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Broad Changes to U.S. Withholding Rules Pass the House

With Final Enactment Likely By Early 2010, Participants in Cross-Border Financial Markets Face Daunting Implementation Task

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House Passage and Next Steps

Proposed tax legislation that would impose significant new withholding and reporting burdens on cross-border payment flows, in an effort to combat tax evasion by U.S. citizens through the use of foreign bank accounts, has moved another step closer to enactment. Initially introduced as a stand-alone bill by House Ways and Means Committee Chairman Charles Rangel and Senate Finance Committee Chairman Max Baucus, the proposals were incorporated as a revenue offset in the "extenders" legislation that passed the House of Representatives on December 9, 2009 (H.R. 4213, the Tax Extenders Act of 2009 ("TEA")). TEA currently awaits action by the Senate, which is likely to take up the bill in early 2010.

A phalanx of Administration officials had previously expressed support for the proposals, starting with President Barack Obama himself, and continuing through Treasury Secretary Tim Geithner, IRS Commissioner Douglas Shulman, and Stephen Shay, the Deputy Assistant Treasury Secretary for international tax policy. Further, a "Statement of Administration Policy" expressing support for TEA was issued on December 8th. Enactment of the proposals by early 2010 appears increasingly likely given the uniform support of key players in the tax legislative process, the pressing need for tax revenue, the political appeal of cracking down on tax evaders, and the proposals' current linkage with the extension of popular expiring provisions such as the R&D tax credit.

Given the strong possibility of prompt enactment, U.S. and non-U.S. banks and investment funds that make or receive U.S.-source cross border payments need to begin addressing the challenges that this legislation will bring. Further, U.S. issuers of debt and equity securities that rely on the international capital markets as a source of funding should begin to consider the potentially significant impact of this legislation on cross-border transactions.

Overview of the Proposed Legislation

The foreign account tax compliance provisions of TEA are based on several previous legislative proposals, including most directly the "Foreign Account Tax Compliance Act of 2009" (H.R. 3933 and S. 1934) ("FATCA") introduced by Mr. Rangel and Mr. Baucus in late October. That bill was in turn based on proposals included in President Obama's 2010 budget, bills proposed by Senator Carl Levin (D-MI) and Representative Lloyd Doggett (D-TX), and a Senator Baucus draft. The current proposals are understood to have been developed in close consultation with the Treasury Department and, like the prior proposals, are fundamentally intended to restrict the opportunities for U.S. taxpayers to evade tax by using non-U.S. financial accounts. While the focus of the legislation is on tax evasion by U.S. citizens, many of its principal effects likely will be felt by U.S. and non-U.S. financial institutions, as well as by other U.S. participants in cross-border capital markets.

The centerpiece of the proposal is a series of provisions that would significantly broaden the 30-percent U.S. withholding tax that applies to most outbound payments of interest, dividends, rents, royalties, and similar amounts. While the United States has long imposed such a withholding tax, the proposed legislation would in many circumstances increase substantially the information-gathering and reporting obligations that must be met in order to reduce withholding under applicable tax treaties and relevant statutory exceptions. As a result, some non-U.S. investors in U.S. securities who are substantively exempt from the U.S. tax may find themselves subject to up-front withholding, with the possibility of filing for a refund (without interest), rather than being able to secure "exemption at source" as they have historically been able to do. The extent to which this happens will depend on how the IRS exercises the broad implementing authority that the legislation would give it, as well as the responses of affected market participants.

The net effect of the web of provisions summarized below will be to confront non-U.S. banks and investment funds with having to choose among three broad options, none of which may be ideal:

(i) Ensure their continued ability to receive U.S.-source payments free of 30-percent withholding by entering into an agreement with the IRS to take on greatly-expanded information-gathering and reporting obligations in respect of U.S. customers and legal entity customers with U.S. owners;

(ii) Ensure their continued ability to receive U.S.-source payments free of 30-percent withholding by declining to maintain *any* accounts for U.S. or U.S.-owned customers (under to-be-issued IRS rules); or

(iii) Accept the imposition of 30-percent withholding with respect to U.S. source payments, subject to account holders' ability to seek refunds of overwithheld amounts.

Presumably the drafters of the legislation contemplate that market participants will divide into these three categories, with the anticipation that most major international financial institutions would choose the first option. On the other hand, smaller entities with predominantly non-U.S. customer bases but significant U.S. holdings may instead choose the second option. And institutions that have neither U.S. customers nor U.S. holdings may be content to adopt the third option.

The Joint Committee on Taxation estimates that the current proposals would prevent U.S. individuals from evading $7.7 billion in U.S. tax over the next ten years.

Revised Withholding Rules for Payments to Foreign Financial Institutions and Other Foreign Entities – Detailed Summary

As noted, the centerpiece of the proposals is the imposition of a 30-percent withholding tax on "withholdable payments" made to a foreign financial institution ("FFI") (as defined below). Withholdable payments include the familiar categories of interest, dividends, rents, and royalties but – in a significant expansion of U.S. withholding rules – would also include gross proceeds from the disposition of stock or securities that produce U.S.-source dividends or interest, even when the disposition is at a loss.[1]

Notwithstanding the potential applicability of treaty or statutory exemptions from U.S. tax, the withholding tax would be required to be collected unless the FFI that receives the payment enters into an agreement with the IRS (an "FFI Agreement"), pursuant to which the FFI will:

(1) Obtain information from each account holder as is necessary to determine which accounts are "U.S. accounts" (as defined below);

(2) Comply with verification and due diligence procedures as the IRS requires with respect to the identification of U.S. accounts, which may include internal procedures and independent review procedures to ensure an FFI's compliance with its obligations;

(3) Report annually certain information, discussed below, with respect to any U.S. account maintained by the FFI;

(4) Withhold the 30-percent tax in respect of certain payments to a "recalcitrant account holder," defined as one who fails to comply with relevant information and waiver requests, as well as with respect to certain account holders that are themselves FFIs;

(5) Comply with requests by the IRS for additional information with respect to any U.S. account maintained by the FFI; and

(6) Attempt to obtain a waiver from the account holder in any case in which foreign law would otherwise prevent the reporting of required information and, if the waiver is not obtained within a reasonable period of time, close the account.

Definition of FFI

An FFI is any foreign 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 or trading in securities, derivatives, or other assets. Thus, in addition to banks, the definition of an FFI includes hedge funds and private equity funds.

Definition of U.S. Account

A "U.S. account" is any "financial account" that is held by one or more specified U.S. persons or U.S.-owned foreign entities.[2] A financial account is any depository or custodial account maintained by an FFI as well as any equity or debt interest in an FFI (other than publicly-traded interests). An exception would apply to depository accounts of less than $50,000. Another exception would apply if the account is held by another financial institution which meets the reporting requirements or the holder of the account is otherwise subject to information reporting requirements that the IRS determines would make the reporting duplicative.

Reporting Requirements

Subject to substantial IRS discretion in implementing these requirements, an FFI generally would be required to report annually with respect to each U.S. account (i) the name, address, and TIN of each account holder who is a specified U.S. person; (ii) the name, address, and TIN of each substantial U.S. owner of any account holder that is a foreign entity; and (iii) the account balance and gross receipts and withdrawals from the account. A "substantial U.S. owner" is a U.S. person who directly or indirectly owns more than 10 percent of the stock of a corporation (by vote or value) or more than 10 percent of the profits or capital interests of a partnership.

The 10-percent threshold is eliminated, requiring reporting of ***any*** U.S. ownership, if a foreign entity is primarily in the business of investing or trading in securities, derivatives, or other assets. Thus, for example, a non-U.S. based hedge fund would be required to report even a nominal U.S. investor in the fund.

Compliance Procedures

The legislation reflects the expectation that FFIs will comply with know-your-customer, anti-money laundering, anti-corruption, or other similar rules to which they are currently subject as well as with such procedures and rules as the IRS may prescribe. Although such existing local-law requirements may mean that FFIs already have procedures in place that collect much of the information required by the new U.S. rules, the U.S. requirements are likely to be more extensive than existing local-law rules.[3] FFIs will thus need to establish procedures to identify specified U.S. account holders (including U.S. owners of non-U.S. entity account holders), and procedures for fulfilling the reporting requirements. Because the legislation grants the IRS extraordinarily broad administrative discretion to implement the new requirements, the practical impact of the rules will significantly depend on the manner in which the IRS exercises this discretion. Ideally the IRS implementation effort will be influenced by a robust dialogue with affected FFIs and other market participants.

The proposed disclosure and reporting requirements would apply in addition to any requirements imposed under the Qualified Intermediary ("QI") program. In addition, withholding would apply to a withholdable payment to an FFI that did not enter into an FFI Agreement with the IRS even if the payment would otherwise be exempt from U.S. withholding tax (for example, because the payment would be portfolio interest).

Similar to the existing QI program, the legislation contemplates that an FFI's compliance with its FFI Agreement will be subject to monitoring under independent review procedures and that the IRS may terminate the agreement if it finds that the FFI is out of compliance.

The legislation also contemplates that an FFI would not be subject to 30-percent withholding tax if it complies with IRS-prescribed procedures which ensure that it does not maintain any U.S. accounts and meets other IRS-prescribed requirements with respect to accounts of other FFIs that it maintains. The IRS may also identify classes of FFIs with respect to which it has determined that the application of these requirements is not necessary to carry out the purposes of the legislation.[4]

Potential for Overwithholding

If an FFI does not enter into an FFI Agreement, or if the IRS terminates an FFI Agreement for noncompliance, all withholdable payments to the FFI will be subject to the 30-percent withholding tax, even if the FFI has no U.S. accountholders, and even if the non-U.S. account holders benefit from reduced rates or exemptions under treaty or statutory rules. In such a case, the FFI's account holders

could file for refunds of any overwithheld amounts. Thus, depending on the manner in which the proposed provisions are implemented – and the responses of FFIs and other market participants – some non-U.S. investors may find it more difficult to make U.S. investments that benefit from reduced withholding taxes at source. If this does occur, the additional administrative and time-value costs of having to apply for refunds of overwithheld U.S. taxes could affect such non-U.S. investors' cross-border investment decisions, potentially affecting U.S. companies' access to international sources of capital.

Impact on U.S. Financial Institutions and Other U.S. Payors

While the legislation's implementation burden will primarily affect non-U.S. financial institutions, it will also affect U.S. financial institutions and other U.S. payors of cross-border payments. Such U.S. payors will be required to adjust their own compliance systems to ensure that FFI payees are identified, that any additional required documentation is received, and that withholding is imposed in the absence of an FFI Agreement. Given the breadth of the definition of an FFI, U.S. payors will likely be particularly concerned about how to ensure that they have accurately determined the FFI or non-FFI status of each of their payees. The interaction of the new rules with existing portfolio interest and treaty-based withholding compliance rules may be complex, depending on how successfully the IRS can integrate the implementation of the new rules with the existing requirements.

Withholding on Payments to Certain Non-Financial Foreign Entities

The proposed legislation would also require a withholding agent to withhold 30 percent of any withholdable payment made to a non-financial foreign entity that does not meet specified requirements. Such a payment to a non-financial foreign entity would not be subject to withholding if the entity provides the withholding agent with: ***either*** a certification that it does not have a substantial U.S. owner ***or*** the name, address, and TIN of each substantial U.S. owner. The withholding agent could rely on such a certification (unless it knew or had reason to know it was incorrect), and would be required to report the name, address, and TIN of each substantial U.S. owner to the IRS. This provision would not apply to any payment beneficially owned by a publicly traded corporation (or affiliate). The provision also would not apply to any payment to a foreign government or subdivision or agency of a foreign government, an international organization, foreign central bank, or any class of persons or payments identified by the IRS as posing a low risk of tax evasion.

This provision could potentially apply, for example, to a U.S. bank making a payment of interest to a non-publicly traded, non-financial foreign entity that has a depository account with the bank. The Joint Committee on Taxation's September 2009 report on President Obama's 2010 budget proposals commented that, in light of markets that have developed in the absence of withholding and documentation requirements with respect to such deposit accounts, consideration should be given to whether special rules or exceptions would be needed to avoid market disruptions because U.S. source interest paid with respect to deposit accounts is generally exempt from the 30-percent withholding tax, without regard to whether the withholding agent received a statement that the beneficial owner was not a U.S. person. Accordingly, depending on whether this suggestion is adopted (either legislatively or administratively), U.S. banks may potentially need to establish new procedures with respect to deposits from such entities.

Effective Date

The provision is proposed to apply to payments made after December 31, 2012. The provision does not require any amount to be deducted or withheld from any payment under any obligation outstanding on the date that is two years after the date of the enactment of TEA.

As initially proposed, FATCA would have applied to payments made after December 31, 2010, and the only payments excluded would have been those made under obligations outstanding on the date of first committee action, but only if the obligation was in bearer form or contained "gross-up" provisions that would have required the issuer to make additional payments by reason of the new withholding tax. Accordingly, the effective date has been substantially delayed, and the grandfather rule for obligations in existence before the provisions take effect has been broadened, presumably recognizing the administrative challenges that will face both market participants and the government in implementing these broad changes.

U.S. and non-U.S. financial institutions will thus have a three-year period in which to modify their compliance systems and procedures to implement the new requirements. Their ability to do so, however, may be slowed by the need to await implementing guidance from Treasury and the IRS, which, as noted above would be granted extraordinarily broad discretion to implement these rules. Thus, if TEA is enacted, affected market participants may find it useful to participate actively in the administrative guidance process in an effort to ensure that such guidance is timely, consistent with marketplace realities, and susceptible of practical implementation.

Other Provisions of the Proposed Legislation

Other significant tax and compliance provisions in TEA include the following:

(1) Repealing the foreign-targeted obligation exception to the denial of a deduction for interest on bonds not issued in registered form, and repealing the treatment as portfolio interest of interest paid on bonds that are not issued in registered form but meet the foreign targeting requirements of section 163(f)(2)(B);

(2) Imposing additional information reporting requirement on individuals and entities who hold offshore accounts and hold stock in a passive foreign investment company;

(3) Requiring withholding on any dividend equivalent payments that are (i) substitute dividends, (ii) made pursuant to a specified notional principal contract, and (iii) any other payment determined by the Treasury to be substantially similar to such payments; and

(4) Taxing income from a "carried interest" in a partnership as ordinary income.

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If you have any questions concerning the proposed legislation, please do not hesitate to contact Rob Culbertson or Michael Caballero in our Washington, D.C. office, or alternatively please contact any of the following Paul Hastings lawyers:

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[1] The definition of a withholdable payment also retains the catch-all category of existing law, applicable to any "fixed or determinable annual or periodical" ("**FDAP**") payments from U.S. sources. An exception is provided for income that is effectively connected with the conduct of a U.S. trade or business.

[2] A specified U.S. person includes a U.S. individual and a U.S. corporation that is not publicly traded, but conversely excludes a publicly-traded corporation and its affiliates, a tax-exempt organization or individual retirement plan, a bank, a real estate investment trust, a regulated investment company, certain trusts, and certain governmental entities.

[3] For example, the EU Third Money Laundering Directive requires identification of persons who own more than 25 percent of an entity account holder, while the proposed U.S. rules would require reporting with respect to a U.S. person who owns more than 10 percent of an entity account holder (and in some cases any U.S. owner as noted above).

[4] The Joint Committee on Taxation's report on TEA states that this may include certain classes of widely held collective investment vehicles and institutions subject to similar due diligence and reporting requirements under other provisions of the Code.