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NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ON THE FATCA FINAL REGULATIONS: PFFI RULES; IGAS; INTERACTION BETWEEN THE REGULATIONS AND CHAPTERS 3 AND 61

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REPORT ON THE FATCA FINAL REGULATIONS: PFFI RULES; IGAS; INTERACTION BETWEEN THE REGULATIONS AND CHAPTERS 3 AND 61

I. <u>Introduction</u>

This report[1] comments on final regulations under Sections 1471 through 1474 of the Code (commonly referred to as "**FATCA**"),[2] which were issued by the U.S. Department of the Treasury ("**Treasury**") and the Internal Revenue Service (the "**IRS**") on January 28, 2013 and amended on September 10, 2013 (the "**Final Regulations**"). The Final Regulations represent a key step in the implementation of FATCA, which in 2014 will begin to impose withholding and reporting obligations on financial institutions and others worldwide.

FATCA was enacted to encourage foreign financial institutions ("**FFIs**") to identify their U.S. accountholders and investors and to report information about accounts and securities held by those persons to the IRS. In general, FATCA provides that an FFI will be subject to a 30% withholding tax on U.S. source dividends, interest and other passive-type income paid to it, as well as on certain other payments made to it, unless it opts to become a "participating FFI" ("**PFFI**"). A PFFI must enter into an agreement (an "**FFI Agreement**") stating that it will participate in the FATCA information reporting regime and will withhold on payments to certain investors and transaction counterparties that do not comply with FATCA's rules. Treasury and the IRS have recently published the form of the FFI Agreement.[3]

The United States has undertaken to negotiate intergovernmental agreements ("**IGAs**") related to FATCA with the governments of a number of countries, in order to help eliminate potential conflicts between FATCA and the legal requirements to which FFIs are subject in those countries (for example, privacy or banking secrecy laws), as well as to increase the efficiency of

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[1] The principal author of this report is Philip Wagman. Significant contributions were made by Kimberley S. Blanchard, Andrew H. Braiterman, Dennis Caracristi, Peter J. Connors, Francisco Duque, Michael Farber, Avrohom Gelber, Jiyeon Lee-Lim, Dean Marsan, David T. Moldenhauer, Eric Naftel, Andrew L. Oringer, Michael J. Pergler, Rebecca Pereira, Michael L. Schler, David R. Sicular, Andrew P. Solomon, Linda Z. Swartz and Adina T. Wagman. This report reflects solely the views of the Tax Section of the New York State Bar Association and not those of its Executive Committee or its House of Delegates.

[2] References in this report to "**Section(s)**", unless otherwise stated, are to sections of the Internal Revenue Code of 1986, as amended (the "**Code**") and the regulations thereunder.

[3] Rev. Proc. 2014-13, § 5 [FFI Agreement], 2014-3 I.R.B. 1. A draft of the form of FFI Agreement was published in the fall of 2013. *See* Notice 2013-69, 2013-46 I.R.B. 503.

A foreign entity that is not an FFI (a "non-financial foreign entity," or "**NFFE**") is not required to enter into an FFI Agreement in order to avoid withholding under FATCA. However, such an NFFE will be subject to withholding on the same types of payments as an FFI would be, unless the NFFE qualifies for an exemption or provides information about any significant U.S. owners it has to the withholding agent.

reporting under FATCA. To date, the United States has signed IGAs with numerous countries, and it is pursuing discussions about IGAs with many more.[4]

Treasury and the IRS have received a tremendous amount of comments on FATCA from a broad range of market participants and other stakeholders, including us.[5] In a report earlier this year, we provided recommendations on the Final Regulations, principally related to the regulations' definitions of "FFI" and "financial account." In this report, we turn to three additional topics which we believe are central to the FATCA regime: the rules in the Final Regulations that deal with PFFIs and FFI Agreements; the proper interpretation of IGAs and the interaction between these agreements and the Final Regulations; and coordination of taxpayers' withholding and reporting obligations under FATCA with their obligations under the rules of chapter 3 (withholding on U.S.-source fixed or determinable, annual or periodical ("**FDAP**") income paid to foreign persons) and chapter 61 (information reporting on payments to non-exempt U.S. persons).[6]

As to the first of these topics, the Final Regulations require an FFI to designate a responsible officer to be accountable for the FFI's compliance with the FFI Agreement. The responsible officer must establish procedures to help ensure the FFI's compliance with these rules, to monitor compliance, address instances of noncompliance and to periodically make certifications to the IRS about these matters. FATCA does not demand perfect compliance in

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4 As of January 3, 2014, Treasury's official website indicated that 18 jurisdictions had signed IGAs with the United States. *See* U.S. Department of the Treasury, Foreign Account Tax Compliance Act Resource Center, http://www.treasury.gov/resource-center/tax-policy/treaties/Pages/FATCA.aspx. In addition, it has recently been reported that a nineteenth jurisdiction has also signed an IGA. *See* Larissa Hoaglund, *Mauritius, U.S. Sign TIEA, FATCA Agreement*, Tax Notes Today, Doc. No. 2013-29898 (Jan. 2, 2014). Another recent press report stated that according to one practitioner, as of November 18, 2013, the United States had initialed 33 IGAs, in addition to those that had been signed as of that date. *See* Eric Kroh, *U.S. Said to Have Initialed FATCA IGAs With 33 Countries*, Tax Notes Today, Doc. No. 2013-26633 (Nov. 19, 2013). Treasury has not confirmed the number of IGAs initialed but not yet signed.

5 We have previously submitted reports on the Final Regulations and the Proposed Regulations, as well as reports on the statute and the three IRS Notices related to FATCA that preceded the Proposed Regulations. *See* New York State Bar Association Tax Section, *Comments on the Foreign Account Tax Compliance Legislation* (Rep. No. 1199, Jan. 11, 2010); New York State Bar Association Tax Section, *Report on IRS Notice 2010-60* (Rep. No. 1224, Nov. 16, 2010); New York State Bar Association Tax Section, *Report on IRS Notice 2011-34 and IRS Notice 2011-53* (Rep. No. 1253, Jan. 12, 2012); New York State Bar Association Tax Section, *Report on the Proposed FATCA Regulations* (Rep. No. 1267, May 29, 2012); New York State Bar Association Tax Section, *Report on the Final FATCA Regulations: Definitions of "FFI", "Financial Account" and Related Terms* (Rep. No. 1282, April 29, 2013).

6 In Revenue Procedure 2014-13, Treasury and the IRS note that they plan to issue temporary regulations early in 2014 which will modify the Final Regulations. They state that the FFI Agreement set forth in the Revenue Procedure contains cross-references to these temporary regulations. This report has been prepared prior to the issuance of such temporary regulations, and the report's discussion of the FFI Agreement, and other topics related to FATCA, is based only on the Final Regulations.

order for an FFI to remain a PFFI. However, the responsible officer is required to certify whether there have been "material failures" or "events of default" in compliance with FATCA and where relevant to describe what steps were, or will be, taken to remedy the failures or defaults. Although neither material failures nor events of default automatically prevent an FFI from being a PFFI, they can lead to the IRS terminating PFFI status. This report seeks to clarify in several respects the definitions of a material failure and of an event of default, as well as adding a reasonable cause exception to some of the more easily triggered events of default. The report also suggests additional changes to the requirements imposed on PFFIs under the Final Regulations and the FFI Agreement.

IGAs provide a means for an FFI to be free from withholding under the Final Regulations, without having to enter into an FFI Agreement. There are two main Models of IGAs. Model 1 IGAs call for a partner country to adopt its own rules and regulations to gather the information sought by FATCA from FFIs acting in that country and to share this information with the U.S. government. There are reciprocal (Model 1A) and nonreciprocal (Model 1B) versions of the Model 1 IGA: the reciprocal version requires the United States to gather annually from U.S. financial institutions information about their accountholders that are residents of the partner country and to provide that information to the partner country, while the nonreciprocal version does not require this. Model 2 IGAs, by comparison, require the partner country to direct FFIs located in the jurisdiction to enter into FFI Agreements with the U.S. government in accordance with the Final Regulations.[7]

The IGAs have rapidly become a key part of the United States' overall approach to implementing FATCA. The Final Regulations have been drafted in a way that is meant to accommodate the existence of a broad array of IGAs, but some of the concepts in the Final Regulations differ from those used in the IGAs. In particular, the Final Regulations generally look to the assets and activities of each entity that is a regarded entity for U.S. federal income tax purposes, determine the status of that regarded entity as an FFI or an NFFE, and then apply the relevant reporting and withholding rules. By comparison, in general IGAs look separately at each disregarded entity or branch owned by a regarded entity, and test the status of the

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[7] Treasury and the IRS have published each of these Model IGAs, and have indicated a preference for the text of actual signed IGAs to closely follow these Models. The IGAs that have been signed to date do track the Model IGAs fairly closely, although not exactly word-for-word. In this report, we analyze the text of the Model IGAs, rather than that of a particular IGA that has been entered into.

In the case of the Model 1B and Model 2 IGAs, Treasury and the IRS have published two versions of each of these Model IGAs: one for a country that has a treaty or tax information exchange agreement ("**TIEA**") with the United States; and the other for a country that does not. The text of the two versions of each of these IGAs differs in only a few respects, none of which are relevant to the issues discussed in this report. In addition, the numbering of the articles and paragraphs cited in this report is the same in the two versions of each of these IGAs (except as specifically stated in notes 89 and 104 below). Thus, our citations in this report to the Model 1B IGA and the Model 2 IGA are to both versions of each such Model IGA (except as specifically stated in notes 89 and 104 below).

disregarded entity or branch as a "Financial Institution" (a term used in the IGAs with a definition that generally corresponds to an "FFI" under the Final Regulations) or an NFFE. As we explain in this report, although the Final Regulations contain some provisions that are meant to reconcile this difference in approach, these provisions need to be clarified; and the IGAs' own approach to disregarded entities and branches should be made more internally consistent. Guidance also should be provided addressing other issues regarding the application of the IGAs, including the reporting obligations of U.S. financial institutions with respect to their accountholders who reside in countries that have Model 1A (reciprocal) IGAs.

Third and finally, the report addresses certain issues about coordination of reporting and withholding under chapter 4 with the rules under chapters 3 and 61. In particular, we provide suggestions about what types of FFIs should be entitled to be qualified intermediaries ("**QIs**"), withholding partnerships ("**WPs**") or withholding trusts ("**WTs**") for purposes of chapters 3 and 61, as well as the FATCA related requirements that should be imposed on QIs, WPs and WTs pursuant to upcoming revisions to the IRS's standard QI, WP and WT agreements. We also discuss coordination between chapters 3 and 4 for presumptions as to when income paid to a U.S. branch of a foreign person should be treated as "effectively connected income" ("**ECI**").

II. <u>Summary of Recommendations</u>

As discussed further in Part III, our principal recommendations are:

1. If a PFFI records a reserve in its financial statements for a potential future tax liability related to its compliance with its FFI Agreement, that should not automatically result in a "material failure" under the FFI Agreement. Instead, there should be a "material failure" only when a PFFI records a non-de minimis reserve for a future tax liability that is likely (or, at least, more likely than not) to be imposed under FATCA, other than in the normal course of the PFFI's compliance with its obligations under FATCA and its FFI Agreement.

2. It should be stated in both the Final Regulations and the form of FFI Agreement that a "material failure" by a PFFI to meet the obligations of its FFI Agreement will not trigger an event of default and a potential termination of the FFI Agreement, unless the material failure occurs in more than limited circumstances (i.e., there are several instances of noncompliance).

3. A PFFI should have an event of default under its FFI Agreement, if it fails to use reasonable efforts to reduce the number of its accountholders that either are recalcitrant accountholders, or are FFIs that have not become PFFIs and are not otherwise deemed to be compliant with FATCA ("**non-participating FFIs**," or "**NFFIs**"). This rule should replace the more stringent provision currently in the Final Regulations that a PFFI has an event of default if it fails to significantly reduce the number of accountholders or payees that are recalcitrant accountholders or NFFIs.

4. For purposes of the rule proposed in recommendation 3, we believe that "reasonable efforts" should be defined through specific requirements that take into account the extent to which the PFFI is able to control whether it has dealings with recalcitrant accountholders and NFFI accountholders, and/or to control whether those accountholders take steps either to provide the information required from them under FATCA (in the case of recalcitrant accountholders) or to become PFFIs (in the case of NFFIs).

5. In the rule that a PFFI has an event of default under its FFI Agreement if it sponsors, promotes, or provides noncustodial distribution services for a local FFI, it should be clarified what constitutes prohibited sponsorship, promotion or distribution. For example, it would be useful to have express confirmation that communications by a PFFI with one of its customers about a local FFI that are not initiated by the PFFI, and that occur in the ordinary course of the PFFI's relationship with the customer, are not prohibited.

6. There should be a "reasonable cause" exception for all events of default under an FFI Agreement (other than those events of default that are specifically defined in the Final Regulations as requiring bad intent on the part of the PFFI).

7. The Final Regulations should be modified to provide a PFFI with a clear timeline for making a request to the IRS to reconsider a notice of default and for submission and review of proposed remediation steps, as well as an indication of the types of remediation steps that may be appropriate in different circumstances.

8. In the Final Regulations' "limited branch" rule and in all other cases where the concept of a branch is relevant under the Final Regulations, the definition of "branch" should cover any instance where a unit, business or office of an entity is subject to a country's laws and regulations as a result of carrying on a business in that country.

9. In the rule providing that a PFFI is deemed to have made a withholdable payment to an affiliated limited FFI when the PFFI makes a payment to the limited FFI under a transaction that "hedges or otherwise provides total return exposure to" a transaction between the PFFI and a third party that gives rise to a withholdable payment, it should be clarified that the transaction between the PFFI and the limited FFI must have economics that fully offset the PFFI's transaction with the third party and also must have been entered into as part of a single plan with the third-party transaction. Comparable clarifications should be made to the similar rule that deals with a transaction between a PFFI and its limited branch that hedges a transaction between the PFFI and a third party which gives rise to withholdable payments.

10. It should be confirmed that, absent express guidance from a particular partner country that requires treatment of group holding companies and treasury centers in that country as "Financial Institutions" under that country's IGA, such entities are intended to be treated as NFFEs if they are established in IGA countries.

11. It should be clarified that an investment vehicle that owns a fixed pool of financial assets, or a pool of financial assets that will change only in accordance with highly detailed, narrow guidelines that largely preclude the exercise of discretion by an investment manager, qualifies as an "Investment Entity" for purposes of the IGAs.

12. In cases where an entity's principal activity is to hold passive assets, and it thus is likely the entity will be classified for purposes of FATCA either as an "Investment Entity" under an IGA (or the corresponding type of FFI under the Final Regulations (an "**investment entity**")), or else as a "passive NFFE" under the Final Regulations, the entity should not be required to determine which classification is appropriate. Instead, the entity should be expressly entitled to elect between these two classifications, so long as the entity certifies that, based on the current and expected future direct and indirect ownership of interests in the entity, the IRS will receive information about the same group (or a broader group) of U.S. investors that hold interests in the entity, as the IRS would have received if the entity had chosen the other classification.

13. In the Final Regulations, the definition of “FFI” should be revised to expressly include any "Financial Institution" as defined in an IGA (including a "Financial Institution" that is a branch or disregarded entity).

14. The Final Regulations’ definition of "NFFE" should be amended to expressly include all legal entities (including disregarded entities) that are treated as NFFEs under an IGA.

15. If a Financial Institution that is a resident of an IGA country has a U.S. branch, that branch should be treated as a U.S. person for purposes of the Final Regulations, with such U.S. person being treated as a financial institution, or a non-financial institution, depending on the nature of its activities conducted by the branch in the United States.

16. As a corollary to our recommendations 13 through 15, the Final Regulations should be revised to clarify that when a regarded foreign entity determines whether it is an FFI or an NFFE, the regarded foreign entity should ignore the activities of all of its branches and disregarded entities that are separately analyzed (as Financial Institutions, NFFEs, or U.S. persons) under the Final Regulations and the IGAs.

17. Treasury and the IRS should consider fully incorporating in the Final Regulations, including in cases where no IGA is applicable, the basic principle reflected in the IGAs of treating each disregarded entity and branch owned by a regarded entity as a separate unit, and determining the FATCA withholding and reporting obligations of that disregarded entity or branch independently from activities carried on by any other disregarded entities or branches of such regarded entity.

18. It should be clarified whether a Financial Institution is required under the IGAs to withhold on recalcitrant accountholders.

19. Guidance should be provided to clarify that under Model 1A and 1B IGAs, a Financial Institution that is required to make annual reports (a "**Reporting Financial Institution**") does not have residual FATCA withholding responsibility, in cases where it acts as an intermediary (other than a QI, WP or WT that has accepted primary withholding responsibility) for a payment to an NFFI, and the primary withholding agent fails to withhold.

20. It should be expressly confirmed that a Reporting Financial Institution under a Model 1A or 1B IGA is not obligated to withhold under FATCA on payments to NFFEs that are not accountholders.

21. The Final Regulations should be revised so that they no longer require a Reporting Financial Institution under an IGA to comply with the obligations imposed on withholding agents by such regulations, if the Reporting Financial Institution is a branch of a U.S. financial institution.

22. Guidance should clarify that a Reporting Financial Institution in a jurisdiction with a Model 1A or Model 1B IGA is required to report to the IRS under Section 1474 only if the Reporting Financial Institution is a QI that has accepted primary withholding responsibility for a payment, or (depending on the government's response to our recommendation 18) if the Reporting Financial Institution is required to withhold on payments to a recalcitrant accountholder.

23. A multinational financial institution should be permitted to apply the "consolidated obligation" rules in the Final Regulations, when an accountholder has accounts with multiple affiliates or branches in the institution's expanded affiliated group, including some located in IGA countries.

24. In their dealings with IGA partner countries, Treasury and the IRS should encourage those countries to adopt uniform rules for Financial Institutions' reporting to the governments of those countries, including the format of such reporting. Preferably, such reporting rules should largely mirror the reporting requirements for a PFFI in the Final Regulations.

25. Treasury and the IRS should encourage partner countries to clarify that if a foreign entity holds an account with a Reporting Financial Institution, and U.S. individuals own interests in the foreign entity which do not give any of them control over the entity acting separately, they will be considered to be "Controlling Persons" of the entity for purposes of the IGA (with the result that the Reporting Financial Institution must report on the account held by the entity) if they act pursuant to a common plan or design to exercise control over the entity, but not otherwise.

26. The U.S. government should work with partner countries to clarify the conditions that will trigger the requirement under an IGA for a Financial Institution to take actions to

resolve "significant non-compliance." Under a Model 1A or 1B IGA, one such trigger should be a notice from the partner country to the United States of significant non-compliance by the Financial Institution. In addition, the U.S. government should work with partner countries to provide guidance about the circumstances in which significant non-compliance will be considered to exist, and will be considered to have been resolved.

27. It should be expressly stated that a Financial Institution must comply with the IGAs' version of the "all or nothing rule" in order to be treated as a Reporting Financial Institution under the applicable IGA and as a deemed-compliant FFI under the Final Regulations.

28. We believe the U.S. government should be viewed as possessing currently the authority to issue regulations as to how U.S. Financial Institutions must report information about their accountholders who are resident in Model 1A IGA countries. Unless a statute is enacted in the near term to provide guidance regarding such reporting, Treasury and the IRS should issue regulations to address this topic. Such regulations will need to cover topics including whether any U.S. Financial Institutions are exempted or subject to only limited requirements; what diligence must be performed on existing accounts, and what process should be followed to obtain information when opening new accounts; what format U.S. Financial Institutions should use for their annual reporting of the relevant information; what periodic review or audit procedures should be followed; and whether the U.S. government will indemnify U.S. Financial Institutions for any breach of relevant confidentiality requirements that occurs when the U.S. government provides information to IGA partner countries' governments.

29. When Treasury and the IRS issue the guidance that they have previously described regarding the impact of FATCA on QI, WP and WT agreements, that guidance should limit eligibility for QI, WP or WT status to those FFIs and NFFEs that are treated under the IGAs and Final Regulations as having sufficient internal resources (or as being sponsored by an entity that has sufficient internal resources) to be able to discharge reporting obligations under chapter 4. In addition, that guidance should tailor the FATCA-related requirements in an entity's QI, WP or WT agreement to correspond to the responsibilities that are imposed on FFIs and NFFEs under the Final Regulations.

30. Treasury and the IRS should conform the presumption rule in the Final Regulations which treats as "effectively connected income" a payment to a U.S. branch of a foreign bank registered with the Federal Reserve Board or of an insurance company that is subject to regulation by a state insurance department, provided that the bank or insurance company provides a GIIN showing that it is a PFFI or deemed-compliant FFI, to the corresponding rule in the chapter 3 regulations. The rule in the chapter 3 regulations does not require that such a GIIN be provided. However, if such an approach is determined not to be appropriate, then the presumption rule in the Final Regulations should be removed altogether.

III. Discussion

A. Requirements for PFFI Status

1. Compliance Procedures; Material Failures

Under the Final Regulations and the FFI Agreement, a PFFI is required to institute policies, practices and procedures to ensure compliance with FATCA. Periodically (generally every 3 years), the PFFI's responsible officer is required to certify either that there have been no material failures and events of default, or that the PFFI is remedying or has remedied any material failures or events of default that have occurred.[8] For this purpose, a "material failure" is defined to include: (A) the deliberate or systemic failure of the participating FFI to report accounts that it was required to treat as U.S. accounts, withhold on passthru payments to the extent required, deposit taxes withheld, or accurately report recalcitrant accountholders or payees that are NFFIs as required; (B) a criminal or civil penalty imposed on the PFFI by a governmental authority based on its failure to comply with applicable anti-money laundering due diligence requirements; and (C) the FFI's establishment of a provision or reserve in its financial statements for a "potential future tax liability" related to the PFFI's "compliance (or lack thereof)" with an FFI agreement.[9]

a. Reserves for future tax liabilities

While the justification for (A) and (B) seems readily apparent, the same cannot be said for (C) as currently drafted. (C) appears to be designed to ensure that a PFFI gives full information to the IRS about the PFFI's possible failures to comply with FATCA. However, this provision would be more effective in achieving this goal if it were more narrowly drafted.

First, applied literally, (C) would cover a PFFI's reserve for an expected future withholding tax to be paid by the PFFI in full compliance with its FFI Agreement. For example, it is possible a PFFI would set up a reserve for an amount that the PFFI has placed in escrow in respect of a chapter 4 tax that is potentially due with respect to a payment, pending a determination of whether the payment should be treated as a withholdable payment.[10] Second, (C) also applies regardless of the amount of the tax provision or reserve. Finally, the rule applies regardless of whether, under applicable local accounting principles, the "potential" future tax liability must be likely to be imposed, in order for a reserve to be required.

<u>Recommendation 1</u>: We believe that (C) would be on a level of materiality comparable to the events described in (A) and (B), if (C) applied only when a PFFI recorded a non-de

8 Treas. Reg. § 1.1471-4(f)(3)(i) – (iii); FFI Agreement, § 8.

9 Treas. Reg. § 1.1471-4(f)(3)(iv)(A) – (C).

10 *See* Treas. Reg. § 1.1471-2(a)(5)(ii).

minimis reserve for a future tax liability that is likely (or, at least, more likely than not) to be imposed under FATCA, other than in the normal course of the PFFI's compliance with its obligations under FATCA and its FFI Agreement. We believe such an approach would avoid causing the IRS to receive large amounts of information that, as a practical matter, may have little or no relevance to it, as may well be the case under (C) as currently drafted. Instead, this approach would highlight for the IRS potentially important information about a PFFI's lapses in carrying out its obligations under chapter 4, which would help the IRS in determining whether to issue a notice of default to a PFFI. This proposal also would limit possible concerns of PFFIs over putting themselves in a position of receiving a notice of default, or otherwise being treated unfavorably, as a result of reserves established in the ordinary course or established for trivial instances of possible noncompliance.

b. Overlap between the definitions of material failure and of event of default

It is not entirely clear under the Final Regulations when a material failure of a PFFI will rise to the level of an event of default. In general, an event of default is defined as a PFFI's failure to perform material obligations under or to substantially comply with its FFI Agreement.[11] This definition appears to be broad enough to capture most or all events that are material failures; indeed, several of the specific actions or omissions that are identified in the Final Regulations as events of default would appear to be, if anything, less significant lapses than a material failure is. Thus, it could be concluded that almost any material failure is an event of default that could lead to termination of the FFI Agreement.

However, the Final Regulations contain a statement that is inconsistent with this reading. In the definition of "material failure," it is said that such a failure "will not constitute an event of default unless such material failure occurs in more than limited circumstances when a [PFFI] has not substantially complied with the requirements of an FFI agreement."[12] This statement appears to mean that a material failure will be an event of default only if the material failure is part of a series of incidents of noncompliance. The quoted statement is not referenced in the definition of an event of default, as an exception or limitation on that definition; and it also is not referenced anywhere in the provisions of the FFI Agreement.

The quoted statement seems to reflect a policy of encouraging PFFIs to come forward with information about compliance lapses, when they provide their periodic certifications under their FFI Agreements. A PFFI can describe a compliance lapse to the government and can explain whether it has been remedied yet or not, without risking termination of the FFI

[11] Treas. Reg. § 1.1471-4(g)(1).

[12] Treas. Reg. § 1.1471-4(f)(3)(iv).

Agreement, provided that the lapse is not part of a pattern that has occurred in more than limited circumstances.

Recommendation 2: Assuming the policy that the Final Regulations and FFI Agreement are intended to reflect is as set forth in the preceding paragraph, we recommend that it be clearly stated in both the Final Regulations and the FFI Agreement that a material failure is not an event of default unless it occurs in more than limited or isolated circumstances.

2. Events of Default and Termination

a. Failure to reduce the number of recalcitrant accountholders and of payees that are NFFIs

One event of default under the Final Regulations and the FFI Agreement is a "[f]ailure to significantly reduce, over a period of time, the number of accountholders or payees that the participating FFI is required to treat as recalcitrant accountholders or nonparticipating FFIs."[13] No further guidance is provided, including on the meaning of "significantly reduce" and "a period of time." We believe this brief, open-ended rule needs to be clarified. As discussed below, in our view, the justification for this type of rule is strongest when applied to a PFFI that has failed to make a reasonable effort to significantly reduce its accountholders that are either recalcitrant accountholders or NFFIs. There is not a similarly persuasive argument in favor of having a PFFI be in default under its FFI Agreement, if it fails to reduce its payments to NFFIs that are not accountholders.

i. Scope of the requirement

In order to assess the rule that a PFFI's failure to reduce its recalcitrant accountholders, and NFFI accountholders or payees is an event of default, it is helpful to understand the purpose the rule is apparently meant to serve. Although the Preamble is silent on this, the structure of the statute and the legislative history of FATCA provide some insight. Section 1471(b)(1)(F) requires a PFFI to obtain from its accountholders a waiver of any foreign legal requirement that would prevent the PFFI from reporting on the accountholders or, if a waiver cannot be obtained, to close the account. By comparison, there is no statutory requirement to close the account of a person that refuses to provide the information a PFFI requires in order to report on the person's account. Instead, Section 1471(b)(1)(D) provides that a PFFI is required to withhold on withholdable payments and foreign passthru payments made to such an accountholder, and also on such payments made to NFFI accountholders and payees.

The Joint Committee on Taxation's Technical Explanation of FATCA elaborates on the role of Section 1471(b)(1)(D):

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[13] Treas. Reg. § 1.1471-4(g)(1)(ii).

> "The provision allowing for withholding on payments made to an accountholder that fails to provide the information required under this provision is not intended to create an alternative to information reporting. It is anticipated that the Secretary may require, under the terms of the [FFI] agreement, that the foreign financial institution achieve certain levels of reporting and make reasonable attempts to acquire the information necessary to comply with the requirements of this section or to close accounts where necessary to meet the purposes of this provision. It is anticipated that the Secretary may also require, under the terms of the agreement that, in the case of new accounts, the foreign financial institution may not withhold as an alternative to collecting the required information."[14]

Thus, Congress' principal goal in adopting withholding requirements for PFFIs was not simply to punish accountholders that refused to gather and provide information required to be reported under FATCA, or to raise revenue from such withholding, but rather to bring about full compliance with the statute's information-gathering and reporting requirements. To that end, it was contemplated that PFFIs might need to do more than just withhold on uncooperative accountholders; rather, PFFIs potentially would be required to increase over time the extent to which their accountholders provide the information which PFFIs are required to report and, thus, are not subject to withholding.[15] Although no absolute requirement would be imposed on PFFIs to close the accounts of persons not providing relevant information, comparable to the requirement for accountholders not waiving a legal requirement that prevented a PFFI from reporting to the IRS, PFFIs would have to take some steps to encourage information to be provided.

In our view, this logic provides a fairly strong justification for expecting a PFFI to make a reasonable effort to reduce the number of its recalcitrant accountholders – while not requiring that such an effort be an unqualified success. A PFFI that continuously, over a material length of time, has a significant number of accountholders that refuse to provide the information required by FATCA might well be being used, with its acquiescence or active cooperation, for the

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[14] Joint Committee on Taxation, Technical Explanation of the Revenue Provisions Contained in Senate Amendment 3310, the "Hiring Incentives to Restore Employment Act," Under Consideration by the Senate (JCX-4-10) at 40 (2010).

[15] In the original legislative proposals for FATCA, an FFI would have been required without exception to obtain information regarding, and report on, its accountholders. *See* H.R. 3933, 111th Cong. §1 (Oct. 27, 2009); S. 1934, 111th Cong. §1 (Oct. 27, 2009). Comments were submitted to the effect that it might be impossible for an FFI to get the cooperation of all of its accountholders in this exercise of obtaining information about them, and proposing withholding on noncompliant accountholders as a possible remedy. *See* Letter from A.B.A. Section of Taxation to Max Baucus, Chair, Senate Finance Committee, Charles E. Grassley, Ranking Member, Senate Finance Committee, Charles B. Rangel, Chair, House Ways and Means Committee, David Camp, Ranking Member, House Ways and Means Committee (Dec. 3, 2009). The final legislation provided for passthru payment withholding by PFFIs with respect to noncompliant accountholders.

avoidance of FATCA. For example, the PFFI might receive payments that, if received directly by the PFFI's recalcitrant accountholders, would be withholdable payments; and the PFFI might then make payments to such accountholders that would not be subject to FATCA withholding, at least absent guidance about foreign passthru payments. It would appear to be a sensible exercise of Treasury's and the IRS's authority to determine that such a PFFI should be viewed as breaching its FFI Agreement.

The provisions in the Final Regulations and the FFI Agreement referenced above seem to be meant to adopt such an approach. However, we believe it should be clarified that reasonable efforts on the PFFI's part, rather than an actual significant reduction in the number of recalcitrant accountholders, is what is required.[16] Such a clarification would fairly reflect the practical limits on a PFFI's ability to impact the actions of its accountholders. In addition, the legislative history quoted above, although not entirely clear, can be read as consistent with such a standard: the legislative history refers to "reasonable attempts" by a PFFI to procure compliance by its accountholders.[17] We discuss below in section ii possible parameters for evaluating whether a PFFI has made a reasonable effort.

In addition, based on the policy considerations just described, we believe the Final Regulations and the FFI Agreement should be revised to clarify that only a PFFI's failure to significantly reduce the number of NFFI payees that are accountholders of the PFFI is an event of default. A rule that extends more broadly than this, to cover a failure to reduce the number of <u>all</u> payees of a PFFI that are NFFIs, is difficult to justify.

If a PFFI has, over time, a significant number of accountholders which are NFFIs, that raises the same basic concern as discussed above: the PFFI could be participating in an arrangement in which it is used to avoid FATCA. The only difference is that, instead of a U.S. person that would be a recalcitrant accountholder directly holding an account with the PFFI, the U.S. person instead would hold an interest in an NFFI, which in turn would hold an account with

[16] In the Final Regulations as currently drafted, the reference to a "significant" reduction could possibly be read as involving a review of a PFFI's overall circumstances -- including its ability to direct accountholders' actions -- in order to determine whether a reduction in recalcitrant accountholders is significant. However, this point is not clear.

[17] The quoted legislative history refers to it being anticipated that an FFI Agreement may require a PFFI to "*achieve certain levels of reporting* and make reasonable attempts to acquire the information necessary to comply with the requirements of this section or to close accounts where necessary to meet the purposes of this provision" (italics added). The italicized text could possibly be read as imposing on a PFFI an absolute requirement to achieve full reporting by a certain percentage of its accountholders. However, when read in context, the better reading appears to be that the PFFI must put into place reporting systems that reflect a certain level of diligence by the PFFI, as well as making reasonable attempts either to require all accountholders to provide the necessary information to the PFFI or else to close their accounts.

the PFFI. A PFFI should be required to make a meaningful effort to avoid being used in this manner.

However, there appears to be little logic for penalizing a PFFI for other dealings with NFFIs. A PFFI must withhold on withholdable payments made to a payee that is an NFFI and is not an accountholder. Such a fact pattern may frequently arise in the ordinary course of a PFFI's business: for example, a foreign bank that is a PFFI may act as facility agent for the lending syndicate on a loan to an unrelated U.S. borrower, where the lending syndicate includes some NFFIs. In such a case, the PFFI seems to have done little if anything to aid the NFFIs in avoiding FATCA. The NFFIs would be subject to the same withholding under FATCA if the PFFI did not act as agent for them, and instead the NFFIs received interest payments directly from the U.S. borrower; and the same would be true if a U.S. financial institution acted as facility agent for the syndicate. In addition, the reporting under chapter 4 would be the same in any of these cases.[18]

The same would be true for payments by a PFFI to a non-accountholder NFFI that are not withholdable payments. For example, payments by a PFFI for services or property (other than financial assets) provided by an NFFI would appear, at least absent unusual circumstances, to have little to do with the type of tax avoidance that moved Congress to enact FATCA. Payments with respect to some financial transactions that are not withholdable payments also would seem to have little to do with the purposes underlying FATCA—for example, payments by a PFFI of interest or dividends on publicly traded debt or equity of a foreign issuer, where the debt or equity is held by an NFFI; or payments of interest on a loan to a foreign borrower, where the PFFI acts as facility agent for a syndicate that includes NFFIs. We assume that the rule in the Final Regulations is not aimed at transactions like this, which present a relatively low level of risk, and have little or no connection with the United States. However, if read literally, the rule covers such transactions.

It is conceivable that the Final Regulations reflect a deliberate policy choice to require PFFIs to reduce all types of transactions with NFFIs, including ordinary-course transactions with a low risk of evasion of FATCA withholding, in order to limit NFFIs' access to the worldwide financial system and, thus, to pressure them to become PFFIs. However, for multiple reasons, this appears not to be the policy underlying the rule in question. First, the Final Regulations do not subject U.S. financial institutions to any comparable obligation to limit their dealings with NFFIs. If the goal were to deprive NFFIs of access to the global financial system, the approach taken in the Final Regulations would seem not to be an effective way of accomplishing this.[19]

18 *See* Treas. Reg. § 1.1474-1(c), (d) (imposing the same reporting requirements on a U.S. person as a PFFI, where the U.S. person or PFFI is the withholding agent for a U.S.-source withholdable payment to an NFFI, or a payment to an NFFI of gross proceeds from a disposition of U.S. debt or U.S. stock).

19 We also note that Model 1A and 1B IGAs do not contain any requirement for a Financial Institution to reduce the amount of payments its makes to NFFIs, or to close accounts of NFFIs.

Second, the government's initial effort to design foreign passthru payment rules reflected a similar approach of putting the burden on PFFIs to achieve FATCA's goals, by seeking to impose transaction costs on their dealings with not only U.S. but also foreign counterparties – including ordinary-course transactions having very limited connections with the United States. Following widespread comments about the problems associated with such an approach, the government has not sought to implement those rules. In view of this history, it would be surprising if the government now decided to revert to the same basic type of approach, in the context of the rule in question concerning PFFI defaults.[20]

We recognize that if, for example, a PFFI enters into a derivative contract with an NFFI which references underlying assets that give rise to withholdable payments, such a transaction may present real potential for avoidance of FATCA. If Treasury and the IRS believe it is important to require PFFIs to reduce the volume of transactions of this type that they enter into with NFFIs, then we believe they should craft a rule that is expressly targeted to such transactions, and that excludes the non-abusive transactions with NFFIs that we have described above. However, it is not clear that even a targeted rule of this kind would fit in to the overall scheme of a PFFI's obligations under the Final Regulations in a logical way. The definition of "financial account" in the Final Regulations reflects a careful balancing by Treasury and the IRS of, on one hand, preventing avoidance (including avoidance through the use of arrangements that could funnel the economics of a PFFI's U.S. investments generating withholdable payments to investors in the PFFI that are not FATCA-compliant) and, on the other hand, limiting the compliance burden for PFFIs. The balance struck by Treasury and the IRS did not include such derivative transactions in the definition of financial account. It is questionable whether it would be efficient now to craft a different rule for PFFIs in a different part of the FFI Agreement regime that does extend to such transactions.

Recommendation 3: We believe that a PFFI should have an event of default under its FFI Agreement if it fails to use reasonable efforts to reduce its accountholders that are either recalcitrant accountholders or NFFIs. This rule should replace the broader rule currently in the Final Regulations and the FFI Agreement.

[20] In this connection, we note that in the Final Regulations, the government required PFFIs to report on a transitional basis on all "foreign reportable payments" (payments that would be U.S. source FDAP income if paid by a U.S. payor) that are made to NFFIs in 2015 and 2016. Treas. Reg. § 1.1474-1(d)(2)(i)(D), (d)(4)(iii)(C). Notice 2013-69, however, indicates that after further consideration, the government has decided to limit such reporting to PFFIs' foreign reportable payments on accounts held by NFFIs. Notice 2013-69, § III.02(C). It would be in keeping with that decision to similarly determine that a PFFI is not required to reduce its payments to non-accountholder NFFIs to avoid default under its FFI Agreement.

ii. Standards for application of a "reasonable efforts" requirement

Recommendation 4: For purposes of the rule described above, we believe that "reasonable efforts" should be defined through specific requirements that take into account the extent to which the PFFI is able to control whether it has any dealings with recalcitrant accountholders and NFFI accountholders, and/or to control whether those accountholders take steps either to provide the information required from them under FATCA (in the case of recalcitrant accountholders) or to become PFFIs (in the case of NFFIs). Such an approach will increase the predictability and, thus, the fairness of the PFFI regime. In addition, such an approach will provide less opportunity for aggressive interpretation by PFFIs seeking to justify questionable conduct than would an open-ended, general rule.

First, a PFFI's actions should be subject to heightened scrutiny, or perhaps presumed to be an event of default, if the PFFI is under common control with a recalcitrant holder or NFFI and, within (say) one year after the PFFI enters into its FFI Agreement, the recalcitrant accountholder or NFFI does not take steps to become fully compliant with FATCA and the PFFI does not terminate their relationship. Examples might include two investment funds with the same general partner, where one such fund (an NFFI) invests in debt or equity of the other (a PFFI); or a private equity fund (an NFFI) that owns a portfolio company (a PFFI).

To some extent, such a rule would overlap with the "all or nothing" rule, under which a PFFI cannot be part of the same expanded affiliated group ("**EAG**") as any NFFI (other than, in 2014 and 2015, a "limited FFI" that is prevented under local law from fully complying with all the obligations imposed on PFFIs).[21] A PFFI that violates the all or nothing rule will be in default under its FFI Agreement; this will be true whether or not the NFFI that is a member of the PFFI's EAG holds an account with the PFFI. As a result, it is somewhat duplicative for our suggested "common control" rule to apply to an NFFI accountholder that is part of the same EAG as a PFFI. However, we believe it would be appropriate for "common control" to be defined more broadly than just membership in the same EAG. Instead, the standard should be whether the same person or persons possess practical control over both a PFFI's decision whether to seek to terminate an account, and the accountholder's decision whether to either cooperate in such termination, provide the information required under FATCA (in the case of a recalcitrant accountholder), or become a PFFI (if the accountholder is an FFI). Under such a definition of "common control," the examples in the preceding paragraph would be covered, even though the PFFI and the NFFI in such examples may very well not be members of the same EAG. This would seem to be an appropriate rule for preventing possible abuse of the PFFI regime.[22]

[21] *See* Treas. Reg. § 1.1471-4(e).

[22] Our proposed rule should not apply to a limited FFI that holds an account with a PFFI in its EAG in 2014 or 2015. The policy behind the rule in Treasury Regulation Section 1.1471-4(e) providing special treatment for

Second, whether or not a PFFI and an accountholder are under common control, a PFFI should be under heightened scrutiny, or be subject to a presumed event of default, if the PFFI has the legal right to compel the closure of an account and fails to exercise that right after (say) one year of noncompliance by the accountholder with requests from the PFFI for information and/or for consents to disclose information to the IRS. In this regard, we believe that a PFFI generally should not be treated as lacking the right to close an account, if the PFFI is prevented by a contractual provision (as opposed to a statute or regulation) from closing the account. However, it seems fair to us to apply a "grandfather rule," to the effect that if an account was opened prior to the issuance of the Final Regulations (which were the first official guidance to impose a requirement for a PFFI to significantly reduce over time its noncompliant accountholders), and the contract setting forth the terms of the account does not permit the PFFI to close the account without a substantial financial penalty, then the PFFI should be treated as lacking a legal right to close the account.

Third, we believe the rules should reflect an acknowledgement that there may be valid reasons for not always requiring a PFFI (as a condition for retaining its PFFI status) to close accounts of NFFIs or recalcitrant accountholders that the PFFI has the ability to close. For example, an FFI located in a particular country may be an NFFI due to a local law that prevents it from becoming a PFFI, rather than due to a voluntary choice on the FFI's part; and that NFFI may have a depository account with a PFFI in a different country for reasons having to do with security of the NFFI's assets, rather than avoidance of FATCA – the NFFI may have no U.S. accountholders. It is not clear that in such circumstances, the PFFI should be compelled either to terminate its relationships with these NFFIs or to risk terminating its FFI Agreement.

In order not to unnecessarily limit access to the international financial system in cases that do not involve a significant risk of avoidance of FATCA, the Final Regulations might provide, for example, that a PFFI is permitted to leave open an account held by an NFFI or a recalcitrant accountholder, where all of the following requirements are met: (i) the accountholder is barred by local law from (in the case of an NFFI) becoming a PFFI, or from (in the case of a recalcitrant accountholder) providing all of the necessary information and consents to the PFFI that maintains the account; (ii) the accountholder provides the necessary information and consents to such PFFI to the maximum extent the accountholder is legally able to do so; and (iii) the accountholder certifies that it does not have any substantial U.S. owner or any significant debt interests or other liabilities owned by or owed to a U.S. person, and that it is not holding the account on behalf of a U.S. person.

It is possible that Treasury and the IRS might have concerns over whether it is feasible to provide an objective standard that permits a PFFI in certain cases to avoid an event of default if it

limited FFIs in 2014 and 2015 is to recognize that it is acceptable for a PFFI to maintain a relationship with a limited FFI in its EAG, on a transitional basis.

fails to promptly exercise its ability to close accounts of NFFIs and recalcitrant accountholders, without leaving some unforeseen opportunity for abuse or manipulation. If the government does have such concerns, then an alternative approach might be to state that a PFFI will trigger an event of default whenever it fails to exercise its ability to close such accounts promptly, but to provide that in appropriate circumstances there would be a presumption that the remedy for the event of default would not be termination of the FFI Agreement. For example, if a PFFI fails to close an account that is held by a NFFI which is legally prohibited from becoming a PFFI, and no other facts indicate a plan to avoid FATCA, then the appropriate remedy might not be termination of the agreement but, instead, for the PFFI to work to transfer the relevant account to a deemed-compliant FFI or a U.S. financial institution.

As a fourth consideration, in cases where a PFFI and its affiliates lack the practical ability either to compel an accountholder to comply with FATCA or to terminate the account, it would seem the PFFI's performance should be judged based on whether it has made a diligent effort to persuade the accountholder either to comply or else to agree to a termination. For example, if the PFFI contacts recalcitrant accountholders and NFFIs at least annually in writing to request that they either comply with FATCA (by providing required information or by becoming PFFIs) or consent to a termination of their accounts, in cases where the PFFI is not under common control with and has no relevant legal rights against the recalcitrant accountholders and NFFIs, that could be treated as sufficient effort by the PFFI to avoid being in default. [23]

Fifth, numerical safe harbors would be useful. For example, "a period of time" for significantly reducing the number of problem accounts could be defined, in the case of accounts for which the PFFI has the ability to close the account, as a short period – say, one year; and a "significant reduction" in such accounts during such period could be defined as elimination of all or the large majority of such accounts (say, at least 75% of the aggregate balance of such accounts), either by causing them to become compliant or by closing them. By comparison, in the case of accounts for which the PFFI lacks the practical ability to close the account, a longer interval would seem to be appropriate – say, the 3-year period between dates on which the PFFI's responsible officer must certify as to the strength of its FATCA compliance practices and

[23] We note that Model 1A and 1B IGAs do not require Financial Institutions to close accounts of NFFIs or recalcitrant accountholders or to force them to comply with FATCA. No official explanation has been provided for this difference from the Final Regulations. However, as is true in the case of other leniencies in the requirements of Model 1A and 1B IGAs, the explanation of the approach taken in the Model 1A and 1B IGAs may be a wish to spare partner countries concerns that there could be a prohibition under local law on a requirement that a Financial Institution close accounts or compel accountholders' compliance with FATCA.

If the Final Regulations are revised so that they do not require a PFFI in a non-IGA country to close accounts of noncompliant accountholders or to cause them to become compliant, in cases where as a practical matter the PFFI does not have the ability to do so, that will help to prevent there from being an arbitrary difference between the Model 1A and 1B IGAs, and the Final Regulations.

procedures.[24] The PFFI could be treated as "significantly reducing" such accounts during that period if, for example, it reduces the aggregate balance of such accounts by at least 33% during the period.[25]

As a further reasonable numerical rule, in a case where a PFFI acquires another financial institution, a "significant reduction" in problem accounts would be measured by reference to the total number of such accounts maintained by both the PFFI and the target financial institution before the acquisition, rather than just the number of problem accounts maintained by the PFFI before the transaction.

Finally, these rules could be bolstered by having a robust process for interaction between the PFFI and the IRS either before, or after, delivery of a notice of default. For example, the IRS could require the PFFI to provide information about the NFFIs and recalcitrant accountholders and the history of their dealings with the PFFI, and to present to the IRS for review a detailed plan, with deadlines and specific milestones, for seeking to reduce the PFFI's dealings with these parties. A PFFI's willingness to commit to such a process would provide a ready means to distinguish between PFFIs that make a good-faith attempt to reduce their dealings with such parties, and PFFIs that do not do so. As presently drafted, the Final Regulations permit, but do not require, any such process.

b. Promotion of a local FFI

A PFFI's sponsorship, promotion or noncustodial distribution for or on behalf of a registered deemed-compliant "local FFI" that is an investment entity is an event of default under the Final Regulations. Although the Preamble does not address the point, the rationale for this rule may be that a PFFI should not have a relationship with a local FFI that allows the PFFI to steer to the local FFI investors who desire to avoid FATCA withholding or reporting of their investments (including by investing in the PFFI through the local FFI). The government also may have been concerned about avoidance of the Final Regulations' requirements that a local FFI not market itself to accountholders outside its country of incorporation, and not maintain accounts for specified U.S. persons that are not residents of that country.[26]

Recommendation 5: Although these are sensible concerns, it would be helpful for the government to state more precisely what qualifies as sponsorship, promotion or noncustodial distribution by a PFFI. It is not difficult to envision cases in which a PFFI would have legitimate reasons for discussing with its customers the types of financial services performed by a local FFI.

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24 *See* Treas. Reg. § 1.1471-4(g)(1)(ii).

25 In other contexts, 33% has been found to be "significant." *Cf.* Treas. Reg. § 1.368-1(d)(4)(iii)(B)(1), (d)(5) Example 10.

26 *See* Treas. Reg. § 1.1471-5(f)(1)(i)(A)(3), (6), (7).

For example, it would be useful to have express confirmation that communications by a PFFI with one of its customers about a local FFI that are not initiated by the PFFI, and that occur in the ordinary course of the PFFI's relationship with the customer, do not constitute impermissible sponsorship, promotion or noncustodial distribution.

c. Reasonable cause for noncompliant actions

A PFFI might inadvertently commit a number of the acts that are events of default. For example, a failure to take "timely" corrective action to remedy a material failure is an event of default; but the Final Regulations do not indicate how to determine when actions are "timely," or distinguish a delay that is unintentional or unavoidable from one that is not.[27] Similarly, making for any reason a (materially or immaterially) incorrect claim for a refund of tax withheld pursuant to chapter 4 is an event of default,[28] as is failing for any reason to inform the IRS within 90 days of a significant change in circumstances.[29] The IRS is permitted, but not required, either not to issue a notice of default with respect to any of these occurrences, or else to reconsider the facts after it has issued a notice of default. However, no standards are provided to guide these decisions.

By comparison, the FFI Agreement provides that a failure by a lead FFI to inform the IRS within 90 days of an acquisition, sale or change in chapter 4 status of an FFI in the FFI group is an event of default only if there is no reasonable cause for such failure.[30] This approach has the benefit of providing some assurance to PFFIs that their FFI Agreements will not be terminated for relatively minor, inadvertent infractions. It also provides a standard to guide a PFFI in using the right level of diligence to comply with chapter 4.

Recommendation 6: We suggest that the reasonable cause exception be broadened to cover all events of default in the Final Regulations and the FFI Agreement (other than those events of default that are specifically defined in the Final Regulations and the FFI Agreement to require bad intent on the part of the PFFI).

We also suggest that Treasury and the IRS describe the key criteria that will be taken into account in determining whether there is reasonable cause. This would be consistent with the

27 Treas. Reg. § 1.1471-4(g)(1)(v).

28 Treas. Reg. § 1.1471-4(g)(1)(vii).

29 FFI Agreement, § 12.05(A).

30 FFI Agreement, § 12.05(B).

approach taken elsewhere in the Code and would make the exception easier for taxpayers and the government to apply.[31]

d. Process for the period from the issuance of a notice of default through termination of the FFI agreement

The Final Regulations and the FFI Agreement provide few details of the process after a notice of default is issued. As noted above, the PFFI can request that the IRS reconsider the notice of default, provided such request is made "within a reasonable period of time."[32] No guidance is provided as to what period is reasonable, nor are any parameters provided for whether, when, and in what form the IRS must respond to such a request. In addition, the IRS has the discretion to agree with a PFFI on a remediation plan after the notice of default is delivered, but there is no guidance as to when this would be appropriate.[33] Once the IRS has delivered a notice of termination, the PFFI has a period of 90 days to appeal that notice, and if it does timely file an appeal, the FFI agreement is considered to continue in effect until the appeal has been decided.[34]

This bare-bones outline of the procedures that apply after a notice of default has been delivered adds to the pressure on spelling out a proper scope for the definition of an event of default. A broad definition of an event of default generally would not be as problematic, if PFFIs knew that procedures were in place that would give them a meaningful opportunity to explain their actions and cure noncompliance. In addition, robust procedures would further FATCA's goal of causing FFIs to report information, rather than just forcing them to suffer withholding.

Such procedures presumably would distinguish between those events of default caused by inadvertance and unintended failures in internal systems, and those caused by culpable conduct. Although the latter category might appear to provide a better case for FFI Agreement termination, it may be more in keeping with the basic intent of FATCA (i.e., to promote reporting, rather than raising revenue through withholding) to excuse PFFIs that take affirmative action to remedy their wrongdoing, including voluntarily conducting an internal investigation and sharing the results with the government, terminating participating employees, and cooperating with any government examination.

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31 Compare Treas. Regs. §§ 1.1362-4 (inadvertent termination of S election), 1.6664-4 (reasonable cause exception to accuracy-related penalties), 301.9100-3 (extension of time for making elections, where taxpayer has acted reasonably and in good faith).

32 Treas. Reg. § 1.1471-4(g)(2).

33 Treas. Reg. § 1.1471-4(g)(3).

34 FFI Agreement, § 12.07(A).

Recommendation 7: We recommend that the Final Regulations be modified to provide a PFFI with a clear timeline for a request to reconsider a notice of default and for submission and review of proposed remediation steps, as well as an indication of the types of remediation steps that may be appropriate in different circumstances.

The procedures for dealing with events of default under a QI agreement provide a useful point of comparison here. Under those procedures, when a QI receives notice from the IRS of a default under the QI agreement, the QI has a specific time period – 60 days – within which it can respond by denying that an event of default has occurred, or by providing a proposed plan to cure the default.[35] The IRS must review such a response and, if it rejects the response, must provide a counter-proposal for how the default can be cured.[36] The QI, in turn, is given an additional 30 days to review and reply to any such rejection and counter-proposal from the IRS; and if the QI does not agree with the IRS's approach, the parties must spend a further 30 days working to resolve their differences.[37] Only if this process ends without an agreed resolution, or if the QI fails to timely reply to the IRS, is the IRS permitted to issue a notice of termination of the QI agreement.[38] Although this procedure is not described in great detail in the IRS's guidance, the guidance does provide a clear structure for an exchange of views between the QI and the IRS, and it focuses on seeking to have the QI and the IRS work with each other to develop remedies that fit the particular circumstances of the QI's default.

3. Limited FFI and Limited Branch Rules

a. Definition of a limited branch

Under the "all or nothing" rule in the Final Regulations, a "limited branch" of a PFFI is a branch that, under the laws of the country where it is located, either is prohibited from reporting on, or closing or transferring, the branch's U.S. accounts, or is prohibited from withholding with respect to, closing or transferring, or blocking accounts held by recalcitrant accountholders or NFFIs.[39] For this purpose, a "branch" is defined as "a unit, business, or office of an FFI that is

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35 Rev. Proc. 2000-12, § 4 (Qualified Intermediary Withholding Agreement), § 11.05, 2000-1 C.B. 387.

36 *Id*.

37 *Id*.

38 *Id*.

39 Treas. Reg. § 1.1471-4(e)(2)(iii). Under the Final Regulations as originally issued, the relevant legal prohibition needed to be in effect on February 15, 2012. This requirement was removed by amendments to the Final Regulations made on September 10, 2013. 78 Fed. Reg. 55,202, 55,205 (amending Treas. Reg. § 1.1471-4(e)(2)(iii)).

treated as a branch under the regulatory regime of a country or is otherwise regulated under the laws of such country as separate from other offices, units, or branches of the FFI."[40]

We believe the Final Regulations provide a useful bright-line rule, in defining a "branch" to include a unit, business or office that is expressly identified in local regulations as a branch. However, it would be helpful to clarify the remainder of the definition of a branch that is quoted above. We believe it is appropriate to cover any case in which a unit, business or office is subject to local laws or regulations of a country as a result of physically carrying on a business there. This seems to be the intent of the second part of the wording quoted above ("or is otherwise regulated under the laws of such country as separate from other offices, units, or branches of the FFI"). However, the relevant legal regime may not expressly provide that the local business is something "separate" that is subject to local regulation; rather, local law may simply apply to any entity that conducts activities in that country – regardless of whether the entity also conducts business anywhere else (or where the other activities are located). This presumably should make no difference for purposes of determining whether the local business is a "branch" under the Final Regulations (or IGAs, as discussed further below).

Recommendation 8: We recommend clarifying that the definition of "branch" covers all cases where a unit, business or office of a PFFI is subject to a country's laws and regulations as a result of carrying on a business in that country.

As discussed further below in Part III.B.2.a, such a definition would have the advantage not only of clarifying the application of the limited branch rules, but also of being capable of use throughout the Final Regulations and IGAs where they refer to branches.

b. Hedging transactions between a PFFI and a limited FFI or limited branch

A PFFI is required to withhold on a withholdable payment that it receives "with respect to a security or instrument held on behalf of a limited FFI (or an account maintained by the limited FFI)."[41] In addition, a PFFI is treated as making a withholdable payment to an affiliated limited FFI, and is required to withhold on that payment, if the limited FFI receives a payment with respect to a transaction between the PFFI and the limited FFI which "hedges or otherwise provides total return exposure to another transaction between such participating FFI and a third party that gives rise to a withholdable payment."[42]

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40 Treas. Reg. § 1.1471-4(e)(2)(ii). Under the Final Regulations as originally issued, an additional requirement was that the unit, office or business in question maintain a separate set of books and records. This requirement was removed by the September 10, 2013 amendments to the Final Regulations. 78 Fed. Reg. 55,202, 55,206-07 (amending Treas. Reg. § 1.1471-4(e)(2)(ii)).

41 Treas. Reg. § 1.1471-4(b)(5)(i).

42 *Id*.

Similarly, a PFFI is required to withhold on a withholdable payment "when it receives the payment on behalf of a limited branch of the participating FFI. A branch of the participating FFI other than a limited branch will be considered to have received a withholdable payment on behalf of a limited branch when such other branch receives a withholdable payment with respect to a security or instrument it holds on behalf of a limited branch (or an account maintained by the limited branch). A branch of a participating FFI other than a limited branch will be considered to hold a security or instrument on behalf of a limited branch when it executes a transaction with a limited branch that hedges or otherwise provides total return exposure to another transaction between such other branch and a third party that gives rise to a withholdable payment."[43]

Although these rules regarding limited FFIs and limited branches are phrased somewhat differently, they appear to be intended to have the same scope: both appear to apply to a payment made by a PFFI to a related limited FFI, or a limited branch, that "hedges or otherwise provides total return exposure to" a transaction between the PFFI and a third party. It would be useful for the government to clarify the scope of the quoted phrase. It appears it is meant to apply to fact patterns that are easily identified: specifically, cases where a PFFI enters into a transaction with a related limited FFI or a limited branch that has fully (not partially) offsetting economics with respect to a third-party transaction. Furthermore, although the Final Regulations do not expressly say so, the rule just described is presumably limited to cases where either the PFFI has designated its transaction with the limited FFI or limited branch in its books and records as a hedge of the PFFI's transaction with a third party, or where the two transactions otherwise are entered into by the PFFI as part of a plan.

Although the term "hedge" in some contexts is construed more broadly than in the interpretation offered above,[44] the above interpretation appears to give appropriate recognition to the full phrase used in the Final Regulations: "hedges *or otherwise provides total return exposure*."[45] The above interpretation also appears consistent with the Final Regulations' concept that the transaction between the PFFI and the limited branch or limited FFI will be sufficiently closely linked to the related transaction between the PFFI and the third party as to justify treating any payment received (or deemed received) by the related limited FFI or limited branch as a withholdable payment – i.e., a payment of U.S.-source FDAP income or a payment of gross proceeds on the disposition of a security generating such income – just as the payment

[43] Treas. Reg. § 1.1471-4(b)(5)(ii).

[44] *Cf.* Treas. Reg. § 1.1221-2(b) (referring to a transaction that allows the taxpayer to "manage," rather than fully eliminate, certain risks associated with an asset).

[45] *See* Treas. Reg. § 1.1471-4(b)(5)(i), (b)(5)(ii) (emphasis added).

in respect of the related transaction would have been treated if received directly by the limited branch or limited FFI from the third party. [46]

<u>Recommendation 9</u>: We recommend that the government provide guidance confirming that the interpretation of Treasury Regulation Section 1.1471-4(b)(5) that we have described, and not a broader or more open-ended interpretation, is what is intended by the government.

B. <u>IGAs</u>

We commend Treasury on its commitment to negotiating IGAs with partner countries, and believe this represents a promising way forward in implementing FATCA. As described below, we believe the IGAs would benefit significantly from the issuance of guidance by the U.S. government that addresses their scope and intended implementation, including guidance explicating a number of issues related to the interaction between the IGAs and the Final Regulations.

1. Definition of "Financial Institution"

a. Holding companies and treasury centers in a corporate group

It would be useful for the government to confirm that it does not view a holding company or treasury center in a corporate group that is formed or resident in an IGA country as being a "Financial Institution" for purposes of the relevant IGA solely as a result of its status as a holding company or treasury center.

The Final Regulations include, as one category of FFI, a holding company or treasury center that either is formed in connection with or availed of by an FFI that is a private equity fund, hedge fund, or similar investment vehicle, or is in an expanded affiliated group that includes a custodial institution, depository institution, insurance company, managed "investment entity" or private equity fund, hedge fund or similar investment vehicle.[47] This category of entity is absent from the Model IGAs' definition of "Financial Institution".[48] The Model IGAs do provide that the definition of a "Financial Institution" includes an "Investment Entity."

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46 By comparison, a broader reading of the rule could rapidly lead to difficult line-drawing and other issues. If the above rule could be read as applying to transactions with less than fully offsetting payments, then a series of questions would need to be addressed as to which portions of which payments under the transaction between the PFFI and the limited FFI, or limited branch, were sufficiently linked to the PFFI's third-party transaction as to justify re-characterizing such payments to the limited FFI or limited branch as withholdable payments.

47 Treas. Reg. § 1.1471-5(e)(1)(v).

48 *See* Model 1A Intergovernmental Agreement, art. 1, ¶ 1(g) [hereinafter Model 1A IGA]; Model 1B Intergovernmental Agreement, art. 1, ¶ 1(g) [hereinafter Model 1B IGA]; Model 2 Intergovernmental Agreement, art. 1, ¶ 1(g) [hereinafter Model 2 IGA].

However, it does not appear that a holding company or treasury center of the type just described fit logically within the IGAs' definition of "Investment Entity," as explained below.

First, an Investment Entity is defined under the Model IGAs as one that conducts as a business on behalf of customers (or is managed by an entity that conducts as a business on behalf of customers) the activities of trading in securities or certain derivatives; portfolio management; or otherwise investing, administering or managing other persons' money.[49] It is hard to construe a company in a corporate group whose principal or only activity is to own shares or debt of other group members as being engaged in a "business" on behalf of "customers" as a result of such activity. Furthermore, a holding company or treasury center would typically be managed by its board of directors and officers, rather than by another entity that engaged in a business of managing investments for customers.

Second, this category of Financial Institution appears to be designed to be broadly similar to an "investment entity" as defined in the Final Regulations. As discussed in our prior report on the Final Regulations, it appears that, logically, a holding company or treasury center in a corporate group would not be an "investment entity," but rather would be governed by the detailed, specific set of rules for such companies set out in the separate category of FFI that the Final Regulations established.[50] It would appear unwarranted to stretch the definition of "Investment Entity," which as discussed in our previous report is more narrowly drafted than that in the Final Regulations, to apply to group holding companies and treasury centers.

As a result, it seems that such entities, if established in an IGA country, should be treated as NFFEs for purposes of the applicable IGA and the Final Regulations.[51] In this connection, we note that the IGAs provide the FATCA partner country with the flexibility to use a definition in the Final Regulations in lieu of a corresponding definition in the applicable IGA, where doing so "would not frustrate the purposes of this Agreement."[52] In view of the clear omission of this category of FFI from the definition of "Financial Institution" in Article 1 of the IGAs, as well as

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49 Model 1A IGA, art. 1, ¶ 1(j); Model 1B IGA, art. 1, ¶ 1(j); Model 2 IGA, art. 1, ¶ 1(k).

50 *See* New York State Bar Association Tax Section, *Report on the Final FATCA Regulations: Definitions of "FFI", "Financial Account" and Related Terms* (Rep. No. 1282, April 29, 2013), Recommendation 3.

51 *See* Model 1A IGA Annex I, ¶ VI.B.2; Model 1B IGA, Annex I, ¶ VI.B.2; Model 2 IGA, Annex I, ¶ VI.B.2; Treas. Reg. § 1.1471-1(b)(74). Treasury Regulation Section 1.1471-1(b)(74) defines an NFFE to include "a foreign entity treated as an NFFE pursuant to a Model 1 IGA or Model 2 IGA." Strictly speaking, the definition of "NFFE" in Annex I to the IGAs applies only for purposes of the diligence and documentation requirements applicable to accounts held by such entities with a Participating Financial Institution that is subject to such IGA, as described in Annex I; the definition does not by its terms apply for all purposes of the IGA. Nevertheless, it seems fairly clear that such definition in Annex I of the IGAs was intended to be incorporated by reference into the Final Regulations' definition of NFFE.

52 Model 1A IGA, art. 4, ¶ 7; Model 1B IGA, art. 4, ¶ 7; Model 2 IGA, art. 3, ¶ 6.

the numerous uncertainties and drafting issues associated with such category of FFI in the Final Regulations,[53] it would appear that the inclusion of group holding companies and treasury centers of the type described in Treasury Regulation Section 1.1471-5(e)(1)(v) as "Financial Institutions" might well "frustrate the purposes" of the IGA to reduce the burdens of FATCA.[54]

Recommendation 10: It would be useful for the U.S. government to confirm that, absent express guidance from a particular partner country regarding treatment of group holding companies and treasury centers in that country as Financial Institutions under Article 4, paragraph 7 of an IGA, such entities are intended to be treated as NFFEs if they are established in IGA countries.

b. Definition of "Investment Entity"

i. Treatment of entities that own a pool of financial assets with limited or no turnover

Some capital markets transactions (for example, unit trusts, and some types of CDOs) involve the formation of a vehicle that issues securities in order to finance an investment in a static pool of financial assets, or a pool of financial assets that will change only in accordance with highly detailed, narrow guidelines that very largely preclude the exercise of discretion by an investment manager. Under the Final Regulations, it appears that such vehicles would be "investment entities" and, thus, FFIs: such a vehicle appears to "function or hold itself out as a collective investment vehicle" established with an investment strategy of investing in financial assets.[55] By comparison, under the IGAs' definition of "Investment Entity," it is not clear such a vehicle is covered: given the vehicle's extreme passivity, it is questionable whether it is engaged in a "business" of investing or managing investments; and it also is questionable (in view of the absence of turnover in its assets) whether it can be said to be "managed" by a manager.

Recommendation 11: In general, the kind of entity just described, which is held out to investors as a means for them to buy interests in a largely static portfolio of financial assets,

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53 *See* New York State Bar Association Tax Section, *Report on the Final FATCA Regulations: Definitions of "FFI", "Financial Account" and Related Terms* (Rep. No. 1282, April 29, 2013), Recommendations 5, 6 and 7.

54 The United Kingdom has extended the definition of "Financial Institution" under its IGA to cover group holding companies and treasury centers. *See* HMRC, Implementation of the International Tax Compliance (United States of America) Regulations 2013 – Guidance Notes ¶ 2.30 (Aug. 14, 2013). However, it has narrowed the definition to cover holding companies and treasury centers (a) whose primary activity is holding shares of, or performing treasury activities for, related entities that are Financial Institutions, or (b) which are formed in connection with or used by private equity funds, hedge funds, or similar investment vehicles. This narrowed definition does not eliminate all the problematic features of the Final Regulations; but it does seek to address some of them.

55 Treas. Reg. § 1.1471-5(e)(4)(i)(C).

resembles a fund with a more actively traded portfolio. A fund that does more trading of the securities it holds would clearly be an "Investment Entity" under an IGA; and it would appear appropriate to clarify that the kinds of fixed-investment entities described, despite having little or no turnover in their portfolios, also are Investment Entities.

ii. Proposed election regarding classification as an Investment Entity

If an entity principally owns a pool of financial assets, and the entity's equity is held by multiple investors, then it generally will be classified either as an investment entity under the Final Regulations (or an Investment Entity, if resident in a country with an IGA), or else as a passive NFFE. In order to distinguish between these two classifications, the entity often will need to carefully consider how to apply fact-based standards to the precise facts related to its assets, owners and activities. In practice, however, the entity not infrequently may end up being required to provide information about the same set of U.S. investors that own equity of the entity, regardless of whether it is treated as an investment entity (or Investment Entity under an IGA), or as a passive NFFE.[56]

An investment entity (or Investment Entity under an IGA) is also required to report on any debt interests it has outstanding that are owned by specified U.S. persons either directly or through certain intermediate foreign entities.[57] A passive NFFE is not required to do such reporting. However, if an entity's debt is held only by institutional lenders – U.S. financial institutions that are not specified U.S. persons, PFFIs, and Reporting Financial Institutions in countries with IGAs – then it would not be necessary for the entity to report on such lenders,

[56] An investment entity must report to the IRS on any specified U.S. person that directly owns an equity interest in it, as well as any NFFE that has a substantial U.S. owner and holds equity of the entity. *See* Treas. Reg. § 1.1471-4(d)(3)(ii), (iii). An Investment Entity's reporting obligations are largely the same, except that if it is subject to a Model 1A or 1B IGA, then it must report to the government of the partner country under the IGA (and, instead of reporting on equity held by NFFEs with substantial U.S. owners, it must report on any equityholder that is a foreign entity in which U.S. individuals own directly or indirectly a controlling interest). *See* Model 1A IGA, art. 1, ¶¶ 1(cc), 1(mm), art. 2, ¶ 2(a); Model 1B IGA, art. 1, ¶¶ 1(y), 1(hh), art. 2, ¶ 2. By comparison, a passive NFFE is required to inform withholding agents of any specified person that directly owns an interest of over 10% in the passive NFFE, or that indirectly owns such interest through one or more intermediate NFFIs or passive NFFEs; and the withholding agents are required to report this information. *See* Treas. Regs. §§ 1.1472-1(b)(1)(ii), 1.1473-1(b)(1), (b)(2). Notice 2013-69 contemplates that a passive NFFE will be able to report this same information directly to the IRS (rather than to withholding agents), at the NFFE's option. *See* Notice 2013-69, ¶ III.02(D). Thus, depending on the circumstances, the reporting regime for an investment entity (or Investment Entity) may require the same, or almost the same, reporting on U.S. direct or indirect equity investors in an entity that the passive NFFE rules do.

[57] The same provisions of the Final Regulations and Model IGAs require this result as are cited in the preceding footnote related to specified U.S. persons that directly or indirectly own equity of an investment entity (or Investment Entity).

regardless of whether the entity is classified as an investment entity (or Investment Entity under an IGA), or as a passive NFFE.

Recommendation 12: In cases where the composition of an entity's assets makes it likely the entity will be classified either as an investment entity (or Investment Entity under an IGA), or as a passive NFFE, the entity should not be required to determine which of these classifications is appropriate. Instead, it should be allowed to file an election choosing either one of these two classifications, so long as the entity certifies that, based on the current and expected future direct and indirect ownership of interests in the entity, the IRS will receive information about the same group (or a broader group) of U.S. investors that hold interests in the entity, as the IRS would have received if the entity had chosen the other classification. As part of its certification, the entity would need to agree that, in the event it becomes aware in the future of direct or indirect U.S. investors in interests in the entity about which it would need to provide information, had the entity chosen the other classification, the entity will provide information about those U.S. investors to the IRS.

We believe that in many cases, an entity holding a pool of financial assets may have fairly complete information about the identity of the U.S. investors (if any) that directly or indirectly own interests in the entity, and the amount of information received by the IRS about those U.S. investors may be largely the same regardless of which classification -- investment entity (or Investment Entity in an IGA country) or passive NFFE – is chosen for the entity. However, the entity may need to undertake a nuanced analysis in order to determine which classification is most appropriate under the Final Regulations or an applicable IGA. It appears to us that the purposes of FATCA can be served without requiring the entity to complete such an analysis, so long as the entity is able to provide the IRS with appropriate assurances to the effect that the entity will be providing information about the same group (or a broader group) of U.S. investors under the classification it chooses, as it would have under the alternative classification. Such an approach may be helpful, for example, in the case of an investment vehicle the equity of which is held principally or entirely by foreign individuals (or by closely held vehicles owned by such individuals), and the debt of which is held by FATCA-compliant financial institutions; such an entity may be able to conclude there will be limited or no changes in the ownership of its equity and debt, and that it is able to identify without great difficulty the owners of such interests that are specified U.S. persons. In that case, the entity could elect its status, without the need for an extensive analysis of which status was more appropriate.[58]

[58] For entities that are not residents of countries with IGAs, our recommendation could be implemented by amending the Final Regulations to provide for the election we have described. In the case of entities that are residents of a country with an IGA, we do not believe an amendment to the IGA is necessary to implement this recommendation, so long as the partner country acknowledges that it will respect an election made by such entities under the Final Regulations.

2. Treatment of Disregarded Entities and Branches

The IGAs deal with cases that involve a regarded entity owning disregarded entities or branches in different countries in a manner that is internally inconsistent, and that also is inconsistent with the approach to such cases adopted in the Final Regulations. We recommend that guidance be provided that removes these inconsistencies, and that incorporates a key principle from the IGAs into the Final Regulations: if a regarded entity owns a disregarded entity or branch in an IGA country, including the entity's head office, then the disregarded entity or branch in that country should be tested separately from the remainder of the regarded entity's activities under the Final Regulations, in order (i) to determine whether such disregarded entity or branch is an FFI or an NFFE and (ii) to apply the relevant rules in FATCA to the disregarded entity or branch based on its status as a financial institution or NFFE. We believe this approach is in keeping with the intent of the IGAs and of the Final Regulations as currently drafted – although it is proposed to make clarifications to both the IGAs and the Final Regulations, as explained below (in parts a. through e.).

In addition, Treasury and the IRS may wish to consider whether to amend the Final Regulations to adopt this type of approach of looking separately at each disregarded entity and branch, even in cases that do <u>not</u> involve an entity that has any activities in a country with an IGA. Such amendments would be motivated more by policy considerations of providing for consistent and fair results, than just by a need to harmonize the Final Regulations with the IGAs.

a. Definition of "branch"

As a preliminary point, we note that the IGAs use, but do not define, the term "branch," and the Final Regulations define that term only for purposes of Treasury Regulation Section 1.1471-4 (as discussed above). We believe a consistent concept of a branch should apply for purposes of both the IGAs and the Final Regulations.

We believe that, as discussed in Part III.A.3.a above, the Final Regulations' current definition of the term is too constrained even for its principal intended use in the limited branch rules. By comparison, the definition of "branch" that we have recommended in that discussion would apply relatively easily not only to a business unit that carries on activities characteristic of an FFI, but also to a business unit that carries on activities characteristic of an NFFE. This appears to us to be a meaningful advantage: it would be useful to have a single, consistent definition of "branch" for purposes of the IGAs and the Final Regulations, given the central importance of this concept.[59]

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[59] Such definition also would be consistent with the concept of a "branch" appearing elsewhere in the Code and Treasury Regulations. *See*, e.g., Treas. Reg. § 1.367(a)-6T(g) (defining a "foreign branch"); *see also* Treas. Reg. § 1.989(a)-1(b)(2) (defining a "qualified business unit").

b. ***Treatment of disregarded entities and branches as "Financial Institutions" under the IGAs and "FFIs" under the Final Regulations***

The Model IGAs all define a "[FATCA Partner] Financial Institution" ("**FATCA Partner Financial Institution**") as "(i) any Financial Institution that is [resident in][60] [FATCA Partner], but excluding any branch of such Financial Institution that is located outside [FATCA Partner], and (ii) any branch of a Financial Institution not [resident in] [FATCA Partner], if such branch is located in [FATCA Partner]."[61] This definition reflects a basic approach of applying FATCA on a branch-by-branch basis to an entity's branches in different countries. We believe such an approach reasonably reflects the partner country's interest in overseeing the activities of a legal entity that are related to that country, and generally avoids the potential for duplicative regulation by multiple countries of the same activities. In addition, under this approach, it is irrelevant whether a legal entity is disregarded for U.S. federal income tax purposes; all that matters is where the entity's branches are located and what activities they carry on. We believe this too is a reasonable methodology: it emphasizes practical reality over a U.S. tax classification that appears to have limited or no relevance to the basic issue at hand of ensuring efficient information reporting on financial accounts.

Each Model IGA goes on to divide Financial Institutions, whether or not disregarded entities or branches, into "Reporting [FATCA Partner] Financial Institutions" (those required to report on accountholders under the Model IGA)[62] (called "Reporting Financial Institutions" in this report), and "Non-Reporting [FATCA Partner] Financial Institutions" (those not required to report on accountholders) ("**Non-Reporting Financial Institutions**").[63] In each case, the Model IGA then goes on to provide that a Reporting Financial Institution will be treated by the U.S. government as complying with, and not subject to withholding under, Section 1471 of the Code provided it meets specific reporting and withholding requirements.[64] A Non-Reporting Financial

[60] A note to the Model IGAs indicates that where the partner country's laws do not have a concept of residence, the IGA will refer to a Financial Institution that is organized under the laws of that country. Model 1A IGA, note 5; Model 1B IGA (preexisting TIEA or DTC), note 5; Model 1B IGA (no TIEA or DTC), note 4; Model 2 IGA (preexisting TIEA or DTC), note 5; Model 2 IGA (no TIEA or DTC), note 4. In practice, the IGAs signed to date, other than the IGAs signed with Bermuda, the Cayman Islands and Switzerland, have all used the concept of residence.

[61] Model 1A IGA, art. 1, ¶ 1(l); Model 1B IGA, art. 1, ¶ 1(l); Model 2 IGA, art. 1, ¶ 1(m).

[62] Model 1A IGA, art. 1, ¶ 1(o); Model 1B IGA, art. 1, ¶ 1(n); Model 2 IGA, art. 1, ¶ 1(o).

[63] Model 1A IGA, art. 1, ¶ 1(q); Model 1B IGA, art. 1, ¶ 1(o); Model 2 IGA, art. 1, ¶ 1(p).

[64] Model 1A IGA art. 4, ¶ 1; Model 1B IGA, art. 4, ¶ 1; Model 2 IGA, art. 3, ¶ 1.

Institution will be treated by the U.S. government as a deemed-compliant FFI for purposes of Section 1471.[65]

However, the Final Regulations are not drafted in a manner that is fully consistent with the scheme laid out by the Model IGAs. The definition of "registered deemed compliant FFI" appears to be intended to cover any Reporting Financial Institution under an IGA:

> "A registered deemed compliant FFI means an FFI that meets the procedural requirements described in paragraph (f)(1)(ii) of this section [i.e., registration on the IRS's FATCA portal] and that either is described in any of paragraphs (f)(1)(i)(A) through (F) of this section [i.e., categories of registered deemed-compliant FFIs in the Final Regulations] or is treated as a registered deemed-compliant FFI under a Model 2 IGA. A registered deemed-compliant FFI also includes any FFI, or branch of an FFI, that is a reporting Model 1 FFI that complies with the registration requirements of a Model 1 IGA."[66]

Read literally, however, this definition provides that a registered deemed-compliant FFI must be an "FFI": the first sentence refers only to FFIs of specific kinds; and the second sentence refers to an FFI, or branch, which is a "reporting Model 1 FFI" – a defined term which encompasses an FFI with respect to which a partner country agrees to exchange information under a Model 1A or Model 1B IGA.[67] An "FFI," in turn, is defined in the Final Regulations as a foreign regarded entity – a disregarded entity (or a branch) cannot be an FFI.[68] This appears to be an inadvertent drafting flaw. The definition of registered deemed-compliant FFI expressly contemplates that a branch can at least in some circumstances be a registered deemed-compliant FFI; and the same apparently is also true for a disregarded entity.[69]

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[65] Model 1A IGA art. 4, ¶ 4; Model 1B IGA art. 4, ¶ 3; Model 2 IGA art. 3, ¶ 4.

[66] Treas. Reg. § 1.1471-5(f)(1) (emphasis added). The quoted language refers to an FFI "treated as a registered deemed-compliant FFI under a Model 2 IGA." The Model 2 IGA uses the term Reporting Financial Institution, rather than registered deemed compliant FFI; but this reference in the Final Regulations appears to be intended as a reference to a Reporting Financial Institution.

[67] Treas. Reg. § 1.1471-1(b)(107).

[68] "The term FFI means, with respect to any entity that is not resident in a country that has in effect a Model 1 IGA or Model 2 IGA, any financial institution (as defined in paragraph (e) of this section) that is a foreign entity. *With respect to any entity that is resident in a country that has in effect a Model 1 IGA or Model 2 IGA, an FFI is any entity that is treated as a Financial Institution pursuant to such Model 1 IGA or Model 2 IGA.* A territory financial institution is not an FFI under this paragraph (d)." Treas. Reg. § 1.1471-5(d) (emphasis added); *see* Treas. Reg. § 1.1471-1(b)(35) (an "entity" means a "person" other than an individual); Treas. Reg. § 1.1471-1(b)(94) (a "person" does not include a disregarded entity).

[69] The FFI Agreement also contains wording that appears to assume the agreement will apply to particular branches of an FFI: "An FFI that agrees to comply with the terms of this agreement applicable to one or more of its

Similarly, the definition of "certified deemed-compliant FFI" in the Final Regulations appears to be intended to include any Financial Institution that qualifies as a Non-Reporting Financial Institution under an IGA.[70] Again, however, the definition incorporates the term FFI, which includes only a regarded entity.

Recommendation 13: The relevant provisions in the IGAs are intended to override the Final Regulations, to the extent they are inconsistent. Nevertheless, to avoid uncertainty as to the application of the Final Regulations, it would be useful to make appropriate amendments to the regulations so that they conform to the approach to disregarded entities and branches taken in the IGAs. Specifically, the definition of "FFI" should be revised to expressly include any Financial Institution as defined in an IGA. This would harmonize the Final Regulations with the IGAs' concept that a branch can be a Financial Institution. If this change is made, then the definitions of registered deemed-compliant FFI, certified deemed-compliant FFI, and nonreporting IGA FFI in the Final Regulations will incorporate that change by reference.

This change to the definition of FFI also will make it clear that a foreign disregarded entity or foreign branch of a U.S. regarded entity can be an FFI under the Final Regulations, just as such a disregarded entity or branch can be a Financial Institution under the IGAs. At present, the definition of an FFI as a foreign regarded entity by its terms excludes such disregarded entities and branches owned by a U.S. entity. The definition also excludes an entity formed under U.S. law that is treated by an IGA country as a resident of such country.[71]

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branches will be treated as a participating FFI with respect to such branches, and such participating FFI branches will not be subject to withholding under section 1471. An FFI (or branch of an FFI) must act in its capacity as a participating FFI with respect to all of the accounts that it maintains for purposes of reporting such accounts and must act as a withholding agent to the extent required under this agreement. A branch of an FFI that cannot satisfy all of the terms of this agreement under the laws of the jurisdiction in which such branch is located must meet the conditions described in § 1.1471-4(e)(2)(iii) to be treated as a limited branch and will be subject to withholding under section 1471 as a nonparticipating FFI." FFI Agreement, §1.02.

[70] *See* Treas. Reg. § 1.1471-5(f)(2), which states that a "certified deemed-compliant FFI" includes any "nonreporting IGA FFI." The term "nonreporting IGA FFI," in turn, means "an FFI that is identified as a nonreporting financial institution pursuant to a Model 1 IGA or Model 2 IGA that is not a registered deemed-compliant FFI." Treas. Reg. § 1.1471-1(b)(76).

[71] Under the Final Regulations, a foreign branch of a U.S. financial institution is generally treated as merely an extension of the U.S. financial institution, both for purposes of the withholding obligations imposed on the branch and for purposes of the withholding obligations imposed on third-party payors making a payment to the branch. *See* Treas. Reg. §§ 1.1471-2(a)(2)(v); 1.1471-3(a)(3)(v). However, the Final Regulations indicate that, at least in some circumstances, a foreign branch is intended to be capable of qualifying as a reporting Model 1 FFI. For example, Treasury Regulation Section 1.1471-2(a)(2)(v) indicates that a foreign branch of a U.S. financial institution is intended to be able to qualify as a reporting Model 1 FFI (although the branch will also be subject to the withholding obligations imposed on a U.S. withholding agent under the Final Regulations, as discussed further below in Part II.B.3). In addition, Treasury Regulation Section 1.1471-1(b)(24) appears to reflect an intent to treat a foreign branch of a U.S. financial institution as a deemed-compliant FFI under the Final Regulations, if the branch is

It also should be noted that in the IGAs, the definition of FATCA Partner Financial Institution includes, with respect to a Financial Institution, a branch located in the partner country. This definition appears to have two technical weaknesses. First, where the parent legal entity is a Financial Institution, the wording literally provides that any branch in the partner country is a FATCA Partner Financial Institution, regardless of whether that branch carries on activities characteristic of a Financial Institution. Second, where the parent legal entity is not a Financial Institution, its branches in the partner country apparently will not be treated as Financial Institutions under the IGA, again regardless of the type of activities the branch carries on. It would seem the basic principles of the IGAs would be best served if a branch carrying on financial activities in the relevant partner country (and only such a branch) were treated as a Financial Institution under that country's IGA.

c. Treatment of disregarded entities and branches as NFFEs under the IGAs and the Final Regulations

Each Model IGA indicates that, if an entity – whether regarded or disregarded – is resident in an IGA partner country, and such entity does not qualify as a Financial Institution, then it will be treated as an NFFE for purposes of the account-holder due diligence procedures that are imposed on Reporting Financial Institutions pursuant to Annex I to the Model IGA.[72] Presumably, such an entity is meant to be treated as an NFFE under the Final Regulations, as well.[73] Again, however, the definition of "NFFE" in the Final Regulations, if read literally, includes only to a regarded entity.[74] On balance, it seems reasonably clear this is inadvertent; and it also appears that the definition in the IGAs should override that in the Final Regulations.

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a QI. ("The term deemed-compliant FFI also includes a QI branch of a U.S. financial institution that is a reporting Model 1 FFI.") In our view, it would make sense to broaden this approach, and provide in the Final Regulations that any Reporting Financial Institution that is a branch of a U.S. regarded entity is a deemed-compliant FFI that is exempt from FATCA withholding and reporting obligations, other than those provided in the relevant IGA.

[72] *See* Model 1A IGA, Annex I, ¶ VI.B.2; Model 1B IGA, Annex I, ¶ VI.B.2; Model 2 IGA, Annex I, ¶ VI.B.2.

[73] "The term NFFE or non-financial foreign entity means a foreign entity that is not a financial institution (including a territory NFFE). The term also means a foreign entity treated as an NFFE pursuant to a Model 1 IGA or Model 2 IGA." Treas. Reg. § 1.1471-1(b)(74). Strictly speaking, the term "NFFE" as used in the IGAs applies only for purposes of the account-holder due diligence procedures imposed on Reporting Financial Institutions under Annex I; the definition does not apply for all purposes of the IGA. Nevertheless, it appears that the Final Regulations' reference to being "treated as an NFFE pursuant to a Model 1 IGA or Model 2 IGA" is meant to apply to any entities that would meet the definition of an NFFE in Appendix I to the Model IGAs.

[74] *See* Treas. Reg. § 1.1471-1(b)(74) ("NFFE" means certain types of foreign "entities"); Treas. Reg. § 1.1471-1(b)(35) ("entity" means a "person" other than an individual); Treas. Reg. § 1.1471-1(b)(94) ("person" does not include a disregarded entity).

Recommendation 14: To avoid any confusion, we recommend that the Final Regulations' definition of NFFE be amended to expressly include all entities, including disregarded entities, that are treated as NFFEs under an IGA.

In addition, the Model IGAs by their terms provide that only an entity that is not a Financial Institution can be an NFFE.[75] Thus, if a company has a branch in an IGA country, and that branch conducts only non-financial activities, the branch is not within the IGA's definition of an NFFE (because the branch is not a separate entity). To conclude that such a branch is not an NFFE under the IGA would be at odds with the approach taken in the IGA to a local branch that carries on financial activities, as well as the approach taken in such IGA to a disregarded entity that conducts non-financial activities. There is no obvious reason for such inconsistency; and such inconsistency creates the potential for confusion among multinational companies or groups. Thus, we recommend that a nonfinancial branch in an IGA country be treated for purposes of the IGA and the Final Regulations as an NFFE.

d. U.S. branch of a non-U.S. entity

Under the IGAs, a U.S. branch of, or a disregarded entity conducting U.S. activities that is owned by, a Financial Institution is not treated as a part of the Financial Institution. The branch or disregarded entity accordingly is not subject to the rules imposed by the IGAs on the Financial Institution. If the U.S. branch is treated under Treasury Regulation Section 1.1441-1(b)(2)(iv)(A) as a U.S. person,[76] then the branch is generally treated for purposes of the Final Regulations as a separate U.S. financial institution with the normal FATCA withholding and reporting obligations for such an institution.[77] In all other cases, the U.S. branch appears to be treated under the Final Regulations not as a U.S. person, but rather as a part of the foreign entity that owns the branch.

Assuming the foreign owner is a Reporting Financial Institution, the owner will be a registered deemed-compliant FFI under the Final Regulations. However, the definition of registered deemed-compliant FFI in the Final Regulations appears not to include the U.S. branch, but rather only to cover that portion of the foreign owner that qualifies as a Reporting Financial

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75 *See* Model 1A IGA, Annex I, ¶ VI.B.2; Model 1B IGA, Annex I, ¶ VI.B.2; Model 2 IGA, Annex I, ¶ VI.B.2.

76 Generally, a U.S. branch of a foreign person will be treated as a U.S. person under Treasury Regulation Section 1.1441-1(b)(2)(iv)(A) with respect to specific payments received by it, if the foreign person is either a bank subject to regulation by the Federal Reserve Board, or an insurance company required to file an annual statement with the insurance department of a U.S. state, and such bank or insurance company agrees with a withholding agent that the branch will be treated as a U.S. person with respect to those payments.

77 *See* Treas. Reg. §§ 1.1471-1(b)(126), (b)(127), 1.1471-3(a)(3)(vi).

Institution under the IGA.[78] As a result, it would appear the U.S. branch has to be treated as an FFI that must become a PFFI under the Final Regulations, in order to be FATCA-compliant.

This result seems counter-intuitive and difficult to justify as a policy matter. First, if the U.S. branch conducts principally or solely non-financial activities, then there does not appear to be a reason to subject the branch to the rules that apply to PFFIs. Second, it appears somewhat arbitrary for the FATCA reporting and withholding obligations of the U.S. branch to depend on the details of the legal formalities of the structure through which that branch is held. If a U.S. regarded subsidiary of a Reporting Financial Institution carries on solely non-financial operations in the United States, then that subsidiary will be treated as a U.S. withholding agent which is not a financial institution, for purposes of the Final Regulations; alternatively, if the U.S. subsidiary carries on financial operations in the United States, then the subsidiary will be treated as a U.S. financial institution. In addition, if a U.S. regarded entity has operations in the United States and also has a financial branch in an IGA country, then the U.S. regarded entity will be treated as a U.S. withholding agent under the Final Regulations, and the branch in the IGA country will be treated as a separate Financial Institution. There does not seem to be a reason to distinguish the outcomes in these cases from the outcome in a case where a Reporting Financial Institution owns a U.S. branch.

Recommendation 15: A better approach would be to treat the U.S. branch of a Financial Institution as a U.S. person for purposes of the Final Regulations, with such U.S. person being treated as a financial institution, or a non-financial institution, depending on the nature of its activities conducted in the United States. We recommend that the Final Regulations be revised accordingly.

e. Treatment of a regarded entity that owns disregarded entities or branches which are treated as separate FFIs or NFFEs under IGAs

Recommendation 16: Under our proposals above, the IGAs and the Final Regulations would be clarified, so that they provide on a consistent basis that disregarded entities and branches in IGA countries would be treated as Financial Institutions or NFFEs pursuant to the relevant IGAs. In addition, a U.S. branch of a Financial Institution in an IGA country would be treated as a separate U.S. person for purposes of FATCA. As a corresponding recommendation, we propose that a regarded foreign entity should ignore the activities of all of its branches and disregarded entities just described, when determining whether the regarded foreign entity is an FFI or an NFFE under the Final Regulations, and when taking the actions required of an FFI or NFFE (as applicable) under the Final Regulations. This proposal is a logical corollary to the proposals above, and we believe that the same drafting changes as are described above would go a long way toward implementing this proposal.

78 *See* note 61 in Part II.B.2.b above, and accompanying text.

f. Potential expansion of the recommended approach to disregarded entities and branches, to cases that do not involve any entities or branches located in countries with IGAs

We note that the above recommendations deal only with coordination between the treatment of disregarded entities and true branches under IGAs, and their treatment under the Final Regulations. The above recommendations do not address whether, as a policy matter, it would be desirable to make broader changes that would alter the basic treatment of disregarded entities and branches provided in the IGAs, or that would alter basic treatment of such entities and branches in the Final Regulations.

Recommendation 17: In general, we believe that the principle in the IGAs of focusing separately on the activities of each disregarded entity and branch owned by a regarded entity, and determining the FATCA withholding and reporting obligations of that disregarded entity or branch independently from activities carried on by other disregarded entities and branches of such regarded entity, has several arguments in its favor. We recommend that Treasury and the IRS consider incorporating that approach more broadly in the Final Regulations, rather than just in cases involving a disregarded entity or branch in a country that has an IGA.

Thus, in the case of an FFI that has disregarded entities or branches in multiple countries, none of which has entered into an IGA, we believe there is a reasonable case for evaluating each disregarded entity or branch of the FFI as a separate unit which has its own withholding and reporting responsibilities under FATCA. First, such an approach provides consistency with the rules that apply in the case of an entity which has one or more branches in a country that has an IGA; and such consistency would seem to lead to less opportunities for confusion on the part of FFIs with multinational operations. Second, such an approach provides flexibility to deal easily with future changes, in which some (or all) of the countries in which the FFI has branches enter into IGAs. As more IGAs continue to be signed, this will become an increasingly common fact pattern.

Third, and related to the above points, an approach that focuses on the existence and physical location of an entity's offices and activities, rather than on the entity itself and its status as regarded or disregarded for U.S. federal income tax purposes, would seem to reduce the possibility for arbitrary outcomes under FATCA: for example, differing status as an FFI or an NFFE for a regarded entity under the Final Regulations depending on whether its subsidiaries have elected to be treated as disregarded entities, or depending on whether a particular branch is held by one regarded entity in an affiliated group rather than another. A reduction in the possibility for arbitrary outcomes would seem to lead to less pitfalls for the unwary and less inappropriate planning opportunities for sophisticated taxpayers.

On the other hand, although a branch-by-branch approach has several advantages as a matter of tax policy, such an approach could have some possible drawbacks as a practical matter.

Withholding and reporting under chapters 3 and 61 has generally been administered to date by looking to the status of the regarded entity receiving a payment; it generally has not been necessary for withholding agents to determine whether a particular disregarded entity or branch owed by a regarded entity has received a payment. It could be burdensome for withholding agents and parties potentially subject to FATCA withholding to be required to apply a disregarded entity-by-disregarded entity, branch-by-branch approach under FATCA which is inconsistent with the framework that they generally follow under chapters 3 and 61.[79] In addition, numerous questions may arise as to how, and how fully, to incorporate such an approach in the Final Regulations. For example, should transactions between branches or disregarded entities owned by the same parent be taken into account, when determining whether each branch is best viewed as an FFI or an NFFE? (For example, a branch that performs treasury functions for other branches might be viewed as an FFI. As another example, a branch that engages in a nonfinancial business, and that also makes loans to other branches, might be viewed as a passive NFFE, depending on the amount of interest deemed to accrue on the inter-branch loans relative to the lender branch's business income.[80]) In addition, a disregarded entity's or branch's withholding and reporting obligations under FATCA could be affected by intercompany transactions: a loan or license by a foreign parent to a disregarded entity or branch carrying on activities in the United States might give rise to imputed withholdable payments, for example.

Similarly, when seeking to detect and prevent abuses, it would be necessary to try to adapt the familiar concepts and precedents that apply to transactions between regarded entities (e.g., anti-conduit principles developed under chapter 3).[81] In this connection, Congress has provided a special sourcing rule, under which interest paid on a deposit with a foreign branch of a U.S. financial institution is treated as a U.S.-source withholdable payment under FATCA, notwithstanding the general treatment of such interest as foreign-source under the Code.[82]

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79 We note that there is some precedent in chapter 3 for analyzing a disregarded entity, or branch, as separate from its owner. Thus, a disregarded entity can claim that it is a resident of a country that has a treaty with the United States and is entitled to the benefit of that treaty. *See* Treas. Reg. § 1.894-1(d). Alternatively, if its owner is resident in a treaty country, the disregarded entity potentially can claim the benefit of such treaty. *Id*. Also, as noted above, a U.S. branch of a foreign depository bank or insurance company sometimes is treated as a U.S. person. *See supra* note 76. However, these are somewhat circumscribed cases, which are the subject of specific, detailed rules. The possible approach described in the text would represent a substantial broadening of the recognition of disregarded entities and branches as separate units.

80 *See* Treas. Reg. § 1.1472-1(c)(1)(iv). It should be noted that the task of measuring such imputed payments between branches could prove to be complex. *Cf. National Westminster, PLC v. United States*, 44 Fed. Cl. 120 (1999), *National Westminster, PLC v. United States*, 58 Fed. Cl. 491 (2003), *both aff'd*,, 512 F.3d 1347 (Fed Cir. 2008).

81 *Cf.* Treas. Reg. § 1.1471-4(b)(5)(ii) (rules concerning when payments are considered to be made to a limited branch of an FFI).

82 I.R.C. § 1473(1)(C); *see also* I.R.C. § 861(a)(1)(A).

Although the legislative history does not give an explanation, Congress may have viewed this rule as appropriate in order to prevent customers of a U.S. financial institution from avoiding FATCA. Carried to its logical conclusion, an approach that examines a foreign disregarded entity or branch separately from its parent would result in the elimination of this sourcing rule.

Ultimately, however, the fewer countries there are that have not signed IGAs as time passes, the less force the above concerns about novelty and complexity of a disregarded entity-by-disregarded entity, branch-by-branch approach will have.

3. Withholding by a Financial Institution

A basic purpose of IGAs is to provide a separate regime for Financial Institutions in partner countries that reduces such institutions' compliance burden and applies instead of, rather than in addition to, the requirements that would otherwise be imposed on such institutions by the Final Regulations. In particular, the IGAs appear to reflect a policy goal of reducing and streamlining FATCA withholding requirements for Financial Institutions in a partner country.[83] We believe the best way to achieve these goals is for the IGAs and the Final Regulations to make it clear that a Reporting Financial Institution will not be required to withhold under FATCA, except to the extent of the limited withholding obligations expressly set forth in the IGA. We discuss below several provisions in the IGAs and in the Final Regulations that should be revised, or else explicated in official guidance, in order to implement this principle.

a. Withholding on payments to recalcitrant accountholders

Article 4, paragraph 2 of the Model 1A and Model 1B IGAs provides:

> "The United States shall not require a Reporting [FATCA Partner] Financial Institution to withhold tax under section 1471 or 1472 of the U.S. Internal Revenue Code with respect to an account held by a recalcitrant account holder (as defined in section 1471(d)(6) of the U.S. Internal Revenue Code), or to close such account, if the U.S. Competent Authority receives the information set forth in subparagraph 2(a) of Article 2 of this Agreement [i.e., information about the identity of the accountholder and the amount of income realized on the assets in the account], subject to the provisions of Article 3 of this Agreement [concerning the timing and manner of automatic information exchange under the IGA], with respect to such account."

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83 *See* Model 1A IGA, art. 6, ¶ 2; Model 1B IGA, art. 6, ¶ 2; Model 2 IGA, art. 5, ¶ 1 (each stating that the United States and its partner country under an IGA "are committed to work together, along with Partner Jurisdictions, to develop a practical and effective alternative approach to achieve the policy objectives of foreign passthru payment and gross proceeds withholding that minimizes burden").

The import of this wording is unclear. It can be read as reflecting an assumption that, if the enumerated conditions are not met, then the Reporting Financial Institution will be required to withhold on payments to a recalcitrant accountholder. However, the quoted wording does not expressly mandate such withholding.[84] The Final Regulations do not modify this result: the regulations' requirement to withhold on recalcitrant accountholders applies to PFFIs, and Reporting Financial Institutions under the IGAs will not become PFFIs.

In addition, strictly speaking, the Model 1A and 1B IGAs require the partner country's government to provide information on a Reporting Financial Institution's accountholders, rather than directly imposing such requirement on the Reporting Financial Institution itself. Thus, it may be intended that the United States will liaise with the partner country's government in the event a Reporting Financial Institution has a recalcitrant accountholder, and that the partner country's government will take steps to address the situation, rather than automatically resorting to a requirement for the Reporting Financial Institution to withhold on the accountholder.

Accordingly, it is possible that Article 4, paragraph 2 is simply meant to be descriptive, pointing out that a partner country is required under the IGA to report information about Reporting Financial Institutions' accountholders (including recalcitrant accountholders), rather than prescribing any requirement for withholding by Reporting Financial Institutions.

Recommendation 18: We recommend that guidance be issued to clarify whether a Financial Institution is required under the IGAs to withhold on recalcitrant accountholders.

b. Withholding on payments to NFFIs

The scope of a Reporting Financial Institution's obligation to withhold on payments to NFFIs and NFFEs is not entirely clear under Model 1A and 1B IGAs. The Model 1A and 1B IGAs provide that a Reporting Financial Institution "shall be treated as complying with, and not subject to withholding under, section 1471 of the U.S. Internal Revenue Code," if the partner country's government complies with its obligations under the IGA and the Reporting Financial Institution does the following:

(a) identifies accounts that are subject to annual reporting under the IGA, and reports on those accounts as required by the IGA;

[84] By comparison, the Model 2 IGA contains a generally analogous provision, which excuses a Reporting Financial Institution from having to withhold on a recalcitrant accountholder, if the relevant partner country's government provides information about that accountholder to the United States. That clause goes on to expressly state that the Reporting Financial Institution is required to withhold, if the partner country's government fails to provide such information. Model 2 IGA, art. 4, ¶ 2.

(b) for 2015 and 2016, reports the Nonparticipating Financial Institutions[85] to which it has made payments, and the amount of those payments;

(c) complies with any registration requirements imposed by the partner country on Financial Institutions;

(d) if the Reporting Financial Institution is a QI, WP or WT that has accepted primary withholding responsibility, withholds on U.S. source withholdable payments to any Nonparticipating Financial Institution; and

(e) if the Reporting Financial Institution is not described in (d) and makes a U.S. source withholdable payment (or acts as an intermediary for such a payment) to a Nonparticipating Financial Institution, provides to the immediate payor the information required for withholding and reporting to occur with respect to the payment.[86]

As noted above, the Final Regulations provide that a Reporting Financial Institution is a deemed-compliant FFI.[87] However, the regulations can be read as raising the possibility that a Reporting Financial Institution may have withholding responsibilities under the regulations, in addition to those set forth in the IGA:

> "The term deemed-compliant FFI includes a registered deemed-compliant FFI (as defined in paragraph (f)(1) of this section), a certified deemed-compliant FFI (as defined in paragraph (f)(2) of this section), and, to the extent provided in paragraph (f)(3) of this section, an owner documented FFI. A deemed-compliant FFI will be treated pursuant to section 1471(b)(2) as having met the requirements of section 1471(b). *A deemed compliant FFI that complies with the due diligence and withholding requirements applicable to such entity as provided in this paragraph (f) will also be deemed to have met its withholding obligations under sections 1471(a) and 1472(a). For this purpose, an intermediary or flow-through entity that has a residual withholding obligation under §1.1471-2(a)(2)(ii) must fulfill such obligation to be considered a deemed-compliant FFI*."[88]

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85 A "**Nonparticipating Financial Institution**" is defined in the IGAs as any NFFI, other than an NFFI that is a Financial Institution under an IGA and has not been designated by the IRS as a Nonparticipating Financial Institution under that IGA due to its noncompliance with its obligations under the IGA. Model 1A IGA art. 1, ¶ 1(r); Model 1B IGA, art. 1, ¶ 1(p).

86 *See* Model 1A IGA art. 4, ¶ 1(a) – (e); Model 1B IGA, art. 4, ¶ 1(a) – (e).

87 Treas. Reg. § 1.1471-5(f).

88 Treas. Reg. § 1.1471-5(f) (emphasis added). We note that the last sentence of the quoted provision can be read as literally providing that if a deemed-compliant FFI that is an intermediary fails even once to satisfy its

If a Reporting Financial Institution complies with requirements (a) through (e) above under a Model 1A or 1B IGA, then it seems fairly clear to us that it will not be subjected to any additional withholding obligation under the provision of the Final Regulations quoted above. Article 4, paragraph 1 of the Model 1A and 1B IGAs provides that a Reporting Financial Institution that complies with such requirements "shall be treated as complying with" Section 1471. Furthermore, the provision of the Final Regulations quoted above refers to "the due diligence and withholding requirements applicable to such entity *as provided in this paragraph (f)*"; and the remaining provisions of paragraph (f) impose such requirements only on deemed-compliant FFIs that are not Reporting Financial Institutions under a Model 1A or 1B IGA.

In this connection, we note that if a Reporting Financial Institution that is not a withholding QI, WP or WT provides to a withholding agent information about NFFIs on whose behalf the Reporting Financial Institution is receiving a U.S. source withholdable payment, as required by Article 4, paragraph 1(e) of the Model 1A or 1B IGA, then the Reporting Financial Institution has no further responsibilities under FATCA. It seems clear this is true even if the withholding agent that makes the withholdable payment fails to withhold properly, and the Reporting Financial Institution knows or has reason to know of such failure. In such a case, the Reporting Financial Institution has no "residual" withholding responsibility under the IGA to compensate for the primary withholding agent's lapse. Even though other types of deemed-compliant FFIs do have such a responsibility under the Final Regulations, it is in keeping with the general policy goal of IGAs to reduce withholding burden on Reporting Financial Institutions that such institutions are exempted from that responsibility. The U.S. government's remedy in such cases is to seek to collect from the primary withholding agent.

However, the result is less clear, in a case where a Reporting Financial Institution that is not a withholding QI, WP or WT fails to provide to the primary withholding agent all of the documentation that is required under Article 4, paragraph 1(e). In such a case, one could conceivably conclude that the Reporting Financial Institution is no longer "treated as complying with" Section 1471, as had been the case under Article 4, paragraph 1 up until such failure, because the Reporting Financial Institution has now breached the requirements of Article 4, paragraph 1(e). Arguably, the Reporting Financial Institution thus becomes subject to the Final Regulations and has a residual responsibility, under Treasury Regulation Section 1.1471-2(a)(2)(ii), to pay the FATCA withholding tax that is due on withholdable payments, in the event the primary withholding agent does not do so.

In our view, the better reading is that a Reporting Financial Institution does not begin to have a residual withholding responsibility, unless and until its status as a Reporting Financial Institution is terminated in accordance with the procedure in the relevant IGA. Article 5,

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residual withholding obligation, then it will cease to be a deemed-compliant FFI. We assume that a notion of reasonable cause is implicit in this rule, although it may be useful for Treasury and the IRS to make this point explicitly.

paragraph 2 of the Model 1A and 1B IGAs requires the United States to notify the partner country of noncompliance and then wait 18 months to see whether the noncompliance is resolved, before deciding whether to terminate a Reporting Financial Institution's status; and the last sentence of Article 4, paragraph 1 states that "[a] Reporting [FATCA Partner] Financial Institution with respect to which the conditions of this paragraph 1 are not satisfied shall not be subject to withholding under section 1471 of the U.S. Internal Revenue Code unless such Reporting [FATCA Partner] Financial Institution is treated by the IRS as a Nonparticipating Financial Institution pursuant to paragraph 2(b) of Article 5 of this Agreement."[89] Strictly speaking, this wording could be read to provide that even though the Reporting Financial Institution is not subject to Section 1471 withholding, it nevertheless is subject to all of the requirements that the Final Regulations impose – including FFIs' residual withholding responsibility under Treasury Regulation Section 1.1471-2(a)(2)(ii). However, we believe the quoted sentence instead is meant to provide that a Reporting Financial Institution does not need to be concerned about its obligations under the Final Regulations (including residual withholding obligations), unless and until its status as a Reporting Financial Institution is terminated. Section 1471 withholding on FFIs is very closely tied to the various obligations that the Final Regulations impose on the FFIs; the function of such withholding is to ensure that those obligations are complied with. Thus, for so long a period as the Reporting Financial Institution is not subject to such withholding, it would make sense that it also is not subject to such obligations.

<u>Recommendation 19</u>: For the reasons described above, we recommend that guidance be issued clarifying that under the Model 1A and 1B IGAs, a Reporting Financial Institution does not have residual FATCA withholding responsibility, in cases where it acts as an intermediary (other than a QI, WP or WT that has accepted primary withholding responsibility) for a payment to an NFFI, and the primary withholding agent fails to withhold.

c. Withholding on payments to NFFEs

Although the Model 1A and 1B IGAs state that a Reporting Financial Institution will be treated as complying with Section 1471 if it takes the actions described in Article 4, paragraph 1(a) through (e), these Model IGAs are silent as to whether the Reporting Financial Institution also will be treated as complying with Section 1472 in such a case. It is fairly clear that the Reporting Financial Institution will not be required to withhold under Treasury Regulation Section 1.1471-4(b) on NFFEs that are recalcitrant accountholders. However, the Model 1A and 1B IGAs do not state whether the Reporting Financial Institution will be required to withhold under Section 1472 on withholdable payments to NFFEs that are not accountholders, if such

[89] Model 1A IGA art. 5, ¶ 2; Model 1B IGA (Preexisting TIEA or DTC), art. 5, ¶ 2. The same text appears Model 1B IGA (No TIEA or DTC), art. 5, ¶3, except that the reference in the quoted text to paragraph 2(b) of Article 5 is instead a reference to paragraph 3(b) of Article 5.

NFFEs do not provide the information about their substantial U.S. owners that is required by Treasury Regulation Section 1.1472-1.

For reasons similar to those discussed above, we believe the intent is not to require such withholding. Article 4, paragraph 1 clearly states that a Reporting Financial Institution is not subject to Section 1471 withholding, so long as it takes the actions described in paragraphs (a) through (e); and those required actions, in turn, involve only withholding on, or providing information about the beneficial owners of, withholdable payments to Nonparticipating Financial Institutions. It would be an odd result if the Model 1A and 1B IGAs, although protecting a Reporting Financial Institution from Section 1471 withholding, left it exposed to liability (as a withholding agent) for any Section 1472 withholding tax it failed to collect on withholdable payments it made to NFFEs. We believe many financial institutions would be surprised to learn that they were subject to such treatment.[90]

Recommendation 20: We recommend that guidance be issued to clarify that a Reporting Financial Institution under a Model 1A or 1B IGA is not obligated to withhold under FATCA on payments to NFFEs that are not accountholders.

d. Withholding by a Reporting Financial Institution that is a branch of a U.S. financial institution

The Final Regulations' treatment of a Reporting Financial Institution that is a branch of a U.S. financial institution appears to be at odds with the provisions of Article 4, paragraph 1 of the Model 1A and 1B IGAs. The Final Regulations indicate that a foreign branch of a U.S. financial institution is intended to be capable of qualifying as a reporting Model 1 FFI under the regulations (as discussed above in Part III.B.2). However, the Final Regulations provide that a branch that does so qualify is required to comply with both the withholding requirements in the

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90 We have considered whether a similar issue arises for Reporting Financial Institutions under Model 2 IGAs. Such IGAs contain wording that is generally analogous to Article 4, paragraph 1 of the Model 1A and 1B IGAs: the Model 2 IGAs provide that a Reporting Financial Institution "shall be treated as complying with the requirements of, and as not subject to withholding under, section 1471 of the U.S. Internal Revenue Code," so long as it enters into and complies with an FFI Agreement. Model 2 IGA, art. 3, ¶ 1. It would be useful to clarify whether, under the Model 2 IGA, it is intended that a Reporting Financial Institution will be required to act as a withholding agent under Section 1472 with respect to payments to non-accountholder NFFEs. Strictly speaking, such withholding is not required under the terms of an FFI Agreement; instead, it is required by Section 1472. However, since the basic purpose of the Model 2 IGAs is to encourage a Reporting Financial Institution to enter into an FFI Agreement and thus, generally, to put itself on a par with a PFFI under the Final Regulations, we believe a Reporting Financial Institution would be less likely to be taken by surprise if it was subject to the same withholding obligations under Section 1472 as a PFFI is.

relevant IGA, and the withholding obligations imposed on U.S. withholding agents under FATCA.[91]

This provision in the Final Regulations appears to conflict with Article 4, paragraph 1 of the Model 1A and 1B IGAs. Article 4, paragraph 1 treats any Reporting Financial Institution that complies with its obligations under the IGA as having complied with Section 1471 -- whether or not the Reporting Financial Institution is a branch of a U.S. financial institution. In addition, this provision in the Final Regulations seems inconsistent with the basic purpose of IGAs to lessen Reporting Financial Institutions' compliance burden. Conceivably, the government was motivated by a desire to prevent potential abuse, when it adopted this rule; but we believe that such potential is no more present in the case of a foreign branch (or disregarded entity) than it would be in the case of a regarded foreign subsidiary of a U.S. financial institution.

Recommendation 21: We recommend that the Final Regulations be revised so that they no longer state that a Reporting Financial Institution which is a branch of a U.S. financial institution must comply with the obligations imposed on withholding agents by the Final Regulations.[92]

e. Reporting on payments by the Financial Institution that are subject to FATCA withholding

Final Regulations under Section 1474 provide that a registered deemed-compliant FFI that is a withholding agent under chapter 4 must file Forms 1042 and 1042-S with the IRS.[93] More specifically, any such FFI that makes a withholdable payment to an NFFI or a recalcitrant accountholder must report that payment, if the FFI is a QI, WP or WT that has accepted primary withholding responsibility with respect to the payment, or if the FFI has not accepted such responsibility but knows or has reason to know the primary withholding agent has

[91] *See* Treas. Reg. § 1.1471-2(a)(2)(v) ("Generally, a foreign branch of a U.S. financial institution is a withholding agent and is not an FFI. However, a QI branch of a U.S. financial institution is both a withholding agent and either a participating FFI or a registered deemed compliant FFI. Accordingly, a QI branch of a U.S. financial institution must withhold in accordance with this section in addition to meeting its obligations under either §1.1471-4(b) and its FFI agreement or §1.1471-5(f). *Similarly, a foreign branch of a U.S. financial institution that is also a reporting Model 1 FFI is both a withholding agent and a registered deemed-compliant FFI. Accordingly, a foreign branch of a U.S. financial institution that is a reporting Model 1 FFI must withhold in accordance with this section.* A foreign branch of a U.S. financial institution that is not a QI is not permitted to make an election to be withheld upon.") (emphasis added).

[92] This recommendation reflects our broader support, as discussed in Part III.B.2 above, for the IGAs' approach of treating each branch as a separate unit from the entity owning it, for purposes of determining the branch's status and its FATCA compliance obligations.

[93] *See* Treas. Reg. § 1.1474-1(c)(2), (d)(4)(iii).

underwithheld.[94] In addition, such an FFI also is required to report on "foreign reportable amounts" that it pays in 2015 and 2016 to NFFIs and recalcitrant accountholders, even though the Final Regulations do not require the FFI to withhold on such amounts.[95]

Neither the Final Regulations nor the Model 1A or 1B IGAs contain any express rule coordinating these reporting obligations under Section 1474 with a Reporting Financial Institution's reporting obligations under a Model 1A or 1B IGA. If our recommendations above are accepted, however, then a Reporting Financial Institution will have very limited withholding obligations under FATCA: it will be required to withhold in cases where it is a QI, WP or WT that has accepted primary withholding responsibility; and it might also be required to withhold on payments to recalcitrant accountholders. Logically, a Reporting Financial Institution should have reporting responsibility under Section 1474 only in these limited cases where it has chapter 4 withholding responsibility. With respect to reporting on "foreign reportable amounts," we note that the Model 1A and 1B IGAs require a Reporting Financial Institution to report to the partner country on all payments the Reporting Financial Institution makes to NFFIs in 2015 and 2016.[96] This provision appears to be designed to supplant the reporting on foreign reportable amounts that is required by the Final Regulations; and it would seem unnecessarily duplicative to require that such amounts also be reported directly to the IRS by the Reporting Financial Institution, under the regulations.

Recommendation 22: Guidance should clarify that a Reporting Financial Institution in a jurisdiction with a Model 1A or Model 1B IGA is only required to report to the IRS under Section 1474 in the event the Reporting Financial Institution is a QI that has accepted primary withholding responsibility for a payment or (depending on the government's response to recommendation 18) is required to withhold on payments to a recalcitrant accountholder.

4. Due Diligence and Reporting on Accounts

a. Uniformity in reporting obligations across IGAs

Annex I to the Model 1A and Model 1B IGAs provides procedures for diligence on accountholders. These procedures track those in the Final Regulations very closely; and Treasury's and the IRS's intent is that Annex I will vary as little as possible between IGAs. This approach tends to achieve uniformity across jurisdictions and, thus, to reduce the FATCA compliance burden for a multinational financial institution.

94 *See* Treas. Reg. § 1.1474-1(d)(4)(iii)(A), (B).

95 *See* Treas. Reg. § 1.1474-1(d)(2)(i)(D), (d)(4)(iii)(C).

96 Model 1A IGA art. 4, ¶ 1(b); Model 1B IGA, art. 4, ¶ 1(b).

Recommendation 23: To further reduce the FATCA compliance burden, we recommend that a multinational financial institution be permitted to apply the "consolidated obligation" rules in the Final Regulations,[97] when an accountholder has accounts with multiple affiliates or branches in the institution's expanded affiliated group, including some located in IGA countries. Broadly, these rules permit a financial institution to treat an investor's accounts with multiple branches or affiliates in the financial institutions as a single account, for purposes of reviewing the documentation the investor has provided (in other words, documents provided by the investor for one account apply across all accounts). These accounts also are aggregated for purposes of determining whether various account balance thresholds in the Final Regulations have been exceeded. There does not appear to be any persuasive reason, in such a case, why the "consolidated obligation" rules should not apply in an IGA country. Although the IGAs do not expressly reference these rules, their application is consistent with the IGAs' basic policy of easing the process for compliance with FATCA.

Recommendation 24: In addition, we recommend that Treasury and the IRS, in their dealings with IGA partner countries, encourage those countries to adopt uniform rules for Financial Institutions' reporting to the governments of those countries, including the format of such reporting; and we recommend that such rules largely mirror the reporting requirements for a PFFI in the Final Regulations. In this connection, we interpret Article 3, paragraph 1 of the Model 1A and Model 1B IGAs as permitting, but not requiring, a Financial Institution to use principles of local tax law to characterize amounts paid with respect to a reportable account.[98] Thus, if a financial institution wishes to do so, it appears it could apply U.S. tax principles across all jurisdictions to determine the amount of payments made on its accounts. This could increase the efficiency of FATCA reporting for an institution with activities in multiple countries.[99] Alternatively, an affiliated group should be permitted to use local GAAP in each jurisdiction for purposes of measuring and determining the character of payments on its financial accounts; this would allow FATCA reporting to be based on reporting already done for another purpose, and would be consistent across jurisdictions, in the sense of permitting reliance on local GAAP in all countries.

b. Definition of "Controlling Person"

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97 *See* Treas. Reg. §§ 1.1471-1(b)(20), 1.1471-3(c)(8).

98 "For purposes of the exchange obligation in Article 2 of this Agreement, the amount and characterization of payments made with respect to a U.S. Reportable Account may be determined in accordance with the principles of the tax laws of [FATCA Partner]." Model 1A IGA, art. 3, ¶ 1; Model 1B IGA, art. 3, ¶ 1.

99 Although not entirely clear, we read the Final Regulations as giving a PFFI a right in all circumstances to choose to use U.S. tax principles, in order to determine the amount and character of payments made with respect to its financial accounts and report such payments. *See* Treas. Reg. § 1.1471-4(d)(4)(iv)(E). Thus, a multinational financial institution that wishes to use U.S. tax principles across jurisdictions will be able to use such principles both for members of its group that are PFFIs, and for members of its group that are Reporting Financial Institutions.

Under the Model IGAs, a Reporting Financial Institution is required to report on any account held by a foreign entity, when the foreign entity has one or more "Controlling Persons" that are specified U.S. persons. For this purpose, "Controlling Persons" is defined as:

> "'**Controlling Persons**' means the natural persons who exercise control over an Entity. In the case of a trust, such term means the settlor, the trustees, the protector (if any), the beneficiaries or class of beneficiaries, and any other natural person exercising ultimate effective control over the trust, and in the case of a legal arrangement other than a trust, such term means persons in equivalent or similar positions. The term "Controlling Persons" shall be interpreted in a manner consistent with the Financial Action Task Force Recommendations."[100]

The Model IGAs do not indicate how this definition should be applied, in a case where multiple unrelated U.S. individuals own interests that, in the aggregate, represent control of a foreign entity that is an accountholder, without any one of the individuals possessing control on his or her own.

The FATF Recommendations, which are referenced in the above wording, do not directly address this issue: the recommendations do not contain a definition of "Controlling Person." However, the FATF Recommendations do set forth principles for a financial institution to apply when it conducts customer due diligence on a legal entity. These call for the financial institution first, to identify those individuals (if any) that have a controlling ownership interest in the entity; second, if the first test has not yielded results, to identify the individuals (if any) that exercise control of the entity through means other than an ownership interest; and third, if the first two tests do not produce results, to identify the individual who is the senior managing official of the entity.[101] As to the first of these three principles, the FATF Recommendations elaborate that "ownership interests can be so diversified that there are no natural persons (whether acting alone or together) exercising control of the legal person or arrangement through ownership."[102] While not dispositive, this suggests that U.S. individuals that each own non-controlling interests in a legal entity, and that have a common plan or design, can be aggregated into a "control group" for purposes of the FATF Recommendations (whereas a group of unrelated shareholders that lack such a plan or design should not be aggregated). This approach is similar to that taken under

[100] Model 1A IGA, art. 1, ¶ 1(mm); Model 1B IGA, art. 1, ¶ 1(hh); Model 2 IGA, art. 1, ¶ 1(ee) (each citing to The Financial Action Task Force, *International Standards on Combating Money Laundering and the Financing of Terrorism & Proliferation - the FATF Recommendations* (February 2012) ("**FATF Recommendations**")).

[101] FATF Recommendations at 60-61.

[102] *Id.* at 60.

various areas of U.S. tax law.[103] This type of flexible standard for control would appear to further the policies behind the IGAs' account reporting rules.

<u>Recommendation 25</u>: We recommend that Treasury and the IRS encourage partner countries to clarify that where U.S. individuals each separately own interests in a foreign entity which do not entitle any of them acting alone to exercise control over the entity, they will be considered Controlling Persons with respect to the entity for purposes of an applicable IGA in the event they act together pursuant to a common plan or design to exercise control, but not otherwise.

5. Enforcement; Termination of Status as a Participating Financial Institution

The Model 1A and Model 1B IGAs provide that, if a Financial Institution does not comply with its obligations under the IGA, it nevertheless will continue to be treated as a Reporting Financial Institution and will not be subject to withholding under the Final Regulations, unless the Financial Institution's noncompliance is not resolved within 18 months after written notice of such non-compliance has been given by the U.S. government to the partner country's government.[104] The Model 2 IGA does not contain an express provision to this effect, although it does indicate that a Reporting Financial Institution will cease to be treated as such, if the Financial Institution's noncompliance is not resolved within 12 months after written notice of such non-compliance has been given by the U.S. government to the partner country's government.[105]

a. Process for establishing that a Financial Institution is a Nonparticipating Financial Institution

<u>Recommendation 26</u>: The U.S. government should work with partner countries to clarify the conditions that will trigger the requirement under an IGA for a Financial Institution to take actions to resolve significant non-compliance, or else to become a Nonparticipating Financial Institution. Under a Model 1A or 1B IGA, one such trigger should be a notice from the partner country to the United States of significant non-compliance by the Financial Institution. In addition, the U.S. government should work with partner countries to provide guidance about

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[103] *See, e.g.*, Rev. Rul. 2003-96, 2003- C.B. (indicating that multiple shareholders of a closely held corporation, acting in concert with a common goal, can be considered to be part of a control group with the corporation for purposes of Section 482); *see also* Treas. Reg. § 1.382-3(a)(1) (group of small shareholders of a loss corporation acting pursuant to a "formal or informal understanding among themselves" can be treated as a single 5% shareholder for purposes of Section 382).

[104] Model 1A IGA, art. 4, ¶ 1, art. 5, ¶ 2; Model 1B IGA (Preexisting TIEA or DTC), art. 4, ¶ 1, art. 5, ¶2; Model 1B IGA (No TIEA or DTC), art. 4, ¶ 1, art. 5, ¶3.

[105] Model 2 IGA, art. 4, ¶ 2.

the circumstances in which significant non-compliance will be considered to exist, and will be considered to have been resolved.

The provisions of the Model IGAs described above require the United States to begin the process for treating a Financial Institution as a Nonparticipating Financial Institution, by notifying the partner country of the United States' determination there has been significant non-compliance by the Financial Institution. However, it is not clear the United States necessarily will be likely to know of non-compliance, in the case of Financial Institutions in countries with Model 1A or 1B IGAs. Those IGAs make the partner country's government responsible for collecting information from Reporting Financial Institutions which is to be provided to the United States. Presumably, the partner country's government will be entitled to provide specific rules about how such reporting should be carried out; to monitor compliance with those reporting rules, as well as a Financial Institution's compliance with the IGA's account review procedures (which are the underpinning for accurately identifying the accounts on which reporting is required), and the withholding requirements (which go hand in hand with the required reporting); and to impose appropriate penalties or remedies, in cases where such monitoring reveals non-compliance. Indeed, above provisions of the Model 1A and 1B IGAs seem to be based on the assumption that the partner country's government, rather than the United States, will be carrying on such activities. It is not clear it would be possible, or desirable, for Treasury or the IRS to audit a Reporting Financial Institution's compliance with the rules imposed by the partner country in order to implement the IGA. Article 5, paragraph 1 of the Model 1A and 1B IGAs entitles the U.S. government to contact a Reporting Financial Institution directly to make inquiries, when the U.S. government has reason to believe the Reporting Financial Institution has failed to wholly comply with its obligations due to "administrative errors or other minor errors," but the IGAs do not appear to contemplate any broader investigative role for the U.S. government.

Article 3, paragraph 6 of the Model 1A and 1B IGAs provides for the United States and the partner country to enter into an agreement to establish procedures for the implementation of Article 5, which would include the procedures under which a Financial Institution can become a Nonparticipating Financial Institution. It would not seem difficult to agree on procedural mechanics to address the issues just described. For example, the United States might be able to determine from a review of the information (or lack thereof) provided by the partner country about accountholders of a particular Reporting Financial Institution that there appears to be a material possibility of non-compliance by that institution. Upon notice from the United States to that effect, the partner country could audit the Reporting Financial Institution and inform the United States of its findings: notice from the partner country of significant non-compliance by the Reporting Financial Institution could trigger the requirement that the Reporting Financial Institution resolve the noncompliance in 18 months or else become a Nonparticipating Financial Institution. (In addition, the partner country's government might on its own initiative audit

Reporting Financial Institutions, and notice by the partner country to the United States that such an audit revealed significant non-compliance logically should trigger the 18-month period.)

It also would be useful for the United States to provide guidance about what it views as "significant non-compliance" by a Reporting Financial Institution under a Model 1A or 1B IGA. Presumably such guidance would be developed jointly with partner countries under Article 3, paragraph 6. Moreover, the IGAs provide no information about the types of actions a partner country is expected to take following a notice of significant non-compliance, and no guidance about what is needed for significant non-compliance to be "resolved" within the 18 months after notice is given, as well as whether it is the United States, or the partner country, that will determine whether the significant non-compliance has been timely resolved. Given the key role to be played under the IGA by the partner country's government in imposing penalties and remedial actions on the Reporting Financial Institution under that country's laws, presumably the partner country's determination that non-compliance has been resolved should generally be entitled to a meaningful degree of deference by the United States.

In the case of a Model 2 IGA, many of the issues described above should not exist. A Reporting Financial Institution under such an IGA will be subject to obligations that are spelled out by Treasury and the IRS in an FFI Agreement, and it will be subject to the same verification procedures as a PFFI in a non-IGA country. The U.S. government will be entitled to obtain information from the Reporting Financial Institution to review its compliance.[106] However, since the Model 2 IGA and the FFI Agreement contain a mechanism parallel to that of the Model 1A and 1B IGAs, providing that a Reporting Financial Institution can be treated as an NFFI only if "significant non-compliance" is not "resolved" within a fixed period after notice is given by the U.S. government, it would be useful to have guidance about what these terms mean (including whether significant non-compliance means a different level of non-compliant conduct than an event of default for a PFFI in a non-IGA country).

b. IGAs' requirements corresponding to the "all or nothing" rule in the Final Regulations

All of the Model IGAs contain a provision substantially similar to the following provision from the Model 1A IGA that represents a variation on the "all or nothing" rule applicable to PFFIs under the Final Regulations:

> "If a [FATCA Partner] Financial Institution, that otherwise meets the requirements described in paragraph 1 of this Article or is described in paragraph 3 or 4 of this Article, has a Related Entity or branch that operates in a jurisdiction that prevents such Related Entity or branch from fulfilling the requirements of a participating FFI or deemed-compliant FFI for purposes of section 1471 of the U.S. Internal Revenue

[106] *See* FFI Agreement, § 8.04(B), (D).

Code or has a Related Entity or branch that is treated as a Nonparticipating Financial Institution solely due to the expiration of the transitional rule for limited FFIs and limited branches under relevant U.S. Treasury Regulations, such [FATCA Partner] Financial Institution shall continue to be in compliance with the terms of this Agreement and shall continue to be treated as a deemed-compliant FFI or exempt beneficial owner, as appropriate, for purposes of section 1471 of the U.S. Internal Revenue Code, provided that:

a) the [FATCA Partner] Financial Institution treats each such Related Entity or branch as a separate Nonparticipating Financial Institution for purposes of all the reporting and withholding requirements of this Agreement and each such Related Entity or branch identifies itself to withholding agents as a Nonparticipating Financial Institution;

b) each such Related Entity or branch identifies its U.S. accounts and reports the information with respect to those accounts as required under section 1471 of the U.S. Internal Revenue Code to the extent permitted under the relevant laws pertaining to the Related Entity or branch; and

c) such Related Entity or branch does not specifically solicit U.S. accounts held by persons that are not resident in the jurisdiction where such Related Entity or branch is located or accounts held by Nonparticipating Financial Institutions that are not established in the jurisdiction where such Related Entity or branch is located, and such Related Entity or branch is not used by the [FATCA Partner] Financial Institution or any other Related Entity to circumvent the obligations under this Agreement or under section 1471 of the U.S. Internal Revenue Code, as appropriate."[107]

<u>Recommendation 27</u>: We propose that the U.S. government expressly state that compliance with the quoted rule is a condition for treatment as a Reporting Financial Institution under the applicable IGA and as a deemed-compliant FFI under the Final Regulations.

In this regard, we note that the rule by its terms states only that a Reporting Financial Institution that complies with a) through c) will be treated as in compliance with the IGA and with the Final Regulations. It does not specify that a failure to comply with the rule will be treated as a violation of the IGA, and can result in a Reporting Financial Institution becoming an NFFI. Thus, if the rule quoted above is read literally, then a Reporting Financial Institution that fails to comply with the rule will fall into a gap, in which it cannot be forced to become a NFFI and cannot be subjected to withholding under Section 1471(a). Presumably, the wording in

[107] Model 1A IGA, art. 4, ¶ 5; Model 1B IGA, art. 4, ¶ 5; Model 2 IGA, art. 3, ¶ 5.

question is better read as imposing a precondition for Reporting Financial Institution status under the IGA, and it would be useful for the U.S. government to expressly confirm this in guidance.[108]

In addition, guidance should be provided regarding the interaction of this provision with the Final Regulations. For example, suppose that a Reporting Financial Institution is a regarded entity that has operations in its home country (Country X, which has entered into an IGA) and also has a branch in Country Y. Country Y has laws that prohibit the branch from taking some or all of the actions that are needed in order to fulfill the reporting and withholding obligations of a PFFI under the Final Regulations. In such a case, it appears that the same type of drafting issues in the Final Regulations as are described in Part III.B.2 above will arise. It would be logical to treat the Country Y branch as an NFFI under the Final Regulations. However, the definition of "NFFI" in the Final Regulations uses the term "FFI," which literally covers only regarded entities;[109] and thus, it is not clear that the Country Y branch, in isolation, can be treated as an NFFI. Presumably, this issue can be addressed through the types of changes we have recommended above in Part III.B.2.

6. Reciprocal Reporting of Accounts of Model 1A IGA Country Residents

Under the Model 1A IGA, the United States is required to obtain information each year from U.S. Financial Institutions about their accountholders that are resident in the partner country. The United States must provide that information to the partner country's government within 9 months after the end of the relevant year.[110] The Model 1A IGA defines a "Reporting U.S. Financial Institution" as a Financial Institution that is resident in the United States, excluding its foreign branches, and a U.S. branch of a Financial Institution that is not resident in the United States, if the branch or the Financial Institution has control, receipt or custody of the income with respect to which information is to be provided under the IGA.[111] The information that must be provided for each person resident in the partner country who holds an account with the Reporting U.S. Financial Institution is the accountholder's name, address, partner country tax identification number, and account number (and the Financial Institution's name and identifying number), as well as the gross amount (in the case of an individual accountholder that owns a depository account) of interest on the account, the gross amount of U.S.-source dividends paid or

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108 We note that such wording refers to a Reporting Financial Institution continuing to qualify as a deemed-compliant FFI "or exempt beneficial owner" under the Final Regulations, so long as requirements a) through c) are met. The Final Regulations provide that an exempt beneficial owner is exempt from FATCA withholding regardless of whether it is a PFFI; and, thus, the "all or nothing" rule applicable to PFFIs does not apply to exempt beneficial owners. *See* Treas. Reg. § 1.1471-2(a)(4)(v). We assume that the Model IGAs are not intended to impose an "all or nothing" type of requirement on an exempt beneficial owner that is a resident of an IGA country.

109 *See* Treas. Reg. § 1.1471-1(b)(75).

110 Model 1A IGA, art. 2 ¶ 2(b); art. 3, ¶¶ 3(b), 5.

111 Model 1A IGA, art. 1, ¶ 1(p).

credited to the account, and the gross amount of other U.S. source income subject to reporting under chapters 3 or 61 of the Code.[112]

The first year for which the United States must provide this information to the partner country is 2014, with the information being due by September 30, 2015. If the partner country has not notified the United States in writing by that date that it is satisfied the United States "has in place . . . the infrastructure for an effective exchange relationship (including established processes for ensuring timely, accurate, and confidential information exchanges . . .)," then the IGA will terminate.[113]

To date, the government has not provided guidance to U.S. Financial Institutions regarding the information reporting they will be required to undertake pursuant to Model 1A IGAs. One question that arises is the source of the U.S. government's authority to impose such requirements. In this regard, the Obama Administration has indicated it will seek a statutory amendment granting regulatory authority to require U.S. Financial Institutions to report the information contemplated by Model 1A IGAs.[114] The Model 1A IGA also makes reference to enactment of legislation: "The Government of the United States acknowledges the need to achieve equivalent levels of reciprocal automatic information exchange with [FATCA Partner]. The Government of the United States is committed to further improve transparency and enhance the exchange relationship with [FATCA Partner] by pursuing the adoption of regulations and

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[112] Model 1A IGA, art. 2, ¶ 2(b).

[113] Model 1A IGA, art. 3, ¶¶ 8-10.

[114] *See* Office of Management and Budget, Fiscal Year 2014: Analytical Perspective Budget of the U.S. Government at 202 (2013):

> "***Provide for reciprocal reporting of information in connection with the implementation of the Foreign Account Tax Compliance Act (FATCA).*** -- In many cases, foreign law would prevent foreign financial institutions from complying with the FATCA provisions of the Hiring Incentives to Restore Employment Act of 2010 by reporting to the IRS information about U.S. accounts. Such legal impediments can be addressed through intergovernmental agreements under which the foreign government agrees to provide the information required by FATCA to the IRS. Requiring U.S. financial institutions to report similar information to the IRS with respect to nonresident accounts would facilitate such intergovernmental cooperation by enabling the IRS to reciprocate in appropriate circumstances by exchanging similar information with cooperative foreign governments to support their efforts to address tax evasion by their residents. The proposal would provide the Secretary of the Treasury with authority to prescribe regulations that would require reporting of information with respect to nonresident alien individuals, entities that are not U.S. persons, and certain U.S. entities held in substantial part by non-U.S. owners, including information regarding account balances and payments made with respect to accounts held by such persons and entities."

advocating and supporting relevant legislation to achieve such equivalent levels of reciprocal automatic information exchange."[115]

If it is intended to seek a statutory amendment that covers reporting by U.S. Financial Institutions of the information that the Model 1A IGA states must be provided to partner countries for the 2014 year (due by September 30, 2015), then presumably such legislation would need to be pursued fairly soon. That would allow Treasury and the IRS time to design appropriate regulations or other guidance, to obtain input from stakeholders on that guidance, and to finalize the guidance sufficiently in advance of September 2015 to give partner countries comfort that the United States is able to sustain "an effective exchange relationship."

In the absence of such a statutory amendment, we believe that the government has sufficient authority under current law to issue regulations concerning the reporting of such information by U.S. Financial Institutions. We recognize that the existing statute does not specifically contemplate IGAs, or the reporting by U.S. Financial Institutions of information designed to help prevent foreign accountholders from evading foreign income taxes. However, on balance, we believe this does not deprive the government of the requisite authority.

In this regard, it is important to note that the Model 1A IGA does not mandate that U.S. Financial Institutions must report all of the same information about partner country accountholders, as Reporting Financial Institutions must report about U.S. accountholders. For example, there is no requirement for a U.S. Financial Institution to report on a partner country accountholder's account balance, or on gross proceeds from the sale of assets held in the account, or on any foreign-source income credited to the account. Instead, the information specifically required to be provided by U.S. Financial Institutions is fairly limited: it is almost exactly the same as what they already report to the IRS under current law in their capacity as withholding agents, under chapters 3 and 61 of the Code. The only new item of information that the Model 1A IGA contemplates will be reported by a U.S. Financial Institution for an accountholder that is a foreign person residing in a country with a Model 1A IGA, is the accountholder's taxpayer identification number assigned to it under the laws of that country (already an item that a U.S. Financial Institution can report to the IRS on an optional basis).[116] In the case of an individual accountholder that is a resident of a country with a Model 1A IGA and also is a U.S. citizen, the only new items of information the U.S. Financial Institution would need to report are the accountholder's country of residence and taxpayer identification number assigned by that country.

The issue of whether the U.S. government has the necessary authority to pursue a program of requiring this information to be reported by U.S. Financial Institutions, for use in an information exchange arrangement under Model 1A IGAs, has two separate components. First, is

[115] Model 1A IGA, art. 6, ¶ 1.

[116] *See* IRS Form 1042-S (2013 version), box 15.

the U.S. government authorized to issue regulations that require U.S. Financial Institutions to report such information to Treasury and the IRS? Second, does the U.S. government have authority to turn over such information to partner countries' governments? As to the first question, several provisions of the Code appear to be in point. Section 6011(a) provides broad authority for regulations regarding reporting by withholding agents;[117] the provisions of chapter of 61 also expressly authorize the issuance of regulations governing the reporting by payors and middlemen on important types of payments;[118] and FATCA itself provides a grant of regulatory authority.[119] It would appear to be a reasonable exercise of the authority given by these provisions to require U.S. Financial Institutions to report the relevant information regarding accountholders resident in Model 1A IGA countries. The U.S. government's ability to obtain such information and provide it to partner countries helps to secure those countries' cooperation in the implementation of FATCA, including by removing impediments to FATCA that currently exist under local law. In addition, separate and apart from considerations related to the promotion of international cooperation in enforcing FATCA, if U.S. Financial Institutions report the information in question, that would tend to aid the IRS in its administration of chapters 3, 4 and 61. (For example, if the IRS receives information from a U.S. Financial Institution about the country where an accountholder resides and his taxpayer identification number there, that may help the IRS to more efficiently audit the accountholder; to obtain additional information from the relevant country about the accountholder under an information exchange agreement or treaty; or to pursue a collection action against the accountholder for unpaid tax.) Accordingly, we believe the government has the authority to issue regulations requiring U.S. Financial Institutions to report to the IRS all of the specific items of information that the Model 1A IGA contemplates will be provided beginning in 2015 (for the 2014 calendar year).

Regarding the second part of the authority issue – whether the U.S. government has the authority to agree to provide the relevant information to a Model 1A IGA country's government – it has been questioned by some whether the U.S. government has the authority to enter into IGAs.[120] There would appear to be multiple potential sources to be considered for the

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[117] I.R.C. § 6011(a) ("When required by regulations prescribed by the Secretary any person made liable for any tax imposed by this title, or with respect to the collection thereof, shall make a return or statement according to the forms and regulations prescribed by the Secretary. Every person required to make a return or statement shall include therein the information required by such forms or regulations."). *See* Treas. Reg. § 1.1461-1(b)(1) (citing Section 6011(a) as the basis for the reporting rules under chapter 3).

[118] *See, e.g.*, I.R.C. §§ 6042 (dividends), 6049 (interest).

[119] I.R.C. § 1474(f) (authorizing the Secretary to "prescribe such regulations or other guidance as may be necessary or appropriate to carry out the purposes of, and prevent the avoidance of, this chapter").

[120] *Compare, e.g.*, Allison Christians, *The Dubious Legal Pedigree of IGAs (and Why It Matters)*, Tax Notes International 565 (Feb. 11, 2013) *with* Susan Morse, *Why FATCA Intergovernmental Agreements Bind the U.S. Government*, Tax Notes International 245 (April 15, 2013).

government's authority to enter into a Model 1A IGA with a particular country. A Model 1A IGA will only be entered into with a partner country that already has in effect an income tax treaty or TIEA with the United States. The recitals to the Model 1A IGA indicate that the IGA is designed to implement the United States' and partner country's rights and obligations under that treaty or TIEA.[121] In addition, even if a Model 1A IGA is not viewed as merely an agreement to implement an existing treaty or TIEA with the relevant partner country, but instead is tested independently of the existing treaty or TIEA, the IGA may qualify on its own as a valid TIEA, entry into which has been sanctioned by Congress.[122]

Recommendation 28: We believe the U.S. government has the authority to issue regulations requiring U.S. Financial Institutions to report to the IRS the specific items of information about partner country accountholders that the Model 1A IGA contemplates will be provided beginning in 2015 (for the 2014 calendar year). We recommend that the government issue such regulations in the near term.

Such regulations will need to cover topics including:

- whether any types of U.S. Financial Institutions will be subjected only to limited diligence and reporting requirements in connection with Model 1A IGA information reporting (or will be completely exempted from having to perform such information reporting), in a manner analogous to the treatment of deemed-compliant FFIs and Non-Reporting Financial Institutions with respect to their exemption from the FATCA diligence and reporting obligations imposed on PFFIs;

- what due diligence a U.S. Financial Institution will need to complete for existing accounts, and whether any accounts of U.S. Financial Institutions will be grandfathered from applicable diligence rules;

- what process a U.S. Financial Institution will need to follow in order to obtain and verify an accountholder's country of residence and his taxpayer identification number in that country, and what presumptions a U.S. Financial Institution should

121 "Whereas, the Parties desire to conclude an agreement to improve international tax compliance and provide for the implementation of FATCA based on domestic reporting and reciprocal automatic exchange pursuant to the [Convention/TIEA], and subject to the confidentiality and other protections provided for therein, including the provisions limiting the use of the information exchanged under the [Convention/TIEA];"

122 *See* I.R.C. § 274(h)(6)(C) (authorizing TIEAs with specified Caribbean Basin countries); *Barquero v. United States*, 18 F.3d 1311 (5th Cir. 1994) (upholding the validity of the United States' TIEA with Mexico, a country to which Section 274(h)(6)(C) does not expressly extend, based in part on Congress' "implicit approval" of entry into such TIEAs).

apply in the event its efforts to obtain the accountholder's country of residence or identifying number are unsuccessful;

- when and how the U.S. Financial Institution should report information about its partner-country accountholders to the IRS, and whether it will be required to provide copies to each accountholder of the information that will be exchanged with the partner country;

- what types of periodic review or certifications will be necessary, and what penalties the government will impose for noncompliance or inadequate systems; and

- whether the government will provide indemnification to the U.S. Financial Institution against any liability that results from a breach by the U.S. government of confidentiality requirements regarding the information that is exchanged with the partner country.

As to the first point listed above, since U.S. Financial Institutions already are withholding agents that have information reporting obligations under Section 1471(a) (as well as chapters 3 and 61), it appears appropriate not to exempt them from the requirement to provide Treasury and the IRS with the information needed for automatic exchange under Model 1A IGAs. This conclusion is based on the assumption that a U.S. Financial Institution will not have meaningfully broader obligations in connection with the reporting of information that will be used in automatic exchange under a Model 1A IGA, than the U.S. Financial Institution already has under Section 1471(a). In particular, for purposes of information reporting related to Model 1A IGAs, a U.S. Financial Institution should be entitled to treat an account as held by the person that is the payee under Treasury Regulation Section 1.1471-3 for payments made in respect of the account. The U.S. Financial Institution's diligence and review procedures with respect to that person for purposes of Section 1471(a) withholding should also satisfy its obligations to determine such person's identity and status for purposes of Model 1A IGAs. In cases where the accountholder provides a foreign address to the U.S. Financial Institution, we propose that the U.S. Financial Institution should be entitled to rely on that address as establishing the accountholder's country of residence, absent clear indicia that the accountholder in fact is resident in some other country (the relevant indicia would be comparable to those that are used to determine when a withholding agent has reason to know that a person claiming foreign status in fact is a U.S. person).[123]

Similarly, regarding an accountholder's taxpayer ID number issued by the Model 1A partner country, the IRS can require foreign persons to provide this number on future Form W-8s (or, in the case of residents of a Model 1A IGA country who are U.S. citizens, Form W-9s) that

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123 *See* Treas. Reg. § 1.1471-3(e)(4)(ii).

they provide in connection with Section 1471(a) withholding. In cases where the U.S. Financial Institution is entitled to rely on a pre-FATCA Form W-8,[124] if the applicable person has not set forth on the form the person's taxpayer identification number in the partner country, then the U.S. Financial Institution should not be required to obtain that number, until it is required to obtain a new IRS Form W-8. (A similar rule should apply in the case of a Form W-9 previously provided to the U.S. Financial Institution by a resident of the partner country who is a U.S. citizen.)

Regulations implementing Model 1A IGAs also should confirm that the proper way for a U.S. Financial Institution to provide the information needed by the U.S. government for automatic exchange with Model 1A partner countries, is through the financial institution's normal annual reporting on IRS Forms 1042 and 1042-S (or, in the case of a U.S. citizen, Form 1099). Form 1042-S would not need to be modified in order to implement this approach (other than to indicate that provision of the recipient's taxpayer identification number in its country of residence is no longer optional, at least for recipients that are resident in countries that have Model 1A IGAs). Form 1099 also would not need to be substantially modified. The approach of providing information on Forms 1042-S and 1099 would help to ensure that U.S. Financial Institutions have a uniform method of reporting for the residents of all the different Model 1A countries, rather than being subject to potentially differing requirements imposed in connection with each Model 1A IGA.

Since the U.S. government will be disclosing to foreign governments substantial amounts of confidential taxpayer information, using an automatic exchange process that it has devised and controls, it would appear fair for the U.S. government to indemnify U.S. Financial Institutions against liability resulting from inadvertent disclosure.

C. Coordination of Documentation and Reporting Under Chapters 3, 4 and 61

1. QI's Status as a PFFI

In the Preamble to the Final Regulations, the government stated it will issue a Revenue Procedure describing the responsibilities of QIs, WPs and WTs under chapter 4. The Revenue Procedure will contain revised wording for all outstanding QI agreements. In Notice 2013-69, the government stated that all QI agreements that are in effect on or after June 30, 2014 will have the revised wording.[125] In addition, in Revenue Procedure 2014-13, the government stated it plans to issue early in 2014 temporary regulations coordinating the application of chapters 3, 4 and 61.[126]

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[124] *See* Treas. Reg. § 1.1471-3(d)(1).

[125] Notice 2013-69, § II.02.

[126] Rev. Proc. 2014-13, § 4.

Recommendation 29: Although we will be able to comment in more detail once all required guidance (including the temporary regulations) have been issued, our basic recommendation is that (a) that the government's guidance in this area limit eligibility for QI, WP or WT status to those FFIs and NFFEs that are treated under the IGAs and Final Regulations as having sufficient internal resources (or as being sponsored by an entity that has sufficient internal resources) to be able to discharge reporting obligations under chapter 4; and (b) that the government's guidance should tailor the FATCA-related requirements in an entity's QI, WP or WT agreement to correspond to the responsibilities imposed on FFIs and NFFEs under the Final Regulations. We explain these recommendations below.

Certain types of deemed-compliant FFIs, including local FFIs, nonregistering local banks, and FFIs with only low-value accounts, have been granted deemed-compliant status because of their small size.[127] A judgment was made that such entities should be excused from having to enter into such an FFI Agreement, in view of the relatively low risk they would be used for tax avoidance and the burdens imposed by such an agreement.[128] However, if such an entity is willing and able to enter into an agreement to be a QI, WP or WT for purposes of chapters 3 and 61, it would seem that it could also assume the obligations of a PFFI, without excessive incremental burden.

Other types of deemed-compliant FFIs would appear better suited to being QIs, WPs and WTs. Such entities should have responsibilities under chapter 4 that are consistent with their treatment under the Final Regulations and the IGAs. For example, sponsored investment entities[129] and sponsored, closely held investment vehicles[130] could become QIs, WPs or WTs, with the sponsor being delegated to fulfill the relevant responsibilities for such entities – similar to a private intermediary arrangement under existing QI agreements.

In the case of a deemed-compliant FFI that is a Reporting Financial Institution, it would seem that the government's guidance should simply defer to the relevant IGA and the requirements of the IGA partner country's law, to determine the extent of the Reporting Financial Institution's FATCA reporting responsibilities. To take a different approach would risk creating a conflict with the applicable IGA.[131] In addition, although the Final Regulations provide

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[127] *See* Treas. Reg. § 1.1471-5(f)(1)(i)(A), (f)(2)(i), (f)(2)(ii).

[128] *See* Preamble, T.D. 9610, 78 Fed. Reg. 5,874, 5,889 (Jan. 28, 2013); Preamble, Notice of Proposed Rulemaking (REG-121647-10, 77 Fed. Reg. 9,022, 9,025 (Feb. 15, 2012).

[129] Treas. Reg. § 1.1471-5(f)(1)(i)(F).

[130] Treas. Reg. § 1.1471-5(f)(2)(iii).

[131] In practice, the IGAs appear to be structured to give a Reporting Financial Institution a choice between accepting primary reporting and withholding responsibility, and passing that responsibility on to another withholding agent, similar to the approach taken in Section 1471(b)(3) for a PFFI.

detailed rules about reporting by a PFFI on its accountholders and payees, the regulations also provide that when a PFFI is a QI, WP or WT, its FATCA reporting responsibilities will be as set forth in its QI, WP or WT agreement.[132] In view of the detailed, systematic rules for reporting by PFFIs in the Final Regulations, it would not appear necessary for the applicable rules in a PFFI's QI, WP or WT agreement to depart significantly from the Final Regulations. Notice 2013-69 and Revenue Procedure 2014-13 indicate the government may well take this approach, in QI agreements for PFFIs.[133]

Last, the Final Regulations contemplate that a NFFE may be a WP or WT as to a withholdable payment.[134] Notice 2013-69 extends this principle, recognizing that it is possible for a NFFE to be a QI, rather than just a WP or WT, and providing that such a QI is an excepted NFFE.[135] A QI generally must be a financial institution, which to date has been defined for purposes of a QI agreement using the definition in Treasury Regulation Section 1.165-12(c)(1)(iv). This definition includes, for example, entities engaged in a lending business that do not hold themselves out as funds and are not managed by a separate entity that is a professional manager, and that thus are not "investment entities" under the Final Regulations.[136] Such entities also would not fall into other categories in the definition of FFI.[137]

It appears reasonable to us to permit most categories of NFFEs to become QIs or (more commonly) WPs or WTs. However, some NFFEs that are excepted nonfinancial entities – specifically, start-up companies and those that are liquidating or reorganizing – presumably would not be eligible for QI, WP or WT status, due to their lack of stable ongoing operations. NFFEs that are WPs or WTs should be required to become direct reporting NFFEs for chapter 4 purposes, under the reporting procedures envisioned in Notice 2013-69.[138] Such direct reporting obligations would fit better with the rules currently governing WPs and WTs than would a system in which these entities merely provide information about their substantial U.S. owners to their withholding agents. Similarly, if an NFFE is a QI, it would make sense for it to be subjected to direct reporting obligations under chapter 4, to the extent it agrees to assume such obligations for purposes of chapters 3 and 61.

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132 Treas. Reg. § 1.1471-4(d)(8).

133 Notice 2013-69, § II.02; Rev. Proc. 2014-13, § 3.

134 Treas. Reg. § 1.1472-1(c)(2).

135 Notice 2013-69, § III.02(E).

136 *See* Treas. Reg. §§ 1.165-12(c)(1)(iv)(G), 1.1471-5(e)(4)(i).

137 *See* Treas. Reg. § 1.1471-5(e)(1), (e)(2), (e)(3).

138 *See* Notice 2013-69, § III.02(E).

2. Presumption Rules

Regulations under Section 1441 provide that a payment of U.S.-source FDAP income to a U.S. branch of a foreign bank that is registered with the Federal Reserve Board, or to a U.S. branch of a foreign insurance company that is subject to regulation by a state insurance department, is presumed to be effectively connected income, unless the withholding agent and the branch agree to treat the branch as a U.S. person or the branch provides documentation indicating it is receiving the payment as agent for other persons.[139] This presumption provides a sensible rule of convenience.

The Final Regulations contain a comparable rule, although the rule requires the foreign bank or insurance company to provide an EIN for the U.S. branch, as well as a GIIN for the bank or insurance company showing that it is either a PFFI or registered deemed-compliant FFI.[140] These extra requirements appear to significantly limit the usefulness of the presumption in the Final Regulations: if the U.S. branch is owned by a PFFI or a deemed-compliant FFI, and the U.S. branch is not treated as a separate U.S. person from its owner or as receiving a payment as an intermediary, then a payment to the branch would not be subject to FATCA withholding. This would be so regardless of whether the payment in question is effectively connected income, or not.[141] In such a case, it would appear to be irrelevant whether the payment can be presumed to be effectively connected income (and, accordingly, not a withholdable payment) for purposes of chapter 4.

The Preamble indicates that it is expected the presumption under Section 1441 will be revised to conform to the one in the Final Regulations.[142]

Recommendation 30: Instead of conforming the presumption in chapter 3 to the one in the Final Regulations, we believe it would be more logical to do the opposite. However, if such an approach is determined not to be appropriate, then we propose removing the presumption rule in the Final Regulations.

If this type of presumption rule is considered to be suitable for purposes of chapter 4, then in order for it to have any real utility, it ought to apply whether or not the foreign owner of the U.S. branch has provided a GIIN indicating that the parent is a PFFI or deemed-compliant FFI. The logic behind the current rule in chapter 3 appears to be that, in view of the kind of the business conducted by a U.S. branch covered by the rule and the fact that it is regulated in the United States, it is appropriate to assume without further inquiry that the payment is ECI that is

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139 Treas. Reg. § 1.1441-1(b)(2)(iv)(B).

140 Treas. Reg. § 1.1471-3(f)(6).

141 *See* Treas. Reg. § 1.1471-2(a)(4)(iii), (iv).

142 TD 9610, 78 Fed. Reg. at 5,879.

not subject to chapter 3 withholding. It would appear that same rationale could also be applied under chapter 4, without adding further requirements that must be satisfied.

On the other hand, a broad-ranging presumption of this type could be seen as creating inappropriate opportunities for avoidance of FATCA, in a case where the foreign owner of the branch is not a PFFI or deemed-compliant FFI. If that view is adopted, then it may make sense to remove the presumption from the Final Regulations, for the sake of simplicity. In the event that the presumption is removed from the Final Regulations, it nevertheless appears reasonable to retain the presumption in the Section 1441 regulations, because the presumption is an appropriate one in the context of chapter 3.