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MEMORANDUM

TO: Clients and Friends of the Firm

FROM: Stanley C. Ruchelman

RE: Foreign Account Tax Compliance Act of 2009

DATE: November 18, 2009

This memorandum is being circulated to provide a topside explanation of tax legislation now being considered in Congress affecting foreign trusts and foreign financial institutions. It is designed to facilitate the provision of bank information to the U.S. Government in order to track offshore investments of U.S. persons and to raise revenue from U.S. person's who are beneficiaries of foreign trusts.

The bill is the "Foreign Account Tax Compliance Act of 2009." Identical legislative language has been introduced in both Houses of Congress and it has the full support of the Administration. The bill has its roots in earlier legislative proposals submitted by the Senate Permanent Subcommittee on Investigation, but has pared away certain over-reaching provisions, including the creation of a tax haven country blacklist and certain negative presumptions in tax litigation arising from specified transactions. It is possible that the bill could be enacted in 2009 as a stand-alone legislation or with as a funding offset for estate tax reform or it could be combined with a larger general tax reform effort in 2010. It is also possible that aspects of the bill could be changed before it is enacted.

The following is a summary of the provisions as of November 13, 2009:

Information Returns, Increased Disclosure and Electronic Filing

1. The most complex provision of the bill adds a new chapter 4 to the Code that requires a foreign financial institution (including a hedge or private equity fund) to enter into an agreement with the I.R.S. under which the institution must either (i) identify and report certain information with respect to accounts owned (directly or indirectly) by U.S. persons, or (ii) report as if the institution were a U.S. institution. If these requirements are not met by a foreign financial institution, U.S. payors must withhold 30% from any withholdable payment made to that institution. If the beneficial owner of such a payment is entitled to a reduced rate of withholding under an income tax treaty, that beneficial owner must file for a credit or refund.

    a. A withholdable payment includes both payments of U.S. source interest, dividends, and other fixed or determinable income annual and periodic income and gross proceeds from the sale of any property of a type which can produce U.S. source interest or dividends.

    b. The foreign financial institution may generally rely on an account holder's certification, but must comply with know-your-customer, anti-money laundering, anti-corruption and similar non-tax rules in making this tax status determination. The provision is subject to a minimum per-holder account threshold of $10,000 per account ($50,000 for existing accounts).

    c. The rules generally do not apply to beneficial owners which are publicly traded corporations, banks, REIT's, RIC's, certain common trust funds or exempt trusts.

    d. The requirements of the bill apply to all foreign financial institutions and are in addition to those which may be imposed under a qualified intermediary agreement.

2. The bill imposes reporting obligations on U.S. withholding agents to obtain information regarding direct and indirect U.S. ownership of accounts.

    a. A U.S. withholding agent is required either (i) to report certain information with respect to each substantial U.S. owner of the beneficial owner of any withholdable payment made to a foreign entity except a publicly traded corporation that is not a financial institution, or (ii) to withhold 30 percent tax from such a payment.

    b. The provision applies to payments made after December 31, 2010, subject to certain transition rules.

3. Certain foreign-targeted bearer bonds currently exempt from registration requirements would no longer be exempt from those regulations and the interest paid would no longer be eligible for the portfolio interest exemption.

4. Reporting of foreign financial accounts would be part of the U.S. tax return, which would be in addition to the requirement to file an FBAR Form that exists under current law. The penalty for failure to make the required disclosure in a taxable year is $10,000, plus additional penalties up to $50,000 after notice.

   a. This modification will regularize the penalty procedures so that well understood procedural rules will be applicable.

   b. The provision is effective for taxable years beginning after date of enactment.

5. Shareholders of P.F.I.C.'s will be required to file an annual information returns containing information specified by the I.R.S.

   a. This accelerates the filing obligation so that the I.R.S. will have knowledge of the status of the foreign corporation prior to a taxable event.

   b. The provision is effective on the date of enactment.

6. A material advisor to a U.S. individual who acquires or forms a foreign entity will be required to file an information return disclosing his or her assistance, if the U.S. client is required to file information returns with respect to the transaction.

   a. A material advisor is any person who provides material aid, assistance, or advice with respect to carrying out such a transaction, and who directly or indirectly derives gross income in excess of $100,000 during a calendar year for providing such aid, assistance, or advice. The $100,000 threshold includes all advice related in any way to the transaction.

   b. A penalty of up to 50% of the advisor's gross income with respect to the transaction is imposed for failure to file the information return.

   c. The provision is effective with respect to aid, assistance, and advice provided after the date of enactment.

7. The I.R.S. will be authorized to require electronic filing for any return filed by a financial institution, even if the institution is excepted from such filing under present law because it is under the 250 return-per-year filing threshold.

Penalties and Statute of Limitations

8. The bill imposes a new accuracy-related penalty of 40% for any understatement attributable to any transaction involving an undisclosed foreign financial asset, which is, in general, a foreign financial asset which is required to be disclosed under present law, but which is not so disclosed. The provision is effective for taxable years after the date of enactment.

9. The bill modifies the statute of limitations on certain understatements related to a foreign financial account or a P.F.I.C.

   a. It suspends the limitations period on assessment of taxes until required disclosures are made with respect to foreign financial assets or P.F.I.C.'s.

   b. It extends the statute of limitations to six years for understatements attributable to omission of gross income in excess of $5,000 with respect to foreign financial assets, even if the amount omitted from the return is less than 25% of gross income.

   c. The provision is effective for returns filed after the date of enactment, and for filed returns for which the present-law assessment period has not expired as of the date of enactment.

Foreign Trusts

10. Under present law, a U.S. person that directly or indirectly transfers property to a foreign trust is treated as the owner of the portion of the trust comprising the transferred property for any taxable year in which there is a U.S. beneficiary of any portion of the trust. This rule does not apply for a taxable year if, under the terms of the trust, no U.S. person may receive any income or corpus from the trust and no U.S. person would receive any benefit if the trust were to terminate. The bill modifies this exception.

    a. A U.S. person will be deemed to have an interest in a foreign trust formed or funded by a U.S. person if, inter alia, the interest is contingent on a future event.

    b. If any person has discretion to make a distribution from a trust for the benefit of any person, the trust is treated as having a U.S. beneficiary unless the trust terms specifically identify the class of distributees and none of those persons is a U.S. person during the taxable year.

    c. Any written, oral, or other side agreement by a U.S. grantor that may result in income or corpus being paid for the benefit of any U.S. person is treated as one of the terms of the trust. Thus, letters of wishes must be disclosed and quite likely letters of intent prepared by the trustee.

    d. A U.S. grantor of a foreign trust must annually submit information that demonstrates the absence of a U.S. beneficiary under the standards of the bill. Failure to properly demonstrate that fact will lead to the presumption that the trust has a U.S. beneficiary for the taxable year. This is in addition to any reporting required to be made by the trust itself under present law. The provision is effective on the date of enactment.

11. The provision extends current law treatment of a loan of cash or marketable securities by a foreign trust to a U.S. grantor, a U.S. beneficiary, or a person related. Such loans are treated as distributions, subject to certain exceptions. Under the proposal, the use of any trust property by the grantor, a beneficiary, or a related person will be viewed to be a trust distribution. The provision is effective for loans made and property used after the date of enactment.

12. The bill modifies the penalties for failure to report information regarding certain foreign trusts. The bill provides minimum fixed penalties, in most cases $10,000, even in cases where the gross reportable amount is not determinable, and places the burden on the taxpayer to provide information sufficient to determine the gross reportable amount. The provision is effective for filings required after December 31, 2009.

Dividend Equivalent Payments

13. The bill provides that dividend equivalent payments are treated as U.S. source income. Such payments are, therefore, subject to U.S. withholding tax if paid to a foreign person.

    a. A dividend equivalent payment is a payment made under a notional principal contract, including a total return swap, that is contingent upon, or determined by reference to, a dividend from U.S. sources.

    b. A dividend-based amount in a swap is separately subject to U.S.-source treatment even if it is partially or fully offset by a counterparty payment.

    c. The provision grants regulatory authority to the Treasury Department to expand this category to substantially similar payments, and to provide certain exceptions.

    d. The provision is effective for payments made 90 days after the date of enactment.

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We trust this explanation is helpful and informative. Nonetheless, I.R.S. regulations require the following statement. This memorandum has not been written as a formal opinion of counsel. Accordingly, any tax advice contained herein is not intended or written by us to be used, and cannot be used, for the purpose of avoiding tax penalties.

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