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Congress Considers Extensive Changes to US Tax Reporting of International Structures

Legislation entitled the "Foreign Account Tax Compliance Act of 2009" was introduced in both Houses of Congress last week by the Chairmen of the House Ways and Means Committee and the Senate Finance Committee and was publicly endorsed by President Obama and his Treasury Secretary. The legislation is described by its sponsors as bringing together the best of various proposals introduced last spring to combat the use of foreign accounts and structures by US tax evaders.

The primary thrust of the legislation is to require every foreign financial institution (regardless of whether it has "Qualified Intermediary" status) to certify to the United States Treasury that the institution has implemented specified due diligence procedures designed to identify "United States accounts" and to provide to the Treasury annually detailed information about US taxpayers who are either "account holders" or "substantial United States owners" of an entity that is an account holder. Any payment of US source income, or of the gross proceeds of sale of an asset that would produce US source income, to a foreign financial institution that does not meet these requirements is subject to a 30% gross withholding tax.

A similar regime requiring certification to withholding agents (rather than the Treasury) is imposed on any "non financial foreign entity" payee. This applies, for example, to a US custodian making payments directly to a foreign entity such as a foreign private corporation.

A second major thrust is to impose a broad new annual information reporting regime somewhat similar to, but not in substitution for, the current "Report of Foreign Bank Accounts" regime under US banking laws. Under the proposals, "any individual" who "holds any interest in a specified foreign financial asset" must file a report for any year during which the aggregate value of all such assets at any time exceeds $50,000. The proposed legislation specifically notes that the Treasury may create regulations regarding how these requirements will apply to non resident aliens, so the drafters apparently intend these reporting requirements to apply to individuals with US tax connections who are not US tax resident. The definition of "specified foreign financial assets" includes stock, securities or other contractual obligations issued other than by a United States person. It also includes "any interest in a foreign entity”.

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A new information reporting regime is also imposed on any person who provides any "material aid, assistance or advice" with respect to any "foreign entity transaction" and who derives gross income in excess of $100,000 during a calendar year for providing such aid, assistance or advice. Fortunately, the reporting obligation is limited to transactions that are reportable by the individual taxpayer himself under specific Code sections (and the new section imposing annual information reporting for foreign financial assets is not included).

There are substantive taxation provisions as well. For example taxation of the use of foreign trust property by a US beneficiary is included but with some welcome clarifications compared to prior proposals. In this draft, tax is imposed only on the value of the use (not the value of the capital asset used). In addition, tax is imposed only if the US beneficiary does not pay fair market value for such use within a reasonable period of time. The tax will take effect with respect to any use occurring on or after the date of enactment.

Additional expansion of the rules applicable to cause a foreign trust to be taxed as a grantor trust to a US settler under Internal Revenue Code section 679 are also included. These primarily codify a conservative interpretation of existing regulations. They also add provisions the effect of which is that any foreign trust to which a living United States person has directly or indirectly made a transfer will be a grantor trust to that person unless the taxpayer "demonstrates to the satisfaction of the Secretary" that the trust does not have a United States beneficiary.

Also included are expanded PFIC information reporting rules, but unlike broader prior drafts the new annual reporting requirements only apply to a "shareholder" of a PFIC. While this requirement will likely apply to both direct and indirect PFIC shareholders (i.e. to any person who would be subject to tax under the PFIC regime if an "excess distribution" were received by the direct owner of a PFIC), it would not apply to individuals who are "beneficiaries" of an entity that holds PFICs but who do not fall within the "indirect" shareholder rule.

Finally a number of miscellaneous changes are also proposed relating to penalties, extension of statutes of limitation and tightening rules with respect to certain debt instruments and notional principal contracts.

For further information please contact any of the following individuals at Bryan Cave, 88 Wood Street, London EC2V 7AJ – Dyke M. Arboneaux (Tel: 020 3207 1173 or email dyke.arboneaux@bryancave.com), Shannon Ryser (Tel: 020 3207 1801 or email sjryser@bryancave.com) or Tracey Cherryman (Tel: 020 3207 1180 or email tracey.cherryman@bryancave.com).