

Foreign Account Tax Compliance Act of 2009

On October 27, H.R. 3933, the Foreign Account Tax Compliance Act of 2009 was introduced in the House of Representatives by House Ways and Means Committee Chairman Rangel. The bill, intended to reduce overseas tax evasion, would affect the ability of U.S. companies to access the Eurobond markets and increase reporting obligations on non-U.S. financial institutions.

Repeal of Exceptions for Foreign Targeted Bearer Obligations

Under current law, foreign targeted bearer obligations (as defined below) are given special treatment in three ways. First, normally interest is not permitted to be deducted for corporate obligations in bearer form, but it is allowed (subject to limitations) for foreign targeted bearer obligations. Second, the United States normally imposes a 30% withholding tax on payments of interest to non-U.S. persons. There is an exception to the withholding tax for foreign targeted bearer obligations. Third, there is a 1% excise tax on the issuer of notes that are issued in bearer form. There is an exception for foreign targeted bearer obligations.

H.R. 3933 would eliminate the exceptions for foreign targeted bearer obligations.

Under current law, an instrument is a foreign targeted bearer obligation if the instrument is not in registered form and: (i) interest on such obligation is payable only outside the United States and its possessions; and (ii) on the face of such obligation there is a statement that any United States person who holds such obligation will be subject to limitations under the United States income tax laws.

To be in registered form, an instrument must be transferable only on the books and records of the issuer or the agent of the issuer (or by the physical surrender of the instrument).

For years before 2007 (and for certain issues before 2009), foreign targeted registered obligations were permitted to be held by a financial institution that periodically certified that no U.S. person held the beneficial ownership of the instruments. Although this exception is still reflected in the regulations, the IRS has indicated that it will generally no longer apply the foreign targeted registered obligations exceptions after 2006.

U.S. companies that had sought to access the Eurobond market have been shifting structures since 2006 to use the foreign targeted bearer obligations exceptions. Repeal of the foreign targeted bearer obligation exceptions would force U.S. companies looking to the Eurobond market to use a two step structure with the issuer in the Eurobond market being a European Union issuer that on-lends the funds to the U.S. borrower. Both from a U.S. and European Union perspective, such structures would need to be sensitive to “beneficial ownership” concerns raised in recent treaty qualification cases.

Imposition of U.S. Information Gathering on Foreign Financial Institutions

The bill would also impose a new 30% withholding requirement on “withholdable payments” made to non-U.S. financial institutions that did not comply with U.S. imposed information reporting requirements applicable to “U.S. financial accounts”:

- Financial accounts generally include deposit accounts, custodial accounts, and certain equity and debt investments in such “financial institutions”;
- U.S. financial accounts are generally defined as financial accounts that are owned either by U.S. persons or by foreign entities that are themselves owned by one or more U.S. persons holding more than 10% equity interests (or any size equity interest in the case of investment funds). Certain exceptions are provided for governmental and tax-exempt owners and for certain small deposit accounts owned by natural persons;
- Non-U.S. financial institutions include not only traditional banks and custodians but also any other foreign entity primarily engaged in the business of investing, reinvesting or trading in securities, commodities, partnership interests;
- Withholdable payments generally includes U.S. source interest, dividends and other periodic payments and gains from the sale of assets that can generate U.S. source interest and dividends.

The intent of the provision appears to be to reduce the ability of U.S. persons to hide money from the I.R.S., but the direct result may be an increased tax burden on non-U.S. financial institutions that make investments in the United States. If the beneficial owner of the payment is the financial institution itself, the financial institution may apply the withheld tax as credit or request a refund if the financial institution is eligible for treaty benefits that would apply a reduced rate of withholding.

Additional Reporting for Foreign Financial Assets and Forming Foreign Entities

The bill would add additional reporting obligations (and penalties) for individuals that hold foreign financial assets in excess of \$50,000. The categories of assets to which the new reporting would apply would include financial accounts held by foreign financial institutions, and stocks and securities issued by non-U.S. persons, any financial instrument with a non-U.S. counterparty, and any interest in a foreign entity if the interest is not held in an account maintained by foreign financial institution.

Similarly, additional reporting is required for forming or acquiring a foreign entity. The disclosure in this case, however, would fall on “material advisors” (generally those advisors making \$100,000 or more on the transaction in a given year).

Also, additional reporting will be required by PFIC shareholders.

Foreign Trusts with U.S. Beneficiaries

The bill would conform the Code to the regulations to clarify that U.S. persons that are only contingent beneficiaries may cause a non-U.S. trust to be treated as having U.S. beneficiaries.

A presumption is also added that if a U.S. person transfers property to a foreign trust that the trust has a U.S. beneficiary.

If a person uses trust property without compensating the trust, the use will generally be treated as a distribution under the bill.

Withholding on Dividend Equivalent Amounts

The bill would modify the U.S. withholding rules to require payors to withhold, generally at 30%, on amounts that are equivalent to dividends under the bill. The term "dividend equivalent" means (i) any payment made pursuant to a notional principal contract that (directly or indirectly) is contingent upon, or determined by reference to, the payment of a dividend from sources within the United States and (ii) any other payment determined by the Treasury to be substantially similar to such a payment.

The bill would allow the Treasury to determine that certain such agreements do not have the potential for tax avoidance and so should not be subject to the withholding.

If you would like to discuss any of the issues addressed in this Client Alert or would simply like to find out more about Chapman, please contact your Chapman counsel, Paul Carman at carman@chapaman.com, Melanie Gnazzo at gnazzo@chapman.com or visit us at www.chapman.com.

This summary is not intended to be tax or legal advice. This summary cannot be used by any taxpayer for the purpose of avoiding tax penalties that may be imposed on the taxpayer. This summary is being used to support the promotion or marketing of transactions related to the issues discussed herein. The taxpayer should consult an independent tax advisor.

Chapman and Cutler LLP is an Illinois limited liability partnership that has elected to be governed by the Illinois Uniform Partnership Act (1997).
© 2009 Chapman and Cutler LLP. All Rights Reserved.