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HOW TO AVOID AMERICA'S 30% WITHHOLDING TAX

Signing an agreement with the United States IRS seems to be the only way to avoid paying the tax implented by the Foreign Account Tax Compliance Act, says Professor William H. Byrnes.

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The United States Federal Government estimates that it loses approximately $345 billion in tax revenues each year "as a result of offshore tax abuses primarily from the use of concealed and undeclared accounts held by US taxpayers or their controlled foreign entities".

In consideration of the objective of eliminating this gap, "it is not surprising that the [US] government recently ratcheted up its pressure on taxpayers who structured their activities, in many cases, with the active help and assistance of promoters and facilitators to avoid reporting their taxable income on their tax returns or hide these offshore accounts from the government".

This recent increased pressure came in the form of the Hiring Incentives to Restore Employment Act which was signed into law by President Obama during the first quarter of 2010. The act provides incentives for job creation, but in order to pay for the incentives, the act also contains significant changes that will affect foreign financial institutions that choose to do business with US persons. In fact, half of the US Congressional Record that contains the act is dedicated to foreign account tax compliance. Consequently, since the new law relates significantly to foreign account tax compliance, many provisions of the law are commonly referred to Foreign Account Tax Compliance Act (FATCA) which was originally introduced by the Senate in 2009.

The touchstone of the new law is to impose upon a foreign financial institution a 30% withholding tax if it fails to provide the information required under the so-called 'Code Sec. 1471(b)' agreement. This agreement is between a foreign financial institution and the Internal Revenue Service (United States Department of the Treasury), and states the financial institution will comply with reporting requirements generally regarding US taxpayers and the IRS will not enforce a 30% withholding tax on payments by US persons to the financial institution. The new withholding tax comes into effect on 1 January 2013.

To avoid the withholding, a foreign financial institution will be required to report (by agreement, election, or otherwise, unless specifically exempted), with respect to each US account maintained by such institution: 1) The name, address, and TIN of each account holder; 2) account number; 3) account balance; and 4) gross receipts and gross withdrawals from the account.

The law will include a number of foreign financial entities doing business with US taxpayers. For the purposes of the new law, a foreign financial institution means a foreign entity that (i) accepts deposits in the ordinary course of a banking or similar business; (ii) holds financial assets for the account of others as a substantial portion of its business; or (iii) is engaged (or holding itself out as being engaged) primarily in the business of investing, reinvesting, or trading in securities interests in partnerships, commodities or any interest (including a futures or forward contract or option) in such securities, partnership interests or commodities.

Furthermore, payments that are within the scope of the act include, any payment of interest, dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodical gains, profits, and income as well as any gross proceeds from the sale or other disposition of any property of a type which can produce interest or dividends, if such payments are from sources within the United States.

These broad definitions will inevitably include not only traditional banking transactions, but also, and not necessarily limited to, insurance contracts, investment trusts, mutual funds, hedge funds and pension plans. One legal journal notes, the act will affect almost every foreign financial institution.

Interestingly, because information disclosure and compliance is sought from international financial entities that themselves may not be subject to US law or tax, the information reporting cannot be mandated in a rule of law but must be incentivised. Therefore, the idea behind the new regime is to coerce foreign financial institutions to report information about their US customers and account holders to the Internal Revenue Service, through a US withholding agent, (individuals subject to US law and tax), who will be required to impose the 30% withholding for non-complying foreign financial institutions at the source of US payments.

Commentators are now suggesting that the above described, incentivised, 'foreign tax piggy-back legislation' can be just as invasive as the US model. In other words, since the US is now asking to know the identities and account balances of Americans that own US accounts, a foreign financial institution will have to know whether or not its accounts are owned by US persons, or if the intended beneficiaries are US persons. To that end, [foreign entities] will be asking global account owners to certify or provide documentation acceptable to the Treasury whether they are specified US persons.

The act will increase transparency in the international financial world, but at increased compliance costs [to] foreign financial institutions. It is no surprise, given the experience of US financial institutions' efforts to comply with financial reporting measures, that foreign institutions will likely need to spend significant sums of money to create operating systems to comply with the act.

Moreover, in its effort to reduce the national tax gap, the US Government is not showing much sympathy to the international financial community. The new law has created an ultimatum for foreign financial institutions; "[t]his bill offers foreign banks a simple choice -- if you wish to access our capital markets, you have to report on US account holders."

Experience has already shown that some foreign financial institutions may determine that the cost of compliance will outweigh the benefits of managing US account holders and therefore the banks no longer want to manage US accounts and have forced the clients out of their institution, notwithstanding the clients' significant account balances.

What's more, in order to avoid unknown complications, some foreign financial institutions will likely avoid investing in US stocks and bonds altogether.

Thus, an unintended result of the act may be to drive capital away from the United States to more user-friendly jurisdictions.

Other provisions relating to foreign trusts

The new HIRE Act also creates new rules with regard to foreign trusts. The new law provides that any use of foreign trust property by a US grantor or US beneficiary, or any US person related to a US grantor or US beneficiary, is treated as a distribution equal to the fair market value of the use of the property for tax purposes.

Thus, a US taxpayer's rent free use of real estate, yacht, art work or other personal property (whether located domestically or internationally), or a taxpayer's interest-free or below-market loan of cash or uncompensated use of marketable securities will trigger a distribution equal to the FMV for the use of such property.

In addition, the new law creates a rebuttable presumption that all foreign trusts have a US beneficiary when a US person directly or indirectly transfers property to a foreign trust.

This presumption may be overcome only by submitting information to the US Department of the Treasury, that demonstrates: (i) under the terms of the trust no part of the income or corpus of the trust may be paid or accumulated during the tax year to or for the benefit of a US person, and (ii) if the trust were terminated during the tax year, no part of the income or corpus could be paid to or for the benefit of a US person.

In sum, the law requires new reporting obligations on foreign trusts and persons creating, making transfers to or receiving distributions from foreign trusts. The provisions relating to foreign trust reporting became generally effective after 18 March 2010.

• Please note that the full articles has footnotes, to acquire the full notes please contact the editor.