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HIRE Act Codifies FATCA Rules, Ban on Bearer Bonds and Rules for Withholding on "Dividend Equivalents"

On March 18, President Obama signed the Hiring Incentives to Restore Employment Act (the "Act"). The Act includes a version of the "Foreign Account Tax Compliance Act," a provision repealing the "TEFRA" rules for U.S. issuers of bearer debt, and a provision imposing U.S. withholding tax on "dividend equivalents" paid or credited under notional principal contracts and certain other transactions. These provisions are substantially similar to ones contained in the tax "extenders" bill passed by the House of Representatives on December 9, 2009. The Act does not, however, contain a provision that would tax income from a service provider's profits interest in an investment partnership at ordinary rates. This memorandum summarizes certain provisions of the Act.

Withholding on Payments to Foreign Entities

Under the Act, any "withholdable payment" made to a foreign entity is subject to a 30% U.S. withholding tax unless the foreign entity complies with certain U.S. reporting requirements or otherwise qualifies for an exemption. The regime applies only to payments made after December 31, 2012 and, in the case of "obligations" (*e.g.,* debt and similar instruments, but not stock), only with respect to obligations issued after March 18, 2012. "Withholdable payments" include (i) all U.S.-source fixed or determinable gains, profits and income, including U.S.-source interest, even if otherwise exempt from U.S. withholding tax, and (ii) any gross proceeds from the sale of any property that can produce U.S.-source interest or dividends. Gross sales proceeds are subject to withholding tax currently only if the property being sold is a U.S. real property interest.

Separate rules apply to foreign financial institutions ("FFIs") and to other foreign entities. FFIs are (i) foreign banks, (ii) foreign custodians or depositaries and (iii) foreign entities engaged primarily in investing or trading in securities, partnership interests, commodities or interests therein ("Foreign Investment Entities"). Offshore private equity funds, offshore hedge funds and other offshore investment vehicles are thus FFIs for purposes of the Act.

Financial Institutions

An FFI that wishes to avoid the withholding tax must enter into an agreement with the Treasury (a "qualified FFI" or "QFFI" agreement) pursuant to which it obtains and reports certain information with respect to its "financial accounts" held by one or more "specified U.S. persons" or "U.S.-owned foreign entities" (each a "U.S. account"). A "financial account" is, unless otherwise specified by the Treasury, a depository or custodial account maintained by the financial institution or an equity or debt interest in the financial institution, other than any regularly traded interest. "Specified U.S. persons" are all U.S. persons other than certain types of entities, such as corporations with regularly traded stock and certain of their affiliates, organizations that are generally exempt from U.S. taxation, banks, real estate investment trusts, regulated investment companies and certain charitable trusts. In general, a foreign entity is treated as a U.S.-owned foreign entity if it has one or more "substantial United States owners." A substantial United States owner is generally a specified U.S. person that owns more than 10% of the foreign entity's equity

interests, except that a Foreign Investment Entity is treated as a U.S.-owned foreign entity if a specified U.S. person owns ***any*** of its equity interests.

Pursuant to its QFFI agreement with the Treasury, an FFI generally will be required to:

- obtain such information from account holders as is necessary to determine which accounts are U.S. accounts;
- comply with such verification and due diligence procedures as the Treasury may require;
- report to the Treasury on an annual basis certain information with respect to each U.S. account, including (i) identifying information with respect to each account holder that is a specified U.S. person (and, in the case of any account holder that is a U.S.-owned foreign entity, with respect to each specified U.S. person whose interest in such entity causes it to be a U.S.-owned foreign entity), (ii) the account balance or value and (iii) unless otherwise specified by the Treasury, the gross receipts and gross withdrawals or payments from the account;
- withhold on "passthru payments" (withholdable payments or payments "attributable" to withholdable payments) that the FFI makes to (i) "recalcitrant" account holders (those that fail to comply with one of certain specified requests for information or action), (ii) non-qualified FFIs and (iii) to the extent appropriate, FFIs that have elected to have their withholding obligations satisfied at source, as described below;
- comply with requests from the Treasury for additional information with respect to any U.S. account; and
- attempt to obtain a waiver, from each holder of a U.S. account, of any foreign law that would otherwise prevent the reporting of any of the foregoing information and, if such waiver is not obtained, close the account.

In lieu of reporting the account balance or value of, and the gross receipts and withdrawals from, any U.S. account, an FFI can elect in its QFFI agreement to provide reports on IRS Form 1099 with respect to all U.S. accounts that it maintains, as if each holder of those accounts that is a specified U.S. person or U.S.-owned foreign entity were a U.S. citizen. Pursuant to this election, both U.S.-source and foreign-source amounts, including gross proceeds, would be subject to 1099 reporting.

Unless otherwise specified by the Treasury, a QFFI will be required to comply with the foregoing provisions with respect to any U.S. account maintained by it or any affiliated FFI (determined under a greater than 50% direct or indirect ownership test) that has not itself entered into an agreement with the Treasury. The provisions of the QFFI agreement will be in addition to any requirements imposed under a "qualified intermediary" agreement entered into with the Treasury.

Alternatively, the Act permits an FFI to enter into a "hybrid" QFFI agreement with the Treasury 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.

A QFFI is not required to report accounts that are held by another QFFI or by a person that is otherwise subject to information reporting requirements that the Treasury determines would make reporting under the regime duplicative. In addition, the Act permits the Treasury to exempt an FFI from the foregoing requirements if the FFI either (i) complies with procedures prescribed by the Treasury to ensure that it maintains no U.S. accounts and provides information as required by the Treasury with respect to other FFIs for which it maintains accounts or (ii) is a member of a class of institutions with respect to which the Treasury determines that the regime is unnecessary.

Non-financial Institutions

The Act generally requires 30% withholding with respect to any "withholdable payment" made to a foreign entity that is ***not*** a "financial institution" if the beneficial owner of the payment is a foreign entity that is not a financial institution, unless:

- the beneficial owner provides the withholding agent with certain identifying information with respect to each of its substantial United States owners or a certification that it has no substantial United States owner;
- the withholding agent does not know or have reason to know that any of this information is incorrect; and
- the withholding agent reports the foregoing identifying information with respect to specified U.S. persons to the Treasury.

No withholding is required, however, if the beneficial owner of the payment is one of certain types of entities, such as a corporation with regularly traded stock. The Treasury also has authority to exempt any class of persons or payments that it identifies as posing a low risk of tax evasion.

Refunds of Withheld Amounts

A beneficial owner of a withholdable payment that is not an FFI is entitled to a refund of withheld amounts to the extent that the withholdable payment is not subject to withholding tax (as if this regime did not apply), provided that it submits such information as the Treasury requires in order to determine who the beneficial owner's substantial United States owners (if any) are. FFIs that are beneficial owners of withholdable payments are entitled to a refund of withheld amounts only if an applicable treaty so provides, and the FFI submits the requisite information.

Repeal of TEFRA Bearer Exemptions

The Act repeals 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) for obligations issued after March 18, 2012. However, the Act contains a provision designed to assure foreign issuers of bearer debt obligations outside the United States that they will not be subject to the TEFRA excise tax, provided that they issue bearer obligations in accordance with provisions essentially equivalent to the existing "TEFRA D" rules.

In addition, the Act clarifies 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 authorizes the Treasury to extend the "portfolio interest exemption" to registered-form debt instruments for which the beneficial owner has not provided an IRS Form W-8BEN if the Treasury 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 give the Treasury authority 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.

Withholding on Dividend Equivalents

The Act imposes U.S. withholding tax on certain "dividend equivalents" paid or credited to non-U.S. people on or after September 14, 2010. Dividend equivalents include (i) substitute dividends paid pursuant to securities lending or sale-repurchase transactions, (ii) payments pursuant to "specified notional principal contracts" and contingent on, or determined by reference to, the payment of dividends

from U.S. sources, and (iii) any other payments determined by the Treasury to be "substantially similar" to the above. The legislative history indicates that the latter category might include payments under "certain forward contracts or other financial contracts that reference stock of U.S. corporations." For purposes of the provision, dividend equivalents are determined on a gross basis, so that withholding tax may be due even if no payment is made to a non-U.S. person (*e.g.,* because a dividend equivalent has been netted against amounts owed by the non-U.S. person).

A "specified notional principal contract" is one:

- in which 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 entering into the contract (a practice known as "crossing in");
- in which the short party transfers the underlying security to the long party in connection with the termination of the contract, a practice known as "crossing out";
- the underlying security with respect to which is not readily tradable on an established securities market;
- in which the short party posts the underlying security as collateral with the long party in connection with entering into the contract; or
- that the Treasury identifies as subject to the regime.

Even for notional principal contracts that are ***not*** "specified notional principal contracts," all dividend equivalents paid after March 18, 2012 will be subject to U.S. withholding tax, unless the Treasury determines that the contract is of a type that has no potential for tax avoidance.

The Act authorizes the Treasury to reduce any resulting withholding tax if there is a chain of dividend equivalents and (i) the taxpayer can establish that a tax has been paid with respect to a dividend or another dividend equivalent in the chain or is not otherwise due, or (ii) the Treasury determines that such reduction is appropriate to address the role of financial intermediaries in the chain.

Individuals Required to Report Foreign Financial Assets

The Act codifies new Section 6038D, which requires any individual who holds any interest in "specified foreign financial assets" during a taxable year to attach certain information with respect to those assets to his or her tax return for that year if the aggregate value of those assets exceeds $50,000 (or a higher amount prescribed by the Treasury). This provision is separate from any requirement to file TD F 90-22.1 (commonly known as the "FBAR"). "Foreign financial assets" include:

- any financial account maintained by an FFI (each as defined above); and
- if not held in an account maintained by a "financial institution," generally any interest in any foreign entity (including stock, debt and any financial or investment contract to which a foreign entity is the counterparty).

Under this provision, interests in offshore private equity funds, hedge funds and other investment funds generally are subject to reporting.

The required information includes the maximum value of each asset during the year, as well as certain identifying information with respect thereto. This provision generally applies to tax years beginning with 2011.

U.S. Persons Required to Report PFIC Interests

The Act requires that, unless otherwise provided by the Treasury, each U.S. person who is a shareholder of a "passive foreign investment company" must file an annual report containing such information as the Treasury may require, effective as of March 18, 2010.

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.

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