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TAX LAW UPDATE | APRIL 1, 2010

HIRING INCENTIVES TO RESTORE EMPLOYMENT ACT

On March 18, 2010, the President signed the Hiring Incentives to Restore Employment Act into law (Public Law 111-147) (the "Act"). The provisions of the Act that address foreign account tax compliance are intended to improve taxpayer compliance by giving the Internal Revenue Service (the "IRS") new administrative tools to detect, deter, and discourage offshore tax abuses. In doing so, the Act imposes broad disclosure and reporting requirements on foreign financial institutions and other foreign entities including private equity funds, hedge funds and certain investment vehicles (including foreign issuers of collateralized debt obligations or collateralized loan obligations), as well as entities engaged in banking or similar businesses. The international tax reform provisions in the Act are limited to provisions regarding withholding and information reporting. The language in the Act is based on proposals included in President Obama's 2010 Budget and legislation introduced in October 2009 as the Foreign Account Tax Compliance Act of 2009 ("FATCA") by Senate Finance Committee Chair Max Baucus (S. 1934) and then-House Ways and Means Committee Chair Charles Rangel (H.R. 3933). FATCA as included in the Act leaves out language from H.R. 3933 that would have required tax or investment advisers to disclose the identities of any clients they assist in buying offshore assets, as well as the assets purchased.

The following alert summarizes certain significant provisions of the Act that address foreign account tax compliance. Other provisions of the Act that address foreign account tax compliance but that are not discussed here address uncompensated use of trust property and reporting requirements of United States owners of foreign trusts. The Act also includes a number of provisions aimed at increasing hiring, such as (a) payroll tax forgiveness; (b) an employee retention credit and (c) an increase in the limitation for initial year expensing of certain depreciable business assets provided under Section 179 of the Internal Revenue Code of 1986 (the "Code").

The changes to withholding and reporting requirements described in this client alert represent fundamental changes. Generally, the broad withholding rules become effective on January 1, 2013. Pending the release of Treasury Regulations on this subject, persons who would be affected by the new withholding and reporting requirements should consider how they will comply with the new provisions well before they become effective. Likewise, the changes described in this client alert regarding notional principal contracts and securities lending transactions that are encompassed in the provision concerning dividend equivalent and substitute dividend payments are a reversal of prior law and, in the absence of prompt Treasury Regulations or clarifying legislative history, are likely to create compliance and operational issues for parties that are obligated to withhold. Parties to equity based notional principal contracts should evaluate whether existing notional principal contracts should be terminated and replaced with Act-compliant transactions prior to September 14, 2010, when they become effective.

I. EXECUTIVE SUMMARY

The foreign account tax compliance provisions in the Act:

- Impose a 30% withholding tax on payments either to foreign financial institutions and trusts that fail to identify U.S. accounts and their owners and assets to the IRS, or to non-financial foreign entities that do not supply the name, address, and tax identification number of any U.S. person that owns more than 10% of the entity. This provision is effective for payments made after December 31, 2012, with some exceptions for grandfathered agreements.

- Subject dividend equivalent payments included in notional principal contracts, and substitute dividend payments in certain securities lending and sales-repurchase agreements, in each case, paid to non-U.S. persons to the same 30% withholding tax levied on dividends paid to non-U.S. persons. This provision is effective for payments made on or after 180 days after March 18, 2010.

- Extend bearer-bond tax penalties to any such bonds marketed to non-U.S. investors, and prevent the U.S. government from issuing bearer bonds. This provision is effective after March 18, 2012.

- Impose penalties as high as $50,000 on U.S. taxpayers who own at least $50,000 in offshore accounts or assets but fail to report the accounts on their annual income tax return. This provision is effective for tax years beginning after March 18, 2010.

- Levy a 40% penalty on the amount of any understatement attributed to undisclosed foreign assets. This provision is effective for tax years after March 18, 2010.

- Extend to six years the statute of limitations for omissions exceeding $5,000 and 25% of reported income derived from offshore assets. This provision is effective for returns filed after March 18, 2010, and for returns filed on or before March 18, 2010, if the applicable statute of limitations has not expired as of such date.

- Require U.S. shareholders in passive foreign investment companies to file annual information returns. This requirement is in addition to the annual reporting requirements for a U.S. holder of an interest in a passive foreign investment company that such holder has elected to treat as a "qualified electing fund." This provision is effective as of March 18, 2010.

- Permit the IRS to mandate that financial firms file U.S. withholding tax returns electronically, even if they file fewer than 250 returns annually. This provision is effective for returns due after March 18, 2010. • Codify U.S. Treasury regulations that treat foreign trusts as having U.S. beneficiaries if any current, future, or contingent beneficiary is a U.S. person.

- Permit the IRS to presume that a foreign trust has U.S. beneficiaries if a U.S. person directly or indirectly transfers property to the foreign trust. This provision is effective for transfers of property after March 18, 2010.

- Establish a $10,000 minimum failure-to-file penalty for some foreign-trust-related information returns. This provision is effective for notices and returns due after December 31, 2009.

II. WITHHOLDING TAX AND INFORMATION REPORTING ON U.S. PAYMENTS TO FOREIGN ACCOUNTS

The Act adds new Code Sections 1471, 1472, 1473, and 1474, and amends Code Section 6611, to provide for withholding taxes to enforce new reporting requirements on specified foreign accounts owned by specified United States persons or by United States owned foreign entities. The provisions establish rules for withholdable payments to foreign financial institutions and for withholdable payments to other foreign entities.

A. Withholding Tax and Information Reporting on U.S. Payments to Foreign Financial Institutions (new Code Section 1471).

(1) Withholding Regime and Reporting Requirements

The Act imposes a 30% withholding tax on "withholdable payments" made to foreign financial institutions (and their 50% affiliates) unless the payee foreign financial institution agrees to (1) disclose the identity of any U.S. person with an account at the institution (or the institution's affiliates), (2) withhold tax (or to elect to have tax withheld) on any withholdable payment that is made to a recalcitrant account holder or another foreign financial institution which does not meet the requirements of the Act, and (3) annually report on the account balance, gross receipts and gross withdrawals and payments from such account. For this purpose, "withholdable payments" include payments of interest (including original issue discount), dividends, rents, salaries, wages and other items of fixed or determinable annual or periodical gains, profits and income, in each case, from sources within the United States, as well as gross proceeds from the sale of any property of a type which can produce interest or dividends from sources within the United States. For purposes of the Act, interest on deposits paid by a foreign branch of a U.S. financial institution is considered to be from sources within the United States. However, the term "withholdable payments" does not include payments of income that is effectively connected with the conduct of a U.S. trade or business. Additionally, according to the Joint Committee Explanation, the IRS may determine that certain payments made with respect to short-term debt or short-term deposits, including gross proceeds paid pose little risk of U.S. tax evasion and may be excluded from withholdable payments for purposes of this provision.

The term "foreign financial institution" is broadly defined by the Act, and includes hedge funds, private equity funds, certain investment vehicles (including foreign issuers of collateralized debt obligations or collateralized loan obligations), and entities that, as a substantial portion of their business, hold financial assets for the account of others. Such term also includes entities that accept deposits in the ordinary course of a banking or similar business. Except as otherwise provided, such term does not include a financial institution that is organized under the laws of any possession of the United States. Additionally, according to the Joint Committee Explanation, the IRS may provide exceptions for certain classes of financial institutions. Such exceptions may include entities such as certain holding companies, research and development subsidiaries, or financing subsidiaries within an affiliated group of nonfinancial operating companies. It also is anticipated that the IRS may prescribe special rules addressing the circumstances in which certain categories of companies, such as certain insurance companies, are financial institutions, or the circumstances in which certain contracts or policies, for example annuity contracts or cash value life insurance contracts, are financial accounts or U.S. accounts for these purposes.

The term "recalcitrant account holder" means any account holder that fails to comply with reasonable requests for the information required to be reported by the foreign financial institution or that fails to provide a valid waiver of an applicable foreign law that would prevent the reporting of such information.

Withholding under the Act applies to all withholdable payments without regard to whether the beneficial owner of the payment is a U.S. person, or is otherwise entitled to an exemption from the imposition of withholding tax pursuant to an applicable tax treaty with the United States or pursuant to U.S. domestic law (for example, pursuant to the so-called "portfolio interest exemption"). The Act exempts any depository account maintained by a foreign financial institution if the holder of such account is a natural person, and, with respect to each holder of such account, the aggregate value of all depository accounts held (in whole or in part) by such holder and maintained by the same financial institution which maintains such account does not exceed $50,000. However, according to the Joint Committee Explanation, to the extent provided by the IRS, financial institutions that are members of the same expanded affiliated group may be treated as a single financial institution for purposes of determining the aggregate value of depository accounts maintained at the financial institution.

The Act provides for the promulgation of regulations by the IRS providing for the coordination of withholding under the Act with existing U.S. non-resident withholding rules, including providing for the proper crediting of amounts deducted and withheld under the Act against amounts required to be deducted and withheld under such other rules. Additionally, according to the Joint Committee Explanation, it is intended that any guidance provided by the IRS under this provision, including documentation and requirements to provide information, be consistent with existing income tax treaties. To the extent that withholding is not imposed by the Act, normal U.S. withholding rules continue to apply.

(2) Reporting Agreement with the IRS to Identify US Account Holders

To avoid the imposition of the 30% withholding tax on "withholdable payments," the Act requires foreign financial institutions to agree to disclose and report on foreign entities that have an account with the foreign financial institution and have substantial U.S. owners. For this purpose foreign entities with substantial U.S. owners include foreign partnerships and corporations with a U.S. owner that owns (directly or indirectly) more than a 10% interest (by vote or value), foreign grantor trusts with owners that are U.S. persons, and, to the extent provided in regulations or other IRS guidance, other trusts where a U.S. person holds (directly or indirectly) more than 10% of the beneficial interests of such trust. In the case of a foreign financial institution, such as a hedge fund or a private equity fund, that is engaged (or holds itself out as engaged) in the business of investing, reinvesting, or trading in securities, partnership interests or commodities (or any interests therein), such institution will be treated as having a substantial U.S. owner if any U.S. person holds an interest in such entity. Foreign financial institutions are not required to disclose and report on publicly traded corporations (or their 50% affiliates), tax-exempt organizations, certain banks, real estate investment trusts, and regulated investment companies.

The provision allowing for withholding on payments made to a recalcitrant account holder is not intended to create an alternative to information reporting according to the Joint Committee Explanation. It is anticipated that the IRS may require that a foreign financial institution entering into a reporting agreement with the IRS achieve certain levels of reporting and make reasonable attempts to acquire the information necessary to comply with the requirements of this provision or to close accounts where necessary to meet the purposes of this provision. It is also anticipated that the IRS may require that, in the case of new accounts, the foreign financial institution may not withhold as an alternative to collecting the required information.

According to the Joint Committee Explanation, it is expected that in complying with the requirements of this provision, the foreign financial institution (and other members of an affiliated group) comply with know-your-customer, anti-money laundering, anti-corruption, or other similar rules to which they are subject, as well as with such procedures and rules as the IRS may prescribe, both with respect to due diligence by the foreign financial institution and verification by or on behalf of the IRS to ensure the accuracy of the information, documentation, or certification obtained to determine if the account is a U.S. account. The disclosure and reporting requirements described above are in addition to any requirements imposed under the qualified intermediary program.

The Act does not change the rules applicable to qualified intermediaries. Additionally, the Act permits a foreign financial institution to comply with its information reporting requirements by electing to be subject to the same reporting requirements as a U.S. financial institution.

(3) Refunds and Credits of Taxes Withheld

A beneficial owner generally will be able to obtain a refund or credit of taxes withheld pursuant to the Act (to the extent that such refund or credit would be permitted under existing withholding rules) by filing a U.S. federal income tax return. No refund or credit will be allowed or paid with respect to any tax properly withheld under the Act unless the beneficial owner of the payment provides such information as the IRS may require to determine whether such beneficial owner is a United States owned foreign entity and the identity of any substantial United States owners of such entity. Additionally, no refund or credit will be available for withholding on payments to a beneficial owner which is a foreign financial institution that is not eligible for benefits under an applicable tax treaty with the United States. In no event will interest be allowed or paid with respect to any credit or refund of tax properly withheld on a payment to a beneficial owner that is a foreign financial institution.

Under this provision, the grace period for which the U.S. government is not required to pay interest on an overpayment is increased from 45 days to 180 days for overpayments resulting from excess amounts deducted and withheld. The increased grace period applies to refunds of withheld taxes with respect to (1) returns due or filed after March 18, 2010 and IRS-initiated adjustments if the refunds are paid after March 18, 2010. According to the Joint Committee Explanation, it is anticipated that the IRS may specify the proper form and information required for a claim for refund and may provide that a purported claim that does not include such information is not considered filed.

According to the Joint Committee Explanation, if tax is withheld under the provision, this credit and refund mechanism ensures that the provisions are consistent with U.S. obligations under existing income tax treaties. U.S. income tax treaties do not require the United States and its treaty partners to follow a specific procedure for providing treaty benefits. For example, in cases in which proof of entitlement to treaty benefits is demonstrated in advance of payment, the United States may permit reduced withholding or exemption at the time of payment. Alternatively, the United States may require withholding at the relevant statutory rate at the time of payment and allow treaty country residents to obtain treaty benefits through a refund process. The credit and refund mechanism ensures that residents of treaty partners continue to obtain treaty benefits in the event tax is withheld under the provision.

B. Withholding Tax and Information Reporting on U.S. Payments to Non-Financial Foreign Entities (new Code Section 1472).

A major point of concern that was identified in connection with underreporting of income by taxpayers was the use of foreign corporations to hold assets offshore. Some of the foreign corporations were set up with the cooperation of foreign bankers. The Act requires foreign entities other than "financial institutions" (as defined above in Part II.A.1) to provide withholding agents with the name, address and taxpayer identification number of any substantial U.S. owners (e.g., an owner that owns more than 10% of a foreign corporation's stock (by vote or value)). Withholding agents are required to report this information to the IRS. Under the Act, any withholding agent making a withholdable payment to a foreign entity that is not a financial institution and that does not comply with these disclosure and reporting requirements will be required to withhold tax at a rate of 30%. Similar rules would also apply to foreign trusts.

The Act exempts publicly-held corporations, entities organized under the laws of a possession of the United States that are wholly owned by one or more bona fide residents of such possession, and certain other foreign entities from these reporting and withholding requirements, and provides the IRS with the regulatory authority to exclude other recipients that pose a low risk of tax evasion. As noted, the Act does not include language contained in H.R. 3933 that would have required tax or investment advisers to disclose the identities of any clients they assist in buying offshore assets, as well as the assets purchased.

C. Effective Date.

Generally, the new withholding and reporting regime will apply to payments made after December 31, 2012. However, withholding under the Act will not apply to any payment under any obligation outstanding on March 18, 2012 or from the gross proceeds from any disposition of such an obligation. Nevertheless, taxpayers who are affected by the new withholding and reporting requirements should consider how they will comply with the new provisions well before January 1 2013, when they become effective.

III. SUBSTITUTE DIVIDENDS AND DIVIDEND EQUIVALENT PAYMENTS

Under law existing prior to enactment of the Act, payments under a notional principal contract that were made to a foreign person generally were treated as foreign source payments that were not subject to U.S. withholding tax. Additionally, prior law did not impose U.S. withholding tax on certain payments made pursuant to securities lending and sale-repurchase transactions. However, the Act amends Code Section 871 to treat a "dividend equivalent" payment as a dividend from sources within the United States. Accordingly, unless reduced by an applicable tax treaty with the United States, such payments generally would be subject to U.S. withholding tax.

A. Definitions.

For this purpose, a "dividend equivalent" payment is (i) any substitute dividend made pursuant to a securities lending or a sale-repurchase transaction that (directly or indirectly) is contingent upon, or determined by reference to, the payment of a dividend from sources within the United States, (ii) a payment made pursuant to a "specified notional principal contract" that (directly or indirectly) is contingent upon, or determined by reference to, the payment of a dividend from sources within the United States, and (iii) any other payment determined by the IRS to be substantially similar to a payment described in the preceding clauses (i) or (ii).

The term "specified notional principal contract" means (A) any notional principal contract if (a) in connection with entering into such contract, any long party to the contract transfers the underlying security to any short party to the contract, (b) in connection with the termination of such contract, any short party to the contract transfers the underlying security to any long party to the contract, (c) the underlying security is not readily tradable on an established securities market, (d) in connection with entering into such contract, the underlying security is posted as collateral by any short party to the contract with any long party to the contract, or (e) such contract is identified by the IRS as a specified notional principal contract; and (B) in the case of payments made after March 18, 2012, any notional principal contract unless the IRS determines that such contract is of a type which does not have the potential for tax avoidance.

According to the Joint Committee Explanation, no inference is intended as to whether the definition of specified notional principal contract, or any determination under this provision that a transaction does not have the potential for the avoidance of taxes on U.S.-source dividends, is relevant in determining whether an agency relationship exists under general tax principles or whether a foreign party to a contract should be treated as having beneficial tax ownership of the stock giving rise to U.S.-source dividends.

The term "long party" means, with respect to any underlying security of any notional principal contract, any party to the contract which is entitled to receive any payment pursuant to such contract which is contingent upon, or determined by reference to, the payment of a dividend from sources within the United States with respect to such underlying security. The term "short party" means, with respect to any underlying security of any notional principal contract, any party to the contract which is not a long party with respect to such underlying security. The term "underlying security" means, with respect to any notional principal contract, the security with respect to which the dividend is paid. For purposes of this term, any index or fixed basket of securities shall be treated as a single security. In applying this rule, according to the Joint Committee Explanation, it is intended that such a security will be deemed to be regularly traded on an established securities market if every component of such index or fixed basket is a security that is readily tradable on an established securities market.

B. Rules Regarding Dividend Equivalent Payments.

The payments that are treated as U.S.-source dividends under this provision are the gross amounts that are used in computing any net amounts transferred to or from the taxpayer. The Joint Committee Explanation provides the example of a "total return swap" referencing stock of a U.S. domestic corporation (an example of a notional principal contract to which this provision generally applies) to illustrate the consequences of this rule. Under a typical total return swap, a foreign investor enters into an agreement with a counterparty under which amounts due to each party are based on the returns generated by a notional investment in a specified dollar amount of the stock underlying the swap. The investor agrees for a specified period to pay to the counterparty (1) an amount calculated by reference to a market interest rate (such as the London Interbank Offered Rate ("LIBOR")) on the notional amount of the underlying stock and (2) any depreciation in the value of the stock. In return, the counterparty agrees for the specified period to pay the investor (1) any dividends paid on the stock and (2) any appreciation in the value of the stock. Amounts owed by each party under this swap typically are netted so that only one party makes an actual payment. The provision treats any dividend-based amount under the swap as a payment even though any actual payment under the swap is a net amount determined in part by other amounts (e.g., the interest amount and the amount of any appreciation or depreciation in value of the referenced stock). Accordingly, a counterparty to a total return swap may be obligated to withhold and remit tax on the gross amount of a dividend equivalent even though, as a result of a netting of payments due under the swap, the counterparty is not required to make an actual payment to the foreign investor.

Dividend equivalent payments do not include payments pursuant to any contract or other arrangement which the IRS determines does not have the potential for tax avoidance. In making this determination, the IRS is permitted to take into account the following factors: (a) the term of the contract (including provisions for early terminations and offsetting financial contracts), (b) the amount of each party's investment and the amounts of collateral posted, (c) whether the price of the equity used to measure the parties entitlements or obligations is based on an objectively observable price, (d) whether either party sells (directly or indirectly) to the other party the security giving rise to dividends from sources within the United States, and (e) whether there are terms that address the hedge position of either party or other conditions which would compel either party to hold or acquire the security giving rise to dividends from sources within the United States.

In the case of any chain of dividend equivalents one or more of which is subject to tax under the Act or Code Section 881, the IRS may reduce such tax, but only to the extent that the taxpayer can establish that such tax has been paid with respect to another dividend equivalent in such chain, or is not otherwise due, or as the IRS determines is appropriate to address the role of financial intermediaries in such chain. For these purposes, a dividend shall be treated as a dividend equivalent.

According to the Joint Committee Explanation, for purposes of the withholding of tax on nonresident aliens and foreign corporations, and taxes to enforce reporting on certain foreign accounts, each person that is a party to a contract or other arrangement that provides for the payment of a dividend equivalent is treated as having control of the payment. Accordingly, the IRS may provide guidance requiring either party to withhold tax on dividend equivalents. The rule treating dividend equivalents as U.S.-source dividends is not intended to limit the authority of the IRS to determine the appropriate source of income from financial arrangements (including notional principal contracts) under present law or to provide additional guidance addressing the source and characterization of substitute payments made in securities lending and similar transactions.

C. Effective Date.

The changes described above are a reversal of prior law, and, in the absence of prompt regulations or clarifying legislative history, are likely to create compliance and operational issues for parties that are obligated to withhold. These changes apply to payments made on or after September 14, 2010. Taxpayers should evaluate whether existing notional principle contracts should be terminated and replaced with HIRE Act compliant transactions.

IV. EXTENSION OF BEARER BOND SANCTIONS TO FOREIGN TARGETED BEARER BONDS

The Act amends Code Sections 149, 163, 165, 871, 881, 1287, and 4701. Under law existing prior to enactment of the Act, issuers and holders of certain foreign targeted bearer bonds were exempt from adverse tax consequences otherwise applicable to bearer bonds. Generally, the issuer of a bearer bond is not allowed to claim an interest deduction on the bond, the earnings and profits of the issuer generally are not reduced by the amount of any interest on the bond, and interest on the bond does not qualify for any applicable tax exemption (e.g., treatment as a tax-exempt municipal bond). Furthermore, certain issuers of bearer bonds are also be subject to an excise tax equal to 1% of the principal amount of the bearer bond multiplied by the number of years of the bond's term. Finally, gain realized on the sale or other disposition of bearer bonds is treated as ordinary income for U.S. federal income tax purposes, and interest on such bonds does not qualify for the portfolio interest exception from U.S. withholding tax. It should be noted that, while the Act preserves the foreign targeted bearer bond exemption noted above for purpose of the 1% excise tax, it eliminates such exemption for purposes of the other issuer and holder sanctions. Therefore, while U.S. issuers will no longer be able to issue foreign targeted bearer bonds without incurring penalties, non-U.S. issuers will continue to be able to issue such bonds without penalties in certain circumstances.

The Act repeals the treatment of interest paid on bonds that are not issued in registered form but that meet certain foreign targeting requirements of prior law as portfolio interest. Under the provision, interest qualifies as portfolio interest only if it is paid on an obligation that is issued in registered form and either (1) the beneficial owner has provided the withholding agent with a statement certifying that the beneficial owner is not a United States person (on IRS Form W-8), or (2) the IRS has determined that such statement is not required in order to carry out the purposes of the provision.

In addition, the changes described above do not impact the treatment of certain bearer debt instruments that are treated as registered debt instruments under existing IRS authorities (e.g., bearer debt instruments that are immobilized). A foreign targeted obligation (as well as any other type of registration-required obligations) will satisfy the registration requirements if it is held through a dematerialized book entry system. The interest deduction and tax exemption for the obligation will not be disallowed solely because of that system. The changes described above apply to debt obligations issued after March 18, 2012.

V. FOREIGN FINANCIAL ASSET REPORTING

A. Disclosure of Information with Respect to Foreign Financial Assets (new Code Section 6038D).

Under law existing prior to enactment of the Act, U.S. persons who transfer assets to, and hold interests in, foreign bank accounts or foreign entities may be subject to self-reporting requirements under both the Code and Title 31 (the Bank Secrecy Act) of the United States Code. Regulations promulgated pursuant to the Bank Secrecy Act provide guidance regarding the disclosure obligation with respect to foreign accounts. Specifically, Treasury Department Form TD F 90-22.1, "Report of Foreign Bank and Financial Accounts," (the "FBAR") must be filed following the year in which the $10,000 filing threshold is met. The FBAR requires disclosure of any account in which the filer has a financial interest or as to which the filer has signature or other authority (in which case the filer must identify the owner of the account). The FBAR is filed with the Treasury Department. Failure to file the FBAR is subject to both criminal and civil penalties. The civil sanctions have included penalties not to exceed (1) $10,000 for failures that are not willful and (2) the greater of $100,000 or 50% of the balance in the account for willful failures. Civil enforcement is delegated to the IRS. According the Joint Committee Explanation, this reflects the fact that a major purpose of the FBAR is to identify potential tax evasion. However, the collection and enforcement powers available to enforce the Code have not been available to the IRS in the enforcement of FBAR civil penalties, which remain collectible only in accord with the procedures for non-tax collections.

Although the FBAR is received and processed by the IRS, it is neither part of the income tax return filed with the IRS nor filed in the same office as that return. As a result, for purposes of the Code, the FBAR is not considered "return information," and its distribution to other law enforcement agencies is not limited by the nondisclosure rules of the Code. Although the obligation to file an FBAR arises under Title 31, individual taxpayers subject to the FBAR reporting requirements are alerted to this requirement in the preparation of annual U.S. income tax returns. For example, Part III ("Foreign Accounts and Trusts") of Schedule B of the IRS Form 1040 questions taxpayers about financial accounts in a foreign country and directs taxpayers to review the exceptions and filing requirements for Form TD F 90-22.1. Responding to this question does not discharge an individual's obligations under Title 31 and constitutes "return information" protected from routine disclosure to those charged with enforcing Title 31.

In general, information reported on an FBAR is available to the IRS and other law enforcement agencies. In contrast, information on income tax returns–including the Schedule B information regarding foreign bank accounts–is not readily available to those within the IRS who are charged with administering FBAR compliance, despite the fact that U.S. returns and return information may be the best source of information for this purpose. The nondisclosure constraints on IRS personnel who examine income tax liability (i.e., Form 1040 reporting) generally preclude the sharing of tax return information with any other IRS personnel or Treasury officials, except for tax administration purposes. Tax administration does not necessarily include administration of Title 31. Because Title 31 includes enforcement of non-tax provisions of the Bank Secrecy Act, Title 31 is not, per se, a "related statute," for purposes of finding that a disclosure of such information would be for tax administration purposes. As a result, IRS personnel charged with investigating and enforcing the civil penalties under Title 31 are not routinely permitted access to Form 1040 information that would support or shed light on the existence of an FBAR violation.

The Act adds new Code Section 6038D to require any individual that holds more than $50,000 (in the aggregate) in (1) a depository or custodial account maintained by a foreign financial institution or (2) any stock or security issued by a foreign entity, interest in a foreign entity, or financial instrument with a foreign counterparty (collectively, "reportable foreign assets") to report information about these accounts and/or assets to the IRS with the individual's annual tax return. An individual is not required to disclose interests that are held in a custodial account with a U.S. financial institution nor is an individual required to identify separately any stock, security instrument, contract, or interest in a foreign financial account disclosed under this provision. In addition, the provision permits the IRS to issue regulations that would apply the reporting obligations to a domestic entity in the same manner as if such entity were an individual if that domestic entity is formed or availed of to hold such interests, directly or indirectly.

Although the nature of the information required by this provision is similar to the information disclosed on an FBAR, it is not identical. For example, a beneficiary of a foreign trust who is not within the scope of the FBAR reporting requirements because his interest in the trust is less than 50% may nonetheless be required to disclose the interest in the trust with his tax return under this provision if the value of his interest in the trust together with the value of other specified foreign financial assets exceeds the aggregate value threshold. Additionally, according to the Joint Committee Explanation, nothing in this provision is intended as a substitute for compliance with the FBAR reporting requirements, which are unchanged by this provision.

Failure to comply with this requirement would give rise to a penalty of $10,000, and higher penalties (up to $50,000) could apply if the failure is not remedied within 90 days following notification from the IRS. To the extent that an individual has an interest in one or more foreign financial assets but the individual does not provide enough information to enable the IRS to determine the aggregate value of the assets, the aggregate value of such identified foreign financial assets will be presumed to have exceeded $50,000 for purposes of assessing the penalty. Foreign law prohibitions against disclosure of the required information cannot be relied upon to establish a reasonable cause excuse to the penalty.

The provision also grants authority to promulgate regulations necessary to carry out the intent of the Act. According to the Joint Committee Explanation, such regulations may include exceptions for nonresident aliens and classes of assets identified by the IRS, including those assets which the IRS determines are subject to reporting requirements under other provisions of the Code. In particular, regulatory exceptions to avoid duplicative reporting requirements are anticipated. The changes described above apply for taxable years beginning after March 18, 2010.

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B. Penalties for Underpayments Attributable to Undisclosed Foreign Financial Assets.

Under law existing prior to enactment of the Act, penalties equal to 20% of the portion of any underpayments that are attributable to any of the following five grounds could be imposed: (1) negligence or disregard of rules or regulations; (2) any substantial understatement of income tax; (3) any substantial valuation misstatement; (4) any substantial overstatement of pension liabilities; and (5) any substantial estate or gift tax valuation understatement. With the exception of a penalty based on negligence or disregard of rules or regulations, these penalties are commonly referred to as accuracy-related penalties, because the imposition of the penalty does not require an inquiry into the culpability of the taxpayer. The Act amends Code Section 6662 to impose a new accuracy related penalty equal to 40% of the amount of any understatement of tax liability that is attributable to an undisclosed foreign financial asset (i.e., any foreign financial asset that a taxpayer is required to disclose and fails to disclose on an information return). Thus, a U.S. person who fails to comply with the various self-reporting requirements for a foreign financial asset and who earns income from or with respect to a transaction involving that asset is subject to a penalty on any resulting underpayment that is double the otherwise applicable penalty for substantial understatements or negligence. The change described above applies for taxable years beginning after March 18, 2010.

C. Modification of the Statute of Limitations for Significant Underreporting of Income in Connection with Reportable Foreign Assets.

Under present law, the extended six year statute of limitations applies where an omission is in excess of 25% of the gross income stated on a tax return. The Act amends Code Sections 6229 and 6501 to extend the six year statute of limitations to omissions that exceed $5,000 and are attributable to one or more reportable foreign assets. The Act also clarifies that the statute of limitations does not begin to run until the taxpayer files the information return disclosing the taxpayer's reportable foreign assets. The changes described above apply to (a) returns filed after March 18, 2010, and (b) returns filed on or before March 18, 2010, if the applicable statute of limitations has not expired as of such date.

VI. ADDITIONAL DISCLOSURE REQUIREMENTS

A. Passive Foreign Investment Company Reporting.

The Act amends Code Section 1298 to require each person who is a shareholder of a passive foreign investment company (a "PFIC") to file an annual report containing such information as the IRS may require. A PFIC generally is defined as any foreign corporation if 75% or more of its gross income for the taxable year consists of passive income, or 50% or more of its assets consist of assets that produce, or are held for the production of, passive income. This requirement is in addition to the annual reporting requirements for a holder of an interest in a PFIC that such holder has elected to treat as a "qualified electing fund." According to the Joint Committee Explanation, however, a person that is subject to the reporting requirements of this provision may also be subject to the reporting requirements the Act's provision requiring disclosure of information with respect to foreign financial assets (as well as the associated penalty provisions) (see new Code Section 6038D discussed above in Part V.A). Unlike the reporting requirements imposed by new Code Section 6038D, however, there are no threshold requirements for reporting under this provision. It is anticipated that the IRS will exercise regulatory authority to avoid duplicative reporting under the two provisions. The change described above takes effect on March 18, 2010.

B. E-Filing of Certain Financial Institution Returns.

The Act amends Code Section 6011 to permit the IRS to require financial institutions to file an electronic return even if the financial institution would file fewer than 250 returns during the calendar year. This provision also makes a conforming amendment to Code Section 6724 permitting assertion of a failure to file penalty against a financial institution that fails to comply with the electronic filing requirements. The changes described above apply to returns the due date for which (determined without regard to exceptions) is after March 18, 2010.

VII. PROVISIONS RELATING TO FOREIGN TRUSTS

A. Clarification of the Definition of a Beneficiary of a Foreign Trust.

Pursuant to current U.S. Treasury Regulations under Code Section 679, a foreign trust is treated as having a U.S. beneficiary if any current, future, or contingent beneficiary of the trust is a U.S. person. The Act codifies this regulation. The Act also clarifies that a foreign trust will be treated as having a U.S. beneficiary if (1) any person has discretion to determine the beneficiaries of the trust unless the terms of the trust specifically identify the class of beneficiaries and none of those beneficiaries are U.S. persons or (2) any written, oral or other agreement could result in a beneficiary of the trust being a U.S. person. The Act also clarifies that the use of any trust property will be treated as a payment from the trust in the amount of the fair market value of such use.

B. Presumption with Respect to Transfers to Foreign Trusts.

The Act amends Code Section 679 to provide that if any U.S. person directly or indirectly transfers property to a foreign trust (other than a trust established for deferred compensation or a charitable trust) the trust is presumed to have a U.S. beneficiary unless such person can demonstrate to the satisfaction of the IRS that such trust has complied with all reporting requirements and has submitted any additional information as the IRS may require with respect to such transfer. The change described in the preceding sentence applies to transfers of property after March 18, 2010.

C. Minimum Penalty with Respect to a Failure to Report on Certain Foreign Trusts.

The Act amends Code Section 6677 to modify the penalties for failure to report information regarding certain foreign trusts. The Act provides minimum fixed penalties for such failures, which, in most cases are $10,000. Such penalties apply even in cases where the gross reportable amount is not determinable. In this regard, the Act places the burden on the taxpayer to provide information sufficient to determine the gross reportable amount. This provision is effective for filings required after December 31, 2009.

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