December 9, 2009

House to Consider Bill Containing Carried Interest Proposal, Ban on Bearer Bonds and Updated FATCA Rules

On December 9, the House of Representatives will consider a bill to extend a variety of expiring tax provisions. As had been expected, the bill will include as revenue raisers a revised version of the "Foreign Account Tax Compliance Act" ("FATCA") and a revised version of Representative Sander Levin's proposal to tax income from a service provider's profits interest in an investment partnership at ordinary rates (the "carry proposal"). We described the highlights of the original FATCA proposal in a memorandum dated October 28, *Highlights of Proposed Legislation Aimed at Combating Offshore Tax Evasion*, and the previous carry proposal in a memorandum dated April 13, *Update on "Carried Interest" Legislation: New Levin Bill*. There follows a brief summary of certain proposed changes that the House is considering making to the originally proposed FATCA and carry proposals.

Tax Carried Interest as Ordinary Income

The revised version of the carry proposal would apply to taxable years ending after December 31, 2009. Otherwise, it is substantially the same as the bill introduced by Representative Levin on April 3, 2009. The proposal would treat income derived from a sponsor's "carried interest" or "incentive allocation" in an investment partnership as ordinary income and subject that income to self-employment tax.

Withholding on Payments to Foreign Entities

Under the original FATCA bill, any "withholdable payment" made to a foreign entity would be subject to a 30% U.S. withholding tax unless the foreign entity complied with certain U.S. reporting requirements or otherwise qualified for an exemption. Under the new proposal, this withholding regime would apply only to payments made after December 31, 2012 (the "payment effective date"), and only with respect to "obligations" issued after the second anniversary of the date of enactment (the "issuance effective date"). Although it is not entirely clear what is meant by "obligations," this term is unlikely to include stock. Thus, U.S.-source dividends paid after the payment effective date presumably would be subject to the withholding regime even if the stock was issued before the issuance effective date.

The original bill would require a foreign financial institution (a "FFI") that wished to avoid the proposed withholding to enter into an agreement with Treasury (a "qualified FFI" or "QFFI" agreement) pursuant to which it would obtain and report certain information with respect to its U.S. account holders. Under the revised proposal, a FFI that enters into a QFFI agreement generally would also be required to agree to withhold on "passthru payments" (withholdable payments or payments "attributable" to withholdable payments) that the FFI makes to either "recalcitrant" account holders (those that fail to comply with one of certain specified requests for information or action) or non-qualified FFIs.

Alternatively, the revised proposal would permit a FFI to enter into a "hybrid" QFFI agreement under which it would *not* perform the withholding described above. Instead, the FFI would agree to provide sufficient information to each withholding agent that makes a withholdable payment to the FFI so that the withholding agent can determine how much of the payment is "allocable" to recalcitrant account holders or non-qualified FFIs, and withhold on that portion of the payment to the FFI.

Under the revised regime, a QFFI would not be required to report accounts that are held by another QFFI or by a person that is otherwise subject to information reporting requirements that Treasury determines would make reporting under the regime duplicative.

The revised regime would also provide an exception for FFIs that (i) comply with procedures prescribed by Treasury (A) to ensure they maintain no U.S. accounts and (B) with respect to other FFIs for which they maintain accounts or (ii) are members of a class of institutions with respect to which Treasury determines that the regime is unnecessary.

The revised proposal would clarify that any beneficial owner that is not a FFI would be entitled to a refund of withheld amounts, provided that it is not otherwise subject to withholding tax and that it provides such information as Treasury requires to determine who its "substantial United States owners" (if any) are.

Repeal of TEFRA Bearer Exemptions

The bill retains the original proposal to repeal the "TEFRA" rules, which permit the issuance of bearer bonds to foreign investors without the imposition of a variety of sanctions, including a potentially significant excise tax. However, the bill contains a provision designed to assure foreign issuers of bearer debt obligations outside the United States that they will not be subject to the excise tax, provided that any such obligation is issued pursuant to arrangements reasonably designed to ensure it will be sold only to a non-U.S. person, interest is payable only outside the United States, and the face of the obligation contains a legend warning U.S. persons who hold the obligation that they will be subject to limitations under U.S. tax law. As a result, bearer obligations issued by a foreign issuer in accordance with provisions essentially equivalent to the existing TEFRA D rules would not be subject to the excise tax.

In addition, the regime would clarify that "dematerialized bonds" (*i.e.,* bonds that are required to be represented only by book entries, and for which no physical certificates are issued or transferred) are treated as in registered form, and also provides authorization for Treasury to extend the "portfolio interest exemption" to registered-form debt instruments for which the beneficial owner has not provided a Form W-8BEN where it determines that this form is not required in order to carry out the purposes of the portfolio interest exemption. It seems likely that these provisions are intended to allow Treasury to allow U.S. issuers to issue dematerialized bonds in certain jurisdictions where dematerialized bonds are the norm (*e.g.,* Japan, Germany and Switzerland), and to exempt interest on those issuances from withholding tax, on the grounds that clearing agencies in those jurisdictions are currently unable to collect and deliver to withholding agents the necessary forms.

As compared to the original proposal, the effective date would be delayed, from issuances after 180 days after the date of enactment in the original proposal to issuances after two years after the date of enactment.

Dividend-Equivalent Payments

The proposed regime for dividend-equivalent payments has been significantly modified. The new proposal would apply to treat as U.S.-source dividends only substitute dividends (a term that is not defined) and "dividend equivalents" (determined on a gross basis, as under the original proposal) under "specified" notional principal contracts ("NPCs"), which are NPCs with respect to which one of the following is true:

(i) the "long party" transfers the security (or index or basket of securities) identified in the contract (the "underlying security") to the "short party" in connection with the inception of the contract;

(ii) the short party transfers the underlying security to the long party in connection with the termination of the contract;

(iii) the underlying security is not readily tradable on an established securities market;

(iv) the underlying security is posted as collateral by the short party in connection with entry into the contract;

(v) the Secretary identifies the contract as subject to the regime; or

(vi) unless the Secretary determines that the contract has no potential for tax avoidance, the dividend-equivalent payment is made after two years after the date of enactment.

The regime would be effective for payments 90 or more days after the date of enactment. Thus, in essence, the regime would provide 90 days' transition to unwind swaps involving "crossing in," "crossing out," or illiquid or pledged underlying securities, and would provide two years' transition relief for all other equity NPCs unless Treasury provides guidance in the interim describing NPC dividend-equivalents that will be exempt from withholding.

It is not clear why the bill refers to "securities" rather than "stock." One possibility is that the term is intended to encompass dividend-like amounts derived with respect to, for example, convertible debt, "high-yield debt obligations," or partnership interests. However, none of these generates payments of amounts that are treated as U.S.-source dividends for U.S. withholding tax purposes.

The regime also authorizes Treasury to reduce any resulting withholding tax if there is a chain of substitute dividends or dividend-equivalents payments and the taxpayer can establish that a tax has been paid with respect to a dividend or another substitute dividend or dividend-equivalent payment in the chain.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact

Harry Ballan	212 450 4827	harry.ballan@davispolk.com
Mary Conway	212 450 4959	mary.conway@davispolk.com
Michael Farber	212 450 4704	michael.farber@davispolk.com
Lucy W. Farr	212 450 4026	lucy.farr@davispolk.com
Rachel D. Kleinberg	650 752 2054	rachel.kleinberg@davispolk.com