

June 9, 2009

The Honorable Max Baucus
Chairman
Committee on Finance
United States Senate
Washington, DC 20510

The Honorable Charles Grassley
Ranking Member
Committee on Finance
United States Senate
Washington, DC 20510

Re: Proposals to Fight Offshore Tax Evasion

Dear Senators Baucus and Grassley:

On behalf of the Organization for International Investment (OFII), we are writing to comment on a discussion draft of legislation circulated by Senate Finance Committee Chairman Max Baucus (D-Mont.) on March 12, 2009, as well as several provisions in the Administration's Fiscal Year 2010 Revenue Proposals issued on May 11, 2009 aimed at fighting offshore tax evasion. OFII supports the Senate Finance Committee's and the Administration's efforts to improve the IRS's ability to detect and deter offshore tax evasion. We are pleased to provide our general support for these proposals, with some suggested modifications that we believe would make the proposals stronger, more effective, easier for the Internal Revenue Service to administer and enforce, and more targeted at taxpayers who regularly engage in tax evasion rather than those who legitimately and consistently make every legitimate effort to comply with existing tax laws.

OFII is a business association representing the U.S. subsidiaries of many of the world's largest international companies. The U.S. subsidiaries of companies based abroad directly employ over 5 million Americans and support an annual U.S. payroll of over \$364 billion. As evidenced by the attached OFII membership list, many OFII members are household name companies with historic and substantial U.S. operations. On behalf of these companies, OFII advocates for the fair, non-discriminatory treatment of U.S. subsidiaries. We undertake these efforts with the goal of making the United States an increasingly attractive market for foreign investment, which will ultimately encourage international companies to conduct more business and employ more Americans within our borders. Given the recent global financial turmoil, as well as companies' increasing ability to conduct worldwide operations through other jurisdictions, OFII's mission is more critical than ever to sustaining and rebuilding the American economy. OFII appreciates the recognition you have given to the important contributions that foreign multinationals make to the growth of the U.S. economy and U.S. employment.

Our detailed comments regarding the discussion draft and the Administration's proposals are attached.

We would be happy to further discuss our views with your staff and can be reached at 202-659-1903. Thank you in advance for your consideration.

Sincerely,

A handwritten signature in black ink, appearing to read 'Nancy McLernon', with a long horizontal flourish extending to the right.

Nancy McLernon
President & CEO
Organization for International Investment

Comments Regarding Proposals to Fight Offshore Tax Evasion

Introductory Comments

On March 12, 2009, Senator Baucus circulated a discussion draft of legislation aimed at fighting offshore tax evasion. As indicated in the press release, the purpose of releasing the preliminary draft was to obtain stakeholder input that will make the proposals stronger, more implementable, and more likely to become law. On May 11, 2009, the United States Treasury issued its General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals. Included in the Administration's proposals are several provisions that are intended to combat the under-reporting of income through the use of accounts and entities in offshore jurisdictions.

Executive Summary of Certain Proposals and Recommendations

Outlined below are summaries of the proposals that are of most relevance to OFII members and OFII's recommendations.

1. Extending the statute of limitations from three to six years for tax returns that reported, or should have reported, certain international transactions, to give the IRS more time to detect and examine offshore activity (Discussion Draft and expanded Administration proposal). The proposed extension would apply to elections to be treated as a Qualified Electing Fund under Section 1295(b) as well as information required to be reported on the following Forms:
 - Form 926 - Return by a U.S. Transferor of Property to a Foreign Corporation
 - Form 5471 - Information Return of U.S. Persons With Respect To Certain Foreign Corporations, including Form 5471, Schedule O - Organization or Reorganization of Foreign Corporation, and Acquisitions and Dispositions of its Stock
 - Form 5472 - Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business
 - Form 8865 - Return of U.S. Persons With Respect to Certain Foreign Partnerships
 - Form 3520 - Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts and Form 3520A - Annual Information Return of Foreign Trust With a U.S. Owner
 - Form TD F 90-22.1 - Report of Foreign Bank and Financial Accounts, commonly referred to as the FBAR (Administration Proposal only); and
 - A new form that would be issued under the Administration proposal for reports by U.S. individuals with respect to certain transfers of money or

property to and receipts from certain foreign bank, brokerage or other financial accounts (Administration Proposal only).

Recommendation: The statute of limitations should not be extended from three to six years for all taxpayers. Instead, the Senate Finance Committee should apply more targeted modifications such as those recommended by OFII below.

2. Requiring the Form 90-TD 22.1, FBAR form to be filed with the income tax return. Currently, the FBAR is filed only with the Treasury's Financial Crimes Enforcement Network (FinCEN). This is intended to cause the FBAR to be treated as tax return information to facilitate the IRS's ability to enforce FBAR filing requirements (Discussion Draft and substantially similar Administration proposal).

Recommendations: The Senate Finance Committee should provide specific exceptions from FBAR filing when: (1) the employer of a U.S. individual is a publicly traded U.S. or foreign corporation (or controlled subsidiary of a U.S. or foreign publicly traded corporation); and (2) the employer (or the relevant publicly traded parent company) files the FBAR to report a financial interest in or signatory authority over the foreign account. An exception from FBAR filing should be included for amounts received as an employee under an employee benefit plan, where the relevant amount is included as gross income on the employee's U.S. federal income tax return. Finally, the Senate Finance Committee should direct the Treasury to consider the administrative burdens associated with completion of the FBAR when determining filing requirements.

3. Requiring that U.S. individuals report any transfer of money or property made to, or receipt of money or property from, any nonqualified intermediary ("NQI") foreign bank, brokerage, or other financial account by the individual or controlled entities (Administration Proposal).

Recommendation: Because of the practical difficulties that individuals will encounter in distinguishing between NQIs and qualified intermediaries ("QIs"), the inability to obtain information regarding accounts that may have been established by employers in connection with payments under employee benefits plans and the duplicative information reporting between this proposal and pre-existing FBAR filing requirements as well as the Administration's proposed third-party reporting, OFII recommends that this proposal not be adopted.

4. Doubling applicable fines and penalties on tax underpayments which directly or indirectly involve any financial arrangement which in any manner relies on the use of offshore payment mechanisms of banks or other entities in foreign jurisdictions or any offshore financial arrangement (Discussion Draft and modified Administration Proposal).

Recommendation: Because of the likely uncertainties associated with compliance relating to these proposals, the Senate Finance Committee should permit taxpayers to assert reasonable cause and good faith exceptions to the increased penalties.

5. Requiring reporting by third parties of transfers of assets to foreign financial accounts (Discussion Draft). The Administration proposal would expand this reporting to include transfers from foreign financial accounts, but would exclude transfers to and from QIs.

Recommendation: The Senate Finance Committee should not include this proposal in any legislation because it is primarily likely to generate voluminous reports regarding routine, legitimate business transactions, making it difficult for the IRS to identify potential U.S. tax evaders.

6. Requiring QIs to identify all account holders that are U.S. persons and report all reportable payments received on behalf of any U.S. account holder on Forms 1099 (Administration Proposal).

Recommendation: The Senate Finance Committee should not include this proposal in any legislation because QIs do not have the U.S. tax technical resources to properly report the character, nature and source of income paid by foreign payors. Developing such resources would be extremely costly and burdensome and potentially prone to errors due to the lack of adequate information from foreign payors. The potential costs associated with the proposal are likely to cause QIs to opt out of QI status, a result that would be contrary to the Administration's goal of increasing tax reporting for offshore accounts by expanding the QI regime.

7. Requiring that for any financial institution to be a QI, commonly-controlled foreign financial institutions must meet certain reporting obligations with respect to account holders or must themselves become QIs (Administration Proposal).

Recommendation: The Senate Finance Committee should take into consideration that many NQIs are ineligible to become QIs and should clarify that NQIs may remain NQIs so long as the NQIs comply with QI reporting with respect to their U.S. person customers. Further, NQIs should be permitted the flexibility to choose whether they wish to: (i) invest in systems to report on U.S. person customers themselves (as NQIs); (ii) become QIs; or (iii) refer their U.S. customers to their QI affiliates.

8. The Administration proposals that would expand information reporting by QIs and impose reporting obligations on NQIs, as well as impose withholding tax on certain payments made to NQIs, if enacted, are proposed to be effective beginning after December 31 of the year of enactment or for payments made after that date.

Recommendation: Although OFII strongly recommends that many of the proposals relating to QIs and NQIs not be included in any legislation, to the extent such

proposals are enacted, the effective date should be no earlier than years beginning on or after January 1 of the third year following the date of enactment.

OFII supports the objectives of these proposals but urges the Senate Finance Committee to consider the suggested modifications below to avoid unintended consequences that may result in the imposition of significant new onerous compliance or financial burdens on taxpayers that are not engaging in tax evasion transactions and that are making every effort to diligently comply with existing tax laws.

Discussion

1. Proposals to extend the 3 year statute of limitations for certain information reporting to 6 years (Discussion Draft and expanded Administration proposal).

As currently drafted, the proposals would extend the three-year statute of limitations to six years for any income tax relating to items required to be reported on the IRS Forms listed above.

For most of the information reporting Forms listed above, there are significant definitional and interpretational uncertainties associated with the completion of the forms. For example, in connection with Forms 5472, in 2004, the IRS issued a lengthy, but, for taxpayers, an inconclusive Chief Counsel Advisory/Legal Memorandum relating to the potential assessment of penalties under Section 6038A(d) with respect to timely-filed Forms 5472.¹ In that Advisory/Memorandum, the IRS concluded that timely filed Forms 5472 would be treated as "substantially incomplete" for purposes of assessing late or non-filing penalties under various scenarios that were based on assumptions that may not reflect actual circumstances encountered by taxpayers.

The proposed modification of Section 6501(c)(8) would apply to taxes imposed under the Internal Revenue Code. In addition, Sec. 6671 treats many of the specific form-related penalties associated with international information reporting as taxes that would be subject to the modified Section 6501(c)(8). Consequently, an extension of the statute of limitations from three years to six years would also apply to potential penalties for forms where a taxpayer has made a reasonable effort to comply with information reporting requirements, but where the IRS might find that a form was "substantially incomplete," because of definitional and interpretational uncertainties associated with the completion of the forms.

OFII fully supports efforts to ensure that taxpayers who attempt to evade taxes through the use of international transactions be held to a more stringent standard. However, taxpayers that consistently make reasonable efforts to comply with existing laws and cooperate in full with the IRS during examinations should not be forced to bear the same burden as tax evaders. As a result, OFII recommends that, the statute of limitations in Section 6501(c)(8) not be extended from three to six years for all taxpayers. Instead OFII recommends that Section 6501(e), which currently provides for a six year statute of limitations for substantial omissions be modified to indicate that substantial omissions include omissions of at least 25% of gross income resulting from the failure to report amounts required to be reported pursuant to an election under Section 1295(b) or under Sections 6038, 6038A, 6038B, 6045, 6046, 6046A or 6048, or 6680 or any required foreign bank account-related reporting. Alternatively, a new six-year statute of limitations could be provided for those situations relating to these information reporting rules where penalties under Chapter 68, Subchapter A, part II (Sections 6662 through 6664) are also found to apply. More targeted modifications such as those recommended by OFII would provide the necessary tools for the IRS to improve enforcement with

¹ CCA/ILM 200429007.

respect to international transactions without unnecessarily burdening those taxpayers who consistently make reasonable attempts to comply with existing tax laws.

2. Proposals to include the FBAR as tax return information (Discussion Draft and Administration Proposals)

OFII generally supports aligning FBAR filing requirements with income tax reporting. However, OFII believes that the Senate Finance Committee should consider adding exceptions to or more details regarding the types of persons that are expected to file a FBAR. The FBAR form, as currently designed is generally intended to detect money laundering or other non-tax criminal activities. As a result, the form needs to be more targeted to appropriate persons if it will be used to detect tax evasion. In addition, the Committee should direct the Treasury to provide clear definitions relating to FBAR filing requirements, by reference to existing definitions in the Internal Revenue Code. Many of the terms currently used in the instructions to the FBAR are undefined and create a significant amount of uncertainty.

One of the most problematic aspects of the FBAR for many OFII members is the filing requirement for persons who have signatory authority, but no financial interest, in a foreign account. The instructions to the form provide an exception to this requirement for employees of U.S. corporations (and their domestic and foreign controlled subsidiaries) where the U.S. parent company's stock is publicly traded in the United States. No such exception is provided for employees of foreign corporations (either a foreign publicly traded parent company or its U.S. subsidiaries). Consequently, U.S. employees of U.S. subsidiaries of foreign parent corporations (i.e., OFII's membership) often have quite onerous FBAR filing requirements where the U.S. employee of the U.S. subsidiary may, for example, act as a signatory on bank accounts for an affiliated foreign corporation's business accounts, where the U.S. employee has no personal financial interest in the accounts.

Another exception is provided in the instructions to the form for employees of federally-supervised banks. No similar exception is provided for U.S. employees of foreign-based banks. Thus, for example, U.S. citizens who work as trust account officers at large European banks overseas where they have limited signatory authority over customers' accounts must also file hundreds of FBAR forms annually, even though they have no personal financial interest in the accounts. The alternative to filing the FBAR forms is to transfer signatory authority to a non-U.S. person, an act which restricts these U.S. individuals' ability to meet conditions of their employment and thus makes the employment of U.S. citizens less attractive to foreign employers.

Another problematic area that can often result in a FBAR filing requirement for U.S. individuals, who often have no personal knowledge of such accounts, is the use of foreign financial accounts by foreign parent corporations for certain payments or awards under employee benefit plans. For example, in some cases, stock awarded to U.S. employees of U.S. subsidiaries as part of a broader global foreign parent employee stock option plan is often temporarily deposited with a foreign financial institution until the relevant employee advises the company's Human Resources department to either sell the stock or

transfer it to his/her own brokerage account. The arrangements with the foreign financial institution are entirely between the foreign parent company and the financial institution, but the financial institution acts as a custodian for both U.S. and non-U.S. employees that have been awarded stock. The U.S. employee has no details regarding the name, account number or other relevant items required by a FBAR with respect to the financial account. Additionally, the individual is unaware that the stock was held on their behalf by a non-U.S. financial institution.

In order to provide more equitable filing requirements for both domestic and foreign corporations, OFII recommends that the Senate Finance Committee provide specific exceptions from FBAR filing:

- (1) the employer of a U.S. individual is a publicly traded U.S. or foreign corporation (or controlled subsidiary of a U.S. or foreign publicly traded corporation; and
- (2) the employer (or the relevant publicly traded parent company) files the FBAR to report a financial interest in or signatory authority over the foreign account.

In addition, to avoid duplicative reporting, OFII recommends that an exception from FBAR filing be included for amounts received as an employee under an employee benefit plan, where the relevant amount is included as gross income on the employee's U.S. federal income tax return.

As a final matter, OFII recommends that the Senate Finance Committee direct the Treasury to consider the administrative burdens associated with completion of the FBAR when determining filing requirements. For example, prior versions of the FBAR required taxpayers to check a box for the range that properly represented the maximum balance of a foreign account. The most recent version of the FBAR directs taxpayers to explicitly state the maximum balance in an account during a calendar year. For business accounts that have thousands of transactions, this more recent requirement is an onerous administrative burden and provides little, if any, additional useful information to the IRS in determining whether a taxpayer may be attempting to evade taxes.

3. Proposal to require reporting of transfers by individuals to or from NQIs (Administration Proposal)

The Administration has proposed requiring reporting by U.S. individuals of transfers either by the individual or controlled entities to and from NQIs. Such a requirement would be duplicative of information regarding the existence of foreign bank accounts already available to the IRS through FBAR reporting and would yet again be available through the Administration's proposed third-party information reporting discussed in point 5 below.

In addition, most individuals are unlikely to understand the distinction between QIs and NQIs. Even if the IRS maintains a list of QIs on its web site, it is likely to be confusing to individuals. For example, if an individual maintains an account with a subsidiary of a large European bank in South Africa, the fact that the European parent company bank may be listed on the IRS's website as a QI may be interpreted by the individual to mean that he maintains his account with a QI, even though the absence of IRS-approved Know-Your-Customer rules for South Africa would generally mean that banks in South Africa are NQIs. The rules relating to QI status are sufficiently complex to expect that most individuals would frequently be unable to make correct distinctions between QIs and NQIs. There is an additional risk of incorrect reporting if the IRS is unable to maintain a list of QIs on its web site that is updated in real time as additional QI agreements are executed or as former QIs change status to NQIs. Determining a financial institution's status as of a particular point in time could be problematic if that status changes.

In addition, as indicated in the FBAR filing requirements above, non-U.S. multinationals may enter into arrangements with foreign banks for the payment of benefits under a global employee benefits plan where the individual is temporarily a beneficial owner of a foreign bank account, but the individual has no specific knowledge or information regarding the account. Such situations could result in missed reporting by the individuals through no fault or action of their own.

For the above reasons, OFII recommends that this proposal not be adopted.

4. Proposals to double fines, penalties and interest associated with offshore financial arrangements (Discussion Draft and modified Administration Proposal)

The discussion draft proposes to double fines, penalties and interest associated with offshore financial arrangements, including amounts paid through foreign banks or entities. As currently drafted, the doubling of fines, penalties and interest could apply very broadly to almost any cross-border transaction, including ordinary business transactions, with no exceptions. While the scope of what constitutes an offshore financial arrangement is not clear, consider a simple example of a U.S. business that makes direct financial payments to a foreign service provider. Assume for example U.S. tax law provides that the payment is not fully deductible but because of a clerical error it is misclassified on the company's books and records and inadvertently deducted in full. If that payment results in an understatement of tax and is treated as an "offshore financial arrangement," under the proposal, the U.S. company may not assert that reasonable cause existed for the understatement of tax and fines, penalties and interest assessed with respect to the understated tax for this item would automatically be doubled. Although the Secretary of the Treasury or the Secretary's delegate would have authority to waive the application of the penalty, this authority would apply only where the offshore payment mechanism was incidental to the transaction. It is not clear whether a direct payment to a foreign service provider such as that described in the example above could be considered "incidental" since there was a direct payment to the foreign corporation.

In order to provide taxpayers with clarity surrounding circumstances under which fines and penalties relating to offshore financial arrangements could be doubled, we strongly urge the Senate Finance Committee to permit taxpayers to assert reasonable cause and good faith exceptions under Sections 6664(c) and (d). The inclusion of those exceptions would also serve to protect taxpayers against potential abuses by the IRS of its authority to impose these doubled fines, penalties and interest in cases that truly are inadvertent errors or mistakes rather than intentional understatements of tax. A near certain imposition of doubled fines, penalties and interest to even the most innocuous of cross-border transactions could ultimately serve to deter both domestic and foreign corporations from engaging in cross-border transactions, further dampening U.S. economic growth and ultimately resulting in further decreases in U.S. exports and employment.

5. Proposals to require third party information reporting regarding transfers to or from foreign financial accounts (Discussion Draft and expanded Administration Proposal)

The discussion draft proposes to require information reporting for all direct or indirect cross-border transfers in excess of \$10,000 to foreign financial institutions, except for transfers by publicly traded corporations. Additionally, the discussion draft proposal would apply to indirect as well as direct transfers. The meaning of the word "indirect" in this context is unclear. We expect that the intent of the use of the term is to refer to situations where there is an intermediary financial institution between the institution originating the transfer and the ultimate destination. If this is the case, it should be stated accordingly for clarification.

The Administration expands this proposal to require reporting of transfers to or from foreign financial institutions by U.S. financial institutions and QIs. Exceptions would be provided for accounts owned by publicly traded companies and their subsidiaries, accounts opened at and transfers made to QIs on behalf of a U.S. person (or certain entities majority owned by U.S. persons) or transfers received by or on behalf of U.S. persons (or certain entities majority owned by U.S. persons) from accounts held by a U.S. person at a QI. Under both proposals, the Treasury Department would be granted regulatory authority to provide additional exceptions to the reporting requirement. The Administration's proposal would be effective for amounts transferred and accounts opened beginning after December 31 of the year of enactment.

Under the discussion draft proposal transfers by publicly traded corporations, but not their subsidiaries would be eligible for an exemption from reporting. The Administration's proposal would, however, extend this exemption to the subsidiaries of publicly traded corporations.

Certain OFII member financial institutions operate on a global basis and have operations in many countries that are not QIs, including certain countries that are significant U.S. trading partners. Historically, there has been no need for such affiliates or branches to become QIs because of limited U.S. investments by customers of such affiliates or

branches. Such affiliates or branches often provide significant import/export financing and also hold local customers' accounts. Examples of countries in which such operations exist for many foreign financial institutions include countries such as Brazil and South Africa, all of which are significant commodity producing and exporting countries as well as China which is a significant importer from and exporter to the United States. None of these countries have IRS-approved Know Your Customer ("KYC") rules, therefore, few, if any, QIs exist in these countries. These affiliates and branches may accommodate fund transfers relating to import/export transactions between large U.S. privately held customers which originate or end with a U.S. or QI affiliate account of those U.S. customers and a customer in the foreign country. Neither the discussion draft nor the Administration proposals would exempt reporting of such ordinary import/export transactions.

As discussed in more detail in Section 7 below with respect to the Administration's proposed effective date for its proposal, it should be noted that few U.S. financial institutions and even fewer QIs would be likely to have the systems or infrastructure in place to implement the Administration's proposal in such a short period of time. Indeed, it would be nearly impossible for most QIs to develop and test the required systems (including markers for exceptions from reporting) and have the resources in place to monitor and risk manage the process in the short time frame envisioned by the proposal.

OFII believes the proposals will likely generate a massive volume of information reports that will merely capture routine, legitimate business transactions of U.S. persons making payments to, or receiving payments from, offshore accounts as payment for goods and services. There is no benefit to be gained from information reporting for transactions the income from which is being reported by U.S. businesses. Similarly, reporting outbound payments for goods and services to foreign persons who are not subject to U.S. federal income taxes does not serve the stated objective of the proposal of improving compliance by U.S. persons. The sheer volume of information that would likely be reportable under this proposal would likely make it nearly impossible for the IRS to find U.S. tax evaders hidden amongst the majority of legitimate business transactions subject to reporting. Additionally, because of potential penalty exposures, any uncertainty regarding an obligation to report could result in financial institutions imposing delays in cross-border transfers of funds, a development which could have disastrous global economic consequences.

For the above reasons, OFII strongly recommends that the Committee not include either this discussion draft or Administration proposal in any legislation.

6. Proposal to expand reporting by QIs (Administration proposal)

The Administration has proposed requiring QIs to identify all account holders that are U.S. persons and report all reportable payments (including payments with respect to foreign securities) received on behalf of any U.S. account holder on Forms 1099 as though the QI were a U.S. financial institution. While the Administration's proposal is

unclear as to how procedures for identifying U.S. persons would be modified or strengthened, any new identification requirements should be as clear and unambiguous as possible without imposing an open-ended due diligence burden on QIs. Ambiguous and open-ended requirements would serve to discourage foreign financial institutions from becoming QIs or retaining QI status. This would be contradictory to the goal of the Administration which is to encourage foreign financial institutions to become QIs, which has proven to be an effective way to ensure compliance with the U.S. tax withholding rules.

With respect to the second part of the proposal to expand information reporting for all income received by U.S. customers of QIs, it should be noted that QIs typically hold non-U.S. securities for their U.S. customers in NQI designated accounts or with affiliates or third party vendors (also called "sub custodians") in the local country where the security issuer resides, whereas U.S. securities are held through U.S. sub custodians. Under the current QI Agreement, QIs are required to file Forms 1099 for their U.S. customers only with respect to U.S.-source income. In most cases, U.S. sub custodians through which a QI's U.S. customers hold U.S. securities file Forms 1099 for the QI's U.S. customers (whose Forms W-9 have been passed to the U.S. sub custodian). In other rare cases, generally if the QI knows that the U.S. sub custodian has not filed or will not file, the appropriate character and nature of the income is generally reported to the QI by the U.S. payor, thus enabling the QI to file required Forms 1099 and properly report the income. Consequently, QIs are currently required to engage in very limited Form 1099 reporting and have no need to develop more than a limited amount of in-house expertise or to make substantive changes to information technology systems in order to comply with the current QI regime. Foreign sub custodians that are not QIs and are not affiliated with US custodians are even less familiar than QIs with U.S. information reporting rules affecting Form 1099 reporting.

Form 1099 reporting is not a simple or straightforward process, even when dealing exclusively with U.S. securities. Accurate and complete Form 1099 reporting to cover the potential range of investments that might be made by a U.S. customer involves, at a minimum,

- (a) Determining whether a payment represents income under U.S. tax principles (*e.g.*, dividend vs. a return of capital),
- (b) Determining the source of the income (because non-U.S. source income paid by a non-U.S. payor or non-U.S. middleman outside the U.S. is generally not reportable by that payor),
- (c) Properly categorizing the income as interest, dividend, substitute dividend, original issue discount ("OID"), etc.

In view of the expanding universe of structured financial products that are offered to individuals in the market today, categorization of instruments and the income they generate has become increasingly complex. For example, certain structured notes are

debt instruments that are subject to Form 1099 reporting, while other similar notes are derivatives with no Form 1099-INT or 1099-OID reporting requirement.

Even when the category of income is clear, proper reporting can be difficult, for example, in the case of OID, which requires an understanding of complex U.S. tax rules to calculate OID accruals.

Beginning in 2011, U.S. financial institutions will also be required to report cost basis information on Form 1099-B. Based on earlier press reports, U.S. financial institutions have indicated that implementation of this reporting requirement will result in a significant systems and financial burden.

U.S. custodians and U.S. financial institutions have the U.S. tax expertise necessary (including internal tax departments and external tax advisors) that enable them to make the above determinations regarding the appropriate U.S. federal income tax treatment of payments received by their customers. In addition, these U.S. intermediaries have the systems and infrastructure in place to carry out Form 1099 reporting. In most cases, these systems and infrastructures have taken years or even decades to develop. In spite of these efforts, based on the results of the IRS's Section 1441 Voluntary Compliance Program and relatively recent updates made to the Internal Revenue Manual, it seems apparent that even after decades of development and implementation of tax reporting systems there may be information reporting deficiencies in some U.S. financial institutions.

Requiring QIs to engage in full information reporting as though they were U.S. financial institutions would require all QIs as well as foreign sub custodians of QIs to quickly develop U.S. tax expertise and establish new systems and infrastructure to serve a comparatively small number of their customers. This requirement will be an extraordinarily expensive and difficult challenge for these foreign financial institutions to meet.

In addition, while U.S. securities are developed with U.S. taxpayers and U.S. federal income tax reporting in mind, foreign securities usually are not. Accordingly, categorizing such income under U.S. federal income tax principles is even more difficult for a foreign intermediary. In many cases it is not possible to obtain information directly from the issuer of a security that would allow for correct reporting as to the character and nature of income. For example, U.S. issuers are generally required to provide payees or intermediaries with OID schedules. Foreign issuers are unlikely to have prepared any such schedules because OID is not a relevant concept under the tax laws of most, if not all, foreign countries.

The significant additional resources that this proposal demands are likely to cause many QIs to opt out of QI status to avoid these new burdens and costs, since direct attempts to pass along these costs to U.S. customers are likely to cause U.S. customers to shift accounts to NQIs. This may occur even if other Administration proposals encouraging NQIs to become QIs (e.g., withholding tax on certain payments to NQIs) are enacted. Foreign financial institutions that have no U.S. presence are the most likely to opt out of

QI status. Thus, the proposed QI changes will likely lead to fewer QIs. Such a result would be contrary to the Administration's goal of increasing tax reporting for offshore accounts by expanding the QI regime. U.S. taxpayers seeking to avoid Form 1099 reporting of their foreign-source income held in offshore accounts would migrate existing offshore QI accounts to NQI offshore foreign financial institutions.

We believe that the effect of this proposal would be to increase the number of NQIs that would be available to establish accounts for U.S. persons with foreign securities. Additionally, the proposed expansion of reporting by QIs will cause compliant QI financial institutions (including foreign affiliates of U.S. financial institutions) to lose customers to NQI financial institutions and will cause U.S. persons to have difficulty finding legitimate financial institutions willing to service them when residing outside of the U.S., further eroding the IRS's ability to access information relating to U.S. persons. Many U.S. nonresident individuals are unable to open accounts with U.S. financial institutions as a result of Patriot Act know-your-customer rules. Further, the expanded reporting requirement would cause a re-pricing of services to customers (in particular, U.S. customers) that could force smaller to medium-sized QIs to cease providing such services or hamper their ability to compete effectively.

For the above reasons, OFII recommends that the Committee not include this proposal in any legislation.

7. Proposal regarding NQIs controlled by financial institutions that also own QIs (Administration Proposal)

The Administration has proposed that the U.S. Treasury be authorized to issue regulations, including authority to require that for any financial institution to be a QI, commonly-controlled foreign financial institutions must meet certain reporting obligations with respect to account holders **or** that a financial institution may be a QI only if all commonly-controlled financial institutions are also QIs. This proposal appears to be targeted to require NQIs affiliated with QIs to report with respect to U.S. persons.

The latter half of the proposal which would require all NQIs affiliated with a QI to become a QI is extremely problematic. First, some of these NQIs may be formed in countries that do not have IRS- approved KYC rules and thus are not permitted to become QIs even if they want to. Second, many of these NQIs may not have a large enough U.S. customer base or base of foreign treaty-benefitted customers investing in U.S. securities to justify the extra costs of becoming a QI, including audit costs and resources required for new tax documentation validation, retention and renewal processes and information reporting systems. Third, the implication is that if the NQI affiliates do not become QIs, the affiliated QIs will lose their QI status, thus increasing the number of NQIs and increasing the risk of the collapse of the QI regime.

Accordingly, OFII recommends that the legislative focus be on the first half of the proposal which would require NQI affiliates of QIs to report with respect to U.S. account holders. This proposal, together with other Administration proposals that would impose

20% to 30% withholding tax on certain payments by US withholding agents to NQIs (including those that are not affiliated with QIs), should be clarified to indicate that NQIs may remain NQIs (and not be subject to additional withholding taxes) so long as the NQIs report with respect to their U.S. person customers.

Further, such NQIs should be permitted the flexibility to choose whether they wish to: (i) invest in systems to report on U.S. person customers themselves (as NQIs); (ii) become QIs (with the consequent additional audit and other costs); or (iii) refer their U.S. customers to QI affiliates (whose QI Agreements already cover reporting for U.S. persons).

8. Administration Proposed Effective Dates for Various QI and NQI Proposals

The Administration's proposals that would expand information reporting by QIs and impose reporting obligations on NQIs, as well as impose withholding tax on certain payments made to NQIs, if enacted, are proposed to be effective beginning after December 31 of the year of enactment or for payments made after that date. Thus if the proposals were enacted in 2009, they would be generally effective January 1, 2010.

Generally, the lead time required to develop and test new information technology systems, especially when related to the implementation of complicated rules, can range from 18 to 24 months. Time is also required to obtain and train the necessary resources to monitor and to develop risk management processes and systems. Thus, as a practical matter, in light of the substantial expenses and resources required to implement these proposals, in particular with respect to increased information reporting by QIs and NQIs (if they should so choose to, assuming the options described in section 6 above are permitted), and the fact that information technology budgets had been set in the previous year and do not include these unexpected outlays, OFII recommends that the effective dates be delayed to provide QIs and NQIs with sufficient time to develop and test systems and procedures required to implement the new rules. Although OFII believes that certain of these proposals will be counterproductive and should not be enacted, if the Committee decides to proceed with these proposals, OFII recommends that, at a minimum, the effective date should be no earlier than years beginning on or after January 1 of the third year following the date of enactment.

Conclusion

OFII supports the Senate Finance Committee's and the Administration's efforts to improve the IRS's ability to detect and deter offshore tax evasion. OFII urges the Committee to avoid overly broad provisions that would increase compliance burdens on those taxpayers that routinely and consistently make every effort to comply with tax laws and properly report cross-border transactions. OFII strongly believes these taxpayers should not be forced to bear the disproportionate burden of any measures intended to detect and deter tax evasion.

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