Presidential Fiscal Year 2010 Revenue Proposals

President Releases Fiscal Year 2010 International Taxation Proposals

SUMMARY

On May 11, 2009, the Obama Administration (the “Administration”) released the “General Explanations of the Administration’s Revenue Proposals” (the “Green Book”). Although the Administration has not released proposed statutory language, the Green Book includes significant detail about the Administration’s Fiscal Year 2010 budget proposals (the “Proposal”). The Proposal, if enacted in its current form, would affect many aspects of U.S. federal income taxation, including individual, corporate, partnership and international taxation. This memorandum discusses key aspects of the Proposal that relate to international taxation. Elements of the Proposal that relate to international taxation would adjust key aspects of (1) the current entity classification rules, (2) the deductibility of expenses allocated to certain foreign activities, (3) the foreign tax credit, (4) international transfers of intangibles, (5) the treatment of interest paid to inverted entities, (6) international reorganizations, (7) the rules governing so-called “80/20 Companies,” (8) equity swaps and (9) the rules governing dual-capacity taxpayers. Additionally, the Proposal recommends that the current information reporting rules and enforcement provisions that govern U.S. international taxation be strengthened. Although the Proposal does not specifically require current inclusion of all income earned through foreign corporations (i.e., the Proposal would not repeal deferral), a number of elements of the Proposal could significantly limit the benefits of deferral. In the near future, we intend to distribute additional memoranda addressing aspects of the Proposal that we anticipate may affect (1) corporate taxpayers and partnerships and (2) individual taxpayers.
DISCUSSION

The Proposal, if enacted in its current form, would make significant changes to both the substantive law and enforcement procedure governing international taxation. Elements of the Proposal that would affect each of these areas are discussed in additional detail below.

A. SUBSTANTIVE PROVISIONS

The Proposal includes a number of new substantive international tax provisions. Amendments to the Internal Revenue Code (the “Code”) that are similar to many of these substantive provisions have been proposed in previous legislation that was not enacted. The substantive provisions of the Proposal would generally become effective for taxable years beginning after December 31, 2010 and the Green Book states that these proposals are expected to raise more than $200 billion between Fiscal Year 2010 and Fiscal Year 2019.

1. Entity Classification

Under the so-called “check-the-box” regulations, U.S. taxpayers may generally elect to treat certain non-U.S. entities as disregarded entities for U.S. federal income tax purposes. As noted in the Proposal, the “check-the-box” rules can be used to create hybrid entities that can in turn be used to reduce taxable income in high-tax foreign jurisdictions while increasing taxable income in lower-tax foreign jurisdictions. Such an arrangement might involve a controlled foreign corporation located in a high-tax foreign jurisdiction (“Country A”) that borrows money from a related disregarded entity located in a low-tax jurisdiction (“Country B”). Under current law, the U.S. shareholder would not be required to currently include the interest income received by the disregarded entity in the low-tax jurisdiction (i.e., the U.S. taxation of this income can be deferred). Interest payable on the loan is deductible for Country A tax purposes, reducing the Country A tax without a corresponding increase in Country B tax. The Code currently includes the “Subpart F” rules, which require current inclusion by certain U.S. shareholders of certain types of income earned by controlled foreign corporations. The Subpart F rules do not, however, apply in this example, as the interest is “paid” to a disregarded entity and is therefore disregarded for U.S. tax purposes.

1 Many elements of the Proposal that relate to international taxation were released in summary form on May 4, 2009. A further discussion of this initial proposal can be found in the Sullivan & Cromwell LLP Client Publication entitled “Presidential Proposal on International Taxation: President Releases Proposal Seeking to Expand U.S. Taxation of Foreign Subsidiaries, Increase International Tax Enforcement, and Make Research and Experimentation Credit Permanent” (May 4, 2009), which can be obtained by following the instructions at the end of this publication.

2 See Treas. Reg. §§ 301.7701-1 through -3.
In 1998, the IRS issued Notice 98-11,3 which indicated that it had become aware of such tax arbitrage opportunities. The IRS indicated in Notice 98-11 that it intended to issue regulations that would treat such entities as separate corporations for Subpart F purposes. The IRS also issued proposed and temporary regulations to that effect.4 Shortly thereafter, the IRS withdrew Notice 98-11 and the associated regulations, “to allow Congress an appropriate period to review the important policy issues raised by the regulations, including the continuing applicability of the policy rationale of Subpart F, and, if appropriate, address these issues by legislation.”5

The Proposal uses a different approach than the temporary and proposed regulations issued under Notice 98-11, which merely recharacterized “hybrid branch payments” as Subpart F income. If enacted, the Proposal would generally prevent foreign eligible entities (other than first-tier entities that are wholly owned by U.S. taxpayers) from being treated as disregarded entities unless they are organized in the same jurisdiction as their parent entities. Entities that are not eligible under the Proposal to be treated as disregarded entities would be treated as corporations. Deemed conversions under the Proposal would be treated in a manner “consistent with Treasury regulations and relevant tax principles.”6 Although not mentioned in the Proposal, presumably such conversions would be characterized as “assets over” contributions of property.7 Accordingly, such deemed conversions would potentially be eligible for nonrecognition if the requirements of Section 351 and Section 367 of the Code are met. At present, it is unknown whether the Administration intends to implement this aspect of the Proposal administratively or legislatively.

2. Deferral of Non-Research Expenses Related to Deferred Income

The Proposal would require taxpayers to defer deductions for expenses, other than research expenses, that are apportioned to foreign-source income to the extent that such income is “not currently subject to U.S. tax.” Current Treasury regulations8 would govern whether an item of expense is allocated to foreign-source income.

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3  1998-1 C.B. 433.
6  It is unclear whether this “consistent” treatment would create unintended consequences, e.g., by creating a “triggering event” for any lower-tier foreign entity deemed to be converted to a corporation with respect to its dual consolidated loss (“DCL”) amounts, potentially resulting in accelerated “recapture” under the DCL rules for foreign losses that a U.S. taxpayer has deducted against U.S. income.
7  See Treas. Reg. § 301.7701-3(g)(1)(iv).
8  Presumably, such allocations would be made under the regulations issued under Section 861, which generally provide, with many special rules and exceptions, that deductions are allocated to the activity producing the related income, e.g., deductions allocable to producing rental income are sourced to the location of the rented property.
source income or domestic-source income. Deferred deductions under this aspect of the Proposal would be carried forward and could become deductible in a subsequent taxable year to the extent that the taxpayer had excess foreign-source income.

An earlier bill, H.R. 3970,\(^9\) which was proposed in the last congressional session but not enacted, similarly would have permitted “foreign-related” deductions to be claimed currently “only to the extent that such deductions are allocable to currently taxed foreign income”\(^{10}\) and would have required that other “foreign-related” deductions be deferred until the associated income was repatriated. Expenses were allocated to unrepatriated foreign income under that proposal by reference to fractions. For example, a fractional approach might allocate such items of expense as foreign or domestic in proportion to the taxpayer’s aggregate amount of foreign income as compared to U.S. income during that taxable year, rather than by reference to the individual items of income to which they are related.

3. Foreign Tax Credit Provisions

Under current law, a U.S. taxpayer may generally claim a credit for income taxes paid to a foreign jurisdiction either directly by the taxpayer\(^{11}\) or indirectly, in the case of certain corporate taxpayers.\(^{12}\) Current law also provides that taxpayers may generally “cross-credit” foreign taxes paid to high-tax jurisdictions against U.S. tax that would otherwise be due on other foreign-source income.

The Proposal includes two separate adjustments to the rules governing the foreign tax credit. Under the first of these, U.S. taxpayers would be required to determine their indirect foreign tax credits on a consolidated basis by combining the earnings and profits of all foreign subsidiaries. A taxpayer’s indirect foreign tax credit would then be creditable only to the extent that such aggregated earnings and profits are repatriated to the U.S. in that year. Although the Proposal includes limited detail about the mechanics of the anticipated limitation on the foreign tax credit, it is possible that the Administration will ultimately recommend language similar to the language included in H.R. 3970, which limited a taxpayer’s ability to claim the foreign tax credit by reference to the percentage of foreign-source income that was repatriated.\(^{13}\) For example, a U.S. taxpayer might have two foreign subsidiaries, one of which had $100


\(^{10}\) Id.

\(^{11}\) See generally I.R.C. § 901. Foreign taxes paid by partnerships and other entities that are not considered corporations under U.S. tax law are generally treated as taxes paid directly by the U.S. taxpayer holding interests in those entities.

\(^{12}\) See generally I.R.C. § 902.

\(^{13}\) See H.R. 3970, 110th Cong. § 3201 (2007). It is noteworthy, however, that H.R. 3970 made this determination by reference to income, while the Proposal appears to make this determination by reference to earnings and profits.
of income, $100 of earnings and profits, and paid $5 in foreign tax, and the second of which had $200 of income, $200 of accumulated earnings and profits, and paid $60 of foreign tax. If the second subsidiary paid a $200 dividend to the U.S. parent, under the Proposal, the U.S. parent would only be able to credit $43.33 ($65 x $200 earnings and profits from the distributing subsidiary/$300 aggregate earnings and profits among both subsidiaries) of the foreign tax paid against its U.S. tax liability, even though it repatriated all of the available cash from a subsidiary that paid $60 in tax.

The second foreign tax credit change in the Proposal would adopt a matching rule that would require taxpayers claiming the foreign tax credit to match items of income and foreign tax. Current law provides that an entity is deemed to have paid a foreign tax if, under foreign law, that entity is legally liable for the foreign tax. Presumably, this proposal is intended to prevent taxpayers from using arrangements such as the structure used in Guardian Industries v. United States, in which a taxpayer claimed a foreign tax credit through its Luxembourg holding company, which was treated as a disregarded entity from the U.S. parent for U.S. federal income tax purposes. The Luxembourg holding company, in turn, was the common parent of several other Luxembourg entities (many of which had earned income that was not currently taxable in the U.S.) and filed a Luxembourg tax return with those other entities as the parent of a unitary group. Under Luxembourg law, the holding company was solely liable for the tax of the entire unitary group, and the taxpayer asserted that it was entitled to claim a U.S. foreign tax credit on the entire amount of Luxembourg tax that was paid, even if some of the income on which that tax was paid could remain in the subsidiaries and accordingly outside the scope of current U.S. tax. Although the plaintiff in Guardian Industries was successful both at trial and on appeal, the Treasury Department published proposed regulations intended to prevent such transactions by requiring that tax credits be apportioned in accordance with income among members of a unitary group even if foreign law does not explicitly impose joint and several liability for tax on members of consolidated groups and placing several limitations on reverse hybrid entities. However, the proposed regulations apportion foreign tax credits among related entities by reference to how foreign law, rather than U.S. law, apportions the associated income. The proposed regulations therefore may permit significant planning opportunities and timing mismatches. The Proposal, which would adopt a matching rule, appears to contemplate a somewhat broader approach than these proposed regulations, possibly including an apportionment of credits by reference to how the U.S. apportions the associated income.

15 65 Fed. Cl. 50 (Ct. Cl. 2005); aff’d, 477 F.3d 1368 (Fed. Cir. 2007).
4. Limitations on Income Shifting Through Intangible Property Transfers

Current law requires that income with respect to a transfer or license of intangible property “be commensurate with the income attributable to the intangible” and permits the IRS to allocate items of income, credit and deduction in cases where such an allocation is necessary to clearly reflect income or prevent tax avoidance. Additionally, certain transfers of intangible property through nonrecognition transactions are treated as sales of that property for a series of contingent payments that relate to the income recognized from the use or sale of that property. In other words, these deemed periodic payments would reduce income in the offshore entity that may be deferred, and increase income in the U.S. entity, thereby increasing U.S. tax.

The Administration believes that the scope of these current rules “is not entirely clear or consistent” and that the current state of these provisions may lead to “inappropriate avoidance of U.S. tax.” The Proposal would clarify that workforce in place, going concern value and goodwill are within the scope of these rules, and can therefore be included in determining the amount of the deemed payments. Additionally, the Proposal would “clarify that in a transfer of multiple intangible properties, the Commissioner may value the intangible properties on an aggregate basis where that achieves a more reliable result” and “clarify that intangible property must be valued at its highest and best use,” as it would be transferred at arm’s length.

5. Limitations on the Deductibility of Interest Paid to Inverted Entities

The so-called “earnings stripping” rules of Section 163(j) currently limit the ability of a corporation to deduct interest paid to related parties. In general, however, the “earnings stripping” rules permit corporations that have a debt:equity ratio of less than 1.5:1 to deduct all interest (including “disqualified interest,” a category that includes interest paid to related parties that do not owe U.S. tax on such interest or unrelated parties if no U.S. tax is owed on such interest and the debt is guaranteed by a related foreign party), and continue to allow all interest that constitutes 50% or less of the corporation’s adjusted net taxable income to be deducted.

The Administration has expressed concern that inverted entities (i.e., where a U.S. parent corporation has been replaced by a newly-created non-U.S. parent corporation) are inappropriately reducing the U.S. tax liability by using related-party debt. Accordingly, the Proposal includes a provision that would eliminate the debt:equity safe harbor described in the preceding paragraph for most inverted corporations and,

17 I.R.C. § 482.
16 See I.R.C. § 367(d).
19 This provision of the Proposal would apply to a corporation that would be an “expatriated entity” under Section 7874 if Section 7874 had been effective for taxable years beginning after July 10, 1989.

footnote continued on next page
moreover, would limit the amount of “disqualified interest” paid to related parties that could be deducted by such taxpayers to 25% of the taxpayer’s adjusted taxable income (except in the case of interest paid to unrelated parties that is guaranteed by a related foreign related party, which would continue to be limited to 50% of the taxpayer’s adjusted taxable income).20

6. Cross-Border Reorganizations

Current law limits the amount of gain that an exchanging shareholder must recognize in a transaction that would, if not for the receipt of certain property, otherwise qualify for tax-free treatment under Code Section 354 or 355 to the lesser of the “boot” received or the total amount of gain that is realized by the exchange.21 Additionally, exchanges that have the effect of a dividend distribution can cause all or part of the gain recognized to reduce the corporation’s earnings and profits.22 The Administration believes that these provisions permit U.S. taxpayers to repatriate profits at inappropriately low U.S. tax rates and notes in the Proposal that these provisions currently permit shareholders who own stock in which there is very little (or no) built-in gain to recognize little or no gain even in such exchanges, even when most or all of the consideration received is “boot” and the corporation has earnings and profits that equal or exceed the amount of “boot” distributed (for example, if shares with a basis of $200 were exchanged by a corporation, in a transaction that would otherwise qualify for tax-free treatment under Section 354, for shares worth $100, and $100 of cash, the corporation would not recognize any gain, even if the $100 of cash were supported by the corporation’s earnings and profits). Accordingly, the Administration has proposed repealing the “boot within gain limitation” with respect to reorganizations in which the acquiror is foreign and the exchange is treated as a dividend under Code Section 356(a)(2).

(footnote continued)

However, this aspect of the Proposal would not apply to any inverted entity that is treated as a domestic corporation under Section 7874.

20 Proposals to further restrict the deductibility of interest under Section 163(j) of the Internal Revenue Code have surfaced in Congress in the past. For example, in 2002, a bill was proposed that would have eliminated the 1.5:1 debt:equity safe harbor and reduced the percentage threshold to 35% for all taxpayers. See H.R. 5095, 107th Cong. (2002). The Proposal appears to specifically target corporations that have engaged in inversion transactions, apparently because a Treasury Department study “did not find conclusive evidence of earnings stripping by foreign-controlled domestic corporations that have not expatriated,” although the Proposal notes that “additional information is needed to determine whether changes to Section 163(j) should be made with respect to” foreign-controlled domestic entities that have not engaged in inversion transactions. The approach taken by the Proposal appears consistent with a similar provision that was included in S.1637 § 7874(d)(2), 107th Cong. (2004), which was passed by the Senate but was not included in the final, enacted version of the American Jobs Creation Act of 2004.

21 See I.R.C. § 356(a)(1).

22 See I.R.C. § 356(a)(2).
7. Repeal of the 80/20 Rules

Under current law, interest paid by a U.S. corporation that derives at least 80% of its income from foreign sources in an active trade or business (an "80/20 Company") is treated as foreign-source income and, accordingly, not subject to U.S. withholding tax. Additionally, dividends paid by an 80/20 Company, although U.S.-source, are proportionally exempted from U.S. withholding tax to the extent that the 80/20 Company’s income is derived from non-U.S. sources. The Administration has proposed repealing these rules.

8. Equity Swaps and Securities Lending Transactions

Current law generally requires withholding agents to collect a 30% withholding tax on payments of U.S.-source fixed or determinable annual or periodical income ("FDAP"), although this rate may be reduced by a tax treaty or statutory provision. In 1997, the IRS issued final regulations governing withholding on securities lending transactions. Shortly thereafter, in response to concerns that “cascading withholding tax” could become due on payments (interest or dividends) made on securities that were lent more than once, the IRS issued Notice 97-66, which provided that “the amount of U.S. withholding tax to be imposed under §§ 1.871-7(b)(2) and 1.881-2(b)(2) with respect to a foreign-to-foreign payment will be the amount of the underlying dividend multiplied by a rate equal to the excess of the rate of U.S. withholding tax that would be applicable to U.S. source dividends paid by a U.S. person directly to the recipient of the substitute payment over the rate of U.S. withholding tax that would be applicable to U.S. source dividends paid by a U.S. person directly to the payor of the substitute payment.” In September 2008, Congressional hearings were held addressing concerns that Notice 97-66 was being used to permit dividend tax avoidance transactions in which a foreign person would lend U.S. stock to a foreign financial institution, which would then sell that stock to a related U.S. person and simultaneously enter into a total return equity swap over the stock with the related U.S. person, either directly or indirectly. Under current law, income earned on such total return swaps is typically not subject to U.S. withholding tax. Moreover, under Notice 97-66, no withholding was required on substitute dividend payments made on the borrowed stock. 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

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24 See I.R.C. § 1441(a). FDAP 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.


26 Additionally, legislation was recently proposed to prevent the avoidance of dividend tax through such transactions. See S. 506, 111th Cong. § 108 (2009); H.R. 1265, 111th Cong. § 108 (2009).
during the dividend payment period and then reacquiring the relevant U.S. stocks after the dividend was paid.

The Proposal indicates that the Administration intends to revoke Notice 97-66 administratively and issue new guidance “that eliminates the benefits of such transactions but minimizes over-withholding.” Additionally, the Proposal would generally treat income received by a foreign person on an equity swap that is attributable to U.S.-source dividends as U.S.-source income subject to withholding unless (1) the foreign person is not required to post more than 20% of the value of the stock as collateral, (2) no provision exists in the equity swap addressing how the counterparty will hedge its exposure to the equity swap, (3) the underlying stock is publicly traded, (4) the notional amount of the swap represents less than both 5% of the total publicly traded float of the class of stock over which the equity swap is executed and 20% of the average daily trading volume of that stock (over 30 days), (6) the foreign person does not sell the stock to the counterparty at the beginning of the swap (i.e., there is no “crossing in”) and the counterparty does not sell the stock to the foreign person when the swap terminates (i.e., there is no “crossing out”), (7) the parties’ entitlements under the swap are determined by reference to an “objectively observable price” and (8) the swap “has a term of at least 90 days.” It is not clear how “income” would be defined under the Proposal. It is also not clear precisely how “sell[ing] the stock to the counterparty at the beginning of the swap,” “sell[ing] the stock to the foreign person when the swap terminates” and other significant terms would be further defined.

9. Modified Tax Rules for Dual-Capacity Taxpayers

Current law limits the ability of a “dual-capacity taxpayer” (a taxpayer who both pays a tax to a non-U.S. jurisdiction and receives an economic benefit from that jurisdiction) to claim the foreign tax credit for such payments. Such taxpayers in jurisdictions that impose a general income tax are generally permitted to treat any amount paid to a foreign jurisdiction that does not exceed that jurisdiction’s general levy as a creditable income tax. Additionally, current law permits dual capacity taxpayers to treat an amount paid to a foreign jurisdiction that does not impose a general income tax as a creditable foreign tax, provided that amount does not exceed the applicable federal net income tax rate.

The Proposal would permit dual-capacity taxpayers to claim the foreign tax credit only if the foreign country to which the tax is paid imposes a general income tax, meaning that the tax is imposed on trade or business income from sources in that country and “has substantial application” to non-dual-capacity taxpayers and to citizens or residents of the jurisdiction imposing the tax. Additionally, the Proposal would create a separate basket for purposes of computing the amount of foreign tax credit available to
taxpayers\textsuperscript{27} for “taxes paid or accrued on certain oil and gas income.” However, the Proposal also intends to leave intact treaty obligations to permit a credit for taxes paid on certain oil and gas income.

B. ENFORCEMENT PROVISIONS

The Proposal recommends significant changes to currently applicable information reporting and withholding provisions, including a significant overhaul of the qualified intermediary program, new withholding provisions and new disclosure requirements. Enforcement provisions in the Proposal would generally become effective on January 1 of the year after they are enacted. The Administration has estimated that these new enforcement provisions, if enacted, would raise nearly $9 billion between Fiscal Year 2010 and Fiscal Year 2019.

1. Revised “Qualified Intermediary” Program

Under current law, in addition to the 30% withholding tax on FDAP as discussed above, payments made to U.S. exempt recipients that do not provide the payor with a taxpayer identification number and make certain other certifications are subject to backup withholding at the rate of 28%. Current Treasury regulations\textsuperscript{28} provide that a non-U.S. financial institution may agree to become a “qualified intermediary” that collects documentation from customers, files information and withholding tax returns and is subject to periodic audits.

The Proposal seeks to tighten the requirements of the “qualified intermediary” program. In particular, “qualified intermediaries” would be required to identify all account holders that are U.S. persons and report all reportable payments (as if the “qualified intermediary” were a U.S. payor). Moreover, the Proposal would grant the Treasury Department regulatory authority to require “qualified intermediaries” to collect information about the beneficial owners of their U.S. account holders and report U.S. beneficial ownership to the IRS. An additional regulatory grant would permit the IRS and Treasury Department to deny “qualified intermediary” status to any financial institution that is a member of a commonly-controlled group that includes one or more other institutions that is not a “qualified intermediary” and does not meet other requirements detailed in regulations. Finally, the Proposal would “clarify” that the IRS may make a list of all “qualified intermediaries” public.

\textsuperscript{27} The amount by which a taxpayer can reduce its U.S. tax with foreign tax credits is generally limited to the percentage of the taxpayer’s income from foreign sources. This limitation is calculated separately for certain types of income and the foreign taxes on such income (i.e., the limitation is calculated by reference to separate “baskets”).

\textsuperscript{28} See generally Treas. Reg. § 1.1441-1(e)(5).
2. Withholding on Payments of FDAP Made Through Nonqualified Intermediaries

Current law permits payments of U.S.-source FDAP to be paid free of withholding (or subject to a reduced rate of withholding) to a qualified resident of a country with which the U.S. maintains a treaty providing for zero or reduced-rate withholding, if the non-U.S. person to whom the payment is made certifies its eligibility for treaty benefits and the withholding agent does not have knowledge or reason to know that the recipient’s certification is inaccurate. The Administration has expressed concern that some parties who are not eligible for a zero or reduced rate of withholding are using this self-reporting system to inappropriately avoid U.S. withholding tax.

Under the Proposal, payments of FDAP to nonqualified intermediaries would generally be treated as made to an unknown foreign person and, accordingly, subject to 30% gross-basis withholding. However, the Treasury Department would be authorized to exempt certain payments made to nonqualified intermediaries, including payments made to a beneficial owner that is a foreign government, central bank, foreign pension fund or similar investor and other payments “that the Treasury Department concludes present a low risk of tax evasion.” Any tax that is over-withheld under this aspect of the Proposal could be refunded, and the Administration has indicated an intent to not have such rules “disrupt ordinary and customary market transactions.”

3. Withholding on Payments of FDAP Made to Foreign Entities If Beneficial Ownership Is Not Documented

As noted above, payments of FDAP made to nonresident foreign persons are subject to a 30% withholding tax unless this tax is abated or reduced by a statutory provision or a tax treaty. The Administration believes that persons who may not be eligible for a reduction in or exemption from this withholding provision may be using entities that appear to be eligible for such a reduction in or exemption from withholding as conduits. Accordingly, the Proposal would, if enacted, require withholding agents to treat any payment made to a non-U.S. entity as made to an unknown foreign person (and subject to 30% withholding) unless the non-U.S. entity “provides documentation of the entity’s foreign owners.” The Proposal does not elaborate further on the type of documentation that would be required under this provision. However, the Proposal indicates an intent to exempt publicly traded companies (and subsidiaries of such companies), foreign governments and pension funds, and, if enacted, would further delegate authority to the Treasury Department to exempt payments to entities engaged in an active trade or business in their local jurisdiction, charitable entities, widely-held investment vehicles and entities that enter into an agreement with the IRS to report their ownership to the IRS and collect documentation from their owners. Other payments could also be exempted in cases where the Treasury Department believes they are unlikely to facilitate tax evasion.

4. Backup Withholding on Gross Proceeds Paid to Certain Nonqualified Intermediaries

Gross broker proceeds (e.g., proceeds from the sale or exchange of stock or securities effected at a U.S. office of a broker) remitted to U.S. non-exempt payees are generally subject to backup withholding at a
rate of 28% if the recipient has not certified that it is not subject to backup withholding or if the recipient has not provided its taxpayer identification number. Gross broker proceeds are, however, exempt from backup withholding and information reporting if the paying broker has received documentation on which it may rely to treat the payment as made to a non-U.S. beneficial owner or foreign payee.

As with payments of FDAP, the Administration has indicated that it believes certain U.S. persons have engaged in tax avoidance transactions that relate to distributions of gross broker proceeds that are distributed through nonqualified intermediaries by inaccurately reporting themselves as foreign persons. In an effort to prevent such transactions and encourage intermediaries to become “qualified intermediaries,” the Proposal would, if enacted, typically impose a 20% withholding tax on gross proceeds from the sale of securities that are paid by a withholding agent to a nonqualified intermediary. However, the Proposal would delegate regulatory authority to the Treasury Department to exempt certain payments, including payments made to a nonqualified intermediary for the benefit of a foreign government, central bank, foreign pension fund, foreign insurance company or similar investor, along with payments made to nonqualified intermediaries in jurisdictions with which the U.S. “has a tax information exchange agreement” and other transactions that, in the opinion of the Treasury Department, do not create a significant risk that they will abet tax evasion. As with the Proposal’s approach to withholding on payments of FDAP, recipients of broker proceeds that have been reduced by this withholding provision would be eligible to apply for a refund of any excess amount withheld.

5. Self-Reporting of Foreign Financial Accounts

The Proposal includes a variety of other new provisions that would, if enacted, significantly increase the level of information reporting that is required with respect to foreign financial accounts. Under current law, U.S. persons who have an interest in or authority over one or more financial accounts in a non-U.S. country must report that interest on a Report of Foreign Bank and Financial Account (“FBAR”) if the aggregate value of all such accounts exceeds $10,000 at any time during the calendar year. Additionally, U.S. persons who directly or indirectly own more than 50% of a corporation, partnership, or trust that owns a non-U.S. account must file an FBAR.

Although current law requires a U.S. person that directly or indirectly holds a non-U.S. financial account to report certain information regarding that account, including the account number, the maximum value during the year and the financial institution at which the account is held, no requirement exists to report transfers to or from a non-U.S. bank account. The Proposal seeks to require U.S. persons to report transfers both to and from non-U.S. bank accounts other than accounts held at “qualified intermediaries” and would, if enacted, impose a strict liability penalty equal to the lesser of $10,000 or 10% of the aggregate value of such transfers on U.S. persons who fail to make such a report. Additionally, the
Proposal would require U.S. persons to declare reportable payments, along with at least some of the information that must currently be reported on an FBAR, on their income tax returns. However, individuals who, in the aggregate, transfer less than $10,000 from and less than $10,000 to their foreign financial accounts would be exempted from reporting transfers on their tax returns. Additionally, the Proposal would delegate regulatory authority to the Treasury Department to exempt arm’s-length payments that are made for services or property in the ordinary course of business.

6. Third-Party Reporting of Foreign Financial Accounts and Foreign Entities

Although, as discussed above, current law requires U.S. persons who own or have signature authority over a non-U.S. financial account to self-report certain information about that account, intermediaries are not required to report any information about such accounts to the IRS or the Treasury Department. The Proposal would supplement the self-reporting regime by requiring U.S. financial intermediaries and all “qualified intermediaries” to report, on an information return, any transfer in excess of $10,000 that is made to or from "a foreign bank, brokerage or other financial account" for the benefit of a U.S. person. The Proposal also would impose a requirement on U.S. intermediaries and “qualified intermediaries” to generally report when a new financial account is opened on behalf of a U.S. person or a foreign entity is formed or acquired on behalf of a U.S. person.

7. Negative Presumptions for Failure to File an FBAR

The Administration has noted that the current self-reporting requirements with respect to non-U.S. financial accounts held by U.S. persons may be difficult to enforce because although the IRS and the Treasury Department may be aware that a foreign account is held by a non-U.S. person, these agencies may not be able to determine whether that account meets the $10,000 self-reporting threshold. The Proposal seeks to establish a rebuttable presumption in civil proceedings that any non-U.S. financial account held by a U.S. person or non-U.S. account over which a U.S. person has signature authority (other than accounts held through qualified intermediaries) contains at least $10,000. Moreover, the Proposal would, if enacted in its current form, establish a second presumption in civil proceedings that any failure by a U.S. person to file a required FBAR is willful if (1) the account is held at a nonqualified

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29 The Proposal would, however, retain the separate requirement that U.S. persons who own financial accounts subject to these reporting requirements file an FBAR. Under the Proposal, a U.S. person that fails to report a foreign financial account on its tax return would be subject to consequences under the Internal Revenue Code, including penalties and an extended statute of limitations, but not Title 31. The penalties prescribed by Title 31 would continue to apply to U.S. persons who fail to file an FBAR.

30 A similar presumption was included in legislation recently introduced by Senator Carl Levin. See S. 506, 111th Cong. (2009). The Proposal appears to be broader than the presumption in S. 506, which applied to accounts located in "offshore secrecy jurisdictions," rather than all accounts that are held through non-qualified intermediaries.
intermediary and (2) the account has a balance of more than $200,000 at any time during the relevant calendar year.

8. Extended Statute of Limitations for Cross-Border Transactions and in Situations Where Taxpayers Fail to Timely Make Required Disclosures

In general, the Code imposes a three-year statute of limitations on the collection of any tax. In cases where a taxpayer fails to report certain information about cross-border transfers and foreign entities to the IRS, however, current law extends this general statute of limitations for three years after the required report is made. The Administration has expressed concern that this three-year period may not give the IRS adequate time to make a proper assessment in certain cases. Accordingly, the Proposal would, if enacted, extend the statute of limitations in cases where a report required to be made under Sections 6038, 6038A, 6038B, 6046, 6046A and 6048 of the Code is not filed on a timely basis until six years after the required information is furnished to the IRS. Additionally, the Proposal would extend the scope of this six-year rule to cover taxpayers who fail to timely file information returns for “qualified electing funds” (certain foreign corporations with a high percentage of gross income from passive investments, or a majority of assets producing passive income, whose shareholders have elected to pay tax currently on the corporation’s income and to file information returns), fail to maintain the records required by Section 6038A of the Code (prescribing requirements for certain foreign-owned U.S. corporations), do not make the Proposal’s tax return disclosure of foreign financial account information or fail to comply on a timely basis with the Proposal’s self-reporting provisions covering transfers to or from certain non-U.S. bank, brokerage or other accounts. Finally, the Proposal indicates that “[t]he [S]ection 6501(c)(8) exception to the general statute of limitations would be made applicable to the entire income tax return.” It is unclear whether, through this statement, the Administration intends a three-year or six-year statute of limitations to apply to taxpayers who do not make timely filings of reports not specifically enumerated in the Proposal or current Section 6501(c)(8) of the Code. These provisions extending the statute of limitations for assessing and collecting tax would, if enacted, become effective for returns due after the date the Proposal is enacted.


The Proposal would, in addition, double the current 20% accuracy-related penalty imposed on certain understatements of income when that understatement “arises from a transaction involving a foreign account that the taxpayer failed to disclose properly” under the Proposal’s requirement that FBAR information be declared on tax returns. As with understatements related to reportable transactions, no “reasonable cause” exception would exist for this penalty. The IRS would be able to assess this new

31 See I.R.C. § 6501(a).
32 See I.R.C. § 6501(c)(8).
penalty starting in taxable years beginning after December 31 of the year when the Proposal is enacted. Additionally, the Proposal would modify the foreign trust reporting penalty to clarify that it may be assessed even if the gross reportable amount of the trust is not known.

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