Alert 10-144

ReedSmith

Tax Alert

Foreign Account Tax Compliance: Witholding and Information Reporting Requirements on 'Withholdable Payments' to Foreign Entities

The Hiring Incentives to Restore Employment Act (the "HIRE Act"), signed into law this past March, includes certain foreign account tax compliance provisions designed to combat offshore tax evasion through increased tax withholding and information reporting obligations with respect to "withholdable payments" made to certain foreign entities (the "FATC Provisions"). The FATC Provisions also require certain foreign financial institutions (broadly defined, as discussed below, to include virtually all offshore investment funds) to disclosure significant information to the Internal Revenue Service (the "IRS") regarding their United States ("U.S.") investors. Although the FATC Provisions discussed herein generally apply only to payments made after December 31, 2012, taxpayers and commentators have raised numerous questions regarding the application and potential impact of these provisions. This *Tax Alert* summarizes these provisions.

General

The FATC Provisions are set forth in new Sections 1471 through 1474 of the Internal Revenue Code of 1986, as amended (the "Code"), and generally impose a 30 percent withholding tax on any "withholdable payment" made to foreign entities unless certain requirements are satisfied. Like other withholding taxes, withholding agents failing to withhold any tax required pursuant to these new rules are liable for the tax.

For purposes of these rules, a "withholdable payment" generally is defined as (i) any payment of interest (including original issue discount), dividends, rents, salaries, wages, premiums, annuities, compensation, remunerations, emoluments and other fixed or determinable annual or periodical gains, profits and income, if such payment is from U.S. sources, and (ii) the *gross proceeds* from the sale or disposition of property of a type, which can produce U.S. source interest or dividends (i.e., debt securities and shares of stock of U.S. issuers), but does not include any item of income that is effectively connected to a U.S. trade or business.

The new requirements distinguish between payments made to a "foreign financial institution" (an "FFI") and payments made to a "non-financial foreign entity" (an "FE"). As described further below, 30 percent withholding generally is imposed on a withholdable payment to (i) an FFI unless the FFI enters into an agreement with the IRS to identify and report significant information with respect to the FFI's "United States accounts," and (ii) an FE, unless the FE identifies its substantial U.S. owners or certifies that it does not have substantial U.S. owners.

For purposes of these rules, an FFI is broadly defined to include any entity that is not a United States person that (i) accepts deposits in the ordinary course of a banking or similar business, (ii) as a substantial portion of its business, holds financial assets for the account of others, or (iii) is engaged (or holds itself out as engaged) primarily in the business of investing, reinvesting, or trading in securities, partnership interests, commodities, or any interests (including derivatives) in such securities, partnership interests, or commodities (a "Foreign Investment Vehicle"). An FE is any entity (other than an FFI) that is not a United States person.

The FATC Provisions generally are effective for payments made after December 31, 2012. Under a grandfather rule, however, these provisions do not require withholding from any payment under any obligation outstanding two years after the enactment date of the HIRE Act (i.e., March 28, 2010), or from the gross proceeds on the disposition of such obligation.

Although the IRS has been provided a broad grant of authority to issue Treasury regulations to implement these new provisions (as well as Treasury regulations to coordinate these new rules with other withholding provisions of the Code), it has not yet issued such Treasury regulations or other guidance (although it has informally stated it is making progress in connection with such guidance and intends to issue initial guidance addressing as many issues as possible). The IRS has requested comments on guidance regarding the interpretation and implementation of the FATC Provisions.

Provisions Applicable to FFIs – New Code Section 1471

New Code Section 1471 generally imposes a 30 percent withholding tax on any withholdable payment made to an FFI, unless an agreement is in effect between the FFI and the IRS, pursuant to which the FFI agrees:

- To obtain such information regarding its account holders as is necessary to determine which (if any) accounts are "United States accounts"
- To comply with IRS verification and due diligence procedures with respect to the identification of United States accounts
- To report annually certain information (e.g., certain identifying information, account balances, and gross receipt and gross withdrawals or payments from the account) to the IRS for each United States account maintained by the FFI
- To withhold 30 percent on any withholdable payments made to a recalcitrant account holder (*i.e.*, generally, any account holder that fails to provide the FFI with information necessary for the FFI to comply with its agreement with the IRS), and other FFIs that do not enter into agreements with the IRS that satisfy the requirements of Section 1471
- To comply with IRS information requests with respect to the FFI's United States accounts
- Where foreign law would otherwise prohibit the reporting of the required information, to attempt to obtain a waiver of such law and if a waiver is not obtained within a reasonable period of time, to close the account

Subject to certain exceptions, a "United States account" generally is any depository or custodial account maintained by, or any non-publicly traded debt or equity interests in, the FFI, which is held by one or more "specified United States persons" or "United States owned foreign entities." A "specified United States person" generally is any United States person that is *not* (i) a publicly traded U.S. corporation (or any of certain affiliates of such corporation); (ii) a tax-exempt organization; (iii) a bank; (iv) a real estate investment trust; (v) a regulated investment company; (vi) a common trust fund; (vii) an exempt trust; and (viii) the United States, any State, the District of Columbia, any possession of the United States or any political subdivision or wholly owned agency or instrumentality thereof. A "United States owned foreign entity" generally is any foreign entity having one or more "substantial United States owners" (generally, any specified United States persons owning more than 10 percent of such foreign entity, such percentage reduced to 0 percent in the case of any FFI that is a Foreign Investment Vehicle).

An FFI generally may be deemed to satisfy these requirements if (i) such FFI complies with such procedures as the IRS may prescribe to ensure that the FFI does not maintain any United States accounts, and such other requirements as the IRS may prescribe with respect to the accounts of other FFIs maintained by such FFI, or (ii) such FFI is a member of a class of institutions with respect to which the IRS has determined the application of these rules is unnecessary. Furthermore, if an FFI elects to be subject to the same reporting requirements applicable to U.S. financial institutions, it will be exempt from certain of the information reporting requirements of Section 1471.

In lieu of withholding 30 percent on a withholdable payment made to a recalcitrant account holder or other FFI, an FFI generally may elect to be subject to 30 percent withholding on such withholdable payment (to the extent allocable to accounts held by the recalcitrant account holder or other FFI), provided the electing FFI notifies the withholding agent of its election and gives sufficient information to the withholding agent to ensure such withholding agent's ability to determine the correct amount of withholding.

The rules applicable to FFIs generally do not apply to withholdable payments made to foreign governments, certain international organizations, foreign central banks of issue, and other classes of persons that the IRS, by regulation, identifies as posing a low risk of tax evasion.

It is worth noting that many foreign entities not commonly thought of as "financial institutions" will be treated as FFIs. More specifically, virtually every offshore investment fund (even investment funds managed by non-U.S. managers) will be a Foreign Investment Vehicle, and therefore, an FFI. Consequently, such funds will be required to enter into agreements with the IRS, as described above, to avoid 30 percent withholding with respect to the *gross proceeds* (not just income or gain) associated with debt and equity investments in United States issuers. This will result in substantial information reporting and compliance burdens not previously imposed on such investment funds.

Provisions Applicable to FEs – New Code Section 1472

New Code Section 1472 generally imposes a 30 percent withholding tax on any withholdable payment made to an FE, unless:

- The FE provides the withholding agent with either (i) a certification that such FE does not have any substantial United States owners (as described above) or (ii) identifying information with respect to its substantial U.S. owners
- The withholding agent does not know, or have reason to know, that any such information is incorrect
- The withholding agent reports the information provided by the FE to the IRS in such manner as the IRS provides

The rules applicable to FEs generally do not apply to (i) withholdable payments, the beneficial owner of which is (A) a publicly traded corporation (or any of certain affiliates of such corporation), (B) an entity organized in a United States possession that is wholly owned by one or more bona fide residents of such possession, (C) a foreign government, (D) an international organization, or (E) a foreign central bank of issue; and (ii) any other class of payments, identified by the IRS as posing a low risk of tax evasion.

Conclusions

Although the new withholding tax and information reporting rules described above are aimed at the legitimate goal of combating offshore tax evasion, these rules are very broad in scope, and likely will have a significant impact on foreign entities as well as on withholding agents. For example, changes to internal systems will be required in order to ensure compliance, including changes in the manner in which United States accounts are opened, and the nature of the documentation to be obtained with respect to such accounts. At a minimum, such changes will likely result in significant administrative and compliance costs.

Furthermore, there are numerous unanswered questions about these new withholding and information reporting rules, including, among other issues, (i) what will be the form of the agreement with the IRS, and what class of institutions will not be required to enter into such agreements, (ii) how will these rules be coordinated with other withholding and information reporting requirements under the Code, including tax treaties and other provisions that provide for exemptions from withholding, (iii) what procedures must be followed in order for FFIs to enter into and comply with agreements with the IRS so as to avoid withholding, (iv) how does an FFI determine whether a person is a specified United States person, and (v) what specific documentation requirements will be necessary to satisfy each of the requirements of the FATC Provisions. As noted above, no such guidance has been issued to date. It is hoped that the IRS will issue significant guidance shortly, and that such guidance will implement these rules in a manner that is commercially feasible.

This *Tax Alert* is intended only to provide a general summary of certain tax-related provisions included in the HIRE Act. We will update our clients as appropriate upon the issuance of any future guidance with respect to the FATC Provisions. If you have any questions or would like additional information about the provisions discussed above, please contact one of the authors, or the Reed Smith attorney with whom you regularly work.

* * * * *

To ensure compliance with Treasury Department regulations, we inform you that any U.S. federal tax advice contained in this communication is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Code or (ii) promoting, marketing or recommending to another party any tax-related matters addressed herein.

Angelo Ciavarella
Partner, New York
+212 549 0339

Ruth N. Holzman
Partner, Century City
+1 310 734 5214

Jeffrey E. Kaylor
Associate, Pittsburgh
+1 412 288 3158

Europe: London, Paris, Munich, Greece

Middle East: Abu Dhabi, Dubai

Asia: Hong Kong, Beijing