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Tax Transactions Update
May 7, 2009

President Obama's International Tax Reform Proposals Regarding Offshore Accounts

On May 4, 2009, President Obama and Treasury Secretary Geithner unveiled two components of the Administration's plan relating to US international tax reform. The first component relates to certain changes to the deferral of foreign earnings and the foreign tax credit rules. The second component generally relates to abusive uses of accounts located in tax havens.

This second point is further segregated into those rules applicable to US businesses that utilize tax havens to avoid the application of certain anti-deferral provisions (i.e., through the use of the so-called "check the box" rules), and those rules applicable to individuals who hold accounts outside the United States, which may avoid current information reporting rules. This Client Update will address this last point — modification of the information reporting rules, the qualified intermediary (QI) program and foreign bank account reporting. A certain familiarity with the information reporting rules, foreign bank account reporting rules, recent legislative proposals relating to this subject and the QI program is presumed.

The Obama Administration hopes to build on prior legislative efforts relating to offshore tax havens in order to pass bipartisan legislation that would likely take effect after 2010. The Administration's proposal generally reflects the prior efforts of Senate Finance Committee Chairman Baucus and Sen. Levin. The highlights of the proposal are as follows:

- Strengthen anti-abuse rules aimed at individuals' abuse of tax havens by:
  - » Modifying the QI program to penalize foreign financial institutions that have not entered into QI Agreements with the IRS ("nonqualified intermediaries" or "NQIs") by imposing new withholding taxes on "US payments" to NQIs and evidentiary presumptions relating to satisfying Report of Foreign Bank and Financial Accounts (FBAR) requirements when an account held by a US citizen is located at an NQI.
  - » Prohibiting a financial institution from qualifying as a QI if any of its commonly controlled affiliates are NQIs.
  - » Increasing penalties relating to failure to file an FBAR or other required information reports relating to an offshore account and extending the statute of limitations for "international tax enforcement" to six years from the date the taxpayer submits required information.
  - » Significantly modifying information reporting requirements by requiring a QI to report US clients' information to the IRS in the same manner as a US financial institution, looking through foreign legal entities to report information relating to the US owner of such entity and requiring a QI to report transactions that establish a foreign legal entity or the

transfer of assets to or from a foreign account on behalf of an individual that is a US person.

 » Enacting rules that would require individuals who are US persons to report transfers of money or property to or from an NQI on their US income tax returns.

- Increase by 800 the IRS international enforcement staff.

The Administration states that its entire international tax proposal would generate approximately $210 billion over the next 10 years. The predominant amount of anticipated revenue is due to amendments aimed at US-controlled foreign businesses (e.g., changes to the anti-deferral, foreign tax credit and the so-called "check the box" rules). Only a relatively small amount of revenue, $8.7 billion, is anticipated to be generated by the changes to the rules applicable to individuals (described below). In this regard, it is possible that the Administration is seeking to utilize public support of policies that would end offshore tax avoidance by individuals in order to pass a sweeping series of international tax provisions that predominantly affect US-controlled multinational businesses and the subsidiaries of such businesses located in low-tax jurisdictions.

As a preliminary matter, it is interesting to note that the Administration's proposal does not contain a so-called blacklist. However, the proposal does reference the initiatives undertaken by the G-20 with respect to certain countries with inadequate information exchange practices, which suggests that the Administration's proposal is in addition to whatever global response is taken by the G-20, or presumably, the OECD or other international organizations. In this regard, the proposal would create certain presumptions that financial institutions that are not QIs are facilitating tax evasion, and the burden of proof will be shifted such that those institutions and their account holders will need to prove that they are not improperly avoiding US federal income tax. One apparent purpose of the Administration's proposal is to force foreign financial institutions to become QIs by penalizing NQIs and their QI affiliates while, at the same time, imposing additional reporting duties on QIs.

NQI Proposals

The Administration has proposed that a withholding tax be applied to payments made by an NQI to a US withholding agent. This withholding tax would be imposed at a rate of 20 to 30 percent and it is unclear whether it would be imposed in addition to or in lieu of the current US withholding tax imposed on payments of US source income to foreign persons. In order to avoid this additional withholding tax, a client of an NQI would need to disclose such client's identity and prove to the IRS that he or she is complying with applicable US tax laws. It is unclear whether this withholding tax would only be applicable to payments of US source income (e.g., dividends paid by US corporations), or whether *any* payment (e.g., sales proceeds, foreign source income payments made by a US paying agent, etc.) made by a US withholding agent to an NQI would be subject to the withholding tax.

The Administration would also adopt a proposal, similar to Sen. Levin's, to create a rebuttable presumption that any account held by a US citizen at an NQI would satisfy the reporting requirements relating to the FBAR. Moreover, the proposal would presume that the failure to file an FBAR would be considered "willful" for purposes of applying the associated failure-to-file penalties, if the account has a balance of more than $200,000 during the calendar year. Generally, the civil penalty for a willful failure-to-file the report is at least $10,000 or 50 percent of the balance of the account, whichever is greater. Additionally, criminal penalties could apply with respect to the willful failure to file an FBAR.

The Administration's proposal also would impose information reporting requirements on US persons who transfer money or other property to or from an NQI. In this regard, the information reporting requirement would be imposed on the US person as part of that person's US tax filing requirements.

Finally, the Administration intends to prohibit QIs from utilizing NQI affiliates to avoid the applicable information reporting rules. The proposal would revise the criteria by which a financial institution may qualify as a QI by giving Treasury the authority to prohibit a financial institution from qualifying as a QI if it has commonly controlled affiliates that are NQIs.

It is unclear whether this proposal would only apply to financial institutions that act as an intermediary for clients or whether these rules would be broad enough to cover trust or other asset management businesses conducted by financial institutions that do not operate as intermediaries for their customers. To the extent that this proposal is applied broadly to all commonly controlled affiliates of a QI, QIs and their affiliates will need to determine whether QI status is warranted in light of the likely increase in compliance costs associated with group-wide QI status.

Increased Penalties and Extension of Statute of Limitations

The Administration's proposal, similar to other recent legislative proposals, increases the penalties applicable to persons who fail to disclose offshore accounts. In this regard, the proposal would double the penalties applicable to a US person's failure to make a required disclosure of a foreign account. This rule would seem to apply to FBAR filings, and might also apply to other information filing requirements applicable to US persons. For example, it is possible that this rule might also apply to information reporting relating to the ownership or control of certain foreign corporations (i.e., Form 5471 reporting) and information reporting relating to foreign trusts (i.e., Form 3520 and Form 3520A reporting).

In addition, the Administration's proposal, like other recent legislative proposals, would extend the three-year statute of limitations with respect to international items to six years after the taxpayer submits required information.

Modifications to QI Program

Under currently applicable rules, there are limits on what information a QI is required to report to the IRS, including information regarding account holders that are US persons. In particular, there are exceptions to the information reporting rules relating to foreign source income or broker proceeds paid to US persons outside the United States. Additionally, a QI is not generally required to report information to the IRS with respect to US persons who indirectly own assets through a foreign corporation, which itself has an account at the QI. The Administration's proposals would change these long standing practices.

As a preliminary matter, the Administration proposes to require that all QIs conduct information reporting relating to US persons in the same manner as US financial institutions are required to report such information. In other words, a QI would no longer qualify for certain exceptions from information reporting that rely on the foreign status of the QI. For example, under this proposal a QI would be obligated to report US- and foreign-source dividends paid to a US person. Similarly, all sales proceeds relating to the sale of property that produces US-source income, as well as property that produces foreign-source income, would be subject to information reporting. Moreover, treating a QI as a US financial institution for information reporting purposes also raises information-reporting issues that are not traditionally addressed by QIs, such as the reporting of bank deposit interest, or other payments to US citizens (e.g., any amount exceeding $600).

Similar to other recent legislative proposals, the proposal would require information reporting with respect to a financial institution's formation of a foreign business entity that is owned by an individual that is a US person. Moreover, QIs would be required to also conduct information reporting with respect to all transfers of assets to or from a foreign financial account owned by an individual that is a US person. The expansion of a QI's obligation to conduct information reporting to all transfers to or from a US person's QI account would represent a significant increase in compliance costs as well as an increase in the volume of information provided to the IRS.

The Administration also proposes to modify the information-reporting rules applicable to US persons who indirectly hold accounts at a QI through a foreign entity that is treated as a corporation for US federal tax purposes. Under current US federal tax rules, a foreign corporation is generally considered the beneficial owner of income paid to it. Therefore, a US person may legitimately hold assets through a foreign corporation and avoid information reporting with respect to such US person under the QI agreement. However, the US person would need to also comply with the applicable information return requirements relating to the ownership of such foreign corporation.

If you have any questions regarding the above or would like to discuss these proposals further, please contact any of the attorneys listed here.

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