Foreign Account Tax Compliance Act of 2009

On October 27, 2009, Senators Baucus and Kerry, together with Representatives Rangel and Neal, introduced the Foreign Account Tax Compliance Act of 2009 (the "Act"). The bill is the product of consultation between Congress and the US Treasury Department (Treasury) and is intended to curb the abuse of offshore bank and investment accounts by US taxpayers. As Congress considers legislation that increases government spending, the Act could be paired with that legislation as a spending offset because it is projected to generate $8 billion in new revenue for the Treasury over the next ten years. This increases the possibility that the Act could be approved by Congress quickly, potentially before the current session comes to an end later this year. Additionally, if the Act is brought up for consideration, it is possible that other members of Congress will seek to amend it, including possibly Senator Levin, who is the author of the Stop Tax Haven Abuse Act, which he first introduced in February 2007 and on which then-Senator Obama joined as a cosponsor.

New Withholding Tax and Information Reporting Regime for Certain Payments to Non-US Financial Institutions

The Act would create a new reporting regime that effectively requires a non-US financial institution to provide full disclosure of a US person's account maintained at that institution. This new reporting regime would be in addition to the current withholding tax regime applicable to US source income paid to non-US persons and the qualified intermediary program (QI program) that generally governs the obligations of non-US financial institutions under the current US withholding tax regime applicable to US source income paid to non-US and US persons.

To the extent that a non-US financial institution does not enter into an agreement with the Treasury or the Internal Revenue Service (IRS) to provide information regarding US persons, a withholding tax will be imposed at a 30 percent rate on all payments to the non-US financial institution of US source income and gross proceeds relating to assets that produce US source income (not merely those payments attributable to US persons or US beneficial owners). Dual withholding would not be required under either the provisions of this bill or the current withholding rules applicable to US source payments. Non-US persons that would otherwise be permitted to obtain tax treaty benefits with respect to a payment of US source income, however, would not be entitled to treaty benefits in respect of this new withholding tax.

INFORMATION EXCHANGE BY NON-US FINANCIAL INSTITUTIONS WOULD ELIMINATE WITHHOLDING TAX

As a preliminary matter, the Act would create a new chapter of the Internal Revenue Code that provides for the imposition of a 30 percent withholding tax either on any payment to a non-US financial institution of US source income or with respect to gross proceeds from the sale of property that produces US source dividends or interest (Withholdable Payments). Accordingly, this withholding tax would apply to all Withholdable Payments made to the non-US financial institution (including those on assets held for the institution's own account), not merely those Withholdable Payments attributable to a US person. This withholding tax could be avoided only if the financial institution enters into an agreement with Treasury or the IRS to provide information relating to certain US persons that directly or indirectly maintain an account at such financial institution (Information Reporting Agreement).

The Information Reporting Agreement would require that the non-US financial institution (i) obtain information from each account owner to determine whether the account was a "United States account"[1] (US Accounts); (ii) comply with verification and due diligence rules relating to the identification of US Accounts (these requirements will be specified by regulation, but it is expected that these rules will be based upon the know your customer (KYC) standards for identifying US persons, including indirect account holders, that are followed in the anti-money laundering (AML) context); (iii) make an annual report of information with respect to its US Accounts (these requirements also would be specified by regulation); (iv) comply with requests by the United States to provide additional information with respect to these US Accounts; and (v) obtain appropriate waivers of local privacy laws from the owner of US Accounts or, to the extent not provided, close the account. Under the Act, information must be reported regarding US Accounts maintained by financial institution affiliates (including controlled partnerships) of a non-US financial institution that has entered into an Information Reporting Agreement.

The legislation authorizes Treasury to terminate an Information Reporting Agreement, and thereby subject an institution to the 30 percent withholding tax, if a determination is made that the non-US financial institution is not in compliance with the agreement. It is unclear under what circumstances such a determination would be made (e.g., whether a technical default would result in such a determination or whether some type of gross noncompliance is required).

NON-US FINANCIAL INSTITUTIONS MAY ELECT TO UNDERTAKE INFORMATION REPORTING AS IF THEY WERE US FINANCIAL INSTITUTIONS, SUBJECT TO CERTAIN MODIFICATIONS

As an alternative to the above information reporting requirements, non-US financial institutions could elect to comply with the information reporting obligations currently imposed on US financial institutions with respect to payments to US persons (i.e., reporting payments on Form 1099). In such case, an electing non-US financial institution would report payments to US Accounts as if the recipient of the payment were a US individual and the payment were considered made in the United States. Prior to making this election, non-US financial institutions should consider the differences between the applicable information reporting rules for US and non-US financial institutions. For instance, some non-US financial institutions may regard the needed changes to internal procedures, IT or other systems to comply with those information reporting rules applicable to US financial institutions as too burdensome, while others may not maintain certain records needed to comply with certain information reporting rules applicable to US financial institutions, such as tax basis reporting.

ALTERNATIVE INFORMATION REPORTING PROCEDURES AND REQUIREMENTS DIFFER FROM TRADITIONAL INFORMATION REPORTING UNDER THE QI AGREEMENT AND CURRENT US INFORMATION RULES

To the extent no election is made, the non-US financial institution would be obligated to provide certain identifying information regarding account holders that are specified US persons and substantial US owners of US owned foreign entities (e.g, name, address, taxpayer identification number). In addition, the non-US financial institution would be obligated to provide the account number, the account balance or value (determined pursuant to regulations issued by Treasury and the IRS) and the gross receipts and gross withdrawals or payments from the account (pursuant to rules to be determined by Treasury and the IRS). In effect, these rules would seem to require that the non-US financial institution provide the account statement relating to a US Account to the IRS.

DOCUMENTATION REQUIREMENTS FOR CERTIFYING NON-US STATUS

Non-US financial institutions would be permitted to rely on certifications (e.g., possibly a suitably modified Form W-8BEN) supplied by the account holder to confirm that the account is not a US Account, p rovided that neither the non-US financial institution nor any affiliate knows or has reason to know that any information provided in the certification is incorrect. The Act does not indicate whether these certifications must be transmitted to, or reviewed by, the IRS. Presumably, the non-US financial institution would be expected to utilize AML procedures to ensure that the certification of non-US status is reliable.

REFUND PROCEDURE LIMITED TO AMOUNTS BENEFICIALLY OWNED BY THE NON-US FINANCIAL INSTITUTION

The Act provides a refund procedure under which a non-US financial institution would be able to claim any applicable income tax treaty benefits to the extent the 30 percent withholding tax is applied to payments beneficially owned by that financial institution. However, there would be no similar refund procedure available for non-US persons that are clients of a financial institution subject to the withholding tax. In other words, non-US persons that hold accounts at non-US financial institutions that have not entered into an Information Reporting Agreement will lose any reduced rate of withholding tax provided pursuant to an applicable income tax treaty.

It appears that one purpose of including this provision is to coerce non-US financial institutions to enter into Information Reporting Agreements with the United States by potentially subjecting those institutions to a competitive disadvantage compared to institutions that have entered into those agreements.

EFFECTIVE DATE

As proposed, the Act will become effective as of December 31, 2010. This is very ambitious in light of the steps that would have to be taken by Treasury, the IRS and the affected institutions by the effective date. By way of comparison, the withholding tax regulations that created the QI program were first announced in 1996 and ultimately did not take effect until 2001. Even then, the IRS faced a significant backlog in reviewing and approving various countries' KYC regimes and entering into QI agreements with non-US financial institutions.

Even assuming Treasury and the IRS are able to meet the effective date, non-US financial institutions will be hard-pressed to accomplish the necessary due diligence required by the Act to determine whether their population of existing accounts involve a US person as owner or beneficiary. Modifications of IT and other systems in order to produce information in a format consistent with the requirements of Information Reporting Agreement, alone, are likely to take several months to implement. Accordingly, it is anticipated that organizations representing the interests of non-US banks will, among other things, seek additional flexibility concerning the effective date of any new reporting requirements.

Non-US Non-Financial Entities Must Disclose Substantial US Owners or Withholding Tax Imposed on US Source Payments

The Act also provides for a similar information reporting regime with respect to Withholdable Payments to non-US entities that are not financial institutions. Under this provision, withholding agents (including QIs) are required to deduct and withhold a 30 percent withholding tax on any Withholdable Payments made to a "non-financial foreign entity," unless the non-financial foreign entity generally provides identifying information about its substantial US owners (as discussed further below) or certifies that it does not have any substantial US owners. The term "non-financial foreign entity" includes *any non-US entity that is not a financial institution* (e.g. non-US hedge funds, non-US private equity funds, non-US trusts, non-US corporations or companies, non-US partnerships or other business vehicles).

Certain US source payments would be exempt from the withholding tax. These include payments beneficially owned by a foreign non-financial entity that is a public corporation or a member of an "expanded affiliated group"[2] of a publicly traded corporation. The withholding tax also does not apply to payments made to any foreign government, political subdivision of a foreign government or wholly owned agency or instrumentality of any foreign government; any international organization, foreign central bank of issue or any other class of persons identified by the Secretary for purposes of the Provision; or to any class of payments identified by the Secretary as posing a low risk of tax evasion. It is not entirely clear what methodology would be used to determine that a class of persons, or class of payments, pose a low risk of tax evasion given the number of entities potentially subject to this withholding tax or information reporting regime. We would expect that Treasury or the IRS would need to create administrable rules or risk creating a complex and burdensome system that would impose withholding tax on payments beneficially owned by persons that are not the intended target of this legislation.

As indicated above, information reporting must occur with respect to a non-financial foreign entity's substantial US owners or withholding tax would be imposed on US source payments beneficially owned by such entity. In order to avoid the imposition of the withholding tax, (i) the payee or the beneficial owner of the payment must provide the withholding agent with either: (A) a certification that the foreign entity does not have a substantial US owner or (B) the name, address and TIN of each substantial US owner; (ii) the withholding agent must not know or have reason to know that the certification or information provided regarding substantial US owners is incorrect; and (iii) the withholding agent must report the name, address, and TIN of each substantial US owner to the Secretary. It would be expected that Treasury or the IRS would need to create a methodology to certify that the entity does not have any substantial US owner, a means to verify certifications and, possibly, a refund mechanism for instances in which tax is improperly withheld due to documentation failures.

Dividend Equivalent Payments Received by Foreign Persons Shall Be Treated as Dividends

The Act provides for parity between actual dividend payments and dividend equivalent amounts for purposes of the withholding tax provisions (Chapter 3 and 4 of the Internal Revenue Code (the Code)). In particular, the Act provides that a "dividend equivalent" will be treated as a dividend from sources within the United States. For this purpose, the term "dividend equivalent" means any payment made pursuant to a notional principal contract that is, directly or indirectly, contingent upon, or determined by reference to, the payment of a dividend from sources within the United States. The term also includes any other payment that the Secretary determines is substantially similar to such a payment. The Joint Committee on Taxation (JCT) provides, as an example in its explanation of the Act, that the Secretary may conclude that payments under certain forward contracts or other financial contracts that reference stock of US corporations are dividend equivalents. A dividend equivalent payment would include the gross amounts that are used in computing any net amounts transferred to or from the taxpayer.

The Act also provides Treasury with regulatory authority to provide exceptions for certain payments that do not have the potential for tax avoidance. The Act specifies several factors that may be considered in making such a determination, including (i) the term of the contract; (ii) the amount of each party's investment and the amounts of any collateral posted; (iii) whether the price of the equity used to measure the parties' entitlements or obligations is based on an objectively observable price or the parties' actual execution prices; (iv) whether either party sells (directly or indirectly) to the other party the stock giving rise to US source dividends; and (v) whether there are terms that address the hedge position of either party or other conditions that would compel either party to hold or acquire the stock giving rise to US-source dividends.

The Act specifies that this provision would be effective with respect to payments that are made on or after the date that is 90 days after the date of enactment. Accordingly, one may presume that until Treasury exercises its regulatory authority to identify payments that do not have the potential for tax avoidance, there may be some disruption to the derivative markets that use assets that produce US source income as the reference security.

Repeal of Foreign Exceptions to Registered Bond Requirements

The Act would repeal several provisions of the Code that allow certain registration-required debt obligations to be issued in non-registered form. In particular, the Act would repeal the rules related to the foreign-targeted debt exception of section 163(f) and the portfolio debt exception of sections 871(h) and 881(c).

The Act would repeal section 163(f)(2)(B), which excludes from the definition of foreign-targeted obligation those obligations that are reasonably designed to ensure that the obligation will be sold (or resold) to a non-US person and where, with respect to obligations not issued in registered form, the interest on the obligation is payable only outside of the United States and the obligation contains a statement on its face indicating that any US holder of the obligation is subject to limitations under US income tax laws.

The repeal of this provision is likely to have broad impact as no deduction would be permitted with respect to an obligation not issued in registered form, unless the obligation is issued by a natural person, matures in one year or less or is not of a type offered to the public. Additionally, an excise tax would now apply to debt obligations that are not in registered form unless similar exceptions to those above are satisfied. Further, sellers of unregistered obligations that have not been subject to such excise tax would not obtain capital gain treatment with respect to gain derived from the sale of the obligation. A conforming amendment to the definition of registration-required obligation would cause all US government obligations to be required to be in registered form and similarly repeal the foreign-targeted obligation exception.

The practical result of this change would be that a list of owners of US government obligations and other publicly issued debt obligations would be maintained by the issuer of the debt obligation.

The Act would also repeal the rule that provides portfolio interest treatment to interest on bonds that are not issued in registered form yet satisfy the foreign-targeted exception of section 163(f)(2)(B). The Act would instead require that in order to qualify as portfolio interest (and be exempt from US withholding tax pursuant to the portfolio debt exception), the owner of the debt obligation would need to provide a statement certifying that the beneficial owner is not a US person. Thus, interest paid to a non-US person on an obligation that is not issued in registered form would be subject to US withholding tax imposed at a 30 percent rate, unless reduced by an applicable income tax treaty.

Advisors Required to Disclose Client's Formation or Acquisition of Non-US Entity

The Act creates section 6116 of the Code that would require certain advisors to disclose their assistance to a US individual who acquires or forms a non-US entity. In particular, the Act would require a "material advisor with respect to a foreign entity transaction" to file an information return that provides certain identifying information regarding the US individual and the foreign entity. For this purpose, the term "material advisor" means any person who provides any material aid, assistance or advice with respect to carrying out one or more foreign entity transactions and who directly or indirectly derives income in excess of $100,000 for providing such aid or assistance or advice during the calendar year.

The Act defines the term "foreign entity transaction" to mean the direct or indirect acquisition of any interest in a non-US entity (including any interest acquired in connection with the formation of such entity) if any US citizen or US resident is required to file an information report under section 6038 (returns for U.S controlled corporations), 6038B (returns for certain transfers to non-US persons), 6046 (returns with respect to the organization or reorganization of non-US corporations and acquisitions of the stock of non-US corporations), 6046A (returns with respect to US person's interest in non-US partnerships) and 6048 (information returns with respect to non-US trusts).

The explanation of the Act provided by the JCT suggests that material advice would include tax or other advice related to the acquisition or creation of the non-US entity. Moreover, the JCT explanation provides that the acquisition of an interest in a non-US entity is intended to include the acquisition of so-called shelf corporations and similar entities.

Failure to provide the required information return within the time provided by Treasury or the IRS subjects the material advisor to a penalty of the greater of $10,000 or 50 percent of the gross income derived by the material advisor for the advice provided with respect to the transaction. The Act provides for a reasonable cause exception to the failure to file the information return in a timely manner.

Passive Foreign Investment Company Reporting

Under current law, a shareholder of a passive foreign investment company (PFIC) is generally required to file certain information (e.g., Form 8621, "Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund") for each tax year in which the US shareholder recognizes gain from the disposition of PFIC stock, receives distributions from a PFIC or makes certain elections with respect to their ownership of PFIC stock. Accordingly, under current law a shareholder of a PFIC may avoid information

reporting on an annual basis to the extent that none of the current reporting obligations are triggered. The Act would modify the PFIC reporting rules to require annual information reporting, pursuant to rules prescribed by Treasury and the IRS.

Provisions Relating to Foreign Trusts

EXPANSION OF FOREIGN TRUSTS TREATED AS HAVING US BENEFICIARIES

The Act codifies certain of the grantor trust rules that treat certain non-US trusts as having a US beneficiary that is considered the owner of the trust. In particular, the Act provides that any non-US trust that grants any person the discretion (by authority given in the trust agreement, by power of appointment or otherwise) to make a distribution from a trust to, or for the benefit of, any person (sometimes referred to as "discretionary trust"), is treated as having a US beneficiary unless the terms of the trust specifically identify the class of persons to whom such distributions may be made and none of those persons are US persons during the taxable year. In conjunction with the withholding provisions of the bill, this provision would require withholding tax be applied to all instances in which a non-US trust has granted discretion to a trustee to make trust distributions without specifying that the potential beneficiaries of the trust do not include US persons.

This provision is likely to raise significant concerns for those persons that have non-US discretionary trusts. To the extent that trusts are not suitably modified and annually certified as having no US beneficiaries, the trust could be considered owned by a US person and any account owned by the trust in a non-US financial institution would be treated as a US account for purposes of the information reporting and withholding tax rules discussed above. Thus, the failure to revise the trust documents to comply with this provision and to provide annual certifications could subject the trust to closure of its bank account (as a US account that has not provided the requisite information to the non-US financial institution) and may subject the non-US financial institution to the 30 percent withholding tax for failure to comply with its Information Reporting Agreement.

PRESUMPTION THAT FOREIGN TRUST HAS UNITED STATES BENEFICIARY

The Act provides that where a US person directly or indirectly transfers property to a non-US trust, the non-US trust will be presumed to have a US beneficiary for purposes of section 679 (non-US trusts having one or more US beneficiaries) unless the US person that directly or indirectly transfers property submits information (as required by Treasury and the IRS) that demonstrates that (i) under the terms of the trust, no part of the income or corpus of the trust may be paid or accumulated during the taxable year to or for the benefit of a US person and (ii) if the trust were terminated during the taxable year, no part of the income or corpus of the trust could be paid to or for the benefit of a US person.

TREATMENT OF UNCOMPENSATED USE OF TRUST PROPERTY AS A DISTRIBUTION

The Act expands certain rules that provide that loans of cash or marketable securities by a non-US trust to a US grantor, beneficiary or other US person related to the US grantor or beneficiary is treated as a distribution of the fair market value (FMV) of the use of the property to the US grantor or beneficiary. The use is not treated as a distribution to the extent that the FMV of the property is paid to the trust within a reasonable period of time.

Similarly, for purposes of determining whether a non-US trust has a US beneficiary under section 679, the Act provides that a loan of cash or marketable securities or the use of any other trust property by a US person is treated as a payment from the trust to the US person in the amount of the loan or the FMV of the use of the property, except to the extent that the US person repays the loan at a market rate of interest or pays the FMV for the use of the property within a reasonable period of time.

EXPANDED REPORTING REQUIREMENT AND NEW MINIMUM PENALTY

The Act expands the reporting requirements relating to non-US trusts that are considered under the trust rules to have a US owner. Generally, the US owner would be required to provide the requested information in addition to ensuring that the non-US trust complies with any reporting obligations it may have.

The Act also modifies the minimum penalty that would apply to failure to report information relating to a non-US trust.

Other Provisions

The Act also requires that all withholding agents that are financial institutions file their information reporting returns electronically, unlike current law that permits financial institutions to file paper returns in cases where the institution would be required to file less than 250 returns during the year.

The Act also provides for certain additional information reporting rules applicable to individuals that own non-US accounts. As a general matter, these rules provide for penalties for failure to report non-US financial assets owned by a US citizen or resident. These rules are generally similar to what is currently required to be reported on TD F 90-22.1, Report of Foreign Bank and Financial Accounts (FBAR), but they would also reach non-US assets owned outside of an account relationship with a non-US financial institution (e.g., non-US stocks or debt obligations). The Act would impose an increased accuracy related penalty for understatements attributable to undisclosed foreign financial assets that were not reported under the information reporting regime applicable to non-US financial assets.

The Act authorizes a new six-year statute of limitations period for assessment of tax on understatements of income attributable to non-US financial assets.

Endnotes

1 For this purpose, the term "United States account" generally means a deposit or custody account that is owned by "specified US persons" or "US owned foreign entities." The term "specified US persons" means all US persons other than certain identified persons, such as publicly traded corporations and tax exempt entities. The term "US owned foreign entities" means any non-US entity owned by one or more "substantial US owners." The term "substantial US owner" means (i) with respect to a corporation, any specified US person that owns, directly or indirectly, more than 10 percent of the corporation (by vote or value), (ii) with respect to a partnership, any specified US person that owns, directly or indirectly, more than 10 percent of the profits or capital interest in such partnership, and (iii) in the case of any trust, any specified US person that is treated as an owner of any portion of the trust under the grantor trust rules. A non-US financial institution may elect to exclude from treatment as a US Account any depository account owned by an individual located at the financial institution and its affiliates that has an aggregate value of less than $10,000 (or $50,000 for existing accounts).

2 For this purpose, the term "expanded affiliated group" means an affiliated group as defined in section 1504(a) (generally, certain commonly controlled chains of corporations), determined by substituting more than 50 percent for 80 percent each place it appears, and without regard to paragraphs (2) (insurance companies) and (3) (foreign corporations) of section 1504(b). For this particular purpose, the term excludes partnerships that are commonly controlled by publicly traded entities.

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