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# Client Alert

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## Proposed Legislation Targets Foreign Accounts with Expansive Withholding Regime

On October 27, 2009, the Foreign Account Tax Compliance Act of 2009 was introduced by Senate Finance Committee Chairman Max Baucus and House Ways and Means Committee Chairman Charles Rangel. The Act seeks to address offshore tax evasion.

Generally, the Act would make significant changes in five main areas:

- 30% withholding would apply to payments made to foreign financial institutions and non-financial foreign entities that do not comply with new information reporting obligations.
- The “foreign targeted obligation” exception to the sanctions imposed on bearer bonds (which include denying the portfolio interest exemption from withholding) would be repealed, with only limited grandfathering of outstanding bearer bonds.
- Additional reporting requirements would apply with respect to foreign financial assets, including equity investments in Passive Foreign Investment Companies. These reporting requirements would supplement existing Foreign Bank and Financial Accounts (FBAR) reporting requirements.
- New reporting requirements and other rules would apply to foreign trusts.
- Withholding tax would be imposed on dividend-equivalent amounts received by foreign persons under equity swaps and certain other financial contracts.

This Client Alert summarizes the Act’s proposed 30% withholding regime as an enforcement mechanism for new reporting requirements on certain foreign accounts owned by U.S. persons and U.S.-owned foreign entities.

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The proposed withholding regime requires a withholding agent to withhold a 30% tax on any “withholdable payment”<sup>1</sup> made to “foreign financial institutions” unless certain information reporting requirements are satisfied. As drafted, the proposed withholding regime would apply to payments made after December 31, 2010, without any exceptions for currently outstanding obligations. Accordingly, depending on the precise “tax gross-up” provisions in an instrument, borrowers may be subject to increased costs or payees may receive less than originally anticipated.

To satisfy the information reporting requirements necessary to avoid imposition of the withholding tax, the foreign financial institution must enter into an agreement with the IRS to:

1. Obtain information from each account holder as necessary to determine if an account is a “U.S. account”;
2. Comply with verification and due diligence procedures to be prescribed by the IRS;
3. Report certain information with respect to U.S. accounts on an annual basis;
4. Comply with requests by the IRS for additional information with respect to any U.S. account; and
5. Attempt to obtain a waiver in any case where foreign law would prevent the reporting of information required with respect to any U.S. account, and close the account if the waiver cannot be obtained.

The due diligence and compliance procedures for the identification and verification of account holders to be prescribed by the IRS may include mandating internal procedures and independent review procedures to ensure compliance with the disclosure requirements and reporting obligations.

The information reporting requirements will be satisfied and 30% withholding tax avoided if the foreign financial institution reports the following information: (1) name, address, and TIN of each account holder that is a U.S. person, (2) name, address, and TIN of each substantial U.S. owner of any account holder that is a U.S.-owned foreign entity, (3) account number, (4) account balance or value, and (5) gross receipts and withdrawals or payments from the account.

The Act defines “foreign financial institution” broadly to include (1) any entity that accepts deposits in the ordinary course of a banking or similar business, (2) any entity engaged in the business of holding financial assets for the account of others, and (3) any entity engaged in the business of investing, reinvesting, or trading in securities, partnership interests, commodities, or any interest in such securities, partnership interests, or commodities (including futures, forwards, or options). Accordingly, the term financial institution includes investment vehicles like hedge funds and private equity funds.

For the purposes of the Act, a “U.S. account” is any financial account held by one or more U.S. persons or U.S.-owned foreign entities. Depository accounts are not treated as financial accounts for this purpose if (1) all account holders are natural persons and (2) the aggregate value of all depository accounts held (in whole or part) by each holder does not exceed \$10,000 or, where the account was in existence on the date of the Act’s enactment, \$50,000. Any equity or debt instrument held in a foreign financial institution is also considered a financial account under the Act and thus will be subject to the withholding/information reporting regime.

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<sup>1</sup> In general, withholdable payments are U.S. source interest, dividends, royalties, or other fixed or determinable annual or periodic payments.

The new reporting requirements mandated by the Act supplement the existing requirements applicable to Qualified Intermediaries. As such, Qualified Intermediaries must satisfy the new regime proposed by the Act in addition to all existing requirements.

The Act adopts a similar regime for non-financial foreign entities. Withholding agents must deduct and withhold a 30% tax on withholdable payments made to non-financial foreign entities unless the entity provides certification that it does not have a substantial U.S. owner or provides the name, address, and TIN of each substantial owner. This regime does not apply to payments beneficially owned by publicly-traded corporations or members of an expanded affiliated group of a publicly-traded corporation. A substantial owner for this purpose is (1) with respect to any corporation, any U.S. person that directly or indirectly owns more than 10 percent of the stock (by vote or value) of such corporation; (2) with respect to any partnership, a U.S. person that directly or indirectly owns more than 10 percent of the profits or capital interest of such partnership; and (3) with respect to any trust, any U.S. person treated as an owner of any portion of such trust under the grantor trust rules. Determination of indirect ownership for these purposes has the potential to be highly problematic.

Taxes withheld under these new provisions are subject to the existing rules providing for foreign tax credits, refunds, and treaty benefits.

Since these provisions would apply to all payments made after the Act's effective date, it is important for borrowers and lenders, and others who issue or invest in securities to review tax gross up provisions in pending transactions to understand what exposures the Act may create. It would also be prudent to review documentation of existing transactions to understand what exposures may exist and whether there are potential ways to mitigate those exposures.

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