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

CONTENTS

INTRODUCTION

This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a technical explanation of the "Foreign Account Tax Compliance Act of 2009."

[1] This document may be cited as follows: Joint Committee on Taxation, *Technical Explanation of the "Foreign Account Tax Compliance Act of 2009"* (JCX-42-09), October 27, 2009. This document can also be found on our website at www.jct.gov.

I. INCREASED DISCLOSURE OF BENEFICIAL OWNERS

A. Reporting on Certain Foreign Accounts (sec. 101 of the bill and new secs. 1471, 1472, 1473, and 1474 of the Code)

Present Law

Withholding on payments to foreign persons

Payments of U.S.-source "fixed or determinable annual or periodical" ("FDAP") income, including interest, dividends, and similar types of investment income, that are made to foreign persons are subject to U.S. withholding tax at a 30-percent rate, unless the withholding agent can establish that the beneficial owner of the amount is eligible for an exemption from withholding or a reduced rate of withholding under an income tax treaty.[2] The term "FDAP income" includes all items of gross income, except gains on sales of property (including market discount on bonds and option premiums) and insurance premiums paid to a foreign insurer or reinsurer.[3]

Interest is derived from U.S. sources if it is paid by the United States or any agency or instrumentality thereof, a State or any political subdivision thereof, or the District of Columbia. Interest is also from U.S. sources if it is paid by a resident or a domestic corporation on a bond, note, or other interest-bearing obligation.[4] Dividend income is sourced by reference to the payor's place of incorporation.[5] Thus, dividends paid by a domestic corporation are generally treated as entirely U.S.-source income. Similarly, dividends paid by a foreign corporation are generally treated as entirely foreign-source income. Rental income is sourced by reference to the location or place of use of the leased property.[6] The nationality or the country of residence of the lessor or lessee does not affect the source of rental income. Rental income from property located or used in the United States (or from any interest in such property) is U.S.-source income, regardless of whether the property is real or personal, intangible or tangible. Royalties are

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[2] Secs. 871, 881, 1441, 1442; Treas. Reg. sec. 1.1441-1(b). Unless otherwise noted, all section references are to the Internal Revenue Code of 1986, as amended (the "Code"). For purposes of the withholding tax rules applicable to payments to nonresident alien individuals and foreign corporations, a withholding agent is defined broadly to include any U.S. or foreign person that has the control, receipt, custody, disposal, or payment of an item of income of a foreign person subject to withholding. Treas. Reg. sec. 1.1441-7(a).

[3] Treas. Reg. sec. 1.1441-2(b)(1)(i), -2(b)(2); Rev. Rul. 2004-75, 2004-2 C.B. 109 (holding that the income of a nonresident alien individual under a life insurance or annuity contract issued by a foreign branch of a U.S. life insurance company is FDAP income from U.S. sources); Rev. Rul. 2004-97, 2004-2 C.B. 516 (stating that Rev. Rul. 2004-75 does not apply to payments made before January 1, 2005, pursuant to binding life insurance or annuity contracts issued by a foreign branch on or before July 12, 2004). However, gain on a sale or exchange of section 306 stock of a domestic corporation is FDAP income to the extent section 306(a) treats the gain as ordinary income. Treas. Reg. sec. 1.306-3(h).

[4] Sec. 861(a)(1); Treas. Reg. sec. 1.861-2(a)(1). Interest paid by the U.S. branch of a foreign corporation is also treated as U.S.-source interest under section 884(f)(1).

[5] Secs. 861(a)(2), 862(a)(2).

[6] Sec. 861(a)(4).

sourced in the place of use (or the privilege of use) of the property for which the royalties are paid.[7] This source rule applies to royalties for the use of either tangible or intangible property, including patents, copyrights, secret processes, formulas, goodwill, trademarks, trade names, and franchises.

The principal statutory exemptions from the 30-percent withholding tax apply to interest on bank deposits, portfolio interest, and capital gains. Since 1984, the United States has not imposed withholding tax on portfolio interest received by a nonresident individual or foreign corporation from sources within the United States.[8] Portfolio interest includes, generally, any interest (including original issue discount) other than interest received by a 10-percent shareholder,[9] certain contingent interest,[10] interest received by a controlled foreign corporation from a related person,[11] and interest received by a bank on an extension of credit made pursuant to a loan agreement entered into in the ordinary course of its trade or business.[12]

In the case of interest paid on a debt obligation that is in registered form,[13] the portfolio interest exemption is available only to the extent that the U.S. person otherwise required to

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[7] *Ibid.*

[8] Secs. 871(h), 881(c). Congress believed that the imposition of a withholding tax on portfolio interest paid on debt obligations issued by U.S. persons might impair the ability of domestic corporations to raise capital in the Eurobond market (i.e., the global market for U.S. dollar-denominated debt obligations). Congress also anticipated that repeal of the withholding tax on portfolio interest would allow the Treasury Department direct access to the Eurobond market. See Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* (JCS-41-84), December 31, 1984, pp. 391-92.

[9] Sec. 871(h)(3). A 10-percent shareholder includes any person who owns 10 percent or more of the total combined voting power of all classes of stock of the corporation (in the case of a corporate obligor), or 10 percent or more of the capital or profits interest of the partnership (in the case of a partnership obligor). The attribution rules of section 318 apply for this purpose, with certain modifications.

[10] Sec. 871(h)(4). Contingent interest generally includes any interest if the amount of such interest is determined by reference to any receipts, sales, or other cash flow of the debtor or a related person; any income or profits of the debtor or a related person; any change in value of any property of the debtor or a related person; any dividend, partnership distributions, or similar payments made by the debtor or a related person; and any other type of contingent interest identified by Treasury regulation. Certain exceptions also apply.

[11] Sec. 881(c)(3)(C). A related person includes, among other things, an individual owning more than 50 percent of the stock of the corporation by value, a corporation that is a member of the same controlled group (defined using a 50-percent common ownership test), a partnership if the same persons own more than 50 percent in value of the stock of the corporation and more than 50 percent of the capital interests in the partnership, any U.S. shareholder (as defined in section 951(b) and generally including any U.S. person who owns 10 percent or more of the voting stock of the corporation), and certain persons related to such a U.S. shareholder.

[12] Sec. 881(c)(3)(A).

[13] An obligation is treated as in registered form if (1) it is registered as to both principal and interest with the issuer (or its agent) and transfer of the obligation may be effected only by surrender of the old instrument and either the reissuance by the issuer of the old instrument to the new holder or the issuance by the issuer of a new instrument to the new holder, (2) the right to principal and stated interest on the obligation may be transferred only through a book entry system maintained by the issuer or its agent, or (3) the obligation is registered as to both

withhold tax (the "withholding agent") has received a statement made by the beneficial owner of the obligation (or a securities clearing organization, bank, or other financial institution that holds customers' securities in the ordinary course of its trade or business) that the beneficial owner is not a U.S. person.[14]

Interest on deposits with foreign branches of domestic banks and domestic savings and loan associations is not treated as U.S.-source income and is thus exempt from U.S. withholding tax (regardless of whether the recipient is a U.S. or foreign person).[15] In addition, interest on bank deposits, deposits with domestic savings and loan associations, and certain amounts held by insurance companies are not subject to the U.S. withholding tax when paid to a foreign person, unless the interest is effectively connected with a U.S. trade or business of the recipient.[16] Similarly, interest and original issue discount on certain short-term obligations is also exempt from U.S. withholding tax when paid to a foreign person.[17] Consequently, there is no information reporting with respect to payments of such amounts.[18]

Gains derived from the sale of property by a nonresident alien individual or foreign corporation generally are exempt from U.S. tax, unless they are or are treated as effectively connected with the conduct of a U.S. trade or business. Gains derived by a nonresident alien individual generally are subject to U.S. taxation only if the individual is present in the United States for 183 days or more during the taxable year.[19] Foreign corporations are subject to tax with respect to certain gains on disposal of timber, coal, or domestic iron ore and certain gains from contingent payments made in connection with sales or exchanges of patents, copyrights,

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principal and interest with the issuer or its agent and may be transferred through both of the foregoing methods. Treas. Reg. sec. 5f.103-1(c).

[14] Sec. 871(h)(2)(B), (5). This certification of non-U.S. ownership most commonly is made on an IRS Form W-8. This certification is not valid if the Secretary determines that statements from the person making the certification do not meet certain requirements.

[15] Sec. 861(a)(1)(B); Treas. Reg. sec. 1.1441-1(b)(4)(iii).

[16] Secs. 871(i)(2)(A), 881(d); Treas. Reg. sec. 1.1441-1(b)(4)(ii). If the bank deposit interest is effectively connected with a U.S. trade or business, it is subject to regular U.S. income tax rather than withholding tax.

[17] Secs. 871(g)(1)(B), 881(a)(3); Treas. Reg. sec. 1.1441-1(b)(4)(iv).

[18] Treas. Reg. sec. 1.1461-1(c)(2)(ii)(A), (B). However, Treasury regulations require a bank to report interest if the recipient is a resident of Canada and the deposit is maintained at an office in the United States. Treas. Reg. secs. 1.6049-4(b)(5), 1.6049-8. This reporting is required to comply with the obligations of the United States under the U.S.-Canada income tax treaty. T.D. 8664, 1996-1 C.B. 292. In 2001, the IRS and the Treasury Department issued proposed regulations that would require annual reporting to the IRS of U.S. bank deposit interest paid to any foreign individual. 66 Fed. Reg. 3925 (Jan. 17, 2001). The 2001 proposed regulations were withdrawn in 2002 and replaced with proposed regulations that would require reporting with respect to payments made only to residents of certain specified countries (Australia, Denmark, Finland, France, Germany, Greece, Ireland, Italy, the Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, and the United Kingdom). 67 Fed. Reg. 50,386 (Aug. 2, 2002). The proposed regulations have not been finalized.

[19] Sec. 871(a)(2). In most cases, however, an individual satisfying this presence test will be treated as a U.S. resident under section 7701(b)(3), and thus will be subject to full residence-based U.S. income taxation.

goodwill, trademarks, and similar intangible property.[20] Most capital gains realized by foreign investors on the sale of portfolio investment securities thus are exempt from U.S. taxation.

The 30-percent withholding tax may be reduced or eliminated by a tax treaty between the United States and the country in which the recipient of income otherwise subject to withholding is resident. Thus, most U.S. income tax treaties provide a zero rate of withholding tax on interest payments (other than certain interest the amount of which is determined by reference to certain income items or other amounts of the debtor or a related person). Most U.S. income tax treaties also reduce the rate of withholding on dividends to 15 percent (in the case of portfolio dividends) and to five percent (in the case of "direct investment" dividends paid to a 10 percent-or-greater shareholder).[21] For royalties, the U.S. withholding rate is typically reduced to five percent or to zero. In each case, the reduced withholding rate is available only to a beneficial owner who qualifies as a resident of the treaty country within the meaning of the treaty and otherwise satisfies any applicable limitation on benefits provisions of the treaty.

Certification of foreign status and reporting by U.S. withholding agents

The U.S. withholding tax rules are administered through a system of self-certification. Thus, a nonresident investor seeking to obtain withholding tax relief for U.S.-source investment income typically must provide a certification, on Internal Revenue Service ("IRS") Form W-8 to the withholding agent in order to establish foreign status and eligibility for an exemption or reduced rate. Provision of the IRS Form W-8 also establishes an exemption from the rules that apply to many U.S. persons governing information reporting on IRS Form 1099 and backup withholding (discussed below).[22]

There are four relevant types of IRS Forms W-8.[23] Three of these forms are designed to be provided to the withholding agent by the beneficial owner of a payment of U.S.-source income:[24] (1) the IRS Form W-8BEN, which is provided by a beneficial owner of U.S.-source non-effectively-connected income; (2) the IRS Form W-8ECI, which is provided by a beneficial

[20] Secs. 881(a), 631(b), (c).

[21] A number of recent U.S. income tax treaties eliminate withholding tax on dividends paid to a majority (typically 80-percent or greater) shareholder, including the present treaties with Australia, Belgium, Denmark, Finland, Germany, Japan, Mexico, the Netherlands, Sweden, and the United Kingdom.

[22] See Treas. Reg. sec. 1.1441-1(b)(5).

[23] A fifth type of IRS Form W-8, the W-8CE, is filed to provide the IRS with notice of a taxpayer's expatriation.

[24] The United States imposes tax on the beneficial owner of income, not its formal recipient. For example, if a U.S. citizen owns securities that are held in "street" name at a brokerage firm, that U.S. citizen (and not the brokerage firm nominee) is treated as the beneficial owner of the securities. A corporation (and not its shareholders) ordinarily is treated as the beneficial owner of the corporation's income. Similarly, a foreign complex trust ordinarily is treated as the beneficial owner of income that it receives, and a U.S. beneficiary or grantor is not subject to tax on that income unless and until he receives a distribution.

owner of U.S.-source effectively-connected income;[25] and (3) the IRS Form W-8EXP, which is provided by a beneficial owner of U.S.-source income that is an exempt organization or foreign government.[26] Each of these forms requires that the beneficial owner provide its name and address and certify that the beneficial owner is not a U.S. person. The IRS Form W-8BEN also includes a certification of eligibility for treaty benefits (for completion where applicable). All certifications on IRS Forms W-8 are made under penalties of perjury.

The fourth type of IRS Form W-8 is the IRS Form W-8IMY, which is provided by a payee that receives a payment of U.S.-source income as an intermediary for the beneficial owner of that income. The intermediary's IRS Form W-8IMY must be accompanied by an IRS Form W-8BEN, W-8EXP, or W-8ECI, as applicable,[27] furnished by the beneficial owner, unless the intermediary is a qualified intermediary ("QI"), a withholding foreign partnership, or a withholding foreign trust. The rules applicable to qualified intermediaries are discussed below. A withholding foreign partnership or trust is a foreign partnership or trust that has entered into an agreement with the IRS to collect appropriate IRS Forms W-8 from its partners or beneficiaries and act as a U.S. withholding agent with respect to those persons.[28]

A withholding agent that makes payments of U.S.-source amounts to a foreign person is required to report those payments, including any amounts of U.S. tax withheld, to the IRS on IRS Forms 1042 and 1042-S by March 15 of the calendar year following the year in which the payment is made.[29]

<u>Information reporting and backup withholding with respect to U.S. persons</u>

Every person engaged in a trade or business must file with the IRS an information return on IRS Form 1099 (or, for wages or other compensation, on IRS Form W-2) for payments of certain amounts totaling at least $600 that it makes to another person in the course of its trade or

[25] The IRS Form W-8ECI requires that the beneficial owner specify the items of income to which the form is intended to apply and certify that those amounts are effectively connected with the conduct of a trade or business in the United States and includible in the beneficial owner's gross income for the taxable year.

[26] The IRS Form W-8EXP requires that the beneficial owner certify as to its qualification as a foreign government, an international organization, a foreign central bank of issue or a foreign tax-exempt organization, in each case meeting certain requirements.

[27] In limited cases, the intermediary may furnish documentary evidence, other than the IRS Form W-8, of the status of the beneficial owner.

[28] Rev. Proc. 2003-64, 2003-32 I.R.B. 306 (July 10, 2003), provides procedures for qualification as a withholding foreign partnership or withholding foreign trust in addition to providing model withholding agreements.

[29] Treas. Reg. sec. 1.1461-1(b), (c). IRS Form 1042, "Annual Withholding Tax Return for U.S.-Source Income of Foreign Persons," is the IRS form on which a withholding agent reports a summary of the total U.S. source income paid and withholding tax withheld on foreign persons for the year. IRS Form 1042-S, "Foreign Person's U.S. Source Income Subject to Withholding," is the IRS form on which a withholding agent reports, to the foreign person and the IRS, a foreign person's U.S.-source income that is subject to reporting.

business.[30] Detailed rules are provided for the reporting of various types of investment income, including interest, dividends, and gross proceeds from brokered transactions (such as a sale of stock).[31] In general, the requirement to file IRS Form 1099 applies with respect to amounts paid to U.S. persons and is linked to the backup withholding rules of section 3406. Thus, to avoid backup withholding, a U.S. payee (other than exempt recipients, including corporations and financial institutions) of interest, dividends, or gross proceeds generally must furnish to the payor an IRS Form W-9 providing that person's name and taxpayer identification number.[32] That information is then used to complete the IRS Form 1099.

If an IRS Form W-9 is not provided by a U.S. payee (other than payees exempt from reporting), the payor is required to impose a backup withholding tax of 28 percent of the gross amount of the payment.[33] The backup withholding tax may be credited by the payee against regular income tax liability.[34] This combination of reporting and backup withholding is designed to ensure that U.S. persons not exempt from reporting pay tax with respect to investment income, either by providing the IRS with the information that it needs to audit payment of the tax or, in the absence of such information, requiring collection of the tax on payment.

As described above, amounts paid to foreign persons are generally exempt from information reporting on IRS Form 1099. Foreign persons are subject to a separate information reporting requirement linked to the nonresident withholding provisions of chapter 3 of the Code.

In the case of U.S. source investment income, the information reporting, backup withholding and nonresident withholding rules apply broadly to any financial institution or other payor, including foreign financial institutions.[35] As a practical matter, however, these reporting and withholding requirements are difficult to enforce with respect to foreign financial institutions, unless these institutions have some connection to the United States, e.g., the institution is a foreign subsidiary of a U.S. financial institution, or the foreign financial

[30] Sec. 6041; Treas. Reg. secs. 1.6041-1, 1.6041-2.

[31] See secs. 6042 (dividends), 6045 (broker reporting), 6049 (interest), and the corresponding Treasury regulations.

[32] See Treas. Reg. secs. 31.3406(d)-1, 31.3406(h)-3.

[33] Sec. 3406(a)(1).

[34] Sec. 3406(h)(10).

[35] See Treas. Reg. secs. 1.1441-7(a) (definition of withholding agent includes foreign persons), 31.3406(a)-2 (payor for backup withholding purposes means the person (the payor) required to file information returns for payments of interest, dividends, and gross proceeds (and other amounts)), 1.6049-4(a)(2) (definition of payor for interest reporting purposes does not exclude foreign persons), 1.6042-3(b)(2) (payor for dividend reporting purposes has the same meaning as for interest reporting purposes), 1.6045-1(a)(1) (brokers required to report include foreign persons). But see Treas. Reg. secs. 1.6049-5(b) (exception for interest from sources outside the U.S. paid outside the U.S. by a non-U.S. payor or a non-U.S. middleman), 1.6045-1(g)(1)(i) (exception for sales effected at an office outside the U.S. by a non-U.S. payor or a non-U.S. middleman), 1.6042-3(b)(1)(iv) (exceptions for distributions from sources outside the U.S. by a non-U.S. payor or a non-U.S. middleman).

institution is doing business in the United States. Moreover, to the extent that these rules apply to foreign financial institutions, the rules may also be modified by QI agreements between the institutions and the IRS, as described below.

The qualified intermediary program

A QI is defined as a foreign financial institution or a foreign clearing organization, other than a U.S. branch or U.S. office of such institution or organization or a foreign branch of a U.S. financial institution that has entered into a withholding and reporting agreement (a "QI agreement") with the IRS.[36]

A foreign financial institution that becomes a QI is not required to forward beneficial ownership information with respect to its customers to a U.S. financial institution or other withholding agent of U.S.-source investment-type income to establish the customer's eligibility for an exemption from, or reduced rate of, U.S. withholding tax.[37] Instead, the QI is permitted to establish for itself the eligibility of its customers for an exemption or reduced rate, based on an IRS Form W-8 or W-9, or other specified documentary evidence, and information as to residence obtained under the know-your-customer rules to which the QI is subject in its home jurisdiction as approved by the IRS or as specified in the QI agreement.[38] The QI certifies as to eligibility on behalf of its customers, and provides withholding rate pool information to the U.S. withholding agent as to the portion of each payment that qualifies for an exemption or reduced rate of withholding.

The IRS has published a model QI agreement for foreign financial institutions.[39] A prospective QI must submit an application to the IRS providing specified information, and any additional information and documentation requested by the IRS. The application must establish to the IRS's satisfaction that the applicant has adequate resources and procedures to comply with the terms of the QI agreement.

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[36] The definition also includes: a foreign branch or office of a U.S. financial institution or U.S. clearing organization; a foreign corporation for purposes of presenting income tax treaty claims on behalf of its shareholders; and any other person acceptable to the IRS, in each case that such person has entered into a withholding agreement with the IRS. Treas. Reg. sec. 1.1441-1(e)(5)(ii).

[37] U.S. withholding agents are allowed to rely on a QI's IRS Form W-8IMY without any underlying beneficial owner documentation. By contrast, nonqualified intermediaries are required both to provide an IRS Form W-8IMY to a U.S. withholding agent and to forward with that document IRS Forms W-8 or W-9 or other specified documentation for each beneficial owner.

[38] See Rev. Proc. 2000-12, 2000-1 C.B. 387, QI agreement secs. 2.12, 2.12, 5.03, 6.01.

[39] Rev. Proc. 2000-12, 2000-1 C.B. 387, *supplemented by* Announcement 2000-50, 2000-1 C.B. 998, and *modified by* Rev. Proc. 2003-64, 2003-2 C.B. 306, and Rev. Proc. 2005-77, 2005-2 C.B. 1176. The QI agreement applies only to foreign financial institutions, foreign clearing organizations, and foreign branches or offices of U.S. financial institutions or U.S. clearing organizations. However, the principles of the QI agreement may be used to conclude agreements with other persons defined as QIs.

Before entering into a QI agreement that provides for the use of documentary evidence obtained under a country's know-your-customer rules, the IRS must receive (1) that country's know-your-customer practices and procedures for opening accounts and (2) responses to 18 related items.[40] If the IRS has already received this information, a particular prospective QI need not submit it again. The IRS has received such information and has approved know-your-customer rules in 59 countries.

A foreign financial institution or other eligible person becomes a QI by entering into an agreement with the IRS. Under the agreement, the financial institution acts as a QI only for accounts that the financial institution has designated as QI accounts. A QI is not required to act as a QI for all of its accounts; however, if a QI designates an account as one for which it will act as a QI, it must act as a QI for all payments made to that account.

The model QI agreement describes in detail the QI's withholding and reporting obligations. Certain key aspects of the model agreement are described below.[41]

Withholding and reporting responsibilities

As a technical matter, all QIs are withholding agents for purposes of the nonresident withholding and reporting rules, and payors (who are required to withhold and report) for purposes of the backup withholding and IRS Form 1099 information reporting rules. However, under the QI agreement, a QI may choose not to assume primary responsibility for nonresident withholding. In that case, the QI is not required to withhold on payments made to non-U.S. customers, or to report those payments on IRS Form 1042-S. Instead, the QI must provide a U.S. withholding agent with an IRS Form W-8IMY that certifies as to the status of its (unnamed) non-U.S. account holders and withholding rate pool information.

Similarly, a QI may choose not to assume primary responsibility for IRS Form 1099 reporting and backup withholding. In that case, the QI is not required to backup withhold on payments made to U.S. customers or to file IRS Forms 1099. Instead, the QI must provide a U.S. payor with an IRS Form W-9 for each of its U.S. non-exempt recipient account holders (i.e., account holders that are U.S. persons not generally exempt from IRS Form 1099 reporting and backup withholding).[42]

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[40] See Rev. Proc. 2000-12, 2000-1 C.B. 387, sec. 3.02.

[41] Additional detail can be found in Joint Committee on Taxation, *Selected Issues Relating to Tax Compliance with Respect to Offshore Accounts and Entities* (JCX-65-08), July 23, 2008.

[42] Regardless of whether a QI assumes primary Form 1099 reporting and backup withholding responsibility, the QI is responsible for IRS Form 1099 reporting and backup withholding on certain reportable payments that are not reportable amounts. See Rev. Proc. 2000-12, 2001-1 C.B. 387, QI agreement sec. 2.43 (defining reportable amount), sec. 2.44 (defining reportable payment), sec. 3.05, sec. 8.04. The reporting responsibility differs depending on whether the QI is a U.S. payor or a non-U.S. payor. Examples of payments for which the QI assumes primary IRS Form 1099 reporting and backup withholding responsibility include certain broker proceeds from the sale of certain assets owned by a U.S. non-exempt recipient and payments of certain foreign-source income to a U.S. non-exempt recipient if such income is paid in the United States or to an account maintained in the United States.

A QI may elect to assume primary nonresident withholding and reporting responsibility, primary backup withholding and IRS Form 1099 reporting responsibility, or both.[43] A QI that assumes such responsibility is subject to all of the related obligations imposed by the Code on U.S. withholding agents or payors. The QI must also provide the U.S. withholding agent (or U.S. payor) additional information about the withholding rates to enable the withholding agent to appropriately withhold and report on payments made through the QI. These rates can be supplied with respect to withholding rate pools that aggregate payments of a single type of income (e.g., interest or dividends) that is subject to a single rate of withholding.

If a U.S. non-exempt recipient has not provided a IRS Form W-9, the QI must disclose the name, address, and taxpayer identification number ("TIN") (if available) to the withholding agent (and the withholding agent must apply backup withholding). However, no such disclosure is necessary if the QI is, under local law, prohibited from making the disclosure and the QI has followed certain procedural requirements (including providing for backup withholding, as described further below).

Documentation of account holders

A QI agrees to use its best efforts to obtain documentation regarding the status of their account holders in accordance with the terms of its QI agreement.[44] A QI must apply presumption rules[45] unless a payment can be reliably associated with valid documentation from the account holder. The QI agrees to adhere to the know-your-customer rules set forth in the QI agreement with respect to the account holder from whom the evidence is obtained.

A QI may treat an account holder as a foreign beneficial owner of an amount if the account holder provides a valid IRS Form W-8 (other than an IRS Form W-8IMY) or valid documentary evidence that supports the account holder's status as a foreign person.[46] With such documentation, a QI generally may treat an account holder as entitled to a reduced rate of withholding if all the requirements for the reduced rate are met and the documentation supports

[43] To the extent that a QI assumes primary responsibility for an account, it must do so for all payments made by the withholding agent to that account. See Rev. Proc. 2000-12, QI agreement sec. 3.

[44] See Rev. Proc. 2000-12, QI agreement sec. 5.

[45] The QI agreement contains its own presumption rules. See Rev. Proc. 2000-12, QI agreement sec. 5.13(C). An amount subject to withholding that is paid outside the United States to an account maintained outside the United States is presumed made to an undocumented foreign account holder (i.e., subject to 30-percent withholding). Payments of U.S. source deposit interest and certain other U.S. source interest and original issue discount paid outside of the United States to an offshore account is presumed made to an undocumented U.S. non-exempt account holder (i.e., subject to backup withholding). For payments of foreign source income, broker proceeds and certain other amounts, the QI can assume such payments are made to an exempt recipient if the amounts are paid outside the United States to an account maintained outside the United States.

[46] Documentary evidence is any documentation obtained under know-your-customer rules per the QI agreement, evidence sufficient to establish a reduced rate of withholding under Treas. Reg. sec. 1.1441-6, and evidence sufficient to establish status for purposes of chapter 61 under Treas. Reg. 1.6049-5(c). See Rev. Proc. 2000-12, QI agreement sec. 2.12.

entitlement to a reduced rate. A QI may not reduce the rate of withholding if the QI knows that the account holder is not the beneficial owner of a payment to the account.

If a foreign account holder is the beneficial owner of a payment, then a QI may shield the account holder's identity from U.S. custodians and the IRS. If a foreign account holder is not the beneficial owner of a payment (for example, because the account holder is a nominee), the account holder must provide the QI with an IRS Form W-8IMY for itself along with specific information about each beneficial owner to which the payment relates. A QI that receives this information may shield the account holder's identity from a U.S. custodian, but not from the IRS.[47]

In general, if an account holder is a U.S. person, the account holder must provide the QI with an IRS Form W-9 or appropriate documentary evidence that supports the account holder's status as a U.S. person. However, if a QI does not have sufficient documentation to determine whether an account holder is a U.S. or foreign person, the QI must apply certain presumption rules detailed in the QI agreement. These presumption rules may not be used to grant a reduced rate of nonresident withholding; instead they merely determine whether a payment should be subject to full nonresident withholding (at a 30-percent rate), subject to backup withholding (at a 28-percent rate), or treated as exempt from backup withholding.

In general, under the QI agreement presumptions, U.S.-source investment income that is paid outside the United States to an offshore account is presumed to be paid to an undocumented foreign account holder. A QI must treat such a payment as subject to withholding at a 30-percent rate and report the payment to an unknown account holder on IRS Form 1042-S. However, most U.S.-source deposit interest and interest or original issue discount on short-term obligations that is paid outside the United States to an offshore account is presumed made to an undocumented U.S. non-exempt recipient account holder and thus is subject to backup withholding at a 28-percent rate.[48] Importantly, both foreign-source income and broker proceeds are presumed to be paid to a U.S. exempt recipient (and thus are exempt from both nonresident and backup withholding) when such amounts are paid outside the United States to an offshore account.

QI information return requirements

A QI must file IRS Form 1042 by March 15 of the year following any calendar year in which the QI acts as a QI. A QI is not required to file IRS Forms 1042-S for amounts paid to each separate account holder, but instead files a separate IRS Form 1042-S for each type of reporting pool.[49] A QI must file separate IRS Forms 1042-S for amounts paid to certain types of account holders, including: (1) other QIs which receive amounts subject to foreign withholding; (2) each foreign account holder of a nonqualified intermediary or other flow-through entity to the

[47] This rule restricts one of the principal benefits of the QI regime, nondisclosure of account holders, to financial institutions that have assumed the documentation and other obligations associated with QI status.

[48] These amounts are statutorily exempt from nonresident withholding when paid to non-U.S. persons.

[49] A reporting pool consists of income that falls within a particular withholding rate and within a particular income code, exemption code, and recipient code as determined on IRS Form 1042-S.

extent that the QI can reliably associate such amounts with valid documentation; and (3) unknown recipients of amounts subject to withholding paid through a nonqualified intermediary or other flow-through entity to the extent the QI cannot reliably associate such amounts with valid documentation. The IRS Form 1042 must also include an attachment setting forth the aggregate amounts of reportable payments paid to U.S. non-exempt recipient account holders, and the number of such account holders, whose identity is prohibited by foreign law (including by contract) from disclosure.[50]

A QI has specified IRS Form 1099[51] filing requirements including: (1) filing an aggregate IRS Form 1099 for each type of reportable amount paid to U.S. non-exempt recipient account holders whose identities are prohibited by law from being disclosed; (2) filing an aggregate IRS Form 1099 for reportable payments other than reportable amounts[52] paid to U.S. non-exempt recipient account holders whose identities are prohibited by law from being disclosed; (3) filing separate IRS Forms 1099 for reportable amounts paid to U.S. non-exempt recipient account holders for whom the QI has not provided an IRS Form W-9 or identifying information to a withholding agent; (4) filing separate IRS Forms 1099 for reportable payments other than reportable amounts paid to U.S. non-exempt recipient account holders; (5) filing separate IRS Forms 1099 for reportable amounts paid to U.S. non-exempt recipient accounts holders for which the QI has assumed primary IRS Form 1099 reporting and backup withholding responsibility; and (6) filing separate IRS Forms 1099 for reportable payments to an account holder that is a U.S. person if the QI has applied backup withholding and the amount was not otherwise reported on an IRS Form 1099.

Foreign law prohibition of disclosure

The QI agreement includes procedures to address situations in which foreign law (including by contract) prohibits the QI from disclosing the identities of U.S. non-exempt recipients (such as individuals). Separate procedures are provided for accounts established with a QI prior to January 1, 2001, and for accounts established on or after January 1, 2001.

Accounts established prior to January 1, 2001.–For accounts established prior to January 1, 2001, if the QI knows that the account holder is a U.S. non-exempt recipient, the QI must (1) request from the account holder the authority to disclose its name, address, TIN (if available), and reportable payments; (2) request from the account holder the authority to sell any assets that

[50] For undisclosed accounts, QIs must separately report each type of reportable payment (determined by reference to the types of income reported on IRS Forms 1099) and the number of undisclosed account holders receiving such payments.

[51] If the QI is required to file IRS Forms 1099, it must file the appropriate form for the type of income paid (e.g., IRS Form 1099-DIV for dividends, IRS Form 1099-INT for interest, and IRS Form 1099-B for broker proceeds).

[52] The term reportable amount generally includes those amounts that would be reported on IRS Form 1042-S if the amount were paid to a foreign account holder. The term reportable payment generally refers to amounts subject to backup withholding, but it has a different meaning depending upon the status of the QI as a U.S. or non-U.S. payor.

generate, or could generate, reportable payments; or (3) request that the account holder disclose itself by mandating the QI to provide an IRS Form W-9 completed by the account holder. The QI must make these requests at least two times during each calendar year and in a manner consistent with the QI's normal communications with the account holder (or at the time and in the manner that the QI is authorized to communicate with the account holder). Until the QI receives a waiver on all prohibitions against disclosure, authorization to sell all assets that generate, or could generate, reportable payments, or a mandate from the account holder to provide an IRS Form W-9, the QI must backup withhold on all reportable payments paid to the account holder and report those payments on IRS Form 1099 or, in certain cases, provide another withholding agent with all of the information required for that withholding agent to backup withhold and report the payments on IRS Form 1099.

Accounts established on or after January 1, 2001.–For any account established by a U.S. non-exempt recipient on or after January 1, 2001, the QI must (1) request from the account holder the authority to disclose its name, address, TIN (if available), and reportable payments; (2) request from the account holder, prior to opening the account, the authority to exclude from the account holder's account any assets that generate, or could generate, reportable payments; or (3) request that the account holder disclose itself by mandating the QI to transfer an IRS Form W-9 completed by the account holder.

If a QI is authorized to disclose the account holder's name, address, TIN, and reportable amounts, it must obtain a valid IRS Form W-9 from the account holder, and, to the extent the QI does not have primary IRS Form 1099 and backup withholding responsibility, provide the IRS Form W-9 to the appropriate withholding agent promptly after obtaining the form. If an IRS Form W-9 is not obtained, the QI must provide the account holder's name, address, and TIN (if available) to the withholding agents from whom the QI receives reportable amounts on behalf of the account holder, together with the withholding rate applicable to the account holder. If a QI is not authorized to disclose an account holder's name, address, TIN (if available), and reportable amounts, but is authorized to exclude from the account holder's account any assets that generate, or could generate, reportable payments, the QI must follow procedures designed to ensure that it will not hold any assets that generate, or could generate, reportable payments in the account holder's account.[53]

External audit procedures

The IRS generally does not audit a QI with respect to withholding and reporting obligations covered by a QI agreement if an approved external auditor conducts an audit of the QI. An external audit must be performed in the second and fifth full calendar years in which the QI agreement is in effect. In general, the IRS must receive the external auditor's report by June 30 of the year following the year being audited.

[53] Under both of these procedures, if the QI is a non-U.S. payor, a U.S. non-exempt recipient may effectively avoid disclosure and backup withholding by investing in assets that generate solely non-reportable payments such as foreign source income (such as bonds issued by a foreign government) paid outside of the United States.

Requirements for the external audit are provided in the QI agreement. In general, the QI must permit the external auditor to have access to all relevant records of the QI, including information regarding specific account holders. In addition, the QI must permit the IRS to communicate directly with the external auditor, review the audit procedures followed by the external auditor, and examine the external auditor's work papers and reports.

In addition to the external audit requirements set forth in the QI agreement, the IRS has issued further guidance (the "QI audit guidance") for an external auditor engaged by a QI to verify the QI's compliance with the QI agreement.[54] An external auditor must conduct its audit in accordance with the procedures described in the QI agreement. However, the QI audit guidance is intended to assist the external auditor in understanding and applying those procedures. The QI audit guidance does not amend, modify, or interpret the QI agreement.

Term of a QI agreement

A QI agreement expires on December 31 of the fifth full calendar year after the year in which the QI agreement first takes effect, although it may be renewed. Either the IRS or the QI may terminate the QI agreement prior to its expiration by delivering a notice of termination to the other party. However, the IRS generally does not terminate a QI agreement unless there is a significant change in circumstances or an event of default occurs, and the IRS determines that the change in circumstance or event of default warrants termination. In the event that an event of default occurs, a QI is given an opportunity to cure it within a specified time.

Know-your-customer due diligence requirements

United States

The U.S. know-your-customer rules[55] require financial institutions[56] to develop and maintain a written customer identification program and anti-money laundering policies and procedures. Additionally, financial institutions must perform customer due diligence. The due diligence requirements are enhanced where the account or the financial institution has a higher risk profile.[57]

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[54] Rev. Proc. 2002-55, 2002-2 C.B. 435.

[55] The U.S. know-your-customer rules are primarily found in the Bank Secrecy Act of 1970 and in Title III, The International Money Laundering Abatement and Anti-Terrorist Financing Act of 2001 of the USA PATRIOT Act.

[56] The term financial institution is broadly defined under 31 U.S.C. sec. 5312(a)(2) or (c)(1) and includes U.S. banks and agencies or branches of foreign banks doing business in the United States, insurance companies, credit unions, brokers and dealers in securities or commodities, money services businesses, and certain casinos.

[57] Relevant risks include the types of accounts held at the financial institution, the methods available for opening accounts, the types of customer identification information available, and the size, location, and customer base of the financial institution. 31 C.F.R. sec. 103.121(b)(2).

A customer identification program at a minimum requires the financial institution to collect the name, date of birth (for individuals), address,[58] and identification number[59] for new customers. In fulfilling their customer due diligence requirements, financial institutions are required to verify enough customer information to enable the financial institution to form a "reasonable belief that it knows the true identity of each customer."[60]

In many cases the know-your-customer rules do not require financial institutions to look through an entity to determine its ultimate ownership.[61] However, based on the financial institution's risk assessment, the financial institution may need to obtain information about individuals with authority or control over such an account in order to verify the identity of the customer.[62] A financial institution's customer due diligence must include gathering sufficient information on a business entity and its owners for the financial institution to understand and assess the risks of the account relationship.[63]

Enhanced due diligence is required if customers are deemed to be of higher risk, and is mandated for certain types of accounts including foreign correspondent accounts, private banking accounts, and accounts for politically exposed persons. Private banking accounts are considered to be of significant risk and enhanced due diligence requires identification of nominal and beneficial owners for these accounts.[64]

Financial institutions must maintain records for a minimum of five years after the account is closed or becomes dormant. They are required to monitor accounts including the frequency, size and ultimate destinations of transfers and must update customer due diligence and enhanced

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[58] For a person other than an individual the address is the principal place of business, local office, or other physical location. 31 C.F.R. sec. 103.121(b)(2)(i)(3)(iii).

[59] For a U.S. person the identification number is the TIN. For a non-U.S. person the identification number could be a TIN, passport number, alien identification number, or number and country of issuance of any other government-issued document evidencing nationality or residence and bearing a photograph or similar safeguard. 31 C.F.R. sec. 103.121(b)(2)(i)(4).

[60] See 31 C.F.R. sec. 103.121(b)(2).

[61] For example, a financial institution is not "required to look through trust, escrow, or similar accounts to verify the identities of beneficiaries and instead will only be required to verify the identity of the named accountholder." See 68 Fed. Reg. 25,090, 25,094 (May 9, 2003).

[62] See 31 C.F.R. sec. 103.121(b)(2)(ii)(C).

[63] In order to assess the risk of the account relationship, a financial institution may need to ascertain the type of business, the purpose of the account, the source of the account funds, and the source of the wealth of the owner or beneficial owner of the entity.

[64] 31 C.F.R. sec. 103.178. A private banking account is an account that (1) requires a minimum deposit of not less than 1 million dollars; (2) is established for the benefit of one or more non-U.S. persons who are direct or beneficial owners of the account; and (3) is administered or managed by an officer, employee or agent of the financial institution. Beneficial owner for these purposes is defined as an individual who has a level of control over, or entitlement to the funds or assets in the account. 31 C.F.R. secs. 103.175(b), 103.175(o).

due diligence when there are significant changes to the customer's profile (for example, volume of transaction activity, risk level, or account type).

European Union Third Money Laundering Directive

The European Union ("EU") Third Money Laundering Directive[65] is also applicable to a broad range of persons including credit institutions and financial institutions as well as to persons acting in the exercise of certain professional activities.[66] It requires systems, adequate policies and procedures for customer due diligence, reporting, record keeping, internal controls, risk assessment, risk management, compliance management, and communication. Required customer due diligence measures go further than the know-your-customer rules in the United States in requiring identification and verification of the beneficial owner and an understanding of the ownership and control structure of the customer in addition to the basic customer identification program and customer due diligence requirements.

A beneficial owner is defined as the natural person who ultimately owns or controls the customer and/or the natural person on whose behalf a transaction or activity is being conducted. For corporations, beneficial owner includes: (1) the natural person or persons who ultimately owns or controls a legal entity through direct or indirect ownership or control over a sufficient percentage (25 percent plus one share) of the shares or voting rights in that legal entity; and 2) the natural person or persons who otherwise exercises control over the management of the legal entity.[67] For foundations, trusts, and like entities that administer and distribute funds, beneficial owner includes: (1) in cases in which future beneficiaries are determined, a natural person who is the beneficiary of 25 percent or more of the property; (2) in cases in which future beneficiaries have yet to be determined, the class of person in whose main interest the legal arrangement is set up or operates; and (3) natural person who exercises control over 25 percent or more of the property.[68] Under the EU Third Money Laundering Directive, EU member states generally must require identification of the customer and any beneficial owners before the establishment of a business relationship.[69]

The EU Third Money Laundering Directive requires ongoing account monitoring including scrutiny of transactions throughout the course of relationship to ensure that the transactions conducted are consistent with the customer and the business risk profile. It requires documents and other information to be updated and requires performance of customer due diligence procedures at appropriate times (such as a change in account signatories or change in

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[65] Directive 2005/60/EC of the European Parliament and of the Council, October 26, 2005 ("EU Third Money Laundering Directive").

[66] The directive applies to auditors, accountants, tax advisors, notaries, legal professionals, real estate agents, certain persons trading in goods (cash transactions in excess of EUR 15,000), and casinos.

[67] EU Third Money Laundering Directive Art. 3(6)(a). Inquiries into beneficial ownership generally may stop at the level of any owner that is a company listed on a regulated market.

[68] EU Third Money Laundering Directive Art. 3(6)(b).

[69] EU Third Money Laundering Directive Art. 9.

the use of an account) for existing customers on a risk sensitive basis. Records must be maintained for up to five years after the customer relationship has ended.

Explanation of Provision

The provision adds a new chapter 4 to the Code that provides for withholding taxes to enforce new reporting requirements on specified foreign accounts owned by specified U.S. persons or by U.S.-owned foreign entities. The provision establishes rules for withholdable payments to foreign financial institutions and withholdable payments to other foreign entities.

Withholdable payments to foreign financial institutions

The provision requires a withholding agent to deduct and withhold a tax equal to 30 percent on any withholdable payment made to a foreign financial institution. However, no withholding is required if the financial institution meets certain requirements. Specifically, withholding is not required if an agreement is in effect between the foreign financial institution and the Secretary of the Treasury (the "Secretary") under which the institution agrees to:

1. Obtain information from each account holder as is necessary to determine which accounts are U.S. accounts;

2. Comply with verification and due diligence procedures as the Secretary requires with respect to the identification of U.S. accounts;

3. Report annually certain information with respect to any U.S. account maintained by such institution;

4. Comply with requests by the Secretary for additional information with respect to any U.S. account maintained by such institution; and

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

The provision applies with respect to U.S. accounts maintained by the foreign financial institution and, except as provided by the Secretary, to U.S. accounts maintained by each other financial institution that is a member of the same expanded affiliated group (other than any foreign financial institution which also enters into an agreement with the Secretary). The Secretary may proscribe due diligence and verification procedures with respect to the identification and verification of account holders. Due diligence could include procedures required by the foreign financial institution to ensure compliance with the agreement. Verification could include independent review procedures to ensure a foreign financial institution's compliance with its obligations under this provision. If the Secretary determines that the foreign financial institution is out of compliance with the agreement, the agreement may be terminated by the Secretary.

A foreign financial institution meets the annual information reporting requirements under the provision by reporting the following information:

1. The name, address, and TIN of each account holder that is a specified U.S. person;

2. The name, address, and TIN of each substantial U.S. owner of any account holder that is a U.S.-owned foreign entity;

3. The account number;

4. The account balance or value (determined at such time and in such manner as the Secretary provides); and

5. The gross receipts and gross withdrawals or payments from the account (determined for such period and in such manner as the Secretary may provide).

This information is required with respect to each U.S. account maintained by the foreign financial institution and, except as provided by the Secretary, each U.S. account maintained by each other foreign financial institution which is a member of the same expanded affiliated group (other than any foreign financial institution that also enters into an agreement with the Secretary).

Alternatively, a foreign financial institution may make an election and report under sections 6041 (information at source), 6042 (returns regarding payments of dividends and corporate earnings and profits), 6045 (returns of brokers), and 6049 (returns regarding payments of interest), as if such institution were a U.S. person (i.e., elect to provide full IRS Form 1099 reporting under these sections). Under this election, the foreign financial institution reports on each account holder that is a specified U.S. person or U.S.-owned foreign entity as if the holder of the account were a natural person and citizen of the United States. As a result, both U.S.- and foreign-source amounts (including gross proceeds) are subject to reporting under this election regardless of whether the amounts are paid inside or outside the United States. If a foreign financial institution makes the election, the institution is also required to report the following information with respect to each U.S. account maintained by the institution: (1) the name, address, and TIN of each account holder that is a specified U.S. person; (2) the name, address, and TIN of each substantial U.S. owner of any account holder that is a U.S.-owned foreign entity; and (3) the account number of the account. This election can be made by a foreign financial institution even if other members of its expanded affiliated group do not make the election. The Secretary has authority to specify the time and manner of the election and to provide other conditions for meeting the reporting requirements of the election.

A foreign financial institution may rely on certification from an account holder as to whether an account is a U.S. account, and with respect to the name, address and TIN of each specified U.S. person and substantial U.S. owner, only if neither the foreign financial institution nor any entity that is a member of the same expanded affiliated group as the foreign financial institution knows, or has reason to know, that any information provided by the account holder in the certification is incorrect. It is expected that in applying this rule, the foreign financial institution and the other members of the same expanded affiliated group comply with know-your-customer, anti-money laundering, anti-corruption, or other similar rules to which they are subject, as well as with such procedures and rules as the Secretary may prescribe, both with respect to due diligence by the foreign financial institution and verification by or on behalf of the IRS.

Foreign financial institutions that have entered into QI or similar agreements with the Secretary, under section 1441 and the regulations thereunder, are required to meet the requirements of this provision in addition to any other requirements imposed under the QI or similar agreement.

Under the provision, a U.S. account is any financial account held by one or more specified U.S. persons or U.S.-owned foreign entities. Depository accounts are not treated as financial accounts for these purposes if (1) all holders of the account are natural persons and (2) the aggregate value of all depository accounts held (in whole or in part) by each holder of the account maintained by the financial institution does not exceed $10,000. A higher threshold of $50,000 applies to accounts in existence on the date of enactment. A foreign financial institution may, however, elect to include all depository accounts held by U.S. individuals as U.S. accounts. All financial institutions that are part of the same expanded affiliated group are treated as a single financial institution for purposes of determining the aggregate value of depository accounts maintained at the financial institution.

A financial account for purposes of this provision is any depository or custodial account maintained by a foreign financial institution and, except as otherwise provided by the Secretary, any equity or debt interest in a foreign financial institution (other than interests that are regularly traded on an established securities market).

A U.S.-owned foreign entity is any foreign entity that has one or more substantial U.S. owners. A foreign entity is any entity which is not a U.S. person.

A foreign financial institution is any financial institution that is a foreign entity. A financial institution for these purposes is (1) any entity that accepts deposits in the ordinary course of a banking or similar business, (2) any entity that is engaged in the business of holding financial assets for the account of others, and (3) any entity engaged (or holding itself out as being engaged) primarily in the business of investing, reinvesting, or trading in securities,[70] interests in partnerships, commodities,[71] or any interest (including a futures or forward contract or option) in such securities, partnership interests, or commodities. Accordingly, the term financial institution may include among other entities, investment vehicles such as hedge funds and private equity funds.

The reporting requirements apply with respect to U.S. accounts maintained by the foreign financial institution and, except as otherwise provided by the Secretary, with respect to U.S. accounts maintained by each other foreign financial institution that is a member of the same expanded affiliated group as such foreign financial institution. An expanded affiliated group for

[70] As defined in section 475(c)(2), without regard to the last sentence thereof.

[71] As defined in section 475(e)(2).

these purposes is an affiliated group as defined in section 1504(a) except that "more than 50 percent" is substituted for "at least 80 percent" each place it appears in that section, and is determined without regard to paragraphs (2) and (3) of section 1504(b). A partnership or any other entity that is not a corporation is treated as a member of an expanded affiliated group if such entity is controlled by members of such group.[72]

Under the provision, a withholding agent includes any person, in whatever capacity, having the control, receipt, custody, disposal, or payment of any withholdable payment. A withholdable payment is any payment of interest, dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodical gains, profits, and income from sources within the United States. The term also includes any gross proceeds from the sale of any property that could produce interest or dividends from sources within the United States.

A substantial U.S. owner is: (1) with respect to any corporation, any specified U.S. person that directly or indirectly owns more than 10 percent of the stock (by vote or value) of such corporation; (2) with respect to any partnership, a specified U.S. person that directly or indirectly owns more than 10 percent of the profits or capital interests of such partnership; and (3) with respect to any trust, any specified U.S. person treated as an owner of any portion of such trust under the grantor trust rules.[73] To the extent the foreign entity is a corporation or partnership engaged (or holding itself out as being engaged) primarily in the business of investing, reinvesting, or trading in securities, interests in partnerships, commodities, or any interest (including a futures or forward contract or option) in such securities, interests or commodities, the 10-percent threshold is reduced to zero percent. In determining whether an entity is a U.S.-owned foreign entity (and whether any person is a substantial U.S. owner of such entity), only specified U.S. persons are considered.

Except as otherwise provided by the Secretary, a specified U.S. person is any U.S. person other than (1) a publicly traded corporation or a member of the same expanded affiliated group as a publicly traded corporation, (2) any tax-exempt organization or individual retirement plan, (3) the United States or a wholly owned agency or instrumentality of the United States, (4) a State, the District of Columbia, any possession of the United States, or a political subdivision or wholly owned agency of a State, the District of Columbia, or a possession of the United States, (5) a bank,[74] (6) a real estate investment trust,[75] (7) a regulated investment company,[76] (8) a

[72] Control for these purposes has the same meaning as control for purposes of section 954(d)(3).

[73] Subpart E of Part I of subchapter J of chapter 1.

[74] As defined in section 581.

[75] As defined in section 856.

[76] As defined in section 851.

common trust fund,[77] and (9) a trust that is exempt from tax under section 664(c)[78] or is described in section 4947(a)(1).[79]

This provision does not apply with respect to a payment if the beneficial owner of such payment is a foreign government, a political subdivision or wholly owned agency of any foreign government, an international organization, a foreign central bank of issue, or any other class of persons identified by the Secretary as posing a low risk of tax evasion.

Withholdable payments to other foreign entities

The provision requires a withholding agent to deduct and withhold a tax equal to 30 percent of any withholdable payment made to a non-financial foreign entity if the beneficial owner of such payment is a non-financial foreign entity that does not meet specified requirements.

A non-financial foreign entity is any foreign entity that is not a financial institution. A non-financial foreign entity meets the requirements of the provision (i.e., payments made to such entity will not be subject to the imposition of 30-percent withholding tax) if the payee or the beneficial owner of the payment provides the withholding agent with either a certification that the foreign entity does not have a substantial U.S. owner, or provides the withholding agent with the name, address, and TIN of each substantial U.S. owner. Additionally, the withholding agent must not know or have reason to know that the certification or information provided regarding substantial U.S. owners is incorrect, and the withholding agent must report the name, address, and TIN of each substantial U.S. owner to the Secretary.

The provision does not apply to any payment beneficially owned by a publicly traded corporation or a member of an expanded affiliated group of a publicly traded corporation (defined as above without including partnerships or other non-corporate entities). Publicly traded corporations (and their affiliates) receiving payments directly from U.S. withholding agents may present a lower risk of tax evasion than other non-financial foreign entities. The provision does not apply to any payment to any foreign government or a political subdivision or wholly owned agency of any foreign government, any international organization, any foreign central bank of issue, any other class of persons identified by the Secretary for purposes of the provision, or to any class of payments identified by the Secretary as posing a low risk of tax evasion.

Credits and refunds

In general, the determination of whether there is an overpayment of tax deducted and withheld under this chapter is made in the same manner as if the tax had been deducted and withheld under subchapter A of chapter 3 (withholding tax on nonresident aliens and foreign

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[77] As defined in section 584(a).

[78] This includes charitable remainder annuity trusts and charitable remainder unitrusts.

[79] This includes certain charitable trusts not exempt under section 501(a).

corporations). Under this rule, if a beneficial owner of a payment is entitled under an income tax treaty to a reduced rate of withholding tax on the payment, that beneficial owner may be eligible for a credit or refund of the excess of the amount withheld under the provision over the amount permitted to be withheld under the treaty. Similarly, if a payment is of an amount not otherwise subject to U.S. tax (because, for instance, the payment represents gross proceeds from the sale of stock or is interest eligible for the portfolio interest exemption), the beneficial owner of the payment generally is eligible for a credit or refund of the full amount of the tax withheld.

The Secretary has the authority to provide guidance ensuring that taxpayers claiming credits or refunds of amounts withheld from payments to which the provision applies supply appropriate documentation establishing that they are the beneficial owners of the payments from which tax was withheld, and that, in circumstances in which treaty benefits are being claimed, they are eligible for treaty benefits.

In the event that the tax is withheld under this chapter, the credit and refund mechanism ensures that the provisions of chapter 4 are consistent with U.S. obligations under existing income tax treaties. U.S. income tax treaties do not require the United States and its treaty partners to follow a specific procedure for providing treaty benefits.[80] For example, in cases in which proof of entitlement to treaty benefits is demonstrated in advance of payment, the United States may permit reduced withholding or exemption at the time of payment. Alternatively, the United States may require withholding at the relevant statutory at the time of payment and allow treaty country residents to obtain treaty benefits through a refund process. The credit and refund mechanism ensures that residents of treaty partners continue to obtain treaty benefits in the event tax is withheld under the provision.

A special rule applies with respect to any tax deducted and withheld from a specified financial institution payment, which is defined as any withholdable payment with respect to which a foreign financial institution is the beneficial owner. Credits and refunds with respect to specified financial institution payments generally are not allowed. However, refunds and credits

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[80] See, for example, the Commentaries on the OECD Model Tax Convention on Income and on Capital, which make clear that individual countries are free to establish procedures for providing any reduced tax rates agreed to by treaty partners. These procedures can include both relief at source and/or full withholding at domestic rates, followed by a refund. See, e.g., Commentary 26.2 to Article 1.

> A number of Articles of the Convention limit the right of a State to tax income derived from its territory. As noted in paragraph 19 of the Commentary on Article 10 as concerns the taxation of dividends, the Convention does not settle procedural questions and each State is free to use the procedure provided in its domestic law in order to apply the limits provided by the Convention. A State can therefore automatically limit the tax that it levies in accordance with the relevant provisions of the Convention, subject to possible prior verification of treaty entitlement, or it can impose the tax provided for under its domestic law and subsequently refund the part of that tax that exceeds the amount that it can levy under the provisions of the Convention.

Ibid. While Commentary 26.2 notes that a refund mechanism is not the preferred approach, the bill establishes such a mechanism for beneficial owners in certain circumstances. This approach serves to address, in part, observed difficulties in identifying U.S. persons who inappropriately seek treaty benefits to which they are not entitled.

are allowed if, with respect to the payment, the foreign financial institution is entitled to an exemption or a reduced rate of tax by reason of any treaty obligation of the United States. In such a case, the foreign financial institution is entitled to an exemption or a reduced rate of tax only to the extent provided under the treaty. In no event will interest be allowed or paid with respect to any credit or refund of tax properly withheld on a specified financial institution payment.

General provisions

Every person required to deduct and withhold any tax under the provision is liable for such tax and is indemnified against claims and demands of any person for the amount of payments made in accordance with the provision.

No person may use information under the provision except for the purpose of meeting any requirements under the provision or for purposes permitted under section 6103. However, the identity of foreign financial institutions that have entered into an agreement with the Secretary is not treated as return information for purposes of section 6103.

Sections 1441 (nonresident alien withholding) and 1445 (real property interest withholding) are amended under the provision to provide that no tax be deducted and withheld from an amount with respect to which tax is required to be deducted and withheld under the provision. The provision is meant to coordinate withholding required under chapter 4 with withholding provisions under chapter 3. The Secretary may provide further coordinating rules to prevent double withholding, including in situations involving tiered U.S. withholding agents.

The provision grants authority to the Secretary to prescribe regulations necessary and appropriate to carry out the purposes of the provision.

Effective Date

The provision generally applies to payments made after December 31, 2010. The provision does not apply to payments made under obligations outstanding on the date of first committee action if the obligation is in bearer form or if the obligation includes (on the date of the issuance of such obligation) a provision under which the issuer would (but for this provision) be required to make additional payments by reason of the provision.

B. Repeal of Certain Foreign Exceptions to Registered Bond Requirements (sec. 102 of the bill and secs. 163, 165, 871, and 1287 of the Code and 31 U.S.C. sec. 3121)

Present Law

Registration requirement and treatment of bonds not issued in registered form

In general, a taxpayer may deduct all interest paid or accrued within the taxable year on indebtedness.[81] For registration-required obligations, a deduction for interest is allowed only if the obligation is in registered form. Generally, an obligation is treated as issued in registered form if the issuer or its agent maintains a registration of the identity of the owner of the obligation and the obligation can be transferred only through this registration system.[82] A registration-required obligation is any obligation other than one that: (1) is made by a natural person; (2) matures in one year or less; (3) is not of a type offered to the public; or (4) is a foreign targeted obligation.[83]

In applying this requirement, the IRS 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 where 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.[84]

A foreign targeted obligation (to which the registration requirement does not apply) is any obligation satisfying the following requirements: (1) there are arrangements reasonably designed to ensure that such obligation will be sold (or resold in connection with the original issue) only to a person who is not a United States person; (2) interest is payable only outside the United States and its possessions; and (3) the face of the obligation contains a statement that any United States person who holds this obligation will be subject to limitations under the U.S. income tax laws.[85]

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[81] Sec. 163(a).

[82] An obligation is treated as in registered form if (1) it is registered as to both principal and interest with the issuer (or its agent) and transfer of the obligation may be effected only by surrender of the old instrument and either the reissuance by the issuer of the old instrument to the new holder or the issuance by the issuer of a new instrument to the new holder, (2) the right to principal and stated interest on the obligation may be transferred only through a book entry system maintained by the issuer or its agent, or (3) the obligation is registered as to both principal and interest with the issuer or its agent and may be transferred through both of the foregoing methods. Treas. Reg. sec. 5f.103-1(c).

[83] Sec. 163(f)(2)(A). The registration requirement is intended to preserve liquidity while reducing opportunities for noncompliant taxpayers to conceal income and property from the reach of the income, estate and gift taxes. See Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982* (JCS-38-82), December 31, 1982, p. 190.

[84] Priv. Ltr. Rul. 1993-43-018 (1993); Priv. Ltr. Rul. 1993-43-019 (1993); Priv. Ltr. Rul. 1996-13-002 (1996); Notice 2006-99, 2006-2 C.B. 907.

[85] Sec. 163(f)(2)(B).

In addition to the denial of an interest deduction, an excise tax is imposed on the issuer of any registration-required obligation that is not in registered form.[86] The excise tax is equal to one percent of the principal amount of the obligation multiplied by the number of calendar years (or portions thereof) during the period beginning on the date of issuance of the obligation and ending on the date of maturity.

Moreover, any gain realized by the beneficial owner of a registration-required obligation that is not in registered form on the sale or other disposition of the obligation is treated as ordinary income (rather than capital gain), unless the issuer of the obligation was subject to the excise tax described above.[87] Finally, deductions for losses realized by beneficial owners of registration-required obligations that are not in a registered form are disallowed.[88]

Under title 31 of the United States Code, every "registration-required obligation" of the U.S. government must be in registered form.[89] For this purpose, a foreign targeted obligation is excluded from the definition of a registration-required obligation.[90] Thus, a U.S. government foreign targeted obligation can be in bearer (rather than registered) form.

<u>Treatment as portfolio interest</u>

Payments of U.S.-source "fixed or determinable annual or periodical" income, including interest, dividends, and similar types of investment income, that are made to foreign persons are subject to U.S. withholding tax at a 30-percent rate, unless the withholding agent can establish that the beneficial owner of the amount is eligible for an exemption from withholding or a reduced rate of withholding under an income tax treaty.[91] In 1984, the Congress repealed the 30-percent tax on portfolio interest received by a nonresident individual or foreign corporation from sources within the United States.[92]

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[86] Sec. 4701.

[87] Sec. 1287.

[88] Sec. 165(j).

[89] 31 U.S.C. sec. 3121(g)(3). For purposes of title 31 of the United States Code, registration-required obligation is defined as any obligation except: (1) an obligation not of a type offered to the public; (2) an obligation having a maturity (at issue) of not more than one year; or (3) a foreign targeted obligation.

[90] 31 U.S.C. sec. 3121(g)(2).

[91] Secs. 871, 881; Treas. Reg. sec. 1.1441-1(b).

[92] Secs. 871(h) and 881(c). Congress believed that the imposition of a withholding tax on portfolio interest paid on debt obligations issued by U.S. persons might impair the ability of U.S. corporations to raise capital in the Eurobond market (i.e., the global market for U.S. dollar-denominated debt obligations). Congress also anticipated that repeal of the withholding tax on portfolio interest would allow the U.S. Treasury Department direct access to the Eurobond market. See Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* (JCS-41-84), December 31, 1984, pp. 391-92.

The term "portfolio interest" means any interest (including original issue discount) that is (1) paid on an obligation that is in registered form and for which the beneficial owner has provided to the U.S. withholding agent a statement certifying that the beneficial owner is not a U.S. person, or (2) paid on an obligation that is not in registered form and that meets the foreign targeting requirements of section 163(f)(2)(B).[93] Portfolio interest, however, does not include interest received by a 10-percent shareholder,[94] certain contingent interest,[95] interest received by a controlled foreign corporation from a related person,[96] and interest received by a bank on an extension of credit made pursuant to a loan agreement entered into in the ordinary course of its trade or business.[97]

Explanation of Provision

Repeal of the foreign targeted obligation exception to the registration requirement

The provision repeals the foreign targeted obligation exception to the denial of a deduction for interest on bonds not issued in registered form. Thus, under the provision, a deduction for interest will be disallowed with respect to any obligation not issued in registered form, unless that obligation (1) is issued by a natural person, (2) matures in one year or less, or (3) is not of a type offered to the public.

In addition, under the provision, the foreign targeted obligation exception is not available with respect to the excise tax applicable to issuers of registration-required obligations that are not in registered form. Thus, the excise tax applies with respect to any obligation that is not in registered form unless the obligation (1) is issued by a natural person, (2) matures in one year or less, or (3) is not of a type offered to the public.

Further, under the provision, the foreign targeted obligation exception will not be available with respect to the ordinary income treatment of any gain realized by the beneficial owner of a registration-required obligation that is not in registered form on the sale or other disposition of the obligation. Thus, any gain realized upon the sale or other disposition of an

[93] In repealing the 30-percent tax on portfolio interest, under the Deficit Reduction Act of 1984, Congress expressed concern about potential compliance problems in connection with obligations issued in bearer form. Given the foreign targeted exception to the registration requirement under section 163(f)(2)(A), U.S. persons intent on evading U.S. tax on interest income might attempt to buy U.S. bearer obligations overseas, claiming to be foreign persons. These persons might then claim the statutory exemption from withholding tax for the interest paid on the obligations and fail to declare the interest income on their U.S. tax returns, without concern that their ownership of the obligations would come to the attention of the IRS. Because of these concerns, Congress expanded the Treasury's authority to require registration of obligations deigned to be sold to foreign persons. See Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* (JCS-41-84), December 31, 1984, p. 393.

[94] Sec. 871(h)(3).

[95] Sec. 871(h)(4).

[96] Sec. 881(c)(3)(C).

[97] Sec. 881(c)(3)(A).

obligation that is not in registered form is treated as ordinary income (rather than capital gain), unless the obligation (1) is issued by a natural person, (2) matures in one year or less, or (3) is not of a type offered to the public, or the issuer of the obligation was subject to the excise tax described above.

The provision includes a conforming change to title 31 of the United States Code that repeals the foreign targeted exception to the definition of a registration-required obligation. Thus, a foreign targeted obligation of the U.S. government must be in registered form.

Repeal of treatment as portfolio interest

The provision repeals the treatment as portfolio interest of interest paid on bonds that are not issued in registered form but meet the foreign targeting requirements of section 163(f)(2)(B). Under the provision, interest qualifies as portfolio interest only if it is paid on an obligation that is issued in registered form and for which the beneficial owner has provided the withholding agent with a statement certifying that the beneficial owner is not a United States person. Thus, under the provision, interest paid to a foreign person on an obligation that is not issued in registered form is subject to U.S. withholding tax at a 30-percent rate, unless the withholding agent can establish that the beneficial owner of the amount is eligible for another exemption from withholding or a reduced rate of withholding under an income tax treaty.

Effective Date

The provision applies to debt obligations issued after the date which is 180 days after the date of enactment.

II. UNDER REPORTING WITH RESPECT TO FOREIGN ASSETS

A. Disclosure of Information with Respect to Foreign Financial Assets (sec. 201 of the bill and new sec. 6038D of the Code)

Present Law

U.S. persons who transfer assets to, and hold interests in, foreign bank accounts or foreign entities may be subject to self-reporting requirements under both Title 26 (the Internal Revenue Code) and Title 31 (the Bank Secrecy Act) of the United States Code.

Since its enactment, the Bank Secrecy Act has been expanded beyond its original focus on large currency transactions, while retaining its broad purpose of obtaining self-reporting of information with "a high degree of usefulness in criminal, tax, or regulatory investigations or proceedings."[98] As the reporting regime has expanded,[99] reporting obligations have been imposed on both financial institutions and account holders. With respect to account holders, a U.S. citizen, resident, or person doing business in the United States is required to keep records and file reports, as specified by the Secretary, when that person enters into a transaction or maintains an account with a foreign financial agency.[100] Regulations promulgated pursuant to broad regulatory authority granted to the Secretary in the Bank Secrecy Act[101] provide additional guidance regarding the disclosure obligation with respect to foreign accounts. The Bank Secrecy Act specifies only that such disclosure contain the following information "in the way and to the extent the Secretary prescribes": (1) the identity and address of participants in a transaction or relationship; (2) the legal capacity in which a participant is acting; (3) the identity of real parties in interest; and (4) a description of the transaction.

Treasury Department Form TD F 90-22.1, "Report of Foreign Bank and Financial Accounts," (the "FBAR") must be filed by June 30 of the year following the year in which the $10,000 filing threshold is met.[102] The FBAR is filed with the Treasury Department at the IRS

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[98] 31 U.S.C. sec. 5311.

[99] See e.g., Title III of the USA PATRIOT Act, Pub. L. No. 107-56 (October 26, 2001) (sections 351 through 366 amended the Bank Secrecy Act as part of a series of reforms directed at international financing of terrorism).

[100] 31 U.S.C. sec. 5314. The term "agency" in the Bank Secrecy Act includes financial institutions.

[101] 31 U.S.C. sec. 5314(a) provides: "Considering the need to avoid impeding or controlling the export or import of monetary instruments and the need to avoid burdening unreasonably a person making a transaction with a foreign financial agency, the Secretary of the Treasury shall require a resident or citizen of the United States or a person in, and doing business in, the United States, to keep records, file reports, or keep records and file reports, when the resident, citizen, or person makes a transaction or maintains a relation for any person with a foreign financial agency."

[102] 31 C.F.R. sec. 103.27(c). The $10,000 threshold is the aggregate value of all foreign financial accounts in which a U.S. person has a financial interest or over which the U.S. person has signature or other authority.

Detroit Computing Center. Failure to file the FBAR is subject to both criminal[103] and civil penalties.[104] Since 2004, the civil sanctions have included penalties not to exceed (1) $10,000 for failures that are not willful and (2) the greater of $100,000 or 50 percent of the balance in the account for willful failures. Although the FBAR is received and processed by the IRS, it is neither part of the income tax return filed with the IRS nor filed in the same office as that return. As a result, for purposes of Title 26, the FBAR is not considered "return information," and its distribution to other law enforcement agencies is not limited by the nondisclosure rules of Title 26.[105]

Although the obligation to file an FBAR arises under Title 31, individual taxpayers subject to the FBAR reporting requirements are alerted to this requirement in the preparation of annual Federal income tax returns. Part III ("Foreign Accounts and Trusts") of Schedule B of the 2008 IRS Form 1040 includes the question, "At any time during 2008, did you have an interest in or signatory or any other authority over a financial account in a foreign country, such as a bank account, securities account, or other financial account?" and directs taxpayers to "See page B-2 for exceptions and filing requirements for Form TD F 90-22.1." The Form 1040 instructions advise individuals who answer "yes" to this question to identify the foreign country or countries in which such accounts are located.[106] Responding to this question does not discharge one's obligations under Title 31 and constitutes "return information" protected from routine disclosure to those charged with enforcing Title 31. In addition, the Form 1040 instructions identify certain types of accounts that are not subject to disclosure, including those instances in which the combined value of all accounts held by the taxpayer did not exceed $10,000 at any point during the relevant tax year.

The FBAR requires disclosure of any account in which the filer has a financial interest or as to which the filer has signature or other authority (in which case the filer must identify the owner of the account). The Treasury Department and the IRS revised the FBAR and its accompanying instructions in October, 2008, to clarify the filing requirements for U.S. persons holding interests in foreign bank accounts.[107] For example, the terminology has been updated to

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[103] 31 U.S.C. sec. 5322 (failure to file is punishable by a fine up to $250,000 and imprisonment for five years, which may double if the violation occurs in conjunction with certain other violations).

[104] 31 U.S.C. sec. 5321(a)(5).

[105] Section 6103 bars disclosure of return information, unless permitted by an exception.

[106] 31 C.F.R. sec. 103.24.

[107] Treasury Department Form TD F 90-22.1, Report of Foreign Bank and Financial Accounts, and its instructions states:

> A financial interest in a bank, securities, or other financial account in a foreign country means an interest described in one of the following three paragraphs: 1. A United States person has a financial interest in each account for which such person is the owner of record or has legal title, whether the account is maintained for his or her own benefit or for the benefit of others including non–United States persons. 2. A United States person has a financial interest in each bank, securities, or other financial account in a foreign country for which the owner of record or holder of legal title is: (a) a person acting as an agent,

reflect new types of financial transactions. For example, "financial account" now specifies that debit or prepaid credit cards are financial accounts,[108] and the definition of "signature or other authority" now encompasses the ability to indirectly exercise this authority, even in the absence of written instructions.[109] The revised instructions also provide that foreign individuals doing business in the United States may be required to file an FBAR.[110] In August, 2009, the IRS requested public comments to help determine the scope and nature of future additional guidance.[111]

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nominee, attorney, or in some other capacity on behalf of the U.S. person; (b) a corporation in which the United States person owns directly or indirectly more than 50 percent of the total value of shares of stock or more than 50 percent of the voting power for all shares of stock; (c) a partnership in which the United States person owns an interest in more than 50 percent of the profits (distributive share of income, taking into account any special allocation agreement) or more than 50 percent of the capital of the partnership; or (d) a trust in which the United States person either has a present beneficial interest, either directly or indirectly, in more than 50 percent of the assets or from which such person receives more than 50 percent of the current income. 3. A United States person has a financial interest in each bank, securities, or other financial account in a foreign country for which the owner of record or holder of legal title is a trust, or a person acting on behalf of a trust, that was established by such United States person and for which a trust protector has been appointed. A trust protector is a person who is responsible for monitoring the activities of a trustee, with the authority to influence the decisions of the trustee or to replace, or recommend the replacement of, the trustee. Correspondent or "nostro" accounts (international interbank transfer accounts) maintained by banks that are used solely for the purpose of bank-to-bank settlement need not be reported on this form, but are subject to other Bank Secrecy Act filing requirements. This exception is intended to encompass those accounts utilized for bank-to-bank settlement purposes only.

[108] See Chief Counsel Advice 200603026 (January 20, 2006) for a discussion of whether payment card accounts constitute financial accounts.

[109] According to the instructions to the FBAR, a person has "signature authority" over an account "if such person can control the disposition of money or other property in it by delivery of a document containing his or her signature (or his or her signature and that of one or more other persons) to the bank or other person with whom the account is maintained." "Other authority" exists in a person "who can exercise comparable power over an account by communication to the bank or other person with whom the account is maintained, either directly or through an agent, nominee, attorney, or in some other capacity on behalf of the US person, either orally or by some other means."

[110] Although the revised instructions currently track the language of the statute in stating that a person in or doing business in the United States is within its purview, and thus merely clarify what has long been required, the IRS announced that pending publication of guidance on the scope of the statute, people could rely on the earlier, unrevised instructions to determine whether they are required to file a FBAR. Announcement 2009-51, 2009-25 I.R.B. 1105. Subsequently, the IRS announced that persons with only signature authority over a foreign financial account as well as for signatories or owners of financial interest in a foreign commingled fund have until June 30, 2010 to file an FBAR for the 2008 and earlier calendar years with respect to those accounts. Notice 2009-62, 2009-35 I.R.B. 260.

[111] Notice 2009-62, 2009-35 I.R.B. 260, specifically requested comments concerning: (1) when a person having only signature authority or having an interest in a commingled fund should be relieved of filing an FBAR; (2) the circumstances under which the FBAR filing exceptions for officers and employees of banks and some publicly traded domestic corporations should be expanded; (3) when an interest in a foreign entity should be subject

The revised instructions explain the basis for reporting other information in more detail, and provide that (1) all foreign persons with an interest in the account must be identified (including foreign identification numbers for each), (2) the highest value held in the account at any point in the year must be disclosed, (3) corporate employees with signature authority but no financial interest are generally required to disclose the signature authority, unless the corporate Chief Financial Officer ("CFO") (or in the case of an employee of a subsidiary, the parent company's CFO) certifies that the account will be reported on the corporate filing and (4) any amended or delinquent filing should be identified as such, and accompanied by an explanatory statement.

In addition to the FBAR requirements under Title 31, there are additional reports required by the Code to be filed with the IRS by U.S. persons engaged in foreign activities, directly or indirectly, through a foreign business entity. Upon the formation, acquisition or ongoing ownership of certain foreign corporations, U.S. persons that are officers, directors, or shareholders must file a Form 5471, "Information Return of U.S. Persons with Respect to Certain Foreign Corporations."[112] Similarly, an IRS Form 8865, "Return of U.S. Persons with Respect to Certain Foreign Partnerships," must be filed with respect to certain interests in a controlled foreign partnership; an IRS Form 3520, "Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts," must be filed with respect to certain foreign trusts; and an IRS Form 8858, "Information Return of U.S. Persons With Respect To Foreign Disregarded Entities" must be filed with respect to a foreign disregarded entity.[113] To the extent that the U.S. person engages in such foreign activities indirectly through a foreign business entity, other self-reporting requirements may apply. In addition, a U.S. person that capitalizes a foreign entity generally is required to file an IRS Form 926, "Return by a U.S. Transferor of Property to a Foreign Corporation."[114]

With the exception of the questions included on Form 1040, Schedule B, there is no requirement to disclose the information includible on FBAR on an individual tax return.

FBAR enforcement responsibility

Until 2003, the Financial Crimes and Enforcement Network ("FinCEN"), an agency of the Department of the Treasury, had responsibility for civil penalty enforcement of FBAR. In 2003, the authority to investigate FBAR compliance was delegated to the IRS Criminal

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to FBAR reporting; and (4) whether the passive asset and passive income thresholds are appropriate and should apply conjunctively.

[112] Secs. 6038, 6046.

[113] Form 8858 is used to satisfy reporting requirements of sections 6011, 6012, 6031, 6038, and related regulations.

[114] Sec. 6038B. The filing of this form may also be required upon future contributions to the foreign corporation.

Investigation Division.[115] As a result, persons who were more than 180 days delinquent in paying any FBAR penalties were referred for collection action to the Financial Management Service of the Treasury Department, which is responsible for such non-tax collections.[116] Continued nonpayment resulted in a referral to the Department of Justice for institution of court proceedings against the delinquent person. In 2003, the Secretary delegated civil enforcement to the IRS.[117] This change reflected the fact that a major purpose of the FBAR was to identify potential tax evasion, and therefore was not closely aligned with FinCEN's core mission.[118] The authority delegated to the IRS in 2003 included the authority to determine and enforce civil penalties,[119] as well as to revise the form and instructions. However, the collection and enforcement powers available to enforce the Internal Revenue Code under Title 26 are not available to the IRS in the enforcement of FBAR civil penalties, which remain collectible only in accord with the procedures for non-tax collections described above.

In general, information reported on an FBAR is available to the IRS and other law enforcement agencies. In contrast, information on income tax returns–including the Schedule B information regarding foreign bank accounts–is not readily available to those within the IRS who are charged with administering FBAR compliance, despite the fact that Federal returns and return information may be the best source of information for this purpose.

The nondisclosure constraints on IRS personnel who examine income tax liability (i.e., Form 1040 reporting) generally preclude the sharing of tax return information with any other IRS personnel or Treasury officials, except for tax administration purposes.[120] Tax administration is defined as "the administration, management, conduct, direction, and supervision of the execution and application of the internal revenue laws or related statutes" and does not necessarily include administration of Title 31.[121] Because Title 31 includes enforcement of non-tax provisions of the

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[115] Treas. Directive 15-14 (December 1, 1992), in which the Secretary delegated to the IRS authority to investigate violations of the Bank Secrecy Act. If the IRS Criminal Investigation Division declines to pursue a possible criminal case, it is to refer the matter to FinCEN for civil enforcement.

[116] 31 U.S.C. sec. 3711(g).

[117] 31 C.F.R. sec. 103.56(g). Memorandum of Agreement and Delegation of Authority for Enforcement of FBAR Requirements (April 2, 2003); News Release, Internal Revenue Service, IR-2003-48 (April 10, 2003).

[118] Secretary of the Treasury, "A Report to Congress in Accordance with sec. 361(b) of the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (USA Patriot Act)" (April 24, 2003).

[119] A penalty may be assessed before the end of the six-year period beginning on the date of the transaction with respect to which the penalty is assessed. 31 U.S.C. sec. 5321(b)(1). A civil action for collection may be commenced within two years of the later of the date of assessment and the date a judgment becomes final in any a related criminal action. 31 U.S.C. sec. 5321(b)(2).

[120] Sec. 6103(h)(1). In essence, section 6103(h)(1) authorizes officers and employees of both the Treasury Department and IRS to have access to return information on the basis of a "need to know" in order to perform a tax administration function.

[121] Sec. 6103(b)(4).

Bank Secrecy Act, Title 31 is not, per se, a "related statute," for purposes of finding that a disclosure of such information would be for tax administration purposes. As a result, IRS personnel charged with investigating and enforcing the civil penalties under Title 31 are not routinely permitted access to Form 1040 information that would support or shed light on the existence of an FBAR violation. Instead, there must be a determination, in writing, that the FBAR violation was in furtherance of a Title 26 violation in order to support a finding that the statutes are "related statutes" for purposes of authorizing the disclosure. The effect of this prerequisite is to subsume the bank account information reported on Form 1040 under the scope of "return information" and therefore, the protection from disclosure provided under Title 26.[122]

Penalties

Failure to comply with the FBAR filing requirements is subject to penalties imposed under Title 31 of the United States Code, and may be both civil and criminal. Since the initial enactment of the Bank Secrecy Act, a willful failure to comply with the FBAR reporting requirement has been subject to a civil penalty. In 2004, the available penalties were expanded to include a reduced penalty for a non-willful failure to file.[123] Willful failure to file an FBAR may be subject to penalties in amounts not to exceed the greater of $100,000 or 50 percent of the amount in the account at the time of the violation.[124] A non-willful, but negligent, failure to file is subject to a penalty of $10,000 for each negligent violation.[125] The penalty may be waived if (1) there is reasonable cause for the failure to report and (2) the amount of the transaction or balance in the account was properly reported. In addition, serious violations are subject to criminal prosecution, potentially resulting in both monetary penalties and imprisonment. Civil and criminal sanctions are not mutually exclusive.

Failure to comply with information returns required by the Internal Revenue Code is subject to a variety of sanctions, including (1) suspension of the applicable statute of limitations,[126] (2) disallowance of otherwise permitted tax attributes, deductions or credits,[127] and (3) imposition of penalties. For most information returns, the failure to file penalty is $50 per return, up to a maximum of $250,000 per taxpayer.[128] Failures to disclose control of any foreign business entity,[129] foreign parties with 25 percent ownership interest in a domestic company, [130]

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[122] Internal Revenue Manual, paragraphs 4.26.14.2 and 4.26.14.2.1.

[123] American Jobs Creation Act of 2004, Pub. L. No. 108-357, sec. 821(b), 118 Stat. 1418. This provision is codified in 31 U.S.C. sec. 5321(a)(5).

[124] 31 U.S.C. sec. 5321(a)(5)(C).

[125] 31 U.S.C. sec. 5321(a)(5)(B)(i), (ii).

[126] Sec. 6501(c)(8).

[127] Secs. 1295, 6038.

[128] Sec. 6721.

[129] Sec. 6038.

[130] Sec. 6038A.

domestic officers and 10 percent owners of a foreign corporation,[131] or change in ownership of a foreign partnership[132] are subject to penalties of $10,000, plus $10,000 for every 30 days the failure to file persists longer than 90 days after the taxpayer is informed of the failure. A failure to report a transfer to a foreign corporation is subject to a penalty equal to 10 percent of the value of the transfer, but is capped at $10,000 if the failure is not willful.[133] Failure to report the creation of a foreign trust is subject to a 35 percent penalty on the reportable amount (or five percent for a Form 3520-A report), plus $10,000 for every 30 days the failure to file persists after 90 days from the date on which the taxpayer is informed of the failure to file. The penalty is capped at the gross reportable amount.[134]

Explanation of Provision

The provision requires individual taxpayers with an interest in a "specified foreign financial asset" during the taxable year to attach a disclosure statement to their income tax return for any year in which the aggregate value of all such assets is greater than $50,000. Although the nature of the information required is similar to the information disclosed on an FBAR, it is not identical. For example, a beneficiary of a foreign trust who is not within the scope of the FBAR reporting requirements because his interest in the trust is less than 50 percent may nonetheless be required to disclose the interest in the trust with his tax return under this provision if the value threshold is met. Nothing in this provision is intended as a substitute for compliance with the FBAR reporting requirements, which are unchanged by this provision.

"Specified foreign financial assets" are depository or custodial accounts at foreign financial institutions and, to the extent not held in an account at a financial institution, (1) stocks or securities issued by foreign persons, (2) any other financial instrument or contract held for investment that is issued by or has a counterparty that is not a U.S. person, and (3) any interest in a foreign entity. The information to be included on the statement includes identifying information for each asset and its maximum value during the taxable year. For an account, the name and address of the institution at which the account is maintained and the account number are required. For a stock or security, the name and address of the issuer, and any other information necessary to identify the stock or security and terms of its issuance must be provided. For all other instruments or contracts, or interests in foreign entities, the information necessary to identify the nature of the instrument, contract or interest must be provided, along with the names and addresses of all foreign issuers and counterparties. An individual is not required under this provision to disclose interests under that are held in a custodial account with a U.S. financial institution nor is an individual required to identify separately any stock, security instrument, contract, or interest in a foreign financial account disclosed under the provision. In addition, the provision permits the Secretary to issue regulations that would apply the reporting

[131] Sec. 6046.

[132] Sec. 6046A.

[133] Sec. 6038B.

[134] Sec. 6048.

obligations to a domestic entity in the same manner as if such entity were an individual if that domestic entity is formed or availed of to hold such interests, directly or indirectly.

Individuals who fail to make the required disclosures are subject to a penalty of $10,000 for the taxable year. An additional penalty may apply if the Secretary notifies an individual by mail of the failure to disclose and the failure to disclose continues. If the failure continues beyond 90 days following the mailing, the penalty increases by $10,000 for each 30 day period (or a fraction thereof), up to a maximum penalty of $50,000 for one taxable period. The computation of the penalty is similar to that applicable to failures to file reports with respect to certain foreign corporations under section 6038. Thus, an individual who is notified of his failure to disclose with respect to a single taxable year under this provision and who takes remedial action on the 95th day after such notice is mailed incurs a penalty of $20,000 comprising the base amount of $10,000, plus $10,000 for the fraction (i.e., the five days) of a 30-day period following the lapse of 90 days after the notice of noncompliance was mailed. An individual who postpones remedial action until the 181st day is subject to the maximum penalty of $50,000: the base amount of $10,000, plus $30,000 for the three 30-day periods, plus $10,000 for the one fraction (i.e., the single day) of a 30-day period following the lapse of 90 days after the notice of noncompliance was mailed.

No penalty is imposed under the provision against an individual who can establish that the failure was due to reasonable cause and not willful neglect. Foreign law prohibitions against disclosure of the required information cannot be relied upon to establish reasonable cause.

To the extent the Secretary determines that the individual has an interest in one or more foreign financial assets but the individual does not provide enough information to enable the Secretary to determine the aggregate value thereof, the aggregate value of such identified foreign financial assets will be presumed to have exceeded $50,000 for purposes of assessing the penalty.

The provision also grants authority to promulgate regulations necessary to carry out the intent. Such regulations may include exceptions for nonresident aliens and classes of assets identified by the Secretary, including those assets which the Secretary determines are presently subject to reporting requirements under the Code. In particular, regulatory exceptions to avoid duplicative reporting requirements are anticipated.

Effective Date

The provision is effective for taxable years beginning after the date of enactment.

B. Penalties for Underpayments Attributable to Undisclosed Foreign Financial Assets (sec. 202 of the bill and sec. 6662 of the Code)

Present Law

The Code imposes penalties equal to 20 percent of the portion of any underpayments that are attributable to any of the following five grounds: (1) negligence or disregard of rules or regulations; (2) any substantial understatement[135] of income tax; (3) any substantial valuation misstatement; (4) any substantial overstatement of pension liabilities; and (5) any substantial estate or gift tax valuation understatement. With the exception of a penalty based on negligence or disregard of rules or regulations, these penalties are commonly referred to as accuracy-related penalties, because the imposition of the penalty does not require an inquiry into the culpability of the taxpayer. If the penalty is asserted, a taxpayer may defend against the penalty by demonstrating that (1) there was "reasonable cause" for the underpayment and (2) the taxpayer acted in good faith.[136] Regulations provide that reasonable cause exists in cases in which the taxpayer "reasonably relies in good faith on the opinion of a professional tax advisor, if the opinion is based on the tax advisor's analysis of the pertinent facts and authorities . . . and unambiguously states that the tax advisor concludes that there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld if challenged" by the IRS.[137]

A penalty for a substantial understatement may be reduced to the extent of the portion of the understatement attributable to an item on the return for which the challenged tax treatment (1) is supported by substantial authority or (2) is adequately disclosed on the return and there was a reasonable basis for such treatment. The tax treatment is considered to have been adequately disclosed only if all relevant facts are disclosed with the return. Regardless of whether an item would otherwise meet either of these tests, this defense is not available with respect to penalties imposed on understatements arising from tax shelters.[138] The Secretary may prescribe a list of positions which the Secretary believes do not meet the requirements for substantial authority under this provision.

Under present law, failure to comply with the various information reporting requirements generally does not, in itself, determine the amount of the penalty imposed on an underpayment of tax. However, such failure to comply may be relevant to (1) establishing negligence under

[135] If the correct income tax liability exceeds that reported by the taxpayer by the greater of 10 percent of the correct tax or $5,000 (or, in the case of corporations, by the lesser of (1) 10 percent of the correct tax (or, if greater, $10,000) or (2) $10 million), then a substantial understatement exists.

[136] Sec. 6664(c).

[137] Treas. Reg. secs. 1.6662-4(g)(4)(i)(B), 1.6664-4(c).

[138] A tax shelter is defined for this purpose as a partnership or other entity, an investment plan or arrangement, or any other plan or arrangement if a significant purpose of such partnership, other entity, plan, or arrangement is the avoidance or evasion of Federal income tax. Sec. 6662(d)(2)(C).

section 6662 or fraudulent intent,[139] (2) determining whether penalties based on culpability are applicable or (3) determining whether certain defenses are available.

In the context of transactions that are subject to the "reportable transaction" disclosure regime,[140] a separate accuracy-related penalty may apply.[141] That penalty applies to "listed transactions" and other "reportable transactions" that have a significant tax avoidance purpose (a "reportable avoidance transaction"). The penalty rate and defenses available to avoid the section 6662A penalty vary, based on the adequacy of disclosure. In general, a 20-percent accuracy-related penalty is imposed on any understatement attributable to an adequately disclosed listed transaction or reportable avoidance transaction.[142] An exception is available if the taxpayer satisfies a higher standard under the reasonable cause and good faith exception. This higher standard requires the taxpayer to demonstrate that there was (1) adequate disclosure of the relevant facts affecting the treatment on the taxpayer's return, (2) substantial authority for the treatment on the taxpayer's return, and (3) a reasonable belief that the treatment on the taxpayer's return was more likely than not the proper treatment.[143] If the transaction is not adequately disclosed, the reasonable cause exception is not available and the taxpayer is subject to a penalty equal to 30 percent of the understatement.[144]

Explanation of Provision

The provision adds a new accuracy related penalty to section 6662. The new provision, which is subject to the same defenses as are otherwise available under section 6662, imposes a 40-percent penalty on any understatement attributable to an undisclosed foreign financial asset. The term "undisclosed foreign financial asset" includes all assets subject to certain information reporting requirements[145] for which the required information was not provided by the taxpayer as required under the applicable reporting provisions. An understatement is attributable to an undisclosed foreign financial asset if it is attributable to any transaction involving such asset. Thus, a U.S. person who fails to comply with the various self-reporting requirements for a foreign financial asset and engages in a transaction with respect to that asset incurs a penalty on

[139] Section 6663 imposes a penalty of 75 percent on that portion of the understatement attributable to fraud. If the government proves that such understatement was attributable to fraud, there is a rebuttable presumption that any other understatement is attributable to fraud.

[140] Secs. 6011 through 6112 require taxpayers and their advisers to disclose certain transactions determined to have the potential for tax avoidance. All such transactions are referred to as "reportable transactions," and include within that class of transactions, those that are "listed," that is, the subject of published guidance in which the Secretary announces his intent to challenge such transactions.

[141] Sec. 6662A.

[142] Sec. 6662A(a).

[143] Sec. 6664(d).

[144] Sec. 6662A(c).

[145] The information reporting requirements identified include sections 6038, 6038A, new 6038D, 6046A, and 6048.

any resulting underpayment that is double the otherwise applicable penalty for substantial understatements or negligence. For example, if a taxpayer fails to disclose amounts held in a foreign financial account, any underpayment of tax related to the transaction that gave rise to the income would be subject to the penalty provision, as would any underpayment related to interest, dividends or other returns accrued on such undisclosed amounts.

Effective Date

The provision is effective for taxable years beginning after the date of enactment.

C. Modification of Statute of Limitations for Significant Omission of Income in Connection with Foreign Assets (sec. 203 of the bill and secs. 6229 and 6501 of the Code)

Present Law

Taxes are generally required to be assessed within three years after a taxpayer's return was filed, whether or not it was timely filed.[146] Of the exceptions to this general rule, only section 6501(c)(8) is specifically targeted at the identification of, and collection of information about, cross-border transactions. Under this exception, the limitation period for assessment of any tax imposed under the Code with respect to any event or period to which information about certain cross-border transactions required to be reported relates does not expire any earlier than three years after the required information is actually provided to the Secretary by the person required to file the return.[147] In general, such information reporting is due with the taxpayer's return; thus, the three-year limitation period commences when a timely and complete (including all information reporting) return is filed. Without the inclusion of the information reporting with the return, the limitation period does not commence until such time as the information reports are subsequently provided to the Secretary, even though the return has been filed.

In the case of a false or fraudulent return filed with the intent to evade tax, or if the taxpayer fails to file a required return, the tax may be assessed, or a proceeding in court for collection of such tax may be begun without assessment, at any time.[148] The limitation period also may be extended by taxpayer consent.[149] If a taxpayer engages in a listed transaction but fails to include any of the information required under section 6011 on any return or statement for a taxable year, the limitation period with respect to such transaction will not expire before the date which is one year after the earlier of (1) the date on which the Secretary is provided the information so required, or (2) the date that a "material advisor" (as defined in section 6111) makes its section 6112(a) list available for inspection pursuant to a request by the Secretary under section 6112(b)(1)(A).[150]

A special rule is provided where there is a substantial omission of income. If a taxpayer omits substantial income on a return, any tax with respect to that return may be assessed and collected within six years of the date on which the return was filed. In the case of income taxes, "substantial" means at least 25 percent of the amount that was properly includible in gross income; for estate and gift taxes, it means 25 percent of a gross estate or total gifts. For this

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[146] Sec. 6501(a).

[147] Required information reporting subject to this three-year rule is reporting under sections 6038 (certain foreign corporations and partnerships), 6038A (certain foreign-owned corporations), 6038B (certain transfers to foreign persons), 6046 (organizations, reorganizations, and acquisitions of stock of foreign corporations), 6046A (interests in foreign partnerships), and 6048 (certain foreign trusts).

[148] Sec. 6501(c).

[149] Sec. 6501(c)(4).

[150] Sec. 6501(c)(10).

purpose, the gross income of a trade or business means gross receipts, without reduction for the cost of sales or services.[151] An amount is not considered to have been omitted if the item properly includible in income is disclosed on the return.[152]

In addition to the exceptions described, there are also circumstances under which the three-year limitation period is suspended. For example, service of an administrative summons triggers the suspension either (1) beginning six months after service (in the case of John Doe summonses)[153] or (2) when a proceeding to quash a summons is initiated by a taxpayer named in a summons to a third-party record-keeper. Judicial proceedings initiated by the government to enforce a summons generally do not suspend the limitation period.

Explanation of Provision

The provision authorizes a new six-year limitations period for assessment of tax on understatements of income attributable to foreign financial assets. The present exception that provides a six-year period for substantial omission of an amount equal to 25 percent of the gross income reported on the return is not changed.

The new exception applies if there is an omission of gross income in excess of $5,000 and the omitted gross income is attributable to an asset with respect to which information reports are required under section 6038D, as applied without regard to the dollar threshold, the statutory exception for nonresident aliens and any exceptions provided by regulation. If a domestic entity is formed or availed of to hold foreign financial assets and is subject to the reporting requirements of section 6038D in the same manner as an individual, the six-year limitations period may also apply to that entity. The Secretary is permitted to assess the resulting deficiency at any time within six years of the filing of the income tax return.

In providing that the applicability of section 6038D information reporting requirements is to be determined without regard to the statutory or regulatory exceptions, the statute ensures that the longer limitation period applies to omissions of income with respect to transactions involving foreign assets owned by individuals. Thus, a regulatory provision that alleviates duplicative reporting obligations by providing that a report that complies with another provision of the Code may satisfy one’s obligations under new section 6038D does not change the nature of the asset subject to reporting. The asset remains one that is subject to the requirements of section 6038D for purposes of determining whether the exception to the three-year statute of limitations applies.

The provision also suspends the limitations period for assessment if a taxpayer fails to provide timely information returns required with respect to passive foreign investment

[151] Sec. 6501(e)(1)(A)(i).

[152] Sec. 6501(e)(1)(A)(ii) provides that, in determining whether an amount was omitted, any amounts that are disclosed in the return or in a statement attached to the return in a manner adequate to apprise the Secretary of the nature and amount of such item are not taken into account.

[153] Sec. 7609(e)(2).

corporations[154] and the new self-reporting of foreign financial assets. The limitations period will not begin to run until the information required by those provisions has been furnished to the Secretary. The provision also clarifies that the extension is not limited to adjustments to income related to the information required to be reported by one of the enumerated sections.

Effective Date

The provision is effective for returns filed after the date of enactment and for any return filed earlier if the assessment period specified in section 6501 for that return has not yet expired as of the date of enactment.

[154] Sec. 1295(b), (f).

III. OTHER DISCLOSURE PROVISIONS

A. Disclosure of Assistance in Acquiring or Forming a Foreign Entity (sec. 301 of the bill and sec. 6116 of the Code)

Present Law

To promote compliance with the individual and corporate income tax, the U.S. Federal income tax rules include broad information reporting requirements. Third-party reporting requirements apply to payments of income or gross proceeds. In general, payments of dividends, interest, capital gains, and other similar amounts to U.S. investors must be reported by payors and brokers on IRS Form 1099.[155] With respect to payments made to foreign investors, payors generally must report each year on IRS Form 1042-S the total amount paid to each recipient and the amount of U.S. tax withheld.[156]

Additionally, 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.[157] For these purposes, a material advisor is defined as any person who (1) provides any material aid, assistance or advice with respect to organizing, managing, promoting, selling, implementing, insuring, or carrying out any reportable transaction, and (2) directly or indirectly derives gross income in excess of the threshold amount (or such other amount as may be prescribed by the Secretary) for such aid, assistance, or advice.[158]

U.S. persons who engage in foreign activities through a foreign business entity may be required to meet certain self-reporting requirements. For example, upon the formation or acquisition, or as a result of ongoing ownership, of certain foreign corporations, U.S. persons that are officers, directors, or shareholders must file IRS Form 5471.[159] Similarly, IRS Form 8865 must be filed with respect to certain interests in a controlled foreign partnership, IRS Form 3520 must be filed with respect to certain foreign trusts, and IRS Form 8858 must be filed with respect to a foreign disregarded entity.[160] Additionally, as part of the initial formation of a foreign business entity, the foreign business entity is often capitalized with cash as well as other

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[155] See, e.g., secs. 6042 (dividends), 6045 (gross proceeds), 6049 (interest).

[156] Treas. Reg. sec. 1.1461-1(c).

[157] Sec. 6111(a).

[158] Sec. 6111(b)(1).

[159] Secs. 6038, 6046.

[160] Form 8858 is used to satisfy the reporting requirements of sections 6011 (general requirements of returns, statements or lists), 6012 (persons required to make returns of information), 6031 (returns of partnership income), 6038 (information reporting with respect to certain foreign corporations and partnerships), and related regulations.

assets and liabilities. If the foreign entity receiving such contributions is a foreign corporation, the U.S. person making the contribution is required to file IRS Form 926.[161]

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.

Explanation of Provision

The provision adds new section 6116, which requires the disclosure of assistance to a U.S. individual in acquiring or forming a foreign entity. Under the provision, each "material advisor" with respect to a foreign entity transaction is required to file an information return setting forth the identity of the foreign entity, the identity of the U.S. citizen or resident acquiring an interest in a foreign entity, and any other information as the Secretary may require.

A "foreign entity transaction" is defined as the direct or indirect acquisition of any interest in a foreign entity (including any interest acquired in connection with the formation of such entity) if any citizen or resident of the United States is required to file a report under section 6038 (certain foreign corporations and partnerships), section 6038B (certain transfers to foreign persons), section 6046 (organization or reorganization of foreign corporations and as to acquisitions of their stock), section 6046A (interests in foreign partnerships), or section 6048 (information with respect to certain foreign trusts) in connection with such acquisition. Any person will be considered a material advisor if the person provides any material aid, assistance, or advice with respect to carrying out one or more foreign entity transactions, and directly or indirectly derives gross income in excess of $100,000 for providing such aid, assistance or advice during the calendar year. It is anticipated that the Secretary will broadly construe this $100,000 threshold to include tax and any other advice incident or related in any way to the acquisition of an interest in a foreign entity.

For purposes of the provision, the acquisition of an interest in a foreign entity is intended to include the acquisition of so-called "shelf companies" and other similar entities (e.g., an entity formed by a service provider shortly before its acquisition by any U.S. citizen or resident).

The information return must be filed no later than the date specified by the Secretary. Any person that fails to timely file an information return with respect to a foreign entity transaction (or that files false or incomplete information with respect to such transaction) is required to pay a penalty equal to the greater of (1) $10,000 or (2) 50 percent of the gross income derived by such person with respect to aid, assistance or advice provided with respect to such transaction before the date the return is filed. However, no penalty will be assessed if the failure to timely file is due to reasonable cause and not willful neglect. By requiring the filing of this information return subject to a penalty, it is anticipated that this provision will provide an incentive for material advisors to properly inform their clients regarding their obligations to disclose foreign financial assets.

[161] Sec. 6038B. Form 926 may also be required to be filed upon future contributions to the foreign corporation.

The Secretary is authorized to issue regulations or other guidance providing: (1) only one material advisor is required to file an information return with respect to a foreign entity transaction in cases in which two or more persons would otherwise be required to meet such requirements; (2) exemptions from the requirements of the provision; and (3) additional rules as may be necessary or appropriate to carry out the purpose of the provision.

Effective Date

The provision is effective with respect to aid, assistance, and advice provided after the date of the enactment.

B. Reporting of Activities with Respect to Passive Foreign Investment Companies (sec. 302 of the bill and sec. 1298 of the Code)

Present Law

In general, active foreign business income derived by a foreign corporation with U.S. owners is not subject to current U.S. taxation until the corporation makes a dividend distribution to those owners. Certain rules, however, restrict the benefit of deferral of U.S. tax on income derived through foreign corporations. One such regime applies to U.S. persons who own stock of passive foreign investment companies ("PFICs"). A PFIC generally is defined as any foreign corporation if 75 percent or more of its gross income for the taxable year consists of passive income, or 50 percent or more of its assets consist of assets that produce, or are held for the production of, passive income.[162] Various sets of income inclusion rules apply to U.S. persons that are shareholders in a PFIC, regardless of their percentage ownership in the company. One set of rules applies to PFICs under which U.S. shareholders pay tax on certain income or gain realized through the companies, plus an interest charge intended to eliminate the benefit of deferral.[163] A second set of rules applies to PFICs that are "qualified electing funds ("QEF"), under which electing U.S. shareholders currently include in gross income their respective shares of the company's earnings, with a separate election to defer payment of tax, subject to an interest charge, on income not currently received.[164] A third set of rules applies to marketable PFIC stock, under which electing U.S. shareholders currently take into account as income (or loss) the difference between the fair market value of the stock as of the close of the taxable year and their adjusted basis in such stock (subject to certain limitations), often referred to as "marking to market."[165]

In general, a U.S. person that is a direct or indirect shareholder of a PFIC must file IRS Form 8621, "Return by a Shareholder of a Passive Foreign Investment Company or Qualifying Electing Fund" for each tax year in which that U.S. person (1) recognizes gain on a direct or indirect disposition of PFIC stock, (2) receives certain direct or indirect distributions from a PFIC, or (3) is making a reportable election.[166] The Code includes a general reporting

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[162] Sec. 1297.

[163] Sec. 1291.

[164] Secs. 1293-1295.

[165] Sec. 1296.

[166] See Instructions to IRS Form 8621. According to the form, reportable elections include the following: (i) an election to treat the PFIC as a QEF; (ii) an election to recognize gain on the deemed sale of a PFIC interest on the first day of the PFIC's tax year as a QEF; (iii) an election to treat an amount equal to the shareholder's post-1986 earnings and profits of a CFC as an excess distribution on the first day of a PFIC's tax year as a QEF that is also a controlled foreign corporation under section 957(a); (iv) an election to extend the time for payment of the shareholder's tax on the undistributed earnings and profits of a QEF; (v) an election to treat as an excess distribution the gain recognized on the deemed sale of the shareholder's interest in the PFIC, or to treat such shareholder's share of the PFIC's post-1986 earnings and profits as an excess distribution, on the last day of its last tax year as a PFIC under section 1297(a) if eligible; or (vi) an election to mark-to-market the PFIC stock that is marketable within the meaning of section 1296(e).

requirement for certain PFIC shareholders which is contingent upon the issuance of regulations.[167] Although Treasury issued proposed regulations in 1992 requiring U.S. persons to file annually Form 8621 for each PFIC of which the person is a shareholder during the taxable year, such regulations have not been finalized and current IRS Form 8621 requires reporting only based on one of the triggering events described above.[168]

Explanation of Provision

The provision requires each person who is a shareholder of a PFIC to file an annual information return containing such information as the Secretary may require.

Effective Date

The provision is effective on the date of enactment.

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[167] Sec. 1291(e) by reference to sec. 1246(f).

[168] Prop. Treas. Reg. sec. 1.1291-1(i).

C. Secretary Permitted to Require Financial Institutions to File Certain Returns Related to Withholding on Foreign Transfers Electronically (sec. 303 of the bill and sec. 6011 of the Code).

Present Law

Withholding responsibility

A withholding agent is any person required to withhold U.S. income tax under sections 1441, 1442, 1443, or 1461. For purposes of these sections, a withholding agent is any person, whether a U.S. or a foreign person, that has the control, receipt, custody, disposal, or payment of an item of income of a foreign person subject to withholding.[169] A withholding agent is personally liable for the tax required to be withheld.[170]

Reporting liability of a withholding agent

Every withholding agent must file an annual return with the IRS on Form 1042, "Annual Withholding Tax Return for U.S. Source Income of Foreign Persons," reporting all taxes withheld during the preceding year and remitting any taxes still owing for such preceding year.[171] IRS Form 1042 must be filed on or before March 15 of the year following the year of the payment. The form must be filled even though no tax has been withheld from income paid during the year.[172] A withholding agent must also file an information return, IRS Form 1042-S, which is entitled "Foreign Person's U.S. Source Income Subject to Withholding," on or before March 15 of year the succeeding the year of payment. IRS Form 1042-S requires the withholding agent to provide all items of income specified in section 1441(b) paid during the previous year to foreign persons.[173] IRS Form 1042-S must be filed for each foreign recipient to whom payments were made during the preceding year,[174] even if no tax was required to have been withheld. A copy of IRS Form 1042-S must be sent to the payee.

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[169] Treas. Reg. sec. 1.1441-7(a)(1).

[170] Sec. 1461.

[171] Treas. Reg. sec.1.1461-1(b)(1).

[172] *Ibid.*

[173] Treas. Reg. sec. 1.1461-1(c)(1). IRS Form 1042-S filings provide information important for the Secretary's purposes in properly effecting refund claims and in meeting IRS's obligations under exchange of information agreements with various treaty partners. Also, the IRS has the ability to validate electronically filed Form 1042-S upon such filing, thereby serving to better ensure the reliability of information included in such filings.

[174] *Ibid.* If payments are made to a nominee or representative of a foreign payee, Form 1042-S must also be sent to the beneficial owner of such payments, if known to the withholding agent.

IRS's authority to require electronic filing

The Internal Revenue Service Restructuring and Reform Act of 1998 ("RRA 1998")[175] states that it is a congressional policy to promote the paperless filing of Federal tax returns. Section 2001(a) of RRA 1998 set a goal for the IRS to have at least 80 percent of all Federal tax and information returns filed electronically by 2007. Section 2001(b) of RRA 1998 requires the IRS to establish a 10-year strategic plan to eliminate barriers to electronic filing.

The Secretary has limited authority to issue regulations specifying which returns must be filed electronically. First, such regulations can only apply to persons required to file at least 250 returns during the year.[176] Second, the Secretary is prohibited from requiring that income tax returns of individuals, estates, and trusts be submitted in any format other than paper (although these returns may be filed electronically by choice). Third, the Secretary, in determining which returns must be filed on magnetic media, must take into account relevant factors, including the ability of a taxpayer to comply with magnetic media filing at reasonable cost.[177]

Accordingly, the Secretary requires corporations and tax-exempt organizations that have assets of $10 million or more and file at least 250 returns during a calendar year, including income tax, information, excise tax, and employment tax returns to file electronically their Form IRS 1120/1120-S income tax returns and IRS Form 990 information returns for tax years ending on or after December 31, 2006. Private foundations and charitable trusts that file at least 250 returns during a calendar year are required to file electronically their IRS Form 990-PF information returns for tax years ending on or after December 31, 2006, regardless of their asset size. Taxpayers can request waivers of the electronic filing requirement if they cannot meet that requirement due to technological constraints, or if compliance with the requirement would result in undue financial burden.

Explanation of Provision

The provision provides an exception to the general annual 250 returns threshold and permits the Secretary to issue regulations to require filing on magnetic media for any return filed by a "financial institution"[178] with respect to any taxes withheld by the "financial institution" for which it is personally liable.[179] Under the provision, the Secretary is authorized to require a financial institution to electronically file returns with respect to any taxes withheld by the financial institutions even though such financial institution would be required to file less than 250 returns during the year.

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[175] Pub. L. No. 105-206 (1998).

[176] Partnerships with more than 100 partners are required to file electronically. Sec. 6011(e)(2).

[177] Sec. 6011(e).

[178] See section 1471(d)(5) in section 101 of the bill.

[179] The "financial institution" is personally liable for any tax withheld in accordance with section 1461 and the proposed section 1474(a) under section 101 of the bill.

Effective Date

The provision applies to returns the due date for which (determined without regard to extensions) is after the date of enactment.

IV. PROVISIONS RELATED TO FOREIGN TRUSTS

A. Clarifications with Respect to Foreign Trusts Which Are Treated as Having a United States Beneficiary (sec. 401 of the bill and sec. 679 of the Code)

Present Law

Under the grantor trust rules, a U.S. person that directly or indirectly transfers property to a foreign trust[180] is generally 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.[181] This treatment generally does not apply to transfers by reason of death, or to transfers of property to the trust in exchange for at least the fair market value of the transferred property.[182] A trust is treated as having a U.S. beneficiary for the taxable year unless (1) under the terms of the trust, no part of the income or corpus of the trust may be paid or accumulated during the taxable year to or for the benefit of a U.S. person, and (2) if the trust were terminated at any time during the taxable year, no part of the income or corpus of the trust could be paid to or for the benefit of a U.S. person.[183]

Regulations under section 679 employ a broad approach in determining whether a foreign trust is treated as having a U.S. beneficiary. The determination of whether the trust has a U.S. beneficiary is made for each taxable year of the transferor. The default rule under the statute and regulations is that a trust has a U.S. beneficiary unless during the U.S. transferor's taxable year the trust meets the two requirements as stated above. Income or corpus may be paid or accumulated to or for the benefit of a U.S. person if, directly or indirectly, income may be distributed to or accumulated for the benefit of a U.S. person, or corpus of the trust may be distributed to or held for the future benefit of a U.S. person.[184] The determination is made without regard to whether income or corpus is actually distributed, and without regard to whether a U.S. person's interest in the trust income or corpus is contingent on a future event. A person who is not a named beneficiary and is not a member of a class of beneficiaries will not be taken into account if the transferor can show that the person's contingent interest in the trust is so remote as to be negligible.[185] In considering whether a foreign trust has a U.S. beneficiary under the terms of the trust, the trust instrument must be read together with other relevant factors

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[180] A trust is a foreign trust if it is not a U.S. person. Sec. 7701(a)(31)(B). A trust is a U.S. person if (1) a U.S. court is able to exercise primary supervision over the administration of the trust, and (2) one or more U.S. persons have the authority to control all substantial decisions of the trust. Sec. 7701(a)(30)(E).

[181] Sec. 679(a)(1). This rule does not apply to transfers to trusts established to fund qualified deferred compensation plans or to trusts exempt from tax under section 501(c)(3).

[182] Sec. 679(a)(2).

[183] Sec. 679(c)(1).

[184] Treas. Reg. sec. 1.679-2(a)(2)(i).

[185] Treas. Reg. sec. 1.679-2(a)(2)(ii).

including (1) all written and oral agreements and understandings related to the trust, (2) memoranda or letters of wishes, (3) all records that relate to the actual distribution of income and corpus, and (4) all other documents that relate to the trust, whether or not of any purported legal effect.[186] Other factors taken into account in determining whether a foreign trust is deemed to have a U.S. beneficiary include whether (1) the terms of the trust allow the trust to be amended to benefit a U.S. person, (2) the trust instrument does not allow such an amendment, but the law applicable to the foreign trust may require payments or accumulations of income or corpus to a U.S. person, or (3) the parties to the trust ignore the terms of the trust, or it reasonably expected that they will do so to benefit a U.S. person.[187]

If a foreign trust that was not treated as a grantor trust acquires a U.S. beneficiary and is treated as a grantor trust under section 679 for the taxable year, the transferor is taxable on the trust's undistributed net income[188] computed at the end of the preceding taxable year.[189] Any additional amount included in the transferor's gross income as a result of this provision is subject to the interest charge rules of section 668.[190]

Explanation of Provision

In determining whether, under section 679, a foreign trust has a U.S. beneficiary, the provision clarifies that an amount is treated as accumulated for the benefit of a U.S. person even if the U.S. person's interest in the trust is contingent on a future event. Under the provision, if any person has the discretion (by authority given in the trust agreement, by power of appointment, or otherwise) to make a distribution from the trust to, or for the benefit of, any person, the trust is treated as having a U.S. beneficiary unless (1) the terms of the trust specifically identify the class of persons to whom such distributions may be made, and (2) none of those persons is a U.S. person during the taxable year. The provision is meant to be consistent with existing regulations under section 679.

The provision clarifies that if any U.S. person who directly or indirectly transfers property to the trust is directly or indirectly involved in any agreement or understanding (whether written, oral, or otherwise) that may result in the income or corpus of the trust being paid or accumulated to or for the benefit of a U.S. person, such agreement or understanding is treated as a term of the trust. It is assumed for these purposes that a transferor of property to the trust is generally directly or indirectly involved with agreements regarding the accumulation or disposition of the income and corpus of the trust.

[186] Treas. Reg. sec. 1.679-2(a)(4)(i).

[187] Treas. Reg. sec. 1.679-2(a)(4)(ii).

[188] Undistributed net income is defined in section 665(a).

[189] Sec. 679(b).

[190] Treas. Reg. sec. 1.679-2(c)(1).

Effective Date

The provision is effective on the date of enactment.

B. Presumption That Foreign Trust Has United States Beneficiary (sec. 402 of the bill and sec. 679 of the Code)

Present Law

Under the grantor trust rules, a U.S. person that directly or indirectly transfers property to a foreign trust[191] is generally treated as the owner of the portion of the trust comprising that property for any taxable year in which there is a U.S. beneficiary of any portion of the trust.[192] This treatment generally does not apply to transfers by reason of death, or to transfers of property to the trust in exchange for at least the fair market value of the transferred property.[193] A trust is treated as having a U.S. beneficiary for the taxable year unless (1) under the terms of the trust, no part of the income or corpus of the trust may be paid or accumulated during the taxable year to or for the benefit of a U.S. person, and (2) if the trust were terminated at any time during the taxable year, no part of the income or corpus of the trust could be paid to or for the benefit of a U.S. person.[194]

Section 6048 imposes various reporting obligations on foreign trusts and persons creating, making transfers to, or receiving distributions from such trusts. Within 90 days after a U.S. person transfers property to a foreign trust, the transferor must provide written notice of the transfer to the Secretary.[195]

Explanation of Provision

Under the provision, a foreign trust[196] is presumed to have a U.S. beneficiary for purposes of section 679 unless the U.S. person that directly or indirectly transfers property to a foreign trust submits information as required by the Secretary and demonstrates to the satisfaction of the Secretary that (1) under the terms of the trust, no part of the income or corpus of the trust may be paid or accumulated during the taxable year to or for the benefit of a U.S. person, and (2) if the trust were terminated during the taxable year, no part of the income or corpus of the trust could be paid to or for the benefit of a U.S. person.

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[191] A trust is a foreign trust if it is not a U.S. person. Sec. 7701(a)(31)(B). A trust is a U.S. person if (1) a U.S. court is able to exercise primary supervision over the administration of the trust and (2) one or more U.S. persons have the authority to control all substantial decisions of the trust. Sec. 7701(a)(30)(E).

[192] Sec. 679(a)(1). This rule does not apply to transfers to trusts established to fund qualified deferred compensation plans or to trusts exempt from tax under section 501(c)(3).

[193] Sec. 679(a)(2).

[194] Sec. 679(c)(1).

[195] Sec. 6048(a).

[196] A foreign trust for this purpose does not include deferred compensation and charitable trusts described in section 6048(a)(3)(B)(ii).

Effective Date

The provision applies to transfers of property after the date of enactment.

C. Uncompensated Use of Trust Property Treated as a Distribution (sec. 403 of the bill and secs. 643 and 679 of the Code)

Present Law

Under section 643(i), a loan of cash or marketable securities made by a foreign trust to any U.S. grantor, U.S. beneficiary, or any other U.S. person who is related to a U.S. grantor or U.S. beneficiary is treated as a distribution by the foreign trust to such grantor or beneficiary. 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.[197] A trust treated under this rule as making a distribution is not treated as a simple trust for the year of the distribution.[198] This rule does not apply for purposes of determining if a trust has a U.S. beneficiary under section 679.

A subsequent repayment, satisfaction, or cancellation of a loan treated as a distribution under section 643(i) is disregarded for tax purposes.[199] This section applies a broad set of related party rules that treat a loan of cash or marketable securities to a spouse, sibling, ancestor, descendant of the grantor or beneficiary, other trusts in which the grantor or beneficiary has an interest, and corporations or partnerships controlled by the beneficiary or grantor or by family members of the beneficiary or grantor, as a distribution to the related grantor or beneficiary.[200]

Explanation of Provision

The provision expands section 643(i) to provide that any use of trust property by the U.S. grantor, U.S. beneficiary or any U.S. person related to a U.S. grantor or U.S. beneficiary is treated as a distribution of the fair market value of the use of the property to the U.S. grantor or U.S. beneficiary. The use of property is not treated as a distribution to the extent that the trust is paid the fair market value for the use of the property within a reasonable period of time. A subsequent return of property treated as a distribution under section 643(i) is disregarded for tax purposes.

For purposes of determining whether a foreign trust has a U.S. beneficiary under section 679, a loan of cash or marketable securities or the use of any other trust property by a U.S. person is treated as a payment from the trust to the U.S. person in the amount of the loan or the fair market value of the use of the property. A loan or use of property is not treated as a payment

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[197] Sec. 643(i)(2)(C).

[198] Sec. 643(i)(2)(D).

[199] Sec. 643(i)(3).

[200] Section 643(i)(2)(B) treats a person as a related person if the relationship between such person would result in a disallowance of losses under sections 267 or 707(b), broadened to include the spouses of members of the family described in such sections.

to the extent that the U.S. person repays the loan at a market rate of interest or pays the fair market value for the use of the trust property within a reasonable period of time.

Effective Date

The provision applies to loans made and uses of property after the date of enactment.

D. Reporting Requirement of United States Owners of Foreign Trusts (sec. 404 of the bill and sec. 6048 of the Code)

Present Law

Section 6048 imposes various reporting obligations on foreign trusts and persons creating, making transfers to, or receiving distributions from such trusts. If a U.S. person is treated as the owner of any portion of a foreign trust under the rules of subpart E of part I of subchapter J of chapter 1 (grantor trust provisions), the U.S. person is responsible for ensuring that the trust files a tax return for the year and that the trust provides other information as the Secretary may require to each U.S. person who (1) is treated as the owner of any portion of the trust, or (2) receives (directly or indirectly) any distribution from the trust.[201]

Explanation of Provision

The provision requires a U.S. person that is treated as an owner of any portion of a foreign trust under the rules of subpart E of part I of subchapter J of chapter 1 (grantor trust provisions) to provide information as the Secretary may require with respect to the trust, in addition to ensuring that the trust complies with its reporting obligations.

Effective Date

The provision applies to notices and returns required to be filed after December 31, 2009.

[201] Sec. 6048(b)(1).

E. Minimum Penalty with Respect to Failure to Report on Certain Foreign Trusts (sec. 405 of the bill and sec. 6677 of the Code)

Present Law

Minimum penalty with respect to failure to report on certain foreign trusts

Section 6048 imposes various reporting obligations on foreign trusts and persons creating, making transfers to, or receiving distributions from such trusts. Generally, a trust is a foreign trust unless a U.S. court is able to exercise primary supervision over the trust's administration and a U.S. trustee has authority to control all substantial decisions of the trust.[202] If a U.S. person creates or transfers property to a foreign trust, the U.S. person generally must report this event and certain other information by the due date for the U.S. person's tax return, including extensions, for the tax year in which the creation of the trust or the transfer occurs.[203] Similar rules apply in the case of the death of a U.S. citizen or resident if the decedent was treated as the owner of any portion of a foreign trust under the grantor trust rules or if any portion of a foreign trust was included in the decedent's gross estate. If a U.S. person directly or indirectly receives a distribution from a foreign trust, the U.S. person generally must report the distribution by the due date for the U.S. person's tax return, including extensions, for the tax year during which the distribution is received.[204] If a U.S. person is the owner of any portion of a foreign grantor trust at any time during the year, the person is responsible for causing an information return to be filed for the trust, which must, among other things, give the name of a U.S. agent for the trust.[205]

If a notice or return required under the rules just described is not filed when due or is filed without all required information, the person required to file is generally subject to a penalty based on the "gross reportable amount."[206] The gross reportable amount is (1) the value of the property transferred to the foreign trust if the delinquency is failure to file notice of the creation of or a transfer to a foreign trust; (2) the value (on the last day of the year) of the portion of a grantor trust owned by a U.S. person who fails to cause an annual return to be filed for the trust; and (3) the amount distributed to a distributee who fails to report distributions.[207] The initial penalty is 35 percent of the gross reportable amount in cases (1) and (3) and five percent in case (2).[208] If the return is more than 90 days late, additional penalties are imposed of $10,000 for

[202] Sec. 7701(a)(30)(E), (31)(B). In addition, for purposes of section 6048, the IRS can classify a trust as foreign if it "has substantial activities, or holds substantial property, outside the United States." Sec. 6048(d)(2).

[203] Sec. 6048(a).

[204] Sec. 6048(c).

[205] Sec. 6048(b).

[206] Sec. 6677(a).

[207] Sec. 6677(c).

[208] Sec. 6677(b).

every 30 days the delinquency continues, except that the aggregate of the penalties may not exceed the gross reportable amount.[209]

Maximum penalty with respect to failure to report on certain foreign trusts

In no event may the penalties imposed with respect to any failure to report under section 6048 exceed the gross reportable amount.[210]

Explanation of Provision

Increase of the minimum penalty with respect to failure to report on certain foreign trusts

Under the provision, the initial penalty for failing to report under section 6048 is the greater of $10,000 or 35 percent of the gross reportable amount in cases (1) and (3) and the greater of $10,000 or five percent of the gross reportable amount in case (2). Thus, an initial penalty of $10,000 may be imposed even where the Secretary has insufficient information to determine the gross reportable amount. The additional $10,000 penalty for every additional 30 days of delinquency continues to apply.

Amendment to the maximum penalty with respect to failure to report on certain foreign trusts

The provision provides that the penalties with respect to failure to report on certain foreign trusts may exceed the gross reportable amount. However, to the extent that a taxpayer provides sufficient information for the Secretary to determine that the aggregate amount of the penalties exceeds the gross reportable amount, the Secretary is required to refund such excess to the taxpayer.

Effective Date

The provision applies to notices and returns required to be filed after December 31, 2009.

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[209] Sec. 6677(a).

[210] *Ibid*.

V. DIVIDEND EQUIVALENT PAYMENTS RECEIVED BY FOREIGN PERSONS TREATED AS DIVIDENDS

A. Dividend Equivalent Payments Received by Foreign Persons Treated as Dividends (sec. 501 of the bill and sec. 871 of the Code)

Present 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 U.S. tax, collected by withholding, at a 30-percent rate, unless the withholding agent can establish that the beneficial owner of the amount is eligible for an exemption from withholding or a reduced rate of withholding under an income tax treaty.[211] Dividends paid by a domestic corporation are generally U.S.-source[212] and therefore potentially subject to withholding tax when paid to foreign persons.

The source of notional principal contract income generally is determined by reference to the residence of the recipient of the income.[213] Consequently, a foreign person's income related to a notional principal contract that references stock of a domestic corporation, including any amount attributable to, or calculated by reference to, dividends paid on the stock, generally is foreign source and is therefore not subject to U.S. withholding tax.

In contrast, a substitute dividend payment made to the transferor of stock in a securities lending transaction or a sale-repurchase transaction is sourced in the same manner as actual dividends paid on the transferred stock.[214] Accordingly, because dividends paid with respect to the stock of a U.S. company are generally U.S. source, if a foreign person lends stock of a U.S. company to another person (or sells the stock to the other person and later repurchases the stock in a transaction treated as a loan for U.S. federal income tax purposes) and receives substitute dividend payments from that other person, the substitute dividend payments are U.S. source and are generally subject to U.S. withholding tax.[215] In 1997, the Treasury and IRS issued Notice 97-

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[211] Secs. 871, 881, 1441, 1442; Treas. Reg. sec. 1.1441-1(b). For purposes of the withholding tax rules applicable to payments to nonresident alien individuals and foreign corporations, a withholding agent is defined broadly to include any U.S. or foreign person that has the control, receipt, custody, disposal, or payment of an item of income of a foreign person subject to withholding. Treas. Reg. sec. 1.1441-7(a).

[212] Sec. 861(a)(2).

[213] Treas. Reg. sec. 1.863-7(b)(1). A notional principal contract is a financial instrument that provides for the payment of amounts by one party to another at specified intervals calculated by reference to a specified index upon a notional principal amount in exchange for specified consideration or a promise to pay similar amounts. Treas. Reg. sec. 1.446-3(c)(1).

[214] Treas. Reg. sec. 1.861-3(a)(6). This regulation defines a substitute dividend payment as a payment, made to the transferor of a security in a securities lending transaction or a sale-repurchase transaction, of an amount equivalent to a dividend distribution which the owner of the transferred security is entitled to receive during the term of the transaction.

[215] For purposes of the imposition of the 30-percent withholding tax, substitute dividend payments (and substitute interest payments) received by a foreign person under a securities lending or sale-repurchase transaction

66 to address concerns that the sourcing rule just described (and the accompanying character rule) could cause the total U.S. withholding tax imposed in a series of securities lending or sale-repurchase transactions to be excessive.[216] In that Notice, the Treasury and IRS also stated that they intended to propose new regulations to provide detailed guidance on how substitute dividend payments made by one foreign person to another foreign person were to be treated. To date, no regulations have been proposed.[217]

Explanation of Provision

The provision treats a dividend equivalent as a dividend from U.S. sources for certain purposes, including the U.S. withholding tax rules applicable to foreign persons.

A dividend equivalent is a payment made under a notional principal contract that directly or indirectly is contingent upon, or determined by reference to, the payment of a dividend from sources within the United States. A dividend equivalent also includes any other payment that the Secretary determines is substantially similar to a payment described in the previous sentence. Under this rule, for example, the Secretary may conclude that payments under certain forward contracts or other financial contracts that reference stock of U.S. corporations are dividend equivalents.

The provision does not apply to any payment under a contract or other arrangement that the Secretary determines does not have the potential for avoidance of the taxes imposed on U.S.-source dividends. Factors that the Secretary may take into account for this purpose include (but are not limited to) the following: the term of the contract (including any provisions for early terminations and the existence of offsetting financial contracts); the amount of each party's investment and the amounts of any collateral posted; whether the price of the equity used to measure the parties' entitlements or obligations is based on an objectively observable price or the parties' actual execution prices; whether either party sells (directly or indirectly) to the other party the stock giving rise to U.S.-source dividends; and whether there are terms that address the hedge position of either party or other conditions that would compel either party to hold or acquire the stock giving rise to U.S.-source dividends. For example, the Secretary may determine based on these factors (and any other factors that the Secretary may take into account) that a contract with a short term that includes a dividend payment date or a contract under which a party hedges its obligation to make dividend-based payments by holding the underlying stock

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have the same character as dividend (and interest) income received in respect of the transferred security. Treas. Reg. secs. 1.871-7(b)(2), 1.881-2(b)(2).

[216] Notice 97-66, 1997-2 C.B. 328 (December 1, 1997).

[217] There is evidence that some taxpayers have taken the position that Notice 97-66 sanctions the elimination of withholding tax in certain situations. See United States Senate, Permanent Subcommittee on Investigations, Committee on Homeland Security and Governmental Affairs, *Dividend Tax Abuse: How Offshore Entities Dodge Taxes on U.S. Stock Dividends*, Staff Report, September 11, 2008, pp. 18-20, 22-23, 40, 47, 52. In the Obama administration's fiscal year 2010 budget, the Treasury Department has announced that, to address the avoidance of U.S. withholding tax through the use of securities lending transactions, it plans to revoke Notice 97-66 and issue guidance that eliminates the benefits of those transactions but minimizes over-withholding. Department of the Treasury, General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals, May 2009, p. 37.

is more likely to have the potential for avoidance of dividend withholding tax than a contract with a longer term or a contract under which the party does not hedge its obligations. No inference is intended as to whether any of these factors, or any determination under this provision that a transaction does not have the potential for the avoidance of taxes on U.S.-source dividends, are relevant in determining whether an agency relationship exists under general tax principles or whether a foreign party to a contract should be treated as having beneficial tax ownership of the stock giving rise to U.S.-source dividends.

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

For purposes of chapter 3 (withholding of tax on nonresident aliens and foreign corporations) and chapter 4 (taxes to enforce reporting on certain foreign accounts), each person that is a party to a contract or other arrangement that provides for the payment of a dividend equivalent is treated as having control of the payment. Accordingly, Treasury may provide guidance requiring either party to withhold tax on dividend equivalents.

The rule treating dividend equivalents as U.S.-source dividends is not intended to limit the authority of the Secretary (1) to determine the appropriate source of income from financial arrangements (including notional principal contracts) under present law section 863 or 865 or (2) to provide guidance addressing the source and characterization of substitute payments made in securities lending and similar transactions.

Effective Date

The provision applies to payments made on or after the date that is 90 days after the date of enactment.

Office of Chief Counsel
Internal Revenue Service
Memorandum

Number:

Release Date:
CC:INTL:BR5 Third Party Communication: None
PRENO-119800-09 Date of Communication: Not Applicable

UILC: 864.02-00

date: September 22, 2009

to: Kathy Robbins
Director of Field Operations
Manhattan, Financial Services

from: Steven A. Musher
Associate Chief Counsel
(International)

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subject: Lending in the United States by Foreign Person Giving Rise to Effectively Connected Income

This memorandum sets forth the legal analysis with respect to certain lending activities undertaken by foreign corporations. This advice may not be used or cited as precedent.

ISSUE

Whether interest income earned by a foreign corporation with respect to loans originated by an agent, whether dependent or independent, in the United States is attributable to "the U.S. office" through which the foreign corporation's banking, financing or similar business activity is carried on, such that the interest income is "effectively connected income"?

CONCLUSION

The interest income received by a foreign corporation with respect to loans that it originated to U.S. borrowers constitutes income effectively connected with such foreign corporation's banking, financing or similar business when an agent, whether dependent or independent, performs origination activities described in the facts below on the foreign corporation's behalf with respect to such loans in the United States.

FACTS

A corporation is organized in Country X ("Foreign Corporation") and 100 percent of the shares in Foreign Corporation are held by shareholders who are not U.S. Persons as defined by Section 7701(a)(30). Country X does not have a bilateral income tax treaty with the United States. Foreign Corporation makes loans to U.S. persons (the "U.S. Borrowers") within the United States.

Foreign Corporation has no office or employees located in the United States. To originate loans to the U.S. Borrowers, Foreign Corporation outsources the origination activities to a United States corporation ("Origination Co."). Under a service agreement between Foreign Corporation and Origination Co., the activities performed by Origination Co. include the solicitation of U.S. Borrowers, the negotiation of the terms of the loans, the performance of the credit analyses with respect to U.S. Borrowers, and all other activities relating to loan origination other than the final approval and signing of the loan documents. Origination Co. conducts these activities on a considerable, continuous, and regular basis. Under the terms of the service agreement, Foreign Corporation pays Origination Co. an arm's length fee for its services. Origination Co. performs the origination activities from an office located in the United States, and Origination Co. is subject to U.S. federal income taxation. Although Origination Co. performs all of the origination activities on behalf of Foreign Corporation, Origination Co. is not authorized to conclude contracts on behalf of Foreign Corporation. Foreign Corporation's employees, who work in an office located outside of the United States, give final approval for the loans and physically sign the loan documents on behalf of Foreign Corporation.

LAW

Section 882

Pursuant to section 882(a)(1) of the Internal Revenue Code, a foreign corporation engaged in a trade or business within the United States during the taxable year is subject to U.S. federal income tax on its taxable income that is effectively connected with the conduct of a trade or business within the United States.

Definition of a "Trade or Business Within the United States"

To be subject to tax under section 882, a foreign corporation must be engaged in a "trade or business within the United States." A "'trade or business within the United States' includes the performance of personal services within the United States at any time within the taxable year . . . ." Section 864(b). The term "trade or business within the United States" does not include "[t]rading in stocks or securities through a resident broker, commission agent, custodian, or other independent agent." Section 864(b)(2)(A)(i). This safe harbor does not apply if the taxpayer has an office or other fixed place of business in the United States at any time during the taxable year through which the transactions in stocks or securities are effected. Section 864(b)(2)(C). In addition, the term "trade or business within the United States" does not include "[t]rading in stocks or securities for the taxpayer's own account, whether by the taxpayer or his employees or through a resident broker, commission agent, custodian, or other independent agent, and whether or not any such employee or agent has discretionary authority to make decisions in effecting the transaction." Section 864(b)(2)(A)(ii). This clause does not apply in the case of a dealer in stocks or securities. Id.

If a foreign corporation does not qualify for the section 864(b) safe harbors, the unavailability of such safe harbors is not a determination that such foreign corporation is engaged in a trade or business within the United States. Treas. Reg. § 1.864-2(e). Rather, whether a foreign corporation is treated as engaged in a trade or business within the United States "shall be determined on the basis of the facts or circumstances in each case." Treas. Reg. § 1.864-2(e).

Definition of "Effectively Connected Income" – U.S. Source Income

Once a foreign corporation is found to be engaged in a trade or business within the United States, the foreign corporation's income must be "effectively connected" with the U.S. trade or business to be taxable under section 882(a). Section 864(c) defines when such foreign corporation's income, gain or loss will be treated as effectively connected with the conduct of a United States trade or business. With respect to U.S. source interest income, when determining that such income is effectively connected with the conduct of a trade or business within the United States, the factors taken into account include whether (A) the income is derived from assets used in or held for use in the conduct of such trade or business, or (B) the activities of such trade or business were a material factor in the realization of the income. Section 864(c)(2).

Notwithstanding the "asset use test" and the "business-activities test" articulated in section 864(c)(2) and the regulations thereunder, Treas. Reg. § 1.864-4(c)(5) provides a special rule for determining whether income is effectively connected with a "banking, financing or similar business activity." Specifically, any U.S. source interest received by a foreign corporation during the taxable year in the active conduct of a banking, financing, or similar business in the United States is treated as effectively connected to the conduct of that business "only if the stock or securities giving rise to such income, gain, or loss are attributable to the U.S. office through which such business is carried on" and the securities were acquired in one of the specified manners enumerated in the regulations, which includes making loans to the public. Treas. Reg. § 1.864-4(c)(5)(ii). A stock or security is deemed to be attributable to a U.S. office "only if such office actively and materially participates in soliciting, negotiating, or performing other activities required to arrange the acquisition of the stock or security." Treas. Reg. §1.864-4(c)(5)(iii). Treas. Reg. § 1.864-4(c)(5)(iv) provides rules for determining when a stock or security was acquired in the course of making loans to the public. Even when U.S. source income from stocks and securities is not effectively connected with the active conduct of a foreign corporation's banking, financing or similar business in the United States, such income may be effectively connected with the conduct of another U.S. trade or business under the "asset-use test," as provided in Treas. Reg. § 1.864-

4(c)(2), or the "business-activities test," as provided in Treas. Reg. § 1.864-4(c)(3). Treas. Reg. § 1.864-4(c)(5)(vi).

Foreign Source Effectively Connected Income

Generally, foreign source interest income is not treated as effectively connected with the conduct of a United States trade or business. Section 864(c)(4)(A). Foreign source interest income of a foreign corporation derived from the active conduct of a banking, financing, or similar business within the United States, however, is treated as effectively connected with the conduct of a United States trade or business "if such person has an office or other fixed place of business within the United States to which such income, gain, or loss is attributable." Section 864(c)(4)(B). For purposes of section 864(c)(4)(B), when determining whether a foreign corporation has an office or other fixed place of business, the office or other fixed place of business of an agent will be disregarded unless the agent (i) has the authority to negotiate and conclude contracts in the name of the foreign corporation and regularly exercises such authority and (ii) is not a general commission agent, broker or other independent agent acting the ordinary course of business. Section 864(c)(5)(A). In addition, a foreign corporation's income, gain or loss will not be attributable to an office or fixed place of business in the United States unless such office or fixed place of business "is a material factor in the production of such income, gain, or loss" and the office or fixed place of business regularly carries on the type of activities from which such income, gain or loss was derived. Section 864(c)(5)(B).

Treas. Reg. § 1.864-5 provides rules for determining when a foreign corporation's foreign source income will be treated as effectively connected with a United States trade or business. Treas. Reg. § 1.864-6 provides rules for determining when a foreign corporation that is engaged in a United States trade or business has an office or fixed place of business in the United States.

With respect to a foreign corporation that is engaged in a U.S. trade or business, Treas. Reg. § 1.864-7 defines the term "office or other fixed place of business" for the purposes of Section 864(c)(4)(B), Treas. Reg. § 1.864-6 and Treas. Reg. § 1.864-5(b), all of which are provisions relating to foreign source effectively connected income. Treas. Reg. § 1.875-7(a)(1). When determining whether a foreign corporation has an office or other fixed place of business with regard to foreign source income, the office of a dependent agent is disregarded unless such agent has the authority to negotiate and conclude contracts in the name of the foreign corporation and regularly exercises that authority. Treas. Reg. § 1.864-7(d)(1)(i).

Source of Interest Income

The source of interest income as foreign or domestic depends upon the borrower. In general, interest income from loans made to U.S. borrowers will be sourced as income from sources within the United States. Section 861(a)(1).

ANALYSIS

Foreign Corporation is engaged in a "trade or business within the United States" pursuant to Section 864(b)(2)

Based on the facts and circumstances described above, Foreign Corporation is engaged in a trade or business within the United States.

Attribution of an Agent's Activities

Although Origination Co. acts on behalf of Foreign Corporation pursuant to a service contract and does not have authority to conclude contracts, Origination Co. performs activities that are a component of Foreign Corporation's lending activities, such as the solicitation of customers, the negotiation of contractual terms and the performance of credit analyses. In similar circumstances, courts have found an agency relationship to exist in fact and have attributed the activities of the U.S. agent to the foreign principal in determining whether the foreign principal conducted considerable, continuous, and regular activity within the United States. See Inverworld, Inc. v. Commissioner, T.C. Memo. 1996-301 (finding that the activities of a U.S. corporation, although nominally an independent contractor and not an agent, were attributed to a foreign corporation where the activities of the U.S. corporation were in fact those of an agent); I.R.S. Tech. Adv. Mem. 80-29-005 (March 27, 1980) ("In resolving the issue of whether the A Trusts are engaged in a trade or business within the United States for purposes of Section 864(b) of the Code, it is irrelevant whether [the company operating the A Trusts' oil leases] is an independent contractor of the A Trusts or the actual agent of the trusts." (citing Lewenhaupt v. Commissioner, 20 T.C. 151 (1953), aff'd, 221 F.2d 227 (9th Cir. 1955))). The activities performed by Origination Co., therefore, are attributable to Foreign Corporation for purposes of determining whether Foreign Corporation engages in a trade or business within the United States.

Courts have found a U.S. trade or business where a taxpayer's U.S. activities, either directly or through an agent, are considerable, continuous, and regular. De Amodio v. Commissioner, 34 T.C. 894, 905-06 (1960), aff'd, 299 F.2d 623 (3rd Cir. 1962) (concluding that the taxpayer had engaged in a U.S. business because the activities of taxpayer's agent were considerable, continuous and regular, and that those activities, which constituted more than the mere ownership of real property or receipt of income from real property, were attributable to the taxpayer); Lewenhaupt v. Commissioner, 20 T.C. 151 (1953), aff'd, 221 F.2d 227 (9th Cir. 1955) (concluding that the taxpayer had engaged in a U.S. business because taxpayer's activities through an agent were considerable, continuous and regular even though the agent received the taxpayer's approval prior to taking any important action); Handfield v. Commissioner, 23 T.C. 633, 637-38 (1955) (concluding that the taxpayer was engaged in a trade or business within the United States because an agent made substantial sales in the

United States on behalf of the taxpayer pursuant to a distribution agreement); Adda v. Commissioner, 10 T.C. 273, 277 (1948) (concluding that the taxpayer engaged in a trade or business within the United States through the activities undertaken by the taxpayer's agent). With respect to Foreign Corporation's lending business, Origination Co. undertakes activities on behalf of Foreign Corporation that are more than ministerial and clerical in nature. See Spermacet Whaling & Shipping Co. v. Commissioner, 30 T.C. 618, 634 (1958), aff'd, 281 F.2d 646 (6th Cir. 1960) (holding that the taxpayer was not engaged in a trade or business within the United States where the U.S. activities of its agent were ministerial and clerical activities that involved "very little exercise of discretion or business judgment necessary to the production of the income"). Because the lending activities of Foreign Corporation, which were carried on by Origination Co., were considerable, continuous, and regular, Foreign Corporation is engaged in a U.S. trade or business.

Lending Trade or Business within the United States

The activities with respect to Foreign Corporation's loans to U.S. Borrowers constitute a trade or business because Foreign Corporation lends money to customers on a considerable, regular and continuous basis with the intention of earning a profit. Compare Inverworld, Inc. v. Commissioner, T.C. Memo. 1996-301 (finding that a foreign corporation was engaged in a trade or business within the United States when its activities in the United States, including lending money to clients, were regular and continuous enough to constitute "'a banking, financing or similar business in the United States'") with Pasquel v. Commissioner, 12 T.C.M. 1431 (1953) (finding that a taxpayer was not engaged a trade or business within the United States when the taxpayer entered into a "single and isolated" financing transaction in the United States). Such trade or business is treated as being within the United States because Foreign Corporation's loan origination activities conducted through Origination Co. occur within the United States. Adda v. Commissioner, 10 T.C. at 277-78 (finding that the taxpayer engaged in a trade or business within the United States through the activities of an agent even though the agent did not have an office in the United States); Inverworld, Inc. v. Commissioner, T.C. Memo. 1996-301; see also, e.g., Pinchot v. Commissioner, 113 F.2d 718, 719-720 (2d. Cir. 1940) (finding that the taxpayer was engaged in a U.S. business because the activities in the United States were considerable, regular and continuous).

Section 864(b)(2) Safe Harbors

Further, because Foreign Corporation regularly and continuously originates loans to customers, such activities constitute a lending trade or business and not trading or investing activities for the purpose of section 864. Compare Inverworld, T.C. Memo. 1996-301 with Higgins v. Commissioner, 312 U.S. 212 (1941) (holding that investing, no matter how extensive the activity, is not a trade or business) and Yaeger v. Commissioner, 889 F.2d 29, 33-34 (2d Cir. 1989) (holding that the taxpayer was an investor rather than a trader because the management of personal securities investment is not the trade or business of a trader and noting that the fundamental criteria that distinguishes a trader from an investor is the length of the holding period and the source of profit). As the Foreign Corporation's lending activities do not constitute "trading" in stock and securities, Foreign Corporation does not qualify for the trading safe harbors under section 864(b)(2). Rather, based upon the facts and circumstances, Foreign Corporation is engaged in a U.S. trade or business. Treas. Reg. § 1.864-2(e).

Foreign Corporation has income effectively connected with a banking or financing business within the United States

The interest income that Foreign Corporation receives with respect to the loans originated in the United States is effectively connected with the conduct of a trade or business within the United States because Foreign Corporation is engaged in a banking business and such interest income is attributable to an office in the United States.

Banking, Financing or Similar Business Activity

Foreign Corporation is treated as engaged in a banking, financing or similar business activity within the United States as described by Treas. Reg. § 1.864-4(c)(5)(i) because its business, through the activities of Origination Co., includes making loans to the public. Because Foreign Corporation is engaged in a banking, financing, or similar business activity, its income from that business may be effectively connected with a trade or business in the United States, notwithstanding the "asset use test" or the "business activity test." Treas. Reg. § 1.864-4(c)(5)(i).

The Office Requirement of Treas. Reg. § 1.864-4(c)(5)

Foreign Corporation's U.S. source interest income from a banking, financing or similar business will be treated as effectively connected income if the securities giving rise to such income are "attributable to the U.S. office through which such business is carried on" and the securities were acquired as a result of making loans to the public. Treas. Reg. § 1.864-4(c)(5)(ii). The regulation requires that the income be attributable to "the U.S. office through which such business is carried on . . . ." Treas. Reg. § 1.864-4(c)(5)(ii) (emphasis added). The regulation does not specify or imply that the U.S. office belong to or be attributable to the taxpayer.

The Service is aware that some taxpayers may have taken the position that the interest income is not effectively connected with banking, financing or similar business activity because the income is not attributable to a U.S. office of the Foreign Corporation and that the office of Foreign Corporation's agent is not attributable to the Foreign Corporation under Treas. Reg. § 1.864-7(d). Because Treas. Reg. § 1.864-4(c)(5) does not provide guidance defining the phrase "the U.S. office," a taxpayer may argue that the definition of the phrase "office or other fixed place of business" provided in Treas. Reg. § 1.864-7 should apply to interpret the phrase "the U.S. office." Under the taxpayer's analysis, because Origination Co. is either an independent agent or does not have the authority to conclude loans on behalf of Foreign Corporation, the office of Origination Co. is not attributable to Foreign Corporation.

This argument misapplies both the statute and the regulations. Unlike section 864(c)(4)(B), section 864(c)(2) contains no "office or other fixed place of business" requirement. Section 864(c)(4)(B) and Treas. Reg. § 1.864-7 apply only for the purpose of foreign source effectively connected income described in section 864(c)(4)(B) and the regulations thereunder. Treas. Reg. § 1.864-7(a)(1). Because the interest income received by Foreign Corporation with respect to loans made to U.S. Borrowers is U.S. source income, the definition contained in Treas. Reg. § 1.864-7 does not apply.

Notwithstanding the court's reliance upon Treas. Reg. § 1.864-7 in Inverworld, the framework of Treas. Reg. § 1.864-7 is not relevant to the application of Treas. Reg. § 1.864-4(c)(5) in this case. In Inverworld, the court used Treas. Reg. § 1.864-7 as a framework for interpreting section 864(b)(2)(C) "because those regulations construe the phrase 'office or other fixed place of business in the United States', which is also found in section 864(b)(2)(C)" even though Treas. Reg. § 1.864-7 does not expressly apply to Section 864(b)(2)(C). T.C. Memo. 1996-301. As previously stated, unlike section 864(b)(2)(C) and Treas. Reg. § 1.864-7, which are concerned with whether or not the taxpayer has a U.S. office (either directly or by attribution), Treas. Reg. § 1.864-4(c)(5)(ii) does not require that the taxpayer have a U.S. office.

The rule in Treas. Reg. § 1.864-4(c)(5)(ii) elaborates a statutory provision that does not contain the same "office or other fixed place of business" requirements found in other sections. As a result, the regulation cannot be read to import the same "office or other fixed place of business" rule of section 864(c)(4)(B). It does not, for example, require by its terms that the office be the office of the taxpayer. A U.S. office of an agent of the taxpayer is sufficient. If the regulations intended that interest income must be attributable to the taxpayer's office to be treated as effectively connected with a banking, financing or other similar business, the regulation would have explicitly stated that the income must be attributable to "the taxpayer's office." Alternatively, the text of the regulation would have used a possessive pronoun to indicate that the office must be the taxpayer's office. Because the regulation requires only that the interest income be attributable to "the U.S. office," a U.S. office of a person other than the taxpayer may satisfy the requirement. Origination Co.'s office satisfies the office requirement articulated in Treas. Reg. § 1.864-4(c)(5)(ii) because Origination Co. has an office in the United States and the day-to-day activities required of Foreign Corporation's lending business take place from the office of Origination Co.

Interest Income Attributable to the U.S. Office

In order to have effectively connected income, the loans originated by Foreign Corporation must be attributable to a U.S. office. A loan will be attributable to a U.S. office "only if such office actively and materially participated in soliciting, negotiating or performing other activities required" for the acquisition of such loan. Treas. Reg. § 1.864-4(c)(5)(iii). Foreign Corporation has engaged Origination Co. to perform its origination activities in the United States, including the solicitation of borrowers and the negotiation of contractual terms. For this purposes, it is enough that Origination Co. is a dependent or independent agent of the taxpayer performing activities described above. To perform loan origination activities on behalf of Foreign Corporation, Origination Co. operates from an office in the United States. Origination Co.'s U.S. office actively and materially participates in the origination of Foreign Corporation's loans to U.S. Borrowers because the activities required to originate such loans occur through that U.S. office. The income from Foreign Corporation's loans to U.S. Borrowers, therefore, is attributable to "the U.S. office" of Origination Co. through which Foreign Corporation carries on its lending business.

Because Origination Co.'s U.S. office actively and materially participated in the day-to-day origination activities, Foreign Corporation's U.S. source interest income is attributable to Origination Co.'s U.S. office, even though Foreign Corporation concluded the loans outside of the United States. Foreign Corporation's interest income with respect to loans made to U.S. Borrowers, therefore, is effectively connected with a trade or business within the United States pursuant to section 864(c)(2).

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

We understand that foreign corporations and non-resident aliens may have used other strategies to originate loans in the United States giving rise to effectively connected income. We encourage you to develop these cases, and we stand ready to assist you in the legal analysis.

Please call Peter Merkel of the Office of the Associate Chief Counsel (International) at (202) 622-3870 (not a toll-free number) if you have any further questions.