

New Offshore Tax Abuse Bill Seeks Increased Transparency, Enhanced Reporting and Stronger Penalties

November 10, 2009

On October 27, 2009, House Ways and Means Committee Chairman Charles Rangel (D-NY) and Senate Finance Committee Chairman Max Baucus (D-MT), along with Ways and Means Select Revenue Measures Subcommittee Chairman Richard Neal (D-MA), and senior Senate Finance Committee member John Kerry (D-MA) introduced the “Foreign Account Tax Compliance Act of 2009” (the “Foreign Account Bill”),¹ which is aimed at curbing the “growing use of foreign financial institutions, foreign trusts, and foreign corporations by U.S. individuals to evade U.S. tax.” The Foreign Account Bill promotes transparency and enhanced reporting with substantial “incentives” to comply. The bill also would repeal foreign-targeted exceptions to registration requirements for debt obligations and would subject certain dividend equivalent payments under notional principal contracts, such as total-return equity swaps, to US withholding tax.

Specifically, the Foreign Account Bill would:

- Impose a 30 percent withholding tax on any “withholdable payment” to a foreign financial institution (including foreign hedge funds, private equity funds and other investment vehicles), unless the foreign financial institution either (1) accepts new reporting and diligence obligations with respect to financial accounts held by specified United States persons or by foreign entities with one or more substantial United States owners (generally defined by reference to more than a 10 percent ownership interest) or (2) elects to be treated as a US financial institution for tax-reporting purposes;
- Impose a 30 percent withholding tax on any withholdable payment to any non-financial foreign entity, unless the beneficial owner certifies that it does not have any substantial United States owners or provides the name, address and taxpayer identification number of each substantial United States owner;
- Repeal the foreign-targeted exceptions to the registration requirements for debt obligations and prevent the US government from issuing any bearer bonds;

¹ The text of the Foreign Account Bill is available [here](#). The text of the Technical Explanation of the Foreign Account Bill prepared by the Staff of the Joint Committee on Taxation (the “Technical Explanation”) is available [here](#).

- Require enhanced disclosure of information with respect to “specified foreign financial assets,” supported by additional penalties, and extend the three-year statute of limitations to six years for any substantial omission related to specified foreign financial assets;
- Require material advisors assisting with the formation of, or any other direct or indirect acquisition of an interest in, any foreign entity to report such formation or acquisition when they have received more than \$100,000 in any year for providing such assistance;
- Require annual reporting by shareholders of passive foreign investment companies;
- Expand the scope of foreign grantor trust provisions and related reporting in an effort to prevent US beneficiaries from “hiding behind” foreign nominees; and
- Re-source certain “dividend equivalent” payments under notional principal contracts such as total return equity swaps.

According to the Joint Committee on Taxation, the Foreign Account Bill would raise an estimated \$8.5 billion over ten years.

Many of the bill's provisions are derived from prior legislative or Obama administration proposals, including the Stop Tax Haven Abuse Act (H.R. 1265, S. 506, introduced in March by Ways and Means Committee member Lloyd Doggett (D-TX) and Senator Carl Levin (D-MI)) and the international tax proposals unveiled in the Obama administration's fiscal year 2010 revenue proposals in May (the “Greenbook”).² For example, the Foreign Account Bill incorporates such provisions from the Stop Tax Haven Abuse Act as an extended six-year statute of limitations for substantial omissions of gross income derived from offshore assets, the treatment of certain dividend equivalent payments received by foreign corporations as US source income, and disclosure rules for tax and investment advisors. The provisions in the Foreign Account Bill relating to imposition of a 30-percent withholding tax, foreign account and asset reporting, the foreign trust penalty, and the re-sourcing of certain dividend equivalent payments are similar to provisions contained in the Greenbook.

Notably not contained in the Foreign Account Bill are the provisions from the Stop Tax Haven Abuse Act pertaining to “blacklist” jurisdictions or the treatment of foreign corporations that are managed and controlled in the United States as domestic corporations for US income tax purposes.

² The text of the Senate version of the Stop Tax Haven Abuse Act is available [here](#). The text of the House version of the Stop Tax Haven Abuse Act is available [here](#). The Greenbook is available [here](#). For coverage of the Stop Tax Haven Abuse Act, see “Stop Tax Haven Abuse Act Reintroduced,” *Focus on Tax Controversy and Litigation*, March 2009, available [here](#). A detailed explanation of many of the proposals in the Greenbook was released as a Client Alert on May 12, 2009, available [here](#).

Although included in the Stop Tax Haven Abuse Act and the Greenbook, a provision codifying the economic substance doctrine is not included in the Foreign Account Bill. The provision, however, has been included in the “Affordable Health Care for America Act” (H.R. 3962), introduced by Representative John D. Dingell (D-MI) and co-sponsored by six other Democratic leaders on October 29, 2009. The House of Representatives passed H.R. 3962, including the codification of the economic substance doctrine, on November 7, 2009.

At a hearing on the Foreign Account Bill before the House Ways and Means Subcommittee on Select Revenue Measures on November 5 (the “November 5th Hearing”), Representative Neal said that he believes the legislation could be enacted by the end of the year. Top Treasury Department and IRS officials testified in support of the bill, including Deputy Assistant Secretary of the Treasury (International Affairs) Stephen Shay and IRS Chief Counsel William Wilkins. Several non-government sector individuals also testified at the hearing in support of the bill.³

Wilkins identified a number of shortcomings that the Foreign Account Bill is intended to address, including, among others, limitations in reporting requirements related to US persons’ investments and the lack of diligence required from foreign intermediaries. Both Wilkins and Shay anticipated that the proposed 30 percent tax withholding and reporting regime would create a strong incentive for foreign financial institutions to provide the IRS with the information it needs to ensure that US account holders are complying with US tax laws.

It is too early to predict whether other countries will follow the lead of the United States in strengthening tax compliance and reporting obligations, but the trend appears to favor heightened obligations to combat perceived tax avoidance and evasion.

The Foreign Account Bill’s key provisions are discussed below.

Provisions Relating to 30 Percent Withholding Tax and Reporting Alternatives

In General

The Foreign Account Bill would rely on a 30 percent withholding tax to encourage foreign financial institutions and other foreign entities to undertake the diligence necessary to identify US beneficial owners of financial accounts and to provide certain information regarding such owners and accounts. A 30 percent withholding tax on all withholdable payments would be avoided if the foreign financial institution or other foreign entity, as the case may be, were to meet information reporting and diligence requirements.

³ The texts of the written testimony from the hearing’s witnesses are available [here](#).

The penalty for failing to meet the requirements would be significant. The 30 percent withholding tax would be imposed on all “withholdable payments,” which not only includes US-sourced interest, dividends, rents, salaries, wages, and other fixed or determinable annual or periodical gains, profits and income but also gross proceeds from the sale of stock or debt obligations. The withholding tax would be withheld without regard to reduced withholding rates under any otherwise-applicable income tax treaty. The beneficial owner would have to request a refund, presumably with appropriate documentation demonstrating eligibility for a reduced rate of withholding tax.

Certain classes of payees would be exempted from the withholding tax, including publicly traded corporations (and certain affiliates thereof), foreign governments, international organizations, foreign central banks, and any class of persons or class of payments posing a low risk of tax evasion, as identified by the Secretary of the Treasury.

Foreign Financial Institutions

Each “foreign financial institution” would be subject to the 30 percent withholding tax unless it were to meet specified reporting and diligence requirements with respect to each “United States account” or were to elect to be treated as a US financial institution. In the latter case, the foreign financial institution would have to report such information with respect to each United States account under sections 6041 (information at source), 6042 (returns regarding payments of dividends and corporate earnings and profits), 6045 (returns of brokers), and 6049 (returns regarding payments of interest) as if it were a US financial institution.

It is important to understand the breadth of the proposal. The proposal would apply to any foreign financial institution, whether or not such financial institution maintains accounts for US beneficial owners. In order to avoid withholding, a foreign financial institution would have to agree to the new reporting and diligence regime, elect to be treated as a US financial institution, or divest itself of assets that give rise to US source income.

The term “foreign financial institution” includes entities traditionally viewed as financial institutions, such as foreign banks and brokerages, as well as entities that are not so traditionally viewed, such as foreign hedge funds, private equity funds and other investment vehicles. Specifically, any “financial institution” that is a foreign entity is a foreign financial institution. A financial institution 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 others, or (iii) is engaged primarily in the business of investing, reinvesting or trading in stock, notes or other securities (as defined in section 475(c)(2)), as well as partnership interests, commodities or any interest in such securities, partnership interests or commodities (an “investment vehicle”).

The term “United States account” is similarly broad, meaning any “financial account” that is held by one or more “specified United States persons” or “United States-owned foreign entities” (defined below). With respect to any financial institution, a financial account includes any depository or custodial account maintained by such financial institution, as well as any equity or debt interest in such financial institution. Interests that are not usually associated with the term “financial account” would be subject to reporting. For example, interests in foreign hedge funds and foreign private equity funds would be included within the scope of the proposed legislation.

Specified United States persons include all United States persons, other than certain excluded persons that are not viewed as presenting a significant tax avoidance threat.⁴ The added focus on United States-owned foreign entities generally would obligate a foreign financial institution to look through financial account holders that are foreign entities.⁵ A “United States-owned foreign entity” is any foreign entity that has one or more substantial United States owners. Substantial United States owners generally include any specified United States persons who own, directly or indirectly, more than 10 percent of the stock of a corporation (determined by vote or value) or more than 10 percent of the profits or capital interests of a partnership. Hedge funds, private equity funds and other investment vehicles, however, are singled out. The 10 percent threshold does not apply to any such investment vehicle, and a specified United States person who owns any interest in an investment vehicle is treated as a substantial United States owner.

Any foreign financial institution that does not elect to be treated as a US financial institution for tax-reporting purposes would be subject to the 30 percent withholding tax unless it were to agree, on behalf of itself and its expanded affiliated group,⁶

- To obtain information from each of its account holders to determine whether such accounts are United States accounts;⁷

⁴ Excluded persons include publicly traded corporations or subsidiaries thereof, section 501(a) tax-exempt organizations, individual retirement plans, the United States, any state, or any wholly owned agency or instrumentality thereof, banks, real estate investment trusts, regulated investment companies, common trust funds, and trusts exempt under section 664(c) or described in section 4947(a)(1).

⁵ As observed in the November 5th Hearing, there are no exceptions for publicly traded corporations or operating companies despite the argument that the opportunity for tax avoidance in those contexts is arguably diminished.

⁶ A corporation would be part of an expanded affiliated group if it would be included in an affiliated group, as determined for section 1504(a) purposes by replacing references to “at least 80 percent” ownership with references to “more than 50 percent” ownership. In addition, a partnership would be included in an expanded affiliated group if the partnership were controlled, within the meaning of section 954(d)(3), by members of such group.

⁷ In the November 5th Hearing, one witness testified that it may not be “feasible” to obtain US certifications or other information from a foreign financial institution’s entire client base, particularly if foreign account holders hold no US assets or have minimal connection with the United States.

- To comply with the verification and due-diligence procedures required by the Secretary with respect to the identification of United States accounts;
- To report annually (i) the name, address and taxpayer identification number of any account holder who is a specified United States person and, in the case of any account holder who is a United States-owned foreign entity, the same information with respect to each substantial United States owner, (ii) the account number, (iii) the account balance or value, and (iv) the gross receipts and gross withdrawals or payments from the account;
- To comply with any request made by the Secretary of the Treasury for additional information with respect to any United States accounts maintained by such financial institution; and
- Either to obtain a waiver when foreign law would prevent the disclosure of the required information or to close the account.

A foreign financial institution would be able to rely on a certification from an account holder to determine whether financial accounts are United States accounts, unless the financial institution or another member of its expanded affiliated group knows, or has reason to know, that any information in the certification is incorrect. The Technical Explanation suggests that the diligence would incorporate compliance with know-your-customer, anti-money laundering, anti-corruption and other similar rules to which the expanded affiliated group is subject, as well as any additional rules that would be prescribed under the authority provided in the Foreign Account Bill.⁸

If a foreign financial institution were to fail to meet the terms of its agreements, the Secretary of the Treasury would be authorized to terminate the agreement and impose the 30 percent withholding tax.

Other Foreign Entities

A 30 percent withholding tax also would be imposed on any withholdable payment to any foreign entity that is not a financial institution (as defined above) if such foreign entity, or another non-financial foreign entity, is the beneficial owner of the payments, unless the beneficial owner or the payee provides the withholding agent with either a certification that the beneficial owner does not have any substantial United States owners or the name, address and taxpayer identification number of each substantial United States owner of such beneficial owner.

⁸ Under existing withholding regulations, a withholding agent must withhold at the full tax rate if it has actual knowledge or reason to know that a claim of US status or a reduced rate of withholding is unreliable or incorrect. See Treas. Reg. § 1.1441-7(b)(1). A withholding agent has reason to know any information in a withholding certificate is unreliable or incorrect if the agent's knowledge of the relevant facts or statements in the certificate is such that a reasonably prudent person in the position of the withholding agent would question the claims made. Treas. Reg. § 1.1441-7(b)(2); see also Treas. Reg. § 1.1441-7(b)(10).

Effective Date

The provisions relating to the 30 percent withholding tax and reporting alternatives generally would apply to withholdable payments made after December 31, 2010. All payments on any obligations that are outstanding as of the date of first committee action would not be subject to the withholding tax if the obligations were in bearer form or were issued with a withholding tax gross-up provision.

The delayed effective date reflects some sensitivity to the lead time that may be needed for foreign financial institutions to incorporate procedures necessary to comply with reporting and diligence requirements. In the November 5th Hearing, Chief Counsel Wilkins acknowledged that the effective dates of the Foreign Account Bill may be modified to address concerns.

Repeal of Foreign-Targeted Exceptions to Registration Requirement for Debt Obligations

Bearer bonds, which lack formal registration identifying the holder of the obligation, allow investors to hold the obligation anonymously, potentially providing non-compliant US beneficial owners with an opportunity for tax avoidance.

Current law significantly restricts the issuance of bearer bonds. Every debt obligation is required to be in registered form unless it (i) is made by a natural person, (ii) matures in one year or less, (iii) is not of a type offered to the public, or (iv) is a "foreign-targeted obligation."⁹ A foreign-targeted obligation is a debt obligation that (i) is designed to be sold (or resold in connection with the original issue) only to non-US persons, (ii) only pays interest outside the United States, and (iii) has a legend stating that US persons who hold the obligations will be subject to limitations under US income tax laws, including the limitations provided in sections 165(j) and 1287(a).¹⁰

Any registration-required obligation that is not in registered form is subject to substantial sanctions. The issuer of any such obligation is denied a deduction for interest paid or accrued thereon.¹¹ The issuer also is subject to an excise tax equal to 1 percent of the principal amount of the obligation multiplied by the number of calendar days from the issuance date until maturity.¹² If the issuer was not subject to the excise tax, then any gain on the sale or other disposition of the debt obligation will be treated as ordinary income, and any loss on the sale or other disposition of the debt obligation will not be deductible.¹³ From the holder's perspective, interest paid or accrued on a

⁹ An obligation generally is treated as issued in registered form if the right to the principal of and stated interest on the obligation must be transferred through a book-entry system maintained by the issuer or its agent. See sections 163(f)(3) and 149(a); Treas. Reg. § 5f.103-1(c).

¹⁰ Section 163(f)(2)(B); Treas. Reg. § 1.163-5(c)(1)(ii)(B).

¹¹ Section 163(f).

¹² Section 4701.

¹³ Sections 165(j), 1287(a).

registration-required obligation that is not in registered form is subject to a 30 percent withholding tax (subject to reduction under an applicable income tax treaty). Such interest does not qualify for the portfolio interest exemption.¹⁴

The Foreign Account Bill would foreclose the use of bearer bonds as a viable financing alternative by repealing the registration exception for foreign-targeted obligations. The bill also would repeal a provision in Title 31 of the United States Code that currently permits the US government to issue foreign-targeted obligations in bearer form.

The repeal of the foreign-targeted exceptions to the registration requirement would apply to debt obligations issued more than 180 days after the date of enactment.

Enhanced Disclosure of Information, Related Penalties, and Extended Statute of Limitations with Respect to Specified Foreign Financial Assets

Enhanced Disclosure in Addition to FBAR and Other Tax Reporting Requirements

The Foreign Account Bill, if enacted, would require any individual US person who holds more than \$50,000 in “specified foreign financial assets” to report such assets with the individual’s US federal income tax return for each taxable year beginning after the date of enactment. In contrast to FBAR reporting (recapped below), the enhanced disclosure would constitute tax return information that would be subject to nondisclosure requirements under section 6103.¹⁵ The provision is similar to provisions proposed in the Greenbook.

The disclosure obligation would apply to “specified foreign financial assets,” which include any “financial account” maintained by a “foreign financial institution,” as those terms are defined for purposes of the 30 percent withholding and reporting proposals discussed above. As indicated above, both terms extend well beyond common notions of “financial accounts” and “financial institutions” and generally would include, for example, investments in offshore hedge funds and private equity funds. To avoid any perceived gap, the proposal also would require disclosure with respect to other enumerated assets not held in an account maintained by a financial institution, including (i) any stock or security issued by a person other than a US person, (ii) any financial instrument or contract held for investment that is issued by or has a counterparty that is not a US person, and (iii) any interest in a foreign entity.

The information that would be required with respect to each asset includes: (1) in the case of any account, the name and address of the

¹⁴ See sections 871(h)(2), 881(c).

¹⁵ The obligation to file an FBAR arises under Title 31 (the Bank Secrecy Act) and is therefore not subject to the nondisclosure requirements.

financial institution in which any account is maintained and the number of the account; (2) in the case of any stock or security, the name and address of the issuer and such information as is necessary to identify the class or issue of which such interest is a part; (3) in the case of any other instrument, contract or interest, information identifying such item, and the names and addresses of all issuers and counterparties with respect to such item; and (4) the maximum value of the asset during the taxable year.

The Foreign Account Bill would not revoke or otherwise change the obligation of each US person who has a financial interest in, or signature or other authority over, any foreign “financial accounts” to file an annual Form TD F 90-22.1, Report of Foreign Bank and Financial Accounts (FBAR). The scope of FBAR reporting remains controversial. As highlighted in Dewey & LeBoeuf Client Alerts in June 2009,¹⁶ the IRS surprised numerous taxpayers, industries and advisors with an expansive view of the scope of FBAR reporting, shortly before the June 30th filing deadline for calendar year 2008. It eventually provided limited relief by extending the filing deadline to September 23, 2009, for certain taxpayers, suspending the 2009 filing requirement for non-US persons, and extending the filing deadline for 2008 and earlier calendar years to June 30, 2010 for persons with signing authority, but no financial interest in, a foreign financial account.¹⁷ A request for comments regarding the scope of FBAR reporting has generated a deluge of comments from trade groups, bar and accounting associations, firms, practitioners, and taxpayers.

In addition to FBAR reporting, numerous other reporting obligations exist with respect to interests in foreign entities and certain foreign transactions.¹⁸ For now, there appears to be a significant risk of overlapping and duplicative disclosure obligations, many of which are bolstered by their own penalty regimes. The Foreign Account Bill, however, would provide regulatory authority to except from specified foreign financial asset reporting classes of assets that are determined to be covered by other disclosure obligations or that are otherwise identified by the IRS.¹⁹

¹⁶ The Client Alert released on June 25, 2009 is available [here](#). The Client Alert released on June 26, 2009, is available [here](#).

¹⁷ See I.R.S. Notice 2009-62, 2009-35 I.R.B. 260; I.R.S. Announcement 2009-51, 2009-25 I.R.B. 1105. The IRS also posted questions and answers (Q&As -9 and -43) on its public Web site (www.irs.gov) that provided relief to certain persons who only recently learned of their obligation to file an FBAR by extending the filing deadline to September as mentioned above.

¹⁸ See, e.g., sections 6038 (controlled foreign corporations and partnerships), 6038B (certain transfers to foreign corporations and partnerships), 6046 (certain events and transactions involving ownership of 10 percent or more of the stock of a foreign corporation), 6046A (certain events and transactions involving ownership of 10 percent or more of the interests of a foreign partnership), 6048 (certain foreign trusts).

¹⁹ Regulatory authority also would be provided to except non-resident aliens from the provision.

Penalties

The penalty for failure to report specified foreign financial assets would be \$10,000 for each taxable year beginning after the date of enactment. If an individual were to fail to disclose the required information within 90 days of receiving notice from the Secretary of the Treasury, the penalty would increase by \$10,000 for each 30-day period, or fraction thereof, beginning after the 90-day period, during which nondisclosure continues, up to \$50,000 for any such failure. No such penalty would be imposed on any failure due to reasonable cause and not due to willful neglect. The fact, however, that a foreign jurisdiction would impose civil or criminal penalties for disclosing required information would not constitute reasonable cause.

The Foreign Account Bill also would increase the understatement penalty from 20 percent to 40 percent on the amount of any understatement of income that is attributable to any “undisclosed foreign financial asset” for taxable years beginning after the date of enactment. An undisclosed foreign financial asset would include any asset with respect to which information is required to be provided under sections 6038, 6038B, 6046A, or 6048 (the general scope of which is noted above) or under proposed section 6038D (relating to specified foreign financial assets as discussed above).

Six-Year Statute of Limitations

The three-year period beginning when a return is filed during which any tax may be assessed would be extended to six years for any substantial omission (*i.e.*, greater than \$5,000) of gross income related to specified foreign financial assets. The six-year period would not begin until the individual files the required information. This provision would apply to returns filed after the date of enactment and returns already filed if the general, three-year statute of limitations has not expired as of the date of enactment.

Increased Reporting Obligations of Material Advisors

Current law requires third-party information reporting in a number of contexts involving US persons engaging in business or investment activities through foreign entities. No third-party information reporting is currently required, however, by advisors who assist such US persons in forming or acquiring foreign entities. The Foreign Account Bill would require “material advisors” to file an information return for each “foreign entity transaction” for which it was engaged, setting forth the identity of the foreign entity, the identity of the US citizen or resident acquiring an interest in a foreign entity, and any other information that may be required by the IRS. The Technical Explanation explains that the provision would provide an incentive for material advisors to inform their clients properly regarding their obligations to disclose foreign financial assets.

A “material advisor” is any person (*i.e.*, a domestic or foreign entity or individual) who provides material aid, assistance or advice with respect to a foreign-entity transaction and directly or indirectly receives more than \$100,000 in gross income in a year for providing such assistance. Material advisors are not limited to lawyers and accountants. As anticipated in the Technical Explanation, the scope of aid, assistance, and advice will be broadly construed to include any advice or assistance incident or related in any way to the acquisition of an interest in a foreign entity.

The term “foreign entity transaction” means any direct or indirect acquisition of any interest in a foreign entity if any US citizen or resident is required to file a report under sections 6038 (controlled foreign corporations and partnerships), 6038B (certain transfers to foreign corporations and partnerships), 6046 (certain events and transactions involving ownership of 10 percent or more of the stock of a foreign corporation), 6046A (certain events and transactions involving ownership of 10 percent or more of the interests of a foreign partnership) and 6048 (certain foreign trusts).

Penalties for failure to timely file information returns with respect to each foreign-entity transaction would equal the greater of (1) \$10,000 or (2) 50 percent of the gross income derived by the material advisor with respect to that transaction. Penalties would not be imposed on any failure due to reasonable cause and not due to willful neglect.

As proposed, the provision could require multiple service providers to file information reports on the same transaction and on transactions that routinely occur in the flow of legitimate, cross-border activity. The proposal provides regulatory authority to the Secretary of the Treasury to avoid duplicative reporting and to provide exemptions from reporting and other rules necessary or appropriate to carry out the purposes of the provision.

The material advisor provision would be effective with respect to aid, assistance and advice provided after the date of enactment.

Annual Reporting Required by Shareholders of Passive Foreign Investment Companies

The Foreign Account Bill would require each shareholder of a passive foreign investment company (PFIC) to file an annual information return with the IRS, providing such information as the IRS may require. A PFIC is generally defined as any foreign corporation wherein 75 percent or more of its gross income for the taxable year consists of dividends, interest, rents, royalties and other passive income, or 50 percent or more of its assets consist of assets that produce, or are held for the production of, passive income.²⁰

²⁰ See section 1297.

Under present law, a shareholder of a PFIC is required to file an information return on IRS Form 8621, but only if the shareholder recognizes gain on the sale of PFIC stock, receives a distribution from a PFIC or makes a reportable election including, among others, an election to treat a PFIC as a qualified electing fund. Shareholders are not relieved from reporting obligations if they do not control the foreign corporation or otherwise have access to required information.

The provision appears to be similar to proposed Treasury regulations issued in 1992, which have not been finalized, with the exception that the provision apparently would apply to all shareholders of a PFIC, whether or not such shareholder is a US person or resident. Those proposed regulations would require a US person to file an annual information return on IRS Form 8621 for each PFIC in which that person owns shares during the taxable year.

The annual information return requirement would be effective as of the date of enactment. Depending on that date, some PFIC shareholders may find it challenging, if not impossible, to obtain all information necessary to comply.

Provisions Relating to Foreign Trusts

The Foreign Account Bill would strengthen significantly foreign trust rules in an effort to prevent the “true beneficiaries” from hiding behind a nominee owner, according to a Floor Statement of Senate Finance Committee Chairman Baucus. Under current law, a US person who directly or indirectly transfers property to a “foreign trust”²¹ generally is treated as the owner of the portion of the trust attributable to the transferred property in any taxable year, if there is a US beneficiary of any portion of the foreign trust for such taxable year.²² In that case, the US person must include in computing taxable income the items of income, deduction, or credits against tax that are attributable to the portion of the trust treated as owned by the US person.

For purposes of determining whether a foreign trust has a US beneficiary, the Foreign Account Bill would presume that a foreign trust has a US beneficiary unless the US transferor were to satisfy certain information reporting and other requirements. In addition, the Foreign Account Bill would address (i) other circumstances in which a foreign trust could be treated as having a US beneficiary, (ii) the effects of uncompensated use of foreign trust property, and (iii) certain reporting requirements with respect to foreign trusts and related penalties.

²¹ A “foreign trust” means any trust other than a trust over which a court within the United States is able to exercise primary supervision and one or more US persons have the authority to control all substantial decisions of the trust. See sections 7701(a)(31)(B), 7701(a)(30)(E).

²² See section 679(a)(1). This treatment generally does not apply to transfers of property to a foreign trust in exchange for at least fair market value of the transferred property or to transfers by reason of death. See section 679(a)(2).

Determination of whether a Foreign Trust Has a US Beneficiary

Under section 679(c)(1), a foreign trust will be treated as having a US beneficiary for a taxable year unless, (i) under the terms of the trust, no part of the income or corpus of the trust could be paid or accumulated during the taxable year to or for the benefit of a US person, or (ii) if the trust were terminated at any time during the taxable year, no part of the income or corpus of the trust could be paid to or for the benefit of a US person.²³

Presumption of US Beneficiary

Under the Foreign Account Bill, if a US person directly or indirectly transfers property to a foreign trust, other than one established for deferred compensation or as a charitable trust, the trust would be presumed to have a US beneficiary. To rebut this presumption, the US transferor would have to submit information as may be required with respect to the transfer and to demonstrate that the trust should not be treated as having a US beneficiary under section 679(c)(1).

Contingent Interests

Current Treasury regulations take into account trust interests that are contingent on a future event, unless the contingent interest is so remote as to be negligible, for purposes of determining whether a foreign trust has US beneficiaries.²⁴ The Foreign Account Bill would add a provision to clarify that US Beneficial Interests include interests that are contingent on a future event.

Unrestricted Discretion to Make Distributions

The Foreign Account Bill also would codify the approach under current Treasury regulations that generally treats the mere possibility of distributions to a US beneficiary as creating US Beneficial Interests.²⁵ If any person were to have the discretion to make a distribution from the trust, the foreign trust would be treated as having a US beneficiary, unless the terms of the trust specifically identify the class of persons that may receive distributions and none of those persons is a US person during the taxable year.

Clarified Scope of Foreign Trust Terms

The Foreign Account Bill would clarify that any agreement or understanding (whether written, oral or otherwise) involving a US transferor, which may result in the payment of trust income or corpus or the accumulation of trust proceeds to or for the benefit of a US person, would be treated as terms of the trust.

²³ The interests of a US person that result in a foreign trust being treated as having a US beneficiary are referred to below as "US Beneficial Interests."

²⁴ See Treas. Reg. § 1.679-2(a)(2)(i).

²⁵ See Treas. Reg. §§ 1.679-2(a)(2)(ii), -2(a)(2)(iii) Examples (10), (11).

Effective Dates

The presumed existence of a US beneficiary would apply to all transfers of property after the date of enactment. All other provisions related to determining whether a foreign trust has a US beneficiary would be effective on the date of enactment, except as indicated below.

Uncompensated Use of Foreign Trust Property

Under current law, a loan of cash or marketable securities by a foreign trust to a US grantor, US beneficiary, or other US person who is related to a US grantor or US beneficiary, generally is treated as a distribution by the foreign trust to such US person.²⁶ A subsequent repayment or cancellation of the loan treated as a distribution is disregarded for tax purposes.

The Foreign Account Bill would treat any use of trust property by any such US person as a distribution of the fair market value of the use of the property to such US person, unless and to the extent that the foreign trust is paid the fair market value for the use of the property within a reasonable period of time. The bill also generally would treat any loan by a foreign trust to, or uncompensated use of trust property by, any such US person as a US Beneficial Interest for purposes of determining whether a foreign trust has a US beneficiary, unless and to the extent that the US person repays the loan at a market rate of interest, or pays the fair market value for the use of the property, within a reasonable period of time.

Provisions related to the uncompensated use of foreign trust property and foreign trust loans would apply to uses of trust property and trust loans made after the date of enactment.

Reporting Requirements and Penalty Regime for Transactions with Foreign Trusts

Section 6048 imposes certain reporting obligations on foreign trusts and persons creating, making transfers to or receiving distributions from foreign trusts. Section 6677 imposes penalties for the failure to file required information generally equal to 35 percent of the “gross reportable amount” (as defined therein) and adds an additional \$10,000 penalty for each 30-day period for which a failure to file continues after a 90-day period beginning when the IRS notifies the person required to file of the failure. In no event, however, can penalties exceed the gross reportable amount.

The Foreign Account Bill would require any US person treated as the owner of any portion of a foreign trust to file such information as may be required by the IRS. The bill also would permit the IRS to impose an initial penalty of \$10,000 under section 6677, even though it has

²⁶ See section 643(i).

insufficient information to determine the gross reportable amount, and would make other adjustments to the penalty regime. These provisions would apply to notices and returns required to be filed after December 31, 2009.

Withholding on Dividend Equivalent Payments under Notional Principal Contracts

The Foreign Account Bill provides for re-sourcing of “dividend equivalent” payments under notional principal contracts, such as total-return equity swaps, similar to the re-sourcing proposal contained in the Greenbook. A “dividend equivalent” is defined in the bill as any payment under a notional principal contract that references, or is contingent upon, dividends paid from sources within the United States. Current law provides that any such payment to foreign persons is generally treated as foreign source income and therefore not subject to US withholding tax (as a regular dividend by a US corporation would).²⁷ The Foreign Account Bill would treat these dividend equivalent payments as having a US source, resulting in the imposition of withholding taxes when these payments are made, or deemed to be made, to non-US persons.

In keeping with the Greenbook, the Foreign Account Bill includes an exception from the re-sourcing rule for dividend equivalent payments made pursuant to certain types of contracts determined by the Treasury Department not to be abusive.²⁸ Specifically, the Foreign Account Bill provides that the Secretary of the Treasury has the discretion to exclude from the re-sourcing rule certain types of contracts that do not “have the potential for tax avoidance.” The Foreign Account Bill provides that the Secretary may take into account the following factors in making that determination:

- The term of the notional principal contract (including provisions for early terminations and offsetting financial contracts);
- The amount of each party’s investment and the amounts of any collateral posted;
- Whether the price of the equity used to measure the parties’ entitlements or obligations is based on an “objectively observable price;”
- Whether either party sells (directly or indirectly) to the other party the security giving rise to dividends from sources within the United States;
- Whether there are terms in the contract that address the hedge position of either party or other conditions that would

²⁷ See Treas. Reg. § 1.863-7(c).

²⁸ The Foreign Account Bill marks a departure from the approach in the corresponding provision in Senator Carl Levin’s Stop Tax Haven Abuse Act bill, which would not provide for any exception to withholding in respect of “dividend equivalent” amounts.

compel either party to hold or acquire the security giving rise to dividends from sources within the United States; and

- Such other factors as the Secretary determines appropriate.

The Greenbook guidelines that were discussed in the May issue of our newsletter *Focus on Tax Controversy and Litigation* (see “Obama Administration Releases Its 2010 Revenue Proposals,” available [here](#)), apparently served as the basis for the above-listed factors, and it is public knowledge that the Treasury Department worked closely with Congress on the drafting of the Foreign Account Bill. Given this background and the Treasury Department’s apparent awareness of the interest in and critical need for a safe harbor to avoid disruption to US capital markets, it is possible that quick regulatory action on this exception will follow a potential enactment of this legislation.

The scope of any safe harbor remains uncertain. The Greenbook proposed an exception to the re-sourcing rule that would have applied to swaps with at least a 90-day term that had certain other characteristics (e.g., 20 percent collateral limit, crossing limitation and 20 percent of the 30-day average daily trading volume swap limit). Given the commentary from the financial community, it is possible that any safe harbor could differ significantly from the Greenbook proposal.²⁹

Importantly, practitioners have argued that even if withholding were to apply to swap payments made under a re-sourcing rule, the amount subject to withholding should be the amount actually paid and received, net of any financing payment made by the party receiving the dividend equivalent payment.³⁰ The Foreign Account Bill takes the opposite approach, requiring withholding on the gross amount of the dividend equivalent payment.

The Foreign Account Bill further provides the Secretary of the Treasury with the authority to make other types of contracts that are not notional principal contracts (as defined in Treasury regulations),³¹ but provide for returns similar to dividend equivalent payments, subject to the re-sourcing rule. It is possible that, pursuant to this authority, other derivative contracts that reference US dividend-paying equities could be subject to US source withholding rules, even where no dividend withholding avoidance was intended. For instance, options, futures

²⁹ Some commentators have stated that the Greenbook proposal was too favorable to taxpayers.

³⁰ Generally, in a total return swap referencing dividend-paying equities, one party receives periodic payments referencing a dividend equivalent over a referenced notional amount and pays periodic interest equivalent payments on the notional amount. Because the periodic payments of interest and dividend equivalent payments often occur at the same time, instead of each party making a gross payment to the other party, the total return swap will typically provide for netting of the periodic payments.

³¹ See Treas. Reg. § 1.446-3(c)(1).

This memorandum is intended only as a general discussion of these issues. It is not considered to be legal advice. We would be pleased to provide additional details or advice about specific situations. For additional information on this important topic, please feel free to call upon your Dewey & LeBoeuf relationship partner.

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and forwards are all types of contracts that could become subject to future Treasury Department guidance under this grant of authority.³²

Two final, and important, issues raised by the re-sourcing rule under the Foreign Account Bill relate to its effective date. First, the bill provides that the rule, and the potential withholding implications arising therefrom, should apply to payments that occur 90 days after the date of enactment of the bill. The Greenbook resourcing proposal, on the other hand, was proposed to apply to payments occurring after December 31, 2010. Accordingly, the Foreign Account Bill, if enacted soon, could potentially be effective significantly earlier than expected by financial market participants based on the Greenbook's prior indication. Second, the Foreign Account Bill does not contain a grandfathering provision for payments made pursuant to derivative contracts entered into prior to the proposed effective date of the bill. Therefore, the current version of the bill would require that dividend equivalent payments on contracts that are already outstanding be subject to withholding and potential gross-up by the payer, based on the standard market documentation for trades. This gross-up obligation may cause payers to seek early termination of these contracts causing disruption in the market.

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³² Stock loan transactions also might be subject to future guidance. Note that the Foreign Account Bill does not directly address perceived withholding tax abuses through stock loan transactions, unlike the Greenbook, which proposed the withdrawal of Notice 97-66, 1997-2 C.B. 328, along with other measures.