

Client Alert.

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Are You Ready for March 18, 2012 —a Key Date in the U.S. Taxation of Cross-Border Financing Transactions

By Thomas Humphreys, Rimmelt Reigersman, Jared Goldberger

We have previously discussed the significance of March 18, 2012 as the effective date of certain cross-border tax provisions included in the Foreign Account Tax Compliance Act (“FATCA”). FATCA was enacted on March 18, 2010 as part of the Hiring Incentives to Restore Employment Act. March 18, 2012, marks the two-year anniversary of its enactment. Among other things, it (i) provides for a new 30% withholding tax on certain payments made to foreign entities that fail to comply with specified reporting or certification requirements and (ii) ends the practice whereby U.S. issuers sell bearer bonds to foreign investors by repealing the U.S. bearer bond exception.¹ March 18, 2012 is a consequential date with respect to both of these provisions and we wanted to remind our clients once again of its tax significance.

REPEAL OF BEARER BOND EXCEPTION

March 18, 2012 marks the end of the nearly 30-year old practice whereby U.S. issuers (and controlled foreign corporations) can sell bearer bonds to foreign investors. Thus, with respect to U.S. issuers of foreign-targeted bearer bonds, FATCA repealed the exception that permits interest deductions for interest on bearer bonds sold under “arrangements reasonably designed to ensure” sales to non-U.S. persons. In addition, interest paid on such bonds will no longer qualify for treatment as “portfolio” interest, thereby subjecting such interest to a 30% U.S. withholding tax (unless reduced under a tax treaty). Also, an excise tax will be imposed on the U.S. issuer of a bearer bond (unless the bearer bond is sold under the “arrangements” noted above) and any gain realized by a holder of such bonds will be treated as ordinary income. The repeal is effective for obligations issued after March 18, 2012.

While bearer bonds outstanding as of March 18, 2012 are “grandfathered,” U.S. issuers and controlled foreign corporations must be mindful of “reopenings” or “upsizings” and modifications of such instruments after March 18, 2012. If a U.S. or controlled foreign corporation issuer “reopens” or “significantly modifies” an outstanding grandfathered bearer bond, for U.S. federal income tax purposes, a new issuance will result, in violation of FATCA’s bearer bond repeal. This new issuance would subject the U.S. or controlled foreign corporation issuer to severe penalties, including an excise tax and the denial of interest deductions for interest paid on the instruments, not to mention subjecting U.S. source interest payments to a 30% withholding tax.

Treasury has yet to publish any guidance with respect to the repeal of the bearer bond rules although it is still possible that proposed or temporary guidance will be issued prior to March 18, 2012.

¹ See our prior client alert discussing these FATCA provisions at <http://www.mofo.com/files/Uploads/Images/100322FATCA.pdf>.

Client Alert.

FATCA WITHHOLDABLE PAYMENT RULES AND GRANDFATHERED OBLIGATIONS

FATCA also introduced a new 30% withholding tax² on any “withholdable payment”³ made to a foreign entity, unless such entity complies with certain reporting requirements or otherwise qualifies for an exemption, and on any “passthru payment” made by foreign entities to specified recipients.

As originally provided for in FATCA, “obligations” outstanding on March 18, 2012 are “grandfathered” and not subject to FATCA reporting and withholding when it takes effect, now scheduled to begin January 1, 2014. An “obligation” for purposes of the grandfather provision is any legal agreement that produces or could produce a withholdable payment or “passthru payment,” other than an instrument that is treated as equity for U.S. tax purposes or that lacks a stated expiration or term. Treasury recently published proposed FATCA regulations,⁴ which, if finalized in their current form, will expand the definition of a grandfathered obligation to include obligations outstanding on January 1, 2013. When the FATCA “withholdable payment” rules take effect, withholding will not be required with respect to any payment under a grandfathered obligation or from the gross proceeds from any disposition of such an obligation.

Despite grandfathered obligations being exempt from FATCA reporting and withholding, any material modification of a grandfathered obligation will result in such obligation being treated as newly issued on the date of the modification. In the case of an obligation that is a debt instrument for U.S. tax purposes, a material modification means a significant modification pursuant to Treasury regulations.⁵ In all other cases, whether a modification of an obligation is material will be determined based upon all relevant facts and circumstances.

Although the proposed FATCA regulations expand the definition of a “grandfathered obligation,” the original effective date of March 18, 2012 is still in the Code. Given that the regulations were issued in proposed form, obligations issued post-March 18, 2012 will not actually be grandfathered obligations until the regulations are finalized. Although we think it is unlikely, it is technically possible that such obligations could still be subject to FATCA reporting and withholding when it takes effect. We think, however, it is likely that this “glitch” will not faze the market which will expect that the regulations will be finalized with the new January 1, 2013 grandfather date.

For all FATCA updates, including the proposed FATCA regulations, see our FATCA website at KNOWFatca.com.

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² See Sections 1471 and 1472. All section references are to the Internal Revenue Code of 1986, as amended.

³ 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 U.S. It also includes gross proceeds from the sale of property that is of a type that can produce U.S.-source dividends or interest, such as stock or debt issued by domestic corporations.

⁴ See our prior client alert discussing the proposed regulations at <http://www.mofo.com/files/Uploads/Images/120214-Withholdable-Payment.pdf>.

⁵ Treasury Regulation Section 1.1001-3.

Client Alert.

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