The “Hiring Incentives to Restore Employment” Act of 2010

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The Reincarnation of the Foreign Account Tax Compliance Act (“FATCA”)

On March 18, 2010, president Obama signed the "Hiring Incentives to Restore Employment Act of 2010" (the "Act") into law. This will dramatically affect most non-US financial institutions, funds and collective investment structures as well as many trustees and family offices investing through these entities by providing the IRS with "new tools to find and prosecute US individuals that hide assets overseas."

The Act focuses on the creation of jobs through tax incentives and contains numerous revenue raising provisions focusing not only on US persons investing outside of the US but also on persons and entities investing into the US.

Summary of Key Provisions

The Act includes a number of new provisions that will significantly modify the US withholding tax and information reporting regimes affecting US persons, non-US banks and other financial intermediaries and their affiliates, non-US hedge and private equity funds, and certain other non-US investment structures.

Additionally, the Act imposes tax consequences on certain US persons using property held by non-US trusts, and introduces a number of new reporting obligations and penalties with respect to interests held by US persons in non-US accounts, entities and trusts.

The Act will also increase the US tax burdens of some non-US persons by disqualifying interest on bearer bonds from the portfolio interest exception, thereby potentially subjecting such interest to US taxation, and by categorizing dividend equivalent payments on certain swaps and securities lending transactions as US source income subject to tax.

Arguably, certain of these provisions could be considered inconsistent with the US government's previously stated goal of making the US capital markets attractive to non-US investors.

Proposed Changes to the US Withholding Tax and Information Reporting Regime Relevant to Non- US Financial Institutions and Investment Vehicles

Foreign Financial Institutions

The Act includes provisions intended to encourage "Foreign Financial Institutions" ("FFIs") to report information about their US account holders to the IRS. The term "financial institution" is broadly defined and generally includes non-US banks, hedge and private equity funds, and potentially certain privately owned investment vehicles.

30% Withholding Tax or IRS Information Agreement

Unless an FFI enters into an agreement with the IRS to report information about its US account holders each year, a 30% withholding tax will apply with respect to "withholdable payments" made to the FFI. Such payments will include: (i) US source dividends, interest (including OID), rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other "fixed or determinable annual or periodic" gains, profits, or income ("FDAP"); and (ii) the gross proceeds from the sale of any property that can produce US source interest or dividends. Thus, 30% will generally be withheld on the full amount realized upon the sale of such US assets, regardless of cost basis. Income effectively connected with a US trade or business ("ECI") is expressly excluded.

Notably, unlike previous proposed versions of this legislation, there is no explicit coordination provision with respect to withholding tax that may be imposed under other US withholding tax regimes, although the Act does authorize the Secretary of the Treasury to provide rules to prevent double withholding.

Withholding on "Passthru" Payments and "Recalcitrant Account Holders"

FFIs will be required to deduct and withhold tax at a 30% rate on "passthru" payments to other financial institutions that are not compliant with an FFI Agreement or to any "recalcitrant account holder" (i.e., account holders that refuse to waive applicable bank secrecy laws or provide requested information) unless the FFI elects to be withheld upon with respect to so much of the payment as is allocable to these recalcitrant account holders and non-compliant FFIs and waives any applicable treaty benefits.

FFIs will also be required to close the account of a "recalcitrant account holder" if they refuse to waive bank secrecy laws, but will be allowed a reasonable period of time to do so.

Disclosure of "United States Accounts"

The information reporting requirement that an FFI will need to enter into with the IRS in order to avoid the application of this 30% withholding tax will generally require the FFI to disclose information relating to "United States accounts" (defined broadly to include any "financial account," including a depository account, custodial account, and "any equity or debt interest in such financial institution" other than an interest regularly traded on an established securities market) held by: (i) a "specified United States person" (the term includes most US persons other than publicly traded corporations, certain tax-favored entities and US governmental entities) or (ii) a "US-owned foreign entity."

There is a de minimus exception for depository accounts held by a natural person if the aggregate value of all accounts held by that person at the financial institution does not exceed $50,000.

An account will be treated as owned by a US-owned foreign entity if that entity has one or more "substantial United States owners."

Substantial United States Owners

The term "substantial United States owner" includes any "specified United States person" who owns, directly or indirectly: (i) a 10% or greater interest (by vote or value) of the stock of a corporation; or (ii) a 10% or greater capital or profits interest in a partnership; or (iii) is treated as the owner of any portion of a trust under the grantor trust rules (i.e., the trust is a so called "grantor trust" with respect to one or more US persons).

The Act also includes a provision allowing the Secretary to issue guidance under which the beneficial owners of trusts may also be treated as substantial US owners if they hold, directly or indirectly, a 10% or greater beneficial interest in the trust.

In addition, a US person who owns any portion of an entity that is engaged primarily in the business of investing, reinvesting, or trading in: (i) securities; (ii) partnership interests; (iii) commodities; or (iv) any interests (including futures or forward contracts or options) in such securities, interests or commodities will be considered to be a "substantial United States owner." Thus, if a US person owns, directly or indirectly, or is deemed to own an interest in non-US investment vehicles, including but not limited to non-US hedge and private equity funds, these investment vehicles will generally be required to report the US person's ownership interest.

Details Required Under IRS Information Agreements

The FFI will generally be required to annually report: (i) the name, address, and TIN of each US account holder (or substantial United States owner); (ii) the account number or designation; (iii) the account balance or value; and (iv) the gross receipts and gross payments or withdrawals from the account.

The FFI agreements will require FFIs to obtain information from the account holder of each account sufficient to determine whether the account is a "United States account," which will also require FFIs to obtain information sufficient to determine whether a non-US entity account holder has one or more "substantial United States owners." These information gathering requirements will apply in addition to any requirements already applicable to these institutions under the currently existing "Qualified Intermediary" regime.

The Act contains a safe-harbor under which an FFI will be deemed to meet the requirements of the FFI agreement if it: (i) complies with procedures prescribed by the Treasury sufficient to ensure that it does not maintain US accounts and meets certain requirements with respect to accounts held by other FFIs; or (ii) is a member of an excluded class of institutions to be determined by the Treasury.

An FFI will also be required to comply with any due diligence or verification procedures imposed by the US Treasury Department and comply with any requests from the US Treasury for additional information concerning any "United States accounts" identified. Entering into such agreements with the IRS will clearly increase the reporting and compliance costs of foreign financial institutions.

Expanded Reporting for Affiliated Groups

In addition to requiring FFIs to report information about their own account holders, these agreements will also require that accounts held by members of their "expanded affiliated group" be reported. Essentially, this "expanded affiliated group" reporting requirement means that if one member of a corporate group enters into such an agreement, all affiliated financial institutions will effectively be required to do so as well.

Duplicative Reporting Exception

The Act contains a provision that eliminates reporting requirements under FFI agreements with respect to certain accounts where: (i) the account is held by another FFI that is itself compliant with an FFI agreement; or (ii) the holder of the account is subject to information reporting requirements which the Secretary determines would make reporting duplicative.

Overlap with Home Country Bank Secrecy Laws

In those instances where local bank secrecy or other laws would prevent the disclosure of account information without a waiver by the account holder, FFIs will be required to obtain such waivers or close the relevant account.
This provision has broad application when applied in conjunction with the affiliated group provisions discussed above, as FFIs with affiliates operating in jurisdictions with bank secrecy laws that would prevent disclosure of such information may find themselves faced with a choice between closing affected accounts or being subject to a 30% US withholding tax as a result of laws governing the operations of such affiliates.

Credit and Refund Procedure

While these new withholding tax provisions arguably conflict with reduced withholding rates available under existing US tax treaties, the Joint Committee of Taxation's Technical Explanation of the Act notes that US income tax treaties do not require the United States to follow a specific procedure for providing treaty benefits. Accordingly, if an account holder is eligible for reduced withholding under an applicable treaty, that account holder can request a credit or a refund from the IRS with respect to amounts withheld on payments to the FFI handling the account. However, the IRS will not pay interest on the amount over-withheld.

The Act also requires that all substantial US owners be identified, and disallows any credit or refund with respect to amounts withheld unless the beneficial owner of the payment provides such information as Treasury may require to determine whether the beneficial owner is a US owned entity and the identity of any substantial US owners.

Application to Non-Financial Foreign Entities

A 30% withholding tax will be imposed on payments to "non-financial foreign entities," (subject to certain exceptions for publicly traded corporations, foreign governments, international organizations, foreign central banks, and such other persons as may be identified in the future) if the non-financial foreign entity is the beneficial owner of the payments and certain exemption requirements are not met.

Exemptions are available for non-US entities that can either: (i) provide the withholding agent with a "certification that such beneficial owner does not have any substantial United States owners"; or (ii) report the name, address, and TIN of each "substantial United States owner" to the US Department of the Treasury.
These new withholding tax provisions will be effective for payments made after December 31, 2012, subject to certain exceptions for grandfathered payment obligations.

Material Advisor Reporting Provisions -- Omitted

Previously proposed versions of this legislation included a provision that would have imposed new reporting obligations and related penalties on advisors assisting in the formation of non-US entities and structures. These provisions were not included in the enacted legislation.

"Specified Foreign Financial Asset" Reporting

Currently, US individuals who directly or indirectly own more than a 50% interest in non-US financial accounts valued, in the aggregate, at more than $10,000 are required to annually report certain information with respect to such accounts on Form TD F 90-22.1 (report of Foreign Bank and Financial Accounts, the "FBAR").
The Act imposes additional information reporting requirements on any US individual that holds interests valued at more than $50,000 (in the aggregate) in: (i) depository or custodial accounts maintained by a non-US financial institution; (ii) non-US stock, interests in non-US entities, and financial instruments or contracts with a non-US counterparty not held within a custodial account of a financial institution.

Although these reporting requirements will initially be applicable only to individuals, the Act provides the IRS with authority to extend these provisions to apply to assets held by US entities.

Failure to provide sufficient information to establish value will result in the presumption that the value exceeds $50,000. Failure to report will be subject to a penalty of $10,000, and additional penalties (up to $50,000) could apply.

This reporting requirement will supplement and be in addition to the currently existing "FBAR" reporting requirements, and will apply without regard to whether the individual owns more than a 50% interest in such accounts, as long as the $50,000 value threshold is met. Although information requested on this filing is similar to the information requested on the FBAR, there are significant differences and going forward many individuals will need to track their foreign assets and accounts so that both reporting obligations can be satisfied.

These reporting requirements will apply in taxable years beginning after the date of enactment.

PFIC Reporting

US direct and indirect shareholders of certain non-US funds and corporations categorized as "passive foreign investment companies" ("PFICs"), are subject to additional US tax and reporting obligations. Currently, US shareholders of PFICs are only required to file information returns if they receive a distribution, recognize gain upon the disposition of their interest in a PFIC, or make certain US tax elections (e.g., QEF elections).

The Act introduces new requirements that US shareholders file annually to report their ownership interest in a PFIC, regardless of whether they receive a distribution or recognize gain. This requirement will supplement and be in addition to the currently existing information reporting requirements.

These reporting requirements have immediate effect.

Uncompensated Use of Trust Property by Beneficiaries Characterized as a Distribution

The Act introduces a provision under which the use of property held by a non-US trust by a US grantor or US beneficiaries of such trust will be treated as a distribution, in the amount of the fair market value of the use of the property, unless the grantor or such beneficiary, as the case may be, pays the trust for the use of the property within a "reasonable period of time."

This provision could have a significant impact on trust structures that own assets such as real estate and art, if the trusts allow the beneficiaries or other US persons to use this property without receiving adequate compensation. This provision will apply to any uncompensated use of trust property occurring after the date of enactment.

Grantor Trust Ownership and Presumption Rules

Current rules provide that a US person is treated as the owner of property transferred to a non-US trust if the trust has a US beneficiary. For this purpose, a trust is treated as having a US beneficiary if any current, future, or contingent beneficiary is a US person.

The Act clarifies that a non-US trust will be treated as having a US beneficiary if: (i) any person has discretion to determine the beneficiaries of the trust (unless the terms of the trust specifically identify the class of beneficiaries and none are US persons); or (ii) any written, oral, or other agreement or understanding could result in income or corpus of the trust being paid to or accumulated for the benefit of a US person.

The Act further provides that where any US person directly or indirectly transfers property to a non-US trust, the trust will be presumed to have a US beneficiary unless that person submits such information as may be required by the IRS with respect to the transfer and can demonstrate that the trust has complied with all relevant reporting requirements.

These provisions have immediate effect, and the presumption rule will apply to transfers following the date of enactment.

Partial Repeal of US Bearer Bond Exception

The US generally imposes a 30% withholding tax on US source interest paid to non-resident aliens and non-US corporations; however, "portfolio interest" is exempt. Some "foreign targeted" debt instruments in bearer form currently qualify for this "portfolio interest exemption" if they meet applicable technical requirements.

The Act will modify this treatment such that interest on bearer bonds will be subject to withholding tax unless the debt is in registered form. However, the Act preserves the previous "bearer bond exception" for US excise tax purposes.

This provision will apply to any such obligations issued 2 years after the date of enactment.

Equity Swaps, Securities Lending Transactions, and Dividend Equivalent Payments

The Act will require that tax be withheld with respect to certain notional principal contract payments characterized as "dividend equivalent payments." This will primarily affect payments relating to equity swaps (e.g. total return swaps), where payments made to a non-US person are contingent upon, or determined by reference to, dividend payments from sources within the United States (and substantially similar arrangements).

These provisions will also apply to certain securities lending transactions. A provision has been added to explicitly address the problem of cascading over-withholding.

This treatment will initially apply with respect to any "specified notional principal contract," defined as any NPC in which: (i) in connection with entering the contract any long party transfers the underlying security to a short party; (ii) in connection with termination of the contract any short party transfers the underlying security to a long party; (iii) the underlying security is not readily tradable on an established exchange; (iv) the underlying security is posted as security by any short party; (v) such other NPCs as the secretary may identify.

This provision will apply for payments made on or after 180 days following the date of enactment. In two years, it will apply more broadly to any NPC other than those specified by the Treasury as not having the potential for tax avoidance.

Other Provisions and Penalties Relating to Underpayments, Extended Statute of limitations and Reporting Requirements and Penalties

The Act also: (i) imposes a 40% penalty with respect to any understatement of income attributable to any undisclosed foreign financial asset; (ii) extends the current three year statute of limitations to six years in cases where an omission of more than $5,000 of income is attributable to one or more reportable foreign assets and this six year period will not begin until a taxpayer files an information return disclosing these reportable assets; (iii) imposes additional reporting requirements on US persons who are treated as the owner of any portion of a non-US trust; and (iv) imposes a minimum penalty of $10,000 with respect to failure to comply with certain information reporting provisions applicable to non-US trusts.

Worldwide Interest

The Act further delays the effective date of a provision allowing a worldwide affiliated corporate group to make an election to determine the foreign source taxable income of the group by allocating and apportioning domestic group members' interest expense on a worldwide basis for foreign tax credit purposes as if all members of the group were a single corporation.

The Act postpones the application of this provision through 2020.