President Signs HIRE Act, Enacting Foreign Account Tax Compliance Provisions Along With Hiring Incentives

On March 18, 2010, President Obama signed into law the Hiring Incentives to Restore Employment Act (the Act). Among the various portions of the Act, this Alert discusses the following notable provisions:

• A payroll tax exemption for employers hiring unemployed workers.
• A business tax credit for retaining such workers.
• Enactment of measures intended to curb offshore tax abuse, adopting in modified form legislation introduced in the US House of Representatives last October.¹

Social Security Tax Exemption

The Act exempts most employers (including tax-exempt entities — provided certain requirements are met — and public institutions of higher education, but not other state and local government employers) from paying the employer portion of the Old Age, Survivors and Disability Insurance (OASDI) tax on wages paid from March 19, 2010 through December 31, 2010 to certain newly hired employees who had been out of work. Covered employees are individuals who (i) begin work any time after February 3, 2010 and before January 1, 2011, (ii) certify, by signed affidavit, they were not employed for more than 40 hours during the 60 days ending on the first day of their new employment, (iii) were not employed to replace another employee except those who quit voluntarily or whose employment was terminated for cause and (iv) do not bear certain relationships to the employer.

The OASDI reduction that would have applied in the first quarter of 2010 will be treated as a payment against the employer’s second quarter OASDI liability. In addition, unless the employer elects out of the OASDI exemption with respect to an employee, the employer is barred from claiming the work opportunity tax credit for that employee under Section 51 of the Internal Revenue Code of 1986, as amended (the Code), during the one-year period starting when that individual was hired.

Business Credit for Worker Retention

The Act increases an employer’s general tax credit under Section 38(b) of the Code for each employee described under the OASDI exemption above (i) who was employed by the employer on any date during the taxable year, (ii) who was employed by the employer for at least 52 consecutive weeks and (iii) whose wages for the last 26 weeks

¹ "With respect to payments made after 2012, foreign financial institutions (and certain affiliates) will be subject to 30 percent withholding tax on ‘withholdable payments’ they receive, unless they comply with certain reporting and diligence requirements . . . ."
of that period equaled at least 80 percent of his or her wages for the first 26 weeks. The credit with respect to each retained worker is the lesser of $1,000 or 6.2 percent of the wages paid by the employer to the retained worker during the 52 consecutive week period.

The retention credit applies to the taxable year ending after March 18, 2010 in which the retained worker first satisfies the 52 consecutive week employment requirement (thus, a calendar year taxpayer would be able to claim the credit for 2011). To the extent the general business credit is attributable to the retention credit, it may not be carried back to a taxable year beginning prior to March 18, 2010, but it may be carried forward.

**Foreign Account Tax Compliance**

**Withholding Tax on Payments to Foreign Financial Institutions**

With respect to payments made after 2012, foreign financial institutions (and certain affiliates) will be subject to 30 percent withholding tax on "withholdable payments" they receive, unless they comply with certain reporting and diligence requirements described below. The withholding tax does not apply to payments on, and gross proceeds from the disposition of, obligations outstanding on March 18, 2012.

"Withholdable payments" include payments of US source income not effectively connected with the conduct of a US trade or business, such as interest (including original issue discount), dividends, rents, salaries, wages and other specified items, and any gross proceeds from the sale or other disposition of any property of a type that can produce US source interest or dividends (generally, debt or equity instruments of US issuers). Withholdable payments also include interest on deposits with a foreign commercial banking branch of a domestic entity.

A "foreign financial institution" is any foreign entity engaged in the business of banking, holding financial assets for the account of others, or investing, reinvesting or trading in securities, partnership interests, commodities or any interest in such assets. This broad definition of foreign financial institution captures many hedge funds, issuers of collateralized debt obligations and offshore private equity funds, in addition to banks, brokers and other traditional institutions.

The withholding tax applies to all withholdable payments as defined, not just to payments the beneficial owners of which are US persons, unless the reporting requirements discussed below are satisfied. In addition, as discussed below, the full 30 percent withholding rate applies even if a treaty would entitle the beneficial owner to an exemption from or a reduced rate of withholding or if the income would not otherwise be subject to US taxation, although the beneficial owner may be eligible for a refund of the withheld amount.

The withholding tax does not apply, however, to any payment to the extent its beneficial owner is a foreign government, international organization, foreign central bank or any class of persons identified by the Secretary of the Treasury (the Treasury) as posing a low risk of tax evasion.

**Reporting and Diligence Requirements for Foreign Financial Institutions**

A foreign financial institution can avoid the new withholding regime described above by entering into an agreement with the Treasury pursuant to which the foreign financial institution agrees to:

(1) Obtain such information regarding each of its account holders as is necessary to determine which accounts are "US accounts."

(2) Report annually certain information regarding any US account the institution maintains, including the
account holder’s (and, in some cases, its owners’) name, address, taxpayer identification number (TIN), account number, account balance or value, and (except to the extent provided by the Treasury) receipts into and withdrawals or payments from the account.

(3) Deduct and withhold 30 percent from any "passthru payment" (meaning a withholdable payment or other payment to the extent attributable to a withholdable payment) made to (A) a "recalcitrant account holder," (B) another foreign financial institution without an agreement with the Treasury or (C) a foreign financial institution that has elected to be withheld upon rather than to withhold with respect to the portion of the payment allocable to recalcitrant account holders or foreign financial institutions without an agreement with the Treasury.

(4) Attempt to obtain a waiver from each US account holder in cases where a foreign law would (without a waiver) prevent reporting, as required under the Act, of information on US accounts maintained by the foreign financial institution and, if a waiver is not obtained from each account holder within a reasonable period of time, close the account.

(5) Comply with certain other verification, diligence and reporting requirements.

A “US account” means, except as otherwise provided by the Treasury, any depository or custodial account maintained by a financial institution and any equity or debt interest in a financial institution not regularly traded on an established securities market (each, a “financial account”) owned by one or more “specified US persons” or “US owned foreign entities,” except, in some cases, certain accounts held by individuals, accounts held by foreign financial institutions with an agreement with the Treasury and accounts whose holders are otherwise subject to information reporting requirements the Treasury determines would make the reporting required by the Act duplicative.

A “specified US person” generally includes any US person, other than publicly traded corporations and their affiliates, tax-exempt organizations, the US and state governments and their political subdivisions and agencies, real estate investment trusts, regulated investment companies, banks 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 more than a 10 percent interest in the entity, and, in the case of a trust, any US person that is an owner of any portion of the trust or, to the extent provided by the Treasury, that directly or indirectly holds more than 10 percent of the trust’s beneficial interests. 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, issuers of collateralized debt obligations and private equity funds) will constitute a substantial US owner for this purpose. Thus, unless a foreign entity engaged primarily in these investing and trading activities has no US owners, the reporting requirements discussed above will apply.

A “recalcitrant account holder” is any account holder that fails to comply with reasonable requests for the information referenced in item (1) above or for its name, address and TIN, or that fails to provide upon request a waiver as described in item (4) above.

The Act permits a foreign financial institution to elect to discharge aspects of its annual information reporting requirement under item (2) above generally in the same manner as if the
institution were a US person (i.e., by complying with IRS Form 1099 reporting requirements). The effect would be that both US- and foreign-source amounts (including gross proceeds) are subject to reporting under this election whether the amounts are paid within or outside the United States. An electing institution must still report, with respect to each US account it maintains, the account number and the name, address and TIN of each account holder that is a specified US person and of each substantial US owner of an account holder that is a US-owned foreign entity.

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.

Refunds, Credits and Interaction With Tax Treaties

The Act provides no relief from withholding at source if the beneficial owner of the payment is entitled to an exemption from 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 over the amount the treaty permits. Similarly, if a payment is of an amount not otherwise subject to US tax (e.g., because the payment represents gross proceeds from the sale of stock or is interest eligible for the portfolio interest exception to withholding), the beneficial owner generally may seek a credit or refund of the tax withheld. In either case, a foreign beneficial owner of a withholdable payment will need to file a US federal income tax return to claim a refund.

If tax is properly deducted and withheld under the Act, no credit or refund is allowed unless the beneficial owner of the payment provides the Treasury with such information as it may require to determine whether the beneficial owner is a US owned foreign entity and to determine the identity of any substantial US owners of the entity.

A special rule applies to any withholdable payment the beneficial owner of which is a foreign financial institution (a “specified financial institution payment”). A credit or refund of tax properly withheld on a specified financial institution payment is only allowed to the extent the foreign financial institution is entitled to an exemption from or a reduced rate of tax under a tax treaty, and no interest will be paid with respect to any such credit or refund.

The Treasury is expected to coordinate the newly enacted withholding provisions with other withholding provisions of the Code, including providing for the proper crediting of amounts deducted and withheld under
the Act against amounts required to be deducted and withheld under other provisions.

The provisions of the Act requiring withholding on withholdable payments to foreign entities are effective for payments made after December 31, 2012, except they do not apply to payments made under, and gross proceeds from any disposition of, obligations outstanding on March 18, 2012.

Additional Reporting Requirements

The Act imposes two other notable information reporting requirements intended to bolster tax compliance with respect to foreign accounts.

First, individual taxpayers with an interest in a “specified foreign financial asset” during the taxable year will be required to attach a disclosure statement to their income tax returns for any year in which the aggregate value of such assets exceeds $50,000 or such higher dollar amount as specified by the Treasury. Increased penalties will apply for understatements of tax attributable to a failure to disclose these and other foreign financial assets. These provisions are effective for taxable years beginning after March 18, 2010. Further, the statute of limitations for assessment of tax is extended to six years for omissions of gross income in excess of $5,000 attributable to a specified foreign financial asset, effective for returns filed after March 18, 2010 (or filed before such date, if the pre-Act statute of limitations has not expired for such returns).

Second, each US shareholder in a passive foreign investment company (PFIC) will be required to file with the IRS annual information returns with respect to such PFIC, containing such information as the Treasury may require. This will expand the reporting obligations of a direct or indirect US shareholder of a PFIC, who under pre-Act law is required to file IRS Form 8621 in each taxable year in which such shareholder receives certain distributions from the PFIC, disposes of PFIC stock or makes or maintains certain elections. This provision became effective upon enactment. The Treasury is expected to exercise its regulatory authority to avoid duplicative reporting.

The Act also:

• permits the Treasury to require financial institutions to file electronically any returns filed with respect to taxes withheld under the provisions of the Act described above and under certain other provisions of the Code (generally relating to withholding on foreign persons).
• with respect to foreign trusts, establishes new rules to determine whether a foreign trust has a US beneficiary, treats certain transactions as distributions from the trust and imposes reporting obligations on owners of any portion of the trust.

Repeal of Exemptions for Foreign-Targeted Bearer Bonds

Under pre-Act law, unregistered bearer bonds properly targeted under certain procedures for sale to foreign persons have been exempt from adverse tax results otherwise applicable to bearer obligations. The Act eliminates several of these exemptions. Under the Act, if bonds are not in registered form, (i) interest deductions on such bonds are disallowed, (ii) gain realized on the sale or other disposition of such an obligation is treated as ordinary income and loss is disallowed and (iii) interest on such bonds no longer qualifies for the portfolio interest exception to withholding. The Act preserves, however, the foreign-targeted obligation exception to the excise tax applicable to issuers of bearer obligations. This provision applies to obligations issued after March 18, 2012.
Dividend Equivalent Payments and Substitute Dividends Paid to Foreign Persons Treated as Dividends Subject to Withholding

The Act treats a “dividend equivalent payment” as a US-source dividend for withholding purposes, subjecting such payments to withholding if paid to foreign persons. While dividends paid by a US issuer to foreign persons are generally US-source income and therefore subject to withholding, under pre-Act law payments on notional principal contract income (including where payments on the contract mirror a US issuer’s dividends and thus are equivalent to dividends) are generally sourced to the residence of the recipient of the income. Withholding generally did not apply under pre-Act law in the case of a foreign recipient of the income.

Under the Act, a “dividend equivalent payment” is (i) any substitute dividend made pursuant to a securities lending or a sale-repurchase transaction that directly or indirectly is contingent upon, or determined by reference to, the payment of a dividend from US sources, (ii) any payment made pursuant to a “specified notional principal contract” that directly or indirectly is contingent upon, or determined by reference to, the payment of a dividend from US sources or (iii) any other payment determined by the Treasury to be substantially similar to such a payment.

A “specified notional principal contract” is any notional principal contract if (i) in connection with entering into such contract, any long party to the contract (i.e., the party entitled to receive any payment that is contingent upon, or determined by reference to, the payment of a dividend from US sources with respect to the underlying security) transfers the underlying security to any short party to the contract, (ii) in connection with such contract’s termination, any short party to the contract transfers the underlying security to any long party to the contract, (iii) the underlying security is not readily tradable on an established securities market, (iv) in connection with entering into such contract, the underlying security is posted as collateral by any short party with any long party to the contract or (v) such contract is identified by the Treasury as a specified notional principal contract.

This provision applies to payments made on or after September 14, 2010. For payments made after March 18, 2012, however, the definition of a specified notional principal contract is expanded to include any notional principal contract unless the Treasury determines that such contract is of a type without the potential for tax avoidance.

Endnotes

Client Alert is published by Latham & Watkins as a news reporting service to clients and other friends. The information contained in this publication should not be construed as legal advice. Should further analysis or explanation of the subject matter be required, please contact the attorney whom you normally consult. A complete list of our Client Alerts can be found on our Web site at www.lw.com.

If you wish to update your contact details or customize the information you receive from Latham & Watkins, please visit www.lw.com/LathamMail.aspx to subscribe to our global client mailings program.