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Reporting, Withholding, and More Reporting: HIRE Act Reporting and Withholding Provisions

by Carol P. Tello, Esq.[*]
Sutherland Asbill & Brennan LLP
Washington, D.C.

INTRODUCTION

With the March 18, 2010, enactment of Chapter 4 (Taxes to Enforce Reporting on Certain Foreign Accounts)[1] of the U.S. Internal Revenue Code of 1986, as amended, additional complexity has been introduced to the already complicated withholding and reporting rules under existing Chapters 3 and 61. The Chapter 4 provisions apply not only to traditional fixed or determinable annual or periodical (FDAP) income, but also to capital gains from the disposition of assets that produce FDAP income. Moreover, the new provisions relating to ''dividend equivalent'' payments will subject to both Chapters 3 and 4 gross payments not only from stock loans and repo transactions but also from notional principal contracts, even if no actual payment is made.

While the Chapter 4 rules are extremely broad in their application, some statutory exceptions and regulatory authority to provide further exceptions have been provided to ameliorate some of the obvious concerns relating to noninvestment income and duplicative reporting. Effectively connected income has been statutorily exempted from the application of the Chapter 4 provisions. Additionally, it may be anticipated that regulations will exempt vendor payments made to foreign entities for goods and services in the ordinary course of business. Moreover, it also may be anticipated that regulations will also exempt payments to foreign finance subsidiaries of non-financial operating companies. It should be noted that payments made directly to an individual (and not through a foreign entity) are not subject to Chapter 4.

The level of reporting that has been introduced not only by the Chapter 4 provisions but also by §§6038D and 1248(f),[2] together with the existing reporting required on Form TD F 90-22.1, Report of Foreign Bank and Financial Accounts (FBAR), would, without regulations to alleviate duplicative reporting of the same payments and the same income, result in administrative and compliance issues that could be unmanageable for taxpayers — and moreover, for the Internal Revenue Service (IRS). Recently proposed regu-

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Carol Tello is the author of a forthcoming BNA Tax Management Portfolio, 915-3rd T.M., *Payments Directed Outside the United States — Withholding and Reporting Under Chapters 3 and 4*.

[1] P.L. 111-147, 124 Stat. 71. Chapter 4 is contained in §501 of the Hiring Incentives for Restoring Employment Act (H.R. 2847) (''HIRE Act'').

[2] All section (''§'') references are to the U.S. Internal Revenue Code of 1986, as amended, or the regulations thereunder, unless otherwise indicated.

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lations[3] providing guidance on FBAR reporting indicate that the Department of the Treasury and the IRS are sensitive to duplicative reporting concerns.

A new reporting provision was enacted with respect to U.S. owners of foreign trusts under §6048(b)(1), as well as some clarifying amendments under §679(c) to identify beneficiaries of foreign trusts. Those provisions are beyond the scope of this discussion, but do address Congressional concerns related to the new reporting requirements.

BACKGROUND

The precursors to the enactment of Chapter 4 — also known as the Foreign Account Tax Compliance Act (FATCA) — were many. For a number of years, the Senate Permanent Subcommittee on Investigations (PSI) had been investigating and issuing reports on the use of tax haven institutions by taxpayers seeking to avoid U.S. tax. As a result of the PSI hearings and reports, several bills (e.g., the Stop Tax Haven Abuse Act) were introduced in Congress to combat the abuses identified by the PSI.

However, it was the focused actions of the G-20 during its 2009 meetings that fueled direct attacks on bank secrecy jurisdictions that were seen as fostering tax avoidance and abuse. During the April 2, 2009 G-20 meeting, the Organisation for Economic Cooperation and Development (OECD) provided a report on national cooperation with OECD standards for tax information exchange, which included a list of four ''uncooperative'' jurisdictions (the so-called ''black'' list) and a ''gray list'' that included Switzerland, Austria, Belgium, and Luxembourg, among others. The issuance of the list set off a flurry of negotiations of tax information exchange agreements, which resulted in all four of the jurisdictions being removed from the ''black'' list and many, including Switzerland, being removed from the ''gray'' list. Switzerland renegotiated its tax information exchange agreements with a number of countries, including the United States, in order to exclude its ''tax fraud'' requirement from the exchange of information provision.

In the United States, the Justice Department brought suit against Union Bank of Switzerland (UBS) for conspiring to defraud the United States by impeding IRS investigations.[4] That suit was ended by a voluntary agreement that required UBS to report income and other information about U.S. clients, as well as certain other information.[5] The IRS announced a voluntary disclosure program for U.S. persons who had not filed FBAR reports and had not reported income from foreign accounts. By the time the program ended on October 15, 2009, more than 14,700 persons had applied to disclose.[6]

In addition to the voluntary disclosure program, the IRS had previously identified withholding as a Tier I audit issue. Moreover, increased attention has been focused on FBAR reporting on foreign financial accounts. Proposed FBAR regulations were issued on February 26, 2010, to provide detailed guidance concerning FBAR reporting.[7]

LEGISLATIVE HISTORY

Chapter 4 was originally introduced as the ''Foreign Account Tax Compliance Act of 2009'' on October 27, 2009, in both the House of Representatives and the Senate[8] and was endorsed by the Secretary of the Treasury.[9] It had been drafted by members from the Senate Finance Committee and the House Ways and Means Committee, with involvement of Joint Committee on Taxation and Treasury Department staff. On December 9, 2009, the House passed a revised bill[10] most significantly changing the effective date from the originally proposed January 1, 2011, to January 1, 2013, with a grandfather exception for existing obligations. As no House or Senate reports were issued, the only extant legislative history is contained in a statement by House Ways and Means Committee Chairman Sander Levin in the *Congressional Record* (the ''Levin Statement'')[11] and in the Joint Committee Staff Technical Explanation of the Revenue Provisions (''JCTE'').[12]

PURPOSE

FATCA is aimed at increasing the disclosure of U.S. beneficial owners of foreign accounts and is far-reaching in its potential impact on U.S. payors, foreign entities, and foreign recipients of U.S.-source income. In addition to requiring foreign entities to re-

[3] 31 CFR 103, 75 Fed. Reg. 8844 (2/26/10).

[4] *U.S. v. UBS AG*, No. 09-20423-CIV (S.D. Fla., Miami Div.).

[5] *Settlement Agreement* (8/19/09). *See also* IR-2009-75 (8/19/09) and Protocol of March 31, 2010, to the U.S.-Switzerland Income Tax Treaty to implement the Settlement Agreement.

[6] IR-2009-16. Prepared remarks of IRS Commissioner Shulman for George Washington University Law School 22d Annual Institute on Current Issues on International Taxation.

[7] 75 Fed. Reg. 8844 (2/26/10).

[8] H.R. 3933 by Reps. Rangel, Neal; S. 1934 by Sens. Baucus, Kerry.

[9] Statement by Treasury Secretary Geithner, TG-332 (2/27/09).

[10] H.R. 4213, Tax Extenders Act of 2009.

[11] 156 *Cong. Rec.* S1745 (3/18/10). ''I want to provide some explanation of how this legislation is intended to work, both to guide the development of implementing regulations and to inform the courts of our legislative intent.''

[12] JCX-4-10 (2/23/10).

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port U.S. beneficial owners of foreign accounts, FATCA provides that U.S. individuals must report on foreign accounts and any interests in a passive foreign investment company (PFIC) under new §§6038D and 1298(f), respectively. Thus, Congress has adopted a ''belt and suspenders'' approach that requires reporting by both payors and beneficial owners.

To ensure compliance with the new reporting rules, FATCA provides new withholding rules for the payment of U.S.-source income, new penalty rules, and an extension of the relevant statute of limitations. The new provisions will increase the compliance burden on both payors of U.S.-source income and foreign recipients. The government believes that these new provisions are necessary because not all foreign entities participate in the Qualified Intermediary (QI) program and prior law imposed only limited obligations on withholding agents to determine the accuracy of self-certified Forms W-8.[13]

The only way a foreign entity will be able to avoid the reach of Chapter 4 will be not to invest in the United States. Just refusing to accept U.S. persons as account holders will not relieve a foreign entity from being subject to the Chapter 4 provisions, because it is the payment of U.S.-source income that triggers its application.[14] Even financial institutions that currently participate in the QI program will be required to comply with the Chapter 4 provisions in a separate reporting agreement with the IRS.

Under Chapter 4, §§1471 and 1472 impose a 30% withholding tax on U.S.-source payments made to foreign entities unless they meet certain reporting requirements, in addition to the Chapter 3 withholding and reporting requirements. Consequently, regulations will be required to coordinate the two Chapters, particularly with the regard to the priority of application and the elimination or reduction of duplicative withholding and reporting requirements.

The Levin Statement cites the reason for this ''strong'' approach. In particular, the Levin Statement describes the Permanent Subcommittee on Investigations July 2008 hearing that demonstrated how UBS and LGT Bank of Liechtenstein were able to help U.S. clients open foreign bank accounts and hide ''millions of dollars in assets'' from the IRS. UBS estimated that it maintained 52,000 such accounts that held an aggregate of $18 billion of assets.[15] Moreover, the Levin Statement cites as the purpose of the legislation to require foreign financial institutions to identify the true beneficial owners and not just accept the nominal owner (e.g., a foreign legal representative, agent, or trustee, or foreign entity) as the owner of the account.[16] Of particular note, the JCTE discusses the definition of ''beneficial owner'' under the European Union Third Money Laundering Directive, which refers to the natural person who ultimately owns or controls the customer or on whose behalf a transaction or activity is being conducted.[17]

EFFECTIVE DATE

Although the provisions generally will be effective for payments made after December 31, 2012,[18] no withholding will be required under the new legislation from any payment made under an obligation outstanding two years after March 18, 2010 (the enactment date), or from any gross proceeds from the disposition of such an obligation.[19] However, the JCTE provides authority for guidance on the application of the §1001 material modification rules in determining whether an obligation is considered ''outstanding.'' Based upon the strong language in the Levin Statement, it may be presumed that the regulatory authority to determine how the §1001 material modification rules are to be applied will be exercised to limit when an obligation is treated as ''outstanding.''

DETAILED DESCRIPTION OF CHAPTER 4

Scope of §§1471 and 1472

Entities to which the §§1471(a) and 1472(a) withholding provisions apply are determined by the definitions of the terms ''foreign financial institution'' and ''non-financial foreign entity.'' The types of accounts to which those provisions apply are determined by the definitions of ''financial account'' and ''United States account.''

Foreign Financial Institution

Section 1471(d)(4) defines the term ''foreign financial institution'' (FFI) as a financial institution that is

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[13] Testimony of Stephen E. Shay, Deputy Assistant Secretary of the Treasury (International Tax Affairs) before the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means (11/5/09).

[14] A number of EU banks have begun closing accounts held by U.S. persons, in addition to refusing to open any new accounts of U.S. persons. The belief is that the bank will then be able to represent that it has no U.S. account holders. Whether this is a practical approach remains to be seen. A bank, to avoid withholding, is required to enter into an agreement with the IRS and perform due diligence on its accounts. The solution proffered by these banks also may not capture accounts held by dual citizens and green card holders or other U.S. residents.

[15] 156 *Cong. Rec.* S1745.

[16] *Id.*

[17] JCTE at 38.

[18] P.L. 111-147, §501(d)(1).

[19] P.L. 111-147, §501(d)(2).

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a foreign entity, but does not include a financial institution organized in a possession of the United States except to the extent provided by the Secretary. Regulations may be issued to the extent necessary to prevent a possessions financial institution from being used as an intermediary in arrangements under which U.S. tax avoidance or evasion is facilitated.[20]

The term ''financial institution'' is an extremely broad definition, referring to any entity that:

- accepts deposits in the ordinary course of a banking or similar business;
- as a substantial portion of its business, holds financial assets for the account of others; or
- is engaged (or holds itself out as being engaged) primarily in the business of investing, reinvesting, or trading in securities (as defined in §475(c)(2) but including §1256 contracts), partnership interests, commodities (as defined in §475(e)(2)), or any interest (including a futures or forward contract or option) in such securities, partnership interests, or commodities.[21]

The Levin Statement explains that the definition of ''foreign financial institution'' is ''clearly intended'' to be applied broadly to include banks, securities firms, money services businesses, money exchange houses, hedge funds, private equity funds, commodity traders, derivative dealers, and any other type of financial firm that holds, invests, or trades assets on behalf of itself or another person.[22] The Levin Statement provides a broader list of types of entities to be included than does the JCTE, which specifically identifies investment vehicles, hedge funds, and private equity funds.[23]

The treatment of insurance companies is not clear. While the JCTE suggests that special rules may be provided to address the circumstances in which insurance companies and other categories of companies are financial institutions.[24] On the other hand, although the more sweeping Levin Statement includes very broad language relating to a catch-all category of any type of financial firm, the types of entities specifically mentioned in the Levin Statement do not include insurance companies. The omission of insurance companies from a list that includes less common types of entities, such as money services businesses, may suggest that Chairman Levin did not contemplate treating insurance companies as FFIs, although the JCTE may imply that insurance companies may be covered at least under certain circumstances. Moreover, the fact that an insurance company is a member of an expanded affiliated group (discussed below) may suggest that insurance companies will have a role in this regime.

The JCTE provides a list of entities that may be excepted from the definition of ''foreign financial institution,'' including certain holding companies, research and development subsidiaries, and financing subsidiaries within an affiliated group of non-financial operating companies.[25] The potential exception for finance subsidiaries is very helpful for multinational corporations that frequently employ an offshore financing subsidiary to more efficiently deploy offshore cash and manage currency issues.

Regulatory authority is provided to deem certain foreign institutions as meeting the reporting requirements if they are members of a class with respect to which the Secretary determines the application of §1471 is not necessary in order to carry out the purposes of §1471.[26] However, the Levin Statement clearly instructs the Treasury to exercise this authority ''narrowly'' and consistent with the purposes of the statute, i.e., to promote disclosure of foreign accounts of U.S. persons.[27]

Non-Financial Foreign Entity

The term ''Non-financial foreign entity'' (Non-FFE) is defined as any foreign entity that is not a financial institution as defined in §1471(d)(5).[28] A foreign entity is defined as any entity that is not a U.S. person.[29] However, §1472 does not apply to payments beneficially owned by:

- a publicly traded corporation or a corporation that is a member of the expanded affiliated group, as defined in §1471(e)(2), of the publicly traded corporation, not including a partnership or other non-corporate entity;[30]
- an entity organized under the laws of a U.S. possession that is wholly owned by one or more bona fide residents of such possession as defined under §937(a);[31]

[20] *See* JCTE at 43.
[21] §1471(d)(5).
[22] 156 *Cong. Rec.* S1745.
[23] JCTE at 44.
[24] *Id.*
[25] *Id.*
[26] §1471(b)(2).
[27] 156 *Cong. Rec.* S1745.
[28] §1472(d).
[29] §1473(5).
[30] §1472(c)(1)(A) and (B).
[31] §1472(c)(1)(C).

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- a foreign government, or any political subdivision or wholly owned agency or instrumentality of a foreign government;[32]
- any international organization or any wholly owned agency or instrumentality thereof;[33]
- any foreign central bank of issue;[34] or
- any class of persons identified by the Secretary for purposes of the provision as posing a low risk of tax evasion (nor does §1472 apply to any class of payments identified by the Secretary as posing a low risk of tax evasion).[35]

Financial Account

The term ''financial account'' is important because it defines the scope of accounts that an FFI or a Non-FFE must consider in determining whether it has any ''U.S. accounts,'' i.e., financial accounts owned by certain U.S. persons as discussed below. The term ''financial account'' means, with respect to any financial institution;

- any depository account maintained by such financial institution;
- any custodial account maintained by such financial institution; or
- any equity or debt interest in such financial institution except for securities publicly traded on an established securities market. Equity or debt interests that constitute a financial account will be treated as maintained by the financial institution.[36]

The Levin Statement indicates that the definition of the term ''account'' should include not only traditional savings accounts, checking and securities accounts, but also debt and equity interests in hedge funds, private equity funds, and other investment firms.[37] Additionally, the JCTE provides authority for special rules that would treat annuity or cash value life insurance contracts as financial accounts.[38]

The proposed FBAR regulations would treat annuity and life insurance contracts with cash value as financial accounts for FBAR purposes.[39] Given the relationship between FBAR reporting and the new and similar (though not identical) §6038D reporting, the proposed FBAR regulations may be a precursor of the regulations to be issued under Chapter 4 and under §6038D. Consequently, at least some annuity and cash value life insurance contracts may be included within the meaning of ''financial account'' for purposes of §1471(d)(2).

The JCTE identifies short-term obligations and short-term deposits as potentially having a low risk of U.S. tax evasion and therefore not to be treated as financial accounts.[40] Although such obligations generally are not subject to U.S. tax in the hands of non-U.S. persons, the JCTE does not explain the reasons for the low risk assessment. When such obligations are held by U.S. persons, the income paid generally is subject to tax.

United States Account

The term ''United States account'' means any financial account that is held by: (1) one or more ''specified U.S. persons''; or (2) a ''United States owned foreign entity.'' [41] However, the term does not include a depository account maintained by a natural person if the aggregate value of all depository accounts held in whole or in part by the holder and maintained by the same financial institution does not exceed $50,000, unless the financial institution elects not to apply this exception.[42] The accounts taken into consideration for this purpose include all accounts held in financial institutions that are members of the same ''expanded affiliated group'' (EAG) to the extent required by regulations.[43]

The term ''expanded affiliated group'' means an affiliated group as defined in §1504(a) but substituting ''more than 50 percent'' for ''at least 80 percent'' and including insurance companies and foreign corporations otherwise excluded under §1504(b)(2) and (3). Also included is a partnership or any other entity if it is controlled within the meaning of §954(d)(3) by members of the group, including any entity treated as a member of the group under this rule.[44]

The challenge for an FFI EAG will be to identify all the accounts held by a single account holder for purposes of the $50,000 de minimis exception. Because of the burden involved in identifying all such accounts, many FFIs may elect not to apply the de minimis exception.

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32 §1472(c)(1)(D).
33 §1472(c)(1)(E).
34 §1472(c)(1)(F).
35 §1472(c)(1)(G).
36 §1471(d)(2).
37 156 *Cong. Rec.* S1745.
38 JCTE at 44.
39 FinCEN Prop. Regs. §31.103.24(c)(3) (2/26/10).
40 JCTE at 43.
41 §1471(d)(1)(A).
42 §1471(d)(1)(B).
43 *Id.*
44 §1471(e)(2).

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Specified United States Person

The term ''specified United States person'' means any U.S. person, with certain exceptions.[45] The Levin Statement states that the term includes a U.S. citizen, U.S. resident, and all types of U.S. businesses.[46] However, it will not include the following entities:

- any publicly traded corporation and members of its affiliated group;
- a tax-exempt organization under §501(a) or an individual retirement plan;
- the United States or any wholly owned agency or instrumentality thereof;
- any State, the District of Columbia, any possession of the United States, or a political subdivision or wholly owned agency of the foregoing;
- any bank as defined in §581;
- any real estate investment trust as defined in §856;
- any regulated investment company as defined in §851;
- any common trust fund as defined in §584(a); and
- any trust exempt from tax under §664(c) or described in §4947(a)(1).[47]

United States Owned Foreign Entity

The term ''United States owned foreign entity'' means any foreign entity that has one or more substantial United States owners.[48] The limitation of ''substantial'' United States owners provides a de minimis exception, except for investment vehicles as discussed below.

Substantial United States Owner

The term ''Substantial United States owner'' means:

- with respect to any corporation, any specified United States person that directly or indirectly owns more than 10% of the stock (by vote or value) of such corporation;
- with respect to any partnership, any specified United States person that directly or indirectly owns more than 10% of the profits or capital interests of such partnership; or
- with respect to any trust, any specified United States person treated as an owner of any portion of such trust under the grantor trust rules.[49]

Significantly, the 10% threshold is reduced to 0% for corporations and partnerships that are engaged (or holding themselves out as engaged) primarily in the business of investing, reinvesting, or trading in securities, interests in partnerships, commodities, or any interest (including a futures or forward contract or option) in such securities, interests or commodities.[50] This means that any interest held by a specified United States person in a foreign hedge fund or foreign private equity fund or other foreign investment vehicle will be subject to Chapter 4.

Chapter 4 as a rule eliminating a de minimis ownership threshold is not surprising for two reasons. First, it is consistent with the passive foreign investment company (PFIC) rules, which have no ownership threshold. If the 10% threshold requirement were not eliminated, the PFIC rules and Chapter 4 would apply to different U.S. persons. Thus, this rule ensures consistent application of reporting of the payments made by the withholding agent and reporting of the ownership of the PFIC interest under §1298(f) by the U.S. PFIC interest holder. Second, the rule is not surprising because, in a large investment fund, a less-than-10% interest owner may nonetheless have a large dollar (or other currency) investment.

30% Withholding Tax Requirement

General Rule

Sections 1471(a) and 1472(a) provide that, unless an FFI or a Non-FFE enters into a reporting agreement with the IRS as described in §1471(b) or meets the requirements for a waiver from withholding under §1472(b), respectively, withholding tax at a 30% rate is required on any ''withholdable payment'' made to that FFI or Non-FFE. According to the Levin Statement, the purpose of this requirement is to force FFIs and Non-FFEs to disclose their U.S. accountholders or pay a ''steep penalty'' for nondisclosure.[51]

Withholdable Payment: FDAP and Gross Proceeds from FDAP-Producing Property

The term ''withholdable payment'' means:

- any U.S.-source payment of interest (including any original issue discount), dividends, rents, salaries, wages, premiums, annuities, compensa-

[45] §1473(3).

[46] 156 *Cong. Rec.* S1745.

[47] §1473(3)(A)–(J).

[48] §1471(d)(3).

[49] §1473(2).

[50] §1473(2)(B).

[51] *Id.*

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tions, remunerations, emoluments, and other fixed or determinable annual or periodical gains, profits, and income;[52] and

- gross proceeds from the sale of any property of a type that can produce U.S.-source interest or dividends.[53]

Note that new §871(l) expands the definition of ''dividend'' to include ''dividend equivalent'' payments for purposes of §§881 and 4948(a) and Chapters 3 and 4, as discussed below.

In determining whether an item of income is U.S.-source, §861(a)(1)(B) does not apply, so that amounts paid by foreign branches of U.S. financial institutions are U.S.-source payments.[54] An exception is provided for items of income that are subject to U.S. tax as effectively connected with a U.S. trade or business.[55]

Note that withholding under Chapter 4 is imposed on items of income that are not subject to U.S. tax. Thus, short-term original issue discount is not subject to U.S. tax under §§871(g)(1)(B) and 881(a)(3) nor subject to withholding under §1441(a), but is subject to withholding under Chapter 4. However, the JCTE states that guidance may be provided that certain short-term obligations or short-term deposits (including proceeds from dispositions of those obligations), which pose a low risk of U.S. tax evasion (as mentioned above), may be excepted from the definition of a ''withholdable payment.''

Moreover, gross proceeds from the sale of U.S. stocks and debt obligations, which are not subject to U.S. tax under §865(a), unless they are effectively connected income, are potentially subject to withholding under Chapter 4. Note that the withholding requirement would not permit an offset for basis and would not limit the withholding to the net gain amount. As a result, a payment that represents a return of capital could be subject to Chapter 4 withholding similar to that of distributions under §1291 of the PFIC rules. If a refund claim is not, or cannot, be made, the Chapter 4 withholding tax would become a final tax on amounts that otherwise would not be subject to U.S. tax. It is not clear how the withholding provision will be enforced in the case of a foreign-to-foreign sale of a U.S. security.

The Levin Statement is clear that the legislation is to apply the term ''withholdable payment'' broadly to cover all types of payments from U.S. sources, including derivative payments originating in the United States.[56] The JCTE also is clear that all ''dividend equivalent'' payments are ''withholdable payments.''[57]

Section 1471(b): IRS Reporting Agreement with Respect to "United States Accounts" of FFIs

IRS Reporting Agreement

The IRS reporting agreement, which must be entered into by an FFI in order to avoid the new 30% withholding tax on payments to the FFI, requires that information on each ''United States account'' be provided to the IRS by the FFI. According to the Levin Statement, the IRS will develop a standard agreement whereby an FFI will provide the information in a standardized electronic format that will permit efficient analysis of the data. Moreover, the Treasury is directed to consult with the Department of Justice to determine how the information should be structured to be best used in tax enforcement.[58] The reporting agreement applies to each member of an EAG.

As part of the reporting agreement required by §1471(b)(1), an FFI must agree to:

- obtain information from each account holder as is necessary to determine which accounts are U.S. accounts;
- comply with verification and due diligence procedures as the Secretary requires with respect to the identification of U.S. accounts;
- report annually certain information with respect to any U.S. account maintained by such institution;
- deduct and withhold a 30% tax on:
  - a ''passthru payment'' made by the FFI to a ''recalcitrant account holder'' or another FFI that does not meet the reporting requirements of §1471(b); and
  - in the case of a passthru payment made by the FFI to an FFI that has in effect an election to be withheld upon under §1471(b)(3), the amount of the payment that is allocable to accounts held by ''recalcitrant account holders'' or FFIs that do not meet the requirements of §1471(b);

[52] §1473(1)(A)(i).

[53] §1473(1)(A)(ii).

[54] §1473(1)(C).

[55] §1473(1)(B).

[56] 156 *Cong. Rec.* S1745.

[57] JCTE at 45.

[58] *Id.*

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- comply with requests by the Secretary for additional information with respect to any U.S. account maintained by such institution; and
- attempt to obtain a waiver in any case in which a foreign law would (but for a waiver) prevent the reporting of information required by the provision with respect to any U.S. account maintained by such institution, and if a waiver is not obtained, close the account.

A deleted provision in a prior version of the legislation would have allowed FFIs to rely on an account holder's certification as to whether the account was a United States account. The enacted version clearly places that burden on the FFI.

While the JCTE contains a discussion of know-your-customer rules and the European Union Third Money Laundering Directive, it should not be assumed that the Chapter 4 regulations will permit total reliance on such existing rules. Treasury officials have already expressed concern about relying on rules that require ''judgment.''

Passthru Payment

The term ''passthru payment'' means any ''withholdable payment'' or other payment to the extent attributable to a withholdable payment.[59]

Recalcitrant Account Holder

The term ''recalcitrant account holder'' means any account holder that:

- fails to comply with reasonable requests for information to determine whether the account is a U.S. account or, with respect to a U.S. account, the name, address, and TIN of the account holder that is a specified United States person or, with respect to a United States owned foreign entity, the name, address, and TIN of each substantial United States owner of the United States owned foreign entity; or
- fails to provide a waiver from foreign law disclosure as required under §1471(b)(1)(F).[60]

The ''passthru payment'' and ''recalcitrant account holder'' provisions were not included in the original version of FATCA, but were added to the Extenders Bill version. The definitions were added to address commentator concerns that all account holders would be penalized by the failure of one account holder to comply. The definition of ''passthru payment'' appears to be circular, although one must assume that it is meant to permit a payment to be allocated between compliant and noncompliant account holders.

Of particular note, the JCTE explicitly states that this provision is not intended to create an alternative to information reporting, and guidance may require that the FFI achieve certain levels of reporting and make reasonable attempts to acquire the necessary information or close accounts where it is not provided.[61]

Information Required to Be Reported on U.S. Accounts

Under §1471(c), the following information must be reported annually:

- the name, address, and TIN of each account holder that is a specified United States person;
- the name, address, and TIN of each substantial United States owner of any account holder that is a United States–owned foreign entity;
- the account number;
- the account balance or value (determined at such time and in such manner as the Secretary provides); and
- The gross receipts and gross withdrawals or payments from the account (as described in regulations to be promulgated).

Alternative Form 1099 Reporting Election

Alternatively, an FFI may elect to be subject to Form 1099 reporting under §§6041, 6042, 6045, and 6049 as if the FFI were a U.S. person and each account holder were a U.S. citizen.[62] Even though one FFI member of an EAG may make this election, the other members of the FFI's EAG are not required to also make the election.[63] The consequence of such a Form 1099 Reporting Election is that the electing FFI would be required to report both the U.S.- and foreign-source income of the U.S. account holder regardless of whether the amounts were paid inside or outside the United States.

Qualified Intermediaries Not Exempt from Chapter 4

The requirements of Chapter 4 are in addition to the obligations imposed by Chapter 3, even for an FFI that is a QI under Chapter 3.[64]

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[59] §1471(d)(7).

[60] §1471(d)(6).

[61] JCTE at 40.

[62] §1471(c)(2).

[63] JCTE at 42.

[64] §1471(c)(3).

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Waiver of Withholding on Payments Made to a Non-FFE Under §1472(b)

Waiver Requirements

The withholding requirement for a payment to a Non-FFE is waived if the beneficial owner of the payment is the Non-FFE or other Non-FFE and:

(i) the payee or the beneficial owner of the payment provides the withholding agent with

(a) a certification that the Non-FFE does not have a substantial United States owner; or

(b) with the name, address, and TIN of each substantial United States owner;

(ii) the withholding agent does not know or have reason to know that the certification or information provided regarding substantial United States owners is incorrect; and

(iii) the withholding agent reports the name, address, and TIN of each substantial United States owner.[65]

The fact that the withholding agent must not have knowledge or reason to know that the information is not correct puts a compliance burden on the withholding agent. While the standard ''reason to know'' is generally understood and specific rules are provided in the §1441 regulations, it is likely that regulations under both Chapters 4 and 3 will require a withholding agent to obtain a higher standard of documentary proof from a payee. Given the indemnification provided under §1474(a), a withholding agent likely will withhold in a questionable situation. Because one of the stated reasons for enacting Chapter 4 was the limited obligation on a withholding agent to determine the accuracy of Forms W-8BEN, additional obligations on withholding agents relating to confirming the identity of the beneficial owner of an account should be anticipated under regulations. It would be helpful if regulations set forth clear guidelines as to what documentation a withholding agent may rely upon in addition to a self-certification contained in a Form W-8BEN.

Foreign Vendor Payments

The JCTE anticipates that regulations may exclude payments made for goods, services, or the use of property if the payment is made pursuant to an arm's-length transaction in the ordinary course of the payor's trade or business.[66] The Chapter 3 and Chapter 61 provisions will continue to apply, however, to foreign vendor payments.

While such an exclusion would seem to be the correct rule from a policy perspective, there will likely be a number of hurdles to overcome to qualify for such an exclusion. As noted, the Chapter 4 provisions are to be interpreted strictly.

General Provisions Applicable to Withholdable Payments

Withholding Agent

''Withholding agent'' means any person, in whatever capacity acting, having the control, receipt, custody, disposal, or payment of any withholdable payment.[67]

The definition of withholding agent for purposes of Chapter 4 differs from that of Chapter 3 only in that it applies to withholdable payments, which includes not only FDAP income but also gross proceeds from dispositions of property that produce FDAP. A withholding agent under Chapter 3, by contrast, is defined only with respect to FDAP income and certain capital gains subject to §1441 withholding tax.

Liability

Each withholding agent as defined under §1473(4) is liable for the tax that should be withheld and is indemnified against claims and demands of any person for the amount of payments made in accordance with the provision.[68] This provision is similar to the Chapter 3 liability and indemnification provision contained in §1461.

Application of §6103

No person may use information obtained under the provisions of Chapter 4 except for the purpose of meeting any requirements under Chapter 4 or for purposes permitted under §6103.[69] However, the identity of FFIs that have entered into an agreement with the Secretary is not treated as return information for purposes of §6103.[70]

Broad Regulatory Authority

Section 1474(f) provides the IRS regulatory authority to issue guidance as necessary or appropriate to carry out the purposes of, and prevent the avoidance

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[65] §1472(b).

[66] JCTE at 46.

[67] §1473(4).

[68] §1474(a).

[69] §1474(c)(1).

[70] §1474(c)(2).

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of, Chapter 4. This broad regulatory authority is very similar to that provided in §7874(g), relating to expatriated entities, which has been very broadly applied.[71]

Credits and Refunds

General Rule

If withholding under Chapter 4 results in an overpayment of U.S. tax by the beneficial owner of the payment, such overpayment is addressed in the same manner as an overpayment under Chapter 3.[72] A beneficial owner eligible for reduced tax under an income tax treaty or for the portfolio interest exemption is entitled to a credit or refund of the amount of the overpayment. Furthermore, a beneficial owner of a payment of gross proceeds from the sale of stock not subject to U.S. tax would generally be eligible for a refund of the total amount of tax withheld.[73]

Beneficial Owner Documentation Requirement

No refund or credit will be allowed unless the beneficial owner of a payment provides information as required under regulations. Regulatory authority is provided to require appropriate documentation to establish that a person is the beneficial owner and, if claiming a treaty benefit, that the person is eligible for such treaty benefit.[74]

Income Tax Treaty Obligations

The JCTE explains that the credit and refund method under Chapter 4 is designed to be consistent with existing U.S. treaty obligations. The JCTE points out that, although a reduction at source on withholding tax is preferred under the OECD Commentary, it is not required. The Chapter 4 mechanism was designed to address prior inappropriate treaty claims by U.S. persons. Under the ''saving'' clause contained in all U.S. income tax treaties, U.S. persons are generally subject to U.S. tax as if the treaty had never come into effect, even if the U.S. person is a U.S. citizen who is a resident of the treaty partner.

Special Rule when an FFI Is the Beneficial Owner

Section 1474(b)(2) provides a special rule applicable to an FFI that is the beneficial owner of a withholdable payment. In that case, a credit or refund is available only to an FFI that is eligible for benefits under an income tax treaty. An FFI that is not eligible for the benefits of an income tax treaty is therefore subject to a final 30% tax if the FFI has not entered into an IRS reporting agreement under §1471(b).[75] This is the case even if under statutory rules (e.g., portfolio interest), withholding would not have otherwise applied. Even where a credit or refund is available to an FFI based on treaty benefits, no interest may be paid on the credit or refund.[76]

IRS Interest Grace Period on Overpayments Extended

Section 6611(e) was amended with respect to Chapters 3 and 4 to increase from 45 to 180 days the grace period during which the IRS is not required to pay interest on an overpayment for: (1) returns filed; (2) claims made for credit or refund; and (3) refunds paid on IRS adjustments after March 18, 2010. Form 1042, the annual return required to be filed by a withholding agent, is due on March 15 for payments made in the prior calendar year. Thus, withholding agents who for 2009 timely filed Form 1042 and requested a refund or credit would not be subject to the extended grace period.[77] However, any claims for a credit or refund made under Chapter 3 after March 18, 2010, would be subject to the extended IRS grace period for payment of interest. Generally, a nonresident alien individual would file a claim for refund on Form 1040NR by April 15 or June 15, depending on the type of U.S. taxable income involved, and would be subject to the extended grace period.

EXPANDED DEFINITION OF ''DIVIDEND''

''Dividend Equivalent'' Payments Treated as U.S.-Source Dividends

Scope of Definition

New §871(l)[78] provides that, for purposes of §§871(a), 881, and 4948(a),[79] a ''dividend equivalent'' is treated as a U.S.-source dividend. Note that, for domestic purposes such as the dividends-received deduction, a ''dividend equivalent'' is not treated as a dividend. This treatment is consistent with the treatment of substitute dividend payments under current law.

The term ''dividend equivalent'' means any substitute dividend made under a securities lending or sale-

[71] *See, e.g.,* Notice 2009-78, 2009-40 I.R.B. 452, in which certain stock was disregarded for purposes of the ownership test.

[72] §1474(b).

[73] JCTE at 47.

[74] §1474(b)(3) and JCTE at 47.

[75] §1474(b)(2)(A)(ii).

[76] §1474(b)(2)(A)(i)(II).

[77] *See* Regs. §§1.1461-2 and -3.

[78] This provision, added by §541 of P.L. 111-147, is effective for payments made on or after 180 days after the Mar. 18, 2010, date of enactment, which means on or after Sept. 14, 2010.

[79] Section 4948 imposes a 4% excise tax on the gross investment income of a foreign private foundation.

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repurchase (''repo'') transaction, a payment made under a ''specified notional principal contract'' that is either directly or indirectly contingent on, or determined by, reference to a U.S.-source dividend, or any other payment designated under regulations as ''substantially similar'' to one of the foregoing payments.[80] The legislation is intended to eliminate the different source rules that previously applied to stock loan and repo payments and payments made under a notional principal contract.[81]

According to the Levin Statement, the ''legislative intent'' of the authors of the provision concerning a ''substantially similar'' payment is that the regulatory authority be used to identify and extend coverage of a ''dividend equivalent'' to stop the ''more subtle abusive practices.'' [82] Furthermore, the Levin Statement encourages Treasury to act quickly.[83]

Impact Under Income Tax Treaties

Although at one time the treatment of a ''dividend equivalent'' as a dividend may not have required such treatment under an income tax treaty, under most recently negotiated treaties the dividend articles contain a definition of ''dividend'' that should encompass a ''dividend equivalent.'' [84] For example, under Article 10(5) of the 2006 U.S. Model Income Tax Treaty, the definition includes not only income from shares or other rights participating in profits, but also income that is subject to the same taxation treatment as income from shares under the tax law of the payor's country of residence. This definition would clearly encompass a ''dividend equivalent,'' which when paid to a foreign person is explicitly treated as a U.S.-source dividend. The Technical Explanation to Article 10(5) provides that the definition is broad and flexible so as to cover all arrangements that yield a return on an equity investment in a corporation as determined under the source state's tax law as well as future arrangements.

September 14, 2010, Effective Date Except for Swap Payments with Respect to Publicly Traded Securities

New §871(l) will apply to treat ''dividend equivalent'' payments made on or after September 14, 2010, as U.S.-source dividend payments.[85] Even though Chapter 4 will not be effective until 2013, §871(l) applies for purposes of §1441 withholding beginning for payments made on or after September 14, 2010. However, until March 18, 2012, the term ''specified notional principal contract'' (as discussed below) applies only to notional principal contracts involving non–publicly traded securities.[86] Until that date, payments made under swap agreements and other notional principal contracts involving publicly traded securities will not be treated as U.S.-source payments that are subject to U.S. withholding tax. Presumably, the extended effective date for swaps involving publicly traded securities is to permit the capital markets to make adjustments.

Definition of ''Specified Notional Principal Contract''

A ''specified notional principal contract'' is a contract with any one of the following five characteristics:[87]

- A ''long party'' transfers the underlying security to any ''short party'' to the contract;
- Upon termination of the contract, any ''short party'' transfers the underlying security to any ''long party'';
- The underlying security is not readily tradable on an established securities market;
- Any ''short party'' to the contract posts the underlying security as collateral with any ''long party'' at the beginning of the contract; or
- The contract is identified in regulations or otherwise as a ''specified notional principal contract.''

The term ''long party'' is defined as any party that receives payments contingent on or determined by

[80] §871(l)(2).

[81] Levin Statement, 156 *Cong. Rec.* S1746. Under prior law, payments made under a notional principal contract were sourced to the residence of the recipient under Regs. §1.863-7(b)(1), while substitute dividend payments were sourced by reference to the underlying dividend under Regs. §1.861-3(a)(6). A foreign recipient of a payment under a notional principal contract therefore was treated as receiving foreign-source income, which is not subject to U.S. tax. The Levin Statement makes the following comment concerning this result: ''But it makes no sense and turns the English language on its head to say the recipient of a payment is the 'source' of that payment.''

[82] 156 *Cong. Rec.* S1746. Presumably, this remark refers to certain interpretations of Notice 97-66, 1997-2 C.B. 328, that would result in no withholding tax on payments to tax haven payees.

[83] *Id.*

[84] An example of a former dividend definition provision that would not encompass a ''dividend equivalent'' is the definition under Article 10(3) of the former income tax treaty between the United States and the United Kingdom, which defined a dividend for U.S. purposes as ''any item that under U.S. law would be treated as a distribution out of earnings and profits.'' A ''dividend equivalent'' clearly would not qualify as a dividend under that definition.

[85] The effective date is 180 days after the Mar. 18, 2010, date of enactment.

[86] §871(l)(3)(B).

[87] §871(l)(3).

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reference to the payment of a dividend with respect to the underlying security.[88] The term ''short party'' is defined as any party that is not a long party with respect to the underlying security.[89] The term ''underlying security'' means the security with respect to which the dividend equivalent is paid.[90] Moreover, any index or fixed basket of securities is treated as a single security.[91]

As noted above, a notional principal contract with respect to publicly traded securities is a ''specified notional principal contract'' only after March 18, 2012.

Not all swaps involve an actual holding of a security. For example, in a ''fully synthetic'' transaction, the foreign person does not own the U.S. security.[92] Presumably, regulations will address such swaps.

Relief for Cascading Payments

To avoid overwithholding with respect to cascading payments, a provision permits a taxpayer to establish that the tax has been paid with respect to another dividend equivalent or an actual dividend in the chain.[93] Authority is provided to address the role of financial intermediaries in the chain.[94] The Levin Statement observes that the burden of proof is ''intentionally high'' due to numerous prior abuses using ''elaborate chains of transactions.'' [95]

Withholding Tax Imposed on Gross Amount of Payment

Significantly, U.S. withholding tax is imposed on the *gross* amount to be paid and not on the net amount that is actually paid.[96] Typically, the swap parties net the payments owed to each other and only the party with a net positive amount actually makes a payment. As a result, a counterparty may be required to withhold U.S. tax on the gross amount of a dividend equivalent even though the counterparty has no obligation to actually pay the other counterparty as a result of the netting of payments. Although the current §1441 regulations require withholding on certain ''payments'' where there is no actual cash payment, transactions subject to the rule generally are between related parties. Such will generally not be the case for notional principal contract payments.

Regulatory Authority for Exemption Where No Tax Avoidance and for ''Substantially Similar'' Payments

Although §871(l) provides regulatory authority to exempt some notional principal contract payments where there is no tax avoidance potential,[97] the Levin Statement instructs Treasury to apply this exception ''very sparingly,'' [98] explaining that it is ''intentionally a very high standard.'' [99] Further, the Levin Statement directs the Treasury to use the explicit legislative directive to ''aggressively'' enforce dividend tax on ''substantially similar'' payments and transactions, citing the JCTE's suggestion that forward contracts or other financial contracts that reference U.S. stock should be treated as dividend equivalents.[100] According to the Levin Statement, ''[t]he point of the 'substantially similar' language is to provide Treasury and the IRS with broad authority and the flexibility needed to prevent misuse of other financial instruments or trading activities to evade U.S. dividend taxes.''[101]

Withholding Agent Definition Broadened for Dividend Equivalent Payments

Each person that is a party to any contract or other arrangement that provides for the payment of a dividend equivalent is treated as having control over such payment for purposes of Chapters 3 and 4.[102] Consequently, all parties to such contracts are treated as withholding agents for purposes of Chapters 3 and 4, and thus are subject to all of the withholding, reporting, and penalty provisions that apply to withholding agents.

Practical Considerations for Taxpayers with Existing Transactions

Because the new rules are applicable to dividend equivalent payments made on or after September 14,

[88] §871(l)(4)(A).

[89] §871(l)(4)(B).

[90] §871(l)(4)(C).

[91] *Id.*

[92] *See* IRS ''Industry Directive on Total Return Swaps Used to Avoid Dividend Withholding Tax'' (Jan. 14, 2010).

[93] §871(l)(6).

[94] *Id.*

[95] 156 *Cong. Rec.* S1747. Most notably, the Sept. 11, 2008, PSI report, *Dividend Tax Abuse: How Offshore Entities Dodge Taxes on U.S. Stock Dividends*, identified so-called ''foreign-to-foreign'' payments usually between entities not eligible for treaty benefits that resulted in no withholding under an interpretation of Notice 97-66, 1997-2 C.B. 328, relating to cascading dividend equivalent payments.

[96] §871(l)(5).

[97] *Id.*

[98] 156 *Cong. Rec.* S1746.

[99] *Id.*

[100] 156 *Cong. Rec.* S1747.

[101] *Id.*

[102] §871(l)(7).

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2010 (except in the case of specified notional principal contracts with respect to publicly traded securities, in which case the new rules apply to payments made after March 18, 2012), existing transactions may be affected. In the case of an existing transaction that is covered by §871(l) and is documented under an ISDA Master Agreement, the imposition of withholding tax on dividend equivalent payments after the effective date generally would be a ''Tax Event,'' which may trigger an early termination of the transaction. It is important to review existing transactions in advance of the effective date so that appropriate steps can be taken to establish an exemption from, or a reduced rate of, withholding tax, terminate the transaction, or agree on a proper allocation of any withholding tax liability.

In anticipation of the enactment of legislation similar to §871(l), some taxpayers have already incorporated language in their transaction documents to address any withholding tax concerns. Going forward, in negotiating new ISDA Master Agreements, it will be important to ensure that dividend equivalent payments qualify for an exemption from, or reduced rate of, withholding tax (e.g., as effectively connected income or pursuant to the terms of a treaty) and, if an exemption is not available, to include language specifically allocating liability for any withholding tax imposed under §871(l). This is important even if the taxpayer does not anticipate entering into specified notional principal contracts at the time the ISDA Master Agreement is negotiated, unless specified notional principal contracts are specifically excluded from the types of transactions permitted to be documented under the agreement.

IMPLEMENTATION

The IRS and Treasury have publicly stated that they already have assembled their team to draft the guidance under FATCA. On April 7, 2010, the IRS issued Announcement 2010-22, ''Announcement Regarding Implementation of FATCA and Request for Comments,'' [103] requesting comments from the public regarding guidance projects and issues concerning the interpretation and implementation of Chapter 4 of the Code and other provisions added by FATCA. In public remarks to various groups during the first quarter of 2010, Steven A. Musher, IRS Associate Chief Counsel (International), announced that the government will begin a consultation process similar to that used for the development of the §1441 regulations. The IRS and Treasury held many consultations with stakeholders (including foreign banks) during that process. Musher stated that he expects that an evolutionary and transitional set of rules will be provided. It is possible that consideration will be given to applying the existing presumption rules under §1441 to permit foreign entities to determine the identity of their account holders. Not surprisingly, Musher has said that he anticipates a different standard for new accounts than for existing accounts, but increasing the requirements for existing accounts over time.

CONCLUSION

To implement the provisions of Chapter 4 within two years is an ambitious agenda. Chapter 4 will have far-reaching effects and the full extent of its impact is not yet known. For example, it is not clear whether insurance companies will be subject to the provisions and, if they are, how the provisions will apply to various insurance products.

The positive news is that the legislative drafters listened to commentators and made significant amendments in the version of FATCA included in the Extenders Bill, which were enacted as part of the HIRE Act. Those amendments, including the extension of the effective date, addressed some of the practical concerns. Hopefully, the IRS and Treasury will continue to listen to stakeholders; engaging in a consultation process is certainly a good beginning.

[103] 2010-16 I.R.B. 1.

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