October 28, 2009

Highlights of Proposed Legislation Aimed at Combating Offshore Tax Evasion

A bill introduced yesterday by Senate Finance Committee Chairman Max Baucus (D.-Mont.) and others contains various proposals aimed at combating offshore tax evasion. The bill includes both new proposals and modifications of certain proposals that were included in the Administration's 2010 budget, bills introduced by Senator Carl Levin (D. Mich.) and Representative Lloyd Doggett (D.-Tex.) and a draft released by Senator Baucus. The Joint Committee on Taxation simultaneously released a technical explanation of the bill, and Secretary Geithner immediately issued a statement supporting the bill, so it appears to have received significant input and backing. Select proposals are highlighted below.

Repeal the "TEFRA" Bearer Exemptions for Foreign Targeted Obligations

The bill would repeal the "TEFRA" rules that permit the issuance of bearer bonds to foreign investors without the imposition of a variety of sanctions. Accordingly, unless one of a number of other (very limited) exceptions applies, an issuer of bearer bonds would not be allowed a deduction for interest on the bonds and would be subject to a potentially significant excise tax. The excise tax, by its terms, applies to foreign as well as U.S. issuers. In addition, interest paid on such bonds would not be eligible for the exemption from U.S. withholding tax generally available for "portfolio interest," and a number of other holder-side sanctions would apply. This provision would be effective for obligations issued more than 180 days after the date of enactment of the bill.

Withhold on Payments to Certain Foreign Entities

Under the 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 from the new provision. "Withholdable payments" would be defined as (i) all U.S.-source fixed or determinable gains, profits and income, including U.S.-source interest, even if it would constitute "portfolio interest" that is 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 under current law only if the property being sold is a U.S. real property interest. Current withholding tax provisions would be amended so that no additional U.S. tax would be withheld from any payments subject to withholding under the new provision.

Separate rules would apply to foreign financial institutions and to other foreign entities. For this purpose, a "foreign financial institution" would be defined to include (i) a foreign bank, (ii) a foreign custodian or depositary and (iii) a foreign entity engaged primarily in investing or trading in securities, partnership interests, commodities or interests therein (a "Foreign Investment Entity"). Offshore private equity funds, offshore hedge funds and other offshore investment vehicles are thus "foreign financial institutions" for purposes of the bill.[1]

A. Financial Institutions

In order to avoid the 30% U.S. withholding tax on "withholdable payments," a foreign financial institution would be required to enter into an agreement with the Treasury pursuant to which it would be required to obtain and report certain information with respect to any "financial account" held by one or more "specified U.S. persons" or U.S.-owned foreign entities (any such account, a "U.S. account"). For this purpose, a "financial account" means any depository or custodial account maintained by the financial

[1] The bill does not provide an exception to this definition for a foreign entity that holds stock of a subsidiary corporation or an interest in a joint venture partnership.

institution and any equity or debt interest in the financial institution, other than any regularly traded interest.[2]

"Specified U.S. persons" are all U.S. persons other than certain types of entities, such as corporations with regularly traded stock; 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 corporation is treated as a U.S.-owned foreign entity if any specified U.S. person owns, directly or indirectly, more than 10% of its stock (by vote or value), and a foreign partnership is treated as a U.S.-owned foreign entity if any specified U.S. person owns more than 10% of its profits or capital interests. A Foreign Investment Entity is treated as a U.S.-owned foreign entity, however, if any specified U.S. person owns any of its stock or profits or capital interests.

Pursuant to its agreement with the Treasury, a foreign financial institution would 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) the gross receipts and gross withdrawals or payments from the account;
- 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 gross withdrawals or payments from, any U.S. account, a foreign financial institution could elect, in its agreement with the Treasury, to provide reports on IRS Form 1099 with respect to each U.S. account it maintains as if the foreign financial institution were a U.S. person and each holder of a U.S. account 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 reporting.

A foreign financial institution that enters into an agreement with the Treasury would be required to comply with the foregoing provisions not only with respect to any U.S. account that it maintains, but also with respect to any U.S. account maintained by any affiliated foreign financial institution (determined under a greater than 50% direct or indirect ownership test) that had not itself entered into an agreement with the Treasury. The provisions of the agreement described by this proposal would be in addition to any requirements imposed under a "qualified intermediary" agreement entered into with the Treasury.

B. Non-financial Institutions

The bill would require 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 either (i) a certification that no specified U.S. person owns, directly or indirectly, more than 10% of its stock, by vote or value (in the case

[2] The Treasury would be granted authority to provide other exceptions to the treatment of equity and debt interests in financial institutions as financial accounts.

of a corporation) or of its profits or capital interests (in the case of a partnership) or (ii) certain identifying information with respect to each such specified U.S. person;

- 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 would be required, however, if the beneficial owner of the payment were one of certain types of entities, such as a corporation with regularly traded stock. The Treasury would be granted authority to exempt any class of persons or payments that it identifies as posing a low risk of tax evasion.

Withhold on Dividend-Equivalent Payments

Following on recent proposals by Senator Levin, Representative Doggett and the Obama Administration, the bill includes a provision that would treat payments of U.S. dividend-equivalent amounts (determined on a gross basis) pursuant to notional principal contracts as U.S.-source dividends for withholding tax purposes. Unlike Senator Levin's proposal, the bill's provision would exclude payments pursuant to any contract or arrangement that the Treasury determines does not have the potential for tax avoidance.[3] Unlike the Administration's proposal, the provision does not include a safe harbor applicable to contracts that have certain features. Instead, it would provide that the Treasury "may take into account" various factors in excluding certain contracts from the application of the provision, such as (i) the term of the contract (including provisions for early terminations and offsetting financial contracts); (ii) the amount of each party's investment and the amounts of any collateral posted; (iii) whether the price of the stock used to measure the parties' entitlements or obligations is based on an objectively observable price; (iv) whether either party sells (directly or indirectly) to the other party shares of the relevant stock; (v) whether there are terms that address the hedge position of either party or other conditions which would compel either party to hold or acquire shares of the relevant stock; and (vi) such other factors as the Treasury determines appropriate.

The provision would apply to payments made on or after the 90th day after enactment.

Require Advisors to Disclose Acquisitions of Foreign Entities by Individuals

The bill would require any "material advisor" (generally, any person who receives more than $100,000 for aiding, assisting or advising a person with respect to the transaction) to provide an information return about any direct or indirect acquisition of an interest in a foreign entity (including pursuant to the formation of the entity), if any U.S. individual was required to file a report relating to that acquisition under Section 6038 (filings by a U.S. person who controls a foreign corporation or partnership), Section 6038B (notice of certain outbound transfers to foreign persons), Section 6046 (filings by U.S. officers, directors or shareholders of a foreign corporation with a significant U.S. shareholder), Section 6046A (filings regarding certain acquisitions, dispositions or changes in interest in a foreign partnership) or Section 6048 (filings with respect to foreign trusts). Unless the material advisor showed reasonable cause for failing to file an information return, the failure would carry a penalty equal to the greater of (i) $10,000 and (ii) 50% of the gross income derived by the advisor with respect to the transaction. The provision would apply to any aid, assistance or advice provided after the date of enactment of the bill.

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[3] Moreover, unlike Senator Levin's proposal, the bill does not address substitute payments made to foreign persons pursuant to sale-repurchase or securities lending transactions with respect to U.S. stock.

Require Individuals to Report Foreign Financial Assets

The bill would require any individual who holds any interest in "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).[4] This provision would be separate from any requirement to file TD F 90-22.1 (the "FBAR"). A "foreign financial asset" would include:

- any "financial account" maintained by a "foreign financial institution," each as defined above; and
- any of the following assets that is not held in an account maintained by a "financial institution" (whether or not foreign): (x) stock or a security issued by a foreign person, (y) a financial instrument or contract held for investment[5] that is issued by (or the counterparty of which is) a foreign person and (z) an interest in a foreign entity.[6]

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

The required information would include the maximum value of each asset,[7] as well as certain identifying information with respect thereto. This provision would apply for tax years beginning after the date of enactment.

[4] It is not clear when during the taxable year (or thereafter) this threshold should be tested. It is also not clear what would constitute an "interest" in a foreign financial asset, although the term might be intended to include situations in which an asset is held "for the benefit of" a taxpayer, as well as perhaps indirect interests, *e.g.,* through partnerships, trusts, etc.

[5] It is not clear whether this includes executory contracts such as notional principal contracts, futures and forward contracts, etc.

[6] It is not clear how these two provisions are intended to interact when an account maintained by a U.S. financial institution holds stock or debt of a foreign financial institution. It is also not clear how the term "stock or a security issued by" a foreign person is intended to differ from "an interest in" a foreign entity, except that the former might include debt of an individual.

[7] This seems clearly to contemplate the maximum value of the asset during the relevant taxable year. It is not clear how non-liquid assets should be valued for this purpose.

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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