THE FOREIGN ACCOUNT TAX COMPLIANCE ACT

On March 18, 2010, the Foreign Account Tax Compliance Act ("FATCA"), Subtitle A of Title V of Public Law 111-147, was enacted into law. The provisions of FATCA are, as the title indicates, intended to promote compliance with U.S. law requiring U.S. persons to report income from offshore accounts. Although the new rules hold important implications for individuals, FATCA is also of great importance for corporations throughout the world. Its provisions will substantially affect foreign investment in the United States by and through foreign entities.

FATCA has essentially five parts, with the following titles: Increased disclosure of beneficial owners; under reporting with respect to foreign assets; other disclosure provisions; provisions related to foreign trusts; substitute dividends and dividend equivalent payments received by foreign persons treated as dividends.

The first of these parts has received the most attention. That part itself contains two separate pieces — one relating to withholding of tax as a means of inducing certain behavior by foreign entities, and the other effecting the repeal of certain foreign exceptions to requirements that debt instruments be issued in registered, not bearer, form.

The core idea in the provisions dealing with withholding is that "withholdable payments" to "foreign financial institutions" and other foreign entities will be subject to 30 percent withholding unless certain steps are taken. In the case of a foreign financial institution, the steps involve agreeing with U.S. tax authorities to ascertain whether certain U.S. persons hold accounts with the institution and, if they do, to report with respect to those accounts. In the case of a non-financial foreign entity, the beneficial owner or payee must provide the withholding agent with either a certification that the owner has no "substantial

United States owners" or information with respect to them. In both cases, foreign entities must comply with the new provisions or face the withholding of tax on "withholdable amounts" having no necessary connection with offshore accounts or investments of U.S. persons. The 30 percent withholding is refundable upon a showing that a lesser amount of tax is due (for example, by reason of a treaty), but as a practical matter withholding will create substantial competitive imbalances between foreign institutions that enter into agreements with the Revenue Service and thus escape the withholding requirement, and those that do not. Make no mistake about it: withholding is a club.

Financial institutions are enjoined to obtain such information as will permit a determination whether "specified United States persons" hold accounts with them. They must comply with verification and due diligence procedures relating to the identification of such accounts and must report information with respect to existing accounts to U.S. authorities. In addition, they must deduct and withhold 30 percent from payments to "recalcitrant account holders" and must comply with requests from the Revenue Service for additional information with respect to U.S. accounts. If there is a foreign law that would prevent the reporting of account information, the institutions are to seek a waiver of that law from the holder of the accounts or, failing in that effort, must close the accounts.

At the discretion of the Revenue Service there are certain potential exceptions for institutions that do not maintain U.S. accounts and that meet IRS requirements with respect to accounts maintained with them by other foreign financial institutions. In addition, the Service may create exceptions for institutions of a class that, in its view, need not execute an agreement.

All of these requirements are in addition to those imposed on qualified intermediaries.

A “financial institution” is one that accepts deposits in the ordinary course of a banking or similar business, or that is in the business of holding financial assets for the account of others, or that is engaged in the business of investing, reinvesting, or trading in securities, partnership interests, commodities, or any interest in them.

A “financial account” includes a depository account, a custodial account, and any equity or debt interest in a financial institution unless that interest is regularly traded. Depository accounts maintained by natural persons in an amount less than $50,000 may be excluded if a particular institution so chooses (which an institution might decline to do in order to reduce its compliance burden).

A “specified United States person” is any U.S. person except for a corporation whose stock is regularly traded or a member of an affiliated group in which there is a corporation whose stock is regularly traded. The term also excludes an exempt organization, a government or government agency, a bank, a real estate investment trust, a regulated investment company, a common trust fund, and an exempt trust.

A “withholdable payment” is U.S. source fixed or determined annual or periodic income, specifically including interest paid by a foreign branch of a bank or savings institution. Most significantly, it includes gross proceeds from the sale of any property of a type that produces U.S. source dividends or interest. Thus, the concept of “withholdable payment” extends beyond normal U.S. source and FDAP concepts.

A “recalcitrant account holder” is any account holder who refuses to comply with requests for information or to provide a waiver of foreign law.

A list of participating foreign financial institutions may be published, presumably for the convenience of withholding agents.

With respect to other foreign entities — non-financial entities — the statute seeks a certification that there are no "substantial United States owners" or, if there are, their names, addresses, and taxpayer identifying numbers. A "substantial United States owner" is any specified U.S. person owning at least 10 percent, by vote or value, in a corporation, or owning at least 10 percent of the profits or capital interest of a partnership (or a commensurate beneficial interest in a non-grantor trust, or any portion of a grantor trust). Except as otherwise provided by IRS, there are exceptions for any corporation whose stock is regularly traded or which is a member of an affiliated group in which there is a member whose stock is regularly traded, a possessions entity, a foreign government, political subdivision, agency, or instrumentality, or an international organization, foreign central bank of issue, or any other class of persons identified by the Service.

All these new rules are effective for payments made after December 31, 2012, but there is an exception from withholding for payments on any obligation, or on the proceeds from the disposition of any obligation, that is outstanding on March 18, 2012.

The second piece of the first part of FATCA repeals foreign exceptions to the requirement that debt obligations be registered. This requirement governs the deductibility of interest, qualification of certain instruments as portfolio debt not subject to U.S. withholding at source, and the issuance of Treasury obligations. All of these exceptions are now abolished, and debt instruments will not qualify unless issued in registered form. The only surviving tolerance of bearer instruments is for foreign bonds under the excise tax imposed by section 4701.

The rules in the second part of FATCA relate to under reporting of foreign assets, and pertain for the most part only to individual account holders. One provision, however, would amend the statute of limitations in such a way that a failure (by any taxpayer) to file a complete

information return would keep the statute open indefinitely until the missing information has been supplied. It seems doubtful that such a far-reaching result was intended, or that it will survive.

In the third part there are disclosure provisions with respect to interests in passive foreign investment companies. In addition, this part of FATCA authorizes the Revenue Service to require financial institutions to file electronic returns relating to withholding on foreign transfers.

The fourth part of FATCA deals with foreign trust rules. The new rules tighten the statute, making it more difficult to avoid having a U.S. beneficiary of a foreign trust and stating clearly that uncompensated use of trust property is treated as a distribution. Under these rules, the grantor trust rules of section 679 will have wider application. In addition, there is a new reporting requirement for U.S. owners of foreign trusts, and a new minimum penalty of $10,000 for failure to report. The effective date for these provisions is generally March 18, 2010, except that the new minimum penalty applies to notices and returns required to be filed after December 31, 2009.

The final part of FATCA states that substitute dividends, dividend equivalents, and other payments contingent upon, or determined with reference to, a U.S. source dividend will themselves be treated as U.S. source dividends for purposes of U.S. taxation of foreign persons at source. This would extend to any payment on a notional principal contract when the underlying security is transferred by the long party to the short party at inception or by the short party to the long party at termination, or the security is not readily tradable, or is posted as collateral by the short party. These notional principal contracts are referred to in the statute as "specified notional principal contracts." For payments after March 18, 2012, all notional

principal contracts are specified unless the Service determines that, in a particular instance, there is no potential for tax avoidance.

In the case of a chain of dividend equivalents, the Revenue Service may reduce tax to the extent the taxpayer can establish that tax has been paid with respect to another link in the chain. For this purpose, a dividend is treated as a dividend equivalent. The IRS is thus enjoined to avoid a cascade effect, a policy of restraint that seems quite generous. It would not have been unreasonable to conclude that all dividend equivalents based on U.S. source dividends constitute U.S. source FDAP income.

The effective date for the new dividend equivalent rules is payments made as of 180 days from the March 18, 2010 date of enactment — that is September 14, 2010.

The foregoing is but a summary of rules that, at various junctures, are considerably more detailed. The summary should be sufficient, however, to demonstrate that FATCA is legislation of enormous reach and serious depth, with a potentially substantial impact on foreign investment in the United States. The wonder is that it sailed through Congress with relatively little debate or apparent objection.

H. David Rosenbloom
Caplin & Drysdale, Chartered
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