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From COKALA Tax Group
For our financial industry subscribers

The new Green Book of Treasury Department explanations of the Obama administration's tax law change proposals is available at <http://www.treas.gov/offices/tax-policy/library/greenbk10.pdf>. Our notes are below, on some of these proposals which are found in the "Combat Under-Reporting of Income on Accounts and Entities in Offshore Jurisdictions" section within the larger heading "Other Revenue Changes and Loophole Closers". The FATCA legislation passed by the U.S. House of Representatives in December, 2009, contains many of these items (Foreign Account Tax Compliance Act, H.R. 3933). The Green Book also introduces some new proposals, and has withdrawn a few including changes to the "check the box" rules for entity classification that the administration proposed last year.

Additional certifications or 30 percent withholding required when making a payment to a foreign financial institution. New reporting – or 30 percent withholding by the withholding agent if the additional information collection and reporting were not done – would be required for payments of U.S.-source FDAP income (fixed and determinable annual or periodic income) and gross proceeds from the sale of any type of property that can produce U.S.-source interest or dividends, when paid to a foreign financial institution. These requirements would be in addition to, and regardless of, existing W-8 documentation requirements and Qualified Intermediary rules. A "foreign financial institution" (FFI) in this regard would include entities engaged primarily in the business of investing, reinvesting, or trading in securities, partnership interests, commodities, or any interests in such. To avoid mandatory 30 percent withholding, the FFI would have to enter into an agreement with the IRS requiring the FFI to identify accounts (including debt and equity securities issued by the FFI that are not regularly traded on an established securities market) held at such FFI, or at an FFI in the same expanded affiliated group, by specified U.S. persons or by foreign entities in which a specified United States person owns, directly or indirectly, an interest of more than 10 percent. The FFI would be required to report the name, address, and taxpayer identification number (TIN) of the U.S. account holder (or each substantial U.S. owner of the United States owned foreign entity account holder), the account balance or value, and the gross receipts and gross withdrawals or payments from the account. Or, instead of reporting the account balance and the gross receipts and gross withdrawals or payments from the account, a FFI could elect to do Form 1099 reporting to the IRS just as U.S. payers are required to do. This is proposed to be effective after December 31, 2012. This proposal is similar in many respects, but not all, to a major provision of FATCA.

Additional certifications or 30 percent withholding required making a payment of FDAP income or gross proceeds to a nonfinancial foreign entity. Any withholding agent making a payment of U.S.-source FDAP income and gross proceeds from the sale of any property of a type which can produce U.S.-source interest or dividends to a foreign entity (other than a foreign financial institution) would be required to withhold a tax of 30 percent, unless the foreign entity certifies that no U.S. person owns, directly or indirectly, an interest of more than 10 percent or the foreign entity provides the name, address, and TIN of each such substantial U.S. owner, and the withholding agent does not know or have reason to know that any information provided is incorrect. Exceptions would be provided for payments to publicly traded companies and their subsidiaries, foreign governments, international organizations, foreign central banks, any entity that is organized under the laws of a possession of the United States and that is wholly owned by one or more bona fide residents of such possession, and other classes of person identified

by the Secretary, or any class of payment identified by the Secretary, as posing a low risk of tax evasion. The proposal would be effective for payments made after December 31, 2012. There is a similar provision in FATCA.

Repeal the portfolio interest exemption for foreign-targeted bearer bonds. Current benefits would no longer be available for any debt obligation not in registered form. Thus, under the proposal, a deduction for interest would be disallowed with respect to any registration-required obligation not issued in registered form – no deduction for interest, denial of ordinary income treatment for gain on sale, and disallowance of loss realized on sale. This would apply to debt obligations issued beginning two years following the date of enactment of the change. The same tax law change is in FATCA but with an effective date 180 days after enactment.

New reporting of foreign assets aggregating over \$50,000. This would be a disclosure required to be reported as part of the U.S. income tax return. It would apply to any U.S. individual who holds an interest in a foreign financial account, an interest in a foreign entity or any financial instrument or contract held for investment and issued by a foreign person. The information return would set forth the name and address of the financial institution that maintains such account or the issuer of the instrument, and the maximum value of the asset during the year. This requirement does not replace, and would be in addition to, FBAR requirements (foreign bank account reporting). This would be applicable to tax years beginning after enactment. The same provision is in FATCA.

40 percent penalty on understatement of income from undisclosed foreign accounts. This would be created by making the current 20-percent accuracy-related penalty applicable to any understatement attributable to undisclosed foreign financial assets, and doubling the penalty to 40 percent in the case of such foreign financial asset understatements. Applicability would be to tax years beginning after the date of enactment. In addition, the administration proposes to extend that statute of limitations to six years (instead of the current three-year limit) for omissions from the person's tax return that represent \$5,000 or more in foreign financial asset income. These provisions are in FATCA.

New reporting of transfers to and from foreign financial accounts. This reporting would be part of the federal income tax return of a U.S. individual, requiring the reporting of any transfer of money or property made to, or receipt of money or property from, any foreign bank, brokerage, or other financial account by the individual. Additionally, any entity of which a U.S. individual owns, directly or indirectly, more than 25 percent of the ownership interest would be required to report any transfer of money or property made to, or receipt of money or property from, any foreign bank, brokerage, or other financial account by the entity. Such an entity would also be required to report the name, address, and taxpayer identification number of any U.S. individual who owns more than 25 percent of the ownership interest in the entity. This reporting requirement would not apply if the cumulative amount or value of transfers, and the cumulative amount or value of receipts that would otherwise be reportable for a given year were each less than \$50,000. The Treasury Department would receive regulatory authority to require the reporting of additional information, including classifying transfers and receipts as for investment or for arm's-length payments in the ordinary course of business for services or tangible property, or such other categories as the Secretary may prescribe. Failure to report a covered transfer would result in the imposition of a penalty equal to the lesser of \$10,000 per reportable transfer or 10 percent of the cumulative amount or value of the unreported covered transfers. This reporting requirement would be effective for all such transfers after December 31, 2012.

New information returns by U.S. financial institutions for transfers to and from foreign accounts.

All transfers of money or property with a value of \$50,000 or to, or received from, a foreign bank, brokerage, or other financial account on behalf of a U.S. individual, or on behalf of any entity of which a U.S. individual owns, directly or indirectly, more than 25 percent of the ownership interest, would be required to file an information return (including, in the case of a transfer by an entity, the name, address, and taxpayer identification number (TIN) of any U.S. individual who owns more than 25 percent of the ownership interest in such entity). Any U.S. financial institution that opens a foreign bank, brokerage, or other financial account on behalf of a U.S. individual, or on behalf of any entity of which a U.S. individual owns, directly or indirectly, more than 25 percent of the ownership interest, would be required to file an information return with the IRS regarding such account, including reporting any amounts of money or property transferred by the financial institution to, or received by it from, such account. There would be reporting exceptions for publicly traded corporations, tax-exempt entities, governments, individual retirement plans, and any wholly owned agency or instrumentality of any one or more of those exempt entities, and also exemptions for any bank (as defined in section 581); any real estate investment trust (as defined in section 856); any regulated investment company (as defined in section 851); any common trust fund (as defined in section 584(a)); any trust which is exempt from tax under section 664(c) or is described in section 4947(a)(1); or an entity engaged in an active trade or business (other than the business of investing or similar activities). This would be applicable to transfers and receipts beginning immediately after the date of enactment.

Electronic IRS filing required for all Forms 1042-S with withholding. Regardless of the existing 250-return threshold, all Forms 1042-S, filed by a financial institution, that report U.S. tax withholding would have to be filed with the IRS electronically. This would be effective for all 1042-S filings due after the date of enactment. FATCA includes the same provision.

Transfer to a foreign trust creates the presumption that there is a U.S. beneficiary. Under the proposal, if a U.S. person directly or indirectly transfers property to a foreign trust (other than certain deferred compensation and charitable trusts), the trust would be presumed to have a U.S. beneficiary for purposes of the grantor trust rules unless the U.S. transferor files an information return with the IRS and demonstrates 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 any 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 any U.S. person. The proposal would also make certain clarifications of existing rules applicable to foreign trusts with U.S. grantors and beneficiaries.

In addition, the use of foreign trust property – other than cash or marketable securities – by a U.S. grantor or beneficiary would be treated as a distribution valued at fair market value. In addition, for purposes of the grantor trust rules, a loan of cash or marketable securities or the use of other property of a foreign trust would be treated as paid or accumulated for the benefit of a U.S. person, except to the extent that the U.S. person repays the loan at market rates (or pays the fair market value of the use) within a reasonable period of time. This would be effective for all such transfers after the date of enactment.

Further, a minimum \$10,000 penalty would be established for failure to report to the IRS the information required to be reported regarding the creation of a foreign trust and certain other information.

All three of these provisions are in FATCA.

Substitute dividend payments deemed to be U.S.-source income for a foreign owner if the underlying equity is a U.S. security. Substitute dividend payments made with respect to equity

swaps referencing U.S. securities would be subject to U.S. withholding rules, because the payments would be deemed to be U.S.-source income, to the extent that the income is attributable to (or calculated by reference to) dividends paid by a domestic corporation. An exception to this source rule would apply to swaps which are unlikely to reflect avoidance of U.S. gross-basis taxation. This provision would be effective for payments made after December 31, 2010. The same provision is in FATCA and has a technical explanation that the payments treated as U.S.-source dividends are the gross amounts used in computing any net amounts transferred to or from the taxpayer.

Repeal the 80/20 company rules. Dividends and interest paid by a domestic corporation are generally U.S.-source income to the recipient and are generally subject to gross basis withholding tax if paid to a foreign person. A limited exception to these general rules applies with respect to a U.S. corporation if at least 80 percent of the corporation's gross income during a three-year testing period is foreign-source and attributable to the active conduct of a foreign trade or business. The proposal is to repeal this exception, I.R.C. Sec. 861(c), effective for tax years beginning after December 31, 2010. The same provision was in the tax legislative proposals presented by the administration last year.

Repeal the "boot within gain" limitation rule. The limitation of I.R.C. Sec. 356(a) would be repealed in the case of a reorganization in which the acquiring corporation is foreign and the shareholder's exchange has the effect of the distribution of a dividend. The Green Book explanation states that there is not a significant policy reason to vary the treatment of a distribution that otherwise qualifies as a dividend by reference to whether it is received in the normal course of a corporation's operations or is instead received as part of a reorganization exchange. Thus, repealing the boot-within-gain limitation for an exchange that has the effect of the distribution of a dividend will provide more uniform treatment for dividends that is less dependent on context. A narrow version of this proposal was in the administration's legislative proposal package last year; it was limited in application to reorganizations in which a U.S. corporation is acquired by a foreign corporation. The new proposal would apply to all reorgs and be effective for taxable years beginning after December 31, 2010.

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