Revenue Offsets in Jobs Act Impact U.S. Persons with Offshore Investments and Certain Non-U.S. Investors

The Hiring Incentives to Restore Employment ("HIRE") Act (the "Act"), signed by the president last week, contains tax breaks for hiring new workers, an expansion of incentives for financing construction activity, and an extension of higher expensing limited for capital investments made by small businesses. It also includes a number of revenue offset provisions, several of which are designed to police offshore investments and trust interests held by U.S. persons and others, that will impact non-U.S. investors in U.S.-source investments. The former provisions can impact not only U.S. citizens but also U.S. resident aliens as well as certain non-U.S. entities, including banks and hedge funds. A brief summary of certain of these "offset" provisions follows.

Withholding Taxes on Payment to "Foreign Financial Institutions" and Other Foreign Entities

Foreign financial institutions that do not certify that they have no U.S. account holders are required to enter into an agreement with the U.S. Treasury to obtain and report identifying and other account-related information with respect to U.S. holders. Failure to comply will result in such foreign institutions being subject to a 30% U.S. withholding tax on U.S.-source interest, dividends, rents, salaries and similar (fixed and determinable annual or periodical) payments, as well as on gross proceeds from the sale or other disposition of property that can produce U.S.-source interest or dividends ("withholdable payments"). Income treated as effectively connected with the conduct by the non-U.S. person of a U.S. trade or business and already subject to U.S. income tax would not be subject to this withholding tax.

If the foreign financial institution is itself the beneficial owner of a payment with respect to which the new tax has been withheld, and is entitled to a reduced rate of tax on the payment under a tax treaty, the institution can claim a credit or refund of over-withheld tax, but no interest is allowed with respect thereto.

The agreement would also require foreign entities themselves to withhold on payments attributable to withholdable payments made to an account holder who does not itself furnish required information, or who is a foreign financial institution not in compliance with the new provisions, unless an election is made to subject such amounts to the withholding tax described above, without reduction pursuant to any treaty provision.

The term "foreign financial institution" is defined to include not only banks, but also entities engaged in investing, or trading in securities, *e.g.*, foreign hedge funds. In addition, other non-financial, foreign entities are subject to the same withholding tax if they do not report information on U.S. owners, unless they can certify that they have no "substantial" (generally over 10%) U.S. owner, with certain exceptions for, *inter alia*, publicly-traded corporations, foreign governments or agencies or instrumentalities thereof, and foreign central banks.

The new rules apply to payments made after December 31, 2012, with a grandfathering rule in respect of payments on any obligation outstanding on the date that is two years after the date of enactment or the gross proceeds from any disposition of such an obligation.

Restriction of Portfolio Interest Exemption

The "portfolio interest" exemption from U.S. withholding tax will no longer be available to "foreign-targeted" obligations that are not issued in registered form. Similarly, the exception for "foreign-targeted" obligations to the denial of a deduction for interest on certain "registration-required" obligations will no longer apply. These provisions are effective with respect to obligations issued after the date that is two years after the date of enactment.

Reporting of Foreign Financial Assets

The Act requires individual taxpayers to disclose on their income tax return any interest in a financial account maintained with a foreign financial institution, any foreign stock, interest in a foreign entity or financial instrument with a foreign counterparty, if the taxpayer's total interest in all of these types of assets combined exceeds $50,000. The penalty for non-disclosure would be $10,000, plus, if the failure continues for more than 90 days after notice of failure to disclose is mailed, an additional penalty of $10,000 for each 30-day period or fraction thereof during which the failure continues after such 90 days, up to a maximum of $50,000. A "reasonable cause" exception to the penalty applies. The penalty for underpayments attributable to undisclosed foreign financial assets would be 40% of the amount of the understatement.

The Act also extends the statute of limitations from three years to six years for significant underreporting of income in connection with undisclosed foreign assets, if the omissions exceed $5,000 and are attributable to one or more reportable foreign assets. These provisions apply to taxable years beginning after the date of enactment.

Substitute Dividends and Dividend-Equivalent Payments Received By Foreign Persons Treated as Dividends

Substitute dividend payments made pursuant to a securities lending or sale-repurchase transaction, as well as payments under a "specified" notional principal contract ("NPC"), in each case that (directly or indirectly) are contingent upon, or determined by reference to, U.S.-source dividends, will be treated as U.S.-source dividend payments and, as such, potentially subject to U.S. withholding tax. The statute also provides for regulations to be promulgated to apply the same rule as to any payments determined to be "substantially similar" to the above-described payments.

A "specified" NPC means a contract where:

- the underlying security is transferred by the counterparty entitled to receive payments pursuant to the NPC that are contingent upon, or determined by reference to, U.S.-source dividends with respect to the underlying security (the "long party") to the other counterparty (the "short party");
- the underlying security is transferred by the short party to the long counterparty upon termination of the contract;
- the underlying security is not readily tradable on an established security market;
- the underlying security is posted as collateral by any short party to the contract with any long party to the contract; or
- the contract is identified in regulations as a "specified NPC."

This provision, which significantly limits the ability to avoid U.S. withholding tax on total return swaps referencing U.S. equity securities, applies to payments made on or after the date that is 180 days after enactment. In addition, any other NPC not determined to be of a type that does not have potential for tax avoidance will be a "specified NPC" with respect to payments made after a date which is two years after the date of enactment.

Delay in Implementation of Worldwide Allocation of Interest

In 2004, Congress provided taxpayers with an election to take advantage of a liberalized rule for allocating interest expense between U.S. and foreign sources for purposes of determining a taxpayer's foreign tax credit limitation. Although enacted in 2004, this election was not available to taxpayers until taxable years beginning after 2008. The provision was then delayed, and the Act further delays the phase-in of this new rule for an additional three years (for taxable years beginning after 2020).

PFIC Reporting

Each U.S. shareholder of a "passive foreign investment company" (or "PFIC") would be required to file an annual information return, even in the absence of any distribution from the PFIC, disposition of stock at a gain or a "qualifying electing fund" election. This provision takes effect on the date of enactment.

U.S. Beneficiary of Foreign Trust

A U.S. person who transfers property directly or indirectly to a foreign trust is treated as the owner of the portion of the trust consisting of the transferred property for any year in which there is a U.S. beneficiary, *i.e.*, the trust is a grantor trust as to the U.S. transferor. The Act:

- 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;
- provides that if there is discretion to make a distribution to any person, the trust is treated as having a U.S. beneficiary unless
    - the terms of the trust specifically identify the class of persons to whom distributions may be made, and
    - none of those persons is a U.S. person during the taxable year;
- clarifies that if any U.S. transferor is directly or indirectly involved in any agreement or understanding that may result in the income or principal of the trust being paid or accumulated for the benefit of a U.S. person, the agreement or understanding is treated as a term of the trust; and
- presumes that the trust has a U.S. beneficiary unless the U.S. transferor submits information to the Secretary that no part of the income or principal may be paid to or accumulated during the year to or for the benefit of a U.S. person, and no part of the income or principal could be paid to a U.S. person if the trust was terminated during the year.

Except with respect to clarifications, these provisions are effective after the date of enactment.

Use of Trust Property Treated as Distribution

Under pre-existing law, a loan of cash or marketable securities to a 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 to such grantor or beneficiary. The Act expands this to provide that any use of trust property by any such persons is treated as a distribution equal to the fair market value of the use of the property, unless the trust is paid the fair market value for the use of the property. This provision applies to loans made and uses of property after the date of enactment.

Reporting and Penalties

The Act requires that the U.S. person who is treated as the owner of a foreign trust provide information as the Secretary may require, and ensure that the trust complies with its reporting obligations. This applies to taxable years beginning after the date of enactment.

The Act increases the minimum penalty to $10,000 for a failure to report on certain foreign trusts with respect to returns required to be filed after December 31, 2009.

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