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President Signs HIRE Act, Including FATCA Provisions Combating Offshore Tax Evasion

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On March 18, 2010, President Obama signed the Hiring Incentives to Restore Employment Act (the "Act"), which hopes to create jobs with measures such as a "Social Security holiday" for employers that hire previously unemployed workers, an extension of highway and mass transit funding, and an expansion of the Build America Bonds program. The cost of the Act is budgeted to be offset, in part, by a slightly modified version of the previously proposed Foreign Account Tax Compliance Act of 2009 (FATCA), which is intended to combat offshore tax evasion through increased information reporting and tax withholding requirements in a variety of common situations involving offshore payees and accounts beneficially owned by U.S. persons. The provision is expected to raise $8.7 billion over 10 years. Following is a summary of certain of the FATCA provisions which are included in the Act.

Increased Disclosure of Beneficial Owners

Subject to a grandfathering provision which exempts payments on, and the gross proceeds from the disposition of, obligations which are outstanding on March 18, 2012, any "withholdable payment" made after December 31, 2012 to a "foreign financial institution" (including affiliates) will, in general, be subject to a 30% U.S. withholding tax unless the foreign financial institution agrees to comply with certain requirements, including:

- obtaining information from accountholders to determine which of its accounts are "U.S. accounts";
- complying with due diligence and verification procedures as may be prescribed by the Secretary of the Treasury (the "Secretary") to determine which of its accounts are U.S. accounts;

- annually reporting certain information with respect to its U.S. accounts, including: the name, address and taxpayer identification number (TIN) of each accountholder that is a U.S. person; the name, address and TIN of each substantial U.S. owner of any account holder that is a "U.S. owned foreign entity"; the account number, the account balance or value; and the gross receipts and withdrawals from the account (or, at the election of the foreign financial institution, complying with IRS Form 1099 information reporting as if it were a U.S. person and each such accountholder was a U.S. natural person);

- withholding (or consenting to the withholding of) 30% of any "passthru payment" to recalcitrant account holders or other foreign financial institutions not in compliance with these requirements;

- complying with any requests from the Secretary regarding any additional information with respect to any of its U.S. accounts; and

- in any case in which any foreign law would prohibit reporting of the required information with respect to a U.S. account, attempting to obtain a waiver from each holder of such account, and, in the event a waiver is not obtained within a reasonable period of time from each such accountholder, closing the account.

The foregoing rules will not apply to any payment beneficially owned by certain exempt payees, including any foreign government, any international organization or any foreign central bank of issue.

Subject to a grandfathering provision which exempts payments on, and the gross proceeds from the disposition of, obligations which are outstanding on March 18, 2012, any withholdable payment made after December 31, 2012 to a "non-financial foreign entity" will be subject to 30% withholding if the beneficial owner of such payment is such entity or any other non-financial foreign entity unless (i) the payee or the beneficial owner of the payment provides (A) certification that such beneficial owner does not have any substantial U.S. owners or (B) the name, address and TIN of each substantial U.S. owner of such beneficial owner, (ii) the withholding agent does not know, or have reason to know, that any information provided pursuant to item (i) is incorrect, and (iii) the withholding agent reports the information provided under item (i)(B). Except as otherwise provided by the Secretary, the foregoing rules will not apply to any payment beneficially owned by certain exempt payees, including a corporation the stock of which is regularly traded on an established securities market or any affiliate of such corporation, any entity which is organized under any possession of the U.S. and wholly owned by one or more residents of such possession, any foreign government, any international organization or any foreign central bank of issue.

The Act introduces several new and significant terms into the Internal Revenue Code, some of which are surprisingly defined and the most salient of which are described below.

- A "withholdable payment" is defined to include not only most U.S. source payments that are subject to withholding under current law, including, among other items, U.S. source interest (including OID), dividends, rents, and royalties, but also interest paid by foreign branches of domestic financial institutions and any gross proceeds from the sale or other disposition of any property of a type which can produce U.S. source interest or dividends. The term does not include any item of income which is effectively connected with the conduct of a U.S. trade or business of a foreign person.

- A "passthru payment" is defined as any withholdable payment or other payment to the extent attributable to a withholdable payment.

- A foreign entity (i.e., any entity which is not a U.S. person) will be either a "foreign financial institution" or a "non-financial foreign entity." A financial institution is defined as any entity that accepts deposits in the ordinary course of a banking or similar business, is engaged in the business of holding financial assets for the account of others, or is engaged (or holds itself out as being engaged) primarily in the business of investing, reinvesting, or trading in securities, partnership interests, commodities or any interest (including a futures or forward contract or option) in such securities, partnership interests, or commodities. Note that investment vehicles such as private equity funds and hedge funds are captured by the definition of a financial institution.

- Except as otherwise provided by the Secretary, a "financial account" is defined with respect to any financial institution as any depository account maintained by such financial institution, any custodial account maintained by such financial institution, and any equity or debt interest in such financial institution (other than interests in the financial institution that are publicly traded).

- A "U.S. account" is defined as any financial account held by one or more "specified U.S. persons" or "U.S. owned foreign entities."

    - Except as otherwise provided by the Secretary, a "specified U.S. person" is defined as any U.S. person other than a publicly traded corporation (and any corporate member of the same expanded affiliated group), any section 501(a) tax-exempt organization or individual retirement plan, the United States or any wholly owned agency or instrumentality thereof, any State, the District of Columbia, any possession of the United States, any political subdivision of any of the foregoing, or any wholly owned agency or instrumentality of any one or more of the foregoing, any bank, any REIT, any RIC, any common trust fund, any charitable remainder annuity trust or charitable remainder unitrust, and certain private foundations.

    - A "U.S. owned foreign entity" is a foreign entity which has one or more substantial United States owners, generally a "specified U.S. person" that owns more than 10% of the foreign financial institution, or any percentage greater than zero if the foreign financial institution is a foreign private equity or hedge fund.

    - Unless the foreign financial institution elects otherwise, a *de minimis* exemption excludes depository accounts held solely by natural persons so long as all depository accounts held, in whole or in part, by each such person at the same financial institution does not exceed $50,000.

Further Limitations on Bearer Bonds

The Act denies a deduction for interest paid on foreign-targeted bearer bonds and makes interest paid on them ineligible for the portfolio interest exemption from the 30% U.S. withholding tax required on interest paid to foreign persons in the absence of treaty protection. The Act maintains the exemption from the excise tax imposed by section 4701(b) of the Internal Revenue Code on foreign-targeted bearer bonds. The Act is effective for bearer bonds issued after March 18, 2012.

Enhanced PFIC Reporting

Except as otherwise provided by the Secretary, the Act requires any U.S. shareholder in a passive foreign investment company (PFIC) to file an annual report containing such information as the Secretary may require. Under previous law, annual reporting on IRS Form 8621 only applied if the U.S. person received a distribution from, or disposed of its interest in, the PFIC, or made certain elections with respect to its interests in the PFIC. The enhanced PFIC reporting is effective beginning March 18, 2010.

Substitute Dividends and Dividend Equivalent Payments Received by Foreign Persons Treated as Dividends

With respect to payments made on or after 180 days after March 18, 2010, the Act treats “dividend equivalents” as U.S. source dividends, subjecting dividend equivalents paid to foreign persons to a 30% U.S. withholding tax in the absence of treaty protection or other exemption. A dividend equivalent is any substitute dividend made pursuant to a securities lending transaction or a sale-repurchase agreement, any payment made pursuant to a specified notional principal contract that is directly or indirectly contingent on, or determined by reference to, the payment of a U.S. source dividend or any other payment determined by the Secretary to be substantially similar to the such payments. A specified notional principal contract is any notional principal contract, if:

- in connection with entering into such contract, any long party transfers the underlying security to any short party to the contract;
- in connection with the termination of such contract, any short party transfers the underlying security to any long party;
- the underlying security is not readily tradable on an established securities market;
- in connection with entering into such contract, the underlying security is posted as collateral by any short party to the contract with any long party to the contract; or
- the contract is identified by the Secretary as a specified notional principal contract.

In the case of any payment made after March 18, 2012, any notional principal contract will be treated as a specified notional principal contract unless the Secretary determines the contract is of a type which does not have the potential for tax avoidance.

If you have any questions about the content of this client alert, please contact the Pillsbury attorney with whom you regularly work or the authors below.

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