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# Offshore financial service providers must report US account holders or face substantial penalties[1]

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## Abstract

The foreign financial institution withholding tax provisions contained within the newly enacted US Hiring Incentives to Restore Employment (HIRE) Act have extensive implications for those offshore financial service providers who have US account holders and are invested in the US capital markets for their own account or that of their clients. These rules leave no doubt that they will result in increased disclosure of US direct and indirect holders.

## Introduction

The Hiring Incentives to Restore Employment (HIRE) Act (Pub. L. No. 111-147) was signed into law on 18 March 2010. The centrepiece of the Act is the creation of tax breaks for businesses hiring new workers and extending higher expensing limits for small businesses that make capital investments. To pay for these tax breaks, however, the Act incorporates provisions of the Foreign Account Tax Compliance Act of 2009 (FACTA), originally introduced in Congress last year.

The withholding tax provisions incorporated in the HIRE Act have far-reaching implications for foreign financial institutions that invest in US capital markets for their own account or for the account of their clients.

*The withholding tax provisions incorporated in the HIRE Act have far-reaching implications for foreign financial institutions that invest in US capital markets*

Although the Hire Act contains provisions that increase a US person's foreign trust tax and reporting requirements by broadening the definition of a US grantor of a foreign trust and what constitutes a distribution to a US beneficiary, as well as adding passive foreign investment company (PFIC) and foreign asset disclosure rules and related penalties that affect US taxpayers in general, this discussion focuses solely on the foreign financial institution withholding tax provisions of the HIRE Act as they have the greatest impact on offshore financial service providers with US clients and investments noted above.

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In addition, there are withholding tax provisions for certain non-financial foreign institutions, but those rules are beyond the scope of this discussion.

### *Existing law*

The United States imposes withholding tax on payments of US source fixed or determinable annual or periodical (FDAP) income to foreign persons that includes interest, dividends and similar types of investment income. Unless the foreign person qualifies for an exemption or treaty relief, the rate of tax is 30 per cent. Specifically, there are statutory exemptions, not discussed herein, from the 30 per cent withholding for interest on bank deposits, portfolio interest and gains on the sale of property (but not real property). Also, many income tax treaties provide for reduced withholding rates, generally 0 per cent on interest and 15 per cent on dividends for treaty residents.

A withholding agent who makes payments of US source income to a foreign person is required to report those payments, including any amounts of US tax withheld to the Internal Revenue Service (IRS). The withheld tax is credited to the recipient of the income.

The US withholding rules have been administered through a system of self-certification. A foreign investor must provide a certification on Form W-8 as to his foreign status to the withholding agent in order to establish eligibility for an exemption or reduced treaty rate.

The IRS has a qualified intermediary (QI) programme with foreign financial institutions that it relies on to enforce US withholding obligations. Generally a QI is a foreign financial institution that has entered into a withholding and reporting agreement with the IRS. A QI is not required to forward beneficial ownership information to a US financial institution or other withholding agent of US source FDAP income to establish that customer's eligibility for an exemption or reduced treaty rate. Instead the QI is permitted to establish for itself such eligibility based on that customer's Form W-8, and information as to KYC rules to which the QI is subject in its home country as approved by the IRS or specified in the QI agreement. The model QI agreement describes in detail the QIs withholding and reporting obligations; it is not discussed herein.

### *HIRE Act*

The HIRE Act adds new rules that provide for withholding taxes to enforce new reporting requirements on specified foreign accounts owned by 'specified US persons', or by 'US-owned foreign entities'.

> *The HIRE Act adds new rules that provide for withholding taxes to enforce new reporting requirements on specified foreign accounts owned by 'specified US persons', or by 'US-owned foreign entities'*

The rules are effective with respect to payments made after 31 December 2012. Before then, foreign financial institutions subject to the new rules will have to decide whether to continue to invest in the US capital markets for their own account or the account of their clients; those that do not agree to comply with the new requirements will automatically be subject to a 30 per cent withholding tax. Alternatively some foreign financial institutions may choose to cease to hold US securities for their own account and not have US account holders or require their US account holder to hold only non-US securities as a condition of maintaining their accounts.

The Treasury Department and the IRS are actively soliciting public comment prior to issuing Treasury regulations, which will be forthcoming.

#### *Withholding tax provisions in HIRE Act applicable to foreign financial institutions*

The HIRE Act requires a withholding agent, which is any person (domestic or foreign) having control, receipt or custody of US source income that is defined as a 'withholdable payment', to deduct and withhold a tax equal to 30 per cent of said withholdable payment that is due to a foreign financial institution

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(FFI) if the FFI does not have an agreement with the IRS under which the FFI agrees to certain criteria.

> *Withhold a tax equal to 30 per cent of said withholdable payment that is due to a FFI if the FFI does not have an agreement with the IRS*

A withholdable payment is any payment of interest (including original issue discount), dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, and other FDAP gains, profits and income from US sources, gross proceeds from the sale of property that could produce US-source interest or dividends, and interest paid on deposits by foreign branches of US banks. It does not include income that is effectively connected with the conduct of a US trade or business.

An FFI is defined as a 'financial institution' organized outside the United States, unless otherwise provided by the US Treasury Secretary. For this purpose, and except as otherwise provided by the Secretary, a financial institution is any entity that (i) accepts deposits in the ordinary course of a banking or similar business; (ii) as a substantial portion of its business, holds financial assets for the account of others; or (iii) is engaged (or holding itself out as being engaged) primarily in the business of investing, reinvesting or trading in securities, interest in partnerships, commodities or any interest (including a futures or forward contract or option) in such securities. Broadly this includes non-US banks, hedge and private equity funds, and potentially private owned investment vehicles.

Under the agreement with the IRS, the FFI must agree to the following:

i. Obtain sufficient information to determine if an account is a 'US account'.

   A US account is defined as any 'financial account' held by one or more 'specified US persons' or 'US-owned foreign entities'. There are exceptions for (a) depository accounts, if each holder is a natural person and the aggregate value of each holder of the account is $50,000 or less (to the extent provided in regulations, financial institutions that are members of the same affiliated group may be treated as a single institution for the $50,000 limitation) and (b) for financial accounts if the account is held by another FFI that has entered into an agreement with the IRS or is otherwise subject to information reporting requirements that the IRS determines would make the reporting requirements with respect to US accounts duplicative.

   A financial account is any depository account, custodial account or debt and equity interest in the FFI (except where regularly traded on a recognized securities market).

   A specified US person includes a US citizen and resident, a US corporation (other than a US publicly traded corporation) a US partnership, a US trust and estate, but does not include US public companies, US exempt entities or US governmental bodies, among others.

   A US-owned foreign entity is an entity that has one or more 'substantial US owners', defined as a specified US person, who directly or indirectly holds a 10 per cent or greater interest by vote or value of a foreign corporation or a 10 per cent or greater capital or profits interest in a partnership, or who is treated as an owner of a foreign trust under the US grantor trust rules. In addition, it includes a specified US person who owns *any* portion of an entity primarily engaged in the business of investing or trading in passive income producing assets. The IRS may also develop regulations which would include direct and indirect beneficial owners with a 10 per cent or greater interest in a foreign *non-grantor* trust.

ii. Comply with verification and due diligence procedures with respect to the US accounts.

   As these will be determined by regulations yet to be promulgated, the due diligence requirements are not yet known but it is likely that such procedures will be similar to those under the Qualified Intermediary agreements.

iii. For every US account, annually report to the IRS certain financial information such as account

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number, value, distributions, withdrawals, contributions, etc.

iv. Provide any other information regarding the US account requested by the US Secretary of Treasury.

v. Attempt to obtain a waiver where foreign law would (but for the waiver) prevent the reporting of such required information with respect to the US account and if a waiver cannot be obtained, close the account.

vi. Deduct and withhold 30 per cent from any 'pass-thru' payments[2] to (i) 'recalcitrant (ie non-compliant) account holders', (ii) other FFIs, such as an offshore hedge fund that have not entered into such an agreement or (iii) an FFI that has elected to be withheld upon with respect to the portion of the payment allocable to a recalcitrant account holder or to an FFI that has not entered into such an agreement.

A non-compliant account holder is defined as someone that (i) fails to comply with reasonable requests for information necessary to determine if the account is a US-owned account; (ii) fails to provide the name, address and taxpayer identification number of each specified US person and each substantial US owner of a US-owned foreign entity or (iii) fails to provide a waiver of any foreign law that would prevent the FFI from reporting the requisite information.

An example is one who refuses to comply with an FFI's request for information under its home country KYC, anti-money laundering and anti-corruption laws and other rules set forth by the US Treasury Secretary to determine if such individual or entity is a specified US person or US-owned foreign entity.

Another example would be where the account holder, a US foreign owned entity, was requested by the FFI for further information such as the name, address and US taxpayer information of each US person and substantial owner of the entity, and said account holder refused to provide such information.

Finally, even if the US account holder complied with the above, but refused to sign a waiver allowing the FFI to avail itself of the home country bank secrecy laws, the US account holder would be non-compliant.

In essence, if an FFI has reason to believe that a person or entity is a US account holder and the account holder refuses to comply with the FFI's request for information or waiver of bank secrecy, the FFI will be required under agreement to withhold and remit 30 per cent tax on the account holder's US source income.

The following are further examples of the application of the overall FFI withholding tax regime.

Example (i): FFI 1 is compliant with its IRS agreement to report all US account holder information. FFI 1 is in control of payment of US source income to FFI 2 by way of receipt of said income as custodian of record. Because FFI 1 controls payment of income it is a withholding agent pursuant to US tax law (as noted below).
FFI 2, a non-US hedge fund, has agreed, by way of an agreement, to report US account holder information to the IRS but has failed to continue to meet all the requirements of the agreement. Therefore, FFI 1 will be required to withhold, and submit, 30 per cent of the US source income payable to FFI 2.

Example (ii): Same facts as above, except FFI 2 did not enter into an agreement with the IRS to report all US account holder information, therefore FFI 1 will be required to withhold and submit 30 per cent of US source income payable to FFI 2.

Example (iii): FFI 2 has elected to have 30 per cent of US source income payable and withheld by FFI 1. Therefore, FFI 1 will withhold and submit 30 per cent of all US source income payable to FFI 2.

2. A pass-thru payment is any withholdable payment or any other payment attributable to a withholdable payment.

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It should be noted that an FFI may be deemed by the US Treasury Secretary, to meet the above requirements if:

i. it complies with procedures prescribed by the US Treasury Secretary to ensure the institution does not maintain US accounts and meets other prescribed requirements with respect to accounts of other FFIs, or
ii. the FFI is a member of a class of institutions for which the US Treasury Secretary has determined that the above requirements are not necessary.

### *Interaction with QI regime*

FFIs that have entered into QI agreements are still required to meet the above requirements, in addition to any other requirements imposed on them under the QI regime. Treasury regulations will need to be issued to coordinate and establish priority with respect to the application with the new withholding rules to avoid duplication.

### *Responsibilities of FFIs*

An FFI may want to consider, if it has not already done so, taking the following actions should it wish to continue to service US clients and maintain US assets for its own account or the accounts of its US clients.

i. Decide before 1 January 2013, the effective date of the above rules, if it wishes to: (a) continue to invest in the US capital markets for its own account or the account of its clients, (b) not have US account holders or (c) require its US account holders to hold only non-US securities as a condition of maintaining their accounts. The only way an FFI can completely avoid the reach of the rules is to avoid investing in the United States: refusing to accept US clients is not enough, since the payment of US source income triggers their application.
ii. If option (a) above is chosen and the FFI derives a withholdable payment, it should enter into an agreement with the IRS with respect to reporting requirements unless the FFI is deemed to meet the reporting requirements, or an exception applies for income that is effectively connected with the conduct of a US trade or business:
    a. Under an agreement with the IRS, a FFI should comply with annual information reporting requirements in respect of US accounts and provide the following information for each US account with respect to each US account holder (ie US person), and substantial US owner where a US-owned foreign entity is the US account holder.
        1. Name of US person
        2. Address of US person
        3. US tax identification number
        4. US person's account balance/value
        5. Gross receipts of each US person
        6. Gross payments made to each US person
        7. Account withdrawals made by each US person
    b. Alternatively, an FFI may make an election and report like a US financial institution, ie provide full IRS Form 1099 reporting on each account of a specified US person or US-owned foreign entity, as if the account holder were a US citizen or resident. This requires reporting on both US and foreign source amounts regardless of whether they are paid inside or outside the United States. In addition, for each account the FFI must provide the following.
        1. Name
        2. Address
        3. US tax identification
        4. Account number
iii. Withhold 30 per cent on all pass-thru payments to recalcitrant account holders or other FFIs that have not entered into such an agreement or to an FFI that has elected to be withheld upon.
iv. Perform sufficient due diligence to determine if an account is a US account by definition. As a general rule home country KYC, anti-money laundering, anti-corruption laws should be sufficient mechanisms to determine whether an

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account is a US account. Accordingly, the FFI should perform sufficient due diligence to verify any direct, or indirect, substantial US owners of an underlying structure and if such owners are of an excluded class of institutions (ie US public companies, US exempt entities or US governmental bodies).

*Perform sufficient due diligence to determine if an account is a US account*

It should be noted that the US Treasury Secretary may institute additional requirements where it is believed that home country rules are not sufficient to determine if an account is a US account:

a. Request copies of all passports (US and foreign) of direct and indirect account holders
b. Request copies of all underlying structure formation documents and information about beneficial ownership, including percentage interests
c. Request copies of all trust instruments for trust accounts and information about grantor and beneficiaries

v. Require US account holders sign a bank secrecy and US Treasury information request waiver

*Require US account holders sign a bank secrecy and US Treasury information request waiver*

vi. Close the account if the US account holder does not sign the bank secrecy and information request waiver

*Close the account if the US account holder does not sign the bank secrecy and information request waiver*

vii. Require US persons to sign a waiver that they obtained US tax counsel regarding the income tax and bank and financial account reporting requirements by a US advisor approved by the financial institution
viii. Do not report duplicative account information
   a. Verify if account information is reported by a related FFI; or
   b. The information would be duplicative pursuant to standards set forth by the US Treasury Secretary
ix. Comply with the procedures to obtain a refund of tax withheld if the FFI is a resident of a country which has an income tax treaty with the United States, and received payment on US investments made for its own account

## Conclusion

It appears clear that the United States believes such far reaching measures will give the IRS sufficient enforcement powers to ensure those US persons and non-US financial institutions that service them will no longer be able to hide such US persons investment activity by way of foreign bank secrecy laws. It also seems clear, as has been proven with previous foreign reporting rules, that Congress has not studied the full impact of these rules and the possible negative effects on the US economy if FFIs move a significant portion of their investments out of the US capital markets as a result of said Act.

*Congress has not studied the full impact of these rules and the possible negative effects on the US economy if FFIs move a significant portion of their investments out of the United States*

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