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## FATCA Update: New Annual PFIC Reporting Rules/Guidance on Definitions and Scope under Chapter 4 Withholding

On April 6, 2010, the Internal Revenue Service (IRS) released an advance copy of Notice 2010-34, which provides guidance pursuant to the recently enacted Section 1298(f), concerning the annual reporting requirements of U.S. persons who are shareholders of a passive foreign investment company (PFIC).

### *PFIC Regime*

A PFIC is a foreign corporation primarily used as a passive investment vehicle. Characterization of a foreign corporation as a PFIC turns on the satisfaction of either an income or asset test. The income test requires that 75 percent or more of a foreign corporation's gross income consist of passive income. The asset test requires that at least 50 percent of the foreign corporation's assets (based on either value or, in certain circumstances, adjusted tax basis) held during the tax year produce passive income.

In general, U.S. persons owning stock—even one share—of a PFIC may be subject to tax at top marginal rates, plus an interest charge, on certain distributions on and dispositions of PFIC stock. Even an indirect owner of PFIC stock may be subject to the regime. Both the gain from a disposition and a targeted distribution (referred to as an "excess distribution") are taxed generally at the highest marginal rate, without regard to the tax attributes of the PFIC stockholder (for example, ignoring its net operating losses). An interest charge is also imposed based on the shareholder's holding period for the PFIC stock. A taxpayer may avoid the PFIC regime by purging the PFIC of its PFIC taint by way of either a deemed sale election or a deemed dividend election or by means of two alternative elections: (1) the qualified electing fund (QEF) or (2) the mark-to-market election. If a QEF election is made, a taxpayer generally includes in income each year its pro-rata share of the PFIC's ordinary earnings and its pro-rata share of the PFIC's net capital gain. Taxpayers holding marketable PFIC stock may make the mark-to-market election to include annually in gross income the excess of the fair market value (FMV) over the PFIC stock's adjusted basis (or, in certain circumstances, take a deduction if adjusted basis is greater than FMV).

### *New Reporting Requirement Under HIRE Act*

On March 18, 2010, President Obama signed the Hiring Incentives to Restore Employment Act of 2010 (the HIRE Act). The HIRE Act amends the IRC by adding a new Code §1298(f). Section 1298(f) requires U.S. persons who are shareholders of a PFIC to file an annual report containing such information as the Secretary may require.

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Section 1298(f) is effective on the date of enactment of the HIRE Act. However, the IRS has issued Notice 2010-34 (IRB 2010-17), which delays the implementation of the new annual reporting requirement. For calendar year taxpayers, the new rules will not apply until filing tax returns for the calendar year 2011.

The IRS is advising taxpayers that existing Form 8621, *Return by a Shareholder of a Passive Foreign Investment Company or a Qualified Electing Fund*, should be filed under the old rules (e.g., upon disposition of stock of a PFIC, or with respect to a qualified electing fund under Code § 1293). New guidance will eventually be forthcoming that implements the new annual reporting requirements.

Shareholders of a PFIC that were not otherwise required to file Form 8621 annually prior to March 18, 2010, will not be required to file an annual report as a result of the addition of § 1298(f) for taxable years beginning before March 18, 2010.

### *Guidance on FATCA Expected Before Effective Date*

The cost of the HIRE Act is offset, in part, by the enactment of an amended version of the previously proposed Foreign Account Tax Compliance Act of 2009 (FATCA). Those provisions are now Title V of the HIRE Act. In general, FATCA represents a major addition to the U.S. withholding tax system. It imposes a new 30 percent withholding tax on certain payments made to foreign financial institutions and non-financial foreign entities that refuse to identify U.S. account holders and investors. FATCA goes into effect for payments made on or after January 1, 2013, except that interest and gross proceeds from obligations outstanding on the date two years after enactment are grandfathered.

An IRS official stated on April 30, 2010, that guidance on the broad new requirements enacted under FATCA is likely to focus first on carveouts and issues of definition and scope. Specifically, initial guidance is expected on the definition of what is considered a foreign financial institution, the scope of accounts to which the requirements apply, and specific carveouts from the legislation. Although the statute defines the broad outline of the FATCA regime, it also gives the IRS and Treasury wide discretion to write the implementing rules. The IRS and Treasury have the power to completely exempt entities or payments from FATCA if there is a low risk of tax evasion. They will also decide what procedures withholding agents and non-U.S. entities must follow. In a recent announcement, the Treasury Department and the IRS requested comments from the public regarding guidance and issues concerning the interpretation and implementation of the FATCA provisions.

The IRS and the Treasury Department are devoting major resources to implementing the new provisions. Of 99 attorneys in the IRS's associate chief counsel, international office, 14 are working on the FATCA provisions, and additional staff will be pulled in as needed. The Treasury's Office of International Tax Counsel has about a third of its lawyers working to implement the FATCA provisions.

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