

New U.S. Tax Reporting Requirements Affect Foreign Issuers

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Client Advisory

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New U.S. tax rules requiring corporate issuers to provide stockholders with information about the cost basis of their shares are creating headaches for domestic corporations, but the burden is substantially more serious for foreign issuers with U.S. shareholders. Effective January 1, 2011, any issuer of stock^[1] must file a return with the Internal Revenue Service, and must issue statements to stockholders, when it takes any organizational action that affects the basis of its stock. The rule applies to all private and public issuers with one or more U.S. shareholders, whether the issuer is foreign or domestic, and regardless of whether their shares are listed on a U.S. exchange. The rules are designed to allow such stockholders (and the IRS) to more easily calculate the tax basis of their shares. Unfortunately, there may be a significant compliance cost for foreign issuers.

Basis is one of the fundamental concepts in U.S. taxation. It represents the holder's "investment" (for tax purposes) in property. The starting point for determining a taxpayer's basis in an asset is generally the cost of the asset. If a taxpayer purchases a share of stock for \$50, his basis—initially, at least—will be \$50, and if he later sells it for \$65 he will be taxed on \$15 of gain. However, certain corporate reorganizations can cause an adjustment to the taxpayer's basis in the stock. For instance, if there is a stock dividend, the taxpayer's initial basis will be apportioned to the shares received.

Of greater concern to foreign issuers, however, is the potential effect on basis of cash dividends on stock. Under the Internal Revenue Code, a cash dividend is taxable as such only to the extent of the issuer's "earnings and profits" (or "E&P"). A distribution that is not out of E&P is not taxable but results in a downward adjustment of basis. E&P is a technical tax accounting concept, with no application outside of U.S. tax law. Accordingly, until now many foreign issuers have not kept track of their E&P. Because of the new rules, however, they will apparently be required to do so going forward. Unfortunately, this would include a historical U.S. tax accounting analysis of the issuer's financial results, as well as ongoing annual updates. An accounting firm with U.S. tax capability will likely need to be retained. Alternatively, an issuer might conclude on the basis of a more cursory review that it is highly likely that distributions have exceeded E&P, and on that basis forgo a more formal "E&P Study."

Issuers that conclude that there has been an action affecting U.S. tax basis may comply with the reporting requirements through either of two methods. First, they may issue two statements: one, to the IRS, generally within 45 days of the corporate action giving rise to the adjustment, and another to each stockholder (or registered owner) by January 15 of the year following the calendar year of the organizational action. However, the IRS has not yet developed the form issuers are required to provide it. In light of this, the IRS has waived the requirement that corporate actions undertaken in 2011 be reported to the IRS within 45 days—instead, reports to shareholders and the IRS are both due on January 17, 2012. (Further, since E&P cannot be determined until the end of the issuer's fiscal year, the IRS will presumably issue additional guidance regarding dividends.)

The statements themselves are not particularly complicated. Issuers are required to report:

- a. the issuer's name and U.S. taxpayer identification number, if it has one,
- b. a description of the reportable transaction, including its effective date,
- c. identification of each security the basis of which is affected by the event, including CUSIP, classification of each security, issuer's account number, security's serial number, ticker symbol, and class,
- d. the general quantitative effect on the basis of each security affected by the reportable event, including any supporting documents, and
- e. contact information for a person at the issuer.

As an alternative to issuing the statements to the IRS and shareholders, the issuer can opt to post the required information in a readily accessible format in an area of its primary public website dedicated to this purpose, provided that the filing deadlines described above are met and that the information will remain accessible to the public for ten years from the date of its posting. This alternative appears much less burdensome, but further guidance from the IRS will be necessary to establish how much information must be contained in these public reports.

Failure to comply with the new rules can result in severe penalties. Fines can range from \$100 to a total of \$3,000,000 for each transaction not properly reported. Additional penalties could be imposed if the failure to report was intentional.

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Endnote

[1] §6045B applies to "specified securities," which, in addition to stock, include bonds, notes, debentures, and other instruments that may be so designated by the Secretary of the Treasury. However, until the end of 2012 the reporting rules relate only to stock and securities treated as stock for U.S. purposes; this advisory therefore refers only to stock.

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