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News

U.S. Supreme Court To Review 'Foreign-Cubed' Case Despite Objections. The Supreme Court agrees to review a lower court decision dismissing a "foreign-cubed" case that raises critical questions about the reach of U.S. federal courts and the U.S. securities fraud laws with respect to foreign securities transactions. The court agrees to review the so-called foreign-cubed case—in which foreign plaintiffs are suing a foreign issuer, Australia-based National Australia Bank Ltd., in U.S. court for violations of U.S. securities laws based on transactions in a foreign country—despite the objections of the Securities and Exchange Commission and the U.S. Solicitor General. (Page 3)

Australian Government Proposes Measures To Reform Market Supervision. The government releases an exposure draft of proposed legislative amendments, along with a related consultation paper, to implement its previously announced decision to make the Australian Securities and Investments Commission the supervisor of real-time trading on Australia's domestic licensed markets. (Page 9)

E.U. Ministers Reach Compromise On New Financial Regulatory Structure. After agreeing to a key sovereignty concession demanded by the United Kingdom, E.U. finance ministers approve the terms of the European Commission's proposed new E.U.-wide financial services regulatory structure designed to prevent the kind of crisis that triggered a near economic meltdown in 2008. (Page 17)

South Korean Ministry Proposes To Allow 'Poison Pills.' South Korean companies would be able to issue special share rights to existing shareholders to deter hostile takeover bids, under an amendment to the Commercial Code planned by the Ministry of Justice as a new milestone in the way the country treats foreign companies seeking to invest in South Korean businesses. (Page 16)

U.K. FSA Would Get New Powers Under Financial Services Bill. The government publishes its Financial Services Bill, which would expand the Financial Services Authority's powers in a number of areas, among other things. (Page 18)

Hong Kong's Largest Market Manipulation Case Decided. The District Court sentences four individuals to jail for terms ranging from 26 months to 30 months, in Hong Kong's largest market manipulation case to date. (Page 12)

Special Report

Proposed U.S. Foreign Account Tax Compliance Act: Impact On Non-U.S. Financial Institutions, Intermediaries, And Investment Vehicles.

Analyzed by Richard Cassell, David Hirsberg, Jay Krause, Jay Rubinstein, Aaron Schumacher, and Theodore Ahlgren, of Withers Worldwide. (Page 27)

Proposed U.S. Foreign Account Tax Compliance Act: Impact On Bearer Debt Instruments. Examined by Andrey Krahmal, of Allen & Overy LLP, London. (Page 30)

Proposed U.S. Foreign Account Tax Compliance Act: Impact On Hedge Funds. Discussed by Joseph A. Riley, of Willkie Farr & Gallagher LLP, New York. (Page 33)

Comment & Analysis

Recent Chinese Measures To Develop The Regulation Of Renminbi Funds. Analyzed by Phill Smith, of Mayer Brown JSM, Hong Kong. (Page 24)

Stephen E. Shay, Deputy Assistant Secretary of the U.S. Treasury, while discussing the U.S. Treasury Department's "multi-pronged approach" to combating tax evasion, noted that the elimination of exceptions to bearer debt instrument sanctions would improve transparency and ensure that investors were not able to use bonds issued by U.S. issuers to keep their identities concealed from the U.S. tax authorities. On behalf of the IRS, Chief Counsel William J. Wilkins also expressed strong support for FATCA and its ability to combat offshore tax evasion. He mentioned the transparency goals of repeal of bearer bond eligibility for the portfolio interest exemption.

Tom Prevost, Tax Director for Credit Suisse (Americas), appeared as an industry representative. In his testimony, Mr. Prevost presented arguments against FATCA provisions that would deny all bearer bonds, including those that are foreign-targeted, the benefit of the portfolio interest exemption from U.S. withholding tax. In his view, a registration requirement would effectively shut U.S. issuers out of certain debt markets worldwide, either because obligations could not be structured to be considered registered for U.S. tax purposes or because issuers could not obtain from holders the documentation required under the portfolio interest exemption. Mr. Prevost also noted that these FATCA provisions would be technically difficult to implement in situations where both the issuer and the investor base are all non-U.S. persons.

Proposed U.S. Foreign Account Tax Compliance Act: Impact On Hedge Funds

By Joseph A. Riley, Partner, Willkie Farr & Gallagher LLP, New York. The author may be contacted by E-mail at jriley@willkie.com.

On October 27, 2009, the House Ways and Means and Senate Finance Committees' Democratic members introduced the Foreign Account Tax Compliance Act of 2009 (H.R. 3933 and S. 1934), a joint legislative proposal on offshore taxation (*see WSLR, November 2009, page 3*).

The bill, immediately endorsed by President Barack Obama and Treasury Secretary Timothy Geithner, includes a series of hedge fund-related provisions. For instance:

- The proposal would require any person who derives gross income in excess of U.S.\$100,000 from providing material aid, assistance or advice to a U.S. individual in the movement of assets to an offshore entity, whether a corporation, partnership or trust, to file a "material advisor" tax return reporting the activity.
- The proposal would require withholding on "dividend equivalent" payments made to foreign persons pursuant to equity swaps on U.S. stocks.

What To Make Of The Bill?

This is a question that is hard to answer given the preliminary nature of the Bill, which may change significantly as it goes through the legislative process. Much remains to be fleshed out before and if the Bill is enacted into law. In light of the paucity of detail and lack of clarity, the U.S. Treasury will most likely have to promulgate further guidance if and when the Bill is enacted.

If enacted, Section 102 of the Bill will restrict the ability of U.S. issuers to access some non-U.S. debt markets. In most European jurisdictions, debt instruments are normally issued in bearer form. Although some markets have existing mechanisms that allow the issuance of bearer debt instruments that are treated as issued in registered form for U.S. federal tax purposes, in a number of jurisdictions it may be impossible or impractical to issue debt instruments in registered form. Further, mechanisms to collect IRS Forms W-8BEN may not exist. Issuers may be unable to issue debt in such markets without adverse U.S. federal tax consequences.

Section 102 of the Bill appears to have been largely overlooked by the media both in and outside the United States, while the other provisions of the Bill have attracted much more attention. This is likely to change, however, because the TEFRA provisions of the Bill strike at the heart of the franchise of many U.S. and non-U.S. financial institutions. The uncertainty created by the Bill warrants close attention by financial institutions in the weeks to come.

- The foreign bank account reporting (FBAR) regime would be substantially expanded.
- The bill would impose additional withholding taxes on payments made to offshore hedge funds, banks and other financial institutions that do not agree to provide reporting as to taxable U.S. clients with interests in offshore funds or accounts.
- Additional provisions would amend current tax rules applicable to foreign trusts and foreign-issued bearer bonds.

The provisions of the proposal would have varying effective dates.

Reporting Required By Persons Assisting In The Formation Or Acquisition Of Non-U.S. Entities

Under the bill, a "material advisor" assisting a U.S. individual in a "foreign entity transaction" would be required to file an information return disclosing the identities of the assisted person and the entity. A "foreign entity transaction" is defined as the direct or indirect acquisition of any interest in a foreign entity (including any interest acquired in connection with the formation

of such entity) if any citizen or resident of the United States is required to report the transaction under certain Internal Revenue Code sections. These Code sections require reporting of transfers to certain foreign corporations, certain foreign partnerships and certain foreign persons, reporting of organizations or reorganizations of certain foreign corporations, and reporting of the existence of interests in certain foreign partnerships and certain foreign trusts.

The bill, immediately endorsed by President Barack Obama and Treasury Secretary Timothy Geithner, includes a series of hedge fund-related provisions.

Under the proposed legislation, a person who provides any material aid, assistance or advice with respect to one or more "foreign entity transactions" and who receives, in total, directly or indirectly more than U.S.\$100,000 from such advice in a single calendar year would be a "material advisor" and would be required to report.

Penalties for failing to file would be the greater of U.S.\$10,000 or 50 percent of the gross income derived by such person with respect to such advice.

Dividend Equivalent Payments

The bill would treat a "dividend equivalent" as a dividend from U.S. sources, for certain purposes. A "dividend equivalent" is defined as a payment made under a "notional principal contract" (a term that includes most swaps) if that payment is contingent upon, or determined by reference to, the payment of a dividend from sources within the United States. The U.S. Treasury Department would be authorized to expand this definition and to exempt from reporting those types of transactions lacking potential for tax avoidance. The withholding obligation would be on a gross basis, such that a party might be subject to withholding even if no net payment was due under the terms of the swap. Similar "dividend equivalent" withholding tax provisions on swaps have been included in other recent legislative tax proposals.

Foreign Bank Account Reporting

The bill would expand the FBAR regime that was so disruptive during 2009. Under the proposal, a new category, the "specified foreign financial asset," would be created so as to require reporting of depository and custodial accounts at foreign financial institutions and, to the extent not held in a financial institution, stocks or securities issued by a foreign person, any other financial instrument or contract held for investment that is issued or held by a foreign counterparty and any interest in a foreign entity. The bill would expand FBAR reporting requirements beyond the current FBAR rules (which would not be replaced by this proposal and would remain in effect), which generally do not require reporting of direct ownership of most stocks and securities.

Under the bill's requirements, an individual with an in-

terest in such assets would be required to report the accounts annually if the aggregate value of such accounts was in excess of U.S.\$50,000, with no minimum value threshold if the values were not demonstrated. The reporting would not be required if the account was with a U.S. financial institution, and specific positions need not be reported if the account holding the positions itself was reported.

The penalties for failure to report would be substantial: U.S.\$10,000 annually, plus an additional U.S.\$10,000 per month (up to a total of U.S.\$50,000) for failing to report despite the mailing of a U.S. Internal Revenue Service (IRS) notice signaling non-compliance. Also, underpayments of tax due to undisclosed foreign financial assets would be subject to a 40 percent penalty on the underpayment of tax. The statute of limitations for reporting income associated with such assets would be extended to six years in many cases, and the running of the statute would be suspended during periods of non-reporting.

In related provisions, a shareholder in a passive foreign investment company (PFIC) would be required to report such ownership annually. The U.S. Treasury would be given broadened authority to require electronic filing of withholding returns.

Withholding For Certain Non-U.S. Accounts

The proposal would require a 30 percent tax on a "withholdable payment" made to a "foreign financial institution" unless the institution had entered into an agreement with the U.S. Treasury to report the identities, account balances and account transaction activity of clients that are "specified U.S. persons" or that are foreign entities with one or more "substantial U.S. owners" that are "specified U.S. persons."

For this purpose, an "account" also includes any equity or debt interest in the financial institution that is not regularly traded on an established securities market, except as otherwise provided by the U.S. Treasury. "Withholdable payments" would include amounts historically subject to withholding, such as U.S. source interest, dividends and similar types of income, but would now also include withholding on portfolio interest and on gross proceeds on the sale of any asset that could produce U.S. source interest or dividends.

"Foreign financial institutions" would include foreign entities engaged primarily in investing or trading in securities or commodities, such as hedge funds and private equity funds, and foreign entities accepting deposits in the ordinary course of a banking business or holding financial assets for others. "Specified U.S. persons" for this purpose would not include tax-exempt institutions, individual retirement plans, mutual funds, real estate investment trusts, publicly traded companies and their affiliates, or banks, among others. A "substantial U.S. owner" is defined as a more than 10 percent owner of a foreign corporation or partnership, or an owner of any portion of a grantor trust; but with respect to any foreign entity that is primarily engaged in investing or trading in securities or commodities, including hedge funds and private equity funds, and is thus considered to be a "foreign financial institution," any ownership in-

terest by a "specified U.S. person," including a U.S.-organized feeder fund, would cause such foreign entity to have "substantial U.S. owners."

Many offshore funds, including master funds in certain master-feeder structures, would be subject to dramatic new withholding tax requirements.

Under the proposal, the agreements with the U.S. Treasury would also need to include agreements to comply with IRS requests for information regarding such accounts and agreements to seek a waiver from foreign law that would otherwise prevent such reporting (with the account to be closed if no such waiver were obtained).

A "foreign financial institution" would have the option to forego this process and to agree to report as if it were a U.S. entity subject to U.S. information reporting rules. The provision would also require withholding of 30 percent on any "withholdable payment" paid to any non-financial foreign entity unless the entity certifies that it is not substantially U.S.-owned or provides the identity of each substantial U.S. owner. An exception applies for payments beneficially owned by certain non-financial foreign entities, including a corporation the stock of which is regularly traded on an established securities market or an affiliate thereof.

Under the proposal, if an offshore hedge fund, private

equity fund, bank or other "foreign financial institution" is the beneficial owner of amounts withheld as "withholdable payments," such withheld amounts would not be creditable or refundable at all unless the "foreign financial institution" is eligible for benefits under a tax treaty with the United States.

Many offshore funds, including master funds in certain master-feeder structures, would be subject to dramatic new withholding tax requirements under this provision, unless they were to agree to enter into such agreements with the U.S. Treasury to provide the required information. It is not difficult to imagine that these efforts will be resisted, including by other governments, but there seems to be real resolve in Washington, including on the part of the President, to employ tough measures to curb perceived opportunities to avoid tax through foreign accounts and investments.

These provisions would be effective for payments made after 2010, and would not apply to payments made under obligations outstanding as of the date of the first Committee action (a Committee vote) on the proposal if the payor would be required to increase payments under the terms of the obligation.

Foreign Trusts, Foreign Bearer Bonds

The proposal also includes a series of provisions relating to the use of foreign trusts and to foreign-issued bearer bonds.

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