

US Targets Foreign Investment

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 associated costs, the act also includes enhanced information-reporting and enforcement measures for US and offshore investments that were originally included in proposals in Congress's Foreign Account Tax Compliance Act of 2009 and were also based on the president's 2011 budget proposals. The new rules are a major revamping of the withholding rules for non-US persons investing in the United States.

US-source payments to a foreign person of fixed or determinable annual or periodical (FDAP) income attract a 30 percent US withholding tax, unless the beneficial owner qualifies for an exemption or a reduced Code or treaty rate. FDAP income generally includes interest and dividends but not a gain on the sale of property. A non-US investor may obtain withholding tax relief for US-source investment income if form W-8 certification provided to the withholding agent establishes the investor's foreign status and eligibility for an exemption or a reduced rate.

The new law, generally effective for payments after 2012, provides new withholding tax rules for foreign entities that do not comply with certain reporting requirements. If a payee foreign financial institution (FFI) or other affected foreign entity fails to comply with the new reporting requirements, a withholding agent must withhold 30 percent from payments of US-source FDAP income and, in a significant departure from current law, of gross proceeds from the sale or disposition of stock and debt.

An FFI includes a bank or another foreign entity engaged in the business of holding financial assets for the account of others or in the business of investing, such as a foreign hedge fund or private equity fund. The new reporting generally requires an FFI to report the name, address, and taxpayer identification number (TIN) of certain US account holders, and generally of each substantial US owner (generally more than 10 percent) of a US-owned foreign entity that is an account holder. The FFI must also annually report the account balance and its gross deposits and withdrawals. Some reporting exceptions are made, including for some US persons such as publicly traded corporations, exempt organizations, and banks; foreign governments and political subdivisions thereof; and others as determined by Treasury.

Similar withholding tax rules for payments to a non-FFI foreign entity of US-source FDAP income or of income from the sale of certain stock or debt impose a 30 percent withholding tax, unless the entity provides the withholding agent with either (1) certification that the entity does not have a substantial US owner, or (2) the name, address, and TIN of its substantial US owner. Excepted foreign entities include publicly traded corporations, foreign governments, and others determined by Treasury.

Starting with the 2011 income tax return, an individual taxpayer must also now disclose on his or her US tax return detailed information about foreign financial assets whose aggregate value exceeds \$50,000. A minimum \$10,000 penalty may apply for non-disclosure (unless reasonable cause exists), and the limitation period does not start to run until the required disclosure is filed. This new reporting is separate from "Report of Foreign Bank and Financial Accounts" (FBAR, IRS form TD F 90-22.1), which each US person must file annually 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. The new definition of "reportable foreign financial assets" is much broader than the definition under the FBAR rules and includes, for example, stock and securities issued by a foreign person and held directly by a taxpayer, including an interest in a foreign entity.

A 20 percent accuracy-related penalty generally applies to any underpayment of tax attributable to a substantial understatement of income tax. For tax years beginning after March 18, 2010, a new penalty is created equal to 40 percent of any understatement attributable to any transaction involving a foreign financial asset not disclosed on an

information return. For instance, if a taxpayer fails to disclose amounts in a foreign financial account, any underpayment of tax related to the transaction that gave rise to the income is subject to the penalty, as is any underpayment related to interest, dividends, or other returns accrued on the undisclosed amounts.

The new law requires a passive foreign investment company (PFIC) shareholder to file an annual information return with its US tax return. A PFIC is generally any foreign corporation if at least 75 percent of its gross income for the tax year is passive or at least 50 percent of its assets produce, or are held for the production of, passive income. Previously, an information return ("Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund," IRS form 8621) was required only if the shareholder received a direct or indirect PFIC distribution, sold or was deemed to sell PFIC stock, or made certain elections such as the qualified electing fund election. Although this new law was effective March 18, 2010, IRS Notice 2010-34 clarifies that PFIC shareholders that before that date were not otherwise required to file form 8621 annually are not required under the new law to file an annual report for tax years beginning before that date.

A new rule ensures that a minimum \$10,000 penalty applies after 2009 to a US taxpayer that fails to file certain information returns related to its interest in a foreign trust. The existing 35 percent penalty for failure to disclose an amount on an information return ("Annual Return To Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts," IRS form 3520) for certain transactions involving a foreign trust (such as the creation of a foreign trust or the transfer of money or property to it) was ineffective in practice because the IRS was sometimes unable to determine the amount required to be disclosed.

Several other new provisions strengthen the tax rules related to US persons and foreign trusts. The HIRE Act repeals the portfolio interest exemption for interest on foreign targeted bearer bonds, treats dividend equivalents as dividends for withholding tax purposes, and delays the worldwide interest allocation rules until tax years beginning after 2020. The new legislation clearly provides the Treasury with opportunities to find and monitor taxpayers that hide offshore assets from the IRS. As with any new law, it is likely that implementation issues will arise and further interpretive guidance will be released. Canadians should be familiar with these rules and the potentially significant impact on their US and offshore investments.

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