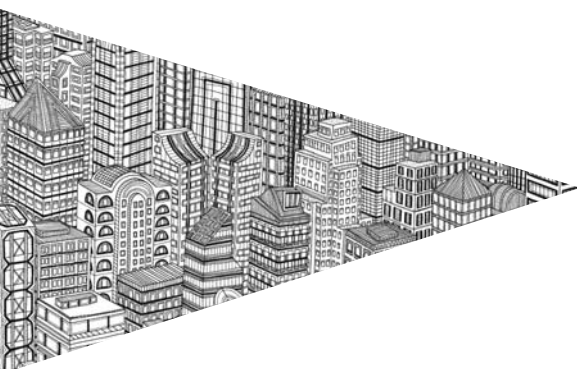


# International Tax Alert



## **HIRE Act signed by President Obama; major changes to US tax rules governing payments to non-US persons/entities**

### Executive summary

On 18 March 2010, President Obama signed into law the *Hiring Incentives to Restore Employment (HIRE) Act* (P.L. 111-147). One of the revenue offsets in the Act is a modified version of provisions from the *Foreign Account Tax Compliance Act of 2009* (S. 1934, H.R. 3933), commonly referred to as "FATCA." The FATCA rules contain, *inter alia*, the most substantial changes to the rules governing payments to non-US persons since the general revision to the withholding tax regulations came into effect in 2001, and will have far-reaching consequences for US persons who handle payments to non-US persons.

The significant provisions of FATCA as contained in the HIRE Act<sup>1</sup> comprise the following:

- ▶ 30% withholding on payments to "foreign financial institutions," including investment funds, of (i) US-source income, such as interest and dividends, and (ii) gross proceeds from the sale of securities that produce US-source interest or dividends, unless the recipient agrees with the IRS to disclose information about accountholders/investors who are US persons or US-owned foreign entities. This provision is effective as of 1 January 2013.

- ▶ 30% withholding (or lower treaty rate) on payments of substitute dividends with respect to US equity securities, and, in some cases, the portion of payments under swap contracts that relate to dividends with respect to US equity securities, unless, in either case, it can be shown that withholding took place upstream with respect to the payment. Notice 97-66<sup>2</sup> {insert link}, the current guidance on withholding tax from payments of substitute dividends to foreign persons, is superseded. This provision is effective for payments made on or after 180 days after date of enactment of the Act, *i.e.*, 14 September 2010; existing contracts are not grandfathered.
- ▶ 30% withholding on certain payments to non-financial foreign entities unless such entities disclose relevant US-owner information. This provision is effective as of 1 January 2013.
- ▶ Repeal of the ability of US borrowers to issue bearer debt into offshore markets, *e.g.*, under the “TEFRA D” rules. This provision is effective for obligations issued more than two years after the date of enactment of the Act, *i.e.*, 18 March 2012.
- ▶ Individuals must report on their tax returns information with respect to offshore financial interests of any kind where the aggregate value of such interests is greater than \$50,000. Failure to disclose could result in penalties of up to \$50,000. This provision is effective for tax years beginning after 18 March 2010, *i.e.*, for individuals using the calendar year as their tax year, 2011 and future years, but not 2010.
- ▶ US persons who are shareholders of passive foreign investment companies (PFICs) are required to file annual returns, under penalty of extension of the statute of limitations for the entire return until the missing information is provided. This provision is effective as of 18 March 2010.
- ▶ A 40% penalty for underpayments of tax attributable to any “undisclosed foreign financial asset understatements.” This provision is effective for tax years beginning after 18 March 2010.
- ▶ If one is required to, but does not, file information with respect to a foreign entity on Forms 926, 5471 or 8865, or under the new rules regarding foreign financial assets and PFICs discussed above, the statute of limitations for the entire return, and not just for deficiencies related to the omitted information, is suspended until the information is provided. This applies to both (a) returns filed after 18 March 2010, and (b) previously-filed returns if the statute of limitations (under prior law) was still open as of 18 March 2010.
- ▶ The statute of limitations is extended to six years for omissions of income in connection with a failure to comply with the new rules discussed above regarding specified foreign financial assets. This applies to both (a) returns filed after 18 March 2010, and (b) previously-filed returns if the statute of limitations (under prior law) was still open as of 18 March 2010.
- ▶ Financial institutions can be required to electronically file information returns (Forms 1042-S) reporting payments to foreign persons, even if such institutions file fewer than 250 returns annually. This requirement applies first to returns for 2010, due on 15 March 2011, and does not apply to returns for 2009, even if the due date for such 2009 returns has been extended past the date of enactment, *i.e.*, 18 March 2010.
- ▶ Finally, the rules and penalties with regard to foreign trusts are strengthened, including enactment of a \$10,000 minimum failure-to-file penalty for information returns with respect to certain transactions involving foreign trusts. Certain of these provisions apply to notices and returns required to be filed after 2009.

## Discussion

### Reporting and withholding on payments to “Foreign Financial Institutions”

New Sections 1471 through 1474 of the Code provide for imposition of withholding taxes in certain circumstances as a mechanism for requiring additional information with respect to certain foreign accounts.

Pursuant to Section 1471, a 30% withholding tax on any “withholdable payment” made to a “foreign financial institution” applies unless

the foreign financial institution agrees with the IRS to do all of the following:

- ▶ Obtain information from each holder of each account maintained by the institution as is necessary to determine which, if any, of such accounts are "United States accounts;"
- ▶ Comply with verification and due diligence procedures that the Treasury Secretary may require with respect to the identification of United States accounts;
- ▶ Report on an annual basis information regarding United States accounts maintained by the institution;
- ▶ Comply with requests by the Treasury Secretary for additional information with respect to any United States account;
- ▶ Attempt to obtain from each holder of a United States account a valid and effective waiver of foreign law that would otherwise prevent the reporting of the information described above, and, if such waiver is not obtained, to close such accounts, and
- ▶ Withhold (or request that an upstream payor withhold) a 30% tax on payments to (i) accounts held by persons who do not cooperate with requests for required information (recalcitrant account holders) and (ii) accounts held by other foreign financial institutions that have not entered into a similar agreement with the IRS, to the extent that

such payments are allocable to withholdable payments (passthrough payments).<sup>3</sup>

For this purpose, foreign financial institutions include, but are not limited to, banks, brokerages and investment funds. Furthermore, non-publicly-traded equity and debt interests in foreign financial institutions are deemed to be "accounts." Thus, for example, a foreign investment fund (unless an exception is available, including under special rules related to publicly traded interests) will be required to enter into the necessary agreement with the IRS in order to invest in US securities without a punitive tax cost.

"Withholdable payments" include US-source fixed or determinable annual or periodical (FDAP) income, e.g., US-source dividends, interest, rents, royalties, and payments for services performed inside the United States, as well as gross proceeds from the sale of assets that produce US-source interest and dividends.

In general, a United States account is an account maintained by a "specified United States person," defined as any US person excluding all of the following: (i) corporations the stock of which is regularly traded on an established securities market and their affiliates, (ii) tax-exempt entities, pension plans and IRAs, (iii) the United States, any possession, state, or political subdivision thereof, or any wholly-owned agency or instrumentality of the foregoing, (iv) banks, (v) real estate investment trusts (REITs), (vi)

regulated investment companies (RICs), (vii) bank common trust funds, (viii) charitable remainder trusts, and (ix) certain nonexempt charitable trusts. An account owned by a foreign entity that has a 10% owner that is a specified United States person is also a United States account. In addition, in the case of an investment fund that is treated as a "foreign financial institution," any interest (unless publicly traded) that is held by a foreign entity with any amount of ownership by a specified United States person is deemed to be a United States account. Such a foreign entity with the requisite ownership by a specified United States person is referred to as a "US-owned foreign entity." Note that financial institutions may, but need not, exclude all accounts held by individuals with a balance not in excess of \$50,000 from treatment as United States accounts.

The IRS has power to deem a foreign financial institution to meet these requirements if either (i) the institution both (a) has suitable procedures to ensure that it has no United States accounts and (b) takes prescribed measures with respect to accounts of other foreign financial institutions maintained by the foreign financial institution, or (ii) the institution is of a class of institutions that the IRS determines may be exempted from such requirements.

The information that the foreign financial institution must report on an annual basis with respect to United States accounts comprises all of the following:

- A. The identity of each holder of a United States account, including the name, address, and taxpayer identification number (TIN) of each account holder that is a "specified United States person," and, in the case of any account holder that is a "US-owned foreign entity," the name, address, and TIN of each substantial US owner of such entity;
- B. The account number;
- C. The account balance or value; and
- D. Unless otherwise provided by the Secretary, the gross receipts of and gross withdrawals or payments from the account.

The requirements described above apply with respect to United States accounts maintained by the foreign financial institution and each other foreign financial institution that is a member of the same "expanded affiliated group."

In lieu of this reporting, foreign financial institutions may elect to perform information reporting on Forms 1099-MISC, 1099-INT, 1099-DIV and 1099-B to the same extent as if they were US persons and each account holder that is a specified United States person or US-owned foreign entity were an individual US citizen.

These requirements are in addition to requirements foreign financial institutions must satisfy under the Qualified Intermediary (QI) program.

The rules described above do not apply to any payment if the beneficial owner of the payment is:

- ▶ A foreign government (or political subdivision, wholly-owned agency, or instrumentality);
- ▶ An international organization (or wholly-owned agency or instrumentality); or
- ▶ A foreign central bank of issue.

The Secretary is given wide powers to grant exemptions from these requirements for those persons, entities and transactions that are identified as posing a low risk of tax evasion.

If a 30% tax is withheld from a payment that is beneficially owned by a foreign financial institution, a refund will only be available under the terms of an income tax treaty.

These rules apply to payments made after 2012, but withholding is not be required for payments with respect to (or proceeds from the sale of) instruments that are outstanding two years after the date of enactment, *i.e.*, 18 March 2012.

#### **Withholding on payments with respect to securities loans and notional principal contracts**

Prior law, as set forth in Notice 97-66, provided the following rules for when a non-US person lends a US equity security to another person, and the borrower makes payments to the lender that correspond to dividend payments that the lender otherwise would have received (substitute or manufactured dividends). The borrower (US or foreign) was required to withhold US tax from a substitute dividend if, and to the extent that, an actual

payment to the lender would have been subject to a higher rate of US tax than an actual payment to the borrower. For example, suppose a foreign person who was not entitled to benefits under a US income tax treaty and was subject to a 30% withholding tax on dividends lent a US equity security to a second foreign person who also was not entitled to treaty benefits. Payments of substitute dividends from the borrower to the lender were exempt from tax (although possibly not reporting), because both the borrower and the lender would be subject to 30% withholding on dividends.

In addition, payments with respect to notional principal contracts (swaps), including total return swaps with respect to US securities, were deemed to be sourced at the residence of the recipient.<sup>4</sup> Treasury regulations further exempted payments pursuant to a notional principal contract paid to a foreign person that were not connected with a US trade or business from withholding tax and information reporting.<sup>5</sup> Thus, payments with respect to notional principal contracts would not be subject to withholding tax when paid to a foreign person.

The HIRE Act provides that substitute dividends with respect to US equity securities are subject to withholding tax just as if they were payments of dividends on such underlying securities. Relief will be available if, and to the extent that, it can be shown that such a

substitute payment already had been subjected to withholding by an upstream withholding agent. Thus, under the above example, payments of substitute dividends with respect to US equity securities between two foreign persons without US treaty benefits will be subject to a 30% tax, unless and to the extent that it can be shown that the payments previously had been subject to withholding by an upstream withholding agent.

The same rule applies to payments with respect to a “specified notional principal contract” that are contingent upon, or determined with reference to, dividends on US equity securities. For payments made up to two years after the date of enactment, i.e., 18 March 2012, “specified notional principal contracts” comprise all of the following:

- ▶ Notional principal contracts in which the underlying security is transferred between the two parties at either the commencement or the termination of the contract (crossing in or crossing out);
- ▶ Notional principal contracts with reference to a security that is not readily tradable on an established securities market;
- ▶ Notional principal contracts in which the underlying security is posted as collateral to the contract, and
- ▶ Any other contract identified by the IRS as a specified notional principal contract.

For payments more than two years after the date of enactment, i.e., after 18 March 2012, *all* notional principal contracts are treated as specified notional principal contracts and are subject to the above rules unless the IRS identifies them as of a type not having the potential for tax avoidance.

The withholding rules for payments with respect to “specified notional principal contracts” apply to any gross amount that references the dividends on US equity securities, even if the amount is ultimately used in computing a net amount which is actually transferred to or from the taxpayer. For example, a counterparty to a total return swap may be obligated to withhold and remit tax on the gross amount of a dividend-equivalent amount even though, as a result of a netting of payments due under the swap, the counterparty is not required to make an actual payment to the foreign investor.

These provisions apply to payments made on or after the date that is 180 days after the date of enactment, i.e., 14 September 2010. *Existing contracts are not grandfathered.*

### **Reporting and withholding on payments to “Non-Financial Foreign Entities”**

New Section 1472 requires US persons making payments of “withholdable payments” as defined above to a foreign person that is not a financial entity (a non-financial foreign entity) to obtain from the beneficial owner either:

- ▶ A certification that the beneficial owner of the payment does not have any substantial US owners, or
- ▶ The name, address and TIN of each substantial US owner from the beneficial owner.

The withholding agent is required to report this information to the IRS. If the withholding agent does not obtain such a certification or information, or knows or has reason to believe that it is false, then the withholding agent is required to withhold a 30% tax from the payment. These rules do not apply to any payment beneficially owned by any of the following:

- ▶ Publicly-traded corporations and related parties,
- ▶ Foreign governments and their political subdivisions and wholly-owned agencies and instrumentalities, and
- ▶ Foreign central banks of issue.

The IRS has wide powers to grant exemptions from these requirements for classes of payees and payments that pose low risks of tax evasion.

These provisions apply to payments made after 2012.

### **Repeal of ability of US persons to issue bearer bonds in foreign-targeted offerings**

Since 1982, US persons who issue bonds of a type offered to the public that are not in “registered” form have been subject to an excise tax and loss of the interest deduction. In addition, there are adverse consequences for US investors

holding such bearer bonds, and non-US investors are not eligible for the portfolio interest exemption for US withholding taxes. Until now, there was an exception for bonds in bearer form issued in foreign-targeted offerings under the “TEFRA C” and “TEFRA D” rules.

The ability to deduct interest on bearer bonds issued abroad and the portfolio interest exemption on such bonds are eliminated, effective for bonds issued more than two years after the date of enactment, *i.e.*, 18 March 2012.<sup>6</sup> Certain “dematerialized” securities will be deemed to be issued in registered form and thus will not be subject to this provision.<sup>7</sup> Thus, this portion of the HIRE Act is primarily relevant for issuers of bonds issued in the form of physical certificates with interest coupons, and such bonds are becoming less common.

### **Enhanced reporting of foreign financial assets**

The Hire Act adds new reporting rules for US holders of foreign financial assets, over and above the existing foreign bank account (FBAR) rules, which require reporting of financial interests in and signatory authority over foreign financial accounts on Form TD F 90-22.1.

Any US individual<sup>8</sup> who holds any interest in a “specified foreign financial asset” is required to report on the individual’s tax return certain information about the asset if the aggregate value of all such assets exceeds \$50,000.<sup>9</sup> The IRS has power to issue regulations extending

this rule to any US domestic entity that is formed or used to hold, directly or indirectly, specified foreign financial assets. Specified foreign financial assets comprise:

- ▶ Depository or custodial accounts with foreign financial institutions, and
- ▶ Any of the following, to the extent that they are not held in either (i) an account with a US financial institution or (ii) an account with a foreign financial institution that itself has been subject to reporting:
  - Stocks and bonds issued by foreign persons,
  - “Financial instruments or contracts held for investment” issued by a non-US person or having a non-US counterparty; and
  - “Any interest in a foreign entity.”

The information to be reported regarding each specified foreign financial asset comprises the following:

- ▶ In the case of any account, the name and address of the financial institution in which the account is maintained and the account number;
- ▶ In the case of any stock or security, the name and address of the issuer and other information necessary to determine its class or issue;
- ▶ In the case of any other instrument, contract, or interest, information necessary to identify it, and the names and addresses of all issuers and counterparties; and

- ▶ The maximum value of the asset during the taxable year.

The penalty for failure to disclose this information is \$10,000, absent reasonable cause. The existence of foreign civil or criminal penalties for disclosing such information is not an acceptable defense. In addition, if an individual does not disclose within a 90 day period after notification from the IRS of a failure to disclose, a \$10,000 penalty for each additional 30-day period of failure to disclose, up to a maximum of \$50,000, applies.

If an individual is determined to have such foreign assets and does not provide sufficient information to demonstrate their aggregate value, the aggregate value is deemed to exceed \$50,000 for purposes of the penalty.

The IRS has authority to grant exemptions from reporting for certain classes of assets, *e.g.*, to prevent duplicate reporting.

These provisions apply to taxable years beginning after 18 March 2010. It must be emphasized that these provisions are *in addition to*, and not in substitution for, the FBAR rules.

### **Reporting of interests in passive foreign investment companies**

Under prior law, the instructions to Form 8621 stated that certain US direct and indirect holders of interests in passive foreign investment companies (PFICs) were to report such interests on the form every year, but only in certain

specified situations. There was no specific statutory or regulatory requirement to do so. The HIRE Act provides that every US shareholder of a PFIC must file a report with respect to the PFIC every year, unless otherwise provided by the IRS. This provision is effective as 18 March 2010.

### **Penalties for underpayments attributable to undisclosed foreign financial assets**

A 40% penalty is imposed on any portion of an underpayment of tax attributable to any foreign financial asset that was required to be, but was not, disclosed by the taxpayer under either (i) the new rules set forth above regarding foreign financial assets (new Section 6038D), or (ii) existing law contained in Sections 6038, 6038B, 6046A, or 6048 (*i.e.*, on Forms 926, 5471, or 8865). An undisclosed foreign financial asset understatement is the portion of the understatement that is attributable to any transaction involving an undisclosed foreign financial asset.

This provision applies to taxable years beginning after 18 March 2010.

### **Extension of statute of limitations related to foreign assets**

There are two provisions extending the statute of limitations for tax deficiencies relating to foreign assets.

First, if one fails to report information about (i) foreign financial assets, under the new rules discussed above, (ii) PFICs, under the

new rules discussed above, or (iii) interests in and transfers to foreign entities that must be reported on Forms 826, 5471 or 8865 under current law, the statute of limitations with respect to the entire return will not begin to run until the missing information is provided. There is an existing rule that suspends the statute of limitation for failure to report information on Forms 926, 5471 or 8865 with respect to items not reported; the new provision extends the statute of limitations in such situations (as well as failure to report with respect to foreign financial assets or PFICs) to the entire return.

Second, the statute of limitations is extended from three years to six years for omissions from gross income of \$5,000 or more attributable to foreign financial assets that either (a) are required to be reported under the new rules discussed above or (b) would have been required to be reported if it were not for the \$50,000 minimum threshold or a regulatory exemption.

The provisions described above apply to returns filed after 18 March 2010, and to returns filed before that date if the statute of limitations for assessment of such taxes has not expired as of that date.

### **Filing Form 1042-S electronically**

Under prior law, the IRS did not have the power to require information returns, such as Forms 1042-S, to be filed electronically if the number to be filed during a calendar year did not exceed 250. The HIRE Act gives

the IRS authority to require financial institutions to file Form 1042-S electronically even if they file fewer than 250 returns during a calendar year.

Since Form 1042-S always is filed on a calendar-year basis and the returns for any year are due on March 15 of the following year, in effect this provision applies for returns with respect to 2010 and future years, but not for returns with respect to 2009, even if the due date for filing such 2009 returns has been extended.

### **Provisions related to foreign trusts** *Clarifications with respect to foreign trusts that are treated as having a US beneficiary*

Section 679(c)(1) is amended to provide that an amount is treated as accumulated for the benefit of a US person even if the US person's interest in a foreign trust is contingent on a future event. In addition, new Section 679(c)(4) provides that if any person has the discretion to make a distribution from a foreign trust to, or for the benefit of, any person, the trust is treated as having a beneficiary that is a US person unless the terms of the trust specifically identify the class of persons to whom the distributions may be made and none of those persons are US persons during the taxable year. Finally, new Section 679(c)(5) provides that if any US person who directly or indirectly transfers property to a foreign trust is directly or indirectly involved in any agreement or understanding that may result in the trust's income

or corpus being paid or accumulated for the benefit of a US person, the agreement or understanding will be treated as a term of the trust.

These provisions are effective as of 18 March 2010.

#### ***Presumption that foreign trust has a US beneficiary***

New Section 679(d) provides that if a US person directly or indirectly transfers property to a foreign trust, the trust will be presumed to have a US beneficiary unless the person submits such information to the Treasury Secretary as may be required with respect to the transfer and demonstrates that the trust satisfies the requirements of Section 679(c)(1)(A) and (B).

This provision applies to transfers of property made after 18 March 2010.

#### ***Uncompensated use of trust property treated as a distribution***

New Section 679(c)(6) provides that any loan of cash or marketable securities (or the use of any other trust property) directly or indirectly to or by any US grantor or beneficiary (or related person) is treated as a distribution to the US grantor or beneficiary, unless the US person repays the loan at a market rate of interest (or pays the fair market value of the use of the property) within a reasonable period of time. A similar provision is included in the definitional rules of Section 643(i).

These provisions apply to loans made, and uses of property after 18 March 2010.

#### ***Reporting requirement for US owners of foreign trusts***

New Section 6048(b)(1) requires that any US person who is treated as an owner of a foreign trust under the grantor trust rules of Sections 671-679 must submit information with respect to the foreign trust for the taxable year as may be prescribed by the Treasury Secretary. This is an expansion of the prior-law rule that such a US owner must ensure that the foreign trust provides certain information.

This provision applies to taxable years beginning after 18 March 2010.

#### ***Minimum penalty with respect to failure to report on certain foreign trusts***

Under existing law, US persons must file reports with respect to transfers to and distributions from foreign trusts, and cause foreign trusts of which they are treated as owners (in whole or in part) under the grantor trust rules to file reports. The penalties for failure to do so are based on varying percentages of the amount of the contribution or distribution or the portion of the trust treated as owned by the US person, as the case may be (the gross reportable amount). The HIRE Act provides a minimum penalty of \$10,000 for such failures, but not to exceed the gross reportable amount.

These provisions apply to notices and returns required to be filed after 31 December 2009.

## **Implications**

The new rules on reporting payments to foreign financial entities and other foreign persons will require major changes to systems and procedures. The effective date of 1 January 2013, therefore is not as far away as it may seem at first blush. Importantly, Treasury and the IRS will need to provide substantial amounts of guidance regarding the implementation of the new regime. Those affected will need to monitor the guidance process very carefully and should consider getting actively involved in working with Treasury and IRS as they address the details that need to be fleshed out. Foreign financial institutions and other withholding agents will need to begin to develop plans for extensive changes to their systems and procedures even while the further guidance is still in process.

Many foreign financial institutions will choose to enter into the new agreement with the IRS that is contemplated by these provisions. It will be important to monitor developments as Treasury and the IRS work to craft the form of this agreement. Affected institutions then will need to follow the procedures to be established for executing such an agreement prior to the effective date of the new withholding/information reporting obligations.

The rules relating to withholding tax from substitute dividends and notional principal contracts require

immediate attention from affected parties, since the effective date is 180 days from enactment, *i.e.*, 14 September 2010.

The rules suspending the statute of limitations with respect to the entire return if there is any failure to make disclosures of foreign assets or interests make it more important

than ever that taxpayers take care to make *all* required disclosures - especially given the heightened importance of statutes of limitations in making financial statement disclosures under FIN 48.

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## Endnotes

1. Note that the Act as enacted does not include a provision that had been contained in the earliest versions of FATCA that would have required certain "material advisors" who assist in the acquisition or formation by a US person of a foreign entity to file a new disclosure providing certain information about the entity and its owners.
2. 1997-2 C.B. 328.
3. The IRS is authorized to require that an institution have no more than a certain level of accounts held by recalcitrant account holders or foreign financial institutions without the necessary IRS agreement.
4. Treas. Reg. Section 1.863-7.
5. Treas. Reg. Section 1.1441-4(a)(3).
6. The exception from the excise tax is not eliminated.
7. See Notice 2006-99, 2006-2 C.B. 907.
8. The IRS is directed to issue regulations exempting nonresident aliens.
9. The IRS has the power to raise this minimum threshold.

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