Revised FATCA Plus Carried Interest Taxation

“Tax Extenders Act of 2009” Introduced to Congress and Passed by House

SUMMARY
On December 9, 2009, the U.S. House of Representatives passed, by a vote of 241-181, the Tax Extenders Act of 2009, H.R. 4213 (the “Bill”), which had been introduced by Representative Charles Rangel two days before. The Bill has received a "Statement of Support" from the President’s Office of Management and Budget. Among other provisions, the Bill: (i) includes a revised version of the Foreign Account Tax Compliance Act of 2009 ("FATCA"), which had been previously introduced on October 27, 2009, (ii) treats income and gains with respect to “carried interests” as ordinary income and (iii) extends for an additional year certain tax incentives and relief provisions that are due to expire, including the research credit, the subpart F “active banking or financing income” exemption, the subpart F “active insurance income” exemption and the subpart F “related party look-through rule.” A discussion of FATCA can be found in the Sullivan & Cromwell LLP Publication entitled New International Tax Bill: Foreign Account Tax Compliance Act Introduced in Congress (Oct. 30, 2009), which can be obtained by following the instructions at the end of this publication.

The Bill makes several noteworthy changes to FATCA, including: (i) the effective date of the Bill’s reporting and withholding provisions has been delayed until January 1, 2013; (ii) the proposed reporting and withholding provisions are subject to a broad grandfather provision that would exempt any “obligation” that is outstanding on the date that is two years after the day on which the Bill is enacted; (iii) there are a number of new limitations on the reporting requirements that would be imposed on foreign financial institutions, including certain “deemed compliance” rules; (iv) under certain circumstances, the Bill would require foreign financial institutions to withhold on non-U.S.-source payments; and (v) the Bill would adjust the definition of a "United States account" to exclude accounts and similar interests held by
one “financial institution” at another “financial institution” if the holder financial institution meets the requirements of the Bill.

With respect to FATCA’s bearer bond provisions, there is an extended grandfather provision and the excise tax provisions have been relaxed. Effectively, the new rules will allow anyone to issue bearer bonds outside the United States under the current “foreign targeting” rules until the day that is two years after the date of the Bill’s enactment, and thereafter most non-U.S. issuers will be exempt from the excise tax and therefore generally able to continue issuing bearer bonds outside the United States.

In addition, the provision in the Bill requiring withholding on “dividend equivalent” payments differs significantly from the equivalent provision in FATCA. Finally, the Bill deletes the “material advisor” provisions in FATCA that would have required persons who were “material advisors” to “foreign entity transactions” (transactions that involve the creation or acquisition of an interest in a foreign entity with respect to which the owner would be required to file certain reports) to file a “material advisor” report with the Treasury Department.

DISCUSSION

A. FOREIGN ACCOUNT TAX COMPLIANCE

The Bill includes a revised version of FATCA. This memorandum focuses on provisions of the Bill that are substantively different from the original provisions of FATCA, which are described in our October 30 memorandum.

The Joint Committee on Taxation has estimated that the tax enforcement provisions of the Bill will raise $7.7 billion over the next 10 years, a somewhat lower figure than the $8.5 billion that the Joint Committee on Taxation had originally estimated FATCA would raise. This reduction in revenue has been attributed to delays in the effective date of certain provisions of the Bill, when compared to the original provisions of FATCA.1


Like FATCA, the Bill would, if enacted, impose a new 30% withholding tax on “withholdable payments” made to “foreign financial institutions” that do not enter into an agreement with the Treasury Department. As under FATCA, such agreements would generally require foreign financial institutions either to: (i) report the name, address and taxpayer identification number of each United States holder (and of each

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1 See Chuck O’Toole, Rangel Introduces Tax Extenders Package as House Schedules Vote, 2009 TNT 233-2 (Dec. 8, 2009).
“substantial United States owner”\(^2\) in the case of an account held by a foreign entity with one or more “substantial United States owners”) and also the account number, the account balance or value, and the gross receipts and gross withdrawals that have been made from the account; or (ii) comply with the information-reporting rules that govern U.S. financial institutions’ accounts of a U.S. citizen.\(^3\) However, significant differences, several of which are explained below, exist between the Bill and FATCA.

**a. Definition of a “Withholdable Payment”**

Under FATCA, a “withholdable payment” was defined to include a U.S.-source payment of interest, dividends, compensation or other fixed or determinable, annual or periodical gains, profits or income, along with the gross proceeds from the sale of any property of a type that can produce U.S.-source interest or dividends. The Bill makes four changes to this definition. First, the Bill would permit the Treasury Department to issue guidance exempting certain payments from being characterized as “withholdable payments.” Second, income treated as effectively connected with a U.S. trade or business would not be considered a “withholdable payment” under the Bill. Therefore, most (if not all) payments to a foreign financial institution’s U.S. branch would not be subject to withholding under the Bill. Third, the Bill would treat interest paid by non-U.S. branches of U.S. financial institutions as a “withholdable payment.” Finally, the Bill would clarify that the gross proceeds from non-sale dispositions from property that can give rise to U.S.-source interest or dividends is a “withholdable payment.”

**b. Deemed Compliance Provision and Limited Withholding Exemptions**

The Bill would include a new “deemed compliance” provision for which no analogue was present in FATCA. Under this “deemed compliance” provision, a foreign financial institution would be treated as complying with the Bill’s information reporting and withholding rules if the institution either: (i) complies

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\(^2\) Under FATCA and the Bill, 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 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 Bill. The Bill 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.

\(^3\) 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).
with procedures that are 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 is not necessary to carry out the purposes of this section.” The Joint Committee Report for the Bill observes that “it is anticipated that the Secretary may provide rules that would permit certain classes of widely held collective investment vehicles to be deemed to meet the requirements of this provision.”

c. Withholding Obligation

Unlike FATCA, the Bill requires a compliant foreign financial institution to withhold at 30% on any “passthru payment” made to (i) a “recalcitrant account holder”, (ii) a foreign financial institution that does not enter into an agreement with the Treasury Department meeting the requirements of the Bill (such an institution that does not enter an agreement with the Treasury Department, a “Nonparticipating FFI”) or (iii) a foreign financial institution that has made the election described below to be withheld upon in respect of payments “allocable to” accounts of such electing financial institutions that are held by “recalcitrant account holders” and Nonparticipating FFIs. The Joint Committee Report specifically notes that “The 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.”

4 Under the Bill, a “passthru payment” is a payment that is a “withholdable payment” or a payment “which is attributable to a withholdable payment.” As such, a “passthru payment” could potentially include an amount of foreign-source income, such as a dividend payment that is attributable to U.S.-source interest. There is no legislative gloss on what it means for a payment to be “attributable” to a withholdable payment.

5 The Joint Committee Report specifically notes that “The 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.”

6 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. The Bill, however, does not include the provision of FATCA that permitted foreign financial institutions to rely on self-certifications so long as neither: (i) the foreign financial institution nor (ii) any member of its “expanded affiliated group” had knowledge or reason to know that the certification was incorrect. However, the Joint Committee report for the Bill 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 (continued)
account holder, does not waive this provision of foreign law. The Bill would permit a foreign financial institution to elect out of the obligation to withhold on passthru payments if it agrees to be withheld upon with respect to 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 foreign financial institution would be required to (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 withheld. The Bill 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.

d. Changes to Definition of “United States Account”

Under FATCA, a “United States account” included a “financial account” held by a “specified United States person” unless the account were held by a natural person and the aggregate value of all accounts held by the same person at that financial institution (or any member of that institution’s expanded affiliated group) did not exceed $10,000 (or $50,000, if all such accounts were in existence on the date of enactment of the Bill). Under the Bill, a “financial account” maintained by a natural person is not a “United States account” if the aggregate value of all accounts held by that person at the financial institution does not exceed $50,000 regardless of when such accounts were established. Furthermore, the Bill states that 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.”

7 The Bill retains the provision, which was also included in FATCA, 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.”

8 However, this election (and the provisions allowing for withholding) do not exempt a “foreign financial institution” from the information reporting provisions of the Bill.

9 A “specified United States person,” under both the Bill and FATCA, is a United States 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).
accounts held by such person at financial institutions in the same “expanded affiliated group” will be counted for these purposes only to the extent provided by the Treasury Department.\textsuperscript{10}

The Bill also contains several new exemptions to avoid “duplicative reporting requirements.” Under these rules, an interest that would otherwise be considered a “United States account” would not be treated as a “United States account” if either: (i) the account is held by another financial institution that meets the reporting requirements of the Bill or (ii) the holder “is otherwise subject to information reporting requirements which the Secretary determines would make the reporting required by this section with respect to United States accounts duplicative.”

This “duplicative reporting requirements” provision presumably would ameliorate some of the difficulties presented by the Bill’s broad definition of a “financial account.” Under both the Bill and FATCA, the term “financial account” 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.” This term could include interests in many foreign investment funds, hedge funds and private equity funds; however, to the extent that interests in such funds or other “financial accounts” are held in a custodial account at a participating financial institution, they would not be treated as “United States accounts.”\textsuperscript{11}

As the Bill is drafted, it appears that “financial accounts” held through domestic intermediaries would not be able to qualify for the benefits of this “duplicative reporting” provision in the absence of Treasury Department guidance. However, it is possible that the Treasury Department will issue guidance including accounts held at domestic custodians within the set of accounts eligible for this provision, or alternatively that the exclusion of domestic custodians is a drafting oversight that will be remedied in a subsequent version of the Bill.

\textsuperscript{10} Under both the Bill and FATCA, 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). More specifically, the Bill, like FATCA, 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. It also includes partnerships and trusts if they are controlled, within the meaning of Section 954(d)(3), by other members of the expanded affiliated group (including other controlled partnerships or trusts).

\textsuperscript{11} Under the Bill, a “financial institution” is generally any entity that “accepts deposits in the ordinary course of a banking or similar business,” “is engaged in the business of holding financial assets for the account of others” or is engaged primarily in the business of investing, reinvesting, or trading in: (i) securities; (ii) partnership interests; (iii) commodities; or (iv) any interests (including futures or forward contracts or options) in such securities, interests or commodities.
e. Refunds

As under FATCA, the Bill generally would permit beneficial owners of payments on which the Bill’s witholding tax has been imposed to claim a refund for such tax. However, as would have been true under FATCA, to the extent that a tax is deducted under the Bill’s withholding provisions from a payment beneficially owned by a Nonparticipating FFI: (i) such withholding, to the extent it is properly deducted, would only be creditable or refundable to the extent a credit or refund is required by a treaty obligation of the United States and (ii) no interest would be paid with respect to any such credit or refund. These provisions are similar to their equivalent provisions in FATCA with certain technical amendments.

However, the Bill adds a new provision that would prohibit refunds or credits to the extent that the beneficial owner of the payment does not provide the Treasury Department with “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.”

f. Effective Date and Grandfathering of Outstanding Obligations

The effective date of the Bill’s withholding provisions has been extended. The Bill would, if enacted, generally become effective for payments made after December 31, 2012. (In contrast, under FATCA as originally proposed, the reporting and withholding provisions would have become effective for payments made after December 31, 2010). In addition, the Bill includes an expanded grandfather provision: the Bill’s withholding requirements will not apply to payments on any “obligation”12 that is outstanding on the day that is two years after the Bill’s date of enactment.13 Under FATCA, as originally proposed, an obligation would have been grandfathered only if it was outstanding on the “date of first committee action” with respect to FATCA and either the issuer would have had to make “gross-up” payments on the obligation for the withheld tax or the obligation was in bearer form.

g. Interest on Overpayments

Under current law, the IRS is not required to pay interest on overpayments if the refund due is 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 is filed.14 The Bill would extend this period to 180 days for refunds with respect to either: (i) any refund claim filed with respect to any tax

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12 The term “obligation” is not defined in the Bill or the Joint Committee Report. It is thus unclear whether non-debt “obligations,” such as stock, are encompassed within this definition.

13 As drafted, it is also unclear whether the Bill’s grandfather provisions are intended to cover, in addition to payments of fixed and determinable, annual or periodical income made with respect to the grandfathered obligations, proceeds from the sale, redemption or other disposition of such obligations.

14 Section 6611(e).
collected under Chapter 3 of Subtitle A of the Internal Revenue Code\textsuperscript{15} or (ii) any tax collected under the withholding provisions of the Bill. This provision of the Bill is new and does not have an analogue in FATCA. In addition, this provision would take effect for: (i) returns filed after the date on which the Bill is enacted; (ii) refund claims made after the date on which the Bill is enacted; and (iii) refunds paid on adjustments initiated by the IRS after the date on which the Bill is enacted.

2. Withholding on “Dividend Equivalent” Payments

If enacted, FATCA would have imposed a 30% withholding tax on “dividend equivalent payments,” which were defined under FATCA as payments “made pursuant to a notional principal contract that (directly or indirectly) [are] contingent upon, or determined by reference to, the payment of a dividend from sources within the United States.” Generally, such payments under FATCA would have included any gross amount used in determining any net amount that is transferred under a notional principal contract; however, FATCA provided the Treasury Department broad powers administratively to exempt payments within the above definition that were determined not to “have the potential for tax avoidance” and prescribed a list of factors for the Treasury Department to consider in making such a determination. In addition to payments on notional principal contracts, FATCA permitted the Treasury Department administratively to include, within the definition of a “dividend equivalent” payment, other payments if such payments were “substantially similar” to a payment made on a notional principal contract.

The Bill would continue the general approach taken by FATCA of treating “dividend equivalent” payments as U.S.-source dividends; however, the Bill is broader than FATCA in several respects. Under the Bill, a “dividend equivalent” would include: (i) any substitute dividend;\textsuperscript{16} (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 (A) any notional principal contract if (i) in connection with entering into such contract, any long party\textsuperscript{17} transfers the underlying

\textsuperscript{15} Chapter 3 of Subtitle A of the Code governs withholding on nonresident aliens and currently comprises Sections 1441-1464.

\textsuperscript{16} The Joint Committee Report notes that the term “substitute dividend” is intended to have the definition of a “substitute dividend” in Treasury Regulations Section 1.861-3(a)(6). As the Bill is currently drafted, a “substitute dividend” is not limited to a “substitute dividend” paid on a U.S. stock; however, it is possible that this is a drafting oversight that will be changed in a subsequent version of the Bill.

\textsuperscript{17} The Bill 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.”
The provisions of FATCA governing “dividend equivalent” payments took effect in 90 days and covered any notional principal contract unless it was exempted by guidance from the Treasury Department. In effect, the Bill postpones the effective date of FATCA’s general rule that “dividend equivalent” payments are subject to withholding unless exempted by the Treasury Department, while also identifying certain transactions that, in the view of Congress, should become subject to these rules more quickly and should not be administratively exempted from the Bill’s provisions. Accordingly the Bill would not grant the Treasury Department the authority to exempt contracts described under (A) above, which include certain so-called “crossing in,” and “crossing out” transactions, as well as transactions where the underlying security is not readily tradeable, and dividend equivalent payments on such transactions would become subject to withholding after 90 days. Like FATCA, the Bill provides that “dividend equivalent” payments are to be computed on a gross basis.

In effect, the Bill would also impose U.S. withholding tax on substitute dividend payments by statute, rather than by regulation as under current law. As a result, current law Notice 97-66 would be

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18 Under the Bill, 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.

19 A “short party” is defined, under the Bill, 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.”

20 Although not apparent from the text of the Bill, footnote 488 of the Joint Committee Report observes that the Treasury Department “may issue guidance addressing the application of this rule in circumstances in which the long party transfers the underlying security to an unrelated third party.”

21 1997-2 C.B. 328. Notice 97-66 was issued in response to concerns that “cascading withholding tax” could become due on interest or dividend payments made on securities that were lent more than once and generally provides limitations on the extent to which the United States will impose its withholding tax on substitute dividend payments made between foreign persons. 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.

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superseded. However, the Bill contains a new section 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
Secretary 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. For purposes of this paragraph, a
dividend shall be treated as a dividend equivalent.”

As with FATCA, because several of the Bill’s regulatory exemptions dealing with “dividend equivalent”
amounts do not appear to be self-executing, substantial uncertainty may exist as to how outstanding
equity swaps should be treated if guidance clarifying the scope of these rules is not promulgated by the
effective date of this provision. For example, it is not clear when a sale of underlying stock would be
treated as made in connection with entering into an equity swap on that stock, assuming that the stock
was not sold to the swap counterparty.

3. Bearer Bonds

As did FATCA, the Bill includes a provision intended to repeal the current exemption from the so-called
“TEFRA” rules for “foreign-targeted obligations.”

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 is potentially
outstanding; and (iii) deny to foreign holders of such obligations the exemption from the 30% U.S.
withholding tax on interest that is generally available for portfolio interest paid on debt of U.S. issuers.22

Under current law, however, “foreign-targeted” bearer obligations that comply with certain requirements
with respect to their offer and sale outside the United States are not considered “registration-required
obligations.”23

“entering into economically equivalent equity swaps during the dividend payment period and then
reacquiring the relevant U.S. stocks after the dividend was paid.

22 See Sections 163(f), 871(h)(2) & 4701.
23 See 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) & 881(c)(2)(A). This exemption, however, does not eliminate
all sanctions on holders of “foreign-targeted” bearer form obligations. In general, 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).
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In a manner similar to FATCA, the Bill would generally repeal the current exemption for “foreign-targeted” bearer obligations. However, in contrast to FATCA, the Bill would retain the excise tax exemption for obligations that are issued in connection with the current “foreign-targeting” requirements.  This effectively permits most non-U.S. issuers to issue foreign-targeted bearer bonds. The Bill would also, if enacted: (i) permit the Treasury Department 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 and (ii) statutorily provide that a dematerialized book-entry system is to be treated as a book-entry system for the purpose of determining whether an obligation is in registered form. This provision would allow the Treasury 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. Additionally, in contrast to the bearer bond provisions of FATCA, which would have applied to any obligation issued more than 180 days after the date on which FATCA was enacted, the bearer bond rules of the Bill will apply only to obligations issued more than two years after the date on which the Bill is enacted.

4. Other Foreign Tax Compliance Provisions


FATCA included a provision that would have required each “material advisor” to file a return with the Treasury Department with respect to any transaction involving direct or indirect acquisition of an interest in a foreign entity (including an interest acquired in connection with the formation of such an entity) if any U.S. citizen or resident is required to file a report under one or more specified provisions in the Code. These provisions have been deleted and do not appear in the Bill.

24 Such obligations would 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.

25 It is unclear how these provisions will apply to foreign entities that apportion their worldwide interest expense to their U.S. branches or to entities that are controlled foreign corporations or PFICs for purposes of computing their earnings and profits and their U.S. shareholders’ subpart F income.

26 We note, however, that dematerialized obligations issued on or after January 1, 2007 are generally considered to be in registered form under current IRS practice. See Notice 2006-99, 2006-2 C.B. 907. A further discussion of Notice 2006-99 can be found in the Sullivan & Cromwell LLP Client 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 Bonds” (November 17, 2006), which can be obtained by following the instructions at the end of this publication.

27 However, other disclosure provisions that were included in FATCA, including the requirement to make a tax return disclosure of an interest in a “specified foreign financial asset” and the PFIC self-reporting
b. Entities Organized in Possessions of the United States

The Bill clarifies that a “foreign financial institution” does not include a financial institution that is organized under the laws of a possession of the United States. Like FATCA, the Bill subjects “withholdable payments” made to “non-financial foreign entities” to a 30% withholding tax if: (i) the non-financial foreign institution payee, or another non-financial foreign entity, is the beneficial owner of the payment and (ii) the Bill’s reporting requirements are not met and the payment is not otherwise exempt. Unlike FATCA, the Bill exempts from these rules any entity that is organized under the laws of a possession of the United States that is wholly owned by one or more bona fide residents of such possession.

c. Provisions Relating to Trusts

The Bill contains a set of proposed rules that would govern trusts that is similar to the provisions governing trusts that were proposed in FATCA. However, in contrast to FATCA, which would have created a new, affirmative presumption that a foreign trust to which a U.S. person has transferred property has a U.S. beneficiary unless the transferor furnishes certain information to the Treasury Department, the Bill merely permits the IRS to treat such a trust as having a U.S. beneficiary, unless, as in FATCA, the transferor furnishes certain information to the Treasury Department.

B. TAXATION OF “CARRIED INTEREST” INCOME AS ORDINARY INCOME

Carried interests are typically interests in partnership profits granted to the managers or sponsors of an investment partnership. Carried interests may be granted without an obligation to invest capital or with interests in profits that are significantly disproportionate to contributed capital. Although the term “carried interest” generally refers to an interest in a fund, such as a private equity fund, hedge fund or real estate fund, partnerships that operate a single business or project may also issue carried interests to their sponsors or managing members. Under current law, carried interests are generally considered “profits interests” in the partnerships, and the character of income from the partnership flows through to the holders of the carried interests. As a result, capital gains, as well as some items of interest and dividend income of a partnership that are allocated to a carried interest, retain their character and are not considered net earnings from self employment for purposes of the Federal Insurance Contributions Act

(continued)

requirement remain in the Bill (although the Bill does clarify that PFIC self-reporting is not required to the extent the requirement is contradicted by guidance issued by the Treasury Department). Similarly, the enhanced penalties and extended statute of limitations that would have applied to U.S. taxpayers who were noncompliant with these provisions are retained in the Bill.

28 Other than a deferred compensation or charitable trust described in Section 6048(a)(3)(B)(ii).

29 A profits interest is an interest in a partnership that does not have any current liquidation value at the time of receipt. See Rev. Proc. 93-27, 1993-2 C.B. 343.

30 Section 702(b).
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 (“FICA”). Additionally, because a carried interest is a partnership interest, gain recognized on the sale of a carried interest is generally treated as capital gain except to the extent such gain is attributable to the inventory or unrealized receivables of the partnership.31

The Bill generally follows and implements the proposals with respect to taxation on carried interests outlined in the “General Explanations of the Administration’s Revenue Proposals” issued by the Obama Administration (the “Green Book Proposal”)32 on May 11, 2009. The Bill also stays very close to the proposed legislation in H.R. 193533 introduced by Representative Sander M. Levin on April 2, 2009. According to the estimate of the Joint Committee on Taxation, the carried interest provisions in the Bill would raise $24.6 billion over 10 years.34

a. Partnership Interest Transferred in Connection with the Performance of Services under Section 83

Under the Bill, a transferee of a partnership interest for services would be required to include in income for the taxable year of the transfer the fair market value (if any) of the partnership interest, unless the transferee affirmatively elects out of this default rule. Under the Bill, the fair market value of the partnership interest would be deemed to be the amount the partner would receive if, at the time of transfer of the partnership interest, the partnership had sold all of its assets at fair market value and distributed the proceeds (reduced by partnership liabilities) to the partners in liquidation of the partnership.35

b. Recharacterization as Ordinary Income or Loss and Exception for Qualified Capital Interest

In particular, the Bill would generally: (i) characterize any net income allocated to an “investment services partnership interest” (as described below) as ordinary income, regardless of the character of the income at the partnership level; (ii) characterize any gain upon the sale of an “investment services partnership interest” as ordinary; and (iii) treat any “built-in gain” with respect to appreciated property distributed to the partner holding such “investment services partnership interest” as an increase in such partner’s distributive share of partnership income. In addition, any net losses allocated with respect to such

31 See Section 751.
32 A further discussion of the Green Book Proposals can be found in the Sullivan & Cromwell LLP Publication entitled Presidential Fiscal Year 2010 Revenue Proposals: President Releases Fiscal Year 2010 Corporate and Partnership Taxation Proposals (May 19, 2009) which can be obtained by following the instructions at the end of this publication.
33 H.R. 1935 (111th Congress, 1st Session).
34 See Chuck O’Toole, Rangel Introduces Tax Extenders Package as House Schedules Vote, 2009 TNT 233-2 (Dec. 8, 2009).
35 The Bill is to a large extent consistent with the proposed regulations regarding the application of Section 83 to the compensatory transfer of a partnership interest in Prop. Reg. 1.83-3.
“investment services partnership interest” in any given year, and any losses from the disposition of an “investment services partnership interest,” would be treated as ordinary, to the extent such losses do not exceed the aggregate net income with respect to such interest in all prior partnership taxable years (to which the Bill’s provision applies) over the aggregate net losses with respect to such interest previously allowed in all prior partnership taxable years (to which the Bill’s provision applies). Any unused net losses would be carried forward, but no adjustment to the basis of the partnership interest would be made on account of any disallowed net losses. In addition, upon any disposition of an investment services partnership interest, the amount of such disallowed net losses would be disregarded for all succeeding partnership taxable years.

“An investment services partnership interest” would be any interest in a partnership which is held (directly or indirectly) by any person if it was reasonably expected (at the time such person acquired such interest) that such person (or any related person) would provide (directly or indirectly) a substantial amount of any of the following services with respect to assets held (directly or indirectly) by the partnership: (i) advising as to the advisability of investing in, purchasing, or selling any specified assets; (ii) managing, acquiring, or disposing of any specified assets; (iii) arranging financing with respect to acquiring specified assets; and (iv) any activity in support of any service described in (i) through (iii) (i) through (iv) collectively, “Investment Management Services”). “Specified assets,” under the Bill would include securities, real estate held for rental or investment, interests in partnerships, commodities, or options or derivative contracts with respect to any of the foregoing.36

The rules applicable to “investment services partnership interests” described above generally would not apply to an investment services partnership interest that is a “qualified capital interest” (as described below) under the Bill, if allocations of net income and net loss with respect to such “qualified capital interest” are made in the same manner as such allocations are made to partners not providing any Investment Management Services,37 and the allocations made to such other partners are “significant” compared with the allocations made with respect to such “qualified capital interest.” The Treasury Department is authorized to determine when allocations to a partnership interest should be treated as allocations to a qualified capital interest where there are no or insignificant partnership allocations to

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36 The Joint Committee Report provides that assets held by a partnership would be considered to include assets held through any other entity, including a corporation and that Treasury regulatory authority is provided to implement this intent.

37 The Joint Committee Report provides that allocations may be considered as being made in the same manner if the qualified capital interest to which such allocations are made are substantially identical to that of other non-service partners as to the degree of risk and with respect to all other economically significant aspects, benefits and burdens.
unrelated nonservice partners. A “qualified capital interest” is that portion of a partner’s interest in partnership capital attributable to: (i) the value of cash and property contributed to the partnership in exchange for such interest; (ii) any amounts included in gross income as a result of such partner’s initial receipt of such interest; and (iii) in general, the cumulative amount of net income allocated to the partner with respect to such interest for taxable years during which these provisions of the Bill apply. However, under the Bill, an investment services partnership interest would not be treated as a qualified capital interest to the extent such interest is acquired in connection with any loan proceeds or other advance made or guaranteed, directly or indirectly, by any partner or the partnership (or by a related person). The amount of qualified capital interest generally would also be reduced by partnership distributions with respect to such interest and, in general, the cumulative amount of net loss with respect to such interest allocated to such partner for taxable years during which these provisions of the Bill apply.

On the disposition of an investment services partnership interest, any portion of which is a qualified capital interest, a special rule would provide that a proportionate amount of the gain or loss on disposition is not subject to recharacterization as ordinary.

c. Anti-Avoidance Rule Regarding Other Income and Treatment under Section 751

Implementing the anti-avoidance rule in the Green Book Proposal, the Bill would also treat certain other income and gain in connection with any Investment Management Services as ordinary income. This would apply when: (i) a person performs (directly or indirectly) Investment Management Services for any entity; (ii) such person holds (directly or indirectly) a disqualified interest (as described below) with respect to such entity; and (iii) the value of such interest (or payments thereunder) is substantially related to the amount of income or gain (whether or not realized) from the assets with respect to which the Investment Management Services are performed. A “disqualified interest” means, with respect to any entity: (i) any interest in such entity other than indebtedness; (ii) convertible or contingent debt of such entity; (iii) any option or other right to acquire property described in (i) or (ii); and (iv) any derivative instrument entered

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38 This provision was not in H.R. 1935. The Joint Committee Report states that it would be appropriate for Treasury to authorize such treatment where all of the partners of the partnership are service providers, so there are no unrelated non-service providers. It is anticipated that Treasury guidance may provide that pro rata allocation of partnership items to qualified capital interests would be appropriate in these circumstances.

39 The Joint Committee Report further provides that for this purpose, any loan or other advance to the partnership made or guaranteed, directly or indirectly by a partner not providing services to the partnership would be treated as a capital interest of that partner, for purposes of determining the amount of the service-providing partner’s qualified capital interest (but not, however, for purposes of comparing allocations).

40 The Joint Committee Report further provides that in the case of the transfer of an investment services partnership interest in a fully taxable transaction, the transferee partner would accede to the amount of qualified capital account of the transferor partner.

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into (directly or indirectly) with such entity or any investor in such entity, but does not include a partnership interest or stock in: (i) a domestic C corporation; (ii) a foreign corporation substantially all of the income of which is either effectively connected with the conduct of a U.S. trade or business or subject to a comprehensive foreign income tax; or (iii) an S corporation.

In applying Section 751 relating to ordinary income treatment of amounts attributable to unrealized receivables and inventory items on a sale or exchange of a partnership interest, an investment services partnership interest would be treated under the Bill as an inventory item of a partnership. Thus, according to the Joint Committee Report, upon the sale or exchange of an interest in a partnership that in turn holds an investment services partnership interest, amounts received by the transferor partner that are attributable to the investment services partnership interest would be considered as ordinary income.

d. Rules Relating to Publicly Traded Partnerships

In general, a publicly traded partnership is treated as a corporation for U.S. federal income tax purposes unless 90% or more of its gross income is “qualifying income” (generally speaking, income that is passive income such as rents, royalties, dividends and interest). The Bill would expand the Green Book Proposal by excluding income treated as ordinary under the carried interest provisions of the Bill from “qualifying income,” thus making it less likely that a publicly traded partnership holding investment services partnership interests would be able to avoid being taxed as a corporation for U.S. federal income tax purposes. The Bill would, however, provide two exceptions. The exclusion would not apply to a publicly traded partnership: (i) that is treated as publicly traded solely by reason of interests in such partnership being convertible into interest in a real estate investment trust which is publicly traded; (ii) 50% or more of the capital and profits interest of which are owned, directly or indirectly, at all times during the taxable year by such real estate investment trust; and (iii) that satisfies the REIT income and asset limitations under Section 856(c)(2), (3) and (4). Under the second exception, the exclusion would not apply to certain publicly treated partnerships: (i) substantially all of the assets of which consist of interests in other partnerships that are traded on an established securities market, and (ii) substantially all of the income of which is ordinary income or Section 1231 gain. The Bill would also provide a 10-year grandfather rule for publicly traded partnerships existing as of the date of the Bill’s enactment by deferring application of these rules to such partnerships for a period of 10 years.

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41 According to the Joint Committee Report, partnership interests that are readily tradable on a secondary market do not qualify; only those that are traded on an established securities market meet the requirement of this exception.

42 Section 1231 gain means: (i) any recognized gain on the sale or exchange of property used in a trade or business; and (ii) any recognized gain from the compulsory or involuntary conversion into other property or money of (A) property used in a trade or business, or (B) any capital assets which are held for more than 1 year and are held in connection with a trade or business or a transaction entered into for profit.
e. Regulatory Authority

The Bill would provide the Treasury Department with regulatory authority to prescribe such regulations as are necessary or appropriate to carry out the purpose of the new provisions. It is expected\textsuperscript{43} that these regulations will, among other things, address the effects, if any, of the provision on: whether income is U.S. or foreign source; how income is characterized for purposes of the foreign tax credit limitation rules; whether income is subject to tax by the United States by reason of Sections 897 and 1445 (sale of U.S. real property) or is exempt from U.S. tax under Section 892 (income of foreign governments); whether income is effectively connected with the conduct of a trade or business within the United States; and whether income is subject to current U.S. tax under the passive foreign investment company or subpart F rules.\textsuperscript{44}

f. Other Provisions

Following the Green Book Proposal, the Bill would also treat any income or gain of an individual from an “investment service partnership interest” as net earnings from self-employment for FICA purposes, and thus subject to Social Security and Medicare tax.

The Bill’s carried interest provisions would generally take effect for taxable years beginning after December 31, 2009, and a special transition rule would apply for any partnership taxable year which includes December 31, 2009. The Bill would apply to dispositions of partnership interests and distributions of partnership property after December 31, 2009. The provisions relating to disqualified interests would take effect on January 1, 2010.

C. EXTENDERS

The Bill would extend certain tax incentives and relief provisions that are due to expire. Extenders on business tax relief include:

- The credit for increasing research activities is extended for one year, through December 31, 2010;
- In determining insurance income and the foreign personal holding company income for subpart F purposes, both the exemptions for active insurance income under Section 953(e)(10)\textsuperscript{45} and for the

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\textsuperscript{43} See the Joint Committee Report.

\textsuperscript{44} Generally, under Section 951, a United States person who owns 10% or more of the voting power ("United States Shareholder") of a controlled foreign corporation (a “CFC”) is required to include currently in its gross income the pro rata share of subpart F income of such CFC. A CFC is generally any foreign corporation if more than 50% of the vote or value of such foreign corporation is owned by United States Shareholders. Under Section 952, Subpart F income generally includes, among other things, insurance income and passive income.

\textsuperscript{45} Under Section 953, subpart F income generally includes any income of a CFC attributable to the issuing or reinsuring of any insurance or annuity contract, except for exempt insurance income. Under Section 953(e), exempt insurance income is generally income derived in active insurance business in a country other than the United States. In addition, because Section 953(e)(10) cross

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active banking or financing income under Section 954(h)(9)\(^{46}\) are extended to taxable years of a foreign corporations beginning before January 1, 2011;

- In determining foreign personal company income for subpart F purposes\(^{47}\), the related-party look-through rule of Section 954(c)(6) (i.e. the rule under which dividends, interest, rents and royalties received or accrued from a controlled foreign corporation which is a related person are not treated as foreign personal holding company income to the extent attributable or properly allocable to income of the related person which is neither subpart F income nor income treated as effectively connected with the conduct of a trade or business in the United States) is extended to taxable years of a foreign corporation beginning before January 1, 2011, and for taxable years of U.S. shareholders with or within which such taxable years of such foreign corporations end;

- The exemptions from gross basis tax and from U.S. federal withholding taxes on interest-related dividend and short-term capital gain dividend paid by a regulated investment company to non-resident alien individuals are extended to dividends with respect to taxable years of the regulated investment company beginning before January 1, 2011;

- The treatment of a regulated investment company as a qualified investment entity for purposes of the rules on disposition of investment in United States real property under Section 897 is extended through December 31, 2010\(^{48}\);

- The look-through of certain regulated investment company stock in determining gross estate of nonresidents is extended to estates of decedents dying before January 1, 2011;

- The 15-year straight-line cost recovery for qualified leasehold improvements, qualified restaurant buildings and improvements, and qualified retail improvements is extended to such properties placed in service before January 1, 2011;

- The 7-year recovery period for motorsports entertainment complexes is extended to properties placed in service before January 1, 2011;

- The railroad track maintenance credit is extended to taxable years beginning before January 1, 2011;

- The special expensing rules for certain film and television productions are extended to qualified film and television productions commencing prior to January 1, 2011;

- The expensing of environmental remediation costs is extended to include expenditures paid or incurred before January 1, 2011;

- The mine rescue team training credit is extended to taxable years beginning on or before December 31, 2010;

- The election to expense advance mine safety equipment is extended through December 31, 2010;

\(^{46}\) Under Section 954(c), subpart F income generally includes “foreign personal holding company income”, which is the portion of the CFC’s gross income consisting of generally passive income such as dividends, interest, royalties, rents, and annuities, gains from certain property transactions giving rise to the types of income described before, income from commodities transactions, income from foreign currency gains, income equivalent to interest, income from notional principal contracts, payments in lieu of dividends and income from certain personal service contract. Section 954(h) provides an exemption from 954(c) for, generally speaking, active banking or financing income of an eligible CFC.

\(^{47}\) Section 954(c).

\(^{48}\) Under Section 897 (h)(2), the term “United States real property interest” does not include any interest in a domestically controlled qualified investment entity.
• The employer wage credit for employees who are active duty members of the uniformed services is extended through December 31, 2010;
• The 5-year depreciation for farming business machinery and equipment is extended to property placed in service before January 1, 2011;
• The suspension of limitation on percentage depletion for oil and gas from marginal wells is extended to taxable years beginning before January 1, 2011.

The Bill would also provide extensions for individual tax reliefs:

• The election to deduct state and local sales taxes in lieu of state and local income taxes is extended to taxable years beginning before January 1, 2011;
• The additional standard deduction for state and local real property taxes is extended to any taxable year beginning in 2010;
• The above-the-line deduction for qualified tuition and related expenses is extended to taxable years beginning before January 1, 2011;
• The deduction for certain expenses of elementary and secondary school teachers is extended to any taxable year beginning in 2010.

Notably, the Bill would not extend the so-called “2009 AMT patch”. Lawmakers are expected to take up the AMT patch in 2010.49

The Bill would provide for extensions for certain provisions affecting charitable gifts and the treatment of tax-exempt organizations:

• Allowance of the charitable deduction for qualified contributions of capital gain real property for conservation purposes is extended to contributions made in taxable years beginning before January 1, 2011;
• The enhanced charitable deduction for contributions of food inventory is extended to contributions made before January 1, 2011;
• The enhanced charitable deduction for contributions of book inventories to public schools is extended to contributions made before January 1, 2011;
• The enhanced charitable deduction for corporate contributions of computer technology and equipment for educational purposes is extended to contributions made during taxable years beginning after December 31, 2009, and before January 1, 2011;
• Tax-free distributions from individual retirement plans for charitable purposes are extended to distributions made in taxable years beginning after December 31, 2009, and before January 1, 2011;
• Modifications of tax treatment of certain payments to controlling exempt organizations are extended to payments received or accrued through December 31, 2010;
• The exclusion of gain or loss on sale or exchange of certain Brownfield sites from unrelated business taxable income is extended to properties acquired by an eligible taxpayer or qualifying partnership before January 1, 2011;
• The basis adjustment to stock of S corporations making charitable contributions of property is extended to contributions made in taxable years beginning before January 1, 2011.

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49 See Chuck O'Toole, Rangel Introduces Tax Extenders Package as House Schedules Vote, 2009 TNT 233-2 (Dec. 8, 2009).
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CONTACTS

New York

David Hariton +1-212-558-4248 haritond@sullcrom.com
Andrew Mason +1-212-558-3759 masona@sullcrom.com
David Spitzer +1-212-558-4376 spitzerd@sullcrom.com
Judith Fiorini +1-212-558-4987 fiorinij@sullcrom.com
Marina Bezrukova +1-212-558-1621 bezrukovam@sullcrom.com
Vivian Ouyang +1-212-558-4195 ouyangy@sullcrom.com
Michael Orchowski +1-212-558-7916 orchowskim@sullcrom.com

London

Andrew Solomon +44-20-7959-8535 solomona@sullcrom.com
Eric Wang +44-20-7959-8411 wangs@sullcrom.com
Aditi Banerjee +44-20-7959-8437 banerjeea@sullcrom.com

Washington, D.C.

Don Korb +1-202-956-7675 korbd@sullcrom.com