New laws will affect cross-border financing transactions

The Hire Act introduces new US withholding tax provisions for taxpayers that fail to comply with new rules on tax evasion explain Thomas Humphreys, Remmelt Reigersman and Armin Gharagozlou of Morrison & Foerster

On March 18 2010, President Obama signed into law the Hiring Incentives to Restore Employment Act (the Act). The Act incorporates the Foreign Account Tax Compliance Act including provisions which:

- introduce a new 30% withholding tax on certain payments made to foreign entities that fail to comply with specified reporting or certification requirements;
- end the practice where US issuers sell bearer bonds to foreign investors by repealing the US bearer bond exception; and
- impose a withholding tax on "dividend equivalents" paid under equity swaps.

These provisions are generally aimed at preventing offshore tax avoidance by US and non-US persons. The new withholding tax applies to relevant payments made after December 31 2012. Importantly, debt obligations outstanding on March 18 2012 are grandfathered from the new withholding tax and from the repeal of the US bearer bond exception.

New withholding tax

The Act introduces a new 30% withholding tax on any "withholdable payment" made to a foreign entity unless such entity complies with certain reporting requirements or otherwise qualifies for an exemption. A withholdable payment generally includes any payment of interest, dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodical gains, profits, and income from sources within the US. It also includes gross proceeds from the sale of property that is of a type that can produce US-source dividends or interest, such as stock or debt issued by domestic corporations. Different rules apply to "foreign financial institutions" (FFIs) and to other foreign entities.

Foreign financial institutions

The new 30% withholding tax on any withholdable payment made to an FFI (whether or not beneficially owned by such institution) applies unless the FFI agrees, pursuant to an agreement entered into with the US Treasury Department, to provide information about each "financial account" held by "specified US persons" and "US-owned foreign entities". The new disclosure requirements are in addition to requirements imposed by a "Qualified Intermediary" agreement.

The term FFI includes banks, brokers and investment funds, including private equity funds and hedge funds. A financial account includes bank accounts, brokerage accounts and other custodial accounts, or an equity or debt interest in the FFI (unless such interest is regularly traded). The term specified US person is any US person other than certain categories of entities such as publicly-traded corporations and their affiliates, banks, mutual funds, real estate investment trusts and charitable trusts. A US-owned foreign entity for this purpose is any entity that has one or more "substantial

US owners" , which generally means:
- in the case of a corporation, if a specified US person, directly or indirectly, owns more than 10% of the stock, by vote or value;
- in the case of a partnership, if a specified US person, directly or indirectly, owns more than 10% of the profits or capital interests; or
- in the case of a trust, if a specified US person is treated as an owner of any portion of the trust under the grantor trust rules.

By entering into the agreement with Treasury (the actual form of agreement is not yet available but presumably will be released by Treasury in the future), the FFI agrees to:
- obtain information necessary to determine which accounts are US accounts;
- comply with verification and due diligence procedures as required by Treasury;
- annually report certain information regarding US accounts (including US accountholder identification information and annual account activity information);
- withhold on "passthru payments" made to
  - recalcitrant account holders;
  - other FFIs that do not enter into an agreement with Treasury; and
  - FFIs that have elected to be withheld upon (as further described below);
- comply with requests by Treasury for additional information with respect to any US accounts; and
- attempt to obtain a waiver from the US accountholder if any foreign law would otherwise prevent the reporting of required information or alternatively close the account.

Instead of reporting the necessary US account information, an FFI may elect to comply with the reporting requirements that apply to US financial institutions, which generally means reporting on Internal Revenue Service (IRS) Forms 1099.

Rather than agreeing with Treasury to act as a withholding agent for reportable payments, an FFI may elect to provide the withholding agents from which it receives payments with the information necessary for the withholding agents to implement the new withholding tax (generally, information that discloses the extent to which payments made to the electing FFI are allocable to accounts subject to the 30% US withholding tax). In addition, the agreement entered into between the electing FFI and Treasury must include a waiver of any right under any tax treaty of the US to any amounts withheld under this election provision.

Furthermore, the Act contains a provision pursuant to which an FFI may be treated as meeting the specified reporting requirements if:
- it complies with procedures ensuring it maintains no US accounts and meets certain requirements to other FFIs maintaining an account with it; or
- such FFI is a member of a class of institutions that would not be subject to these provisions.

Implementing procedures, requirements, and determinations in respect of this provision would be determined by Treasury in future guidance.

Foreign non-financial institutions

The new withholding tax also applies to any withholdable payment made to a non-financial foreign entity, unless the non-financial foreign entity provides the withholding agent with either:
- a certification that it does not have a substantial US owner; or
- the name, address, and taxpayer identification number of each substantial US owner.

This provision does not apply to payments made to a publicly-traded non-financial foreign entity, or any of its affiliates.

Treaty relief, credits, and refunds

If the beneficial owner of a payment is entitled to treaty benefits, the withholding tax rate imposed on any withholdable payment may be reduced or eliminated by the provisions of an applicable tax treaty and such beneficial owner would be entitled to a partial or full refund or credit. In addition, even if a treaty is not available, the beneficial owner (other than an FFI) of a withholdable payment on which the 30% tax is withheld may otherwise be entitled to a full refund or credit of the tax (for example, because payments are eligible for the portfolio interest exemption or represent gross proceeds from the sale of a capital asset). In such a case, a non-US person would have to file a US tax return to obtain a full or partial refund or credit. Similarly, a US person with a foreign bank account on which it receives payments that are withheld on, presumably would have to claim a refund or credit on its US tax return.

Effective date

The new withholding tax applies to any withholdable payment made after December 31 2012, and, in the case of "obligations," only to payments on obligations issued after March 18 2012. Therefore, debt obligations (but not stock) outstanding on March 18 2012, are grandfathered.

Announcement 2010-22

On April 7 2010, the Treasury and the IRS released Announcement 2010-22. The announcement solicits comments for future guidance and other issues concerning the interpretation and implantation of this new tax provision and other provisions of the Act.

Repeal of US bearer bond exception

In 1982, Congress passed the Tax Equity and Fiscal Responsibility Act (TEFRA), which restricts the issuance of debt instruments in bearer form. Under TEFRA, issuers of debt instruments in bearer form generally are denied deductions for US federal income tax purposes for interest paid on such debt instruments and are subject to an excise tax (equal to 1% of the principal amount of the bonds times the number of years to maturity). Various sanctions also apply to holders. These sanctions, however, do not apply to bearer debt instruments that are issued under circumstances in which they are unlikely to be sold to US persons. These circumstances include an issuance of foreign-targeted bearer debt instruments that complies with Treasury regulations referred to as TEFRA C and TEFRA D.

The US imposes a 30% withholding tax on all US source interest paid to non-resident aliens and foreign corporations. In 1984, Congress exempted "portfolio interest" from the US withholding tax to encourage investment in US debt. Portfolio interest is any US source interest other than interest received from certain related parties or interest earned by a bank on an extension of credit in the ordinary course of its lending business. In addition, Congress provided that debt instruments in bearer form do not qualify for the portfolio interest exemption (with the result that interest paid on such instruments is generally subject to the 30% US withholding tax) unless such instruments are issued in compliance with the foreign-targeted requirements imposed by TEFRA.

Many US issuers have European medium-term note or other foreign-targeted programmes under which they issue bearer notes to non-US investors. These issuances comply with TEFRA regulations and, as such, the instruments are not subject to the sanctions described above or to US withholding tax. In addition, many non-US issuers include TEFRA restrictions in their debt offerings outside the US to ensure that they are not subject to the TEFRA excise tax.

Some foreign jurisdictions, for example, Switzerland, do not permit their residents to certify as to their identity. Accordingly, there are special rules in the TEFRA regulations that permit offerings to be sold into those jurisdictions in bearer form if certain additional requirements are met.

Sanctions on issuances of bearer bonds

The Act ends the practice by US issuers of selling bearer bonds to foreign investors under TEFRA C and TEFRA D. Thus, for US issuers of foreign-targeted bearer bonds, the Act repeals the exception to a denial of interest deduction for interest on bearer bonds. In addition, interest paid on such bonds would no longer qualify for treatment as portfolio interest, thereby subjecting such interest to a 30% withholding tax and any gain realised by a holder of such bonds would be treated as ordinary income.

As a result, US issuers will have to revise their existing programmes to prohibit bearer debt. US issuers may have a harder time raising capital in foreign jurisdictions where investors in those jurisdictions are unwilling to provide the non-US beneficial ownership certification (for example, IRS Form W-8BEN) required for registered debt. However, the Act includes a provision giving Treasury the authority to determine that certification as to non-US beneficial ownership is not required to qualify for the portfolio interest exemption from withholding tax on payments of interest on certain registered debt obligations. In addition, the Act codifies IRS Notice 2006-99 providing that debt obligations cleared through dematerialised book-entry systems (such as JASDEC in Japan, or other book-entry systems specified by the Treasury) would be treated as being issued in registered form. It seems that these provisions are aimed at giving Treasury the authority to prescribe rules pursuant to which US issuers would be able to raise debt capital from jurisdictions where bonds are typically held in dematerialised form or where investors are legally barred from certifying as to residency (for example, Switzerland). Whether Treasury would, in fact, exercise such authority remains to be seen.

The Act preserves the exception to the excise tax for bearer bonds issued under TEFRA-compliant procedures. As a result, foreign issuers of a foreign-to-foreign bearer debt offering that is TEFRA-compliant would not be subject to the excise tax.

Effective date

The repeal of the US bearer bond exception applies to debt obligations issued after March 18 2012. Therefore, debt obligations in bearer form outstanding on March 18 2012 are grandfathered.

Dividend washing

In September 2008, the Senate Permanent Subcommittee on Investigations released a report entitled "Dividend Tax Abuse: How Offshore Entities Dodge Taxes on US Stock Dividends."

The report described a range of transactions employed by financial institutions aimed at enabling non-US clients to avoid US withholding taxes on dividends paid with respect to US securities. As described in the report, US withholding taxes on dividends are avoided through the use of either swaps or stock-lending transactions, or a combination thereof. Swaps are generally treated as notional principal contracts for US federal income tax purposes.

Transactions involving swaps rely on a Treasury regulation that provides that the source of any payments made pursuant to the swap is determined according to the country of residence of the person receiving the payment.

Although substitute dividend payments made under a stock-lending agreement are sourced in the same manner as the dividends relating to the underlying stock (and would therefore be US source if made with respect to stock of a US corporation), transactions involving stock lending rely on IRS Notice 97-66 to avoid US dividend withholding tax. The notice addressed the concern expressed by practitioners with respect to a "cascading effect" of dividend withholding tax if the same US securities are the subject of multiple stock-lending transactions and therefore multiple substitute dividend payments.

Withholding on dividend equivalents

The Act treats as a US-source dividend any "dividend equivalent" for purposes of US withholding tax provisions. A dividend equivalent is:

- any substitute dividend (made pursuant to a securities-lending or repo transaction;
- any amount paid pursuant to a "specified notional principal contract," and that is contingent on, or determined by reference to, the payment of a US-source dividend; and
- any amount that the Treasury determines is substantially similar to a payment described in the first two bullet points.

A specified notional principal contract is any notional principal contract if

- in connection with entering into the contract, any long party (that is, the party entitled to receive the dividend related payment) transfers the underlying security;
- in connection with the termination of the contract, any short party (that is, any party that is not a long party) transfers the underlying securities to any long party;
- the underlying security is not readily tradable on an established securities market;
- in connection with entering into the contract, any short party to the contract posts the underlying security as collateral; or
- the Treasury identifies the contract as a specified notional principal contact.

In addition, unless the Treasury determines that a notional principal contract is of a type that does not have the potential for tax avoidance, any notional principal contract pursuant to which payments are made after March 18 2012, will be a specified notional principal contract.

To address the concern about the cascading effect of such a dividend withholding tax, the Act includes a provision pursuant to which the Treasury may reduce the tax if one or more of the dividend equivalents is subject to tax and to the extent the taxpayer establishes that the tax has been paid on another dividend equivalent in the chain or if Treasury determines such reduction is appropriate to address the role of financial intermediaries (see the discussion below regarding Notice 2010-46). For the purposes of this provision, an actual dividend payment is treated as a dividend equivalent.

Effective date

This provision applies to payments of dividend equivalents made on or after September 14 2010 (that is, the 180th day after enactment of the Act). Therefore, these provisions apply to existing swaps.

Notice 2010-46

On May 20 2010, Treasury and the IRS issued Notice 2010-46 (hereafter the notice) which withdraws Notice 97-66 effective for payments made on or after September 14 2010.

For payments made before September 14 2010, taxpayers may continue to rely on Notice 97-66 to avoid a cascading effect of dividend withholding tax unless the withholding agent or foreign lender knows or has reason to know that a principal purpose of the relevant transaction is the reduction or elimination of the amount of gross-basis tax that would have been due in the absence of the transaction.

The notice sets forth the withholding and reporting framework for future regulations that will address dividend equivalents. The notice prescribes a documentation-based system under which withholding agents will be able to reduce withholding where withholding is shown to have been made on another substitute dividend payment or dividend with respect to identical securities. In addition, certain financial institutions (referred to in the notice as "Qualified Securities Lenders") will be exempt from withholding at source on receipt of substitute dividend payments provided they assume responsibility and liability for properly withholding, reporting, depositing, and paying US tax with respect to substitute dividend payments. Furthermore, the notice provides transition rules that withholding agents may rely upon for payments made after September 14 2010 and until the regulations have been issued.

Reporting of foreign assets

The Act requires 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 (that is, bank and brokerage accounts), and, unless held in a custodial account with a US financial institution, stock or securities issued by foreign persons, any other financial instrument or contract held for investment that is issued by or has a counterparty that is not a US person and 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 the 2011 taxable year.

The Act also includes provisions regarding penalties for underpayments attributable to undisclosed foreign financial assets and modifies the statue of limitations for significant omissions of income in connection with foreign assets.

Reporting for PFICs

The Act includes a provision that requires US shareholders of a passive foreign investment company (PFIC) to file information returns as required by Treasury. This would be in addition to the filing requirements already imposed on shareholders of a PFIC and is effective as of March 18 2010.

Foreign trusts

Under the US federal income tax law, foreign trusts with US owners or US beneficiaries are subject to various reporting obligations. The failure to comply with the reporting obligations may result in the imposition of steep penalties on US owners or US beneficiaries. The Act includes several provisions affecting foreign trusts, including:

- codification of current Treasury Regulations providing that even if a US person's trust interest is contingent, an amount is treated as accumulated for the benefit of such US person;
- presumption that a foreign trust has a US beneficiary if any US person transfers property to the trust (unless certain information is provided to the Treasury secretary);
- treatment of a trust as having a US beneficiary unless the terms of the trust specifically prohibit any distributions to be made to US persons;
- use of trust property by the US grantor, US 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;
- imposition of additional filing requirements on a US person that is treated as an owner of any portion of a foreign trust, and
- imposition of a minimum penalty of $10,000 in the case of a failure to file certain information returns.