SULLIVAN & CROMWELL LLP

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FATCA: Proposed Regulations

IRS and Treasury Department Release Proposed FATCA Regulations

SUMMARY

On February 8, 2012, the IRS and Treasury Department issued proposed regulations (the "Proposed Regulations") under the foreign account tax compliance ("FATCA") provisions of the Internal Revenue Code. The Proposed Regulations provide significant detail regarding how the IRS and Treasury Department expect to implement FATCA, and appear intended—to the extent possible—to coordinate FATCA withholding and information reporting with the current rules requiring withholding on U.S.-source income paid to nonresident aliens and information reporting on U.S. persons. Highlights of the Proposed Regulations include proposals to:

- Extend the deadline for issuing obligations that are "grandfathered" from withholding under FATCA from March 18, 2012 to December 31, 2012;
- Postpone withholding on foreign-source "passthru payments" until at least January 1, 2017;
- Treat certain insurance companies as "financial institutions" for FATCA purposes, and treat both cash-value life insurance contracts and annuity contracts as "financial accounts";
- Expand the categories of institutions that may register or certify as "deemed-compliant" under FATCA;
- Provide temporary relief for Foreign Financial Institutions ("FFIs") that have affiliates that are subject to local laws that conflict with the reporting and withholding required by FATCA; and
- Revise the account identification and due diligence steps that are required of FFIs that agree to report information on their U.S. account holders to the IRS (such FFIs, "Participating FFIs"). Significantly, the Proposed Regulations provide that certain accounts existing as of the date of a Participating FFI's agreement with the IRS (such an agreement, an "FFI Agreement") may be subjected to more limited due diligence than "new" accounts, and do not include the earlier proposal to subject "private banking" accounts to heightened scrutiny.

The Proposed Regulations do not include a draft FFI Agreement. The preamble to the Proposed Regulations indicates that the IRS intends for a draft agreement to be published in "early 2012" and for the agreement to be finalized in the autumn of 2012.

In a related development, on February 8, 2012, the Treasury Department issued a joint statement (the "Joint Statement") with five European countries. The Joint Statement outlines the commitment of the IRS and the other signatories to pursue an intergovernmental approach to FATCA implementation and provides a possible framework for bilateral information-sharing agreements with countries that agree to become "FATCA Partners".

This publication provides an introduction to the Proposed Regulations and expands on the aspects of the Proposed Regulations that differ from earlier guidance. Sullivan & Cromwell LLP expects to release a more detailed memorandum, which will provide an in-depth discussion of the mechanics of the implementation of FATCA under the Proposed Regulations, in the future.

BACKGROUND

FATCA was enacted on March 18, 2010, as a section of the "Hiring Incentives to Restore Employment Act". The provisions that comprise FATCA were colloquially so named because they were previously introduced as the "Foreign Account Tax Compliance Act".

FATCA is intended to reduce the evasion of U.S. tax by U.S. citizens and residents who hold offshore assets. To accomplish this objective, FATCA encourages: (i) FFIs to sign agreements to report information on their U.S. account holders to the IRS and (ii) other foreign entities to provide information regarding their beneficial owners to U.S. withholding agents, including Participating FFIs. If entities do not comply, FATCA requires withholding agents to collect a 30% withholding tax on payments of U.S.-source "withholdable payments" made to these entities. FATCA also requires Participating FFIs to withhold on "passthru payments" (which, as discussed below, include both "withholdable payments" and certain non-U.S. source payments) made to "recalcitrant account holders" and to FFIs that do not sign an FFI agreement with the IRS (such FFIs, "Nonparticipating FFIs").

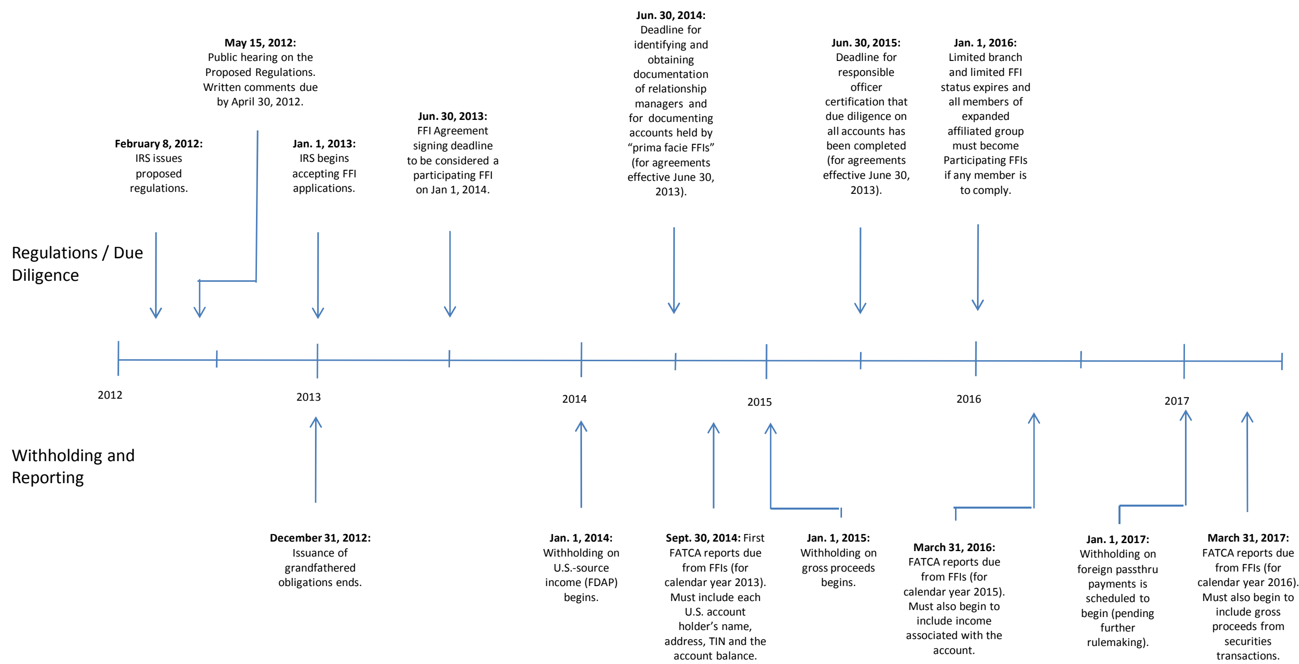
The IRS released preliminary FATCA guidance in the form of three Notices (Notice 2010-60 in August 2010, Notice 2011-34 in April 2011, and Notice 2011-53 in July 2011 (collectively, the "FATCA Notices")).[1] The Proposed Regulations are generally consistent with the preliminary guidance set forth in the FATCA Notices, but further develop key areas and revise certain proposals made in the FATCA Notices. The Preamble to the Proposed Regulations states that the IRS has made these refinements in response to comments received regarding the FATCA Notices.

1 A discussion of the three FATCA Notices can be found in the Sullivan & Cromwell LLP publications entitled "IRS Releases Preliminary Guidance on the FATCA Provisions of the Hire Act" (September 13, 2010), "Supplemental Notice Provides Additional Guidance on the Information Reporting and Withholding Rules for Foreign Financial Institutions" (April 14, 2011), "IRS and Treasury Department Propose 'Phase-In' of FATCA Requirements" (July 15, 2011), and "IRS Clarifies that Withholding on Payments Made to NFFEs Will Commence at the Same Time as Withholding on Payments Made to Nonparticipating FFIs" (July 26, 2011), which can be obtained by following the instructions at the end of this publication.

THE PROPOSED REGULATIONS

A. TIMELINE FOR IMPLEMENTATION

The Proposed Regulations and the FATCA Notices provide a schedule for the implementation of FATCA, which will be phased in beginning with the deadline for issuing "grandfathered obligations" and the opening of the FFI electronic registration system. The following timeline illustrates this schedule:



As illustrated above, the obligations that Participating FFIs will have under FATCA will increase over time. Notice 2011-53 stated that FFI Agreements will need to be signed by June 30, 2013 for FFIs to be considered Participating FFIs on January 1, 2014 (when the first FATCA withholding will begin), and the Proposed Regulations do not suggest an intent to modify this deadline. Consistent with Notice 2011-53, the Proposed Regulations provide that the first FATCA reports by FFIs to the IRS will be due on September 30, 2014. In general, FATCA reports will thereafter be due on or before March 31 of each subsequent year.

B. GRANDFATHERED OBLIGATIONS

1. Extended Grandfather Deadline

FATCA includes a "grandfather" provision that exempts from FATCA withholding any "obligation" outstanding on March 18, 2012. The Proposed Regulations expand the scope of this provision to any payment made under, or gross proceeds from the disposition of, an obligation outstanding on January 1, 2013. Under the Proposed Regulations, an obligation is “outstanding” on January 1, 2013 if: (i) in the case of an obligation characterized as indebtedness for U.S. federal income tax purposes, it has an issue date that is before January 1, 2013 and (ii) in the case of any other obligation, a legally binding agreement establishing the obligation was executed between the parties to the agreement before January 1, 2013. On account of this definition, an obligation will (with the potential exception of certain debt instruments that are issued on or after January 1, 2013, but are treated as having an earlier “issue date”) need to be issued no later than December 31, 2012 to be grandfathered.

A possible exception to the December 31, 2012 date may exist with respect to certain debt instruments. Debt instruments that are issued within a 13-day period may, at times, be treated as part of the same “issue” and as having the same “issue date”. In addition, the original issue discount (“OID”) regulations provide that debt obligations issued in a “qualified reopening” have the same “issue price” and “issue date” as the original bonds. Qualified reopenings of “publicly traded” debt securities issued with *de minimis* OID can continue indefinitely, so long as the additional bonds are also issued with no more than a *de minimis* amount of OID. It is not clear whether the IRS and Treasury Department intend for the Proposed Regulations to grandfather such “additional” debt obligations if they are first sold to the public after December 31, 2012.

2. “Obligation” Defined

FATCA and its legislative history do not define the term “obligation”. Notice 2011-53 provided that the term “obligation” generally would mean any legal agreement that produces or could produce passthru payments, but subject to the proviso that instruments treated as equity for U.S. tax purposes, as well as agreements that lack a definitive expiration or term, would not be “obligations” subject to grandfathering. The Proposed Regulations generally adopt this definition, but add additional specific exclusions and examples of agreements that are “obligations”.

In particular, the Proposed Regulations provide that the following are not “obligations” that can benefit from grandfathering: (i) brokerage agreements, custodial agreements, or other similar agreements to hold financial assets for the accounts of others that require the payment of income with respect to those assets, and (ii) master agreements (like ISDA Master Agreements for swaps) that set forth general or standard terms to apply to a series of transactions without specific terms for a particular contract.

The Proposed Regulations set forth the following as examples of agreements that can constitute “obligations”:

- debt instruments, as defined under the Code (for example, a bond, guaranteed investment certificate, or term deposit);[2]

[2] The Proposed Regulations define debt instrument by reference to Section 1275(a)(1) of the Code which defines debt instrument for purposes of the “original issue discount” rules.

- binding agreements to extend credit for a fixed term (such as revolving credit facilities), if the material terms under which credit will be provided are fixed;
- life insurance contracts that are payable upon either death or attaining a specific age;
- term certain (i.e., fixed-term) annuity contracts; and
- derivatives transactions, if entered into between counterparties under an ISDA Master Agreement, evidenced by a confirmation.[3]

A material modification[4] of a debt instrument after December 31, 2012 will cause that instrument to be treated as newly issued or executed on the date of the modification, and payments made pursuant to the obligation after the modification will be subject to withholding under FATCA.

Although not included in the Proposed Regulations, the IRS and Treasury Department are considering (and seeking further comment with respect to) whether certain self-liquidating equity interests in securitization vehicles should be treated as "obligations" that may be grandfathered.[5]

C. DEFINITIONS

The Proposed Regulations provide new guidance regarding many of the defined terms that will govern how FATCA is implemented.

1. Financial Accounts, U.S. Accounts and Specified U.S. Persons

The FATCA Code Sections define a "financial account" as, with respect to any financial institution: "(i) any depository account maintained by such financial institution, (ii) any custodial account maintained by such financial institution, and (iii) any equity or debt interest in such financial institution (other than interests which are regularly traded on an established securities market)".

The provisions of the Proposed Regulations expand the definition of "financial account" by adding a fourth type of "financial account": any cash value insurance contract or annuity contract issued by a "financial institution".

However, the Proposed Regulations also restrict the definition of financial account by providing that a debt (other than a deposit) or equity interest in an FFI that is a bank, broker-dealer or custodian will generally not be a "financial account", even if it is not regularly traded on an established securities market. Equity or debt interests in banks, brokerage firms, and insurance companies are financial accounts if "the value of the debt or equity interest is determined, directly or indirectly, primarily by reference to assets

3 Note, however, that an ISDA Master Agreement alone is not an "obligation" for this purpose.

4 For obligations that are treated as debt for U.S. federal income tax purposes, the Proposed Regulations rely on the definition of material modification under Section 1.1001-3 of the Regulations, which sets forth the conditions on which a debt will be treated as exchanged. For other obligations, whether a "material modification" has occurred will, under the Proposed Regulations, be determined by reference to all relevant facts and circumstances.

5 Section XIX.G of the Preamble to the Proposed Regulations.

that give rise to withholdable payments". The Proposed Regulations also exclude certain accounts from the definition of a "financial account", including certain retirement and pension plans and regulated savings plans that are limited both as to the amount that can be contributed and as to the access a holder has to the funds in the account.[6]

Equity and debt interests in an investment vehicle (and when relevant, in other financial institutions) are also excluded from the definition of financial account if they are "regularly traded on an established securities market". The Proposed Regulations define debt or equity interests that are regularly traded as interests where (i) trades in the interests are effected (other than in *de minimis* quantities) on an established securities market on at least 60 days during the prior calendar year, and (ii) the aggregate number of such interests that were traded on an established securities market during the prior calendar year was at least 10% of the average number of interests outstanding during the prior calendar year.[7] For these purposes, "established securities market" is defined broadly to include most national exchanges.[8] The Proposed Regulations do not address interests that lack a trading history on which to base this determination (such as newly issued debt or equity interests).

2. U.S. Account

Under the FATCA Code provisions, a "U.S. Account" is any financial account held by one or more "Specified U.S. Persons" or "U.S.-Owned Foreign Entities" (both as defined below), except for depository accounts held solely by U.S. individuals if the aggregate value of all depository accounts held by that individual in the same financial institution does not exceed $50,000 (unless the FFI elects not to exclude these accounts). Pursuant to the Proposed Regulations, the "Holder" of a U.S. Account is the person or entity listed or identified as the Holder with the FFI, and flow-through entities can be listed as the Holder. The flow-through entity's owners or beneficiaries are generally not Holders except in the case of some grantor trusts and accounts held by agents.

With respect to insurance contracts that are financial accounts, the Holder is generally the person who can access the cash value of the contract or change a beneficiary under the contract. If the contract holder cannot access the cash value of the contract or change a beneficiary, then each beneficiary is treated as a Holder of the contract for FATCA purposes. When the obligation to pay under the contract becomes fixed, the beneficiary of that payment is the Holder.

6 However, the Proposed Regulations state that for the purposes of reporting foreign financial accounts under Section 6038D, these retirement, pension, and savings accounts are not excluded and may be subject to reporting as specified foreign financial assets on Form 8938.

7 Proposed Regulations § 1.1471-5(b)(3)(iv).

8 Proposed Regulations § 1.1472-1(c)(1)(i)(C).

a. Specified U.S. Person

The Proposed Regulations generally track the statutory definition of “Specified U.S. Person”. Specified U.S. Persons under the Proposed Regulations thus include any U.S. persons that are not in an exempted class. Consistent with the statutory exemptions, the Proposed Regulations provide that publicly traded corporations (and other members of a publicly traded corporation’s expanded affiliated group), tax-exempt organizations, individual retirement plans, U.S. governmental units, banks, real estate investment trusts, regulated investment companies, common trust funds, and certain tax-exempt trusts will not be “Specified U.S. Persons”. In addition (and newly), the Proposed Regulations exempt from the definition of “Specified U.S. Person” both: (i) brokers that are required to furnish information returns regarding their customers to the IRS[9] and (ii) dealers in securities, commodities and derivatives that are registered under federal or U.S. state law.

b. U.S.-Owned Foreign Entity

Under FATCA, the term “U.S.-Owned Foreign Entity” includes any foreign entity which has one or more “Substantial U.S. Owners,” which generally include Specified U.S. Persons with greater than 10% direct or indirect interest in a non-U.S. entity.[10] However, a “special rule for investment vehicles” treats a Specified U.S. Person with any interest in an entity that is primarily engaged in investment activities as a Substantial U.S. Owner.

The Proposed Regulations elaborate upon these definitions and provide a draft set of rules for determining indirect ownership in this context. Significantly, the Proposed Regulations provide that for the purpose of determining whether an entity has Substantial U.S. Owners, the owner of an option to acquire stock, a partnership interest or a beneficial interest in a trust will be treated as owning the asset underlying the option. The Proposed Regulations also state that “Owner-Documented FFIs”, which are discussed in more detail below, with one or more Specified U.S. Persons as owners will be treated as U.S.-Owned Foreign Entities.

3. Foreign Financial Institutions

Under FATCA, an FFI is defined as any “financial institution” which is a foreign entity, although financial institutions organized under the laws of any U.S. possession are generally not treated as FFIs. The Code lists three types of “financial institutions”, which roughly correspond to banks, entities with custodial functions (including broker-dealers), and investment vehicles. The Proposed Regulations add detail to this definition,[11] and consistent with FATCA’s legislative history, include insurance companies that issue

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[9] *See* Section 6045 and Treasury Regulations § 1.6045-1.

[10] For FATCA purposes, a “foreign entity” is any entity that is not a U.S. person, including a territory entity. An “entity” is any person other than an individual.

[11] Specifically, the Proposed Regulations state that the following are FFIs:

investment-type insurance contracts or annuity contracts under which the entities are required to make payments with respect to a financial account.

The Proposed Regulations, in a manner that is generally consistent with the FATCA Notices, also provide certain exclusions from the definition of an FFI. These include: (i) certain nonfinancial holding companies; (ii) certain startup companies; (iii) nonfinancial entities that are liquidating or emerging from reorganization or bankruptcy; (iv) hedging or financing centers of a nonfinancial group; and (v) certain not-for-profit entities.[12]

4. Affiliated Groups

Notice 2011-34 stated that each FFI that is a member of an Expanded Affiliated Group must be a participating FFI (or be deemed-compliant) in order for any member of the Expanded Affiliated Group to become a Participating FFI.

The Preamble to the Proposed Regulations observes that local law restrictions may limit the ability of certain FFIs to become participating FFIs. The Proposed Regulations therefore provide a transition period during which the existence of a Nonparticipating FFI affiliate in a jurisdiction that prohibits reporting, closing, transferring, blocking or withholding will not impair the ability of other members in an

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Entities engaged in a banking or similar business: "an entity is considered to be engaged in a banking or similar business if, in the ordinary course of its business with customers, the entity engages in one or more of the following activities –

A. Accepts deposits of funds;
B. Makes personal, mortgage, industrial or other loans;
C. Purchases, sells, discounts or negotiates accounts receivable, installment obligations, notes, drafts, checks, bills of exchange, acceptances or other evidences of indebtedness;
D. Issues letters of credit and negotiates drafts drawn thereunder;
E. Provides trust or fiduciary services;
F. Finances foreign exchange transactions;
G. Enters into, purchases, or disposes of finance leases or leased assets; or
H. Provides charge and credit card services".

Entities holding financial assets as a substantial portion of its business: "an entity holds financial assets for the account of others as a substantial portion of its business if the entity's gross income attributable to the holding of financial assets and related financial services equals or exceeds 20 percent of the entity's gross income during the shorter of –

A. The three-year period ending on December 31 of the year in which the determination is made; or
B. The period during which the entity has been in existence".

Entities in the business of investing, reinvesting and trading: "an entity is engaged primarily in the business of investing, reinvesting, or trading if the entity's gross income attributable to such activities equals or exceeds 50 percent of the entity's gross income during the shorter of –

A. The three-year period ending on December 31 of the year in which the determination is made; or
B. The period during which the entity has been in existence".

Any insurance company (or the holding company of an insurance company) that issues or is obligated to make payments with respect to a "financial account" as defined above.

[12] As described in Code Section 501(c).

Expanded Affiliated Group to become Participating FFIs. Such nonparticipating FFIs ("Limited FFIs") will be required to register with the IRS and agree to perform due diligence to identify U.S. accounts and agree not to open accounts that are treated as "U.S. Accounts" or are held by Nonparticipating FFIs. Limited FFIs will be subject to withholding as Nonparticipating FFIs. Similar rules will also apply to branches of FFIs that operate in jurisdictions with local laws that conflict with FATCA (such branches, "Limited Branches"). The grace period for Limited FFIs and Limited Branches will expire on January 1, 2016, however, and from that date, an FFI cannot be a participating FFI unless every branch of every FFI in its expanded affiliated group complies with FATCA.

D. RULES FOR QUALIFIED INTERMEDIARIES, FOREIGN WITHHOLDING PARTNERSHIPS AND FOREIGN WITHHOLDING TRUSTS

Notice 2011-34 made clear that every qualified intermediary ("QI"), withholding partnership ("WP") and withholding trust ("WT"), whose withholding agreements are currently covered by the nonresident alien withholding provisions of the Code, will be required to become a Participating FFI (or, where applicable, a deemed-compliant FFI). The Proposed Regulations further this requirement, and the Preamble states that the current nonresident alien withholding agreements will be amended to conform to the FATCA withholding requirements.

Transition rules for the new withholding agreements for QIs, WPs and WTs will be forthcoming. The Preamble states that the IRS and Treasury Department are seeking comments as to whether such QIs, WPs and WTs should be allowed to follow the same internal verification procedures as other FFIs, instead of following the current rule, which provides that they must verify their status through an external audit.

E. DEEMED COMPLIANCE

The Proposed Regulations expand upon the previously announced categories of FFIs that will be "deemed-compliant" with FATCA, and provide for two general types of deemed-compliant FFIs: Registered Deemed-Compliant FFIs and Certified Deemed-Compliant FFIs.

1. Registered Deemed-Compliant FFIs

To qualify as a Registered Deemed-Compliant FFI, an FFI will be required to register with the IRS and certify that certain procedural requirements will be followed. This certification will need to be renewed every three years, or more frequently if there is a change in the FFI's circumstances. Under the Proposed Regulations, the following classes of FFIs will be eligible to become Registered Deemed-Compliant FFIs:

- Local FFIs;
    - To qualify, an FFI must have no fixed place of business outside its country of organization; in addition, the FFI cannot solicit outside its jurisdiction of organization, 98% of the FFI's account holders must be residents of the country in which it is organized, it must have policies and procedures in place to ensure that it does not open or maintain accounts for Specified U.S. Persons that are not residents of its country of organization, for

nonparticipating FFIs or for entities controlled or beneficially owned by Specified U.S. Persons, and certain other requirements must be met.

- Nonreporting members of participating FFI groups;
    - To qualify, an FFI must review its preexisting accounts and transfer all preexisting accounts that are identified as U.S. accounts to another member of its expanded affiliated group. It must also ensure that, for new accounts and for existing accounts with changed circumstances, there are policies and procedures in place to identify whether any of these accounts are or become U.S. accounts and to transfer them to another member of the affiliated group within 90 days.
- Qualified Collective Investment Vehicles;
    - To qualify, an FFI must be an investment vehicle and regulated as such by its country of incorporation or organization, and all of the FFI's direct holders must be Participating FFIs, Deemed-Compliant FFIs or exempt beneficial owners.
- Restricted Funds;
    - To qualify, an FFI must be an investment vehicle incorporated or organized in an FATF-compliant jurisdiction[13] and be regulated as an investment fund by its country of incorporation or organization; interests in the fund may be sold only through compliant distributors; it must have distribution agreements in place that prohibit sales of interests to U.S. persons, Nonparticipating FFIs and passive non-financial foreign entities with one or more substantial U.S. owners (other than interests distributed by and held through a Participating FFI); and it must comply with various account identification and account redemption rules.
- FFIs that comply with the FATCA requirements under an agreement between the United States and the jurisdiction in which the FFI is located.

2. Certified Deemed-Compliant FFIs

Certified Deemed-Compliant FFIs will not be required to register with the IRS but will be required to certify to a withholding agent on a Form W-8 that they meet the applicable requirements. The Proposed Regulations indicate that Certified Deemed-Complaint FFIs are expected to include the following:

- Nonregistering Local Banks;
    - These are FFIs that provide basic banking services only, with a balance sheet below a specified threshold ($175 million on the bank's balance sheet, $500 million on the combined balance sheet of its entire expanded affiliated group).
- Retirement Plans;
    - These are FFIs that must be organized for providing retirement or pension benefits, and are subject to certain limitations.
- Non-Profit Organizations;

[13] The "FATF" is the Financial Action Task Force, an intergovernmental body that develops anti-money laundering policies. A jurisdiction is "FATF-compliant" if it (i) is not subject to an FATF call on its members and other jurisdictions to apply counter-measures to protect the international financial system from the ongoing and substantial money laundering and terrorist financing (ML/TF) risks emanating from the jurisdiction; (ii) is not a jurisdiction with strategic AML/CFT deficiencies that has not made sufficient progress in addressing the deficiencies; and (iii) is not a jurisdiction with strategic AML/CFT deficiencies, irrespective of whether the jurisdiction has agreed upon an action plan with the FATF.

- These are FFIs that are tax-exempt in their country of origin, and that are subject to safeguards that prevent private inurement or ownership.

- FFIs with Only Low Value Accounts;
    - These are FFIs that must be a bank or broker in which no account has a value in excess of $50,000, and the entire expanded affiliated group must have no more than $50 million in assets.
- Owner-Documented FFIs;
    - "Owner-Documented FFIs"—unlike the other certified deemed-compliant FFIs above—may only be certified deemed-compliant with respect to a specific withholding agent, which must be a U.S. financial institution or a participating FFI. An Owner-Documented FFI will be required to provide its designated withholding agent with all due diligence documentation required by the IRS under the Proposed Regulations, and the withholding agent will need to agree to report to the IRS all information required to be reported under the Proposed Regulations on behalf of the Owner-Documented FFI.[14] In addition, the FFI must be an investment company and may not be affiliated with any other FFI that is not an investment company. Owner-Documented FFIs will also be prohibited from maintaining financial accounts for any nonparticipating FFIs (or issuing debt which constitutes a financial account to any person in excess of $50,000).

F. PARTICIPATING FFIs

1. FFI Agreements

The Preamble states that a draft FFI Agreement will be made available during early 2012 and that the IRS and Treasury Department intend to finalize the required FFI Agreement in the autumn of 2012. As discussed above, according to Notice 2011-53, an FFI will be required to sign an FFI Agreement with the IRS by June 30, 2013 to be considered a Participating FFI in January 2014, when FATCA withholding will commence.

2. Due Diligence

The Proposed Regulations modify the due diligence that Participating FFIs will be required to conduct on "financial accounts", a topic that was a significant focus of the FATCA Notices. A more comprehensive discussion of the due diligence procedures that Participating FFIs will be required to undertake will be included in a subsequent Sullivan & Cromwell LLP publication. However, key changes made to the due diligence procedures that were prescribed by the FATCA Notices include the following:

- The Preamble explicitly states that if a Participating FFI complies with its FFI Agreement, it will not be held to a "strict liability" standard for failure to identify a U.S. Account;
- For pre-existing individual accounts (accounts opened before an FFI agreement is signed with the IRS), FFIs will be permitted to rely on an electronic review of their records to identify U.S. Accounts. For accounts that exceed $1 million, FFIs will be required to conduct a manual review, unless the FFI's electronic search capabilities meet certain requirements;

14 The required documentation is listed in Prop. Treas. Reg. § 1.1471-3(d)(7), and generally requires the Owner-Documented FFI to identify and provide documentation with respect to all owners of the Owner-Documented FFI.

- Pre-existing accounts that are below the "low-value" threshold ($50,000 in the case of individual accounts, $250,000 in the case of cash-value life insurance policies, annuities and entity accounts) need not be treated as U.S. Accounts for FATCA reporting purposes, unless the accounts are not depository accounts and were previously identified as being held by a U.S. person, and, in the case of entity accounts, need not be treated as being held by a non-Participating FFI;
- Pre-existing accounts that are initially below the "low-value" threshold ($50,000 in the case of individual deposit accounts, $250,000 in the case of cash-value insurance policies, annuities and entity accounts) and were not treated as U.S. Accounts will not be subject to an additional review unless the account balance exceeds $1 million;
- The Proposed Regulations do away with the FATCA Notice proposal to require enhanced scrutiny for "private banking" accounts, but retain additional requirements for accounts with a balance exceeding $1 million. Specifically, the Proposed Regulations retain a requirement (previously included in the "private banking" proposal) that FFIs identify any relationship manager associated with such a "high value" account and determine whether the relationship manager has actual knowledge that the account holder is a U.S. person;[15]
- The Proposed Regulations modify the due diligence steps to require Participating FFIs to identify entity accounts held by certain "*prima facie*" FFIs,[16] which must be documented within one year of the effective date of the Participating FFIs' FFI Agreement.
- For new accounts (that is, any accounts opened after an FFI agreement is signed with the IRS), for purposes of reporting on U.S. Accounts, FFIs will generally be permitted to rely on their current customer intake procedures so long as those provisions include obtaining certain documentation. The Proposed Regulations require that these procedures be supplemented in three specific instances, where the client: (i) is another FFI, (ii) is a passive investment entity, or (iii) is identified as possessing U.S. indicia (e.g., a U.S. birthplace, a U.S. address and newly under the Proposed Regulations, a U.S. telephone number). For withholding purposes, additional information—in the form of written statements and/or documentation—will likely need to be obtained for the FFI to be able to make payments of certain U.S.-source amounts (and any other passthru payments) to entity accounts.

3. FATCA Reporting

Under FATCA, FFIs will be required to furnish annual information reports to the IRS with respect to all U.S. Accounts. Notice 2011-53 provided a "phased-in" schedule for this FATCA reporting, which prescribed that (i) the first FATCA reports (covering calendar year 2013) would be due on September 30, 2014, and (ii) at a Participating FFI's option, this initial report could consist of the account holder's name, address, taxpayer identification number, account number and account balance.

The Proposed Regulations extend this "limited reporting" provision to reports covering the 2014 calendar year, and prescribe that 2014 (and subsequent) reports will be due on March 31 of the year following the

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15 Relationship managers must report all foreign accounts held by the account holder, wherever held, of which they are aware or have reason to be aware, for purposes of aggregating all of an individual's foreign accounts. FFIs are also required to implement procedures to ensure that a relationship manager identifies any change in circumstances of an account and informs the FFI.

16 "*Prima facie* FFIs" are entities with respect to which either: (i) the withholding agent has a designation that the account holder is a QI or an NQI in its electronically searchable records or (ii) in the case of accounts maintained in the United States, the account holder is either documented or presumed to be a foreign entity, and the withholding agent has electronically searchable records containing certain standardized industry codes.

calendar year covered by the report. For FATCA reports covering calendar year 2015, Participating FFIs will also be required to report income (but not gross proceeds) associated with the account. “Full” FATCA reports, including information about gross proceeds, will be required in subsequent years. Additionally, for all years, a Participating FFI will be required to report the year-end aggregate number and year-end aggregate value of accounts held by recalcitrant account holders that: (i) have indicia of U.S. status, (ii) do not have such indicia and (iii) are dormant accounts.

The Proposed Regulations clarify that the account balance and income and gross proceeds associated with the account may be reported either in the currency in which the account is maintained or in U.S. dollars.

4. Officer Certification

The Proposed Regulations require “responsible officers” to certify that the FFI is conducting the due diligence and reporting requirements contained in their FFI agreement. Responsible officers of the FFI are also required to certify that to their knowledge, the FFI is not engaged in counseling its clients in methods for avoiding the FATCA reporting requirements, and the FFI has not had any practices or procedures in place to do so. This certification must cover the period from August 6, 2011 through the date of the certification, and will need to be renewed periodically.

G. WITHHOLDING

1. Coordination With Other Withholding Requirements Under the Code

The Preamble to the Proposed Regulations states that it is the intention of the Treasury Department and the IRS that FATCA withholding and reporting requirements are coordinated, where possible, with other withholding and reporting requirements under the Code, including withholding requirements for QIs, WPs, and WTs. The IRS and Treasury also intend to update existing IRS Forms used for reporting and gathering information that may be used for FATCA purposes, and to amend current Treasury Regulations where applicable.

2. Identification of the Payee

The Proposed Regulations provide substantial guidance for determining who the “payee” is for FATCA purposes and for determining whether the payee is subject to withholding under FATCA. In general, the documentation requirements with respect to payees are similar to those under the other withholding requirements under the Code, but are expanded in order to determine whether a payee is an FFI, or whether it is acting as an agent or intermediary with respect to a payment. In addition to the payee identification information provided on a Form W-8 or W-9, the Proposed Regulations list specific situations in which further documentation or verification is required and the standards of knowledge for associating specific types of payees with the identification information they have provided.

Generally the "payee" is the person to whom a payment is made, regardless of whether such a person is the beneficial owner of the account. There are, however, several exceptions to this rule under the Proposed Regulations. In particular, the payee will not be the direct recipient of the payment if the payment is made to (i) certain foreign agents or intermediaries that have appropriately identified themselves as such, (ii) certain foreign flow-through entities that have appropriately identified themselves as such,[17] (iii) a U.S. person that is known to be acting as an intermediary or agent of a foreign person, unless the U.S. person is a financial institution and certain other conditions apply, (iv) territory financial institutions that are acting as agents or intermediaries or that are flow-through entities, unless certain conditions apply, (v) disregarded entities or branches, other than Limited Branches, (vi) U.S. branches of certain foreign banks or foreign insurance companies, or (vii) foreign branches of a U.S. financial institution. In addition, the Proposed Regulations provide special rules for determining the "payee" in cases where the recipient is a territory financial institution, disregarded entity or branch, a U.S. branch of certain foreign banks or foreign insurance companies, or a foreign branch of a U.S. financial institution.

3. Withholdable Payments

FATCA requires withholding on payments to Nonparticipating FFIs by U.S. withholding agents and Participating FFIs. Withholding on certain withholdable payments will begin on January 1, 2014. This withholding will initially be limited to withholdable payments of "U.S.-source" interest, dividends, rents, royalties, and other income that is considered fixed or determinable annual or periodical income for U.S. federal income tax purposes.[18]

FATCA also includes in the definition of "withholdable payments" all gross proceeds from the sale of instruments that produce U.S.-source dividends and interest. Currently, such gross proceeds are not generally subject to U.S. federal income tax withholding. Gross proceeds withholding will begin on sales or other dispositions occurring on January 1, 2015.

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[17] Specifically, a foreign flow-through entity will not be the "payee" unless the flow-through entity is: (i) an FFI, other than a Participating FFI receiving a payment of a U.S. source withholdable payment that is not a payment of withholdable gross proceeds, (ii) an active NFFE or excepted FFI that is not acting as an agent or intermediary with respect to the payment, (iii) a WP or WT that is not acting as an agent or intermediary with respect to the payment, or (iv) a flow-through entity that is receiving the payment of income effectively connected with a trade or business in the U.S. or the gross proceeds from the sale of property that can produce income excluded from the definition of a withholdable payment.

If a foreign flow-through entity is not treated as the payee, the "payee" of the relevant payments it receives is the partner, beneficiary, or owner, as the case may be, of the flow-through entity.

[18] §§ 1.1441-2(b)(1) and 1.1441-2(c).

4. Passthru Payments

FATCA requires Participating FFIs to withhold on "passthru" payments made to Nonparticipating FFIs and recalcitrant account holders. The definition of such "passthru" payments is broader than the definition of withholdable payments above.

The Proposed Regulations divide passthru payments into two categories: (i) withholdable payments and (ii) "foreign passthru payments". Withholding on passthru payments that are withholdable payments will begin on January 1, 2014, along with other FATCA withholding. However, no withholding will be required on foreign passthru payments until January 1, 2017, at the earliest. As a temporary replacement for such withholding, Participating FFIs will be required to report the aggregate amount of any "foreign reportable amounts" paid to each Nonparticipating FFI to which it makes such payments during 2015 and 2016. Although additional types of payments may be added, the Proposed Regulations currently treat as a "foreign reportable amount" any payment to a Nonparticipating FFI by the Participating FFI of fixed and determinable, annual or periodical income income (e.g., dividends, interest) that would have been a withholdable payment if paid by a U.S. person. Thus a Participating FFI will generally have to report the amount of interest and dividends it pays to Nonparticipating FFIs on non-grandfathered debt and equity obligations (including deposit accounts).

This delay in withholding is due to the Proposed Regulations currently reserving on the definition of "foreign passthru payments". Notice 2011-34 proposed a definition of "passthru payments" that would have: (i) treated payments of "U.S.-source" amounts that were made by a Participating FFI in a custodial capacity as passthru payments and (ii) treated non-custodial payments made by Participating FFIs as passthru payments in proportion to the payor's assets that were "U.S. Assets". This "passthru payment percentage" was to be calculated quarterly by each Participating FFI. The proposal in Notice 2011-34 was the subject of considerable criticism from industry participants and the bar.

The Preamble to the Proposed Regulations states that the IRS and Treasury Department request comments on ways to reduce the compliance burden of passthru payment withholding, such as allowing payors to elect to rely on safe harbor passthru percentages rather than requiring each payor to calculate its own percentage. The Preamble also acknowledges the potential for abuse caused by the difference between the withholding requirements for U.S. entities and FFIs, as only FFIs would be required to withhold on Foreign Passthru Payments. The IRS and Treasury Department are actively seeking a method to prevent U.S. entities from being used as "blockers" for FFIs that seek to avoid withholding on foreign passthru payments.

5. Payments beneficially owned by exempt beneficial owners

FATCA statutorily provides that foreign governments, political subdivisions of a foreign government and their wholly owned agencies or instrumentalities (such owners, "Sovereign Owners") (along with international organizations, foreign central banks and any other class of persons identified as posing a "low risk of tax evasion") are exempt from FATCA withholding. The Proposed Regulations expand on these categories by specifying six classes of "exempt beneficial owners": (i) qualifying Sovereign Owners (as discussed in more detail below); (ii) international organizations and wholly owned agencies or instrumentalities of an international organization; (iii) foreign central banks of issue; (iv) governments of U.S. possessions; (v) certain foreign retirement funds; and (vi) investment entities wholly owned by one or more other exempt beneficial owners.

As noted above, the Proposed Regulations provide new detail regarding which Sovereign Owners are expected to qualify as exempt beneficial owners. In particular, to qualify as an exempt Sovereign Owner, the Proposed Regulations indicate that the recipient must either be an "integral part" of a foreign sovereign or a qualifying "controlled entity". An "integral part" of a foreign sovereign is a governing authority of a foreign country, but does not include any individual who is a sovereign, official, or administrator acting in a private or personal capacity. To qualify for an exemption, the net earnings of an "integral part" must also be credited to its own account or to other accounts of the foreign sovereign, with no portion inuring to the benefit of any private person. A "controlled entity" of a Sovereign Owner is legally separate from the foreign sovereign, but may qualify under the Proposed Regulations as an exempt beneficial owner if: (i) it is wholly owned and controlled by a foreign sovereign directly or indirectly through one or more controlled entities, (ii) it has all net earnings credited to its own account or to other accounts of the foreign government with no portion of its income inuring to the benefit of a private person, and (iii) its assets vest with the foreign sovereign upon dissolution. In the case of both an "integral part" and a "controlled entity", income will generally not be considered to "inure to the benefit of" a private person if the relevant income benefits persons who are the intended beneficiaries of a governmental program that is carried on by the foreign sovereign, and the activities of which constitute governmental functions.[19] However, income typically will be considered to "inure to the benefit of" a private person if it benefits: (i) private persons through the use of a government entity for personal investment (including the operation of a commercial banking business providing services to private persons), or (ii) private persons who divert the income from its intended use by the exertion of influence or control through means explicitly or implicitly approved of by the foreign sovereign. Significantly, however (and in contrast to the regulations under Section 892 of the Code), the qualification of a Sovereign Owner as an exempt beneficial owner will not depend on whether the income is derived from the conduct of a "commercial activity", unless that activity is conducted by a controlled entity that is a financial institution that conducts a banking or custodial business, as defined for FATCA purposes.

[19] Such governmental functions are defined, in the Proposed Regulations, by cross-reference to the regulations under Section 892 of the Code. Section 892 generally exempts eligible foreign governments (and certain controlled entities) from U.S. federal income tax on investment income, but does not apply to income from "commercial activities" or income received by "controlled commercial entities".

While the FATCA Notices indicated that certain retirement plans were likely to be identified as exempt owners that posed a "low risk of tax evasion", the Proposed Regulations further develop this anticipated exemption. In particular, a retirement fund is an exempt beneficial owner under the Proposed Regulations if it meets either of two requirements:

- It is (A) established in a country with which the United States has an income tax treaty in force and is generally exempt from income taxation in that country; (B) operated principally to administer or provide pension or retirement benefits; and (C) entitled to benefits under the treaty on income that the fund derives from U.S. sources as a resident of the other country that satisfies any applicable limitation on benefits requirement; or
- It (A) is formed for the provision of retirement or pension benefits under the law of the country in which is established; (B) with certain limited exceptions, receives all of its contributions from government, employer, or employee contributions that are limited by reference to earned income; (C) does not have a single beneficiary with a right to more than five percent of the entity's assets; and (D) either (1) is exempt from tax on investment income under the laws of the country in which it is established or in which it operates due to its status as a retirement or pension plan, or (2) receives 50 percent or more of its total contributions, with certain limited exceptions, from the government and the employer.

ANTICIPATED ADDITIONAL GUIDANCE AND REQUEST FOR COMMENT

The IRS will hold a public hearing on the Proposed Regulations on May 15, 2012. Written comments on the Proposed Regulations are due by April 30, 2012, and requests to speak and outlines of topics to be discussed at the public hearing must be received by May 1, 2012.

The Preamble to the Proposed Regulations specifically solicits comments on certain aspects of the Proposed Regulations as well as on areas of FATCA for which the Proposed Regulations currently do not provide guidance. In particular, the IRS has requested comments with respect to: (i) methods to reduce the burden on Participating FFIs of withholding on foreign passthru payments, (ii) additional categories of entities that should be deemed-compliant, (iii) grandfathering of certain investment vehicles, (iv) the scope and content of periodic reviews of accounts required by FFI agreements, (v) the definition of "other financial payments"—payments other than fixed or determinable, annual or periodical income for which reporting by Participating FFIs is required, (vi) safeguards against abuse of the system for refunding tax withheld, (vii) amendments to the audit process with respect to QIs, WPs, and WTs, (viii) whether certain equity interests in securitization vehicles that invest in specific debt instruments only, and which must liquidate by a certain time, should be considered grandfathered obligations, and (ix) methods to determine the amount of gross proceeds allocable to a partner, beneficiary, or owner in the entity for purposes of FATCA withholding.

Additional guidance from the IRS and Treasury Department is expected. This guidance will include a draft model FFI Agreement in "early 2012" which is expected to be finalized in the fall of 2012. The electronic system for registering as an FFI or a registered deemed-compliant FFI will include registration instructions. The IRS intends to update the withholding agreements that QIs, WPs, and WTs are required to sign to incorporate the requirements of a Participating FFI and to modify the relevant Treasury regulations describing these agreements accordingly. The IRS intends to update the Form W-8 series to include information that FFIs will be required to collect in order to identify U.S. Accounts. Additional guidance is also expected in the form of further regulations, particularly with respect to the issues identified above for which the IRS solicits further comments.

THE JOINT AGREEMENT

The Treasury Department and the governments of France, Germany, Italy, Spain and the United Kingdom issued a joint statement on February 8, 2012 that outlines these countries' intention to "intensify their co-operation in combating international tax evasion" and to explore common approaches to implementing FATCA. The joint statement outlines a possible framework for FATCA implementation based on reciprocal reporting between the United States and a country with which the United States signs an agreement (a "FATCA Partner"). The United States, France, Germany, Italy, Spain and the United Kingdom would commit to working with other potential FATCA Partners, the OECD, and the European Union to develop a common model for an automatic information-exchange framework and to develop higher reporting and due diligence standards.

Under the possible framework, the FATCA Partner would agree to collect the information required under FATCA from FFIs in its jurisdiction and transfer this information to the United States. In return, the United States would not require FFIs located in the jurisdiction of a FATCA Partner to sign an agreement directly with the United States and would instead allow such FFIs to comply with FATCA by reporting to the FATCA Partner instead of the IRS. FFIs in the FATCA Partner would also not be subject to U.S. withholding under FATCA, would not be required to withhold on passthru payments to recalcitrant account holders and other FFIs organized in any FATCA Partner, and would not be required to terminate the accounts of recalcitrant account holders. The United States would also commit to reciprocity with respect to the collection and reporting of information to the relevant FATCA Partner authorities with respect to the U.S. accounts of residents of the FATCA Partner. The Proposed Regulations do not exempt FFIs if the FFIs are located in a FATCA Partner's jurisdiction, but do provide flexibility, generally allowing such FFIs to become Registered Deemed-Compliant FFIs, as discussed above.

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