HIRE Act Imposes Broad New Reporting Requirements and Withholding Tax on Foreign Entities

On March 18, 2010, President Obama signed into law H.R. 2847, the Hiring Incentives to Restore Employment Act (HIRE). HIRE includes several provisions intended to stimulate hiring of U.S. workers, including payroll tax forgiveness and a business credit for companies with respect to certain newly hired persons. The costs of these provisions are projected to be offset, in part, by the enactment of key aspects of legislation that was previously introduced but not enacted (the Foreign Account Tax Compliance Act of 2009 (H.R. 3933, S. 1934)). These rules are designed to crack down on perceived tax avoidance by U.S. persons. Beginning in 2013, a 30% withholding tax will apply to most U.S. source payments (including any gross proceeds realized upon the sale of debt and equity investments in U.S. entities and payments of portfolio interest) made to foreign entities that fail to disclose detailed information about U.S. account holders and investors. The new reporting and withholding rules are intended to supplement the existing withholding and reporting rules with respect to payments of U.S. source income. However, the new rules introduce a host of new concepts and terms to the tax law, many of which are potentially far reaching. Detailed Treasury guidance will be necessary to implement these complex provisions and coordinate them with existing rules. Clients operating foreign private equity funds, hedge funds, and other foreign investment vehicles with U.S. investors, as well as investors in such entities, are likely to be impacted by the new reporting rules and should monitor these rules and forthcoming regulations closely.

There are several other tax-related provisions in HIRE, including new reporting requirements (and increased penalties for failures to comply) for individuals holding interests in foreign financial assets and certain foreign entities, rules imposing withholding tax on synthetic dividend payments under certain derivative contracts, and provisions that adversely affect the tax treatment of interest paid on bearer bonds. The effective dates of these provisions vary.

1. Foreign Financial Institutions—Information Reporting and Withholding

What do the new rules do? The centerpiece of the new reporting regime is a new 30% withholding tax on most payments of U.S. source income to a broadly-defined group of foreign entities, including foreign hedge funds and private equity funds, unless they enter into an agreement with the IRS and disclose certain information regarding U.S. account holders and investors, enter into an agreement with the IRS and elect to report as U.S. financial institutions, or refuse to maintain accounts for, or accept investments by, U.S. persons.

These new reporting rules will create significant burdens for foreign entities. The bill acknowledges this by delaying application of the reporting rules and withholding tax to payments made after December 31, 2012 and by providing a favorable grandfathering rule.

Who is subject to the new rules? Foreign financial institutions (FFIs) will be subject to these new rules. FFIs are broadly defined to include (i) foreign banks, (ii) foreign custodians or depositaries, and (iii) foreign entities primarily engaged in the business of investing, reinvesting, or trading in securities, partnership interests, or commodities, or any interest in such items. The definition of an FFI is broad enough to include foreign private equity funds, hedge funds, and other foreign investment vehicles. In addition, non-financial foreign entities generally will be subject to similar reporting rules. However, the bill provides exceptions for certain non-financial foreign entities (for example, publicly traded companies) and also authorizes Treasury to provide additional exceptions.

What payments may be subject to the 30% withholding tax? The 30% withholding tax applies to "withholdable payments" to an FFI that does not satisfy one of the requirements described below. The withholding tax applies regardless of whether the payments are for the benefit of a U.S. person. Withholdable payments generally include U.S. source payments of interest (including portfolio interest and interest paid by foreign branches of U.S. financial institutions), dividends, rents, and other gains, profits, and income, as well as any gross proceeds from the sale of any property that can produce U.S. source interest or dividends. Withholding on portfolio interest, interest on foreign branch deposits, and gross proceeds is a significant departure from prior law. Items of income effectively connected with the conduct of a U.S. trade or business by a foreign person are not subject to the withholding tax. The effective date for the new withholding tax has been delayed to apply to payments made after December 31, 2012, which will permit Treasury to issue much needed guidance and foreign entities to determine their obligations and implement procedures under the new rules. In addition, a favorable grandfathering rule provides that the 30% withholding tax will not apply to any payment made pursuant to an obligation that is outstanding on the two-year anniversary of HIRE's enactment date (or the gross proceeds from any disposition of such an obligation).

What can be done to prevent the 30% withholding tax from applying? An FFI has three alternatives under the new regime in order to prevent the 30% withholding tax. Each could involve a substantial administrative burden for an FFI. Significant details about the alternatives remain to be provided by the U.S. Treasury in expected forthcoming guidance:

- *Enter into an agreement with the IRS and disclose information regarding U.S. account holders and investors:* An FFI may enter into an agreement with the IRS whereby it agrees to obtain and verify certain information from all account holders and investors to determine which are U.S. account holders or investors. U.S. account holders or investors for this purpose generally are U.S. persons or foreign entities with one or more direct or indirect 10% U.S. owners. A special rule eliminates the 10% threshold and requires FFIs that are primarily engaged in investing or trading activities (including most foreign hedge funds and private equity funds) to obtain and report information regarding any indirect U.S. investors (regardless of percentage ownership). An FFI may be required to withhold at the 30% rate on payments to, or close the account of, any "recalcitrant account holder" (those account holders or investors that do not provide, or are prohibited by foreign law from providing, the required information). An FFI will be required to disclose specified information about U.S. account holders or investors including account holder information (including name, address and identification number) and account information (including the account number, the account balance or value, and withdrawals and other activity). Note that an FFI is not required to disclose information about certain U.S. account holders or investors, including REITs, mutual funds, publicly traded companies, tax-exempt organizations and retirement plans, certain charitable trusts and natural persons whose aggregate depositary accounts with the FFI do not exceed a de minimis threshold of $50,000.

  The bill does not include critical details about the requirements and operation of the new regime. The U.S. Treasury will need to issue detailed guidance before FFIs can implement these rules. For example, the U.S. Treasury needs to provide guidance about the agreement procedure and terms, the verification and due diligence rules for identifying U.S. account holders and investors, and ongoing compliance procedures.

- *Enter into an agreement with the IRS and report as a U.S. financial institution.* An FFI may enter into an agreement with the IRS (generally similar to that described above) and elect to comply with the same reporting requirements as U.S. financial institutions, which would include, among other requirements, reporting payments to U.S. persons on IRS Form 1099. Treasury needs to provide details about the scope and mechanics of this agreement and election.

- *Refuse to maintain accounts for, or permit investments by U.S. persons:* An FFI may choose to comply with procedures to be issued by Treasury to ensure that it does not maintain U.S. accounts or permit U.S. investors. The details of such procedures are not yet known.

2. Other Reporting and Tax-Related Provisions

Among other tax-related changes, HIRE includes the following:

- *Individual information reporting and penalties.* Effective for tax years beginning after the date of enactment, individuals will be required to report their interests in foreign financial assets (broadly defined to include foreign private equity funds, hedge funds and other foreign investment vehicles) with an aggregate value in excess of $50,000. Noncompliance could result in (i) penalties of $10,000 per taxable year, (ii) a new 40% accuracy related penalty on understatements of income attributable to undisclosed foreign financial assets, and (iii) the application of a new six-year statute of limitations. These new reporting requirements are in addition to the Foreign Bank and Financial Account Report (FBAR) reporting requirements.

- *PFIC reporting.* Effective as of the date of enactment of HIRE (March 18, 2010), each U.S. shareholder of a foreign corporation that qualifies as a "passive foreign investment company" (PFIC) will be required to file an annual information return. This is a change from current law, which only requires PFIC reporting if a U.S. person receives a distribution from, disposes of an interest in, or makes certain elections with respect to, a PFIC. The U.S. Treasury is expected to provide guidance specifying the information to be provided. Absent U.S. Treasury guidance preventing duplicative reporting, this reporting is in addition to the individual reporting requirements described above.

- *Bearer bonds and portfolio interest.* HIRE substantially alters the rules regarding bearer bonds by eliminating the deduction for interest paid by U.S. issuers and imposing a 30% withholding tax on interest paid to foreign persons (unless they establish that they are otherwise eligible for an exemption from, or reduction of, withholding). These rules apply to bearer bonds issued after the date that is two years after the date of enactment of HIRE.

- *"Dividend equivalent" payments.* HIRE includes rules imposing a withholding tax on synthetic dividend payments under certain derivatives contracts. Please see Ropes & Gray's Alert, dated March 19, 2010 for more information on these provisions.

If you have any questions concerning the HIRE provisions, please contact a member of the Ropes & Gray Tax & Benefits Department.

CIRCULAR 230 DISCLOSURE

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