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## Provisions in HIRE Act Aimed at Offshore Tax Evasion Will Have Far-Reaching Impact on Private Investment Funds and Swap Participants

Amid the contentious build-up to the final passage of the healthcare bill, the Hiring Incentives to Restore Employment Act (“HIRE Act”) was signed into law with relatively little fanfare. The HIRE Act includes as a revenue-raiser the Foreign Account Tax Compliance Act (“FATCA”), which will require increased information reporting by foreign financial institutions, including offshore hedge funds and other offshore commingled investment vehicles. The HIRE Act also will impose U.S. withholding tax on certain swap payments that are contingent upon or determined by reference to U.S.-source dividends. A separate [alert](#) discusses some of the tax provisions in the healthcare bill.

### Enhanced Reporting and Withholding Requirements under FATCA Generally

At its core, FATCA seeks to enlist foreign financial institutions (“FFIs”), including hedge funds and other commingled investment vehicles, in curbing U.S. tax evasion by having them obtain and report annually to the Internal Revenue Service (“IRS”) information about their “United States accounts.” Because these requirements cannot be imposed directly on non-U.S. companies, FATCA accomplishes this extra-territorial application of U.S. law by imposing a 30% withholding tax on certain U.S.-source payments to any FFI that does not comply. Although the law is generally not effective until 2013, hedge funds and other FFIs will soon need to begin grappling with the compliance challenges posed by FATCA.

FATCA has been dubbed “QI 2.0” because it builds on the current “qualified intermediary” or “QI” rules relating to the U.S. withholding tax on certain payments of U.S.-source passive income made through certain foreign financial institutions. FATCA, however, applies to a broader spectrum of payments and institutions, overrides benefits embodied in U.S. tax treaties, and can require disclosure of the ownership of a foreign entity.

Specifically, FATCA imposes a 30% withholding tax on any “withholdable payment” made to an FFI that has not entered into an information-sharing agreement with the IRS. A withholding payment is (1) any U.S.-source payment of interest, dividends and other similar passive income (referred to generally as “fixed and determinable annual or periodical” or “FDAP” income) and (2) any gross proceeds from the sale or other disposition of any property of a type that can produce U.S.-source interest or dividends. The first category is broader than the similarly defined category that is currently subject to withholding, because FATCA does not reflect the exclusion for portfolio interest. The second category is new, reaching payments

to a non-U.S. person even when the property is sold at a loss.<sup>1</sup> One policy question raised by FATCA is whether FFIs will spurn U.S. markets in order to avoid the “withholdable payments” that are used to enforce FATCA’s information-sharing requirements.

An FFI is defined as any foreign institution that (1) accepts deposits in the ordinary course of a banking or similar business, (2) as a substantial part of its business, holds financial assets for the account of others, or (3) is engaged (or holds itself out as being engaged) primarily in the business of investing, reinvesting, or trading in securities, partnership interests, commodities or any interest therein. This final category would cover hedge funds, funds-of-funds, and other private funds.

An FFI receiving withholdable payments can avoid the new 30% withholding tax if it enters into an information-sharing agreement with the IRS. Pursuant to such an agreement, the FFI would need to agree (1) to obtain information on its account holders to determine which accounts are “United States accounts,” (2) to comply with such verification and due diligence procedures as may be required with respect to the identification of United States accounts, (3) to report information about each United States account to the IRS annually, including the name, account number, balance and (unless regulations provide otherwise) deposits and withdrawals during the year, (4) to withhold on “passthru payments” as described further below, (5) to comply with any IRS requests for additional information, and (6) if foreign law would prevent such disclosure, to obtain a waiver or close the account.

Unlike the original version of FATCA introduced in October 2009, the provisions included in the HIRE Act permit the Department of the Treasury to issue regulations deeming certain categories of FFIs as meeting the information-sharing requirements without entering into an agreement. Such exclusions

might apply where the institution complies with procedures to ensure that it does not maintain United States accounts (without permitting other FFIs to circumvent FATCA’s requirements) or where an information-sharing agreement between governments would obviate the need for agreements with individual FFIs in that jurisdiction.

The term “United States account” is defined in a manner that will require FFIs to look through to the owners of account holders. A United States account is any “financial account” held by one or more “specified United States persons” or “United States owned foreign entities.” A financial account is a depository or custodial account and any debt or equity interest in an FFI (other than interests that are regularly traded on an established securities market). Because a hedge fund is included in the definition of FFI, an interest in a hedge fund would generally be treated as a financial account for this purpose. A specified United States person is essentially any U.S. person, other than publicly traded corporations, their affiliates, tax-exempt organizations, governments, banks, real estate investment trusts, regulated investment companies, and common trust funds. A United States owned foreign entity is a foreign entity with one or more “substantial United States owners,” generally defined as an owner of a more than 10% interest. The 10% threshold, however, does not apply if the foreign entity is an investment fund. Thus, any U.S. owners of a foreign investment fund would cause its accounts to be United States accounts.

FATCA attempts to avoid duplicative reporting with respect to United States accounts. An account is excluded if it is held by another financial institution that has entered into an information-sharing agreement, or (under regulations) if the holder of the account is already subject to other information reporting requirements.

As part of its information-sharing agreement with the IRS, an FFI must agree to withhold on payments (“passthru payments”) attributable to account holders who do not provide information (“recalcitrant account holders”) or other FFIs that have not entered into information-sharing agreements. Alternatively, an FFI may elect to provide information so that a withholding agent can determine (and withhold tax from) the portion of

<sup>1</sup> Currently, a withholding tax is imposed on payments to a non-U.S. person on the sale or other disposition of a United States real property interest. The withholding rate of 10% reflects an estimation of the average tax that would be due on the sale as a withholding agent typically would not know the amount of the non-U.S. person’s gain or loss. A certificate can be obtained from the IRS for reduced or no tax withholding on a showing of the actual amount of gain or loss.

any withholdable payment allocable to recalcitrant account holders and non-qualified FFIs. Without such a provision (which was not present in the original FATCA proposed legislation), an FFI might face withholding on all payments to it, even if the information-sharing problems resulted from the actions of only a small number of account holders.

FATCA also provides for withholding on withholdable payments to a non-financial foreign entity if such entity is the beneficial owner of the payment and fails to provide information on its substantial United States owners. As above, exceptions are provided for publicly traded corporations, their affiliates, foreign governments, international organizations, and foreign central banks. Regulations may exclude other types of entities, or classes of payments that pose a lower risk of tax evasion.

One controversial aspect of FATCA is that the withholding tax can override – or at least delay – benefits granted under bilateral U.S. tax treaties. Under the regular withholding rules, a non-U.S. person may ensure that a reduced rate of withholding available under a treaty will apply at the time of payment by providing a Form W-8BEN (or other applicable Form W-8). By contrast, under FATCA the full 30% withholding rate will apply even if a lower treaty rate is available or the payment is not otherwise subject to substantive U.S. tax (such as a payment of portfolio interest). A beneficial owner entitled to the benefits of a tax treaty would then need to apply for a refund. No refund is available, however, unless the beneficial owner provides information as may be necessary to determine whether it is a United States owned foreign entity and the identity of any substantial United States owners. FATCA also makes clear that no refund is available without a treaty if the FFI is the beneficial owner of the payment. Thus, an FFI formed in a jurisdiction with which the United States does not have a treaty, such as the Cayman Islands, can avoid FATCA's withholding tax provisions only by entering into an information-sharing agreement (or avoiding U.S.-source payments).

The FATCA rules described above generally apply to payments made after December 31, 2012. A grandfather rule provides that no withholding is required from any payment made under an

obligation outstanding on the date that is two years after the date of enactment, or from gross proceeds from any disposition of such an obligation. Thus, payments on debt obligations issued until March 18, 2012, will not be subject to the FATCA withholding tax. Given the experience with the introduction of the QI rules in the late 1990s, it is possible that the effective date of the FATCA rules could be pushed back, especially as 2013 approaches, to give FFIs more time to put their compliance systems in place.

### **Withholding on Dividend Equivalent Payments under Swaps**

As discussed above, regular withholding tax applies to U.S.-source dividends paid to non-U.S. persons. This withholding tax also generally applies to substitute dividend payments made under securities lending or repurchase transactions, but has not applied to payments made under swaps (“notional principal contracts” in tax parlance). FATCA extends the withholding tax to swap payments to the extent they are directly or indirectly contingent upon, or determined by reference to, U.S.-source dividends.

The withholding tax is effective for dividend-equivalent payments made on or after the date that is 180 days after the date of enactment. For the first two years following enactment, the new withholding rules apply only in certain enumerated situations indicating an avoidance motive, such as where a non-U.S. person sells U.S. stock (which would pay a dividend subject to withholding) and then enters into a swap with the buyer. After two years following enactment, the withholding tax will apply to all dividend-equivalent payments under swaps except as otherwise provided in regulations. Regulations will need to provide guidance on what portion of a swap payment is contingent upon, or determined by reference to, U.S.-source dividends.

### **“Shadow” FBAR Form and Increased PFIC Reporting**

FATCA also introduces a tax form similar (but in addition) to the FBAR form. A U.S. person will be required to file this form if “specified financial assets” exceed \$50,000 in the aggregate. Specified financial assets are defined as any financial account with an FFI (both as defined above) and, for assets not held with a financial institution, any stock,

security, financial instrument or contract issued by a non-U.S. person, or any interest in a foreign entity. This form will be required starting in 2011 (tax years beginning after the date of enactment).

FATCA also requires an annual filing by each shareholder of a passive foreign investment company ("PFIC"). In the past, PFIC shareholders were required to file such a form only upon the occurrence of certain events, such as a sale or distribution or in connection with the making of an election. This provision is effective as of the date of enactment. It is not clear how PFIC shareholders, especially small shareholders, will be able to obtain the information necessary to complete the form.

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