

# INCREASED REPORTING AND ENFORCEMENT MEASURES FOR U.S. AND OFFSHORE INVESTMENTS

*Federal/International Tax Alert*  
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On March 18, 2010, President Obama signed into law the Hiring Incentives to Restore Employment (HIRE) Act, which is intended to provide new incentives for hiring and retaining employees. To offset some of the costs of this legislation, the new law also includes a comprehensive set of initiatives aimed at increasing information-reporting and enforcement measures for U.S. and offshore investments. These measures were originally included in earlier bills proposed by Congress (Foreign Account Tax Compliance Act of 2009 (FATCA)) and are also based on proposals included in President Obama's 2011 budget. The new rules provide a major revamping of the withholding rules for non-U.S. persons investing in the United States.

The following is a summary of some of the key provisions relating to the new information-reporting and compliance measures for U.S. and offshore investments.

## Withholding Tax on Certain U.S.-Source Payments to Foreign Entities

U.S.-source payments made to foreign persons of fixed or determinable annual or periodical (FDAP) income are subject to a 30 percent U.S. withholding tax, unless the beneficial owner qualifies for an exemption or a reduced withholding rate under the Internal Revenue Code or an income tax treaty. FDAP income generally includes interest and dividends but not gains on sales of property. A nonresident investor may obtain withholding tax relief for U.S.-source investment income if certification is provided on Form W-8 to the withholding agent, establishing the investor's foreign status and eligibility for an exemption or reduced withholding rate.

The new legislation provides new withholding tax rules for foreign entities that do not comply with certain reporting requirements. The law requires withholding agents to withhold 30 percent on U.S.-source FDAP payments and, in a significant departure from current law, gross proceeds from the sale or disposition of stock and debt paid to foreign financial institutions (FFIs) and other foreign entities that fail to comply with the new reporting requirements. The new reporting generally requires

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the FFI, which includes banks and other foreign entities engaged in the business of holding financial assets for the account of others or in the business of investing (e.g., foreign hedge funds and private equity funds), to report the name, address, and taxpayer identification number (TIN) of certain U.S. account holders (other than accounts owned by certain U.S. persons such as publicly traded corporations, exempt organizations, and banks). In addition, the FFI must annually report the account balance, and the gross receipts and withdrawals from such account. If an account holder is a U.S.-owned foreign entity, the FFI is generally required to report the name, address, and TIN of each substantial U.S. owner (i.e., generally more than 10 percent) of the foreign entity. The new law does provide for some exceptions to the reporting requirement (e.g., for foreign governments and political subdivisions thereof and others as determined by the Treasury Department).

The new legislation also imposes similar withholding tax rules on payments to foreign entities that are not FFIs. Any payment of U.S.-source FDAP income, or income from the sale of certain stock or debt, will be subject to a 30 percent withholding tax to non-FFI foreign entities unless the entity provides the withholding agent with either (1) a certification that it does not have a substantial U.S. owner, or (2) if it does have substantial U.S. owners, the name, address, and TIN of its substantial U.S. owners. As with payments to FFIs, there will be exceptions for certain foreign entities (e.g., publicly traded corporations, foreign governments, and others as determined by the Treasury Department).

**These new provisions are generally effective for payments made after December 31, 2012, with certain exceptions.**

## Disclosure of Foreign Assets on U.S. Tax Returns

Individual taxpayers will now be required to disclose on their U.S. tax returns detailed information about foreign financial assets if the aggregate value of the assets exceeds \$50,000, starting on 2011 income tax returns. A \$10,000 minimum penalty may be imposed for failure to comply with this requirement, unless the failure is due to reasonable cause and not willful neglect. In addition, the statute of limitations will not begin to run until the disclosure statement is filed. This new reporting is separate from the TD F 90-22.1 (Foreign Bank Account Report (FBAR)) which must be filed annually by all U.S. persons with the U.S. Treasury Department to report a financial interest in, or signature or other authority over, bank accounts, securities accounts, or other financial accounts in foreign countries, if the aggregate value of the accounts exceeds \$10,000. Because the FBAR filing is not provided for in the Internal Revenue Code, FBAR enforcement by the IRS has been difficult. The new reporting requirement will give the IRS broader discretion for imposing penalties for noncompliance.

Significantly, the definition of reportable foreign financial assets for tax reporting purposes under this new provision is much broader than under the FBAR rules, and includes, among other items, stock and securities issued by foreign persons and held directly by a taxpayer, including interests in foreign entities.

## Extension of Statute of Limitations for Certain Omissions of Income from Foreign Assets

The IRS must generally assess taxes within three years after a taxpayer's return was filed, unless an exception applies. The new legislation extends the statute of limitations for certain omissions of income related to foreign assets. Existing law extends the statute of limitations to six years if a taxpayer omits from gross income an amount exceeding 25 percent of reported income. The statute is now also extended to six years when the omitted amount exceeds \$5,000 and is attributed to one or more reportable foreign assets. This provision applies to returns filed after March 18, 2010, as well as returns for which the statute of limitations is still open as of March 18, 2010.

## Penalties for Underpayments from Undisclosed Foreign Financial Assets

A 20 percent accuracy-related penalty generally applies to the portion of any underpayment of tax attributable to any substantial understatement of income tax. The legislation imposes a new penalty equal to 40 percent of the amount of any understatement that is attributable to an undisclosed foreign financial asset (i.e., any foreign financial asset that a taxpayer is required to disclose and fails to disclose on an information return). An understatement is attributable to an undisclosed foreign financial asset if it is attributable to any transaction involving the asset. For instance, 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 is subject to the penalty provision, as is any underpayment related to interest, dividends, or other returns accrued on such undisclosed amounts. This provision is effective for tax years beginning after March 18, 2010.

## Increased Reporting for Shareholders in Passive Foreign Investment Companies

The new legislation requires a shareholder of a passive foreign investment company (PFIC) to file an annual information return with the shareholder's U.S. tax return. A PFIC is generally defined as any foreign corporation if 75 percent or more of its gross income for the tax 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. Previous law only required the information return if the shareholder received a direct or indirect distribution from a PFIC, sold or was deemed to sell stock of a PFIC, or made certain elections with respect to the PFIC shares (i.e., qualified electing fund election). The new annual PFIC reporting takes effect on March 18, 2010.

## Failure-to-File Penalty for Certain Foreign Trust Information Returns

A \$10,000 minimum failure-to-file penalty will be imposed for the failure to file certain information returns related to a U.S. person's interest in a foreign trust. A U.S. taxpayer that fails to file an information return (i.e., Form 3520) with respect to certain transactions involving foreign trusts (e.g., the creation of a foreign trust, the transfer of money or property

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to a foreign trust, etc.) is generally subject to a 35 percent penalty of the amount required to be disclosed. In some instances, the IRS may be unable to determine the amount that was required to be disclosed. This new provision will ensure that a minimum penalty of \$10,000 be imposed for any such failure to file, and applies to notices and returns required to be filed after December 31, 2009.

The legislation also enacts several other provisions aimed at strengthening the tax rules applicable to U.S. persons and foreign trusts.

### Conclusion

In addition to the foregoing, the HIRE Act also repeals the portfolio interest exemption for interest on foreign targeted bearer bonds, treats dividend equivalent amounts as dividends for withholding tax purposes and delays the worldwide interest allocation rules until tax years beginning after December 31, 2020. The new legislation clearly provides the U.S. Treasury with opportunities to find and monitor U.S. taxpayers that hide offshore assets from the Internal Revenue Service. As with any new piece of legislation, there will likely be several issues that arise with respect to the implementation of these new reporting requirements. It is also likely that there will be further guidance interpreting these rules. International tax practitioners should be familiar with these rules as they could significantly impact their U.S. and non-U.S. clients.