March 24, 2010

“Hiring Incentives to Restore Employment Act” Enacted

Legislation Includes Foreign Account Provisions and Employment Incentives

SUMMARY

On March 18, 2010, the President signed into law the “Hiring Incentives to Restore Employment Act” (the “Act”). The Act includes foreign financial account provisions, in part taken from the previously introduced Foreign Account Tax Compliance Act (“FATCA”), which require: (i) foreign financial institutions to report information on their account holders, and (ii) other foreign entities to report information on their beneficial owners. In the absence of compliance, there will be a 30% withholding tax on payments of U.S.-source investment income. The Act also incorporates other provisions adapted from FATCA, including: (i) the elimination of the withholding tax exemption for bearer bonds; (ii) the imposition of withholding tax on substitute dividend and dividend equivalent payments; (iii) increased disclosure by U.S. taxpayers with respect to foreign assets; (iv) new rules on the treatment of foreign trusts; and (v) new reporting requirements for investors in passive foreign investment companies. In addition, the Act extends the period during which the IRS is not required to pay interest on certain overpayments of tax. Many provisions in the Act are also similar to provisions in the Tax Extenders Act of 2009, a bill that included a compliance section that was adapted from FATCA.

The withholding tax provisions of the Act that apply to payments made to foreign financial institutions and certain other foreign entities are generally effective for payments made after the end of 2012.

The Act includes business tax provisions, including new tax incentives for employers who hire or retain certain “qualified individuals” and an extension of the 2009 limitations on the election to expense the cost of certain depreciable property under Section 179. Additionally, the Act delays the effective date of the worldwide interest allocation rules to December 31, 2020 and accelerates the schedule under which corporate taxpayers with assets of at least $1 billion will be required to pay estimated taxes.
DISCUSSION

A. INTERNATIONAL TAX PROVISIONS

The Act includes substantive and procedural provisions that will significantly alter the U.S. rules on withholding, information reporting, "dividend equivalent" payments, self-disclosure and trust reporting. In addition, the Act adjusts the timeframe on which interest is paid on refunds of certain cross-border withholding taxes and delays the application of the worldwide interest allocation rules. Many of these rules are taken from previously introduced legislation, including FATCA and the Tax Extenders Act of 2009.¹

1. Withholding and Third-Party Information Reporting

The Act establishes two new programs intended to induce foreign financial institutions that receive U.S.-source investment income to provide information about their U.S. customers to the IRS and to induce other foreign entities that receive U.S.-source investment income to obtain and report information on their U.S. beneficial owners. The penalty for not participating is a 30% withholding tax on “withholdable payments”² made to noncompliant foreign financial institutions (“Nonparticipating FFIs”) and non-financial foreign entity payees. The withholding tax applies to all “withholdable payments” made to a Nonparticipating FFI, including payments received by a Nonparticipating FFI on behalf of one of its clients (although as discussed further below, such clients may be entitled to claim a refund or credit for this tax).

These provisions generally track those set forth in the previously introduced Tax Extenders Act of 2009, but with changes. In particular, the Act (i) gives the Treasury the authority to modify the definition of a “financial account;” (ii) gives the Treasury the authority to limit the information to be provided by participating foreign financial Institutions on gross receipts and withdrawals from accounts; (iii) narrows the definition of a foreign financial institution, which previously included any foreign entity that held financial assets for the account of others, to an entity that “as a substantial part of its business, holds


²  For this purpose, a “withholdable payment” generally includes: (i) a U.S.-source payment of interest, dividends, compensation or other fixed or determinable, annual or periodical gains, profits or income; (ii) gross proceeds from the sale or other disposition of any property of a type that can produce U.S.-source interest or dividends; and (iii) interest paid by a non-U.S. branch of a U.S. financial institution. However, the Act exempts income effectively connected with a U.S. trade or business from the definition of a “withholdable payment,” with the consequence that most (if not all) payments to a foreign financial institution’s U.S. branch are not subject to the new withholding provisions of the Act. In addition, the Act authorizes the Treasury Department to issue guidance exempting other payments from being characterized as “withholdable payments.” See Section 1473(1). References to a "Section" in this publication are to sections of the Internal Revenue Code of 1986, as amended (the "Code").
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financial assets for the account of others; and (iv) clarifies that the exemption for income on obligations that are outstanding on March 28, 2012, also applies to the gross proceeds from the sale of such obligations.

a. Foreign Financial Institutions

To avoid withholding tax, the Act requires that a “foreign financial institution” enter into an information reporting agreement with the Treasury Department that will require the “foreign financial institution” (such an institution, a “Participating FFI”) to obtain and report certain information about its “United States accounts.” The definition of a “foreign financial institution” may include entities that are not conventionally known as financial institutions, including most non-U.S. private equity and hedge funds, public mutual funds and private family investment vehicles. A “United States account,” for this purpose, generally includes both: (i) a “financial account” held directly by a “specified United States person” and (ii) a “financial account” held by a foreign entity that, directly or indirectly, has one or more “substantial United States owners.” Unless exempted by Treasury Department guidance, a “financial account” includes a

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3 Emphasis added.

4 The Act generally defines a “foreign financial institution” as a “financial institution” that is a foreign entity. A “financial institution” is generally any entity that “accepts deposits in the ordinary course of a banking or similar business,” “as a substantial portion of its business, holds financial assets for the account of others” or “is engaged (or holds itself out as being engaged) primarily in the business of investing, reinvesting, or trading in: (i) securities; (ii) partnership interests; (iii) commodities; or (iv) any interests (including futures contracts, forward contracts or options) in such securities, interests or commodities. See Sections 1471(d)(4) and (5). The Treasury has regulatory authority to modify this definition, and it is expected that regulations will limit its application and exclude holding companies that “invest” in the shares of affiliated non-financial operating companies and finance companies for such operating companies.

5 A “specified United States person” is a U.S. person, other than a publicly traded corporation, a corporation in the same expanded affiliated group as a publicly traded corporation, an organization exempt from tax under Section 501(a), an individual retirement plan, a governmental unit, a bank, a real estate investment trust, a regulated investment company, a common trust fund or a trust that is either exempt from tax under Section 664(c) or described in Section 4947(a)(1). See Section 1473(3).

6 Under the Act, a “substantial United States owner” is typically a U.S. person with a 10% or greater interest in the entity (measured, in the case of a corporation, by vote or value, and in the case of a partnership, by capital or profits) or, in the case of a so-called grantor trust, a person treated as an owner of any portion of the trust. However, a U.S. person who owns any portion of an entity that is engaged primarily in the business of investing, reinvesting or trading in securities, interests in partnerships, commodities, or any interests (including futures or forward contracts or options) in such securities, interests or commodities would be a “substantial United States owner” under the Act. The Act also provides that a “substantial United States owner” includes, to the extent provided by the Treasury Department in regulations or other guidance, any “specified United States person” that holds, directly or indirectly, more than 10% of the beneficial interests of a trust that is not a grantor trust. See Section 1473(2).

However, the Act exempts an account from being characterized as a “United States account” if each holder of the account is a natural person and the aggregate value of all accounts held by each holder of the account at the financial institution maintaining the account (and, to the extent provided for in guidance from the Treasury Department, at financial institutions in the relevant financial institution’s

(footnote continued)
depository account, a custodial account and “any equity or debt interest in such financial institution” other than an interest that is “regularly traded on an established securities market.” Because of the breadth of these definitions, the Act’s reporting provisions are quite broad and could, absent Treasury Department guidance to the contrary, apply to privately placed notes and certain equity and debt instruments issued by hedge funds and private equity funds that would not ordinarily be thought of as “accounts.”

### i. Information Reporting Agreements

The agreements prescribed by the Act will require Participating FFIs to: (i) obtain information from the holder of each account that is sufficient to determine whether the account is a “United States account” (including information about foreign entities so as to determine whether the entity has one or more “substantial United States owners”); (ii) comply with any due diligence and verification procedures that the Treasury Department requires with respect to identifying “United States accounts;”\(^7\) (iii) comply with requests by the Treasury Department for additional information about “United States accounts;” and (iv) in cases where foreign law prohibits reporting without a waiver by the account holder, attempt to obtain such a waiver, and, if such a waiver cannot be obtained, close the account.\(^9\) Such agreements will also require Participating FFIs either to:

- report the following information with respect to each “United States account” held at the institution:
  - the name, address and taxpayer identification number of each U.S. holder of a “United States account;”

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\(^7\) The Act’s reporting requirements are in addition to any requirements imposed on an institution that is a “qualified intermediary.”

\(^8\) The Joint Committee report accompanying the Act indicates that: “[i]t is expected that in complying with the requirements of this provision, the foreign financial institution and the other members of the same expanded affiliated group comply with know-your-customer, anti-money laundering, anti-corruption, or other similar rules to which they are subject, as well as with such procedures and rules as the Secretary may prescribe, both with respect to due diligence by the foreign financial institution and verification by or on behalf of the IRS to ensure the accuracy of the information, documentation, or certification obtained to determine if the account is a United States account,” and further that the “Secretary may use existing know-your-customer, anti-money laundering, anti-corruption, and other regulatory requirements as a basis in crafting due diligence and verification procedures in jurisdictions where those requirements provide reasonable assurance that the foreign financial institution is in compliance with the requirements of this provision.”

\(^9\) See Section 1471(b).
the name, address and taxpayer identification number of each “substantial United States owner” in the case of an account held by a foreign entity with one or more “substantial United States owners;” and

- the account number, the account balance or value, and, except to the extent provided by the Treasury Department, the gross receipts and gross withdrawals that have been made from the account;\(^{10}\) or

- elect to comply with the information-reporting rules that govern U.S. financial institutions’ accounts of a U.S. citizen.\(^{11}\)

### ii. Expanded Affiliated Group Reporting

In addition to requiring a Participating FFI to report information about its own account holders, except as maybe exempted by regulations to be prescribed by the Treasury Department, such agreements would also require reporting with respect to accounts held at financial institutions in the “expanded affiliated group” of the Participating FFI. Effectively, this provision may mean that if one member of an “expanded affiliated group” agrees to become a Participating FFI, all financial institution members of the “expanded affiliated group” must do so, and if one member of the “expanded affiliated group” is barred from participating in the program by bank secrecy or related laws, no member can become a Participating FFI.

Under these provisions, a financial institution generally would be part of an “expanded affiliated group” that includes another financial institution if: (i) one financial institution controls the other financial institution directly or through a chain of controlled entities; or (ii) they are both under the common control (directly or through a chain of controlled entities) of a single corporation (whether or not such corporation is a financial institution itself).\(^{12}\) Control for this purpose generally exists, in the case of a corporation, if a person owns more than 50% of the equity of the corporation (measured by vote and value, but excluding the value of certain straight preferred shares), and, in the case of a partnership or trust, if a person owns more than 50% (by value) of the beneficial interests in such partnership or trust.

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\(^{10}\) See Section 1471(c)(1).

\(^{11}\) Section 1471(c)(2). Under this election, a foreign financial institution would be required to report any information with respect to each “United States account” that the foreign financial institution would be required to report under certain sections of the Code as if the foreign financial institution were a U.S. financial institution and each holder of such account were a natural person and a U.S. citizen. These sections require information reporting on wages, rent and other fixed or determinable annual or periodical income made in the course of a trade or business (Section 6041), dividends (Section 6042), broker proceeds (Section 6045) and interest (Section 6049).

\(^{12}\) The Act defines an “expanded affiliated group” as an “affiliated group,” as defined by Section 1504(a), but by substituting a more-than-50% ownership requirement for the at-least-80% ownership requirement in each place where it appears in Section 1504(a), and disregarding the Section 1504(b)(2) prohibition on including insurance companies in an affiliated group and the Section 1504(b)(3) prohibition on including non-U.S. corporations in an affiliated group. A partnership or trust is also considered a member of an “expanded affiliated group” if it is controlled, within the meaning of Section 954(d)(3), by other members of the expanded affiliated group (including other controlled partnerships or trusts). See Section 1471(e)(2).
iii. Requirement to Withhold

The Act also requires a Participating FFI to withhold at 30% on any “passthru payment” made to: (i) a “recalcitrant account holder;” (ii) a Nonparticipating FFI; or (iii) a foreign financial institution that has made the election described below to be subject to withholding on payments “allocable to” accounts of such electing financial institutions that are held by either “recalcitrant account holders” or Nonparticipating FFIs. Under the Act, a “recalcitrant account holder” is an account holder that either: (i) “fails to comply with reasonable requests for” certain information;¹⁴ or (ii) in cases where foreign law prohibits information reporting without the consent of the account holder, does not waive this provision of foreign law.¹⁵ If the Treasury Department determines that a Participating FFI is not complying with its information reporting agreement, the Act permits the Treasury Department to terminate the agreement unilaterally.¹⁶

iv. Election to Be Subject to Withholding Rather than Withhold

The Act permits a Participating FFI to elect out of the obligation to withhold (but not the obligation to comply with information reporting) on passthru payments if it agrees to be subject to withholding on payments made to the institution that are “allocable to” either: (i) a “recalcitrant account holder;” or (ii) a Nonparticipating FFI.

To make this election, a Participating FFI must (i) notify each withholding agent with respect to each withholdable payment of both the institution’s election and “such other information as may be necessary for the withholding agent to determine the appropriate amount to deduct and withhold from such payment;” and (ii) waive “any right” under any U.S. tax treaty with respect to any amount deducted and

¹³ Under the Act, a “passthru payment” is any payment, whether or not a “withholdable payment,” “to the extent attributable to a withholdable payment.” See Section 1471(d)(7). As such, a “passthru payment” could potentially include an amount of foreign-source income, such as a dividend payment of a non-U.S. investment fund that is attributable to U.S.-source interest received by the fund. There is no legislative gloss on what it means for a payment to be “attributable” to a withholdable payment.

¹⁴ Specifically, such requests include: (i) the information necessary to determine whether an account is a “United States account;” and (ii) if an account is a “United States account,” the name, address and taxpayer identification number of each account holder that is a “specified United States person” and, in the case of an account holder that is a “United States-owned foreign entity,” the name, address and taxpayer identification number of each “substantial United States owner” of the entity. See Section 1471(d)(6), Section 1471(b)(1)(A) and Section 1471(c)(1)(A).

¹⁵ As noted above, the Act also contains a provision that requires “foreign financial institutions” to close accounts maintained by holders who refuse to provide a waiver of an applicable provision of foreign law that prohibits information reporting “within a reasonable period of time.” See Section 1471(b)(1)(F).

¹⁶ The Joint Committee Report accompanying the Act specifically notes that: “[t]he provision allowing for withholding on payments made to an account holder that fails to provide the information required under this provision is not intended to create an alternative to information reporting. It is anticipated that the Secretary may require, under the terms of the agreement, that the foreign financial institution achieve certain levels of reporting and make reasonable attempts to acquire the information necessary to comply with the requirements of this section or to close accounts where necessary to meet the purposes of this provision.”
withheld. The Act also provides that this election may be made with respect to certain classes or types of accounts, to the extent provided in guidance issued by the Treasury Department.

v. Deemed Compliance

The Act also includes a “deemed compliance” provision, under which a foreign financial institution will be treated as complying with the Act’s information reporting and withholding rules if the institution either: (i) complies with procedures to be prescribed by the Treasury Department to ensure that the institution does not maintain United States accounts and meets any other requirements prescribed by the Treasury Department with respect to accounts held by other foreign financial institutions; or (ii) “is a member of a class of institutions with respect to which” the Treasury Department “has determined that the application [of the foreign financial institution withholding tax] is not necessary to carry out the purposes of” that tax. The Joint Committee Report accompanying the Act observes that “it is anticipated that the Secretary may provide rules that would permit certain classes of widely held collective investment vehicles, and to the limited extent necessary to implement these rules, the entities providing administration, distribution and payment services on behalf of those vehicles to be deemed to meet the requirements of this provision.”

b. Non-Financial Foreign Entities

The Act will generally subject “withdrawable payments” made to “non-financial foreign entities” to a 30% withholding tax if the non-financial foreign entity payee, or another non-financial foreign entity, is the beneficial owner of the payment and the requirements for exemption under the Act are not met.

The Act’s exemption requirements would generally be satisfied by the beneficial owner or payee providing the withholding agent with either: (i) “a certification that such beneficial owner does not have any substantial United States owners;” or (ii) the name, address and taxpayer identification number of “each substantial United States owner of such beneficial owner.” Such information would need to be reported to the Treasury Department. The Act exempts payments made to publicly traded corporations, members of an expanded affiliated group that includes a publicly traded corporation, foreign governments (and their instrumentalities), international organizations, foreign central banks, entities organized in a possession of the United States and other classes of recipients identified in guidance issued by the

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17 Section 1471(b)(2).
18 Section 1272(b)(1). As noted above, a “substantial United States owner” is typically a U.S. person with a 10% or greater interest in the entity (measured, in the case of a corporation, by vote or value, and in the case of a partnership, by capital or profits) or, in the case of a trust, a person treated as an owner of any portion of the trust, although a U.S. person who owns any portion of an entity engaged primarily in the business of investing, reinvesting or trading in securities, interests in partnerships, commodities or any interests (including futures or forward contracts or options) in such securities, interests or commodities would be a “substantial United States owner” under the Act. See Section 1473(2).
c. Refunds and Credits

In general, beneficial owners who receive payments that have been reduced by the withholding provisions of the Act will be entitled to apply for a refund or credit to the extent they are so eligible. However, withholding on payments beneficially owned by a foreign financial institution will only be creditable or refundable to the extent a credit or refund is required by a treaty obligation of the United States. In addition, parties applying for a refund of the withholding tax imposed by the Act will be required to provide "such information as the Secretary may require to determine whether such beneficial owner is a United States owned foreign entity . . . and the identity of any substantial United States owners of such entity."  

d. Effective Date

The withholding provisions of the Act are generally effective for payments made after December 31, 2012. However, the Act's withholding provisions do not apply to payments or gross proceeds from the disposition of any "obligation" that is outstanding on March 18, 2012.

2. Withholding on “Dividend Equivalent” Payments

The Act imposes a new 30% withholding tax on “dividend equivalent payments.” The provisions in the Act are substantially similar to those in the previously introduced Tax Extenders Act of 2009 but clarify the definition of a substitute dividend payment; grant additional authority to the Treasury Department to address over-withholding on tiers of payments between financial intermediaries; and extend the effective date from 90 days after enactment to 180 days after enactment.

a. Background

Current law generally requires withholding agents to collect a 30% withholding tax on payments of U.S.-source dividends and other fixed or determinable annual or periodical income, unless the rate is reduced by a tax treaty. While current law generally does not impose withholding tax on equity swap payments, it does impose withholding tax on substitute dividend payments made in a securities loan involving U.S. stock. In 1997, the IRS and the Treasury Department issued final regulations governing

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19 See Section 1472(c).
20 See Section 1474(b).
21 The term “obligation,” however, is not defined in the Act or in the Joint Committee Report accompanying the Act. It is thus unclear whether non-debt “obligations” such as stock are encompassed within this definition.
22 See Section 1441(a). Fixed or determinable annual or periodical income generally includes interest (other than portfolio interest), dividends, rents, salaries, wages, premiums, annuities, compensation and other items of annual or periodical gain, profit or income.
withholding on securities lending transactions. Shortly thereafter, in response to concerns that “cascading withholding tax” would be due on dividend equivalent payments made in respect of securities that were lent more than once, the IRS issued Notice 97-66, which generally limits the extent to which withholding tax will be imposed on substitute dividend payments made between foreign persons.

b. Explanation

Under the Act, a “dividend equivalent,” which will be subject to withholding, includes: (i) any substitute dividend made pursuant to a securities lending or a sale-repurchase transaction that (directly or indirectly) is contingent upon, or determined by reference to, the payment of a dividend from sources within the United States; (ii) any payment made pursuant to a “specified notional principal contract” that is directly or indirectly contingent upon, or determined by reference to, the payment of a U.S.-source dividend; and (iii) any payment determined by the Treasury Department to be “substantially similar” to either a substitute dividend or a payment made on a “specified notional principal contract” that is contingent on, or determined by reference to, a U.S.-source dividend. For this purpose, a “specified notional principal contract” is defined as:

- any notional principal contract if:
  - in connection with entering into such contract, any long party to the contract transfers the underlying security to any short party to the contract (i.e., “crossing in” occurs);
  - in connection with the termination of such contract, any short party to the contract transfers the underlying security to any long party to the contract (i.e., “crossing out” occurs);

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24 In September 2008, Congressional hearings were held addressing concerns that Notice 97-66 was being used to permit tax avoidance transactions, including transactions in which a foreign person would: (i) lend U.S. stock to a foreign financial institution, which would then sell that stock to a related U.S. person; and (ii) simultaneously enter into a total return equity swap with respect to the loaned stock with the related U.S. person, either directly or indirectly. The hearings also addressed concerns that foreign investors (including foreign hedge funds) were avoiding U.S. withholding tax by transferring U.S. stocks to U.S. broker-dealers (either directly or indirectly) shortly before a dividend payment date, entering into economically equivalent equity swaps during the dividend payment period and then reacquiring the relevant U.S. stocks after the dividend was paid.

25 See Section 871(l)(2).

26 The Act defines a “long party” as “with respect to any underlying security of any notional principal contract, any party to the contract which is entitled to receive any payment pursuant to such contract which is contingent upon, or determined by reference to, the payment of a dividend from sources within the United States with respect to such underlying security.” Section 871(l)(4)(A).

27 Under the Act, an “underlying security” is defined as the security with respect to which a “dividend equivalent” is paid. For this purpose, an index or basket of stocks is considered a single security. See Section 871(l)(4)(C).

28 A “short party” is defined, under the Act, as “with respect to any underlying security of any notional principal contract, any party to the contract which is not a long party with respect to such underlying security.” See Section 871(l)(4)(B).
the underlying security is not readily tradable on an established securities market;
• in connection with entering into such contract, the underlying security is posted as collateral by any short party to the contract; or
• the contract is identified by the Treasury as a specified notional principal contract; and
• with respect to payments made after March 18, 2012, the rules will apply to any notional principal contract unless the Treasury determines that such contract is “of a type which does not have the potential for tax avoidance.”

Such “dividend equivalent” payments are to be computed on a gross basis, rather than a net basis.

In effect, the Act imposes U.S. withholding tax on substitute dividend payments and as a result, Notice 97-66 presumably will be void after this provision of the Act takes effect. However, the Act includes language providing that: “[i]n the case of any chain of dividend equivalents one or more of which is subject to tax under this section or section 881, the [Treasury] may reduce such tax, but only to the extent that the taxpayer can establish that such tax has been paid with respect to another dividend equivalent in such chain, or is not otherwise due, or as the Secretary determines is appropriate to address the role of financial intermediaries in such chain. For purposes of this paragraph, a dividend shall be treated as a dividend equivalent.”

This provision has two effective dates: September 14, 2010 (with respect to “specified notional principal contracts” where: (i) there is “crossing in,” or “crossing out;” (ii) the reference equity is posted as collateral; (iii) the reference equity is not publicly traded; or (iv) the contract is identified in Treasury guidance as a “specified notional principal contract”) and March 18, 2012 (with respect to any notional principal contract that is not specifically exempted by Treasury guidance).


With limited exceptions, the Act repeals the current exemption to the TEFRA rules for “foreign-targeted” bearer obligations. The provisions in the Act are substantially similar to those in the previously introduced Tax Extenders Act of 2009. One notable change is a provision that allows the Treasury to identify book-entry systems that, in addition to dematerialized book-entry systems, will be treated as systems that meet the requirements for a security to be treated as being in registered form.

a. Background

The current TEFRA rules generally: (i) deny interest deductions to the issuer of a “registration-required obligation” that is not issued in registered form; (ii) impose an excise tax on the issuers of such obligations equal to 1% of the obligation’s principal amount for each year that the obligation may be outstanding; and (iii) deny to foreign holders of such obligations the exemption from the 30% U.S.

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29 See Section 871(l)(3).
withholding tax on interest that is generally available for portfolio interest paid on debt of U.S. issuers. Under these rules, however, “foreign-targeted” bearer obligations that comply with certain requirements with respect to their initial offer and sale outside the United States are not considered “registration-required obligations.”

b. Explanation

The Act generally repeals the current exemption to the TEFRA rules for “foreign-targeted” bearer obligations, but:

- retains the excise tax exemption for obligations that are issued in compliance with the current “foreign-targeting” requirements;
- permits the Treasury administratively to exempt non-U.S. recipients from the requirement to provide an IRS Form W-8 or other certification in order to qualify for the portfolio-interest exception to withholding on U.S.-source interest payments in situations where the Treasury has determined that “such a statement is not required in order to carry out the purposes of this subsection”; and
- provides that a dematerialized book-entry system and other book-entry systems identified by the Treasury are to be treated as a book-entry system for the purpose of determining whether an obligation is in registered form.

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30 See Sections 163(f), 871(h)(2) and 4701.

31 See former Section 163(f)(2)(B). Under this provision, interest must be payable only outside the United States and its possessions; a legend must appear on the obligation stating that a United States person who holds the obligation will be subject to limitations under U.S. income tax laws, and “arrangements reasonably designed to ensure that such obligation will be sold (or resold in connection with the original issue) only to a person who is not a United States person,” must be in place. See also Sections 871(h)(2)(A) and 881(c)(2)(A). In addition, any gain recognized by a U.S. holder of a bearer form obligation that would have been a “registration-required obligation” had it not been issued in compliance with the foreign-targeting rules is treated as ordinary income, see Section 1287, and owners of such foreign-targeted obligations are not permitted to claim loss deductions on the sale or exchange of the instrument, see Section 165(j).

32 Such obligations will need to meet the following three requirements: (i) the obligation would need to be issued under arrangements “reasonably designed to ensure” that the obligation will not be sold (or resold in connection with the original issue) to a United States person; (ii) interest on the obligation would need to be payable only outside the United States and its possessions; and (iii) the obligation would need to be legended. Currently, a bearer bond issued in compliance with the TEFRA C rules is exempted from the legending requirement.

33 See Section 871(h)(2).

34 This provision allows the Treasury Department to exempt bonds that are legally in bearer form from U.S. withholding tax if they are issued through the European and Japanese clearing systems. However, dematerialized obligations issued on or after January 1, 2007 are generally considered to be in registered form under current IRS practice, so long as physical bearer certificates cannot be obtained by a holder absent the occurrence of an extraordinary event, such as the cessation of operation of the book-entry system. See Notice 2006-99, 2006-2 C.B. 907. A further discussion of Notice 2006-99 can be found in the Sullivan & Cromwell LLP publication entitled “Dematerialized Book-Entry Systems: Internal Revenue Service Announces Treatment of Bonds Held Through Dematerialized Book-Entry Systems and Intent to Eliminate Rules for Foreign-Targeted Registered (footnote continued)
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The bearer bond rules of the Act will apply to obligations issued after March 18, 2012.

4. Interest on Overpayments

Under prior law, the IRS was not required to pay interest on overpayments if the refund due was remitted to the taxpayer within 45 days of the later of: (i) the due date of the relevant return (determined without regard to extensions); or (ii) the date on which the relevant return was filed. The Act would extend this period to 180 days for refunds with respect to either: (i) any refund claim filed with respect to any tax collected under Chapter 3 of Subtitle A of the Code; or (ii) any tax collected under the withholding provisions of the Act. This provision will take effect for: (i) returns due after March 18, 2010; (ii) refund claims made after March 18, 2010; and (iii) refunds paid on adjustments initiated by the IRS after March 18, 2010.


The Act requires holders of certain foreign assets to disclose their ownership of, and information about, those assets on their tax returns, imposes penalties on holders of such assets who fail to make the required declarations and extends the statute of limitations to six years with respect to underreported income that arises from an “undisclosed foreign asset.” These provisions of the Act are the same as those contained in the Tax Extenders Act of 2009.

a. Background

The current instructions to the FBAR require U.S. citizens and residents, as well as persons in and doing business in the United States, to file an FBAR if such persons have a financial interest in, or signature or other authority over, a foreign financial account and the aggregate value of all such foreign financial accounts exceeds $10,000 at any time during a calendar year. A financial interest generally includes an account held by an entity where a U.S. person directly or indirectly owns more than 50% of the (footnote continued)

Bonds” (November 17, 2006), which can be obtained by following the instructions at the end of this publication.

35 See Section 6611(e).

36 Chapter 3 of Subtitle A of the Code governs withholding on nonresident aliens and currently comprises Sections 1441-1464.

37 The IRS, in Announcement 2009-51, suspended the reporting requirement with respect to FBARs due on June 30, 2009 for persons who are not U.S. citizens, residents or domestic entities, and announced its intent to issue additional guidance with respect to FBARs due in subsequent years. In announcement 2010-16, the IRS suspended the requirement to file FBARs due on June 30, 2010 for persons who are not U.S. citizens, residents or domestic entities. Pursuant to Notice 2009-62 and Notice 2010-23, the IRS has also suspended filing requirements until June 30, 2011, for persons with signature authority over, but no financial interest in, a foreign financial account, announced its intention to issue regulations and requested comments with respect to FBAR filing requirements.

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corporation or partnership, or has a beneficial interest in over 50% of the assets or income of a trust that owns a non-U.S. account.

b. Disclosure Requirement

Under the Act, an individual U.S. taxpayer who has an interest in a “specified foreign financial asset” will be required to include a disclosure statement declaring the asset and certain other information on an attachment to his or her tax return if, at any time during his or her taxable year, the aggregate value of all “foreign financial assets” exceeds $50,000 (or any higher amount prescribed by the Secretary of the Treasury). For this purpose, a “specified foreign financial asset” includes: (i) a “financial account” maintained at a “foreign financial institution;” and (ii) to the extent not held in an account at a “financial institution,” a stock or security issued by a non-U.S. person, a financial instrument or contract held for investment if the counterparty is a non-U.S. person and any interest in a “foreign entity.” Although the “specified foreign financial asset” requirements overlap somewhat with the current FBAR filing requirements, the Act does not supplant the current requirement that holders of foreign financial accounts file an FBAR. This new disclosure requirement is effective for taxable years beginning after March 18, 2010.

c. Penalties for Nondisclosure and Extended Statute of Limitations

The Act prescribes a penalty of $10,000 if any individual fails to furnish a complete disclosure statement on a timely basis. Additionally, the Act imposes a supplemental penalty, equal to $10,000 for each 30-day period (or fraction thereof) that a taxpayer remains non-compliant with the Act’s disclosure requirements after the 90th (ninetieth) day after the day on which the Treasury Department mails a notice of non-compliance to the taxpayer. These “failure to disclose” penalties are, however, waived if an individual’s failure to disclose results from “reasonable cause” and not “willful neglect.”

38 As with the provisions covering third-party financial account reporting, a “financial account,” under the Act, includes a depository account, a custodial account and, except as otherwise provided by the Treasury Department, “any equity or debt interest in such financial institution” other than an interest that is “regularly traded on an established securities market.” Accordingly, this requirement could apply to privately placed notes and other financial products that would not ordinarily be thought of as “accounts.”

39 See Section 6038D(b).

40 Moreover, this overlap is not complete. The technical explanation of the Act notes that, for example, a beneficiary of a foreign trust who owns an interest of less than 50% is not within the scope of the current FBAR requirements, but would be covered by the Act. Moreover, the Act’s definition of a “financial account” differs significantly from the definition in the instructions to the FBAR.

41 See Section 6038D(d). The maximum amount of any such supplemental penalty that may be imposed, however, is $50,000.

42 See Section 6038D(g). “Reasonable cause” does not, however, include the fact that a foreign jurisdiction would impose a civil or criminal penalty on the individual for disclosing the information required by the Act. See id.
In addition to the “failure to disclose” penalties described above, the Act imposes a new, 40% accuracy-related penalty on understatements of income that are attributable to an “undisclosed foreign financial asset.” Under the Act, an asset is an “undisclosed foreign financial asset” if it is an asset with respect to which information is required to be provided under either (i) the Act’s requirement to disclose interests in “specified foreign financial assets;” or (ii) certain other disclosure requirements of the Code, and the taxpayer does not provide the required information during the relevant taxable year. The other disclosure requirements that would be covered by this aspect of the Act include information-reporting requirements relating to: (i) controlled foreign corporations and partnerships; (ii) transfers to foreign corporations and partnerships; (iii) certain organizations, reorganizations and acquisitions of stock in foreign corporations; (iv) certain acquisitions, dispositions of, and substantial changes to, interests in foreign partnerships; and (v) certain transactions involving foreign trusts (generally including the creation or transfer of property to a foreign trust and the death of a U.S. person who was treated as the owner of a foreign trust, or whose estate includes any portion of a foreign trust).

Moreover, the Act extends the statute of limitations to six years for collecting taxes attributable to an omission of income that exceeds $5,000 if the understatement is attributable to one or more foreign assets that is covered by the Act’s “specified foreign asset” disclosure requirement or the Act’s PFIC self-reporting requirement (described below). Whether the statute of limitations would be extended would be determined without regard to whether the taxpayer’s holdings met the dollar thresholds that determine whether the Act’s “specified foreign asset” and PFIC disclosure requirements actually apply to a particular taxpayer. The Act’s nondisclosure penalties become effective for taxable years beginning after March 18, 2010. The extended statute of limitations in the Act is effective for returns filed after March 18, 2010, and if the statute of limitations was still open for the return on the Act’s enactment date, for returns filed before March 18, 2010.

6. PFIC Self-Reporting

The Act requires holders of shares in a passive foreign investment company (“PFIC”) file an annual report with the Treasury Department. This provision is the same as that contained in the previously introduced Tax Extenders Act of 2009.

See Sections 6662(b)(7) and 6662(j).
See Section 6038.
See Section 6038B.
See Section 6046.
See Section 6046A.
See Section 6048.
See Section 6501(e)(1)(A).
a. **Background**

Subject to exceptions for banks and insurance companies, a foreign corporation is a PFIC if either: (i) 75% or more of its gross income for the taxable year is passive income; or (ii) the average of the percentage of its assets during the taxable year that produce passive income or that are held for the production of passive income is at least 50%. Although a holder of PFIC stock is subject to certain adverse tax consequences, there was no requirement, prior to the Act, that the holder report any information to the Treasury Department about shares of a PFIC unless the holder: (i) recognized gain on a direct or indirect disposition of PFIC stock; (ii) received direct or indirect distributions from a PFIC; or (iii) made a “reportable election” (including an election to treat a PFIC as a “qualified electing fund”).

b. **Explanation**

The Act amends Section 1298 to require any person who is a shareholder in a PFIC to file an annual report containing “such information as the Secretary may require.” The PFIC self-reporting provision of the Act is effective immediately, although it will not have any direct consequences until the information to be reported is determined.

7. **Delay in the Effective Date of the Worldwide Interest Allocation Rules**

The Act delays the application of the worldwide interest allocation rules of Section 864(f).

Taxpayers are required to allocate interest and other expenses among U.S. and non-U.S. sources for foreign tax credit limitation purposes and for certain other purposes. Generally, for the purpose of allocating interest expense, all domestic corporations that are members of the same affiliated group are treated as one corporation, and the interest expense is allocated on the basis of assets. Foreign corporations are not, however, treated as members of an affiliated group; thus their assets and interest expense are not included in this calculation.

The American Jobs Creation Act of 2004 provided that a domestic corporation could elect to allocate interest as if all members of its worldwide affiliated group were a single corporation. If this election were made, the worldwide affiliated group would consist of all corporations in an affiliated group, and also all controlled foreign corporations that would be members of the affiliated group if the rule excluding foreign corporations did not apply. This election would, for many taxpayers, reduce the amount of interest expense allocated to foreign-source income for foreign tax credit limitation purposes, and thus, for such taxpayers, would increase the amount of available foreign tax credits.

The “worldwide interest allocation rules” were originally to be effective for taxable years beginning after December 31, 2008, but the Housing and Economic Recovery Act of 2008 delayed the effectiveness of

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50 See Section 1297(a).

51 P.L. 108-357.
these rules by two years to taxable years beginning after December 31, 2010, and the Worker, Homeownership and Business Assistance Act of 2009 further deferred these rules until taxable years beginning after December 31, 2017. Under the Act, these rules will not take effect until taxable years beginning after December 31, 2020.

8. Foreign Trusts

The trust provisions of the Act provide that, for purposes of determining whether a U.S. person shall be treated as the owner of a foreign trust: (i) amounts are treated as accumulated for the benefit of a U.S. person even if that U.S. person’s interest in the trust is contingent; and (ii) a foreign trust is treated as having a U.S. beneficiary if any person has discretion to make distributions from the trust unless, under the terms of the trust, the class of persons to whom distributions may be made is identified and none of those persons is a U.S. person during the year. Moreover, the Act: (i) creates a presumption that a foreign trust to which a U.S. person has transferred property has a U.S. beneficiary unless the transferor can demonstrate, to the satisfaction of the Treasury Department, that the trust complied with any relevant reporting requirements; and (ii) treats any uncompensated use of trust property by a U.S. grantor, U.S. beneficiary or U.S. person related to the grantor or beneficiary as a distribution equal to the fair market value of the use of such property. The Act also broadens the current foreign trust reporting requirements and modifies the current trust reporting penalty assessment scheme. These provisions are generally the same as those contained in the Tax Extenders Act of 2009.

a. Definitional Clarifications

Under Section 679, a U.S. person who transfers property to a foreign trust is generally treated as the owner of the trust if, at any time during the taxable year of the transferor, the trust has a U.S. beneficiary, a characterization that will result in tax liability for the transferor on the income of the trust under the grantor trust rules. A trust is treated as having a U.S. beneficiary if, under the terms of the trust, any part of the income or corpus of the trust may be paid to or accumulated for the benefit of a U.S. person or would be paid to a U.S. person if the trust were to terminate.

The Act clarifies when a trust will be treated as having a U.S. beneficiary for purposes of Section 679. First, it provides that an amount is treated as accumulated for the benefit of a U.S. person even if that U.S. person’s “interest in the trust is contingent on a future event.” Second, the Act states that if a person has discretion to make a trust distribution to or for the benefit of any person, the trust will be treated as having a U.S. beneficiary unless both: (i) the terms of the trust specifically identify the class of persons to whom such distributions may be made; and (ii) none of those persons is a U.S. person during

52 P.L. 111-92.
53 See Section 679(c)(1) (as amended by the Act).

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the relevant taxable year. The Act provides that if a U.S. person who transfers property to a trust is involved in an “agreement or understanding (whether written, oral or otherwise) that may result in the income or corpus of the trust being paid or accumulated to or for the benefit of” a U.S. person, that agreement or understanding will be characterized “as a term of the trust.” These provisions are effective immediately.

b. Presumption that a Foreign Trust Has a U.S. Beneficiary in the Absence of Documentation to the Contrary

The Act permits the IRS to treat a foreign trust to which a U.S. person has transferred property as having a U.S. beneficiary unless the transferor furnishes information that the Treasury may require regarding the transfer and demonstrates that the terms of the trust satisfy the requirements of Section 679(c)(1). This provision applies to transfers made after March 18, 2010.

c. Use of Foreign Trust Property

Current law provides that if a foreign trust makes a loan of cash or marketable securities to a U.S. grantor, U.S. beneficiary or U.S. person who is related to such a grantor or beneficiary, the amount of such loan is treated as a distribution from the trust to such grantor or beneficiary. The Act expands this treatment to cover the use of a foreign trust’s property by a U.S. grantor or U.S. beneficiary (or U.S. person who is related to such a grantor or beneficiary) unless the U.S. person pays fair market value for the use of the trust property. The uncompensated use of trust property will be treated as a distribution to the U.S. grantor or the U.S. beneficiary, as the case may be, equal to the fair market value of the use of such property. Thus a U.S. beneficiary of a foreign trust that owns real estate will, under the Act, be treated as having received a distribution from the trust of the value of the use of the real estate (e.g., as a vacation home) without paying fair market value rent.

Additionally, the Act provides that a loan of cash or marketable securities to, or the use of trust property by, a U.S. person (without regard to whether that U.S. person is a beneficiary of the trust) will generally be treated as paid to or accumulated for the benefit of a U.S. person. This means that any trust making

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54 See Section 679(c)(4).
55 See Section 679(c)(5).
56 Other than a deferred compensation or charitable trust described in Section 6048(a)(3)(B)(ii).
57 Section 679(c)(1) is satisfied if (A) “under the terms of the trust, no part of the income or corpus of the trust may be paid or accumulated during the taxable year to or for the benefit of a United States person” and (B) if the trust were terminated at any time during the taxable year, “no part of the income or corpus of such trust could be paid to or for the benefit of a United States person.”
58 See Section 643(i). Although the IRS has not yet issued regulations providing an exception from this treatment for a loan with arm’s-length terms where there is a reasonable expectation that the loan will be repaid, it has stated in Notice 97-34, 1997-1 C.B. 422 that certain “qualified obligations” would not be treated as distributions from a foreign trust.
such a loan to or allowing such use by a U.S. person would be treated as having a U.S. beneficiary under the grantor trust rules. However, this new provision does not apply if (i) the loan is repaid at a market rate of interest; or (ii) the fair market value of the use is paid to the trust, in each case within a reasonable period of time.\(^\text{59}\) What constitutes a “reasonable period of time” is not specified in the Act.

These new provisions are effective for loans made, and uses of property that occur, after March 18, 2010.

d. Trust Reporting Requirements and Penalties

Additionally, the Act broadens former law to require that any U.S. person who is treated as the owner of any portion of a foreign trust “submit such information as the Secretary may prescribe with respect to such trust for such year.”\(^\text{60}\) This requirement will first apply to taxable years beginning after March 18, 2010.

The Act also imposes an initial penalty equal to the greater of $10,000 or 35% of the gross reportable amount for failing to file a notice or return required by the Code. Prior to the enactment of the Act, the relevant law imposed an initial failure-to-file penalty equal to 35% of the gross reportable amount plus additional penalties for continued delinquency. The Act increases the initial penalty to the greater of 35% of the gross reportable amount and $10,000, a change that allows the IRS to assess penalties without knowing the gross reportable amount. After the taxpayer provides information sufficient to determine the gross reportable amount, the total penalties will be capped at the gross reportable amount, and the IRS will reduce or refund any excess penalty that was collected or levied.\(^\text{61}\) This new penalty provision is retroactive and applies to notices required to be filed after December 31, 2009.

B. EMPLOYMENT TAX INCENTIVES

The Act contains two provisions to encourage the hiring and retention of unemployed workers. First, the Act temporarily exempts “qualified employers” from payroll taxes (including Social Security tax, disability insurance, hospital insurance and railroad retirement taxes) assessed with respect to wages paid to “qualified individuals” performing services for the “qualified employer” in the employer’s trade or business (or in the case of a nonprofit organization, in furtherance of the purpose or function that qualified the employer as a nonprofit organization) between March 18, 2010 and December 31, 2010.\(^\text{62}\) For this purpose, “qualified employers” include non-government employers and public institutions of higher

\(^{59}\) See Section 679(c)(6).

\(^{60}\) See Section 6048(b)(1).

\(^{61}\) See Sections 6677(a)(1) and (a)(2).

\(^{62}\) However, payroll taxes attributable to the first calendar quarter of 2010 will be required to be paid but will be credited against other payroll taxes the employer must pay in the second quarter.
A “qualified individual” is an individual hired after February 3, 2010 but before January 1, 2011, who certifies that he or she has not been employed more than 40 hours in the 60 days preceding his or her hire date. This individual cannot be hired in place of another employee unless that employee left voluntarily or was dismissed for cause and cannot bear certain relationships to the qualified employer. The employer may elect to forego this exemption if it so chooses.

In addition, the Act provides a one-time business credit to employers that retain certain newly hired individuals. This business credit will be equal to the lesser of $1,000 or 6.2% of the wages paid by such employer to a “retained worker” during a 52-consecutive week period that the worker is employed, and can be taken in the taxable year in which an employee first qualifies as a retained worker.

A retained worker is a “qualified individual” (as defined above) who (i) is in the employ of the employer at any time during the taxable year in which the credit is taken; (ii) has been employed for at least a 52-consecutive week period; and (iii) has been paid wages during the last 26 weeks of the 52-consecutive week period that are equal to at least 80% of the wages paid the first 26 weeks of such period. The employer is not permitted to carry this credit to a prior taxable year. The Act contains special rules governing the application of this credit to possessions of the United States and their residents.

C. DUE DATES OF CORPORATE ESTIMATED TAXES

The Act also accelerates the timeframe on which estimated taxes must be paid for a corporation with at least $1 billion in assets. Specifically, estimated tax installments due in July, August or September 2014 will now be required to be 157.75% of the amount that would otherwise be due, an increase of 23%. Additionally, the Act increases the amount of any installments due in July, August or September 2015 to 121.5% of the amount that would otherwise be due, and the amount of such payments due in July, August or September 2019 to 106.5% of the amount that would otherwise be due. In each case, the installment due after the payment that was increased, is decreased to reflect the increased amount paid in the earlier installment.

D. SECTION 179 DEDUCTION

The Act increases both the Section 179 deduction (which permits taxpayers to expense certain business assets that would otherwise be treated as depreciable property) and the “investment limitation” (after which the Section 179 deduction begins to phase out) vis-à-vis taxable year 2010. The base level of the Section 179 deduction is $25,000, and the base level of the “investment limitation” is $200,000. However,

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63 For the purposes of the exemption from liability for railroad retirement taxes, a public institution of higher education is not a qualified employer.

64 See Section 3111(d). The Act appropriates money to the Federal Old-Age and Survivors Trust Fund, the Federal Disability Insurance Trust Fund and the Social Security Equivalent Benefit Account, which are typically funded by these payroll taxes, and directs that the money be transferred at the time and in the manner that the payroll taxes would have been transferred.

“Hiring Incentives to Restore Employment Act” Enacted
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Hiring Incentives to Restore Employment Act" Enacted March 24, 2010

the Small Business and Work Opportunity Act of 2007 temporarily increased the Section 179 deduction to $125,000 (indexed for inflation during the relevant years) and the “investment limitation” to $500,000 (also indexed for inflation), for taxable years beginning between 2007 and 2010. Subsequent economic stimulus legislation increased the maximum Section 179 deduction to $250,000 and the “investment limitation” to $800,000 for taxable years beginning in 2008 and 2009. Under the Act, the Section 179 deduction will remain at $250,000, and the “investment limitation” will remain at $800,000 for taxable years beginning in 2010. Thereafter, absent other legislation, the maximum Section 179 deduction will revert to $25,000, and the “investment limitation” will return to $200,000.

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“Hiring Incentives to Restore Employment Act” Enacted March 24, 2010
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