge funds. A "financial account" includes bank accounts, brokerage accounts, and other custodial accounts, or an equity or debt interest in the FFI (unless such interest is regularly traded). The term "specified U.S. person" is any U.S. person other than certain categories of entities such as publicly-traded corporations and their affiliates, banks, mutual funds, real estate investment trusts, and charitable trusts. A "U.S.-owned foreign entity" for this purpose is any entity that has one or more "substantial U.S. owners," which generally means (i) in the case of a corporation, if a specified U.S. person, directly or indirectly, owns more than 10% of the stock, by vote or value, (ii) in the case of a partnership, if a specified U.S. person, directly or indirectly, owns more than 10% of the profits or capital interests, or (iii) in the case of a trust, if a specified U.S. person is treated as an owner of any portion of the trust under the grantor trust rules.

By entering into the agreement with Treasury[1], the FFI agrees to (i) obtain information necessary to determine which accounts are U.S. accounts, (ii) comply with verification and due diligence procedures as required by Treasury, (iii) annually report certain information regarding U.S. accounts (including U.S. accountholder identification information and annual account activity information), (iv) withhold on "passthru payments" made to (1) recalcitrant account holders, (2) other FFIs that do not enter into an agreement with Treasury, and (3) FFIs that have elected to be withheld upon (as further described below), (v) comply with requests by Treasury for additional information with respect to any U.S. accounts, and (vi) attempt to obtain a waiver from the U.S. accountholder if any foreign law would otherwise prevent the reporting of required information or alternatively close the account. Instead of reporting the necessary U.S. account information, an FFI may elect to comply with the reporting requirements that apply to U.S. financial institutions, which generally means reporting on Internal Revenue Service ("IRS") Forms 1099.

Rather than agreeing with Treasury to act as a withholding agent in respect of reportable payments, an FFI may elect to provide the withholding agents from which it receives payments with the information necessary for the withholding agents to implement the new withholding tax (generally, information that discloses the extent to which payments made to the electing FFI are allocable to accounts subject to the 30% U.S. withholding tax). In addition, the agreement entered into between the electing FFI and Treasury must include a waiver of any right under any tax treaty of the U.S. with respect to any amounts withheld under this election provision.

Further, the Act contains a provision pursuant to which an FFI may be treated as meeting the specified reporting requirements if (i) it complies with procedures ensuring it maintains no U.S. accounts and meets certain requirements with respect to other FFIs maintaining an account with it, or (ii) such FFI is a member of a class of institutions that would not be subject to these provisions. Implementing procedures, requirements, and determinations in respect of this provision would be determined by Treasury in future guidance.

Foreign Non-Financial Institutions

The new withholding tax also applies to any withholdable payment made to a non-financial foreign entity, unless the non-financial foreign entity provides the withholding agent with either (i) a certification that it does not have a substantial U.S. owner, or (ii) the name, address, and taxpayer identification number of each substantial U.S. owner. This provision does not apply to payments made to a publicly-traded non-financial foreign entity, or any of its affiliates.

Treaty Relief, Credits, and Refunds

If the beneficial owner of a payment is entitled to treaty benefits, the withholding tax rate imposed on any withholdable payment may be reduced or eliminated by the provisions of an applicable tax treaty and such beneficial owner would be entitled to a partial or full refund or credit. In addition, even if a treaty is not available, the beneficial owner (other than an FFI) of a withholdable payment on which the 30% tax is withheld may otherwise be entitled to a full refund or credit of the tax (e.g., because payments are eligible for the portfolio interest exemption or represent gross proceeds from the sale of a capital asset). In such a case, a non-U.S. person would have to file a U.S. tax return to obtain a full or partial refund or

[1] The actual form of agreement is not yet available but presumably will be released by Treasury in the future.

credit. Similarly, a U.S. person with a foreign bank account on which it receives payments that are withheld on, presumably would have to claim a refund or credit on its U.S. tax return.

Effective Date

The new withholding tax applies to any withholdable payment made after December 31, 2012, and, in the case of "obligations," only with respect to payments on obligations issued after March 18, 2012. Therefore, debt obligations (but not stock) outstanding on March 18, 2012, are grandfathered.

REPEAL OF U.S. BEARER BOND EXCEPTION

Background

In 1982, Congress passed the Tax Equity and Fiscal Responsibility Act ("TEFRA"), which restricts the issuance of debt instruments in bearer form. Under TEFRA, issuers of debt instruments in bearer form generally are denied deductions for U.S. federal income tax purposes for interest paid with respect to such debt instruments and are subject to an excise tax (equal to 1% of the principal amount of the bonds times the number of years to maturity). Various sanctions also apply to holders. The aforementioned sanctions, however, do not apply with respect to bearer debt instruments that are issued under circumstances in which they are unlikely to be sold to U.S. persons. These circumstances include an issuance of foreign-targeted bearer debt instruments that complies with Treasury regulations referred to as "TEFRA C" and "TEFRA D."

The U.S. imposes a 30% withholding tax on all U.S. source interest paid to non-resident aliens and foreign corporations. In 1984, Congress exempted "portfolio interest" from the U.S. withholding tax in order to encourage investment in U.S. debt. Portfolio interest is any U.S. source interest other than interest received from certain related parties, or interest earned by a bank on an extension of credit in the ordinary course of its lending business. In addition, Congress provided that debt instruments in bearer form do not qualify for the portfolio interest exemption (with the result that interest paid on such instruments is generally subject to the 30% U.S. withholding tax) unless such instruments are issued in compliance with the foreign-targeted requirements imposed by TEFRA.

Many U.S. issuers have European medium-term note or other foreign-targeted programs under which they issue bearer notes to non-U.S. investors. These issuances comply with TEFRA regulations and, as such, the instruments are not subject to the sanctions described above or to U.S. withholding tax. In addition, many non-U.S. issuers include TEFRA restrictions in their debt offerings outside the U.S. to ensure that they are not subject to the TEFRA excise tax.

Some foreign jurisdictions, e.g., Switzerland, do not permit their residents to certify as to their identity. Accordingly, there are special rules in the TEFRA regulations that permit offerings to be sold into those jurisdictions in bearer form if certain additional requirements are met.

Sanctions on Issuances of Bearer Bonds

The Act ends the practice by U.S. issuers of selling bearer bonds to foreign investors under TEFRA C and TEFRA D. Thus, with respect to U.S. issuers of foreign-targeted bearer bonds, the Act repeals the exception to a denial of interest deduction for interest on bearer bonds. In addition, interest paid on such bonds would no longer qualify for treatment as portfolio interest, thereby subjecting such interest to a 30% withholding tax, and any gain realized by a holder of such bonds would be treated as ordinary income.

As a result, U.S. issuers will have to revise their existing programs to prohibit bearer debt. U.S. issuers may have a harder time raising capital in foreign jurisdictions to the extent investors in those jurisdictions are unwilling to provide the non-U.S. beneficial ownership certification (e.g., IRS Form W-8BEN) required for registered debt. However, the Act includes a provision giving Treasury the authority to determine that certification as to non-U.S. beneficial ownership is not required to qualify for the portfolio interest exemption from withholding tax on payments of interest on certain registered debt obligations. In addition, the Act codifies IRS Notice 2006-99[2] providing that debt obligations cleared through dematerialized book-entry systems (such as JASDEC in Japan, or other book-entry systems specified by the Treasury) would be treated as being issued in registered form. It seems that these provisions are aimed at giving Treasury the authority to prescribe rules pursuant to which U.S. issuers would be able to raise debt capital from jurisdictions where bonds are typically held in dematerialized form or where investors are legally barred from certifying as to residency (e.g., Switzerland). Whether Treasury would, in fact, exercise such authority remains to be seen.

The Act preserves the exception to the excise tax for bearer bonds issued under TEFRA-compliant procedures. As a result, foreign issuers of a “foreign-to-foreign” bearer debt offering that is TEFRA-compliant would not be subject to the excise tax.

Effective Date

The repeal of the U.S. bearer bond exception applies to debt obligations issued after March 18, 2012. Therefore, debt obligations in bearer form outstanding on March 18, 2012 are grandfathered.

“DIVIDEND WASHING”

Background

In September 2008, the Senate Permanent Subcommittee on Investigations released a report entitled “Dividend Tax Abuse: How Offshore Entities Dodge Taxes on U.S. Stock Dividends.” The report described a range of transactions employed by financial institutions aimed at enabling non-U.S. clients to avoid U.S. withholding taxes on dividends paid with respect to U.S. securities. As described in the report, U.S. withholding taxes on dividends are avoided through the use of either swaps[3] or stock-lending transactions, or a combination thereof. Transactions involving swaps rely on a Treasury regulation that provides that the source of any payments made pursuant to the swap is determined according to the country of residence of the person receiving the payment. Although substitute dividend payments made under a stock-lending agreement are sourced in the same manner as the dividends with respect to the underlying stock (and would therefore be U.S. source if made with respect to stock of a U.S. corporation), transactions involving stock lending rely on a decade-old IRS Notice to avoid U.S. dividend withholding tax.[4]

Withholding on “Dividend Equivalents”

The Act treats as a U.S.-source dividend any “dividend equivalent” for purposes of U.S. withholding tax provisions. A “dividend equivalent” is (i) any substitute dividend (made pursuant to a securities-lending or “repo” transaction), (ii) any

[2] Notice 2006-99, 2006-2 C.B. 907.
[3] Swaps are generally treated as notional principal contracts for U.S. federal income tax purposes.
[4] Notice 97-66, 1997-48 I.R.B. (1997). The notice addressed the concern expressed by practitioners with respect to a “cascading effect” of dividend withholding tax if the same U.S. securities are the subject of multiple stock-lending transactions and therefore multiple substitute dividend payments.

amount paid pursuant to a “specified notional principal contract,” and that is contingent on, or determined by reference to, the payment of a U.S.-source dividend, and (iii) any amount that the Treasury determines is substantially similar to a payment described in (i) and (ii).

A specified notional principal contract is any notional principal contract if (i) in connection with entering into the contract, any long party (i.e., the party entitled to receive the dividend related payment) transfers the underlying security, (ii) in connection with the termination of the contract, any short party (i.e., any party that is not a long party) transfers the underlying securities to any long party, (iii) the underlying security is not readily tradable on an established securities market, (iv) in connection with entering into the contract, any short party to the contract posts the underlying security as collateral, or (v) the Treasury identifies the contract as a specified notional principal contact. In addition, unless the Treasury determines that a notional principal contract is of a type that does not have the potential for tax avoidance, any notional principal contract pursuant to which payments are made after March 18, 2012, will be a specified notional principal contract.

To address the concern with respect to the cascading effect of such a dividend withholding tax, the Act includes a provision pursuant to which the Treasury may reduce the tax if one or more of the dividend equivalents is subject to tax and to the extent the taxpayer establishes that the tax has been paid on another dividend equivalent in the chain or if Treasury determines such reduction is appropriate to address the role of financial intermediaries. For purposes of this provision, an actual dividend payment is treated as a dividend equivalent.

Effective Date

This provision applies to payments of “dividend equivalents” made on or after September 14, 2010 (i.e., the 180th day after enactment of the Act). Therefore, these provisions apply to existing swaps.

CERTAIN ADDITIONAL PROVISIONS

Reporting of Foreign Assets

The Act requires individual taxpayers who have an interest in a “specified foreign financial asset” to attach a statement to their income tax return if the aggregate value of all such assets during any year is greater than $50,000. A “specified foreign financial asset” would include depository and custodial accounts at foreign financial institutions (i.e., bank and brokerage accounts), and, unless held in a custodial account with a U.S. financial institution, (i) stock or securities issued by foreign persons, (ii) any other financial instrument or contract held for investment that is issued by or has a counterparty that is not a U.S. person, and (iii) any interest in a foreign entity. Interests in foreign private equity and hedge funds would be subject to reporting under this provision. These disclosure requirements would be separate from and in addition to any requirement to file Treasury Form TD F 90-22.1 (the Report of Foreign Bank and Financial Accounts or “FBAR”). Failure to comply with this provision would subject an individual to a maximum penalty of $50,000. This provision would be effective for the 2011 taxable year.[5]

[5] The Act also includes provisions regarding penalties for underpayments attributable to undisclosed foreign financial assets and modifies the statue of limitations for significant omissions of income in connection with foreign assets.

Reporting with Respect to PFICs

The Act includes a provision that requires U.S. shareholders of a “passive foreign investment company” (“PFIC”) to file information returns as required by Treasury. This would be in addition to the filing requirements already imposed on shareholders of a PFIC and is effective as of March 18, 2010.

Foreign Trusts

Under current law, foreign trusts with U.S. owners or U.S. beneficiaries are subject to various reporting obligations. The failure to comply with the reporting obligations may result in the imposition of steep penalties on U.S. owners or U.S. beneficiaries. The Act includes several provisions affecting foreign trusts, including the following: (i) codification of current Treasury Regulations providing that even if a U.S. person’s trust interest is contingent, an amount is treated as accumulated for the benefit of such U.S. person, (ii) presumption that a foreign trust has a U.S. beneficiary if any U.S. person transfers property to the trust (unless certain information is provided to the Treasury Secretary), (iii) treatment of a trust as having a U.S. beneficiary unless the terms of the trust specifically prohibit any distributions to be made to U.S. persons, (iv) use of trust property by the U.S. grantor, U.S. beneficiary or a related party, would be treated as a distribution of the fair market value of the use of the property to such person, (v) imposition of additional filing requirements on a U.S. person that is treated as an owner of any portion of a foreign trust, and (vi) imposition of a minimum penalty of $10,000 in the case of a failure to file certain information returns.

Contact:

Thomas A. Humphreys
(212) 468-8006
thumphreys@mofo.com

Stephen L. Feldman
(212) 336-8470
sfeldman@mofo.com

Shamir Merali
(212) 336-4149
smerali@mofo.com

Remmelt A. Reigersman
(212) 336-4259
rreigersman@mofo.com

Armin Gharagozlou
(212) 336-4327
agharagozlou@mofo.com