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Foreign Account Tax Compliance Act of 2009 – Congress Sets Its Sights On Overseas Tax Evasion

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by Thomas A. Humphreys, Shamir Merali, Remmelt A. Reigersman

On October 27, 2009, Senator Max Baucus (D-Montana) and Representative Charles Rangel (D-New York), chairmen of the Congressional tax writing committees, introduced the Foreign Account Tax Compliance Act of 2009 (the "Bill") in the U.S. Congress. A statement released by the House Ways and Means Committee indicates that the Bill "is intended to clamp down on tax evasion and improve taxpayer compliance by giving the IRS new administrative tools to detect, deter and discourage offshore tax abuses." If enacted in its current form, the Bill would, among other things, close down "dividend-washing" transactions (arrangements involving swaps that are perceived to impermissibly avoid a U.S. withholding tax on U.S.-source dividends), require increased reporting with respect to foreign assets held by U.S. persons, impose disclosure requirements on advisors who help set up foreign entities, and strengthen rules and penalties relating to foreign trusts. Both President Barack Obama and Treasury Secretary Timothy Geithner issued statements giving their unqualified support for the Bill.

Related Practices:

- Federal Tax
- Tax

This is the last in our series of three alerts addressing the provisions of the Bill. Please see our first client alert addressing the Bill's proposed repeal of the U.S. bearer debt exception at http://www.mofo.com/news/updates/files/16103.html and our second client alert addressing the Bill's provisions regarding a 30% withholding tax on payments to foreign financial institutions and foreign entities unless certain information reporting and certification requirements are met at http://www.mofo.com/news/updates/files/16106.html.

"Dividend Washing"

Under current law, the source of any payments made pursuant to a notional principal contract (or swap) is determined by reference to the residence of the person receiving the payment. Accordingly, payments (including any amounts determined by reference to dividends) received by a foreign person that enters into a swap with respect to an underlying U.S. stock are treated as foreign source payments not subject to U.S. tax. By contract, a direct distribution to the foreign person of a dividend generally would be

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subject to a 30% withholding tax (unless reduced by an applicable treaty). The Bill would treat as a U.S.-source dividend, for purposes of U.S. withholding tax provisions, any amount (determined on a gross basis, *i.e.*, without regard to any offsetting payments under the swap) paid pursuant to a swap contract and that is contingent on, or determined by reference to, the payment of a U.S.-source dividend (such amount, a "dividend equivalent"). The provision would not apply to payments made pursuant to a contract that the Secretary of the Treasury determines does not have the potential for avoidance of taxes imposed on U.S.-source dividends. The provision would, however, apply to payments made on or after the 90th day after enactment of the Bill. Therefore, if enacted, it would apply to existing swaps.

Reporting of Foreign Assets

The Bill would require individual taxpayers who have an interest in a "specified foreign financial asset" to attach a statement to their income tax return if the aggregate value of all such assets during any year is greater than $50,000. A "specified foreign financial asset" would include depository and custodial accounts at foreign financial institutions (*i.e.*, bank and brokerage accounts), and, unless held in a custodial account with a U.S. financial institution, (i) stock or securities issued by foreign persons, (ii) any other financial instrument or contract held for investment that is issued by or has a counterparty that is not a U.S. person, and (iii) any interest in a foreign entity. Interests in foreign private equity and hedge funds would be subject to reporting under this provision. These disclosure requirements would be separate from and in addition to any requirement to file Treasury Form TD F 90-22.1 (the Report of Foreign Bank and Financial Accounts or "FBAR"). Failure to comply with this provision would subject an individual to a maximum penalty of $50,000. This provision would be effective for taxable years beginning after the date of enactment.[1]

Disclosure by Material Advisors

The Bill would require a "material advisor" to file an information return in connection with any assistance to a U.S. individual in directly or indirectly acquiring or forming a foreign entity. A "material advisor" would be any person that provides material aid, assistance, or advice with respect to the acquisition or formation of the foreign entity, and that derives gross income in excess of $100,000 in connection therewith. Failure to comply would subject the material advisor to a penalty equal to the greater of (i) $10,000 or (ii) 50% of the gross income derived by the material advisor in connection with the aid, assistance or advice. This provision would apply to any aid, assistance and advice that is provided after the date of enactment of the Bill.[2]

Foreign Trusts

Under current law, foreign trusts with U.S. owners or U.S. beneficiaries are subject to various reporting obligations. The failure to comply with the reporting obligations may result in the imposition of steep penalties on U.S. owners or U.S. beneficiaries. The Bill includes several provisions affecting foreign trusts, including the following: (i) codification of current Treasury Regulations providing that even if a U.S. person's trust interest is contingent, an amount is treated as accumulated for the benefit of such U.S. person, (ii) presumption that a foreign trust has a U.S. beneficiary if any U.S. person transfers property to the trust (unless certain information is provided to the Treasury Secretary), (iii) treatment of a trust as having a U.S. beneficiary unless the terms of the trust specifically prohibit any distributions to be made to U.S. persons, (iv) use of trust property by the U.S. grantor, U.S. beneficiary or a related party, would be treated as a distribution of the fair market value of the use of the property to such person, (v) imposition of additional filing requirements on a U.S. person that is treated as an owner of any portion of a foreign trust, and (vi) imposition of a minimum penalty of $10,000 in the case of a failure to file certain information returns.

Links

Text of the Bill as introduced in the U.S. Congress can be found at http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:h3933ih.txt.pdf and the technical explanation of the Bill as provided by the Joint Committee on Taxation can be found at http://jct.gov/publications.html?func=startdown&id=3596.

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Footnotes

[1] The Bill also includes provisions regarding penalties for underpayments attributable to undisclosed foreign financial assets and would modify the statue of limitations for significant omissions of income in connection with foreign assets.

[2] Further, the Bill includes a provision that would require shareholders of a "passive foreign investment company" ("PFIC") to file information returns as required by the Treasury Secretary. This would be in addition to the filing requirements already imposed on shareholders of a PFIC. In addition, the Bill would provide for an exception to the general rule that the Treasury Secretary may require electronic filing of returns only with respect to persons required to file at least 250 returns during the year. This exception would apply to returns to be filed by "financial institutions" with respect to taxes for which it is personally liable.

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