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The Foreign Account Tax Compliance Act of 2009

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Application to Non-Financial Foreign EntitiesOn October 27, 2009, proposed US tax legislation entitled the "Foreign Account Tax Compliance Act of 2009" (the "Bill") was introduced by both houses of the US legislature and endorsed by the Obama administration through the US Secretary of the Treasury. Substantial support for the Bill in both houses of Congress and by the Obama administration make it likely that some form of the Bill will be enacted.

If enacted in its current form, the Bill would introduce a number of new provisions that would significantly modify the US withholding tax and information reporting regimes, affecting US persons, non-US banks and other financial intermediaries and their affiliates, non-US hedge and private equity funds, and certain other non-US investment structures.

Additionally, the Bill would impose tax consequences on US persons using property held by non-US trusts. The Bill contains a number of additional provisions imposing new reporting obligations and penalties with respect to interests in foreign accounts, entities and trusts as well as upon individuals or organizations providing aid, advice or assistance with regard to the establishment of certain foreign entities. Lastly, the Bill increases the US tax burdens of some foreign persons by disqualifying interest on bearer bonds from the portfolio interest exception, thereby potentially subjecting such interest to US taxation, and categorizing dividend equivalent payments on swaps as taxable US source income.

Arguably, certain provisions of the Bill could be considered inconsistent with the US government's previously stated goal of making US capital markets more attractive to non-US investors.

Proposed Changes to the US Withholding Tax and Information Reporting Regime Relevant to Non-US Financial Institutions and Investment Vehicles

Foreign Financial Institutions

The Bill includes provisions intended to encourage "Foreign Financial Institutions" (" FFIs") to report information about their US account holders to the IRS. The term "financial institution" is broadly defined and includes any entity that: (i) accepts deposits in the ordinary course of a banking or similar business; (ii) is engaged in the business of holding financial assets for the account of others; or (iii) is engaged primarily in the business of investing, reinvesting, or trading in securities, partnership interests, commodities; or any interest in such securities, partnership interests, or commodities. Non-US banks, hedge and private equity funds, and potentially certain privately owned investment vehicles, would be subject to these rules.

30% Withholding Tax or IRS Information Agreement

Unless an FFI enters into an agreement with the IRS to report information about its US account holders each year, a 30% withholding tax will apply with respect to "withholdable payments" made to the FFI. These payments would include: (i) US source dividends, interest (including OID), rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other "fixed or determinable annual or periodic" gains, profits, or income ("FDAP"); and (ii) the gross proceeds from the sale of any property that can produce US source interest or dividends.

The information reporting requirement that an FFI would need to enter into with the IRS in order to avoid the application of this 30% withholding tax, would require the FFI to disclose information relating to "United States accounts" (defined broadly to include any "financial account," including a depository account, custodial account, and "any equity or debt interest in such financial institution" other than an interest regularly traded on an established securities market) held by a (i) "specified United States person" (the term includes most US persons other than publicly traded corporations, certain tax-favored entities and US governmental entities) or (ii) "US-owned foreign entity."

There is a de minimus exception for depository accounts if the account holder is a natural person and the aggregate value of all such accounts held by that person at the financial institution does not exceed $10,000 ($50,000 if all such accounts were in existence on the date of enactment of the bill).

An account will be owned by a US-owned foreign entity if the entity has one or more "substantial United States owners."

The term "substantial United States owner" includes any "specified United States person" who owns, directly or indirectly: (i) a 10% or greater interest (by vote or value) of the stock of a corporation; or (ii) a 10% or greater capital or profits interest in a partnership; or (iii) is treated as the owner of any portion of a trust under the grantor trust rules (i.e., the trust is a so called "grantor trust" with respect to one or more US persons).

Moreover, a US person who owns any portion of an entity that is engaged primarily in the business of investing, reinvesting, or trading in (i) securities; (ii) partnership interests; (iii) commodities; or (iv) any interests (including futures or forward contracts or options) in such securities, interests or commodities would be considered to be a "substantial United States owner." Thus, if a US person owns, directly or indirectly, or is deemed to own an interest in non-US investment vehicles, including but not limited to non-US hedge and private equity funds, these investment vehicles would generally be required to report the US person's ownership interest.

While these provisions arguably conflict with reduced withholding rates available under existing US tax treaties, the Joint Committee of Taxation's Technical Explanation of the Bill notes that US income tax treaties do not require the United States to follow a specific procedure for providing treaty benefits. Accordingly, if an account holder is eligible for reduced withholding under an applicable treaty, that account holder can request a credit or a refund from the IRS with respect to amounts withheld on payments to the FFI handling the account.

Details Required Under IRS Information Agreements

The FFI would generally be required to annually report: (i) the name, address, and TIN of each US account holder (or substantial United States owner); (ii) the account number or designation; (iii) the account balance or value; and (iv) the gross receipts and gross payments or withdrawals from the account.

These agreements would require FFIs to obtain information from the account holder of each account sufficient to determine whether the account is a "United States account," which would also require FFIs to obtain information sufficient to determine whether a non-US entity account holder has one or more "substantial United States owners." These information gathering requirements would apply in addition to any requirements already applicable to these institutions under the currently existing "Qualified Intermediary" regime.

An FFI would also be required to comply with any due diligence or verification procedures imposed by the US Treasury Department with respect to this process, and comply with any requests from the US Treasury for additional information concerning any "United States accounts" identified. Entering into such agreements with the IRS will clearly increase the reporting and compliance costs of foreign financial institutions.

Expanded Reporting for Affiliated Groups

In addition to requiring FFIs to report information about their own account holders, these agreements would also require that accounts held by members of their "expanded affiliated group" be reported. Essentially, this "expanded affiliated group" reporting requirement would mean that if one member of a corporate group enters into such an agreement, all affiliated financial institutions would effectively be required to do so as well.

Overlap with Home Country Bank Secrecy Laws

In those instances where local bank secrecy or other laws would prevent the disclosure of account information without a waiver by the account holder, FFIs will be required to obtain such waivers or close the relevant account.

This provision has broad application when applied in conjunction with the affiliated group provisions discussed above, as FFIs with affiliates operating in jurisdictions with bank secrecy laws that would prevent disclosure of such information could potentially find themselves faced with a choice between closing affected accounts or being subject to a 30% US withholding tax as a result of laws governing the operations of such affiliates. The interaction between the affiliated group provisions of the Bill and this provision, which is in part an attempt by the US government to circumvent bank secrecy laws in other countries, may potentially place FFIs between Scylla and Charybdis if they wish to participate in the US capital markets and remain appealing to non-US depositors and investors.

Application to Non-Financial Foreign Entities

In addition, the Bill would generally impose a 30% withholding tax on payments to "non-financial foreign entities," (subject to certain exceptions for publicly traded corporations, foreign governments, international organizations, foreign central banks, and such other persons as may be identified in the future) if the non-financial foreign entity is the beneficial owner of the payments and certain exemption requirements are not met. Exemptions are available for non-US entities that can either (i) provide the withholding agent with a "certification that such beneficial owner does not have any substantial United States owners"; or (ii) report the name, address, and TIN of each "substantial United States owner" to the US Department of the Treasury.

"Specified Foreign Financial Asset" Reporting

Currently, US individuals who directly or indirectly own more than a 50% interest in non-US financial accounts valued, in the aggregate, at more than $10,000 are required to annually report certain information with respect to such accounts on Form TD F 90-22.1 (report of Foreign Bank and Financial Accounts, the "FBAR").
The Bill would impose additional information reporting requirements on any US individual that holds interests of more than $50,000 (in the aggregate) in: (i) depository or custodial accounts maintained by a non-US financial institution; (ii) non-US stock, interests in non-US entities, and financial instruments or contracts with a non-US counterparty not held within a custodial account of a financial institution.

The Bill provides the IRS with authority to extend these provisions to US entities.

Failure to report would be subject to a penalty of $10,000, and additional penalties could apply. This reporting requirement would supplement and be in addition to the currently existing "FBAR" reporting requirements, and would apply without regard to whether the individual owns more than a 50% interest in such accounts, as long as the $50,000 value threshold is met. Although information requested on this filing is similar to the information requested on the FBAR, there are significant differences and going forward many individuals will need to track their foreign assets and accounts so that both reporting obligations can be satisfied.

PFIC Reporting

US direct and indirect shareholders of certain non-US funds and corporations categorized as "passive foreign investment companies" (" PFICs"), are subject to additional US tax and reporting obligations. Currently, US shareholders of PFICs are only required to file information returns if they receive a distribution, recognize gain upon the disposition of their interest in a PFIC, or make certain US tax elections (e.g. QEF elections).

The Bill would introduce new requirements that a US shareholder annually report their ownership interest in a PFIC, regardless of whether they receive a distribution or recognize gain. This requirement would supplement and be in addition to the currently existing information reporting requirements.

Uncompensated Use of Trust Property By Beneficiaries Characterized as a Distribution

The Bill would introduce a provision under which the use of property held by a non-US trust by a US grantor or US beneficiaries of such trust will be treated as a distribution, in the amount of the fair market value of the use of the property, unless the grantor or such beneficiary, as the case may be, pays the trust for the use of the property within a "reasonable period of time."

This provision could have a significant impact on trust structures that own assets such as real estate and art, if the trusts allow the beneficiaries or other US persons to use this property without receiving adequate compensation.

Grantor Trust Ownership and Presumption Rules

Current rules provide that a US person is treated as the owner of property transferred to a non-US trust if the trust has a US beneficiary. Such a trust is treated as having a US beneficiary if any current, future, or contingent beneficiary is a US person, for this purpose.

The Bill clarifies that a non-US trust will be treated as having a US beneficiary if: (i) any person has discretion to determine the beneficiaries of the trust (unless the terms of the trust specifically identify the class of beneficiaries and none are US persons); or (ii) any written, oral, or other agreement or understanding could result in income or corpus of the trust being paid to or accumulated for the benefit of a US person.

The Bill further provides that where any US person directly or indirectly transfers property to a non-US trust, the trust would be presumed to have a US beneficiary unless that person submits such information as may be required by the IRS with respect to the transfer and can demonstrate that the trust has complied with all relevant reporting requirements.

Additionally, uncompensated use of the trust property by US persons would be treated as payments to those persons, whether or not they are beneficiaries of the trust, resulting in the application of this provision.

Material Advisor Reporting Provisions

Any person who derives gross income in excess of $100,000 for providing any material aid, assistance, or advice to US individuals in connection with forming or acquiring certain direct or indirect interests in non-US entities would be required to file an information return reporting the identity of the non-US entity and the US individual. These provisions would potentially subject a number of individuals, including hedge fund sponsors, lawyers, and other advisors to reporting requirements.

Failure to comply with these reporting provisions would subject such person to a penalty of up to 50% of the gross income derived in connection with aiding, assisting, or advising on the transaction.

Repeal of US Bearer Bond Exception

The US generally imposes a 30% withholding tax on US source interest paid to non-resident aliens and non-US corporations; however, "portfolio interest" is exempt. Currently, some "foreign targeted" debt instruments in bearer form can qualify for this "portfolio interest exemption" if they meet applicable technical requirements. The Bill would modify this treatment such that interest on bearer bonds would be subject to withholding tax, and various additional excise taxes could also apply, unless debt is in registered form.

Equity Swaps and Dividend Equivalent Payments

The Bill would require that tax be withheld with respect to certain notional principal contract payments characterized as "dividend equivalent payments." This would primarily affect payments relating to equity swaps (e.g. total return swaps), where payments made to a non-US person are contingent upon, or determined by reference to, dividend payments from sources within the United States (and substantially similar arrangements).

Other Provisions and Penalties Relating to Underpayments, Extended Statute of limitations and Reporting Requirements and Penalties

The Bill would also (i) impose a 40% penalty with respect to any understatement of income attributable to any undisclosed foreign financial asset; (ii) extend the current three year statute of limitations to six years in cases where an omission of more than $5,000 of income is attributable to one or more reportable foreign assets and this six year period will not begin until a taxpayer files an information return disclosing these reportable assets; and (iii) impose additional reporting requirements on US persons who are treated as the owner of any portion of a non-US trust and a minimum penalty of $10,000 with respect to failure to comply with information reporting provisions applicable to non-US trusts.

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