

Client Alert

Latham & Watkins
Tax Department

Foreign Account Tax Compliance Act of 2009 Introduced in Congress

On October 27, 2009, Senator Max Baucus (D-Montana) and Representative Charles Rangel (D-New York) introduced the Foreign Account Tax Compliance Act of 2009 (the Bill) to Congress. The Bill is the latest example of efforts by Congress and the Obama administration to curb offshore tax abuse and it seeks to ensure that US persons report and pay tax on income and gains earned through foreign entities. While there can be no certainty regarding the outcome of the legislative process, this legislation currently appears to have a good chance of passage by the Democratic-controlled Congress. The following discussion summarizes certain key provisions in the Bill.

Withholding Tax on Payments to Foreign Financial Institutions

The Bill provides for a withholding tax at a 30 percent rate on payments of US source income, such as interest (including original issue discount), dividends, rents, salaries and other specified items, and the gross proceeds from the sale of any property of a type which can produce US source interest or dividends (generally, equity or debt instruments of US issuers) (collectively, withholdable payments) made to a "foreign financial institution." A "foreign financial institution" is any foreign entity that is engaged in the business of banking,

holding financial assets for the account of others or investing, reinvesting or trading in securities, commodities and derivatives. The definition of foreign financial institution is broad and would cover not only banks, brokers and other traditional financial institutions, but also most hedge funds and private equity funds formed offshore. It is also important to note that this withholding would apply to all withholdable payments as defined, and not just to payments the beneficial owners of which are US persons, unless the reporting requirements set forth in this *Alert* are satisfied. In addition, as explained further, withholding is required at the full 30 percent rate on withholdable payments even if the beneficial owner would be entitled to an exemption or reduced rate under a treaty or if the income or gain would not otherwise attract US tax, subject to the beneficial owner being able to seek a refund of the withheld amount.

Withholding may be avoided if a foreign financial institution enters into an agreement with the Secretary of the Treasury (the Treasury) whereby such institution agrees to (1) obtain information from each of its account holders as is necessary to determine which accounts are "US accounts," (2) report annually certain information with respect to any US account maintained by such institution (including the account holder's (and, in some cases, its

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owners') name, address, TIN, account number and balance, as well as certain other information) and (3) comply with certain other diligence and reporting requirements. For this purpose, a "US account" means any depository or custodial account maintained by a financial institution and, except as otherwise provided by the Treasury, any equity or debt interest in a financial institution that is not regularly traded on an established securities market (each, a "financial account") owned by one or more "specified United States persons" or "US owned foreign entities" except, in some cases, certain accounts held by individuals.

A specified US person generally includes any US person, other than publicly traded corporations and their affiliates, tax-exempt organizations, the US government and its political subdivisions, real estate investment trusts, regulated investment companies and certain other excluded entities. A US owned foreign entity is a foreign entity with a substantial US owner, which generally means, in the case of a partnership or corporation, a specified US person with a 10 percent or greater interest in the entity, and, in the case of a trust, any US person who is an owner of such trust. It is important to note, however, that any US owner of a financial institution engaged primarily in the business of investing, reinvesting or trading in securities, partnership interests, commodities or any interest in such assets (*i.e.*, most hedge funds or private equity funds), will constitute a substantial US owner for this purpose. The Bill also permits a foreign financial institution to elect to discharge its annual information reporting requirement under the aforementioned item (2) in the preceding paragraph generally in the same manner as if such institution were a US person.

In the case of a foreign financial institution that is a qualified intermediary, these new requirements will be in addition to any existing withholding and reporting requirements.

Withholding Tax on Payments to Foreign Non-Financial Institutions

The Bill would also require a withholding tax at a rate of 30 percent on withholdable payments made to a foreign entity other than a foreign financial institution, unless the beneficial owner or payee provides the withholding agent with either a certification that the beneficial owner does not have any substantial US owners or provides the name, address and taxpayer ID number of each such substantial US owner and certain other requirements are met and the withholding agent does not know or have reason to know that the information provided is incorrect. This provision would not apply to certain payees that are publicly traded corporations (or affiliates), foreign governments, international organizations or agencies, foreign central banks or any other class of person identified by the Treasury or to any class of payments identified by the Treasury as posing a low risk of tax evasion.

Reduced Rates of Withholding Under Tax Treaties and Items Otherwise Exempt From US Tax

Under the Bill, there is no relief from withholding at source if the beneficial owner is entitled to an exemption or reduced rate of withholding under a tax treaty. Instead, a beneficial owner may be eligible for a credit or refund of the excess of the amount withheld under the provision over the amount permitted to be withheld under the treaty. This will require foreign beneficial owners of withholdable payments to file a US tax return to claim a refund. A special rule applies with regard to any withholdable payment with respect to which a foreign financial institution is the beneficial

owner (a “specified financial institution payment”). In such a case, credits and refunds are only allowed if the foreign financial institution is entitled to an exemption or a reduced rate of tax under a tax treaty. Interest will not be paid with respect to any credit or refund of tax on a specified financial institution payment.

If a withholdable payment represents gross proceeds from the sale of stock or debt, or is interest eligible for the portfolio interest exemption or is an amount not otherwise subject to US tax, there is no relief from withholding at source, but the beneficial owner of the payment generally is eligible for a credit or refund of the full amount of the tax withheld. Again, this will require foreign beneficial owners of payments to file a US tax return to claim a refund.

These provisions of the Bill requiring withholding on withholdable payments to foreign entities unless the reporting requirements are satisfied would be effective for payments made after December 31, 2010, except that they would not apply to payments made under obligations outstanding on the date of first committee action if the obligation is in bearer form or if the obligation when issued requires gross-up payments that would take effect upon enactment of the Bill.

Additional Reporting Requirements

The Bill would also impose additional information reporting requirements.

First, certain advisors who assist US persons in acquiring or forming a foreign entity would have certain disclosure obligations. Under this provision, each “material advisor” to such a transaction would be required to file an information return with the IRS setting forth the identity of the foreign entity, the identity of the US citizen or resident acquiring an interest in, or forming, the foreign entity, and any other information as the Treasury may

require. A “material advisor” is defined as any person who provides material aid, assistance or advice and derives gross income in excess of \$100,000 for providing such aid, assistance or advice.

Second, each US shareholder in a passive foreign investment company (PFIC) would be required to file annual information returns with respect to such PFIC with the IRS.

Third, individual taxpayers with an interest in a “specified foreign financial asset” during the taxable year would be required to attach a disclosure statement to their income tax returns for any year in which the aggregate value of all such assets exceeds \$50,000 or such higher dollar amount as specified by the Treasury.

Each of these provisions would be effective for taxable years from and after the date of enactment of the Bill.

Repeal of Exemptions For Foreign-Targeted Bearer Bonds

Under existing law, bearer bonds properly targeted under certain procedures for sale to foreign persons enjoy exemption from adverse tax results otherwise applicable to bearer obligations. The Bill eliminates these exemptions. Under the Bill, (1) interest deductions on such bonds will be disallowed, (2) an excise tax payable by the issuer will apply equal to 1 percent of the principal amount of the obligation for each year it is potentially outstanding, (3) gain realized on sale or other disposition of any such obligation will be treated as ordinary income and (4) interest on such bonds will no longer qualify for the portfolio interest exception from withholding. The provision applies to obligations issued after the date that is 180 days after the date of enactment of the Bill.

Dividend Equivalent Payments

The Bill would also treat a “dividend equivalent payment” as a US-source dividend for withholding purposes and such dividend equivalent payments would therefore be subject to withholding if paid to foreign persons. A “dividend equivalent payment” is defined as a payment made under a notional principal contract that directly or indirectly is contingent upon, or determined by reference to, the payment of a dividend from US sources. Under present law, whereas dividends paid by a US issuer to foreign persons are generally US-source income and therefore subject to withholding tax, payments on notional principal contract income to foreign persons are generally foreign source income and therefore not subject to withholding tax. The Bill would treat dividend equivalent payments on notional principal contracts as US-source income for withholding purposes. In addition, the Treasury would have the authority to exclude payments that do not have the potential for tax avoidance.

This provision would be effective for payments made on or after 90 days after the enactment of the Bill.

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