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Client Alert

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"HIRE ACT" GIVES EFFECT TO FATCA PROVISIONS, IMPOSING WITHHOLDING AND REPORTING REQUIREMENTS TO COMBAT OFFSHORE TAX EVASION

On March 18, 2010, President Obama signed the Hiring Incentives to Restore Employment Act (the "HIRE Act") into law. The cost of the HIRE Act is offset, in part, by the enactment of an amended version of the previously proposed Foreign Account Tax Compliance Act of 2009 ("FATCA"). The amended FATCA provisions are expected to raise $8.7 billion over 10 years by combating offshore tax evasion

Generally, the amended FATCA provisions make significant changes in five principal areas:

- 30% withholding would apply to payments made to foreign financial institutions and non-financial foreign entities that do not comply with new information reporting obligations.
- The "foreign targeted obligation" exception to the sanctions imposed on bearer bonds (which include denying the portfolio interest exemption from withholding) would be repealed, with only limited grandfathering of outstanding bearer bonds.
- Additional reporting requirements would apply with respect to foreign financial assets, including equity investments in Passive Foreign Investment Companies. These reporting requirements would supplement existing FBAR reporting requirements.
- New reporting requirements and other rules would apply to foreign trusts
- Withholding tax would be imposed on dividend-equivalent amounts received by foreign persons under equity swaps and certain other financial contracts.

This Client Alert summarizes the HIRE Act's proposed 30% withholding regime as an enforcement mechanism for new reporting requirements on certain foreign accounts owned by U.S. persons and U.S.-owned foreign entities.

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The proposed withholding regime requires a withholding agent to withhold a 30% tax on any "withholdable payment"[1] made to "foreign financial institutions" unless the foreign financial institution enters into an agreement with the Internal Revenue Service (the "IRS") to:

1. Obtain information from each account holder as necessary to determine if an account is a "U.S. account";
2. Comply with verification and due diligence procedures as required to identify U.S. accounts;
3. Report certain information with respect to U.S. accounts on an annual basis;
4. Comply with requests by the IRS for additional information with respect to any U.S. account;
5. Attempt to obtain a waiver in any case where foreign law would prevent the reporting of information required with respect to any U.S. account, and close the account if the waiver cannot be obtained; and
6. Deduct and withhold 30% on any passthru payment made by the institution to a recalcitrant holder,[2] other foreign financial institution that does not have an agreement with the IRS to comply with these requirements, or other foreign financial institutions that elects withholding in lieu of compliance with the information reporting regime.

The information reporting requirements will be satisfied and 30% withholding tax avoided if the foreign financial institution reports the following information to the IRS: (1) name, address, and TIN of each account holder that is a U.S. person, (2) name address and TIN of each substantial U.S. owner of any account holder that is a U.S. owned foreign entity, (3) account number, (4) account balance or value, and (5) gross receipts and withdrawals or payments from the account.

The HIRE Act defines "foreign financial institution" broadly to include (1) any entity that accepts deposits in the ordinary course of a banking or similar business, (2) any entity that holds financial assets for the account of others as a substantial portion of its business, and (3) any entity engaged in the business of investing, reinvesting, or trading in securities, partnership interests, commodities, or any interest in such securities, partnership interests, or commodities (including futures, forwards or options). Accordingly, the term foreign financial institution includes investment vehicles like hedge funds and private equity funds.

Pursuant to the HIRE Act, a "U.S. account" is any financial account held by one or more "specified U.S. persons"[3] or a foreign entity that has one or more "substantial U.S. owners"[4].

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[1] Withholdable payments include U.S. source interest, dividends, royalties, or other fixed or determinable annual or periodic payments, and gross proceeds from the sale or other disposition of any property which produces U.S. source interest or dividends. Income effectively connected with a U.S. trade or business and U.S. source interest paid by a foreign branch of a domestic financial institution is excluded from the definition of withholdable payments.

[2] A "recalcitrant holder" is an account holder that refuses to comply with reasonable information requests or to obtain a waiver where foreign law precludes compliance.

[3] A "specified U.S. person" is defined as any U.S. person other than (a) a publicly traded corporation (and any member of the same expanded affiliated group); (b) any 501(a) tax exempt organization or an individual retirement plan; (c) the United States or any wholly owned agency or instrumentality thereof; (d) any state, the District of Columbia, U.S. possessions and any agency or instrumentality thereof; (e) any bank; (f) any RIC, REIT, or common trust fund; and (g) certain tax exempt trusts.

[4] A "substantial U.S. owner" is defined as any U.S. person that (a) owns, directly or indirectly, more than 10% of the stock of a corporation, by vote or value; (b) owns, directly or indirectly, more than 10% of the profits interest or capital interest in a partnership; (c) owns any interest in a foreign grantor trust; or (d) to the extent provided by the Secretary in regulations or other guidance, owns more than 10% of the beneficial interest in a trust. Determination of indirect ownership for these purposes has the potential to be highly problematic.

The reporting requirements imposed by the FATCA provisions supplement the existing requirements applicable to Qualified Intermediaries. As such, Qualified Intermediaries must satisfy the new regime proposed by the HIRE Act in addition to all existing requirements.

The HIRE Act adopts a similar regime for non-financial foreign entities. Withholding agents must deduct and withhold a 30% tax on withholdable payments made to non-financial foreign entities unless the payee or beneficial owner of the payment provides certification that the foreign entity does not have a substantial U.S. owner or provides the name, address and TIN of each substantial owner. This regime does not apply to payments beneficially owned by (1) publicly traded corporations or members of an expanded affiliated group of a publicly traded corporation (2) foreign governments, political subdivisions of foreign governments, or any agency or instrumentality thereof; (3) entities organized under the laws of a U.S. possession and which is wholly owned by residents of that possession; (4) international organizations and wholly owned agencies or instrumentalities thereof; (5) foreign central banks of issue; or (6) other classes of persons identified by the Secretary.

Taxes withheld under these new provisions are generally subject to the existing rules providing for foreign tax credits, refunds and treaty benefits. However, no credit or refund will be paid unless the beneficial owner of that payment supplies the IRS with information sufficient to establish that the beneficial owner is a U.S. owned foreign entity and the identity of any substantial U.S. owners thereof.

The HIRE Act's withholding and information reporting provisions are applicable to payments made after December 31, 2012. The HIRE Act does, however, provide a limited grandfather provision for obligations outstanding on March 18, 2012, two years after the date of enactment. No deduction or withholding must be made for payments on or from gross proceeds from the disposition of a grandfathered obligation.

One of the main practical effects of the FATCA provisions of the HIRE Act is the need to revisit most routine credit and other documents that provide for a "gross-up" for U.S. withholding taxes. Although market reactions have not been uniform to date, we expect that payors generally will negotiate to be relieved of any gross-up obligations for FATCA – related withholding.

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