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Proposed Legislation Focused on Offshore Tax Evasion*

OVERVIEW

On October 27, 2009, Senators Max Baucus and John Kerry and Congressmen Charles Rangel and Richard Neal unveiled the proposed Foreign Account Tax Compliance Act of 2009 (the "Bill"), together with an accompanying technical explanation prepared by the Staff of the Joint Committee on Taxation (the "JCT Report"). The Bill is a consensus agreement among Senate Finance Committee Chairman Max Baucus, House Ways and Means Committee Chairman Charles Rangel and the Obama Administration. The Bill follows up on earlier proposals to combat offshore tax evasion that were proposed by the Administration, Senators Baucus and Carl Levin and Representative Lloyd Doggett. The Ways and Means Select Subcommittee has scheduled a hearing on the Bill for November 5, 2009. At this time, we believe that there is a relatively high likelihood that the central parts of the Bill will be enacted.

The main provisions of the Bill would:

- Create a complicated and expansive reporting and withholding tax regime (which we have dubbed "QI 2.0") intended to force non-U.S. financial intermediaries and investment vehicles to identify U.S. account holders and investors, including U.S. investors who may be hiding behind foreign entities

- Enact a companion disclosure provision (backed up by a withholding tax for non-disclosure) for non-financial foreign entities

- Repeal the foreign-targeted bearer bond exception of TEFRA (and the related exception to the portfolio interest exemption), so that debt sold in international capital markets cannot be in bearer form

- Impose withholding tax on dividend-equivalent amounts in equity swaps in respect of U.S. stocks and on other dividend-equivalent payments, subject to exceptions to be determined under Treasury guidance

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- Enact additional reporting requirements for offshore bank accounts and investments and changes to penalties and the statute of limitations for failures to report

In a number of important respects, the Bill is responsive to concerns expressed by the private sector regarding prior proposals. However, the extension of the QI 2.0 regime beyond traditional financial institutions to virtually every type of foreign investment entity (including hedge funds, private equity funds, securitization vehicles and other investment vehicles, whether widely held or privately owned) poses a potentially substantial compliance burden on perhaps hundreds of thousands of entities. The Bill sets forth a framework for the QI 2.0 regime and requires that the Treasury Department and the Internal Revenue Service (the "IRS") develop detailed and complex guidance.

The challenge faced by Congress, the Treasury Department and the IRS is to craft a regime that balances the legitimate interest of the United States in ensuring compliance with the U.S. tax law against administrability and cost considerations, and that does so in a manner that reflects a careful understanding of how the global capital markets and the financial systems operate. Much will depend on the nature of the detailed guidance that is developed and on the amount of time allowed for its implementation. The challenges of achieving the right balance on the substantive and timing issues are significant because a system that is administratively overly complex and expensive, or that cannot be implemented on a timely basis, conceivably could result in market disruptions and disinvestment from the U.S. capital markets.

Given the complexity of the implementation issues presented by the QI 2.0 regime for both the Government and financial institutions and investment vehicles, we expect that the December 31, 2010 proposed effective date for these provisions will need to be postponed for a number of years. It is important that the legislation as passed allow for this flexibility.

The remainder of this Alert Memo summarizes the Bill's principal provisions, identifies certain key issues raised by the QI 2.0 regime and other provisions of the Bill, and provides preliminary observations regarding its implications for various types of financial intermediaries, including banks, securities firms, investment entities and securitization vehicles.

SUMMARY OF THE BILL'S PRINCIPAL PROVISIONS

1. New "QI 2.0" Regime for All Non-U.S. Financial Institutions, Investment Funds and Securitization Vehicles, Focused on Disclosure of U.S. Account Holders; Failure to Qualify Results in 30% Withholding Tax on U.S. Source FDAP Income and Gross Proceeds from the Sale of U.S. Stocks and Securities.

a. Description

Under current law, a non-U.S. financial intermediary receiving income from U.S. sources for the account of its customers can claim the benefit of an exemption from U.S. withholding tax either by providing required tax certifications for each investor or by entering into a qualified intermediary ("QI") agreement with the U.S. tax authorities. Banks and securities dealers that receive and process thousands of payments from U.S. sources, and have commensurately large compliance departments, have tended to enter into QI agreements. Smaller institutions, and particularly investment vehicles that receive income from U.S. sources primarily or exclusively for their own account, have instead typically provided individual certifications.

The Bill would eliminate this flexibility. It would require all entities in a very broadly-defined class of "foreign financial institutions" ("FFIs") to enter into agreements with the IRS that appear to be patterned after the existing QI reporting regime. However, this new "QI 2.0" regime would operate as a parallel system and in addition to the existing regime.[1] Under this new regime, withholding agents would be required to withhold a 30% tax from payments to an FFI of (i) U.S. source dividends, interest or other "FDAP" income, and (ii) any gross proceeds from the sale of assets that can produce U.S. source dividends or interest (collectively, "withholdable payments"), ***unless*** the FFI enters into a QI 2.0 agreement with the IRS.[2]

The withholding tax is designed to compel FFIs to enter into QI 2.0 agreements that require the FFI to provide information to the IRS with respect to certain U.S. account holders. Unlike existing withholding tax rules, there is no necessary connection between the

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[1] Guidance will need to be provided as to the interaction between the existing QI regime and the QI 2.0 regime, which guidance should endeavor to minimize inconsistencies as well as unnecessary and duplicative requirements on QIs.

[2] The general requirements for this agreement are set forth in proposed Section 1471(b)(1) of the Internal Revenue Code of 1986, as amended (the "Code"). To avoid duplication, amounts subject to tax under this new regime would not also be taxed under the withholding tax for foreign investors in respect of FDAP income or FIRPTA gains (Sections 1441, 1442 and 1445 of the Code).

The Bill exempts payments that are beneficially owned by foreign governments, foreign central banks and international organizations, and authorizes the Treasury Department to extend exemptions to other classes of payments that it determines pose a low risk of tax evasion.

beneficial owner of the payment and the application of the withholding tax. Thus, the withholding tax would apply to an FFI that has not entered into a QI 2.0 agreement with the IRS even if the FFI has no U.S. customers and even if it holds U.S. securities solely for its own account and has provided the information required to claim an exemption from U.S. tax under current law. For example, an interest payment on U.S. Treasuries owned by a foreign bank for its own account, or for the account of non-U.S. account holders, generally would be subject to the new withholding tax unless the foreign bank agreed to report, among other things, payments of bank deposit interest to certain U.S. account holders. The fact that the deposit interest paid by the foreign bank would itself be foreign source income would not affect the reporting obligation. Further, the extension of the withholding requirement to gross proceeds would increase significantly the potential costs of noncompliance.

Under the Bill, an FFI includes not only foreign banks and foreign custodial businesses but also any foreign entity engaged primarily in the business of investing or trading in securities, partnership interests, commodities or any derivative interests therein (a "Foreign Investment Entity"). Thus, FFIs would generally include non-U.S. hedge funds, private equity funds, securitization vehicles and other investment funds (whether widely held or privately owned).[3]

Under the QI 2.0 agreement, an FFI would agree with the Treasury to:

- obtain such information from account holders as is necessary to determine which accounts maintained by the FFI (or its affiliates)[4] are "U.S. accounts";
- comply with such verification and due diligence procedures as the Treasury Department may require with respect to the identification of U.S. accounts;
- report annually to the Treasury certain information with respect to each U.S. account maintained by the FFI (or its affiliates);
- comply with requests from the IRS for additional information with respect to each U.S. account; and
- attempt to obtain a waiver, from each holder of a U.S. account, of any foreign law that would otherwise prevent the reporting of any of the foregoing information, and if a waiver is not obtained, to close the account.

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[3] The definition of Foreign Investment Entity as currently drafted is extremely broad. Further guidance will need to be provided as to whether and under what circumstances various types of entities (such as pension funds and insurance companies, or any business segment thereof, as well as holding companies with operating subsidiaries) are Foreign Investment Entities.

[4] In general, under the Bill a corporation, partnership or other entity is affiliated with another if there is more-than-50% common, direct or indirect ownership of both entities.

For this purpose, a "U.S. account" is any financial account that is held by one or more "specified U.S. persons" or "U.S.-owned foreign entities."[5] A "specified U.S. person" is any U.S. individual, corporation, partnership, trust or other entity, other than a publicly traded corporation and its affiliates, a bank, real estate investment trust, regulated investment company, government entity and certain tax-exempt organizations and trusts. A "U.S.-owned foreign entity" is a foreign entity that has one or more "substantial U.S. owners;" and a "substantial U.S. owner" essentially is a specified U.S. person that (i) owns, directly or indirectly, a greater-than-10% stock interest (by vote or value) or partnership capital or profits interest, (ii) is treated as an owner of a grantor trust or (iii) owns *any* interest in a Foreign Investment Entity. A "financial account" includes not only any depository or custodial account maintained by the FFI, but also non-publicly traded equity and debt interests in the FFI.[6]

As a result of these rules, an FFI would be required to report information regarding U.S. persons that are individuals or non-publicly held entities and that either have financial accounts with the FFI or hold any non-publicly traded debt or equity interests in the FFI, including such U.S. shareholders of investment funds and holders of debt and equity issued by securitization vehicles. In addition, an FFI would be required to report specified U.S. persons that own greater-than-10% interests in non-financial foreign entities that hold U.S. accounts with or in the FFI.

For each specified U.S. person and each substantial owner of a U.S.-owned foreign entity that holds a U.S. account with or in the FFI, the FFI would be required to report annually (i) the name, address and TIN of the specified U.S. person, (ii) the account number, (iii) the account balance or value and (iv) the gross receipts and gross withdrawals or payments from the account. Alternatively, an FFI can elect to provide full IRS Form 1099 reporting with respect to the U.S. accounts it maintains, as if the FFI were a U.S. person and each specified U.S. person or U.S.-owned foreign entity were a U.S. individual. Thus, the FFI could not treat any such entity as an exempt recipient but instead would need to report with respect thereto. Whether or not the FFI elects Form 1099 reporting, it would be

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5 An exception is provided, unless an FFI elects otherwise, for a depository account that is held solely by natural persons if the aggregate value of all depository accounts of such holder at the FFI (and its affiliates) does not exceed $10,000 ($50,000 if all such accounts were in existence on the date of enactment of the Bill). As a practical matter, FFIs may find it easier to report with respect to all depository accounts, rather than monitoring fluctuating balances and exchange rates to confirm that a particular account continues to qualify for the exception.

6 The Bill authorizes the Treasury Department to provide other exceptions to the treatment of equity and debt interests in an FFI as financial accounts. It would be sensible for the Treasury Department to use this authority to exclude debt or equity of traditional financial institutions from this rule. Furthermore, as applied to debt or equity, the requirement to close accounts if a holder will not or cannot waive foreign nondisclosure rules is tantamount to a requirement to repay debt or equity. However, a repayment of outstanding debt or equity may not be permissible under the terms of the instrument or under local law.

required to report to the IRS information with respect to both U.S. source and foreign source amounts in accounts of specified U.S. persons holding U.S. accounts with or in the FFI.

The foregoing reporting requirements would apply not only with respect to the U.S. accounts maintained by the FFI itself, but would also cover any U.S. account maintained by any affiliated FFI that has not itself entered into a QI 2.0 agreement.

The Bill would also impose new reporting and withholding provisions in respect of foreign entities that are *not* financial institutions. Specifically, it would impose a 30% withholding tax on withholdable payments[7] to such entities unless the beneficial owner (or, if different, the payee) of the payments provides the withholding agent with either (i) a certification that the beneficial owner does not have any (direct or indirect) substantial U.S. owners or (ii) the name, address and TIN of each substantial U.S. owner; the withholding agent does not know or have reason to know that the information is incorrect; and the withholding agent reports that information to the IRS.

The JCT Report indicates that these new withholding taxes on FFIs and non-financial entities are intended to function similarly to a backup withholding tax, so that beneficial owners would be eligible to claim a refund or credit for any withholding in excess of their substantive tax liabilities. However, a special rule provides that, except to the extent required by a treaty, no refunds or credits would be available if the beneficial owner of the payment is itself an FFI. In addition, before refunds and credits can be expected to be available, an effective and efficient mechanism for substantiating those claims would need to be developed by the IRS.

b. Open Issues

The Bill establishes an overall framework for the new QI 2.0 regime, but leaves many of the key aspects (as well as numerous details) to be filled in by IRS guidance. Accordingly, it is difficult to assess how workable these rules will be in practice. Questions that need to be resolved by guidance include:

- *How to determine whether someone is a specified U.S. person*. The Bill and the JCT Report suggest that an FFI generally would need to rely on certifications received from account holders (for example, by having them provide an expanded version of IRS Forms W-8BEN or W-9) and, in addition, would need to determine that it has no contrary knowledge by checking Know-Your-Customer (KYC) and Anti-Money Laundering (AML) information in the possession of the FFI and its affiliates. The required cross-

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7 The Bill exempts payments that are beneficially owned by publicly traded corporations and their corporate affiliates, foreign governments, foreign central banks and international organizations, and authorizes the Treasury Department to extend exemptions to other classes of payments that it determines pose a low risk of tax evasion.

checking would represent a significant expansion beyond what current QI rules require, and would be very burdensome and costly for most financial institutions given the way their systems and records are currently maintained. Consequently, in developing guidance, the IRS should take into account the time required to adapt systems to any new requirements, and should craft the new requirements so that they can be implemented in a reasonable and practical way.

- *The extent of verification and due diligence required under the QI 2.0 agreements*. The Bill and JCT Report do not provide details regarding the contemplated nature or extent of the IRS verification process for QI 2.0 agreements. If the new QI 2.0 requirements impose an audit requirement comparable to that required under the QI program, however, the burdens that will be imposed by such a requirement will be problematic for many FFIs, particularly smaller FFIs. Guidance regarding due diligence will also need to take account of similar considerations.

- *Consequences of a failure to obtain identifying information from account holders or holders of non-publicly traded debt or equity of the FFI*.

    - While not clear, in the case of non-disclosing holders of non-publicly traded debt or equity interests in a Foreign Investment Entity, it appears likely that the intention is to require withholding on their share of the entity's U.S. source FDAP income and gross proceeds. However, in many cases, payments from the FFI to such holders would not be considered U.S. source payments, and thus would not be withholdable payments. If the intention is nonetheless to require withholding on payments to non-disclosing holders to the extent attributable to withholdable payments received by the FFI (which might require modifying the statutory language), allocation and tracing rules would be needed to determine which portion of the holders' share of the entity's overall income or receipts is to be treated as withholdable payments.

    - Subject to the foregoing uncertainty, presumably the FFI would withhold from its withholdable payments to any account holder (including holders of debt or equity of the FFI) that fails to provide the necessary identifying information,[8] but under what circumstances, if

[8] The Bill explicitly provides for such withholding with respect to withholdable payments made to foreign account holders that are (i) FFIs that have not entered into a QI 2.0 agreement with the IRS and (ii) non-financial foreign entities. Foreign persons (including persons who are deemed to be foreign persons under the regulatory presumptions because they do not properly certify their status) are subject to withholding with respect to U.S. source FDAP under Code Sections 1441and 1442, subject to certain exceptions.

any, would a failure disqualify the QI 2.0 agreement altogether? It will be important to confirm that, for example, the inability of a fund-of-funds (FOF) investment company to identify X% of its investor base necessitates only that the FOF withhold with regard to that X% of investors, but does not invalidate the QI 2.0 agreement as a whole (or agreements with affiliates), nor does it taint the qualification of the QI 2.0 agreements entered into by other FFIs in which the FOF has invested, directly or indirectly.

  - Similarly, guidance needs to be provided as to the consequences of an inability or failure (inadvertent or otherwise) of a foreign bank or other traditional financial institution to obtain proper identification in respect of each and every depositor or other creditor. The Bill does not appear to require withholding in respect of payments to such non-complying depositors or other creditors (since such payments would not be U.S. source and would have no necessary relationship to withholdable payments received by the FFI). Under what circumstances, if any, would the FFI be precluded from entering into a QI 2.0 agreement (and therefore would be subject to withholding tax in respect of all withholdable payments received by it) as a result of such compliance gaps? If the FFI is permitted to enter into a QI 2.0 agreement despite such lapses in compliance, what penalties (if any) will be imposed on the FFIs with respect to such lapses?

- *How the rules apply in the case of tiered FFIs and multiple withholding agents*, including:

  - How does a withholding agent determine whether an account holder is an FFI or not, and if it is an FFI, that it has a QI 2.0 agreement in effect? The amounts potentially at stake are very significant. For example, an inadvertent compliance failure in respect of a $5 billion overnight securities loan could trigger a $1.5 billion withholding tax liability with respect to the gross proceeds. A workable mechanism must be developed to enable payors to be absolutely sure that the information that they are relying on is sufficient, and that their failure to withhold tax will not be subject to an after-the-fact challenge.

  - A payment may pass through multiple financial intermediaries on its way from the original issuer to the ultimate beneficial owner. Clarification should be provided regarding the obligations of each person in the chain of payments.[9] For example, where a U.S. paying

[9] The guidance should address, *inter alia*, the application of these rules to securities clearing organizations.

agent for an issuer pays interest to a hedge fund's prime brokerage account at an offshore broker, it seems sensible for the U.S. paying agent to look solely to the offshore broker's QI 2.0 status and for the offshore broker to look solely to the hedge fund's QI 2.0 status. Moreover, where a stock purchaser buys shares on a stock exchange and pays the purchase price through its brokerage account to a seller's broker, it seems sensible to treat only the purchasing broker (and not the purchaser, who may be a retail customer) as the withholding agent with respect to the gross proceeds. Resolving these issues is very important given that the new rules would potentially apply to all purchases of all debt and stocks of U.S. issuers, whether on an exchange or in a private sale.

- *Withholding tax exposure from "footfaults"*. In addition to evaluating the costs and burdens of setting up compliance, verification and due diligence processes and systems, FFIs (as well as U.S. withholding agents) will wish to evaluate the likelihood and consequences that technical and immaterial lapses (for example, failing to obtain a fully compliant certification from an account holder that the FFI (or U.S. withholding agent) knows is not a specified U.S. person) will result in unrecoverable, after-the-fact withholding tax costs, as a result of strict guidance standards or aggressive IRS enforcement. As illustrated above, the withholding tax burden can easily dwarf its small profit (especially where the FFI is simply a custodian).

c. Preliminary Observations

FFIs generally. Unless tempered by future guidance, every FFI, including every Foreign Investment Entity and every other non-U.S. financial institution that, directly or indirectly, receives any U.S. source FDAP income or gross proceeds from the sale of U.S. stock and securities (and perhaps any such entity that holds debt or equity of another FFI that in turn receives such withholdable payments) would need to enter into a QI 2.0 agreement with the IRS in order to avoid withholding tax. There is no *de minimis* rule. The smallest of entities, organized for purposes unrelated to U.S. taxes by investors having no connection with the United States – for example, a French family investment vehicle holding shares in a U.K. mutual fund – would need to enter into a QI 2.0 agreement if the mutual fund maintains a U.S. bank account or holds excess cash in U.S. Treasuries. As a result, perhaps hundreds of thousands of entities would be required to enter into agreements with the IRS as a condition to their ability to hold interests in non-U.S. investment vehicles that derive *any* U.S. source income. The administrative challenges (including the necessary time period) of implementing such a regime without driving investors away from the U.S. markets should not be underestimated. Congress and the Treasury Department will face a very difficult balancing exercise in developing rules that achieve the Bill's policy objectives without

imposing burdens that discourage non-U.S. investors from purchasing U.S. securities and entering into transactions with U.S. financial institutions.[10]

Banks, securities firms and other traditional financial institutions. While many traditional financial institutions have QI systems in place, the new QI 2.0 rules will require significant updates and expansion of existing systems and procedures. The QI rules apply to a discrete (and generally relatively small) portion of a financial institution's business (essentially, its broker and custodial businesses for customer investments in U.S. securities). By contrast the QI 2.0 regime applies to numerous other business lines (including retail banking, securities and derivatives dealing, funds management, etc.). If the QI 2.0 regime requires an FFI to obtain a certification from each and every customer, counterparty, lender and depositor, for many institutions, the regime would involve many millions of new certifications (e.g., from all of a Japanese or Chinese bank's retail customers, without regard to whether the bank holds any U.S. securities for the account of those customers or in fact has any U.S. account holders). Moreover, most financial institutions do not currently have the systems in place to enable them to match KYC/AML information with account-level tax reporting, and certainly not across different legal entities.

The ability of an FFI to provide information regarding account balances, gross receipts and gross withdrawals in lieu of full 1099 reporting (as suggested by some commenters on the Obama Administration's earlier proposal) should be welcome, since implementation of full 1099 reporting would be very difficult for most financial institutions (most QIs typically elect to have such 1099 reporting performed by the U.S. withholding agent).

Funds and other investment vehicles. As noted above, there are potentially significant implementation challenges in applying the new QI 2.0 regime to FFIs that are Foreign Investment Entities. The magnitude of those challenges will depend on the manner in which the Treasury responds to the legislative mandate (not only with respect to the reasonableness of the substantive requirements, but also the amount of lead time provided for the development of new systems, and the provision of workable exceptions for cases in which administrative burdens clearly outweigh any compliance benefits). Nonetheless, major hedge funds and other investment funds that have large infrastructures and significant U.S. investments are likely to enter into QI 2.0 agreements. It will be interesting to see how other FFIs respond to this new regime.

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[10] One possible way of achieving this balance might be for the new regime to encourage investments to flow into larger investment vehicles that can comply with the QI 2.0 regime. However, this would appear to require, at a minimum, that closely held FFIs (such as the French family investment vehicle holding shares in a U.K. mutual fund) be excused from the requirement that they enter into a QI 2.0 agreement with the IRS and instead to require that they provide certifications to FFIs in or through which they invest, similar to what is required with respect to non-financial foreign entities under proposed Section 1472.

Securitization vehicles. A typical offshore securitization vehicle (such as a CBO issuer) holds U.S securities and issues multiple tranches of debt and equity securities. In many cases, there will be no mechanism by which an issuer can force holders of outstanding securities to comply with certification requirements that were not contemplated at the time the securities were issued. Moreover, the consequences of a particular investor's failure to comply may be borne not by that investor but by holders of other interests in the securitization vehicle. As a result, certain groups of investors (such as equity holders whose equity has no value or senior creditors that will be paid in full in all events) may have no practical incentive to provide tax certifications. If an investor's failure to comply means that a securitization vehicle cannot enter into a QI 2.0 agreement, the resulting U.S. withholding tax costs may be borne to a great extent by investors that did comply. In some cases, it may be possible for an issuer to overcome this problem by electing to report under the Form 1099 rules, since under those rules the issuer should be able to report with respect to its FFI payees even where it lacks information regarding the beneficial owners behind the FFI payees. Another concern may be the QI 2.0 compliance costs, which have not been budgeted for in the structure or provided for in the indenture. It may be appropriate for Congress or the Treasury Department to craft a special grandfather rule for outstanding debt or equity interests in existing securitization vehicles.

Borrowers and other U.S. withholding agents. As noted, U.S. (and non-U.S.) financial institutions that act as withholding agents will need to significantly revamp their withholding tax procedures and systems to reflect the requirements of the new regime, including identifying FFIs that have entered into QI 2.0 agreements with the IRS, determining the extent to which payments to FFIs that have not entered into QI 2.0 agreements are nonetheless exempt from the new withholding tax (for example, because the beneficial owner is a foreign government) and implementing the new withholding tax and reporting rules relating to payments to non-FFI entities. These modifications are likely to be costly and time-consuming.

The new regime will also apply to payors of U.S. source interest, dividends and other FDAP and U.S. source gross proceeds that are not traditional financial institutions, including borrowers under private loan agreements. As noted above, the Treasury and the IRS can ease compliance burdens by confirming that obligors that are not financial institutions will be excused from these new requirements so long as they are making a payment to a U.S. financial institution that in turn is subject to these rules. However, to the extent that obligors and other withholding agents that are not financial institutions are subject to these rules, it will be important for there to be clear, simple and readily accessible guidance as to their application.

d. Effective Date

The QI 2.0 regime is proposed to become effective for payments made after December 31, 2010. As noted above, given the need for the Government to develop, and for financial institutions and investment vehicles to then implement, guidance on the numerous

and complex issues presented by the QI 2.0 regime, we expect that the December 31, 2010 proposed effective date for these provisions will need to be postponed for a number of years. In this regard, the time and cost of developing guidance and systems for the existing QI regime as well as for brokers' reporting of basis are instructive as to the time period that would be needed to implement a major change of the type QI 2.0 represents. It would be helpful if the Bill text were to give clear authority to the Treasury Department to defer implementation dates.

The Bill contains a grandfather rule for obligations outstanding on the date of first committee action on the Bill, if the obligation is in bearer form or would trigger a gross-up obligation as a result of the enactment of the QI 2.0 regime. The grandfather rule for debt with gross-up provisions should helpfully enable existing loan agreements and other debt securities with gross-up provisions (and any related call rights) that might otherwise be triggered as a result of the enactment of the Bill to avoid triggering those provisions.[11] As discussed below, however, the interaction of the grandfather rule for bearer-form debt with other provisions of the Bill may increase the potential for market disruption in a manner that the drafters apparently did not anticipate.

2. Repeal of the Foreign-Targeted Bearer Bond Exception of TEFRA (and the Related Exception to the Portfolio Interest Exemption).

Since 1982, the "TEFRA" rules generally have prohibited issuers from issuing debt obligations in bearer form, subject to certain exceptions. The principal exception to this restriction is for obligations that are issued under "arrangements reasonably designed to ensure" their sale to non-U.S. persons. (This exception is commonly referred to as the "Eurobond exception.") In the case of obligations of U.S. issuers, compliance with the Eurobond exception also generally allows interest on the obligations to qualify for the portfolio interest exemption from U.S. withholding tax without the need to obtain tax certifications required in respect of obligations that are in registered form. Violation of the TEFRA rules subjects the issuer to a number of sanctions, including the imposition of an excise tax, the denial of interest deductions and the disqualification of interest payments from the portfolio interest exemption.

The Bill would repeal the Eurobond exception, effective for obligations issued more than 180 days after the date of the Bill's enactment. Thus, issuers will no longer be permitted to avoid the TEFRA sanctions, and will no longer be able to rely on the portfolio interest exemption, simply by issuing obligations outside the United States.[12] The repeal's

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[11] However, in the absence of further guidance, it appears that the grandfather rule may not cover loans entered into pursuant to commitments in existence on the date of first committee action on the Bill, drawdowns after such date on a revolving credit agreement, debt instruments that have been materially modified after such date and similar situations where relief would seem to be appropriate.

[12] The Bill would retain the current-law exceptions for obligations that (1) are issued by natural persons, (2) mature in one year or less or (3) are not of a type offered to the public.

delayed effective date appears intended to provide issuers with a short adjustment period, during which they have the opportunity to restructure existing borrowing programs. However, the new QI 2.0 regime described above will apply (as noted above) to any bearer-form obligations that are issued after the first date on which a Congressional committee takes action on the Bill. Thus, interest paid on such bearer-form obligations will become subject to the documentation and withholding tax rules of the QI 2.0 regime when that regime becomes effective, even though the TEFRA-related provisions of the Bill provide a transition period of 180 days after enactment. If this disparity in effective dates is not corrected, the 180-day window will have no practical consequences, and U.S. issuers will effectively be required to cease issuing obligations in bearer form (and amend the documentation of continuing borrowing programs) before the date of first committee action.[13] We believe that this result was not intended, and hope that the effective date of the QI 2.0 rules will be conformed, by grandfathering bearer-form obligations issued prior to the effective date of the TEFRA-related provisions of the Bill.

The repeal of the Eurobond exception will restrict access to some non-U.S. markets in a manner that could adversely affect U.S. borrowers (and their foreign affiliates) that have relied significantly on those markets. In a number of markets, securities traditionally have been issued in bearer form. In many or most cases, workable mechanisms exist to reconcile the local market preference for bearer-form obligations with the U.S. requirement that obligations be in registered form (including through the use of arrangements that are treated as bearer for non-U.S., and registered for U.S., purposes). In a limited but potentially important number of cases, however, it may not be feasible to issue securities in registered form, or there may not be sufficiently well-developed mechanisms to permit the effective collection of IRS Form W-8BEN.[14] Thus, issuers may be unable to issue debt in such markets, or may be able to do so only in a manner that causes interest on the obligations to be subject to withholding tax at a 30 % rate, effectively precluding them from raising funds in these markets.

Congress should consider giving the Treasury Department authority to adopt targeted exceptions to the repeal of the Eurobond exception in cases where it determines that there is little risk of U.S. tax avoidance. For example, historically it has been difficult or impossible to obtain tax certifications from Japanese retail investors, but we understand that the characteristics of the Japanese market are such that it is not likely to provide meaningful opportunities for U.S. investors to evade tax. Consideration should be given to authorizing the Treasury Department to craft a narrowly tailored exception that would preserve U.S.

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[13] Debt obligations issued in a cross-border context typically require that the issuer bear the cost of any withholding tax imposed on payments on the obligations, but give the issuer the right to redeem the obligations in the event such a tax is imposed.

[14] Interest payments on obligations that are in registered form generally will qualify for the portfolio interest exemption from U.S. withholding tax only if the beneficial owners provide a certification on IRS Form W-8BEN (or if similar documentation is provided through the QI rules).

issuers' access to Japanese funding sources while preserving the Government's interest in minimizing opportunities for tax evasion.

We also note that the proposed repeal of the Eurobond exception could subject non-U.S. issuers that issue bearer bonds outside the United States in customary capital markets transactions to the U.S. excise tax. We believe that such an extra-territorial extension of the U.S. excise tax is not called for and may be a drafting oversight.

3. Dividend-Equivalent Payments under Equity Swaps.

Under current law, payments on equity swaps to a non-U.S. person generally are not subject to U.S. withholding tax even if the payments are determined by reference to dividends on U.S. equity securities that would have been subject to U.S. withholding tax in the hands of the foreign swap counterparty, *unless* the U.S. tax authorities successfully recharacterize the swap as another form of transaction (for example, a securities loan or leveraged investment in the underlying shares). The Bill effectively would reverse that presumption by providing that dividend-equivalent payments on equity swaps generally are subject to U.S. withholding tax except to the extent the Treasury Department determines otherwise. It is anticipated that the Treasury Department will prescribe rules exempting a specified class of equity swaps prior to the effective date of the Bill, under principles similar to those proposed earlier by the Obama Administration (which addressed the term, pricing, collateral and certain other terms of the swap, and whether there is a related sale of the stock between the parties). The market impact of this change will depend on the timeliness and reasonableness of the guidance that the Treasury Department provides.

For affected swaps, the withholding tax would apply to the *gross* dividend-equivalent payment, and thus might exceed the total amount of the payment determined by reference to the dividend-equivalent amount. The dividend-equivalent payor is required to collect the tax even if it receives a net payment rather than actually making a payment. The withholding tax rate would be 30%, but generally would be reduced if the foreign party is eligible for the benefits of a U.S. income tax treaty. The Treasury Department may also extend the withholding tax to apply to payments substantially similar to dividend-equivalent amounts under other types of contracts.

By its terms the withholding tax for non-exempt swaps would apply not only to a swap payment by a U.S. person to a foreign person but also to a swap payment made by a foreign person to another foreign person. In this regard the proposed rule is similar to the rules that currently apply for cross-border securities loans on U.S. equities. The Treasury Department is reported to be considering changes to existing guidance providing relief from the "cascading dividend" problem in the context of cross-border securities loans (although it is unclear whether such relief would extend to non-exempt swaps).

The new rule is proposed to apply to swap payments made 90 days or more after enactment. As a result, a non-exempt swap currently in existence and still outstanding at

that time will be subject to the withholding tax, which ordinarily would permit such a swap to be terminated early.

4. Other New Reporting Requirements Under the Bill.

The Bill contains other reporting requirements and revises the applicable statute of limitations and penalties for failures to report. The new requirements and changes include:

- The Bill would require a "material advisor" (including an investment bank, law firm or other adviser that, in general, receives more than $100,000 for aiding, assisting or advising) with respect to the direct or indirect acquisition of any interest in a foreign entity, including in connection with its formation, to report the identity of the foreign entity and information regarding any U.S. citizen or resident that is required to file a report under certain Code provisions in connection with that acquisition. Failure to file such a report without reasonable cause would subject the material advisor to penalties.

  These rules will apply to a broad range of non-abusive activities, such as the organization of securitization vehicles and of offshore special purpose vehicles by private equity funds acquiring non-U.S. companies. This regime will need to be implemented in such a way that material advisers that form entities but have no reliable knowledge of the identity of the investors – for example, a securitization vehicle – can comply even though they do not have all of the required information.

- The Bill would create a "shadow FBAR" reporting regime, requiring individuals to report with their tax returns any interest in "specified foreign financial assets" if the aggregate value of such assets exceeds $50,000. "Specified foreign financial assets" include (1) "financial accounts" maintained by a "foreign financial institution," each as defined for purposes of the new QI 2.0 regime, and (2) if not held in an account maintained by a financial institution, any stock or securities of a foreign issuer, any financial instrument or contract held for investment that has a foreign issuer or counterparty, and any interest in a foreign entity. Interests in offshore investment funds, even if not subject to FBAR reporting, would have to be reported under this provision. Taxpayers would still be required to file FBARs, as under current law.

- The Bill would require shareholders of passive foreign investment companies (PFICs) to report their interests annually.

- The Bill would make a number of technical changes to the trust rules, and would expand the reporting obligations of U.S. owners of foreign trusts and penalties for failure to report.[15]

- The Bill would impose a six-year statute of limitations for tax assessment on understatements over $5,000 of income attributable to specified foreign financial assets, as defined above. If a taxpayer fails to file information returns with regards to PFICs or specified foreign financial assets, the limitations period would not expire until three years after the required information is furnished.

- The Bill would impose a new 40% penalty on any understatement attributable to an undisclosed foreign financial asset.

- The Bill permits the Treasury Department to require any financial institution (as defined for purposes of the FFI rules) to file electronically certain withholding tax returns even if such financial institution files fewer than 250 such returns for the year.

* * *

Please feel free to contact any of your regular contacts at the firm or any of our U.S. partners and counsel listed under Tax in the "Practices" section of our website (http://www.clearygottlieb.com) if you have any questions.

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[15] The current trust reporting regime is not workable for foreign investment trusts. It would be very helpful if in reviewing the reporting rules for foreign trusts, the Bill allowed such a trust an election to be treated as a domestic trust subject to the reporting rules applicable to widely-held fixed investment trusts.

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