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CCH BRIEFING *Special Report*

Jobs Bill Places Offshore Financial Firms under Reporting and Tax Regime

Highlights

- ✔ New reporting and tax withholding requirements imposed
- ✔ Most foreign investment firms and entities covered
- ✔ IRS agreements specified for reporting, in lieu of withholding
- ✔ Qualified Intermediary program participants not exempted
- ✔ IRS authorized to establish verification and due-diligence procedures
- ✔ Bearer bond tax sanction extended to foreign markets
- ✔ Penalty for underreporting foreign financial assets imposed
- ✔ Rules for determining if foreign trust has U.S. beneficiaries codified
- ✔ Dividend-equivalent payments subjected to withholding

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The Hiring Incentives to Restore Employment Act (HIRE), HR 2847, creates a vast new reporting and taxing regime for foreign financial institutions with U.S. accountholders. Under Title V, the Foreign Account Tax Compliance Act, the legislation casts a wide net in search of undisclosed accounts and hidden income. It adds a new Chapter 4 to the Internal Revenue Code, essentially requiring foreign financial institutions to identify their customers who are U.S. persons or U.S.-owned foreign entities and then report to the IRS on all payments to, or activity in the accounts of, those persons. Participation in the existing Treasury Qualified Intermediary program will not exempt a firm from the new reporting obligations.

The legislation's principal focus is tax compliance by U.S. persons that have accounts with foreign financial institutions. The Act imposes substantial new reporting and tax-withholding obligations on a broad range of foreign financial institutions that could potentially hold accounts of U.S. persons. The reporting and withholding obligations imposed on the foreign financial institutions will serve as a backstop to the existing obligations of the U.S. persons themselves, who have a duty to report and pay U.S. tax on the income they earn through any financial account, foreign or domestic. These new reporting obligations for financial institutions will be enforced through the imposition of a 30-percent U.S. withholding tax on a wide range of U.S. payments to foreign financial institutions that do not satisfy the reporting obligations.

The legislation provides substantial flexibility to Treasury and the IRS to issue regulations detailing how the new reporting and withholding tax regime will work. It also gives Treasury broad authority to establish verification and due-diligence procedures with respect to a foreign financial institution's identification of any U.S. accounts.

Impact: *Industry representatives have voiced concerns that thousands of foreign investment entities, including hedge funds, private equity funds, mutual funds, securitization vehicles and other investment funds, will have to enter into agreements with the IRS pursuant to new Chapter 4. Implementation of new Chapter 4 will, they believe, present many operational challenges and expenses for foreign financial institutions.*

New Chapter 4 also provides for withholding taxes as a means to enforce new reporting requirements on specified foreign accounts owned by specified U.S. persons or by U.S.-owned foreign entities. The provision establishes rules for withholdable payments to foreign financial institutions and for withholdable payments to other foreign entities. The Act will essentially present foreign financial institutions, foreign trusts and foreign corporations with the choice of entering into agreements with the IRS to provide information

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about their U.S. accountholders, grantors and owners or becoming subject to 30-percent withholding.

The legislation will increase the disclosure of beneficial ownership. As a tax enforcement tool, U.S. financial institutions must file annual information returns disclosing and reporting on the activities of bank accounts held by U.S. individuals. Congress believes that many Americans looking to evade their tax obligations in the United States have sought to hide income and assets from the IRS by opening secret foreign bank accounts with foreign financial institutions. Some foreign financial institutions have agreed to provide information on the U.S.-source income of U.S. accountholders as part of the Treasury's Qualified Intermediary program established in 2000.

Covered Institutions

The HIRE Act defines "foreign financial institution" broadly to include many securities firms and investment vehicles. Firms meeting the definition must enter into agreements with the IRS and report information annually in order to avoid a new U.S. withholding tax on U.S.-source dividends, interest and other income, as well as U.S.-related gross proceeds. The Act also imposes related reporting and tax withholding requirements in respect of payments made to non-financial foreign entities.

The reach of the legislation goes beyond traditional financial institutions and covers virtually every type of foreign investment entity. The Act broadly defines foreign financial institution to comprise not only foreign banks but also any foreign entity engaged primarily in the business of investing or trading in securities, partnership interests, commodities or any derivative interests therein. According to the Joint Committee on Taxation, investment vehicles such as hedge funds and private equity funds will fall within this definition. The new regime also covers fund entities and fund managers who are not currently within the scope of the Qualified Intermediary program.

Also affected by the legislation are typical offshore securitization vehicles that hold U.S assets and issue their own equity and debt securities, such as collateralized debt obligation (CDO) issuers. These securitization vehicles presumably constitute foreign financial institutions under the legislation. As such, they will have to enter into an information-reporting agreement with the IRS and report on U.S. holders of non-publicly-traded debt and equity that they have issued, or otherwise be subject to the withholding tax on their U.S. investments. Foreign securitization vehicles currently in existence have invested billions of dollars in the United States, particularly in loans and other debt instruments issued by U.S. companies.

A typical CDO is structured as an offshore corporation that invests in loans and other debt instruments issued by U.S. companies. These CDOs, in turn, issue several classes of non-publicly-traded debt and equity securities themselves, which divide up the cash flows on the underlying U.S. investments. Another example of a typical securitization vehicle is a grantor trust that invests in U.S. debt or equity investments and, in turn, issues pass-through certificates representing the cash flows on those investments. Pass-through interests in U.S. investments could also be structured as shares of an offshore cell company.

The legislation's principal goal is to collect tax from U.S. taxpayers who have evaded their responsibilities by investing through foreign financial institutions and foreign entities not subject to IRS reporting obligations. To achieve this goal, the legislation imposes the risk of a withholding tax on a broad class of U.S.-related payments (including gross proceeds) to a broad class of foreign investors, unless the foreign financial institutions and foreign entities agree to provide information to the IRS regarding their U.S. account holders and owners. Essentially, the withholding tax will function as a "hammer" to induce reporting.

Many of the foreign financial institutions that hold accounts on behalf of U.S. persons fall outside the reach of U.S. law. As a result, the current ability of the United States to require foreign financial institutions to disclose and report on U.S. accountholders is significantly limited. Although these foreign financial institutions are outside the direct reach of U.S. law, many of them have substantial investments in U.S. financial assets or hold substantial U.S. financial assets for the account of others.

The federal government imposes a tax on the beneficial owner of income, not its formal recipient. For example, if a U.S. citizen owns securities that are held in street name at a brokerage firm, that U.S. citizen (and not the brokerage-firm nominee) is treated as the beneficial owner of the securities. A corporation (and not its shareholders) ordinarily is treated as the beneficial owner of the corporation's income. Similarly, a foreign complex trust ordinarily is treated as the beneficial owner of income that it receives, and a U.S. beneficiary or grantor is not subject to tax on that income unless and until he or she receives a distribution.

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Information-Sharing Agreements

The HIRE Act imposes a 30-percent withholding tax on certain income from U.S. financial assets held by a foreign financial institution unless the foreign financial institution agrees to: (1) disclose the identity of any U.S. individual that has an account with the institution or its affiliates; and (2) annually report on the account balance, gross receipts and gross withdrawals and payments from the account. Foreign financial institutions also must agree to disclose and report on foreign entities that have substantial U.S. owners. These disclosure and reporting requirements are in addition to any requirements imposed under the Qualified Intermediary program. It is expected that foreign financial institutions will comply with these disclosure and reporting requirements in order to avoid paying this withholding tax.

In addition to requiring 30-percent withholding on the expanded category of withholdable payments for financial institutions that do not enter into an agreement with the IRS, new Internal Revenue Code Section 1474(b)(2) will deny a credit or refund to a foreign financial institution that is the beneficial owner of a payment except to the extent that the firm is eligible for a reduced treaty rate of withholding. The section will also deny interest on refunds.

The agreement between the IRS and the foreign financial institution must contain several provisions. Specifically, the foreign financial institution must obtain information regarding each holder of each account maintained by the firm as is necessary to determine which accounts are U.S. accounts, to comply with verification and due-diligence procedures with respect to the identification of U.S. accounts, and to report annually information with respect to any U.S. account maintained by the firm. The foreign financial institution must also deduct and withhold 30 percent from any pass-through payment that is made to a recalcitrant account holder or another financial institution that does not enter into an agreement. A pass-through payment is any withholdable payment or payment that is attributable to a withholdable payment.

A "recalcitrant account holder" is defined as any account holder that fails to comply with reasonable requests for information necessary to determine if the account is a U.S. account; fails to provide the name, address, and TIN of each specified U.S. person and each substantial U.S. owner of a U.S. owned foreign entity; or fails to provide a waiver of any foreign law that would prevent the foreign financial institution from reporting any information required under this provision.

Importantly, the foreign financial institution must agree with the IRS to try to obtain a waiver when foreign law would prevent the reporting of information required by the provision with respect to any U.S. account and to close the account if a waiver is not obtained from each account holder within a reasonable time period. Finally, the foreign financial institution must comply with any Treasury verification and due-diligence procedures for identifying U.S. accounts, as well as requests for additional information with respect to any U.S. account. The Act defines a "U.S. account" as any financial account held by one or more specified U.S. persons or U.S.-owned foreign entities but does not include accounts of $50,000 or less held by natural persons.

If the Secretary determines that a foreign financial institution is not complying with the agreement, the Secretary may terminate the agreement.

Qualified Intermediary Program

This new reporting and withholding regime is in addition to the vital role many foreign financial institutions currently play in contributing to U.S. tax compliance and enforcement through their participation in the Qualified Intermediary ("QI") program. The IRS set up the QI program to help ensure compliance when offshore transactions occur.

Under the program, foreign financial institutions voluntarily report income earned and taxes withheld on U.S.-source income, providing some assurance that taxes on U.S.-source income sent offshore are properly withheld and that income is properly reported. Foreign financial institutions that are part of the QI program assume responsibility for ensuring the proper imposition of the U.S. withholding tax with respect to the foreign persons that hold accounts with those institutions. This means that the foreign financial institution agrees to collect identifying documentation from its customers, withhold U.S tax based on that documentation, and deposit the withheld tax with the IRS. It also agrees to submit to periodic audits performed by external auditors supervised by IRS examiners.

The additional obligations under the new regime will substantially increase the U.S. reporting and withholding responsibilities of those foreign financial institutions that currently participate in the QI program. Specifically, it will require the determination of the tax status of all customers in order to identify any U.S. persons and the reporting of all payments to, or activity in the accounts of, any U.S. customers. In addition, the proposed new regime will extend to thousands of foreign financial institutions, including very small institutions, which fall outside the QI program's coverage either because they do not handle the kinds of U.S. investments that are covered by QI rules or because they have not entered into a QI agreement.

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Non-Financial Foreign Entities

The Act adds a new Section 1472 to the Internal Revenue Code to deal with withholdable payments to non-financial foreign entities, which it defines as any foreign entities that are not financial institutions. Specifically, the legislation requires a withholding agent to deduct and withhold a tax equal to 30 percent of any withholdable payment made to a non-financial foreign entity if the beneficial owner of the payment is a non-financial foreign entity that does not meet specified requirements.

A non-financial foreign entity meets the requirements of the provision, and payments made to it will not be subject to the imposition of 30-percent withholding tax, if the payee or the beneficial owner of the payment provides the withholding agent with either: (1) a certification that the foreign entity does not have a substantial U.S. owner; or (2) the name, address and TIN of each substantial U.S. owner. The Act defines a "substantial U.S. owner" as a person who owns more than ten percent of the company's stock or is entitled to more than ten percent of the profits in a partnership. In the case of an investment firm, however, that limit is reduced from ten percent to zero.

Additionally, the withholding agent cannot know or have reason to know that the certification or information provided regarding substantial U.S. owners is incorrect, and the withholding agent must report the name, address and TIN of each substantial U.S. owner to the Secretary.

Carve-Outs

The legislation provides a carve-out for corporations whose stock is regularly traded on an established securities market. The carve-out is presumably based on a congressional belief that the risk of tax evasion in connection with a publicly-traded corporation is low. Similarly, the legislation provides a carve-out for charitable and other organizations that are exempt from tax under IRC Section 501(a), again presumably because these entities pose a low risk of being used to facilitate U.S. tax evasion. A further carve-out is provided for SEC-regulated investment companies.

Verification and Due Diligence

The HIRE Act does not mandate any particular method or procedure to identify U.S. accounts. As noted, however, the legislation does give Treasury broad authority to establish verification and due-diligence procedures with respect to a foreign financial institution's identification of any U.S. accounts. It is expected that, in identifying U.S. accounts, foreign financial institutions will employ know-your-customer techniques, as well as any procedures and rules that the Secretary may prescribe, both with respect to due diligence by the foreign financial institution and verification by or on behalf of the IRS to ensure the accuracy of the information, documentation or certification obtained to determine if the account is a U.S. account.

The Secretary may use existing know-your-customer, anti-money-laundering, anti-corruption and other regulatory requirements as a basis in crafting due-diligence and verification procedures in jurisdictions where those requirements provide reasonable assurance that the foreign financial institution is in compliance with the legislation's requirements.

Under the current QI program, QIs have long been able to rely on know-your-customer documentation in lieu of obtaining certifications in appropriate cases. The U.S. know-your-customer rules require financial institutions to develop and maintain a written customer-identification program and anti-money laundering policies and procedures. In addition, financial institutions must perform customer due diligence. The due-diligence requirements are enhanced where the account or the financial institution has a higher risk profile.

Generally, a customer-identification program requires the financial institution, at a minimum, to collect the name, date of birth (for individuals), address and identification number for new customers. In fulfilling their customer due-diligence requirements, institutions must verify enough customer information to enable the firm to form a reasonable belief that it knows each customer's true identity.

In many cases, the know-your-customer rules do not require firms to look through an entity to determine its ultimate ownership. However, based on its risk assessment, the financial institution may have to obtain information about individuals with authority or control over such an account in order to verify the customer's identity.

Industry Concerns

Securities industry representatives have voiced concerns that the HIRE Act will necessitate costly reporting systems that will be extremely difficult to implement. Moreover, even if building those reporting systems were feasible, their use may be impermissible under U.S. and foreign securities, data-protection and privacy laws.

For example, the sharing of relevant information may be prohibited under the so-called Chinese walls required under U.S. securities laws. Specifically, the Exchange Act

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requires broker-dealers to adopt policies and procedures designed to prevent insider trading and tipping, and the Investment Advisers Act requires investment advisers to establish policies and procedures reasonably designed to prevent insider trading and tipping.

In part to avoid SEC reporting requirements, many collective investment vehicles established in European countries go to some lengths to exclude U.S. investors. In these cases, the application form and prospectus will typically provide that the fund is not open to U.S. investors. If a U.S. investor incorrectly states that he or she is eligible to invest and the fund manager subsequently discovers that the investor is a U.S. citizen, the investor will have to redeem his or her investment immediately, at net asset value at that time. Accordingly, EU associations have urged that IRS regulations exempt from the new reporting regime investment funds that specifically prohibit investment by U.S. persons.

EU groups have also asked the IRS to consider a more general exemption from the new regime for widely-held and regulated collective-investment vehicles, especially in situations where particular administrative difficulties apply. EU countries typically have wide-ranging regulations that determine the nature of investments, risk profile, diversification strategies and levels of gearing that a fund can have, and highly prescriptive rules as to the nature, content and distribution of a fund's legal, financial and marketing documentation. In the case of the EU UCITS Directive, the pan-European regulated retail fund directive, these rules are onerous. With these funds, a lone investor can have no control over the investment strategy or the continued existence of the fund, which would make such a fund a less attractive vehicle for tax evasion by larger investors.

There is also concern that the legislation contemplates the sharing of personal client information with the U.S. government, as well as between affiliated companies across multiple jurisdictions. This disclosure and information-sharing would potentially violate the privacy and confidentiality laws of various countries.

Registered Bond Requirements

The HIRE Act also extends the bearer-bond tax sanction to bearer bonds designed for foreign markets. Bearer bonds, which are bonds that do not have an official record of ownership, allow individuals to invest anonymously. Recognizing the potential for U.S. individuals to take advantage of bearer bonds to avoid U.S. taxes, President Reagan and Congress took steps in 1982 to eliminate bearer bonds in the United States. First, they prevented the U.S. government from issuing bearer bonds that would be marketed to U.S. investors. Second, they imposed sanctions on issuers of bearer bonds that could be purchased by U.S. investors.

Under these sanctions, the issuer of such a bearer bond cannot claim any interest deductions on the bond, the earnings and profits of a corporation are generally not reduced by the amount of any interest on the bond, and interest on the bond will not qualify for any applicable tax exemption, such that applicable to municipal bonds.

Furthermore, certain issuers of these bearer bonds are also subject to an excise tax equal to one percent of the bond's principal amount multiplied by its term. If the issuer of the bearer bond is not subject to the excise tax, then the holder will face additional sanctions that apply when the bond is sold, exchanged or lost or becomes worthless. The additional sanctions include loss of capital gains treatment and denial of loss deductions.

Because the federal government is asking other countries to eliminate opportunities for U.S. investors to purchase bearer bonds issued outside the United States, the Act extends these sanctions, other than the excise tax, to bearer bonds that are marketed to foreign investors and prevents the U.S. government from issuing any bearer bonds.

Specifically, the legislation repeals the foreign-targeted-obligation exception to the denial of a deduction for interest on bonds not issued in registered form. Thus, a deduction for interest is disallowed with respect to any obligation not issued in registered form, unless that obligation is issued by a natural person, matures in one year or less, or is not of a type offered to the public.

The Act preserves the ordinary-income treatment under present law of any gain realized by the beneficial owner from the sale or other disposition of a registration-required obligation that is not in registered form. Similarly, it does not change the present rule disallowing deductions for losses realized by a beneficial owner of a registration-required obligation that is not in a registered form.

The foreign-targeted-obligation exception is available with respect to the excise tax applicable to issuers of registration-required obligations that are not in registered form. Thus, the excise tax applies with respect to any obligation that is not in registered form unless the obligation is issued by a natural person, matures in one year or less, is not of a type offered to the public, or is a foreign targeted obligation.

The legislation repeals the treatment as portfolio interest of interest paid on bonds that are not issued in registered form but meet the foreign targeting requirements of IRC Section 163(f)(2)(B). Interest qualifies as

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portfolio interest only if it is paid on an obligation that is issued in registered form and either the beneficial owner has provided the withholding agent with a statement certifying that the beneficial owner is not a U.S. person or the Secretary has determined that the statement is not required to carry out the purposes of the subsection.

It is anticipated that Treasury may exercise its authority under this rule to waive the requirement of collecting Forms W-8 in circumstances in which the Secretary has determined there is a low risk of tax evasion and there are adequate documentation standards within the country of tax residency of the beneficial owner of the obligations in question.

Generally, however, as a result of the provision, interest paid to a foreign person on an obligation that is not issued in registered form is subject to U.S withholding tax at a 30-percent rate, unless the withholding agent can establish that the beneficial owner is eligible for an exemption from withholding other than the portfolio-interest exemption or for a reduced rate of withholding under an income-tax treaty.

The legislation also provides that a debt obligation held through a dematerialized book entry system is treated, for purposes of IRC Section 163(f), as held through a book entry system for the purpose of treating the obligation as being in registered form. A debt obligation that is formally in bearer form is treated, for the purposes of Section 163(f), as held in a book-entry system as long as the debt obligation may be transferred only by book entries and the holder of the obligation does not have the ability to withdraw the obligation from the book-entry system and obtain a physical certificate in bearer form in the ordinary course of business. The issuance of physical certificates in bearer form in the event that the book-entry system goes out of existence would be an extraordinary event that is not in the ordinary course of business.

Under-Reporting of Foreign Assets

U.S. persons who transfer assets to, and hold interests in, foreign bank accounts or foreign entities may be subject to self-reporting under both the Internal Revenue Code and the Bank Secrecy Act.

Since its enactment, the Bank Secrecy Act has been expanded beyond its original focus on large currency transactions, while retaining its broad purpose of obtaining self-reporting of information useful to criminal, tax or regulatory investigations or proceedings. As the reporting regime has expanded, reporting obligations have been imposed on both financial institutions and account holders. With respect to account holders, a U.S. person doing business in the United States must keep records and file reports when entering into a transaction or maintaining an account with a foreign financial agency.

The Bank Secrecy Act requires that this disclosure contain the identity and address of participants in a transaction or relationship, the legal capacity in which the participants are acting, the identity of real parties in interest, and a description of the transaction.

Treasury Form TD F 90-22.1, the FBAR, must be filed by June 30 of the year following the year in which a $10,000 filing threshold is met. The FBAR is filed with the Treasury Department. Although the obligation to file an FBAR arises under Title 31, individual taxpayers subject to the FBAR reporting requirements are alerted to this requirement in the preparation of annual federal income-tax returns.

The FBAR requires disclosure of any account in which the filer has a financial interest or as to which the filer has signature or other authority (in which case, the filer must identify the owner of the account).

The HIRE Act adds Section 6038D to the Internal Revenue Code to impose a foreign-financial-asset reporting requirement on any individual who holds more than $50,000 (in the aggregate) in a depository or custodial account maintained by a foreign financial institution or any foreign stock, interest in a foreign entity, or financial instrument with a foreign counterparty not held in a custodial account of a financial institution. Such an individual must report information about these accounts and assets to Treasury with his or her annual tax return. Failure to comply with this requirement would incur a penalty of $10,000, and higher penalties (up to $50,000) could apply if the failure was not remedied within 90 days following notification from Treasury.

To the extent the Secretary determines that the individual has an interest in one or more foreign financial assets, but the individual does not provide enough information to enable the Secretary to determine the aggregate value, the aggregate value will be presumed to exceed $50,000 for purposes of assessing the penalty.

Although the information required under the legislation is similar to the information disclosed on an FBAR, it is not identical. For example, a beneficiary of a foreign trust who is not subject to FBAR reporting requirements because his or her interest in the trust is less than 50 percent may still have to

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disclose the interest on his or her tax return under this provision if the value threshold is met. Nothing in this provision is intended as a substitute for compliance with the FBAR reporting requirements, which are unchanged by this provision.

Specified foreign financial assets are depository or custodial accounts at foreign financial institutions and, to the extent not held in an account at a financial institution, stocks or securities issued by foreign persons, 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 any interest in a foreign entity. The information to be included on the statement includes identifying information for each asset and its maximum value during the taxable year. For an account, the name and address of the institution at which the account is maintained and the account number are required.

For a stock or security, the name and address of the issuer and any other information necessary to identify the stock or security and terms of its issuance must be provided. For all other instruments, contracts or interests in foreign entities, the information necessary to identify the nature of the instrument, contract or interest must be provided, along with the names and addresses of all foreign issuers and counterparties.

An individual need not disclose interests that are held in a custodial account with a U.S. financial institution. An individual also does not have to identify separately any stock, security instrument, contract, or interest in a foreign financial account disclosed under the provision. In addition, the provision permits the Secretary to issue regulations that would apply the reporting obligations to a domestic entity in the same manner as if the entity were an individual if that domestic entity is formed or availed of to hold such interests, directly or indirectly.

The legislation also imposes a penalty equal to 40 percent of the amount of any understatement that is attributable to an undisclosed foreign financial asset, i.e., any foreign financial asset that a taxpayer must, but does not, disclose on an information return.

This new accuracy-related penalty is subject to the same defenses as are otherwise available under IRC Section 6662. Regulations provide that reasonable cause exists in cases in which the taxpayer reasonably relies in good faith on the opinion of a professional tax advisor, if the opinion: (1) is based on the tax advisor's analysis of the pertinent facts and authorities; and (2) unambiguously states that the tax advisor concludes that there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld if challenged by the IRS. [Reg. §§ 1.6662-4(g)(4)(i)(B), 1.6664-4(c).]

The term "undisclosed foreign financial asset" includes all assets subject to certain information-reporting requirements for which the required information was not provided by the taxpayer. An understatement is attributable to an undisclosed foreign financial asset if it is attributable to any transaction involving the asset.

Thus, a U.S. person who fails to comply with the various self-reporting requirements for a foreign financial asset, and who engages in a transaction involving that asset, will incur a penalty on any resulting underpayment that is double the otherwise applicable penalty for substantial understatements or negligence. For example, if a taxpayer fails to disclose amounts held in a foreign financial account, any underpayment of tax related to the transaction that gave rise to the income would be subject to the penalty provision, as would any underpayment related to interest, dividends or other returns accrued on these undisclosed amounts.

Statute of Limitations

Under present law, additional federal tax liabilities in the form of tax, interest, and penalties must be assessed by the Internal Revenue Service within three years after the date a return is filed. If an assessment is not made within the required time period, the additional liabilities generally cannot be assessed or collected at any future time. However, the three-year limitations period is extended to six years when there is a substantial omission of an amount equal to or greater than 25 percent of the gross income reported on the return.

Without changing the existing six-year extension, the HIRE Act authorizes a new six-year limitations period for assessment of tax on understatements of income attributable to foreign financial assets when the omission exceeds $5000. It also clarifies that the statute of limitations does not begin to run until the taxpayer files the information return disclosing the taxpayer's reportable foreign assets. This additional time gives the IRS an opportunity to identify the omission and determine the taxpayer's correct tax liability. In particular, it is often difficult for the IRS to identify omissions that arise in connection with foreign assets.

The legislation also suspends the limitations period for assessment if a taxpayer fails to provide timely information returns required with respect to passive foreign investment corporations and the new self-reporting of foreign financial assets. The limitations period will not begin to run until the information required by those provisions has been furnished to the Secretary.

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Passive Foreign Investment Companies

Under present law, shareholders of passive foreign investment companies do not have to file an information return with the IRS unless: (1) they recognize gain on the sale of passive foreign investment company stock; (2) they receive a distribution from such a company; or (3) the investment company makes a reportable election. The Act requires shareholders of passive foreign investment companies to file an annual report containing this information as Treasury may require.

Active foreign business income derived by a foreign corporation with U.S. owners is not subject to current U.S. taxation until the corporation makes a dividend distribution to those owners. Certain rules, however, restrict the benefit of deferral of U.S. tax on income derived through foreign corporations. One such regime applies to U.S. persons who own the stock of passive foreign investment companies, which is any foreign corporation if 75 percent or more of its gross income for the taxable year consists of passive income, or 50 percent or more of its assets consist of assets that produce, or are held for the production of, passive income.

Various income-inclusion rules apply to U.S. shareholders of a passive foreign investment company, regardless of their percentage of ownership in the company. One set of rules applies to passive foreign investment companies under which U.S. shareholders pay tax on certain income or gain realized through the companies, plus an interest charge intended to eliminate the benefit of deferral. A second set of rules applies to passive foreign investment companies that are qualified electing funds, under which electing U.S. shareholders currently include in gross income their respective shares of the company's earnings, with a separate election to defer payment of tax (subject to an interest charge) on income not currently received.

A third set of rules applies to marketable stock of passive foreign investment companies, under which electing U.S. shareholders currently take into account as income (or loss) the difference between the fair market value of the stock as of the close of the taxable year and their adjusted basis in such stock, often referred to as marking to market.

In general, a U.S. person that is a direct or indirect shareholder of a passive foreign investment company must file IRS Form 8621, "Return by a Shareholder of a Passive Foreign Investment Company or Qualifying Electing Fund," for each tax year in which that person recognizes gain on a disposition of stock, receives distributions from a passive foreign investment company, or is making a reportable election. The Code includes a general reporting requirement for passive shareholders that is contingent on the issuance of regulations. Although Treasury issued proposed regulations in 1992 requiring U.S. persons to file annually Form 8621 for each passive foreign investment company of which the person is a shareholder during the taxable year, these regulations have not been finalized, and current IRS Form 8621 requires reporting only based on one of the triggering events.

The legislation requires that each U.S. person who is a shareholder of a passive foreign investment company must file an annual information return containing such information as Treasury may require. A person that meets the reporting requirements of this provision may, however, also meet the reporting requirements of new Section 6038D of the Code requiring disclosure of information with respect to foreign financial assets. It is anticipated that the Secretary will adopt regulations under this provision or new Section 6038D to avoid duplicative reporting.

Electronic Filing

The Internal Revenue Service Restructuring and Reform Act of 1998 states that it is a congressional policy to promote the paperless filing of federal tax returns. Treasury has limited authority, however, to issue regulations specifying which returns must be filed electronically. First, any such regulations can only apply to persons required to file at least 250 returns during the year. Second, the Secretary is prohibited from requiring individuals, estates and trusts to submit income tax returns in any format other than paper, although these returns may be filed electronically by choice.

The HIRE Act provides an exception for financial institutions with respect to returns relating to withholding taxes. Thus, Treasury may require a financial institution to file an electronic return even if it would file fewer than 250 returns during the calendar year.

Foreign Trusts

Under present law, a U.S. person is treated as the owner of the property transferred to a foreign trust if the trust has a U.S. beneficiary. A trust is treated as having a U.S. beneficiary unless, 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 U.S. person, and if the trust were terminated, no part of the income or corpus of the trust could be paid to or for the benefit of a U.S. person. [IRC §679.]

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A trust is a foreign trust if it is not a U.S. person. [IRC § 7701(a)(31)(B).] A trust is a U.S. person if a federal court is able to exercise primary supervision over the administration of the trust and one or more U.S. persons have the authority to control all substantial decisions of the trust. [IRC § 7701(a)(30)(E).]

Regulations under section 679 employ a broad approach in determining whether a foreign trust is treated as having a U.S. beneficiary. The determination of whether the trust has a U.S. beneficiary is made for each taxable year of the transferor. The default rule under the statute and regulations is that a trust has a U.S. beneficiary unless, during the U.S. transferor's taxable year, no part of the trust income or corpus may be paid to or for the benefit of a U.S. person.

The determination is made without regard to whether income or corpus is actually distributed and without regard to whether a U.S. person's interest in the trust income or corpus is contingent on a future event. A person who is not a named beneficiary and is not a member of a class of beneficiaries will not be considered if the transferor can show that the person's contingent interest in the trust is so remote as to be negligible.

Notwithstanding these requirements, some taxpayers have taken positions that are contrary to these regulations. To enhance compliance with the regulations, the HIRE Act essentially codifies the regulations into the statute. Thus, in determining whether a foreign trust has a U.S. beneficiary, an amount is treated as accumulated for the benefit of a U.S. person, even if the U.S. person's interest in the trust is contingent on a future event. Under the provision, if any person has the discretion to make a distribution from the trust to, or for the benefit of, any person, the trust is treated as having a U.S. beneficiary, unless the terms of the trust specifically identify the class of persons to whom those distributions may be made, and none of those persons is a U.S. person.

The legislation also clarifies that if any U.S. person who transfers property to the trust is involved in any agreement that may result in the income or corpus of the trust being paid or accumulated to or for the benefit of a U.S. person, that agreement is treated as a term of the trust.

The Act further clarifies that a foreign trust will be treated as having a U.S. beneficiary for purposes of Section 679 if: (1) any person has discretion to determine the trust beneficiaries, unless the trust's terms specifically identify the class of beneficiaries and none of those beneficiaries are U.S. persons; or (2) any written, oral or other agreement could result in a trust beneficiary being a U.S. person. As a final clarification, the legislation makes clear that the use of any trust property will be treated as a payment from the trust equal to the use's fair market value.

The legislation provides that if a U.S. person directly or indirectly transfers property to a foreign trust, other than a trust established for deferred compensation or a charitable trust, Treasury may treat the trust as having a U.S. beneficiary unless that person: (1) demonstrates to the satisfaction of the IRS that no part of the trust may be paid or accumulated during the year for the benefit of a U.S. person, and if the trust were terminated during the year, no part of the trust could be paid to a U.S. person; and (2) provides any additional information as the Secretary may require with respect to that transfer.

Loan of Securities by Foreign Trust

Under IRC Section 643(i), a loan of cash or marketable securities made by a foreign trust to any U.S. grantor, U.S. beneficiary, or any other U.S. person who is related to a U.S. grantor or U.S. beneficiary is treated as a distribution by the foreign trust to that grantor or beneficiary. This section applies a broad set of related-party rules that treat a loan of cash or marketable securities to a spouse, sibling, ancestor, descendant of the grantor or beneficiary, other trusts in which the grantor or beneficiary has an interest, and corporations or partnerships controlled by the beneficiary or grantor or by family members of the beneficiary or grantor, as a distribution to the related grantor or beneficiary.

The HIRE Act expands Section 643(i) to provide that any use of trust property by a U.S. grantor, a U.S. beneficiary or any U.S. person related to a U.S. grantor or U.S. beneficiary is treated as a distribution of the fair market value of the use of the property to the U.S. grantor or U.S. beneficiary. The use of property is not treated as a distribution to the extent that the trust is paid the fair market value for the use of the property within a reasonable period of time. A subsequent return of property treated as a distribution under Section 643(i) is disregarded for tax purposes.

For purposes of determining whether a foreign trust has a U.S. beneficiary under Section 679, a loan of cash or marketable securities or the use of any other trust property by a U.S. person is treated as a payment from the trust to the U.S. person in the amount of the loan or the fair market value of the use of the property. A loan or use of property is not treated as a payment to the extent that the U.S. person repays the loan at a market rate of interest or pays the fair market value for the use of the trust property within a reasonable period of time.

Reporting by U.S. Owners

Section 6048 of the Code imposes various reporting obligations on foreign trusts and persons creating,

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making transfers to, or receiving distributions from such trusts. If a U.S. person is treated as the owner of any portion of a foreign trust under the grantor trust provisions, the U.S. person is responsible for ensuring that the trust files a tax return for the year and that the trust provides other information as the Secretary may require to each U.S. person who is treated as the owner of any portion of the trust or receives any distribution from the trust.

The HIRE Act requires a U.S. person that is treated as an owner of any portion of a foreign trust under the grantor trust provisions to provide such information as the Secretary may require with respect to the trust, in addition to ensuring that the trust complies with its reporting obligations.

Under present law, a taxpayer that fails to file an information return with respect to certain transactions involving foreign trusts is subject to a penalty of 35 percent of the amount required to be disclosed on such return. If the IRS uncovers the existence of an undisclosed foreign trust but is unable to determine the amount required to be disclosed on such return, it is unable to impose a penalty under present law.

The new legislation imposes a minimum penalty of $10,000 on any such failure to file. Notwithstanding this minimum penalty, in no event would the penalties imposed on taxpayers for failing to file an information return with respect to a foreign trust exceed the amount required to be disclosed on that return.

Dividend-Equivalent Payments on Derivatives Transactions

Under present law, dividend payments made to foreign investors are subject to withholding tax at a rate of 30 percent, unless otherwise reduced by an applicable tax treaty. To avoid this withholding tax, foreign investors have entered into transactions that provide them with substitute dividend payments that are not subject to withholding. Foreign persons seek to avoid the 30-percent withholding tax imposed on U.S.-source dividends by temporarily converting U.S. stock into economically equivalent derivative investments such as total return swaps. Under current law, payments to foreign persons pursuant to equity swap transactions are not subject to U.S. withholding.

The HIRE Act ends this scenario by treating dividend equivalent amounts as generally U.S. source, thereby subjecting them to the withholding tax. Provisions applicable to payments made 90 or more days after the date of enactment provide that dividend-equivalent payments on these equity swap transactions would be subject to a 30-percent U.S. withholding tax.

The Act requires withholding on substitute dividend payments and any dividend equivalent payments that are included in notional principal contracts, such as total return swap agreements, and authorizes Treasury to adopt rules requiring withholding on substitute dividends and dividend-equivalent payments that are included in other financial arrangements.

The example of a total return swap referencing stock of a domestic corporation (an example of a notional principal contract to which the provision generally applies) illustrates the consequences of this rule. Under a typical total return swap, a foreign investor enters into an agreement with a counterparty under which amounts due to each party are based on the returns generated by a notional investment in a specified dollar amount of the stock underlying the swap. The investor agrees for a specified period to pay to the counterparty an amount calculated by reference to a market interest rate (such as the London Interbank Offered Rate (LIBOR)) on the notional amount of the underlying stock and any depreciation in the value of the stock.

In return, the counterparty agrees for the specified period to pay the investor any dividends paid on the stock and any appreciation in the value of the stock. Amounts owed by each party under this swap typically are netted so that only one party makes an actual payment. The provision treats any dividend-based amount under the swap as a payment, even though any actual payment under the swap is a net amount determined in part by other amounts (e.g., the interest amount and the amount of any appreciation or depreciation in value of the referenced stock).

Accordingly, a counterparty to a total return swap may be obligated to withhold and remit tax on the gross amount of a dividend equivalent even though, as a result of a netting of payments due under the swap, the counterparty is not required to make an actual payment to the foreign investor.

Impact: *Some commentators, most notably the Chamber of Commerce, expressed concern that these provisions would cause market disruptions because they are not clear on which transactions could be subject to this new withholding requirement. They also noted that these provisions could wind up governing transactions not intended to be targeted by the legislation, such as equity swap transactions structured to comport with the practices of foreign markets.*

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Effective Dates

The new reporting and withholding requirements for foreign financial institutions — new Internal Revenue Code Sections 1471, 1472, 1473 and 1474 — generally apply to payments made after December 31, 2012. The provisions dealing with treatment of bonds not issued in registered form apply to debt obligations issued after the date that is two years after the date of enactment. The provisions concerning the disclosure of information with respect to foreign financial assets, adding new IRC Section 6038D, take effect upon enactment. Similarly, the provisions dealing with the reporting of activities with regard to passive foreign investment companies, amending IRC Section 1298, take effect upon enactment. In addition, the provisions dealing with foreign trusts, amending IRC Section 679, are generally effective on the date of enactment. Finally, the provisions concerning dividend-equivalent payments, amending IRC Section 871, apply to payments made at least 180 days after the date of enactment.

About the Author

James Hamilton is a Principal Analyst at Wolters Kluwer Law & Business, a leading provider of corporate and securities information, and a prolific blogger (Jim Hamilton's World of Securities Regulation, at *http://jimhamiltonblog.blogspot.com*). Hamilton has been tracking, analyzing and explaining securities law and regulation for 30 years as an analyst for CCH. He has written and spoken extensively on federal securities law and has been cited as an authority by a federal court. His analysis of the Sarbanes-Oxley Act, the *Sarbanes-Oxley Manual: A Handbook for the Act and SEC Rules,* is considered a definitive explanation of the Act. His other works include the popular guidebook *Responsibilities of Corporate Officers and Directors under Federal Securities Law,* the *Guide to Internal Controls*, and the monthly newsletter *Hedge Funds and Private Equity: Regulatory and Risk Management Update*. In addition to his many books and articles, Hamilton serves as a leading contributor to the industry-standard publication, the *CCH Federal Securities Law Reporter*. Hamilton received an LL.M. from New York University School of Law.

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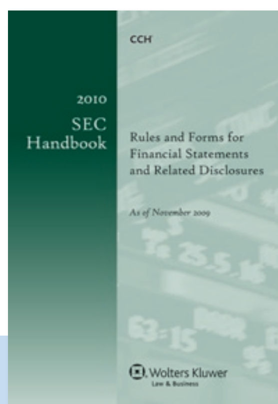

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