



Congress takes aim at offshore tax evasion

On February 24, 2010 the US Senate passed a Bill containing provisions aimed at offshore tax avoidance. These provisions represent significant departures from current US law. This briefing summarizes key provisions of the Bill, which impose (i) a 30 percent withholding tax on (a) payments to foreign financial institutions that do not comply with enhanced information reporting obligations and (b) dividend-equivalent payments linked to US equities, and (ii) enhanced reporting requirements with respect to offshore assets.

This briefing provides only general information, not advice on which you can rely to avoid US tax penalties.

On February 24, 2010 the US Senate passed the “Hiring Incentives to Restore Employment Act” (S.A. 3310 to H.R. 2847). The Bill aims to provide incentives for hiring and retaining workers, and extends certain land transportation programs. The cost of the Bill is offset by provisions aimed at offshore tax avoidance and evasion. These provisions represent significant departures from current US federal tax law.

This briefing summarizes certain key provisions of the Bill, which:

- impose a 30 percent withholding tax on a broad range of payments to foreign financial institutions (defined to include private investment funds) that do not comply with certain enhanced information-reporting and withholding requirements;
- impose additional reporting requirements for offshore assets, and enhanced penalties for failures to report such assets; and
- treat dividend-equivalent payments on certain notional principal contracts linked to US equities as US-source and thus subject to withholding tax of up to 30 percent.

Before these provisions can become law, the Bill must be passed by the US House of Representatives, which passed similar proposals last December. Passage by the US House of Representatives may occur in the near future. The Obama Administration strongly supports the Senate Bill, and President Obama is likely to sign the Bill into law very soon after it passes the US House of Representatives.

30 percent withholding tax on payments to foreign financial institutions

The Bill introduces a new withholding tax to enforce enhanced information-reporting by foreign financial institutions for accounts held by certain categories of US persons. Accounts for this purpose include (unless otherwise provided in regulations issued by the US Treasury Department) not only depository accounts and custodial accounts but also non-publicly traded debt or equity interests in the relevant foreign financial institution.¹ Any person who is required to withhold the tax but fails to do so is liable for the tax.

The new 30 percent withholding tax applies to any “withholdable payment” to a foreign financial institution that does not enter into an agreement with the Treasury to comply with new information-reporting requirements or qualify for exemption. A withholdable payment is any payment of US-source fixed or determinable, annual or periodical gains, profits and income.² In addition to the foregoing items, which already are subject to a 30 percent withholding tax when paid to non-US persons (as reduced by applicable domestic and treaty exemptions and reductions), withholdable payments for the purposes of this provision include gross proceeds from the sale

¹ An equity or debt interest in a foreign financial institution is treated as an account maintained by that institution.

² Any item constituting income effectively connected with a US trade or business is not a withholdable payment.

or other disposition of stock or debt of US issuers (or of swaps referencing stock of US issuers).

Except as otherwise provided by the Treasury, a foreign financial institution for this purpose is any entity that is organized outside the US, and its possessions, that:

- accepts deposits in the ordinary course of a banking or similar business;
- as a substantial portion of its business, holds financial assets for the account of others; or
- is engaged (or holds itself out as engaged) primarily in the business of investing, reinvesting or trading in stocks, bonds, other indebtedness, securities of widely traded partnerships and trusts, derivatives, partnership interests, commodities or interests (including futures, forwards or options) in the foregoing.

The definition of “foreign financial institution” thus is broad enough to capture hedge funds, private equity funds and other offshore investment vehicles. Payments of US-source income to such funds therefore become subject to 30 percent withholding tax unless the fund enters into an agreement with the Treasury.

Agreements with the Treasury

Payments to a foreign financial institution are exempt from the new withholding tax if the foreign financial institution enters into an agreement with the Treasury, under which the institution agrees:

- to obtain the necessary information on each holder of an account it maintains to determine whether the account is owned by a “specified US person”³ or a “US-owned foreign entity” (referred to as “US accounts”)⁴;
- to comply with any verification and due diligence procedures the Treasury may require with respect to identifying US accounts;

- to report to the Treasury annually for each US account maintained by the institution (i) the name, address and taxpayer identification number of each account holder that is a “specified US person” and of each “substantial US owner” of a “US-owned foreign entity” holding an account, (ii) the account number, (iii) the account balance or value, and (iv) except to the extent provided by the Treasury, the gross receipts and gross withdrawals or payments from the account. No report is required if another financial institution has already reported the required information or reporting otherwise would be duplicative. Alternatively, a foreign financial institution may elect to report on US accounts as though it were a US financial institution reporting with respect to accounts of individual US citizens;
- to deduct and withhold a tax of 30 percent of any withholdable payment paid through to a “recalcitrant” account holder (ie an account holder who does not cooperate in providing information or waivers) or to another foreign financial institution that either fails to satisfy the conditions imposed by the Bill or has elected to be withheld upon rather than to withhold on its account holders;
- to comply with requests from the Treasury for additional information on US accounts;
- if foreign law would prevent reporting of account information, to attempt to obtain a valid and effective waiver of that law from each holder of a US account and, if a waiver is not obtained within a reasonable period, to close the account; and
- if the foreign financial institution does not wish to withhold tax itself, to inform the withholding agent for each payment of its election, to provide all the information the withholding agent needs to determine the appropriate amount of withholding and to waive any benefits under an income tax treaty with respect to the withholding.

The requirements to enter into an agreement with the Treasury and report on US accounts are imposed in addition to existing requirements imposed on foreign financial institutions that are qualified intermediaries under existing law.

³ Except as provided by the Treasury, a “specified US person” is any US person (generally, a US citizen, individual US resident, domestic corporation, domestic partnership, trust subject to the control of a US person and the primary supervision of a US court or estate, the income of which is subject to US federal income tax regardless of its source) other than (i) a publicly traded corporation or any of its 50 percent-related affiliates, (ii) a tax-exempt organization, (iii) an individual retirement plan, (iv) the US and its agencies and political subdivisions, (v) a bank, (vi) a real estate investment trust, (vii) a regulated investment company, and (viii) a tax-exempt trust falling within certain specified categories.

⁴ The Bill exempts depository accounts owned by individuals, provided that the aggregate value of all depository accounts held by the individual at a single financial institution (and its 50 percent affiliates) does not exceed \$50,000.

A “US-owned foreign entity” for these purposes is any entity that is not treated as a US person for US tax purposes⁵ and has one or more “substantial US owners”. Substantial US owners generally are “specified US persons” that own, directly or indirectly, more than 10 percent of the stock of a corporation (by vote or value), more than 10 percent of the capital or profits interests in a partnership, or (to the extent provided by the Treasury) more than 10 percent of the beneficial interests in a trust. Any person treated as an owner of any portion of a grantor trust is treated as a substantial US owner of the trust. Under a special rule applicable to investment vehicles, any ownership by a “specified US person” results in the vehicle being treated as a US-owned foreign entity. Thus, any account owned by an offshore investment vehicle, such as a hedge fund or private equity fund, with even a single small US investor, is treated as a US account subject to reporting.

Certain foreign financial institutions deemed to meet requirements for exemption

The Treasury may treat a foreign financial institution as exempt from the 30 percent withholding tax if it (i) complies with any procedures required by the Treasury to ensure that the institution does not maintain US accounts, and (ii) meets any requirements imposed by the Treasury with respect to accounts it maintains for other foreign financial institutions. In addition, the Treasury is granted discretion to establish other classes of foreign financial institutions exempt from the 30 percent withholding tax. At this time there is no indication of what other categories of exemption might be extended by the Treasury.

Exemption for payments to certain classes of persons

The new 30 percent withholding tax will not apply to payments beneficially owned by:

- a foreign government, its political subdivisions or any of its wholly owned agencies or instrumentalities;
- an international organization or any of its wholly owned agencies or instrumentalities;
- any foreign central bank of issue; or

- any other class of persons identified by the Treasury as posing a low risk of tax evasion.

Credits and refunds

In general, the beneficial owner of a payment on which the new 30 percent withholding tax is imposed is entitled to credit the amount withheld against its US federal income tax liability and to claim a refund if that amount exceeds such tax liability. No credit or refund is allowed unless information is provided permitting the Treasury to determine whether the beneficial owner is a US-owned foreign entity and, if so, to determine the identity of each substantial US owner.

A special rule applies to payments beneficially owned by a foreign financial institution. Under that rule only the amount attributable to a rate reduction required under a tax treaty is allowed. This rule would seem to prohibit refunds in cases of inadvertent withholding.

Effective date and grandfathering

Once enacted, the provision applies to all withholdable payments made after December 31, 2012 other than payments under any “obligation” outstanding on the second anniversary of the date the Bill is enacted, and proceeds from the sale of such an obligation. It is not clear what instruments other than debt instruments are intended to be covered by the grandfather rule for obligations.

Enhanced reporting obligations regarding offshore assets and related penalties

The Bill requires each US shareholder of a passive foreign investment company (PFIC) to file an annual report, as required by the Treasury. Offshore investment funds treated as corporations for US federal income tax purposes generally qualify as PFICs. Thus, investors in such funds are required to complete a new form, to be developed by the Treasury. This provision takes effect on the date of enactment.

The Bill also introduces a new disclosure regime requiring individuals who hold “specified foreign financial assets” with an aggregate value exceeding \$50,000 (or a higher amount determined by the Treasury) to report certain

⁵ The following persons are US persons for US federal tax purposes: a US citizen, an individual US resident, a domestic corporation, a domestic partnership, a trust subject to the control of a US person and the primary supervision of a US court, and an estate the income of which is subject to US federal income tax regardless of its source.

information annually with their US federal income tax returns. Under a special rule, domestic entities formed to hold, directly or indirectly, specified foreign assets are subject to the same requirements as an individual. Specified foreign financial assets are:

- financial accounts maintained at financial institutions, as those terms are defined for the purposes of the new 30 percent withholding tax; and
- stocks or securities of non-US issuers, financial instruments or contracts held for investment with non-US issuers or counterparties and interests in foreign entities, where the foregoing assets are not held in an account at a financial institution.

Thus, the Bill requires individual US investors and managers owning interests in offshore investment funds to disclose information about their positions to the Treasury with their tax returns.

Affected taxpayers must disclose:

- the name and address of the financial institution holding a financial account and the account number, the name and address of the issuer of stock or securities, and information identifying the stock or securities, or the name and address of the issuer or counterparty with respect to an instrument, contract or interest, and information identifying that instrument, contract or interest, as applicable; and
- the maximum value of the asset during the calendar year.

A penalty of \$10,000 is imposed on a failure to provide the foregoing information in a timely fashion. If a taxpayer fails to disclose the information even after the Treasury has notified them of such failure and such failure continues for more than 90 days after notice, an additional penalty of \$10,000 is imposed for each 30-day period (or fraction thereof), up to a maximum of \$50,000. Penalties for understatements of tax attributable to undisclosed foreign assets, which include assets for which disclosure is required under the new reporting provision and assets subject to certain existing disclosure provisions, are increased from 20 percent to 40 percent. In addition, the statute of limitations on assessment and collections with respect to omissions of income exceeding \$5,000 attributable to certain offshore assets is extended to six years.

The new disclosure requirement and penalty provisions apply to taxable years beginning after the date of enactment. The extension of the statute of limitations applies to tax returns filed after the date of enactment and to returns for which the statute of limitations remains open at that time of enactment.

Dividend-equivalent payments in equity swaps subject to US withholding tax

Dividends paid by US corporations to foreign shareholders are treated as payments from US sources and thus subject to 30 percent US gross basis withholding tax (unless a reduced treaty rate applies). In addition, by regulation, dividend substitute payments on repurchase agreements and securities lending transactions over US equities (and “substantially similar” transactions) are treated as US-source and potentially subject to withholding. Payments under notional principal contracts, however, are sourced by reference to the residence of the payee and thus are generally exempt from US withholding tax.⁶ Accordingly, assuming a swap is respected as a notional principal contract, payments determined by reference to dividends on shares of US corporations generally have not been taxed.

In the last few years, the US tax authorities have been investigating the use of equity swaps to avoid US dividend withholding tax.⁷ However, until now they should have been able to impose withholding tax on payments under a swap over US equities only if the swap can be recharacterized under common law substance-over-form principles either as (i) passing tax ownership of the underlying shares to the foreign investor or (ii) a securities loan, repurchase agreement or “substantially similar” transaction.

The Bill introduces a new sourcing rule that treats “dividend-equivalent” payments referencing US equities as US-source dividend payments and thus as subject to US

⁶ When the substitute dividend regulations were issued in proposed form, the US Internal Revenue Service requested comments on whether a similar rule should be applied to dividend-equivalent payments under equity swaps. 57 Fed. Reg. 860 (January 9, 1992). No further action was taken at the time.

⁷ Eg “Officials Defend Positions on Swaps, Prepaid Forward Contracts”, 120 Tax Notes 21 (July 7, 2008).

withholding tax rules applicable to foreign persons as well as the new 30 percent withholding tax described above. Dividend-equivalent payments encompass a broad range of payments, including:

- substitute dividend payments made pursuant to a securities lending or a sale-repurchase transaction that (directly or indirectly) is contingent upon, or determined by reference to, the payment of a US-source dividend;
- payments made under “specified notional principal contracts” that are directly or indirectly contingent upon, or determined by reference to, the payment of a US-source dividend; and
- to the extent determined by the Treasury, substantially similar payments (eg payments under certain options or forward contracts used to create an instrument that mimics an equity swap, such as by “rolling up” dividends and value payments into a single net payment on settlement).

During the first two years after enactment, only notional principal contracts exhibiting one or more of five enumerated characteristics are treated as specified notional principal contracts; thereafter, the sourcing rule applies to every notional principal contract referencing US equities, unless it is of a type the Treasury determines not to have tax avoidance potential. The five enumerated characteristics are whether:

- a long party transfers the underlying security⁸ to the short party in connection with entering into the contract;
- a short party transfers the underlying security to a long party in connection with termination;
- the underlying security is not readily tradable on an established securities market;
- the underlying security is posted as collateral with a long party by a short party; or
- the notional principal contract is of a type identified by the Treasury.

The provision treats any dividend-based amount under a swap as a payment, even if no actual payment is made (for instance, if a payment is netted against other amounts due

under the terms of the swap). Thus, a counterparty could be required to withhold even if netting causes no actual payment to be made.

The withholding tax generally does not apply if the dividend payment itself or another dividend-equivalent payment in the same chain of transactions is subject to withholding, withholding is not otherwise due or, as the Treasury determines is appropriate, to address the role of financial intermediaries in the chain. Unlike some earlier proposed legislation,⁹ the Bill is silent on whether dividend-equivalent payments would be treated as dividends for purposes of income tax treaties. Thus, it is unclear whether treaty-eligible investors would be able to claim a reduced rate of withholding under a treaty on the basis that dividend-equivalent payments are dividends for purposes of US income tax treaties (as is presently provided by regulation for substitute dividend payments). A treaty would apply only if the foreign counterparty could satisfy limitation on benefits provisions, which may be difficult for investment funds and special purpose vehicles.

This provision applies to payments made on or after the date that is 180 days after the date of enactment.

⁸ For purposes of the Bill, any index or fixed basket of securities is treated as a single underlying security.

⁹ See “Stop Tax Haven Abuse Act”, S. 506, 111th Cong. § 108(a)(4) (2009); “Stop Tax Haven Abuse Act”, H.R. 1265, 111th Cong. § 108(a)(4) (2009).

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