PRICEWATERHOUSECOOPERS

Flash News

Important amendment of US withholding and reporting regulations

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Draft bill provides for substantial tightening of current regulations as well as enlarging the number of persons concerned

On October 27, 2009, a new US legislation has been introduced which will significantly change US withholding tax and reporting obligations. This is likely to impact financial service and asset management industry.

1. Overview of the Proposed Changes

A new US draft bill ("Foreign Account Tax Compliance Act of 2009") was introduced on October 27, 2009, which would significantly change US withholding and reporting regulations. It would potentially impact most participants in the financial services and asset management industry, including hedge funds, private equity and other investment vehicles. For institutions already acting as Qualified Intermediary ("QI"), these new rules would be applicable in addition to those fixed in the QI agreement.

Further detailed guidance would need to be issued by the US tax authority ("IRS") to clarify procedures and conditions. It is unclear whether and to what extent worldwide efforts of industry will be successful to water down the provisions respectively postpone the effective date of the provisions.

1.1. Payments to Foreign Financial Institutions (incl. Investment Vehicles)

Any withholding agent has to deduct 30% withholding tax on all "withholdable payments" made to "foreign financial institutions". This includes fixed or determinable annual or periodical gains, profits and income from sources within the US (i.e. amongst others interest, dividends, rents….) as well as any gross proceeds from the sale of any property that could produce interest or dividends from sources within the US.

No withholding tax needs to be deducted if the "foreign financial institution" (es defined in a very broad sense, including investment vehicles) enters into an agreement with the IRS to:

- Provide an annual report containing certain information regarding to any US account maintained by such institution (incl. any affiliated financial institution); in this sense:
  - "US account" is defined as any account held by one or more specified US persons or "US-owned foreign entities"
  - A "US-owned foreign entity" would be any corporation, partnership or trust in which a specified US person owns directly or indirectly more than 10% of

the stock (by vote or value), interest, profits or capital (depending on type of entity); to the extend that the foreign entity is a corporation or partnership engaged primarily in the business of investing, reinvesting or trading in securities, commodities, interest in partnerships etc., the 10% threshold is reduced to zero. Exceptions are foreseen in case that US person is e.g. a US publicly traded company (or an affiliated entity), a US real estate investment fund, a US exempt organization or retirement plan, a regulated US investment company etc.

- Information to be reported will include name, address and account number as well as account balance or value, gross receipts and gross withdrawals or payments from the account.
- Alternatively, the foreign financial institution might elect to report the payments made (from US and non-US source) with forms 1099 as if the account holder were a natural person and citizen of the US; this would apply also to payments made to accounts held by US-owned foreign entities.
- A foreign financial institution resident in a state where such report would be prohibited by law should attempt to obtain a waiver; if the waiver is not given, the foreign financial institution has to close the account.
- Foreign financial institutions may elect not to report certain small accounts held by US individuals (i.e. threshold USD 10,000, respectively USD 50,000 if account existed at the date of enactment), taking into account all accounts held by such US persons with affiliated financial institutions at an aggregate level.

- Undergo a not yet defined procedure of verification of such report

The reporting requirements apply with respect to all affiliated financial institutions of the extended group.

The definition of “foreign financial institution” is very broad and includes e.g. not only banks but any entity that (1) accepts deposits in the course of banking or similar business, (2) is engaged in the business of holding financial assets for the account of others, or (3) is engaged primarily in the business of investing, reinvesting or trading in securities, interest in partnerships, commodities or any other interest (e.g futures, forwards) in such investments. Therefore, this may include foreign partnerships, foreign trusts, hedge funds, private equity funds and other investment vehicles.

A withholding agent is defined as any person in whatever capacity, having the control, receipt, custody, disposal or payment of any withholdable payment.

The draft law provides certain exceptions in case the beneficial owner is e.g. foreign government, an international organization, a central bank or any other class of person identified by the Secretary as posing low risk of tax evasion.

These provisions would be effective for payments made after December 31, 2010.

1.2. Payments to Foreign Entities

In case payment is made to a foreign entity which is not a financial institution in the meaning as set out above, any withholding agent needs to deduct and withhold 30% withholding tax on any withholdable payment as defined above (e.g. US source

interest and dividends, sales proceeds from property which might produce US source interest and dividends).

Such payments will not be subject to 30% withholding 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 US owner, or provides the withholding agent with the name, address and TIN of such substantial US owner. In addition, the withholding agent must not know or have reason to know that the certification or information provided is incorrect. And the withholding agent must report name, address and TIN of such substantial US owner to the IRS.

Exceptions apply to any payment beneficially owned by e.g. a publicly traded company (of affiliate thereof), foreign government, international organization.

The following provisions would be effective for payments made after December 31, 2010.

1.3. Refund Procedure

The draft bill entitles the IRS to issue regulations under which the application of reduced treaty rates may be permitted. Alternatively, the IRS may also require a withholding at 30% and allow treaty country residents to obtain treaty benefits through a refund process. It is still unclear, which procedure will be applicable and whether the IRS will make a distinction depending on the country of residence of the entity through which the payments are made.

1.4. Electronic Filing

Currently, no electronic filing is required unless the withholding agent files more than 250 forms. Under the draft bill, the IRS may require electronic filing even though such financial institution would be required to file less than 250 forms during the year. According to the draft bill, this provision would apply to returns the due date for which (determined without regard to extensions) is after the date of enactment.

1.5. Dividend Equivalent Payments on Equity Swaps

Payments made under a notional contract that directly or indirectly is contingent upon, or determined by reference to, the payment of a dividend from a source within the US would under the draft law be treated like a dividend from US source. The amount subject to reporting and withholding is the gross amount before offsetting other payments to be made under the Swap (e.g. the interest amount and amount of any appreciation or depreciation of the referenced stock). Accordingly, a counterparty of a total return swap may be obliged to withhold and remit tax on the gross amount of the dividend equivalent even though, as a result of the netting under the swap agreement, the counterparty is not required to make any payment to the foreign investor.

With respect to this provision, any person that is a party to a contract or other arrangement that provides for a dividend equivalent payment is treated as having control on the payment and IRS may require either party involved to withhold tax.

The IRS may however issue guidance under which the contract or arrangement is not considered having a potential for avoidance of tax (e.g. taking into account the amounts involved, the term of the contract, etc.). Payments under such contracts or arrangements would not be considered as a dividend equivalent under this provision.

1.6. Other Provisions

- Extension of sanctions against bearer bonds

In order to reduce opportunities for US investors to avoid taxation, payments made on an obligation, which is not issued in registered form, will be subject to 30% withholding unless the withholding agent can establish that the beneficial owner is entitled for another reduction (e.g. under a tax treaty).

- Disclosure to be made by US individual taxpayers regarding foreign financial assets (incl. penalties) and Passive Foreign Investment Companies

US individual taxpayers are already today obliged to report under certain conditions specified foreign assets (incl. e.g. foreign bank accounts). Such reporting requirements will be extended and important penalties are fixed with respect to failures of such reporting.

- Extension of statute of limitations

The period for assessment of tax on understatements of income attributable to foreign financial assets would be extended to six years. This will give the IRS more time to investigate and assess such tax.

- Disclosure of assistance in acquiring or forming a foreign entity

Each “material advisor” with respect to a foreign entity transaction is required to file an information return disclosing amongst others the identity of the foreign entity and the US citizen or resident acquiring an interest (directly or indirectly) in a foreign entity. Any person will be considered as a material advisor if the person provides any material aid, assistance or advice (incl. tax advice) with respect to such a transaction and deriving gross income exceeding USD 100,000 for providing such service.

- Provisions related to trusts

The draft law provides for several changes to trust rules (e.g. conditions under which a trust is having a US beneficiary), and expands reporting obligations of US owners.

- QI Audit

The draft bill does not include further guidance on potential changes of the QI audit rules. In this respect, we refer to the Announcement 2008-98 (October 14, 2008). It is however very likely that further amendments to the QI audit guidelines will be made in order to verify QI’s compliance with the new obligations.

2. Actions to be Taken

As the law has not been voted yet and further guidance needs to be issued by the IRS, some details remain unclear. In addition, industry provides comments and input to the US government and the IRS in order to better define, modify and postpone the effective date of the changes.

However, given the likelihood that many of the draft regulations might be voted, all market players already now need to start:

- Understand the new draft legislation and the obligations resulting from the bill;
- Perform a high level analysis of the general impact on their specific business (client structure, investments, operations, cash flows, risk areas);
- Undergo a more detailed analysis of the options and their impact in order to prepare the business decision;
- Once the business decision is taken, implement new systems and procedures.

3. How PwC Can Help

PwC has the technical and practical expertise with respect to Qualified Intermediary as well as reporting and compliance topics. In addition, PwC’s international practice has experts with respect to structures, involving any legal type or business, with investors from the US or making investments into the US. Our local experts are supported by a dedicated team of experienced professionals in the US.

With respect to the change of the US tax legislation, PwC could:

- Understanding the new rules: At a first stage, a workshop might be held in order to inform all the relevant stakeholders and departments within your organization about the potential changes;
- Perform high level analysis of impact: PwC Experts from Tax and Advisory might support you in performing a health check and analyzing the impact of the new rules to your specific activity;
- Detailed analysis: PwC Experts can assist you in analyzing the current operations, determine the options and assess the impact per option. The purpose of this exercise is to support your in your decision making process;
- Implementation: Depending on your redefined strategy, PwC Experts might support the implementation process.

PwC ACADEMY will, in collaboration with the technical experts from PwC, offer trainings which could be tailored to your specific needs.

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