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December 3, 2009

The Honorable Max Baucus  
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Re: Comments on Foreign Account Tax Compliance Act of 2009, H.R. 3933 and S. 1934

Dear Chairmen and Ranking Members:

Enclosed are Comments on Foreign Account Tax Compliance Act of 2009, H.R. 3933 and S. 1934. These comments represent the views of the American Bar Association Section of Taxation. They have not been approved by the Board of Governors or the House of Delegates of the American Bar Association and should not be construed as representing the policy of the American Bar Association.

We appreciate your consideration of the enclosed comments. Representatives of the Section would be pleased to discuss this statement with you or your respective staffs. Please contact, Helen Hubbard, the Section's Vice Chair for Government Relations, at (202) 452-7005 if that would be helpful.

Sincerely,

Stuart M. Lewis  
Chair, Section of Taxation

Enclosure

cc: Honorable Timothy F. Geithner, Secretary, Department of the Treasury  
Honorable Douglas H. Shulman, Commissioner, Internal Revenue Service  
Honorable Michael Mundaca, Acting Assistant Secretary (Tax Policy), Department of the Treasury  
Honorable William J. Wilkins, Chief Counsel, Internal Revenue Service  
John L. Buckley, Chief Tax Counsel, House Ways and Means Committee  
Russell Sullivan, Staff Director, Senate Finance Committee  
Cathy Koch, Chief Tax Counsel, Senate Finance Committee  
Jon Traub, Republican Staff Director, House Ways and Means Committee  
Kolan Davis, Republican Staff Director, Senate Finance Committee

Mark Prater, Republican Chief Tax Counsel, Senate Finance Committee

Dave Olander, Republican Chief Tax Counsel, House Ways and Means Committee

Thomas A. Barthold, Chief of Staff, Joint Committee on Taxation

Emily S. McMahon, Deputy Assistant Secretary (Tax Policy), Department of the Treasury

Stephen E. Shay, Deputy Assistant Secretary (International Tax Affairs), Department of the Treasury

Manal S. Corwin, International Tax Counsel, Department of the Treasury

**AMERICAN BAR ASSOCIATION**  
**SECTION OF TAXATION**  
**COMMENTS ON H.R. 3933 AND S. 1934**

## TABLE OF CONTENTS

	<u>Page</u>
RELATIONSHIP TO THE STATEMENT OF POLICY REGARDING U.S. INTERNATIONAL TAXATION .....	1
OVERVIEW .....	1
SUMMARY OF RECOMMENDATIONS .....	2
DISCUSSION .....	5
I.    Expanded Information Reporting Provisions (Section 101 of the Bill).....	5
A.    Background.....	5
B.    Overview of Proposed Regime .....	6
C.    General Observations on Section 101 of the Bill.....	10
D.    Specific Comments on Section 101 of the Bill.....	11
II.   Repeal of the Foreign Targeted Obligation Exception for Bearer Bonds (Section 102 of the Bill).....	17
A.    Background.....	17
B.    Summary of Provision .....	18
C.    Comments .....	19
III.  Material Advisor Reporting (Section 301 of the Bill) .....	20
A.    Background.....	20
B.    Summary of the Provision .....	20
C.    Recommendation to Remove Section 301 .....	22
D.    Specific Comments. ....	23
IV.  Amendments to Certain Trust Rules (Sections 401- 405 of the Bill).....	26
A.    Background.....	26
B.    Summary of the Provision .....	27
C.    Comment.....	28

V.	Dividend Equivalent Payments to Foreign Persons Treated as Dividends (Section 501 of the Bill).....	28
A.	Background.....	28
B.	Summary of the Provision .....	29
C.	Comments .....	30

**AMERICAN BAR ASSOCIATION  
SECTION OF TAXATION**

**COMMENTS ON H.R. 3933 AND S. 1934**

These comments are submitted on behalf of the American Bar Association Section of Taxation. They have not been approved by the House of Delegates or the Board of Governors of the American Bar Association and should not be construed as representing the position of the American Bar Association.

**STATEMENT OF POLICY REGARDING U.S. INTERNATIONAL TAXATION**

On June 9, 2009, the ABA Section of Taxation submitted a Statement of Policy Regarding U.S. International Taxation.<sup>1</sup> In that Statement we addressed certain tax policy objectives as they relate to international enforcement issues and noted that the Obama Administration has made a number of legislative proposals in connection with its Fiscal Year 2010 budget proposal to Congress. Certain of those proposals are found in the Foreign Account Tax Compliance Act of 2009, H.R. 3933 and S. 1934 (“FATCA” or the “Bill”), which were introduced on October 27, 2009.

This submission reviews certain aspects of FATCA and makes suggestions for issues to be considered as the legislation is developed.

**OVERVIEW**

We set forth below a summary of our recommendations, followed by the discussion of the respective provisions of the Bill.

Part I of the discussion addresses section 101 of the Bill. Section 101 provides for new information reporting rules for foreign financial and non-financial entities, backed up by new withholding provisions, and is outlined in section A of Part I. Part II describes section 102 of the Bill, which would result in a repeal of the exception to the registration requirement for foreign targeted bearer bonds. In Part III of this report, we address Title III of the Bill, which imposes a new reporting obligation on certain advisors. In Part IV we describe and comment on Title IV of the Bill, the rules with respect to trusts, and Part V addresses Title V of the Bill, which contains a new sourcing rule for certain equity-based swaps and other notional principal contracts.

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<sup>1</sup> American Bar Association Section of Taxation, Statement of Policy Regarding U.S. International Taxation available at <http://www.abanet.org/tax/pubpolicy/2009/090609policyintltax.pdf>.

## SUMMARY OF RECOMMENDATIONS

### 1. *New Information Reporting and Withholding Provision.*

a. We recommend that the new information reporting and withholding regime of section 101 of the Bill not be effective prior to such time as the Treasury Department (“Treasury”) may determine is reasonable to permit compliance by foreign entities with requirements that would be imposed under the agreement that a foreign financial institution (“FFI”) would be required to enter into with Treasury pursuant to new section 1471(b)<sup>2</sup> to avoid withholding on withholdable payments thereunder (the “section 1471(b) agreement”). Adequate lead time may require two or more years following enactment.

b. We recommend that Congress authorize Treasury to provide workable guidelines for the information-gathering and reporting obligations of FFIs, data measurement, disclosure and account holder monitoring and that the Bill provide that those guidelines, if followed, would be deemed satisfactory compliance. In this connection, we recommend that the Bill clarify that FFIs may identify “United States accounts” (as defined below) by means other than and without obtaining certification from the account holder (while also retaining the option of relying on such certification). For example, FFIs should be permitted to use, principally or exclusively, information obtained pursuant to existing “Know-Your-Customer” or “Anti Money Laundering” procedures (“KYC/AML procedures”), particularly in the case of accounts in countries currently represented in the qualified intermediary (“QI”) program.

c. We recommend that Congress authorize Treasury to exclude from the scope of the definition of FFIs certain types of investment entities that Treasury determines would not create a significant risk of tax abuse and certain classes of FFIs if Treasury determined that such exclusion would be in furtherance of the overall purposes of the Bill. We also recommend consideration of an exclusion of reporting and withholding on payments to U.S. branches of a foreign bank.

d. Regarding the definition of “financial account,” we recommend raising the *de minimis* amount below which account holders are not subject to reporting. We also recommend that Congress authorize Treasury to limit to potential abuse situations the requirement that the *de minimis* amount be determined by including accounts maintained not only at the financial institution that entered into the section 1471(b) agreement but also any of its 50% affiliates. In addition, we recommend that Congress authorize Treasury to provide broad exceptions to the treatment of debt interests not regularly traded on an established securities market as “financial accounts” and that the legislative history include certain examples such as short-term interbank deposits.

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<sup>2</sup> References to a “section” are to a section of the Internal Revenue Code of 1986, as amended (the “Code”), unless otherwise indicated. References to new sections are to amendments to the Code as proposed by the Bill. References to a section of the Bill are identified as such in the text.

e. We recommend that Congress authorize Treasury to exclude foreign entities not prone to abuse from the category of United States owned foreign entities subject to the information reporting requirements in respect of substantial United States owners. Further, we recommend that a *de minimis* threshold for a “substantial United States owner” generally be extended to an interest in any FFI.

f. We recommend that the legislative history indicate that the independent review procedures applicable to FFIs entering into section 1471(b) agreements with Treasury should be tailored to what is reasonable in light of the associated costs and other burdens.

g. We recommend that redundant information reporting in tiered FFI structures be eliminated.

h. We recommend that Congress clarify that an FFI has not failed to comply with its section 1471(b) agreement solely on account of its inability to collect information on all United States accounts. Instead, depending on the circumstances, the FFI should be permitted to, for example, treat an account as a United States account, self-withhold or terminate the account. Specific authority would be required to permit withholding on foreign source income, as discussed below. We further recommend that Congress authorize Treasury to issue regulations providing rules in respect of incomplete information gathering.

i. We recommend that the Bill address the likelihood that an FFI that has entered into a section 1471(b) agreement often would be required to obtain information from an investor that receives solely foreign source income and hence, given that withholding would not be extended to foreign source payments, it would be difficult to obtain information or certification from reluctant investors, and noncompliance might be common for those investors so inclined.

j. We recommend that exceptions be made to the denial of a refund for withholding on payments beneficially owned by FFIs that do not enter into a section 1471(b) agreement for particular situations including, for example, erroneous withholding.

k. We recommend that guidance be provided, possibly through the legislative history, clarifying what measures are required to ascertain indirect substantial ownership of non-financial foreign entities.

l. We recommend that Congress reconsider the need for withholding on gross proceeds from the sale of property that could produce U.S.-source dividends or interest in light of the FATCA withholding regime with respect to U.S.-source dividends or interest.

## 2. *Repeal of Exception to Registration Requirement for Foreign Targeted Bearer Bonds.*

a. We recommend that Congress authorize Treasury to allow issuers to issue foreign targeted bearer obligations in one or more specified jurisdictions, subject to periodic review, if a specified jurisdiction is determined to be important for the capital markets and it is also determined that meeting the registration requirements under established local practice is not feasible.

b. We recommend that foreign issuers, other than, generally, controlled foreign corporations or partnerships or disregarded entities owned by United States persons, issuing foreign targeted bearer bonds not be subjected to the section 4701 excise tax.

c. We recommend that the effective date for the bearer bond exception from FATCA withholding be consistent with the effective date for the repeal of the current statutory exception for foreign targeted obligations.

3. *Material Advisor Reporting.*

a. Unless the scope of the section 301 of the Bill is limited as described below, we recommend that the provision be deleted from the legislation as being overly broad and not in keeping with the articulated goals of the legislation.

b. If section 301 of the Bill is retained, we recommend that

- the threshold fee of \$100,000 for a material advisor be limited to fees paid for written tax advice;
- Congress clarify that reportable persons are limited to individuals;
- acquisitions of an interest in a foreign entity that is an operating company, as opposed to an investment or trading entity, and acquisitions by U.S. business entities of an interest in a foreign entity that is an operating business as opposed to an investment or trading entity not be reportable by the advisor, even if a U.S. individual has a reporting obligation with respect to the acquisition;
- advisors not have any obligation for return filing unless the reporting individual is the person to whom the advisors rendered the advice; and
- a “direct or indirect” interest be defined by reference to section 958(a).

4. *Trust Provisions.* With respect to Title IV of the Bill, we recommend that the legislative history provide some guidance as to when a loan or the use of property is considered to be repaid at fair market value within a reasonable time.

5. *Dividend Equivalents.*

a. We recommend that the effective date of the new sourcing rule for dividend equivalents in section 501 of the Bill be extended to allow institutions to come into compliance and to allow Treasury to provide workable guidance regarding payments that are to be treated as dividend equivalents.

b. Thus, we recommend that the residual rule for sourcing not become effective until appropriate exceptions have been identified.

c. We recommend that grandfathering be provided for certain contracts entered into based upon current law, at least for a period that allows for an orderly termination by mutual agreement between the counterparties.

d. We recommend that Treasury be authorized to issue regulations that avoid double withholding as a result of characterizing dividend equivalents as U.S.-source payments.

## **DISCUSSION**

### **I. Expanded Information Reporting Provisions (Section 101 of the Bill)**

The goal of the Bill as a whole, and section 101 of the Bill in particular, is to impede offshore tax evasion by United States persons. The provisions would bolster the government's arsenal in that effort and would make it more difficult for United States persons to hide income and assets offshore. We applaud the efforts of Congress and the Administration in this endeavor.

We believe that the Bill generally would serve this purpose well by extending substantially the information reporting regime currently in place. Although the Bill would impose heavy costs and burdens on financial intermediaries, we believe the extended information reporting regime generally would be workable, subject to our specific comments below.

The Bill is an improvement in our view over earlier proposed legislation having a similar overall purpose, because an approach relying on increased reporting is far more likely to be effective than approaches such as targeting certain countries by creating blacklists. We recognize, however, that for increased information reporting to be effective, the information must be provided in a way that can be processed, accessed and compared with other data in the systems maintained by the Internal Revenue Service (the "Service"). To the extent that the Bill would make it easier for the government to identify that relatively small number of individuals who seek to evade their U.S. tax responsibilities by using FFIs and non-financial foreign entities ("NFFE"), we anticipate a salutary deterrence effect.

Because FFIs would be required to expend significant resources to implement the Bill, we encourage efforts to streamline the reporting and disclosure process wherever possible, as described further in our comments below.

#### **A. Background**

Section 101 of the Bill would dramatically change the withholding tax regime by imposing a 30% gross withholding tax on U.S.-source payments and gross proceeds from the sale of any equity or debt instrument issued by a U.S. issuer made to foreign entities, whether as nominee or as beneficial owner. The withholding tax could be avoided only if the foreign entity and its United States account or interest holders comply with extensive new reporting requirements.

The intended target of this change are those relatively few U.S. individuals who otherwise would attempt to avoid U.S. tax on income received through foreign intermediaries or foreign beneficial owner entities. The revenue estimate at the Joint Committee on Taxation is \$8.5 billion.

No doubt, the vast majority of Americans are upset that, as reported in the press, certain individuals have avoided their income tax obligations through the use of offshore accounts. Self-reporting alone has proved inadequate.

There has been a dramatic proliferation of information exchange agreements, but relying on those agreements alone has proved insufficient. The factors that appear to affect the utility of information exchange agreements include the requested government's lack of access to the information under its own laws, the requirement that the requesting government identify specific facts relevant to cases for which the information is requested, the (at best) delay in obtaining the information, and the fact that the data often would not be in a computer-accessible form. Accordingly, an approach based on expanded third-party intermediary reporting (even one that is backed up by a withholding requirement, as here) is not unreasonable, although it would result in significant compliance burdens on financial intermediaries and on foreign entities generally.

## B. Overview of Proposed Regime

The overall objective of the proposals is to improve compliance by having in place a system to obtain third party reporting concerning foreign financial accounts of United States persons, including those owning investments through closely held foreign entities, and information on payments (including foreign source payments) to such persons or entities. Obtaining such information can only be accomplished with the assistance of FFIs and other entities, but currently such institutions generally have no obligation or incentive to provide information.

The Bill's approach to this problem, which is based on the Obama Administration's budget proposals, is to establish a withholding tax regime ("FATCA withholding") as a "stick" to obtain information about U.S. ownership of foreign accounts and entities and payments to such account owners and entities. The omitted action or failure triggering withholding would not necessarily have any relevance to the status of the beneficial owner of the income, and would not necessarily even be a failure by such beneficial owner, and the amount withheld often would bear no relationship to any income that is taxable. The withheld tax could, depending on the nature of the underlying payments (and other than in the case of non-treaty eligible beneficial owner financial institutions), be refundable even if the failure giving rise to the withholding were not remedied. Thus, the proposed regime bears some resemblance to the backup withholding regime, but in effect is quite different.

The proposed regime would be buckled onto the existing withholding tax regimes. To the extent FATCA withholding would not be required, the "normal" withholding tax rules would continue to apply. To the extent FATCA withholding would be required (due to noncompliance), withholding would not be required under the normal withholding tax rules,<sup>3</sup> but to obtain a refund (if permitted) the normal regime would be applicable.

Section 101 of the Bill would add new sections 1471 through 1474. New sections 1471 and 1472 would require a 30% withholding on "withholdable payments" made after December 31,

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<sup>3</sup> For this purpose, the normal withholding rules include withholding under section 1445, dealing with withholding on United States real property interests.

2010, to a FFI or NFFE that does not comply with the new information reporting requirements. These provisions would not apply to any “obligation” outstanding on the date of first committee action that either is in bearer form or requires the issuer to make gross-up payments by reason of the withholding imposed under the Bill pursuant to the terms of the obligation as of the issue date.

New section 1473(1) would define a “withholdable payment” as U.S.-source interest, dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments and other fixed or determinable, annual or periodical gains, profits and income (*i.e.*, payments otherwise subject to nonresident withholding under sections 871(a)(1)(A) or 881(a)(1)). In addition, withholdable payments would include all original issue discount (“OID”) and the gross proceeds from the sale of property that could produce U.S.-source interest or dividends. Thus, unlike sections 871(a)(1)(C) and 881(a)(3), withholding on OID would appear to apply to the entire amount of OID accrued through the date of payment and would not be limited to the amount accrued while the instrument was held by the payee.

With the exception described below, amounts withheld under new section 1471 or new section 1472 on payments to FFIs or NFFEs would be refundable to the beneficial owner to the extent they otherwise would be refundable under the normal nonresident withholding tax rules of sections 1441 through 1446.<sup>4</sup> Thus, for example, amounts withheld on the payment of gross proceeds or on payments qualifying as portfolio interest, or amounts withheld that exceed the withholding required under an applicable income tax treaty, would be refundable to a nonresident that shows its status as beneficial owner. Amounts withheld from payments beneficially owned by a U.S. taxpayer would be creditable against the taxpayer’s regular income tax.

Under section 1474(b)(2), an FFI that is the beneficial owner of a withholdable payment would be able to obtain a refund, however, only if and to the extent that the FFI is entitled to a reduced rate of withholding under an applicable U.S. income tax treaty, regardless of whether the FFI would otherwise not have been subject to withholding on the payment under the normal nonresident withholding tax rules.<sup>5</sup> This provision would therefore overrule sections 871 and 881 with respect to, for example, portfolio interest and would be akin to an excise tax to the extent imposed on a return of invested capital or the receipt of OID accrued prior to the owner’s holding period.

The FATCA withholding or information reporting requirements would not apply to payments to a foreign government and its political subdivisions or their wholly owned agencies or instrumentalities, to an international organization or its wholly owned agency or instrumentality, to a foreign central bank of issue, or to a member of a class of persons that Treasury has identified as posing a low risk of tax evasion. The FATCA withholding or information reporting requirements also would not apply to payments made to an NFFE that is a corporation whose

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<sup>4</sup> New section 1472(b)(1).

<sup>5</sup> No interest would be paid in respect of such any refund to an FFI that is the beneficial owner.

stock is regularly traded on an established securities market or to any of its 50% affiliates,<sup>6</sup> or to a payment of a kind identified by the Secretary as posing a low risk of tax evasion.

The information reporting requirements that would have to be met to switch off the new FATCA withholding would be different for FFIs on the one hand and NFFEs on the other and are described below.

### *1. Foreign Financial Institutions*

FFIs would comprise any bank or similar deposit-taking institution, any entity engaged in the business of holding financial assets for the account of others and any entity engaged or holding itself out as being engaged primarily in the business of investing, reinvesting or trading in securities, partnership interests, commodities or interests or derivatives therein, provided the entity is not a United States person. Such entities would include not only financial institutions in the narrow sense (*e.g.*, banks) but also, for example, securitization vehicles, private equity funds, hedge funds and family investment vehicles.

Under section 1471(a), payments to an FFI, whether in an intermediary capacity or as beneficial owner, would not be not subject to 30% FATCA withholding if the payee FFI enters into a section 1471(b) agreement with the Secretary with respect to accounts maintained by the FFI, or its 50% affiliates that have not separately entered into such a section 1471(b) agreement with the Secretary, to identify “United States accounts” in accordance with verification and due diligence procedures to be specified in regulations, to make annual reports of such United States accounts to the Treasury in accordance with Treasury regulations and to comply with requests by the Secretary for additional information. In addition, the FFI would have to agree to close any United States account if a foreign law prevents information reporting unless waiver of such foreign law can be obtained. Treasury may terminate a section 1471(b) agreement if it determines that the FFI has not complied with the section 1471(b) agreement.

A “United States account” would be defined to cover not only any depository and custodial account, but also equity and debt interests in the FFI not regularly traded on an established securities market, provided in each case the United States account is held by one or more “specified United States persons” or “United States owned foreign entities.”<sup>7</sup> United States accounts would not include depository accounts owned solely by a natural person if all of the accounts owned by the person at the FFI and its 50% affiliates have an aggregate value of \$10,000 or less (or \$50,000 or less, if all accounts are in existence at the time of FATCA’s enactment).<sup>8</sup>

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<sup>6</sup> A “50% affiliate” is a member of an affiliated group applying the rules of affiliation through a common parent described in section 1504(a), but (1) using a more-than-50% stock ownership for affiliation instead of an 80%-or-more stock ownership, (2) including insurance companies and foreign corporations and (3) including partnerships and other non-corporate entities if 50% or more of the value is directly or indirectly owned by 50% affiliates.

<sup>7</sup> New section 1471(d)(1).

<sup>8</sup> New section 1471(d)(1)(B).

A “specified United States person” would be any United States person other than a publicly traded corporation (or its 50% affiliates), a bank, a real estate investment trust, a mutual fund (*i.e.*, a regulated investment company), a tax-exempt organization, an individual retirement plan, certain charitable or partially charitable trusts, the United States or its wholly owned agencies or instrumentalities, any State, any United States possession or the District of Columbia or any of their political subdivisions or wholly owned agencies, or a common trust fund.<sup>9</sup>

A “United States owned foreign entity” would be any foreign entity with one or more “substantial United States owners,” that is, any FFI (other than a deposit-taking or custodial institution) in which a specified United States person directly or indirectly owns any interest (regardless of absolute or relative value or voting rights); any other foreign corporation or partnership in which a specified United States person directly or indirectly owns more than ten percent of the equity interests (by vote or value in the case of corporations, and in capital or profits in the case of partnerships); and any trust of which a specified United States person is treated as an owner under the grantor trust rules.<sup>10</sup>

An agreeing FFI would be required annually to report, with respect to each United States account maintained by it, the account number and the name, address and taxpayer identification number (“TIN”) of each account holder that is a specified United States person or, in the case of a United States owned foreign entity, of each substantial United States owner. In addition, the FFI would have to report the account balance or value and the gross receipts and gross withdrawals or payments from the account. Alternatively, the FFI would be able to elect full Form 1099 reporting with respect to each account holder that is a specified United States person or United States owned foreign entity, treating the account holder as a U.S. citizen for this purpose. In determining the reportable information, an FFI may rely on certification from the account holder(s) as long as neither the institution nor any of its 50% affiliates knows or has reason to know that any information so provided is incorrect.

## 2. *Non Financial Foreign Entities*

Under new section 1472, withholdable payments to NFFEs would be exempt from the 30% FATCA withholding tax only if the foreign entity either certifies to the withholding agent the absence of substantial United States owners or provides their names, addresses and TINs. The withholding agent would be required to report the name, address and TIN of each such substantial United States owner of the NFFE to Treasury. The withholding agent would be required to withhold if it actually knows or has reason to know that the certification or information is incorrect.

Thus, a beneficial owner’s status as either an FFI or an NFFE would have dramatically different consequences. An FFI would be subject to an obligation to enter into an agreement imposing the section 1471(b) account reporting obligations (including disclosure of ownership of its non-publicly traded equity or debt) and, failing to do so, would be subject to the sanction of complete

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<sup>9</sup> New section 1473(3).

<sup>10</sup> New section 1473(2).

nonrefundability of FATCA withholding, unless an income tax treaty applied. An NFFE, by contrast, would “only” be required to provide information concerning any substantial United States owner of equity, and FATCA withholding would in principle at least be refundable or creditable if appropriate tax returns are filed.

### C. General Observations on Section 101 of the Bill

As noted in the press release accompanying introduction of the Bill,<sup>11</sup> the Bill reflects input and incorporates certain suggestions made by various interested parties, including representatives of taxpayers, trade groups and bar associations,<sup>12</sup> as to what type of withholding approach might be workable if a blanket withholding requirement were viewed as necessary to enforce offshore compliance by the guilty few. In particular, that approach envisioned some sort of diligence and certification by financial institutions not subject to the qualified intermediary (“QI”) regime pursuant to an agreement with the Secretary, and some sort of certification by other non-exempted foreign entities, in each case based on a good faith effort.

The Bill relaxes some of the positions in the earlier proposals, which would have, for example, imposed automatic withholding on U.S.-source amounts paid to any financial institution that is not a QI, and would have applied regardless of conflicts with income tax treaties. Overall, the Bill’s provisions are much more workable than parts of earlier legislative proposals. As discussed below, we believe that further focus on practical difficulties, in consultation with affected financial institutions, is warranted. Given the complexity of the financial systems that would be affected by the provisions, delegation of authority to Treasury to a greater extent than often is the case seems necessary.

The Bill reflects a determination by its drafters that a distinction between regulated financial institutions, at one end of the spectrum, and passive private investment vehicles, at the other end of the spectrum, would not be meaningful given the objectives of the legislation. We generally agree with this conclusion in principle, but we note that as a result every foreign investment entity however small, and every fund however complex its ownership structure—in each case regardless of its U.S. contacts beyond ownership of instruments paying U.S.-source income—would therefore be required to enter into an agreement with the Secretary and undertake the obligations set forth therein or suffer the new section 1471 withholding tax (which would be nonrefundable for payments it beneficially owns if it is not treaty-eligible). Alternatively, it could drop out of the system by electing not to own U.S. investments.

Further, the Bill reflects a decision to implement a unified foreign account reporting regime that applies to foreign QIs and non-QIs, instead of a two-track approach that would require a new

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<sup>11</sup> Rangel, Baucus, Neal, Kerry Improve Plan to Tackle Offshore Tax Abuse Through Increased Transparency, Enhanced Reporting and Stronger Penalties; House-Senate Proposal Detects, Deters, Discourages Overseas Tax Evasion available at <http://waysandmeans.house.gov/News.asp?FormMode=print&ID=958>.

<sup>12</sup> E.g., NYSBA Report No. 1189, Report on Qualified Intermediary and Related Withholding and Information Reporting Legislation Proposal by the Administration, September 10, 2009, available at [http://www.nysba.org/AM/Template.cfm?Section=Tax\\_Section\\_Reports\\_2009&CONTENTID=31802&TEMPLATE=/CM/ContentDisplay.cfm](http://www.nysba.org/AM/Template.cfm?Section=Tax_Section_Reports_2009&CONTENTID=31802&TEMPLATE=/CM/ContentDisplay.cfm).

regime for non-QIs and modify the existing QI regime. This approach is in our view the simplest, fastest and on balance most effective way to implement the new regime. The QI regime remains relevant to the normal nonresident withholding and backup withholding regimes.

The new requirements would impose not just burdens but also risks of liability for withholding tax on a person entering into a section 1471(b) agreement, as well as on an NFFE that receives withholdable payments. We do not have the appropriate expertise concerning the potential effect on investment flows into the United States. Intuitively, one would expect that a significant number of FFIs would opt not to participate and therefore would opt not to hold U.S. investments. The extent of nonparticipation presumably would be affected by the choices made in setting forth the requirements of the section 1471(b) agreement, as well as by the relative size and nature of the FFI and the importance of the U.S. market to its owners or clientele.

We also note that other countries may well determine to subject entities that are foreign from their standpoint (including U.S. entities) to parallel compliance requirements, with a withholding “stick” to the extent that the entities derive investment income from such countries. The arguments in favor of relying on financial intermediaries to enforce tax compliance have equivalent merit from the standpoint of foreign tax systems.

#### D. Specific Comments on Section 101 of the Bill

1. *Delay Effective Date to Permit Guidance and Implementation of the New Reporting and Withholding Regime.* The section 101 effective date generally only permits a one-year implementation period and will strain the administrative capabilities of FFIs. We recommend that the provisions not be effective prior to such time as Treasury may determine is reasonable to permit compliance by FFIs and NFFEs, which may be two or more years following enactment.

Under the Bill, FFIs would have to enter into an agreement with the Service to avoid the 30% withholding tax and would have to collect account information not only for its own account holders and non-regularly traded equity and debt holders but for those of its 50% affiliates. In practice, whether entering into a section 1471(b) agreement would be acceptable to an FFI would depend on the particular requirements underlying the section 1471(b) obligation. The Bill offers little guidance on the extent of the obligations, including the frequency of measurement of the financial data, and the extent of verification procedures required. It is critical that this guidance be made available for FFIs to decide whether to change their systems to continue to invest in U.S. securities, and if so, to allow the time to do so before any effective date.

Section 101 of the Bill is intended to promote compliance by United States persons and to obtain information, not to result in a large volume of withholding tax or frighten investors or intermediaries from the U.S. markets. In order that this may occur, it is essential that FFIs are confident that they can develop processes to handle the transaction volume without a significant error rate.

2. *Broad Treasury Authority.* We recommend that the Bill authorize Treasury to provide workable guidelines for FFIs to follow regarding the information-gathering and reporting obligations, data measurement, disclosure, account holder monitoring, verification and error correction that, if followed, would be deemed satisfactory compliance.

Specifically, such guidelines should address the following:

a. *Tolerable Compliance Reporting Burden on FFIs and Affiliates.* Given the enormous number of entities that would be FFIs and thus required to enter into section 1471(b) agreements with Treasury to avoid nonrefundable FATCA withholding on U.S.-source income and certain gross proceeds from sales, we recommend that the form of the section 1471(b) agreement be as simple as possible for foreign investment entities (*i.e.*, FFIs that are not custodial or deposit-taking entities). It should be self-executing (*i.e.*, all the entity should need to do is complete and sign the form) to permit FFIs to immediately enter in section 1471(b) agreements. In addition, any new certification and information reporting forms required for information reporting by FFIs and NFFE's should be simple to ease confusion and potential for errors caused by complexity.

b. *Provide Rules for Account Data Collection and Transmission to Service.* The Bill would require FFIs to report, in addition to the account number and account balance or value, the gross receipts and gross withdrawals or payments from relevant accounts, at such time and in such manner as the Secretary may prescribe. We recommend that, considering the additional burdens involved, withdrawals or payment information (as opposed to account balances or value) be required only to the extent the Secretary determines that such information is necessary or appropriate.

c. *Clarify Standards for Determining U.S. Status of Financial Accounts.* Under section 1471(b)(1), an FFI that enters a section 1471(b) agreement must determine for each account whether it is held by a specified U.S. person or a U.S.-owned foreign entity. The Bill is relatively strict with respect to the requirements to obtain account owner information. For example, section 1471(b)(1) on its face imposes an unconditional obligation to obtain the required information. Section 1471(c)(3) helpfully provides that an FFI may rely on certification from an account holder. It is possible that an FFI will obtain certifications upon the opening of a new account or for existing QI accounts when a Form W-8 is obtained. Certification should prove very useful for many smaller FFIs. It will not be possible, however, for a large FFI to obtain certification forms for its entire global client base. As we understand that no implication is intended that certification is the preferred much less exclusive approach, we believe that the Bill or legislative history should clarify that and specifically refer to certain alternatives to direct account certification from an account holder.

For example, we believe that FFIs subject to KYC/AML procedures (in particular, those in countries represented in the QI program) should be permitted to use those procedures as their basis, and to use information on file for existing account holders. We recommend that Treasury be granted authority and discretion to issue guidelines that delineate the diligence procedures and standards, if any, that would be required in addition to approved KYC/AML procedures, and to provide FFIs with safe harbors and presumptions that FFIs can rely upon. It would also be helpful to provide Treasury authorization and discretion to do the same in respect of the KYC/AML rules for FFIs in countries without current approved procedures and to address corresponding requirements for FFIs that are not institutions subject to such rules. Treasury would need time and resources to evaluate and to draft and implement written standards and presumptions for the new reporting and withholding requirements.

3. *The Definition of “Foreign Financial Institution.”* The Bill treats not only foreign regulated financial institutions (*e.g.*, financial institutions that accept deposits in the ordinary course of a banking or similar business) as FFIs, but also any foreign investment entity. This applies regardless of the size of the entity, the size of its investments, or the number of its owners and creditors or accountholders. Foreign entities that are in the business of selling securities to customers, foreign traders for their own accounts and foreign investment vehicles (including family-owned vehicles), as well as offshore securitization vehicles such as CDOs or CLOs apparently would all be treated as FFIs.

We understand that this approach is desirable to prevent foreign entities and U.S. taxpayers from inappropriately avoiding the regime. We recommend, however, that Treasury be authorized to exempt certain types of investment entities that it may determine would not present a significant risk of tax abuse from the FFI regime if those entities are subjected instead to the NFFE regime. We also recommend that Treasury be authorized to permit certain classes of entities to be subject to the NFFE regime rather than the FFI regime if it determines that this is under the circumstances in furtherance of the purposes of the Bill. By way of example, if an investment entity has only nine or fewer owners, any above-average investor might be reported as a substantial United States owner under the NFFE rules if those applied.<sup>13</sup>

Rules similar to the NFFE rules might appropriately be applied (perhaps electively) even to more widely held funds, possibly on a modified basis such that the ten percent NFFE threshold is reduced below ten percent, though not to zero percent as proposed to apply under the FFI rules (*see* also paragraph 5 below). Some flexibility in crafting rules in this regard would diminish the likelihood of certain funds opting out of the system by not holding (or investing in entities holding) US investments, by offering them a basis, short of a section 1471(b) agreement, to provide a requesting FFI that is a party to such an agreement a certification of significant U.S. owners.<sup>14</sup>

Further, we recommend that consideration be given to exempting payments to the U.S. branch of a foreign bank from the FFI regime, given that concerns relevant to a foreign entity would not seem to apply to a U.S. branch of a foreign bank (which is subject certain reporting (*e.g.*, Form 1099 reporting)<sup>15</sup> obligations much like a domestic bank). Such an exception would have to be limited to withholdable payments to the branch as opposed to other parts of the bank.

4. *The Scope of “Financial Account.”* Under the Bill, a financial account would include depository or custodial accounts maintained by an FFI and any equity or debt interests in such FFI that are not regularly traded on an established securities market (but not contractual interests).

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<sup>13</sup> We note that holders of debt or contract rights also may have to be taken into account to prevent abuse.

<sup>14</sup> To the extent a fund’s interests are held in “street name,” the fund should be able to avoid section 1471 withholding on that basis. We are not in a position to estimate to what extent interests in funds are so held.

<sup>15</sup> *E.g.*, Treas. Reg. § 1.6049-5(c)(5)(i)(F).

Under the Bill, depository accounts held by individuals in an FFI and its 50% affiliates that do not exceed in the aggregate \$10,000 (\$50,000 if all such accounts were in existence on the date of enactment) would not be United States accounts. We believe the threshold amount is too low to permit an institution with perhaps millions of account holders a tolerable compliance burden. We do not believe that the objectives of the Bill would be seriously compromised by a more substantial threshold, considering there is at least some effort and costs for a U.S. individual to establish an overseas account. In our view, this *de minimis* exception should be increased to a more meaningful amount, though a requirement to report below such higher threshold in situations in which Treasury may determine may be appropriate. We also do not believe that this *de minimis* exception should be limited to accounts maintained by an individual.

We further believe that the aggregation requirement should be revised such that aggregation may be required by Treasury pursuant to regulations to the extent that it determines is appropriate under the circumstances to further the purposes of section 101 of the Bill. Many large FFIs have business units that operate for the most part separately and therefore would have administrative difficulties in accessing and comparing account information from all relevant 50% affiliates on a cost-effective basis. Although they presumably could develop systems at substantial cost to gather and compare the information centrally, we question the ultimate benefit of the requirement, given that a U.S. investor who truly intends to avoid the rules by splitting accounts could use unrelated FFIs in any event. We believe that a regulatory rule designed to target potential abuse cases would achieve substantially the same objectives with less disruption of normal operations.

Debt interests that are not regularly traded on an established securities market would be included as financial accounts, presumably on the basis that in some cases they can serve as a substitute for a depository or custodial account. We believe, however, that a broad inclusion of debt instruments and institutional deposits would greatly increase compliance burdens in view of the frequent and often short-term borrowings by FFIs. We recommend that, pursuant to regulatory authority and legislative history, Treasury be authorized to create appropriate exceptions and that such exceptions should be in place prior to the effective date of section 101 of the Bill.

5. *United States Owned Foreign Entities.* FFIs must treat accounts of United States owned foreign entities as United States accounts and provide identifying information in respect of substantial United States owners of such entities. We recommend that Treasury be authorized, by statute or legislative history, to exclude from United States owned foreign entities categories of entities not prone to tax abuse. Examples might be publicly traded entities and any entity if substantially all of its assets (applying look-through principles for 25% subsidiaries) consists of active business operations. Further, it is not clear why the definition of “specified United States person” does not exclude qualified pension funds.

There is no *de minimis* rule for U.S. ownership of interests in foreign investment entities that are not deposit-taking or custodial entities. For the latter, a U.S. owner is “substantial” only if it has a greater-than-ten-percent equity interest. We believe that the purpose for this difference is to equate investment through a foreign investment entity to a deposit or custodial account in a regulated entity, for which there is only the \$10,000 *de minimis* threshold. We recognize the theoretical rationale, but nevertheless believe that some significant threshold, even if less than

ten percent, is needed to avoid substantial compliance burdens that may cause, in particular, investment funds to opt out of the system by avoiding U.S. investments.<sup>16</sup>

6. *Clarification of Verification and Audit Procedures.* An FFI will also be required to have procedures in place to ensure compliance with its section 1471(b) agreement, and verification would include independent review procedures to ensure an FFI's compliance with its obligations. If the Secretary determines that the FFI is out of compliance with the section 1471(b) agreement, the agreement may be terminated. Given that, unlike the QI system that only applies to a limited subset of designated accounts that are chosen for inclusion in a QI arrangement, a section 1471(b) agreement would apply to all accounts of the FFI as well as the accounts of its 50% affiliates, the independent review presumably would be designed to be less onerous than the external audit procedures currently applicable to QIs. Procedures separately taking into account the capacities of smaller, noninstitutional entities would be appropriate. We recommend guidance in the legislative history indicating that the requirements should be reasonable under the circumstances, taking into account the costs and burdens.

7. *Eliminate Redundant FFI Reporting.* In the context of tiered FFIs, such as in a master-feeder structure of hedge funds or in a fund of funds, the Bill would require not only separate agreements and certifications at each level but also for each FFI to obtain and disclose the identity of any substantial United States owner (for testing which, under the Bill as it stands, there often would be no *de minimis* threshold and which may be an indirect owner, through other tiers) of a United States owned foreign entity that has an account or holds non-regularly traded debt or equity interests in the FFI.

We suggest that Congress consider avoiding such separate agreements and certifications at each level. For example, if there are tiers of FFIs, it would seem appropriate for the FFI that has entered into a section 1471(b) agreement and is closest in the payment chain to the ultimate payee to comply with section 1471(b) and for "lower" tier FFIs to be permitted to rely on compliance by such FFI as certified by it, rather than be required also to obtain and disclose information in respect of any substantial United States owner of an "upper-tier" FFI. That could also avoid what we believe would be an unintended requirement for the section 1471(b) agreement FFI to disclose investors to another intermediary.

8. *Procedures under Section 1471(b) Agreement When Information Cannot Be Obtained.* On the face of the Bill, flawless execution is presumed. An FFI that has entered into an agreement with the Secretary is expected to collect information on all United States accounts and, if it cannot do so because foreign law is not waived, to terminate the account. We believe that the Bill should clarify that, when an FFI has a section 1471(b) agreement in place, to the extent that information is unobtainable from the holder of a "financial account" despite adequate demands by the FFI, that the section 1471(b) agreement is not thereby breached, provided the degree of noncompliance does not indicate a systems failure or abuse of the rules.

The action that should be required to be taken by the FFI may depend on the circumstances. In appropriate cases, the FFI may be required to presume the account to be a United States account

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<sup>16</sup> See, however, the immediately preceding footnote regarding fund interests held in street name.

(including in the case of non-regularly traded debt or equity of the FFI), should be obligated to withhold at the 30% rate on U.S.-source income deemed allocable to the account, and deposit the withheld amount with Treasury, and should be treated as satisfying its reporting obligation under the agreement by reporting available information (to the extent it can legally report it) in respect of the account holder to the Secretary.<sup>17</sup>

In other cases, as for example when U.S.-source income cannot be associated with the noncompliant account and the FFI does not choose to deposit the withholding tax out of funds available to it (in effect, self-withhold), it may be more appropriate to require that the account be terminated. Of course that will not be possible in many situations (including, *e.g.*, investments in funds and investments in equity or medium- or long-term debt of financial institutions). Treasury should be authorized to address these issues.

9. *Investments Paying Foreign Source Income.* We note that the Bill would create an incentive for U.S. and foreign investors wishing to avoid compliance to shift investments to FFIs that themselves have no withholdable payments from the United States to avoid the new reporting and withholding tax regime. Doing so would not require foregoing exposure to U.S. dollar investments. For example, such investors still could buy U.S. dollar denominated instruments of such an FFI paying foreign source interest.

Of perhaps greater concern, the Bill would not address the case in which an FFI makes debt or equity investments in a second FFI (a corporation for U.S. tax purposes) that is invested in US securities. Similarly, an NFFE might invest in a corporate FFI with U.S. investments. The instruments held by the first FFI and by the NFFE would generate foreign source income and thus not result in withholdable payments. In extreme cases, the arrangement could amount to a conduit arrangement. A similar issue arises when a custodial account holds principally or only foreign securities.

From one standpoint it would be helpful if withholding could be imposed on foreign source income payable to a noncompliant party. This would be preferable to requiring that an FFI self-withhold as it would provide incentive on the investor or accountholder to comply and would place the monetary burden of the withholding where it should be. The withholding “tax” would be in the nature of a penalty for failure to provide information rather than an income tax. We are, however, doubtful that such a mechanism could be achieved commercially and that an FFI could or would agree to it.<sup>18</sup> Further, any such approach would raise significant issues under our tax treaties.

We believe that Treasury has existing authority under section 7701(1) to address abusive cases of a conduit nature. We recommend that the information reporting required under section 101 of

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<sup>17</sup> An FFI willing to deposit withholding tax should not be required to terminate the account of a person (though, if cooperation is refused, that surely will happen without action by the institution).

<sup>18</sup> We do not believe simply defining the amount as U.S. source income would be meaningful, except in the much smaller subset of cases in which a conduit arrangement exists.

the Bill should include reporting in respect of any potential conduit arrangement of which the reporting entity is aware.

10. *Refunds.* Both the old withholding regime under sections 871, 881, 1441, 1442 and 1445 and the new reporting and withholding regime under new sections 1471 through 1474 rely upon the refund regime found in subchapter A of Chapter 3 of the Code. Great pressure would be placed on the refund system. The process of associating withheld tax with the beneficial owner in the context of a noncomplying intermediary, or in the context of the QI regime, is not clear. It also is not clear that the Service has the capability to administer a refund process of the scope the Bill would provide.

It does not appear that refunds always should be denied to an FFI that is a beneficial owner of a payment and not treaty-eligible. For example, an amount might be withheld erroneously (yet still considered withheld “under section 1471(a)”). Further, the nature of the sanction argues for allowing Treasury to classify certain types of FFIs as NFFEs.<sup>19</sup>

11. *NFFE Diligence.* It is not clear why reliance on owner certification in the absence of other knowledge or reason to know would not be satisfactory for purposes of section 1472 as well as section 1471, assuming that “indirect” ownership in the definition of “substantial United States owner” requires looking through entities. Even in an NFFE context, it may be difficult to ascertain ownership through tiers. The problem would be more significant if certain relatively passive FFIs are reclassified into or permitted to elect the NFFE regime, as we have suggested above may be appropriate. We also recommend that some guidance, perhaps in the legislative history, be provided concerning the measures that would be reasonable for determining indirect ownership.

12. *Gross Proceeds Withholding.* The risk of withholding on gross proceeds raises the stakes of being wrong to a very considerable extent, such that numerous entities may decline to participate and instead opt out of U.S. securities. Given withholding on income, it might be asked again whether gross proceeds withholding, at least at a 30% rate, is a necessary “stick.” Although it is conceivable that an account may be invested nearly entirely in non-dividend paying stocks, we think that is unlikely and an insufficient reason to view gross proceeds withholding as necessary to enforce compliance.<sup>20</sup>

## **II. Repeal of the Foreign Targeted Obligation Exception for Bearer Bonds (Section 102 of the Bill)**

### **A. Background**

Under present law, a “registration-required” obligation that is not issued in registered form generally carries with it punitive tax consequences for both the issuer and the holder: the issuer

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<sup>19</sup> Allowing Treasury to classify certain types of FFIs as NFFEs is discussed in paragraph 3 above.

<sup>20</sup> If this recommendation is accepted, special rules may need to be adopted for section 103 tax-exempt obligations, which are not subject to interest withholding.

cannot deduct interest paid or accrued on the obligation and must pay an excise tax equal to one percent of the principal amount of the obligation multiplied by the number of calendar years (or portions thereof) from the date of issuance to the date of maturity; interest paid on the obligation does not qualify for the portfolio interest exemption to the 30-percent withholding tax on U.S.-source interest imposed by sections 871 and 881; and any loss recognized on the sale or other disposition of the obligation is disallowed to its holder.

When these provisions were enacted over 25 years ago, Congress determined that U.S. individuals holding bearer bonds created the potential for tax evasion. Congress was also aware, however, that certain markets were primarily bearer bond markets and an important source of debt financing for many U.S. corporate borrowers. The current law and regulations therefore adopted a flexible approach to the problem and permitted issuers to exempt from the registration requirement bearer bonds that are “foreign targeted obligations.” As noted in the Joint Committee explanation, in applying this requirement, the Service has adopted a flexible approach that recognizes that a debt obligation that is formally in bearer (*i.e.*, not in registered) form is nonetheless “in registered form” for these purposes when there are arrangements that preclude individual investors from obtaining definitive bearer securities or that permit such securities to be issued only upon the occurrence of an extraordinary event.<sup>21</sup>

Obligations are “foreign targeted” if there are arrangements reasonably designed to ensure that the obligation will be sold (or resold in connection with the original issue) only to non-United States persons; interest is payable only outside the United States and its possessions; and the face of the obligation contains a statement that any United States person holding the obligation will be subject to limitations under U.S. tax laws. The so-called TEFRA C and TEFRA D regulations currently specify detailed rules for meeting these requirements.<sup>22</sup>

#### B. Summary of Provision

Under section 102(c) of the Bill, the exception for foreign targeted obligations would be repealed. Thus, foreign targeted obligations would be registration-required obligations and, therefore, subject to the above penalty in the case of an issuer and additional tax consequences for the issuer and holders, unless issued in registered form.<sup>23</sup>

Obligations that are made by a natural person, that mature in one year or less or that are not of a type offered to the public, which are currently excepted from the registration requirement, would be unaffected by the repeal of the exception for foreign targeted obligations.

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<sup>21</sup> See PLR 9343018-9 (July 29, 1993); PLR 9613002 (March 29, 1996); Notice 2006-99, 2006-2 C.B. 907.

<sup>22</sup> See Treas. Reg. §§ 1.163-5(c)(2)(i)(C) and (D).

<sup>23</sup> Under applicable Treasury regulations, an obligation is “in registered form” if (1) it is registered with the issuer or its agent as to principal and stated interest, and transfer may be effected only by surrender of the old instrument and the issuance of a new instrument or reissuance of the old instrument to the new holder; (2) the right to principal and stated interest may be transferred only through a book entry system maintained by the issuer or its agent; or (3) it is registered with the issuer or its agent as to principal and stated interest, and transfer may be effected through both of the preceding methods.

Repeal would be effective for debt obligations issued more than 180 days after the date of enactment. However, because FATCA withholding would apply under section 101 of the Bill to U.S.-source payments made after December 31, 2010, on bearer bonds issued after the date of first committee action on the Bill, the effective date for the repeal and the effective date for FATCA withholding do not coincide.

### C. Comments

We generally believe that the repeal of the foreign targeted exception is a reasonable measure in light of the overall purpose of the Bill. It would be inconsistent with the approach of section 101 of the Bill to continue to allow the use of bearer instruments, notwithstanding that they are structured to meet the foreign targeting rules. Accordingly, if the approach in section 101 of the Bill is adopted, then from a consistency standpoint the effective elimination of U.S. issuers from the bearer instrument market as a result of the withholding tax and sanctions for registration-required obligations makes sense as a general rule. We note, however, the following considerations.

1. The repeal seemingly would increase, at least to some extent, borrowing costs of affected issuers. This is because there appear to be still, at least for the time being, certain markets in which it is not feasible to issue instruments in registered form (or in bearer form but under arrangements causing them to meet the registered form requirements for U.S. tax purposes, or when they are issued in registered form but the necessary W-8BEN compliance is not feasible). We are not qualified to express a view on what additional cost may be entailed, which may in any given case differ depending on whether the funds are needed locally or used globally. A possible approach to address this issue would be to authorize Treasury to allow issuers to continue to issue foreign targeted bearer obligations in a specified jurisdiction or jurisdictions that are determined to be important to the capital markets and in which meeting the registration requirement is not feasible, subject to periodic review of the continued need for an exception.

2. As currently drafted, the repeal would apply to all issuers, wherever located, resident or organized, including all non-U.S. issuers. The repeal would therefore on its face apply the section 4701 excise tax to non-U.S. issuers that issue foreign targeted bearer bonds without any connection to interstate commerce. Even if the excise tax in such cases might not be enforced as a practical matter, we recommend that, subject to specific exceptions as described in paragraph 3 below, the excise tax be made inapplicable to non-U.S. issuers issuing foreign targeted obligations.

We believe that it would not be unreasonable to subject certain U.S.-owned issuers to the excise tax on the issuance of bearer form obligations (other than in excepted markets as described in paragraph 1 above). Specifically, the foreign issuers that we recommend for exemption from the excise tax would not include disregarded entities owned by United States persons or, in general, controlled foreign corporations within the meaning of section 957<sup>24</sup> or controlled foreign partnerships within the meaning section 6038(a)(5) or their respective disregarded subsidiaries.

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<sup>24</sup> For this purpose, a lower ownership threshold than provided in section 957 might be appropriate.

3. The inconsistency in effective dates noted above would in effect prohibit the issuance of foreign targeted bearer bonds after the date of first committee action, which is earlier than the effective date for section 102 of the Bill. We believe that this is an unintended inconsistency, and the effective date for FATCA withholding and reporting on newly issued bearer bonds should be conformed to the effective date for the repeal of the exception for foreign targeted bearer bonds. That is, we believe the exemption from section 101 of the Bill should apply to bearer bonds issued prior to 180 days after date of enactment and not merely payments prior to January 1, 2011.

### **III. Material Advisor Reporting (Section 301 of the Bill)**

#### **A. Background**

The Senate Permanent Subcommittee on Investigations (“PSI”) has, since 2003, been investigating the involvement of advisors in creating arrangements designed to avoid U.S. taxation, and to avoid reporting of non-U.S. assets. In 2008 the PSI held hearings on the practices of certain non-U.S. banks and focused on the tax evasion that was occurring among high net worth individuals who would, with the assistance and advice of the banks, form foreign entities to “shield” themselves from reporting obligations so that the tax evasion would not be detected. The Service has gathered “more insight about the manner in which U.S. persons hide their income offshore and conceal their identities from the Internal Revenue Service. The use of secret offshore accounts, often in the name of offshore entities, like trusts or corporations—sometimes with the assistance of advisors—makes it increasingly difficult for the IRS to gather the information it needs to enforce our tax laws.”<sup>25</sup>

To promote compliance with the individual and corporate income tax, the U.S. federal income tax rules include broad information reporting requirements, including third-party reporting requirements for payments of income or gross proceeds, dividends, interest, capital gains, and other amounts paid by payors. Under section 6111, each material advisor with respect to any reportable transaction is required to file an information return setting forth information identifying and describing the transaction, a description of any potential tax benefits expected to result from the transaction, and such other information as the Secretary may prescribe. U.S. persons who engage in foreign activities through a foreign business entity may be required to meet certain self-reporting requirements. No third-party information reporting is required with respect to those advisors who assist such U.S. person to form or acquire a foreign business.<sup>26</sup>

#### **B. Summary of the Provision**

Section 301 of the Bill provides that a material advisor is required to file a return with the Service if the advisor renders material aid, assistance or advice (“advice”) with respect to a direct

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<sup>25</sup> Prepared Statement of William J. Wilkins, Internal Revenue Service Chief Counsel, Before the House Ways And Means Subcommittee On Select Revenue Measures on the “Foreign Account Tax Compliance Act Of 2009,” November 5, 2009.

<sup>26</sup> Technical Explanation of the “Foreign Account Tax Compliance Act Of 2009, “ Prepared by the Staff of the Joint Committee on Taxation, October 27, 2009, JCX-42-09, (the “Joint Committee Report”) at 42-43.

or indirect acquisition of any interest in a foreign entity (the “acquisition”) if a U.S. citizen or resident is required to file a report under section 6038, 6038B, 6046, 6046A or 6048 in connection with such acquisition. The report requires the identification of the foreign entity and the U.S. citizen or resident and “such other information as the Secretary may prescribe.”

A material advisor is one who provides the noted assistance, and who “directly or indirectly” derives gross income in excess of \$100,000 for providing such assistance during the calendar year. Failure of the advisor to file the required return subjects the advisor to potential penalties equal to the greater of \$10,000 or 50% of the gross income earned with respect to the rendering of the advice.

Under the existing regime, a U.S. person, including a U.S. citizen or resident, is generally required to file pursuant to the referenced sections in connection with the acquisition, formation, capitalization, ownership or disposition of an interest in a foreign corporation, a foreign disregarded entity, a foreign partnership or certain trusts. In particular, reporting is required by:

1. A United States person who owns or acquires ten percent, by vote or value of a foreign corporation or who owns more than 50% of the stock of a foreign corporation;<sup>27</sup>
2. A United States person who transfers more than \$100,000 to a foreign corporation or a foreign partnership during the taxable year;<sup>28</sup>
3. A United States person with an interest in a foreign corporation that owns a foreign disregarded entity;<sup>29</sup>
4. A U.S. citizen or resident who becomes an officer or a director of a foreign corporation if a United States person owns ten percent or more of the vote or value of the foreign corporation;<sup>30</sup>
5. A United States person who owns or acquires a ten percent interest in the capital or profits of a foreign partnership or who owns more than 50% interest in the capital or profits of a foreign partnership;<sup>31</sup>

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<sup>27</sup> Sections 6038, 6046. The information is provided on a Form 5471, *Information Return of U.S. Persons With Respect To Certain Foreign Corporations*. The amount of information that is required depends on the level of ownership and control held by the U.S. person.

<sup>28</sup> Section 6038B. The transfer to a foreign corporation is reported on Form 926, *Return by a U.S. Transferor of Property to a Foreign Corporation*. If the transfer is made by a partnership (whether domestic or foreign), it is treated as if the partners made the transfer in proportion to their interests in the partnership. Thus, a U.S. partner will need to file the Form 926 if the partnership makes a transfer to a foreign corporation and the partner’s proportionate share is greater than \$100,000. The transfer to a foreign partnership must be disclosed on Schedule O of Form 8865, *Return of U.S. Persons With Respect to Certain Foreign Partnerships*.

<sup>29</sup> Ownership of a foreign disregarded entity must be disclosed on Form 8858, *Information Return of U.S. Persons With Respect to Foreign Disregarded Entities*, which states that it is required under the authority of sections 6011, 6012, and 6038.

<sup>30</sup> *Id.*

6. A United States person who transfers property to a foreign corporation in a non-taxable exchange, including the transfer of cash to an entity upon formation;<sup>32</sup> and

7. A United States person who creates a foreign trust, transfers property, including cash, to a foreign trust, or is a beneficiary of a foreign trust and receives a distribution from the trust.<sup>33</sup>

C. Recommendation to Remove Section 301

As noted above, we strongly support the efforts of the Congress and the Treasury Department to focus on the foreign reporting requirements of noncompliant U.S. taxpayers, both in educating those taxpayers who have been previously unaware of those requirements and in encouraging those taxpayers who have purposefully evaded the requirements to come into compliance.

While we support these efforts, we do have significant concerns about aspects of the legislation as they may apply to attorneys who are involved in advising and assisting their clients to structure their foreign business operations and investments in compliance with the tax law.

We compare the proposed reporting rules with the system of reporting that is in place under sections 6111 and 6112, upon which these provisions seem to be modeled. Under sections 6111 and 6112, an advisor may be a “material advisor” with reporting obligations to the Service if the advisor makes a tax statement for the benefit of a taxpayer who the advisor “knows is or reasonably expects to be” required to disclose the relevant transaction as a “reportable transaction” pursuant to regulations promulgated under section 6011. These proposed requirements do not have the same limits on their coverage.

The material advisor disclosure requirement under section 6111 and the attendant Form 8918, *Material Advisor Disclosure Statement*, requires a material advisor to disclose particular features of the transaction and the names of other advisors, but does not require that the advisor disclose or identify the names of the relevant taxpayers. Section 6112 requires that the material advisor maintain a separate list of reportable transactions and the names of taxpayers are only required to be disclosed upon request by the Service in the context of a particular transaction. This is an important matter to attorneys who are obligated by professional ethics to maintain the confidences of their clients and are subject to sanction or even disbarment for breaching those ethical obligations. For the most part, the transactions that would be disclosed by material advisors under the proposed legislation are ordinary and legitimate international business transactions and investments, unlike the reportable transactions. The reporting requirements that

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(continued...)

<sup>31</sup> Sections 6038 and 6046A.

<sup>32</sup> Section 6038B. The transfer of the property is reported on Form 926, *Return by a U.S. Transferor of Property to a Foreign Corporation*.

<sup>33</sup> Section 6048. Reporting is handled on forms 3520, *Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts*, and 3520-A, *Annual Information Return of Foreign Trust With a U.S. Owner*.

would be imposed by the legislation require disclosures of what may be sensitive client information by attorneys and accountants working on ordinary transactions.

The disclosures are also duplicative of filings that must be made by taxpayers in regard to the transactions and that will be made by compliant taxpayers. We believe that it is questionable whether the benefits of the duplicative information obtained from the contemplated system are significant considering the burdens imposed.

Looking at the proposed requirements from these perspectives, they seem overly broad, burdensome and costly, with little return for the government. Those taxpayers who are intentionally avoiding their reporting responsibilities and tax obligations will likely avoid these additional requirements as well by working with foreign, not U.S., advisors. Those taxpayers who want to comply are burdened by these new provisions, and may avoid seeking the advice they need. Ultimately, the government may not realize the benefits sought.

For the above reasons we recommend that the section be deleted from the legislation.

#### D. Specific Comments.

If the provision is to be retained, we recommend the following amendments.

1. *Who Can Be a Material Advisor.* A material advisor is any person: “(1) who provides any material aid, assistance, or advice with respect to carrying out one or more foreign entity transactions, and (2) who directly or indirectly derives gross income in excess of \$100,000 for providing such aid, assistance or advice during the calendar year,” and with respect to which any U.S. citizen or resident has to file one of the reports referenced above. If the statutory language is meant to trigger the reporting requirements whenever the aggregate gross income of the advisor derived from *all* foreign entity transactions exceeds \$100,000 during the year (as opposed to a per transaction threshold), the reporting regime will result in the reporting of many transactions, some of which are instances where only *de minimis* amounts of tax advice is rendered, and will result in some cases in hundreds of reportable transactions. We recommend that the reporting threshold be amended to make the provisions applicable only to specific transactions in which only the tax related fees exceed a \$100,000 threshold.

The material advisor standard as written may apply not only to professional tax advisors, such as attorneys and accountants, but may include investment bankers, management companies within private equity funds, and perhaps employees of an organization engaging in the reportable transactions.<sup>34</sup> The standard may also apply to foreign lawyers and tax advisors not otherwise connected to the United States and who have no knowledge of these requirements. We believe the requirement will trigger numerous filings with respect to the same transactions. We suggest that Congress consider a simplified procedure allowing advisors to file a short form disclosure that incorporates by reference disclosures made by other filers.

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<sup>34</sup> There is no exception provided for employees as in the definition of a “tax return preparer.” See section 7701(a)(36)(B)(ii).

Further, a person may be a material advisor without rendering any tax advice. In contrast, under sections 6111 and 6112, an advisor must make a “tax statement” to be a material advisor for purposes of the requirement to maintain lists and disclose reportable transactions.<sup>35</sup> For people or organizations who are not engaged to render tax advice, it is difficult to understand why these rules should be imposed upon them. Although we do not advocate undertaking transactions without tax advice, there are companies that legitimately advise on or implement foreign transactions without rendering tax advice. For example, an independent appraiser may provide a valuation of a foreign business in connection with a foreign transaction without ever being aware of the tax filing requirements. We suggest that those businesses should not be burdened with having to advise on the U.S. tax reporting rules. This can be accomplished by adding a similar “tax statement” requirement to the proposed legislation.

In addition to requiring that an advisor make a tax statement, we suggest that Congress consider requiring that the statement be in writing in order for new section 6116 to apply. Otherwise, oral statements and other casual advice rendered in the course of a regular and routine advisory relationship might cause an advisor to fall inadvertently under the requirements of new section 6116. Oral and other informal advice usually is preliminary to more reasoned consideration and finalization of a plan. It may not result in a completed transaction, and whether and when it should be reported would sometimes be difficult to determine. The burden imposed on advisors to report that is triggered by an oral statement or other informal or casual advice would be significant. Given the broad scope of the transactions that could be caught under new section 6116, tracking such advice would be challenging for law and accounting firms, making compliance difficult, if not impossible, in the face of the severe penalties. [[We suggest, therefore, that Congress consider making new section 6116 applicable only in the case of formal written advice that constitutes a tax statement relevant to a completed transaction. Further, we suggest that the requirements not be triggered by unanticipated subsequent events that may later occur and were not known at the time the advice was rendered that may cause the transaction to be reportable.

2. *Status of the Reporting Person.* A material advisor is obligated to file an informational return if any citizen or resident of the United States is obligated to file one of the reports listed above. As a preliminary note, we understand that the phrase “citizen or resident” of the United States implicates only individuals. There is some concern that this phrase could also include entities because for certain purposes a corporation or partnership can be resident in the United States.<sup>36</sup> In our view, if the phrase was intended to include entities, the legislation would have used the phrase “United States person,” as defined in section 7701(a)(30).<sup>37</sup> In addition, the reporting sections referenced above clearly distinguish between U.S. citizens and residents and

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<sup>35</sup> Treas. Reg. § 301.6111-3(b)(2).

<sup>36</sup> See, for example, section 865(g)(1)(A) which characterizes a corporation as “U.S. resident” solely for purposes of sourcing income from the sale of personal property.

<sup>37</sup> Section 7701(a)(30) defines a United States person as (A) a U.S. citizen or resident, (B) a domestic partnership, (C) a domestic corporation, (D) a non-foreign estate and (E) certain trusts.

United States persons, the more inclusive term. It would be helpful to clarify that only individuals are implicated by this phrase.

3. *Non-Individual Acquirors.* The PSI investigation raised concerns about the use by U.S. individuals of foreign entities to evade the reporting requirements that would have permitted the Service to identify any tax evasion that was occurring. There was no indication that U.S. corporations or operating businesses were not complying with their reporting obligations with respect to their foreign operations and investment.

Section 301 of the Bill does not require that an individual be the acquiror of the interest in the foreign entity, but only requires that an individual has a reporting obligation with respect to the acquisition. The goal of the provision is to help support the reporting of foreign financial assets<sup>38</sup> by U.S. individuals, but given the difference between the identification of the acquiror and the reporting person some standard corporate transactions may be brought into coverage of the section. For example, assume that U.S. Corporation 1, a large multinational publicly traded company, acquires Foreign Corporation, which owns numerous other foreign corporations. Foreign Corporation and the subsidiaries become controlled foreign corporations (“CFCs”). Commonly, U.S. individuals will be named as directors or officers of some of those CFCs. Under section 301 of the Bill, the advisors to U.S. Corporation 1 will be required to report the acquisition because there is a direct and an indirect acquisition of foreign corporations, and a U.S. individual has an obligation to file a Form 5471, *Information Return of U.S. Persons With Respect To Certain Foreign Corporations*, with respect to the acquisition. We do not believe such reporting would be useful to the Service, and would be very burdensome to the advisor and the client.

Similarly, if a U.S. citizen acquires a significant stake in a foreign operating company, the reporting does not further the goals of the legislation, as it is not a circumstance in which the U.S. citizen effectively acquired an interest in a “financial account.”

We recommend that acquisitions made by U.S. business entities that are operating companies (as opposed to entities that are in the investment or trading business) both before and after the acquisition of a foreign entity be exempted from the definition of foreign financial transaction. In evaluating the status of the entity as an operating company we recommend that it be done on a look through basis similar to the approach applied under current law for passive foreign investment company (“PFIC”) purposes.

Additionally, we recommend that acquisitions by a U.S. individual of a business entity that is an operating company, made directly or indirectly, also be exempted from the definition of a foreign financial transaction. In the case of acquisition of stock of a foreign corporation, the foreign corporation might be treated as an operating company if it is not a PFIC.

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<sup>38</sup> We note that the Joint Committee Report references reporting of foreign financial assets, but the proposed statutory language would require more limited reporting. We suggest that the legislative history and the statutory language be consistent to avoid confusion.

4. *Relationship of Advisor and Reporting Person.* It would be helpful to clarify the required relationship between the individual who has the filing obligation and the advisor. For example, assume that Foreign Corporation offers 30% of its stock for sale to the public. Advisor A assists U.S. Corporation with evaluating the offer and with implementing the purchase of a 5% interest in Foreign Corporation. In the same offering, Advisor B assists Mr. X, a U.S. citizen, with evaluating the offer and with implementing the purchase of a 10% interest in Foreign Corporation. Assuming that Advisor B satisfies the fee threshold, and given that Mr. X has the required filing obligations, Advisor B is subject to the reporting obligations. The question is whether Advisor A has reporting obligations because “a” U.S. individual has a filing obligation with respect to the overall acquisition. We believe that the better reading of section 301 of the Bill is that Advisor A should not have a reporting obligation, because Advisor A did not provide any advice to a U.S. individual who has a reporting obligation with respect to the acquisition that he or she is making. It would be helpful, however, to clarify that there needs to be a relationship between the advisor and the reporting individual. We recommend that an advisor not have an obligation to make independent inquiries of third parties who are not clients. Imposing such an obligation is particularly problematic in the context of transactions in which the reporting obligation is triggered by subjective inquiries with respect to facts known only to the third party.

5. *Application of Section 6103.* If a taxpayer believes that the information required to be submitted pursuant to section 301 of the Bill is not protected from disclosure, the implementation of the provision could cause some taxpayers to avoid advisors who will comply. We recommend that Congress clarify that the reports submitted pursuant to section 301 of the Bill are protected submissions under section 6103.

#### **IV. Amendments to Certain Trust Rules (Sections 401- 405 of the Bill)**

##### **A. Background**

Sections 671 to 679 contain the grantor trust rules, under which the grantor and other persons are treated as the owner of a portion of a trust. Under section 679, a U.S. person that directly or indirectly transfers property to a foreign trust is treated as the owner of the portion of the trust comprising the transferred property for any taxable year in which there is a U.S. beneficiary of any portion of the trust. Regulations under this section promulgated in 2001 effectively prevent evasion of U.S. tax by giving a very broad construction of the statute. The regulations broadly define indirect transfers. In addition, regulations promulgated in 1999 defining “grantor”<sup>39</sup> prevent using nominees to escape section 679.

Section 679 does not apply for a taxable year if, under the terms of the trust, no U.S. person may receive any income or corpus from the trust and no U.S. person would receive any benefit if the trust were to terminate.<sup>40</sup> Under section 643(i), if a foreign trust makes a loan of cash or marketable securities directly or indirectly to a grantor or beneficiary of the trust who is a U.S. person or any U.S. person who is related to such grantor or beneficiary, the amount shall be

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<sup>39</sup> Treas. Reg. §1.671-2(e).

<sup>40</sup> Section 672(b).

treated as a distribution except as provided in regulations. In Notice 97-34,<sup>41</sup> Treasury announced that regulations once adopted would provide that only loans made as “qualified obligations,” by the terms of which repayment could be fairly presumed, would be treated as loans and not distributions. This rule applies for purposes of determining if the foreign trust is a simple or complex trust, computing the distribution deduction for the trust, determining the amount of gross income of the beneficiaries, and computing any accumulation distribution. Loans to tax-exempt entities are excluded from this rule. A trust treated under this rule as making a distribution is not treated as a simple trust for the year of the distribution. This rule does not apply for purposes of determining if a trust has a U.S. beneficiary under section 679.

#### B. Summary of the Provision

Section 401 of the Bill<sup>42</sup> modifies section 679 by providing that a U.S. person will be deemed to have an interest in a foreign trust formed or funded by a U.S. person if the interest is contingent on a future event.<sup>43</sup> In addition, if any person has discretion to make a distribution from a trust for the benefit of any person, the trust is treated as having a U.S. beneficiary unless the trust terms specifically identify the class of distributees and none of those persons is a U.S. person during the taxable year. Any written, oral, or other side agreement by a U.S. grantor that may result in income or corpus being paid for the benefit of any U.S. person is treated as one of the terms of the trust.

Section 402 of the Bill provides that if any U.S. person directly or indirectly transfers property to a foreign trust, the trust shall be presumed to have a U.S. beneficiary unless the transferor submits information to the Secretary as the Secretary may require with respect to such transfer and demonstrates to the satisfaction of the Secretary the absence of a U.S. beneficiary. This is in addition to any reporting required to be made by the trust itself under present law. The provision is effective on the date of enactment.

Section 403(a) of the Bill modifies the uncompensated use rules for foreign trusts that are not treated as grantor trusts by providing that the rules will apply when the use of trust property is permitted (but, unlike in the case of a loan, only the fair market value of the use of the property is deemed distributed). Under section 403(b) of the Bill an exception applies to the extent that the

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<sup>41</sup> 1997-1 CB 422, at 428

<sup>42</sup> Part IV of the Bill is similar in some respects to section 106 of the Stop Tax Haven Abuse Act, S. 506 and H.R. 1265, which were introduced on March 2, 2009, and March 3, 2009, respectively. The Stop Tax Haven Abuse Act, if enacted, would have made the following changes to the treatment of both foreign and domestic trusts: (1) amended section 672 (a definitional section) to attribute all powers and interests held by a trust protector of a foreign trust to the U.S. trust grantor; (2) amended section 679 to treat a U.S. person who receives or uses cash or other property from a foreign trust as a beneficiary of that trust, unless the exchange was for fair market value; (3) expanded the list of taxable trust distributions under section 643(i) (dealing with foreign trusts, as described above) to include loans of real estate, marketable securities, and personal property of any kind, including artwork, furnishings and jewelry; and (4) amended section 679 to treat foreign trusts with current or future U.S. beneficiaries, including contingent U.S. beneficiaries, as grantor trusts, rather than limiting that treatment to trusts with current U.S. beneficiaries.

<sup>43</sup> This provision appears to be consistent with Treas. Reg. § 1.679-2(a)(2)(i).

trust is paid the fair market value of such use within a reasonable period of time. Section 403(c) of the Bill would amend section 679(c) (dealing with grantor trusts) to add uncompensated use rules for the purpose of determining whether a trust has a U.S. beneficiary. Both provisions are effective for loans made and property used after the date of enactment.

Section 404 of the Bill provides that the grantor shall provide such information as the Secretary may prescribe with respect to the trust. The amendment would be effective for taxable years beginning after the date of enactment.

Section 405 of the Bill modifies the penalties for failure to report information regarding certain foreign trusts. The Bill provides minimum fixed penalties, in most cases \$10,000, even in cases in which the gross reportable amount is not determinable, and places the burden on the taxpayer to provide information sufficient to determine the gross reportable amount to ensure that the penalty does not exceed the gross reportable amount. The provision is effective for notices and returns required after December 31, 2009.

Although the proposed Bill follows the approach of previously introduced legislation, the Bill is more narrowly focused and does not attribute the powers of a trust protector to the U.S. grantor.

#### C. Comments

The trust provisions of the Bill generally are consistent with the objectives of the Bill. We have only minor comments.

1. Under current regulations, a trust is treated as having a United States beneficiary if distributions are made to a U.S. person even if the distribution is in violation of the trust terms.<sup>44</sup> The provisions of the Bill, if enacted, might be difficult to reconcile with this existing regulation.

2. It would be helpful to include in the legislative history guidance as to when a loan or the use of property will be considered to be repaid at fair market value within a reasonable time.

### V. **Dividend Equivalent Payments to Foreign Persons Treated as Dividends (Section 501 of the Bill)**

#### A. Background

Under current law, payments of U.S.-source “fixed or determinable annual or periodical” income including interest, dividends and similar types of investment income made to foreign persons are generally subject to a 30% withholding tax unless the rate is reduced by treaty. Dividends paid by a domestic corporation are generally U.S. source under section 861(a)(2) and therefore potentially subject to withholding tax.

The source of income received under notional principal contracts, however, generally is determined by reference to the residence of the recipient. Thus, unless recharacterized under

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<sup>44</sup> Treas. Reg. §1.679-2(a)(4)(ii)(C) and Example 2.

common law principles in an abusive case, a foreign person's income related to a notional principal contract or so-called "equity swap" that references stock in a domestic corporation, including any amount attributable to dividends paid on the stock, generally is foreign source income and therefore not subject to U.S. withholding tax.

Equity swaps are therefore widely recognized as having the consequence of eliminating a withholdable dividend payment under the netting treatment and sourcing rule for swaps. Further, swaps have been marketed as a means of avoiding withholding tax. Consequently, steps to address this issue are understandable.<sup>45</sup>

## B. Summary of the Provision

Section 501(a) of the Bill would add new section 871(l) to the Code, pursuant to which "dividend equivalent" amounts would be treated as dividends from U.S. sources for purposes of sections 871 and 881 and consequently subject to U.S. withholding tax under sections 1441 and 1442. A "dividend equivalent" would be any payment made under a notional principal contract (*i.e.*, a swap) that is directly or indirectly contingent upon (or determined by reference to) the payment of a U.S.-source dividend. The Bill also grants Treasury broad powers to identify as dividend equivalents any other transactions or payments that are substantially similar to dividend equivalents under notional principal contracts and the Joint Committee Explanation mentions payments under forward contracts that reference stock of U.S. corporations.

The dividend equivalent amount subject to U.S. withholding tax would be the gross amount used in computing any net amounts transferred to or from the taxpayer under the notional principal contract. A party to a total return swap may, therefore, be obligated to withhold and pay tax to Treasury on a gross dividend-based amount even though the party is not required to make an actual payment to its foreign counterparty.

Section 501 of the Bill further grants Treasury the authority to exclude payments from the scope of dividend equivalents if made in transactions that it determines do not have the potential for the avoidance of tax. Section 501 of the Bill lists five non-exclusive factors that the Secretary "may take into account:" (1) the term (including provisions for early terminations and offsetting financial contracts); (2) the amount of each party's investment and the amount of collateral posted; (3) whether the price of the equity used to measure the parties' entitlements or

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<sup>45</sup> Under current law a substitute dividend payment made to the transferor of stock in a securities lending transaction has the same source as the dividend, and substitute payments in respect of a stock lending transaction in respect of stock of U.S. issuers are therefore generally subject to U.S. withholding tax. To avoid multiple inclusions in respect of the same underlying dividend payment, however, Notice 97-66, 1997-2 C.B. 328, limits withholding tax in respect of foreign-to-foreign substitute dividend payments in a manner such that no U.S. withholding tax is imposed on such a payment if the overall U.S. withholding tax in respect of the underlying payments is not reduced. Treas. Reg. §§ 1.861-3(a)(6), 1.871-7(b)(2) and 1.881-2(b)(2). The treatment of stock lending transactions under Notice 97-66, however, can result in withholding tax results similar to those targeted by the swap provision of the Bill. Congress held hearings in September 2008 addressing, among other matters, abusive equity swaps and raised concerns that Notice 97-66 was being used by taxpayers to justify tax avoidance transactions, including where a foreign person would lend U.S. stock to a FFI who would then sell the stock to a related U.S. person and at the same time enter into a total return equity swap with this U.S. person. At the hearing, Internal Revenue Service Commissioner Shulman was requested to address the treatment of these transactions.

obligations is based on an objectively observable price; (4) whether either party sells (directly or indirectly) to the other party the security giving rise to dividends from sources within the United States; and (5) 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 U.S.-source dividends. While neither the Bill nor the Joint Committee Explanation specifies the relevance of the factors, the list indicates that the exceptions should have a fairly broad application. Absent such regulations, however, all payments in respect of total return swaps determined by reference to dividends with respect to U.S. equity would be U.S.-source dividend equivalents, regardless of the residence or place of organization of the counterparties to the swap.

Section 871(l) would apply to dividend equivalent payments made (actually or constructively) more than 90 days after the date of enactment.

### C. Comments

One may question whether a withholding tax on dividends paid with respect to stock is sound tax policy. Nevertheless, current law imposes such a tax, and therefore we believe that rules preventing abusive avoidance of the tax are appropriate. Such transactions may exist under various labels (*e.g.*, equity or total return swap, forward contract, financial contract).

Our specific comments are as follows.

1. *Effective Date Should Allow Treasury Time to Implement Exceptions to Dividend Equivalents and to Allow Institutions Close-out of Existing Equity Swaps.* Guidance implementing the authorized exceptions should be promulgated sufficiently in advance of the provision's effectiveness to allow institutions to assess their outstanding contracts and come into compliance. This is not necessarily provided under the current effective date, in that it is not tied to the promulgation of guidance and may be an inadequate period even if the rules were known on enactment.

For the most part, outstanding equity swaps that would be adversely affected under section 501 would be terminated if the Bill is enacted, either pursuant to the terms of the swap (*i.e.*, as a result of a Change of Tax Law or Change of Law provision under standard ISDA documentation) or by mutual agreement between the counterparties, to avoid a gross-up for amounts withheld. A mutual agreement may take a longer period than provided by the effective date for section 501 of the Bill, particularly for a party that has entered into numerous equity swaps.

2. *Consider Grandfathering of Existing Contracts.* We recommend that existing contracts be excepted from the application of section 871(l), at least for some period, so that taxpayers are not unfairly penalized for their outstanding equity swaps and derivatives that were entered into based upon current law and may close out existing swaps in an orderly fashion. We recommend that this apply to such contracts entered into before, or pursuant to a binding agreement in existence before, October 28, 2009.

3. *Exceptions from Dividend Equivalents.* A payment made under a notional principal contract that is directly or indirectly contingent upon or determined by reference to the payment of a U.S.-source dividend would be treated as a dividend equivalent subject to U.S. withholding

tax unless identified as a non-abusive, commercial transaction by Treasury. Conversely, other transactions are so treated only if first identified by Treasury, either under the five factors listed above or “any other factors” it deems appropriate.

We agree that deferring the issue of demarcating between abusive and non-abusive transactions to Treasury is the appropriate approach for such a complex and fact-specific subject matter. We also agree that the relevant factors are generally set forth in sufficient breadth to permit appropriate rules to be developed.

We understand why the statute would be drafted with a residual rule treating dividend equivalents in respect of notional principal contracts as U.S.-source withholdable payments. Our primary concern, as noted above, is that sufficient lead time be permitted in the statute initially and by delegation of authority to Treasury, to allow for the creation of appropriate exceptions in a timely way. The normal Treasury regulation process would put taxpayers on fair notice and allow for consultation with taxpayers and industry groups with the appropriate expertise and knowledge about the market place. Thus, we recommend that the residual rule for sourcing not become effective until appropriate exceptions have been identified.

4. *Avoid Potential Double Withholding on Equity Swaps.* There is an issue of possible double withholding because of the way the equity swap business is done at a number of taxpayers. Firms often centralize their swap trading activities in one legal entity to achieve netting benefits for credit and balance sheet purposes. However, the risk for the positions may be managed in a different legal entity so there is a mirror internal swap for each client swap. This mirror swap creates the potential for double withholding. We recommend that consideration be given to an exemption for the second withholding tax when the taxpayer is able to demonstrate to the Service that an internal mirror situation exists and withholding tax actually was imposed at gross on the first client swap.

Further, we believe the legislation could apply to swaps between two foreign parties. In such a case, if the first foreign party has been subject to withholding on a dividend or dividend equivalent to which the swap relates, the payment to the second foreign party should not again be subject to withholding (other than to the extent the applicable withholding rate on such payment may be higher than the rate applicable to the initial payment). A similar problem was addressed by the Service in connection with securities lending,<sup>46</sup> and we recommend that a similar approach be adapted to the proposed legislation.

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<sup>46</sup> Notice 97-66. Specifically, U.S. withholding tax on a substitute dividend payment is limited to the amount of substitute dividend multiplied by a rate equal to the excess, if any, of the U.S. withholding tax rate that would have been imposed on the recipient of the substitute payment, if the recipient had received the actual dividend payment directly, over the same rate applicable to the payor of the substitute payment. This amount is further reduced by actual withholding tax imposed on the underlying dividend or substitute dividend payments (if any) earlier in a chain of securities lending transactions. Notice 97-66, section 3.